

Weekly commentary

June 26, 2023

BlackRock

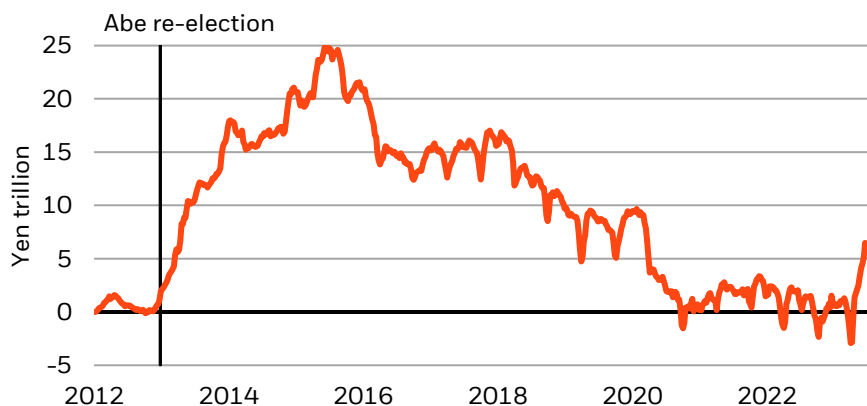
Japan stands out from developed pack

- We see the outlook brightening for Japanese stocks vs. developed peers given fewer supply constraints, supportive monetary policy and corporate reforms.
- Developed market (DM) short-term bond yields rose last week after the Bank of England hiked rates again. We see central banks compelled to hold policy tight.
- We're gauging U.S. consumer spending and inflation in the PCE data out this week. We expect to see still-persistent inflation in U.S. and euro area data.

We see the outlook brightening for Japanese stocks and are rethinking our modest underweight that is currently in line with other DMs. We initially saw risks if the Bank of Japan (BOJ) scrapped its cap on government bond yields to curb inflation. We now believe inflation is unlikely to stick due to fewer supply constraints. So the BOJ may opt to keep policy loose to sustain above-target inflation. Plus, corporate reforms are spurring a shareholder-friendly shift – a key development this year.

Renewed interest

Cumulative foreign flows into Japanese equities, 2012-2023



Source: BlackRock Investment Institute and Japan Ministry of Finance, with data from Refinitiv Datastream, June 2023.
Notes: The chart shows cumulative net weekly flows into Japanese equities by foreign investors since the start of 2012.

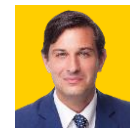
We've seen some investors get excited about foreign investment in Japanese stocks surging since April (see the dark orange line in chart), a reversal from the lackluster interest of recent years. There have also been questions about whether enthusiasm may be overdone. We believe assessing the change calls for a longer-term perspective – looking back more than a decade ago when then Prime Minister Shinzo Abe introduced his “three arrow” approach to structural economic reform. Investment in Japanese equities began to slide in late 2015 as the initial euphoria over monetary policy, fiscal policy and corporate reforms faded – especially as the corporate reforms took time to pan out. Global investor interest has picked up in recent weeks, but the uptick does not come close to offsetting the outflows since 2015. What's reviving foreign investor interest? A more shareholder-friendly approach by Japan's companies and loose monetary policy not unwinding quickly.



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Case in point: The Tokyo Stock Exchange has asked companies that are trading under their book value to publish plans “as soon as possible” on lifting their stock prices. The exchange specifically called for better balance sheet management as many companies hoarded cash over the past decade. We think it makes sense for companies to deploy this cash by investing in growth opportunities or buying back shares now that the growth outlook has improved and inflation has returned. We see this as a potentially pivotal moment for Japan: Roughly half of its companies trade below book value and roughly half have cash on their balance sheets after subtracting liabilities, Refinitiv data shows. Signs companies are complying may appear in coming weeks during Japan’s annual shareholder meeting season. Plus, Japanese investors could be the next key buyers thanks to tax incentives starting in January 2024 that encourage savers to shift their money from cash into investments.

On the macro front, the BOJ’s efforts to raise inflation – after a long battle with deflation – are a stark difference from other DM central banks that are still hiking rates to deal with stubborn inflation. We thought the BOJ would be forced to scrap its yield cap and quickly tighten monetary policy because inflation surged above its 2% target. We saw risks that getting rid of the cap would push up global yields and reduce risk appetite. That’s why we went underweight Japanese stocks in February on our tactical horizon of six to 12 months, in line with our underweight to other DM stocks. Yet now we think the BOJ will be slow to tighten monetary policy, even if it alters its yield cap as it has signaled it will in coming months.

