Japan

A greater role in portfolios

May 2024

A new policy paradigm

Japanese inflation is at 2%,[1] the Bank of Japan has exited[2] its negative interest rate policy and is on a normalisation path just as global peers are gearing up to ease, and the growth backdrop is stagnating. All this raises the question: why look at Japan now?

Firstly, the growth backdrop appears challenged but not concerning, in our view. Final GDP readings for Q4 were revised higher[3] and survey data and activity indicators, such as PMIs[4], point to a bottoming out of activity. The wage negotiation progress in March, resulting in a 5.3%[5] rise in wages, suggests that a virtuous cycle of inflation is starting to take hold.

Secondly, we believe the BoJ's shift towards positive policy rates should be taken as a step towards policy normalisation, not a tightening of financial conditions. We see this as a positive: Japan's financial system is functioning at a level that doesn't require constant central bank intervention. The policy shift has only been made possible by the hard-won return to inflation: we don't think the BoJ will risk undoing this, meaning that policy will likely remain relatively accommodative.

Thirdly, while the end of yield curve control removes a guaranteed buyer from the bond market, we see potential for institutional investors that historically only bought bonds to rotate into equities as the new policy paradigm takes hold.

Reform momentum

Return on equity and capital efficiency have historically lagged in Japan[6] versus other developed markets, causing some investors to steer away from the region. We see this changing, however, with momentum behind broad-based reforms supporting BlackRock Investment Institute's positive tactical and strategic view on Japan. Increased focus on shareholder value is not a flash in the pan, in our view: it represents the culmination of a decade of corporate reform[6] driven by the Tokyo Stock Exchange. We think progress on shareholder reforms justifies a higher valuation premium for Japanese equities.

Meanwhile, the push to encourage domestic investors to participate in the equity market through favourable tax treatment offers another tailwind[7]. With 55% of Japanese household assets in currency and deposits earning little or no interest and only 10% in equities (versus 39% and 20% in the US and eurozone, respectively – see chart 1), this could be a catalyst for a shift in domestic allocations to Japanese equities[8].

For more on the macro and micro cases for Japanese equities, see Spotlight on Japan: back in business.

Overlooked

Japan has often been overlooked by international investors in the past. We see reasons for this to change, however, and for investors to refocus on Japanese equities amid an inflation renaissance, corporate reform and increasing domestic investor participation.

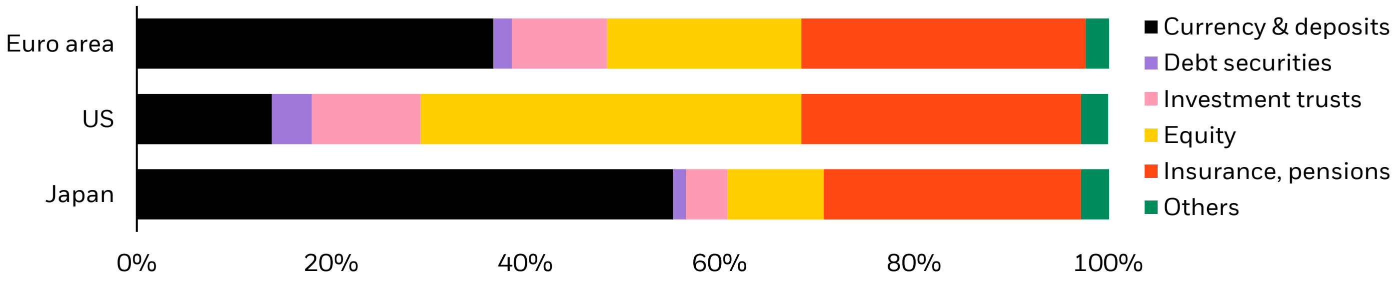
Room to rise

Positioning data shows that investors are only just starting to warm to Japanese equities. We therefore see plenty of room for allocations to rise.

Improving portfolios

Our analysis suggests that closing underweights to Japanese equities can significantly improve portfolio risk-return profiles. We outline a range of ways to access Japan through index and/or alpha-seeking exposures.

Chart 1: Composition of household assets across the euro area, US and Japan, June 2023



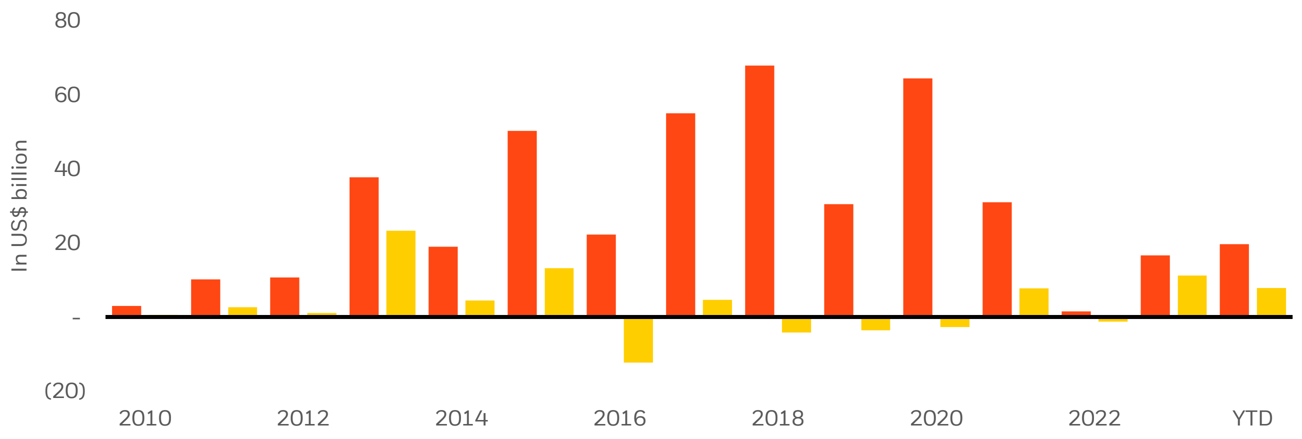
Source: Bank of Japan, Goldman Sachs Research, as of 1 June 2023. BoJ data as of August 2022.