Why? Japan’s inflation has picked up sharply, partly due to the energy crunch as the West tried to wean itself off of Russian supplies. The impact did not hit Japan’s economy as hard as Europe and has since faded as energy prices fell, reducing the drag on incomes. Import prices have also started to cool. Other inflation drivers are easing, too: Wage gains have fizzled since the end of 2022. Japan’s labor market does not face the same constraints as in other DMs and has room to grow without stoking inflation. We see the BOJ being more cautious in tightening policy to ensure inflation has become embedded.

Bottom line: The BOJ likely winding down its ultra-loose policy slowly and corporate reforms differentiate Japan’s stocks from DM peers, we think, even as we stay cautious on DMs overall. We see higher inflation spurring households to search for better returns instead of hoarding cash, especially as incentives for stock investment are rolled out. Japanese investors may bring money back home if bond yields rise with changes to the BOJ’s yield cap. We think foreign investors could consider unhedged Japanese equity exposures to benefit from any yen strength. We see the BOJ intervening again if the yen weakens too much.

Market backdrop

DM short-term bond yields rose last week even as equities lost some steam. The Bank of England raised rates by more than the market expected, pinning the two-year gilt yield near 15-year highs. The Swiss and Norwegian central banks also hiked. We think central banks are being compelled to hold policy tight as inflation remains persistent. We see a tighter policy era ahead – and expect that to reinforce the new regime of greater macro and market volatility.

Assets in review

Selected asset performance, 2023 year-to-date return and range



Past performance is not a reliable indicator of current or future results. Indexes are unmanaged and do not account for fees. It is not possible to invest directly in an index.

Sources: BlackRock Investment Institute, with data from Refinitiv Datastream as of June 22, 2023. Notes: The two ends of the bars show the lowest and highest returns at any point in the last 12-months, and the dots represent current year-to-date returns. Emerging market (EM), high yield and global corporate investment grade (IG) returns are denominated in U.S. dollars, and the rest in local currencies. Indexes or prices used are: spot Brent crude, ICE U.S. Dollar Index (DXY), spot gold, MSCI Emerging Markets Index, MSCI Europe Index, Refinitiv Datastream 10-year benchmark government bond index (U.S., Germany and Italy), Bank of America Merrill Lynch Global High Yield Index, J.P. Morgan EMBI Index, Bank of America Merrill Lynch Global Broad Corporate Index and MSCI USA Index.

Macro take

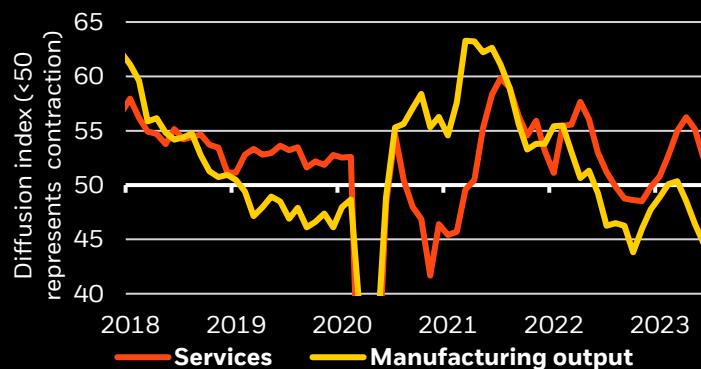
Europe entered a recession in the first quarter of this year, according to official GDP data. That's largely due to the energy shock triggered last year by Russia's invasion of Ukraine. High energy and food prices have squeezed people's pockets and slowed economic activity.

The European Central Bank (ECB) and others had hoped that growth would recover as the impact of higher energy prices faded. But instead, the lagged effects of the ECB's rate hikes are starting to bite. Activity has been weaker than expected this month, according to PMIs – a survey of manufacturing and services business managers. Services activity growth slowed, while manufacturing activity contracted. See the chart.

We think there's more weakness ahead, with employment and future orders also dropping. One glimmer of hope is cooling costs for manufacturers. The ECB might halt its rate hikes if activity keeps deteriorating – but we don't think it will think about cutting rates as inflationary pressures remain strong. See our Macro take blog posts [here](#).

Euro area activity weakening

Euro area services and manufacturing PMI, 2018–2023



Source: BlackRock Investment Institute, S&P Global, with data from Haver Analytics, June 2023. Notes: The chart shows the Purchasing Managers Institute (PMI) survey of euro area manufacturing and services firms (orange and yellow respectively). The series are expressed as the share of respondents reporting an increase in activity during the month minus those reporting a decrease, so a reading of less than 50 denotes a drop in activity on the month. The June 2023 number is a flash release and may be revised.

Investment themes

1 Pricing in the damage

- Recession is foretold as central banks try to bring inflation back down to policy targets. It's the opposite of past recessions: Rate cuts are not on the way to help support risk assets, in our view.
- That's why the old playbook of simply "buying the dip" doesn't apply in this regime of sharper trade-offs and greater macro volatility. The new playbook calls for a continuous reassessment of how much of the economic damage being generated by central banks is in the price.
- In the U.S., it's now evident in the financial cracks emerging from higher interest rates on top of rate-sensitive sectors. Higher mortgage rates have hurt sales of new homes. We also see other warning signs, such as deteriorating CEO confidence, delayed capital spending plans and consumers depleting savings.
- The ultimate economic damage depends on how far central banks go to get inflation down. The Federal Reserve paused rates in June but signaled further hikes ahead. The European Central Bank hiked again in June. We see the ECB going full steam ahead with rate hikes to get inflation to target – regardless of the damage that entails.
- **Investment implication:** We're tactically underweight DM equities. They're not pricing the recession we see ahead.

2 Rethinking bonds

- Fixed income finally offers "income" after yields surged globally. This has boosted the allure of bonds after investors were starved for yield for years. We take a granular investment approach to capitalize on this, rather than taking broad, aggregate exposures.
- Short-term government bonds looks more attractive for income at current yields, and we like their ability to preserve capital. Tighter credit and financial conditions reduce the appeal of credit.
- In the old playbook, long-term government bonds would be part of the package as they historically have shielded portfolios from recession. Not this time, we think. The negative correlation between stock and bond returns has already flipped, meaning they can both go down at the same time. Why? Central banks are unlikely to come to the rescue with rapid rate cuts in recessions they engineered to bring down inflation to policy targets. If anything, policy rates may stay higher for longer than the market is expecting. Investors also will increasingly ask for more compensation to hold long-term government bonds – or term premium – amid high debt levels, rising supply and higher inflation.
- **Investment implication:** We prefer short-term government bonds over long-term government bonds.

3 Living with inflation

- High inflation has sparked cost-of-living crises, putting pressure on central banks to tame inflation with whatever it takes. Yet there has been little debate about the damage to growth and jobs. We think the "politics of inflation" narrative is on the cusp of changing. The Fed's rapid rate hikes will stop without inflation being back on track to return fully to 2% targets, in our view. We think we are going to be living with inflation. We do see inflation cooling as spending patterns normalize and energy prices relent – but we see it persisting above policy targets in coming years.
- Beyond Covid-related supply disruptions, we see three long-term constraints keeping the new regime in place and inflation above pre-pandemic levels: aging populations, geopolitical fragmentation and the transition to a lower-carbon world.
- **Investment implication:** We're overweight inflation-linked bonds on a tactical and strategic horizon.

Week ahead

June 26

Germany Ifo business survey

June 30

U.S. PCE; euro area inflation;
China manufacturing PMI;
UK GDP

June 27

U.S. consumer confidence

We're gauging U.S. consumer spending and inflation in the PCE data out this week. Euro area inflation is also in focus. We see major central banks keeping interest rates higher for longer to fight sticky inflation driven by supply constraints. We expect core inflation to stay above policy targets for some time.

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, June 2023

	Underweight	Neutral	Overweight	● Previous view	
Asset	Strategic view		Tactical view		
Equities	<p>+1</p>		<p>-1</p>		<p>We are overweight equities in our strategic views as we estimate the overall return of stocks will be greater than fixed-income assets over the coming decade. Valuations on a long horizon do not appear stretched to us. Tactically, we're underweight DM stocks as central banks' rate hikes cause financial cracks and economic damage. Corporate earnings expectations have yet to fully reflect even a modest recession. We are overweight EM stocks and have a relative preference due to China's restart, peaking EM rate cycles and a broadly weaker U.S. dollar.</p>
Credit	<p>Neutral</p>		<p>Neutral</p>		<p>Strategically, we are neutral global investment grade. We don't think yields compensate investors for tightening credit conditions. We are neutral high yield as we see the asset class as more vulnerable to recession risks. Tactically, we're neutral investment grade due to tightening credit and financial conditions. We're underweight high yield as we see a recession coming and prefer to be up in quality. We're overweight local-currency EM debt – we see it as more resilient with monetary policy tightening further along than in DMs.</p>
Govt bonds	<p>Neutral</p>		<p>-1</p>		<p>We are neutral in our strategic view on government bonds. This reflects an overweight to short-term government bonds and max overweight to inflation-linked bonds. We stay underweight nominal long-term bonds: Markets are underappreciating the persistence of high inflation and investors likely demanding a higher term premium, in our view. Tactically, we're underweight long-dated DM government bonds for the same reason. We favor short-dated government bonds – higher yields now offer attractive income with limited risk from interest rate swings.</p>
Private markets	<p>Neutral</p>		<p>—</p>		<p>We're underweight private growth assets and overweight on private credit from a starting allocation that is much larger than what most qualified investors hold. We find private credit yields more attractive than in public credit, and we like its floating-rate nature given our view that policy rates will remain higher for longer than markets expect. We think private credit can help fill a lending gap left by banks after sector turmoil. Overall, private assets are not immune to higher macro and market volatility or higher rates, and public market selloffs have reduced their relative appeal. Private allocations are long-term commitments, however, and we see opportunities as assets reprice over time. Private markets are a complex asset class not suitable for all investors.</p>

Note: Views are from a U.S. dollar perspective. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding any particular funds, strategy or security.

Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, June 2023

Underweight
Neutral
Overweight
● Previous view

Asset	View	Commentary
Equities	Developed markets	We are underweight. Earnings expectations and valuations don't fully reflect recession risk. We prefer a sectoral approach: energy and healthcare.
	United States	We are underweight. Financial cracks are emerging from Fed rate hikes. We don't think earnings expectations reflect the recession we see ahead.
	Europe	We are underweight. The impact of higher interest rates and elevated inflation pose a challenge for earnings, even as the energy shock fades.
	UK	We are underweight. Earnings expectations don't fully reflect the economic damage we see ahead.
	Japan	We are underweight. The Bank of Japan looks set to wind down its ultra-loose policy. Japan is exposed to the weaker activity we see in other DM economies.
	Emerging markets	We are overweight and have a relative preference over DM stocks due to China's powerful restart, peaking EM rate cycles and a broadly weaker U.S. dollar.
	China	We see short-term opportunities from China's restart. But geopolitical risks have risen, and we still see long-term, structural challenges and risks.
	Asia ex-Japan	We are neutral. China's restart is a positive yet we don't see valuations compelling enough to turn overweight.
	Long U.S. Treasuries	We are underweight. We see long-term yields moving up further as investors demand a greater term premium.
	Short U.S. Treasuries	We are overweight. We prefer short-term government bonds for income as interest rates stay higher for longer.
Fixed Income	Global inflation-linked bonds	We are overweight. We see market pricing underestimating the risk of persistently higher inflation.
	Euro area govt bonds	We are underweight. We see investors demanding greater term premium, with peripheral bonds at risk from tighter financial conditions.
	UK gilts	We are neutral. We find gilt yields attractive as they have risen back near levels reached during 2022's budget turmoil. We prefer short-dated gilts for income.
	China govt bonds	We are neutral. Yields are less attractive relative to those on short-term DM government bonds.
	Global IG credit	We are neutral. We see tighter credit and financial conditions. We prefer European investment grade over the U.S. given more attractive valuations.
	U.S. agency MBS	We're neutral. We see agency MBS as a high-quality exposure within diversified bond allocations. But spreads near long-term averages look less compelling.
	Global high yield	We are underweight. We think spreads are still too tight, given our expectation for tighter credit and financial conditions – and an eventual recession.
	Emerging hard currency	We are neutral. We see support from higher commodities prices yet it is vulnerable to rising U.S. yields.
	Emerging local currency	We are overweight due to China's restart, and we see EM debt as more resilient to tightening financial conditions than DM as EM hiking cycles near peaks.
	Asia fixed income	We are neutral. We don't find valuations compelling enough yet to turn more positive.

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