1 Japan internal affairs ministry as of March 22, 2024. 2 Bank of Japan, as of March 19, 2024. 3 Japan Cabinet Office as of March 11, 2024. 4 S&P Global Japan PMI as of Feb. 21, 2024. 5 Rengo Trade Union as of March 15, 2024. 6 Japan Stock Exchange Enhancing Coporate Governance as of Feb. 1, 2024. 7 Japan Nippon Individual Savings Account as of Nov. 29, 2023. 8 Bank of Japan as of Aug. 30, 2023.

Sizing Japan in portfolios

Foreign investors have been returning to Japanese equity ETPs with conviction in 2024: EMEA- and US-listed Japanese equity ETPs have gathered US$1.7 billion and US$3.5 billion YTD, respectively – already reaching 50% of the totals witnessed across 2023 as a whole[9]. This suggests that investors are staring to warm to Japan, but we think there's further to go after years of persistent selling. In fact, since 2023 foreign investors have bought a net ¥8 trillion in Japanese equities, but this only around a quarter of their net selling since 2015[9].

Chart 2: Flows into Japan ETP Exposures



Source: BlackRock as of April 30, 2024

Finally, as Japan's weighting in indexes rebalances in line with its higher market capitalization, passive investors will need to continue to allocate to Japanese equities. Since January 2021, Japan's representation in the MSCI AC Asia Pacific Index has gone from 32 to 35%[10].

Japan's role as a diversifier

We see an important role for Japanese equities in portfolios and a strong case for closing underweight allocations, due not only to the strategic investment case outlined previously, but also to their diversification benefits. As chart 3 highlights, Japanese equities are relatively uncorrelated to other markets, with sub-50% correlation to most; only Chinese equities provide comparable levels of diversification.

Chart 3: 10-year forward-looking correlations between Japan and other major equity markets, April 2024

	US	Europe ex UK	UK	Japan	APAC ex Japan	China	EM	Global
US	100%	76%	70%	54%	69%	49%	71%	98%
Europe ex UK	76%	100%	83%	46%	76%	46%	72%	84%
UK	70%	83%	100%	41%	75%	48%	65%	78%
Japan	54%	46%	41%	100%	44%	36%	48%	59%
APAC ex Japan	69%	76%	75%	44%	100%	57%	79%	79%
China	49%	46%	48%	36%	57%	100%	50%	57%
EM	71%	72%	65%	48%	79%	50%	100%	80%
Global	98%	84%	78%	59%	79%	57%	80%	100%

Source: BlackRock, April 2024. US = MSCI US Index; Europe ex UK = MSCI Europe ex UK Index; UK = MSCI UK Index; Japan = MSCI Japan Index; APAC ex Japan = MSCI Pacific ex Japan Index; China = MSCI China Index; EM = MSCI EM Index; Global = MSCI All Country World Index. Index performance is for illustrative purposes only. Investors cannot directly invest into an index.

9 BlackRock and Markit, as of 16 April 2024. 10 MSCI as of March 31, 2024.

BlackRock.

The optimal Japanese equity allocation

Based on BlackRock's 10-year capital market assumptions (CMAs)[11] – which are our long-term expected risk and returns across asset classes – Japanese equities have one of the highest expected returns in the DM equity space. Not only can macro and rate conditions in Japan offer a different type of portfolio return driver, but the sector composition of Japan's stock market is well-diversified compared with other developed markets. For example, rather than being dominated by a handful of tech stocks, as in the US stock market, or by semiconductors as in Korea and Taiwan, Japan provides access to a range of industries, along with low correlations to other asset classes.

Chart 4: Weight of Top 3 Company Holdings

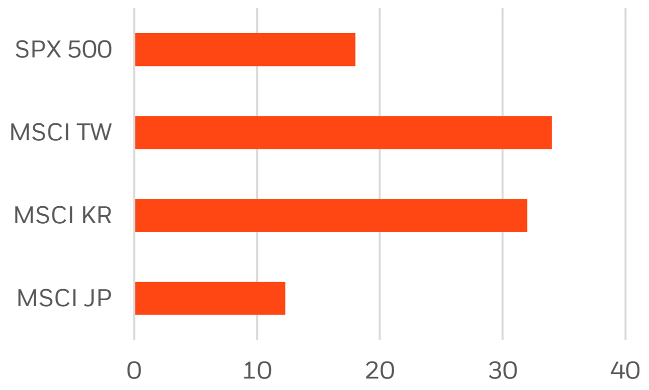
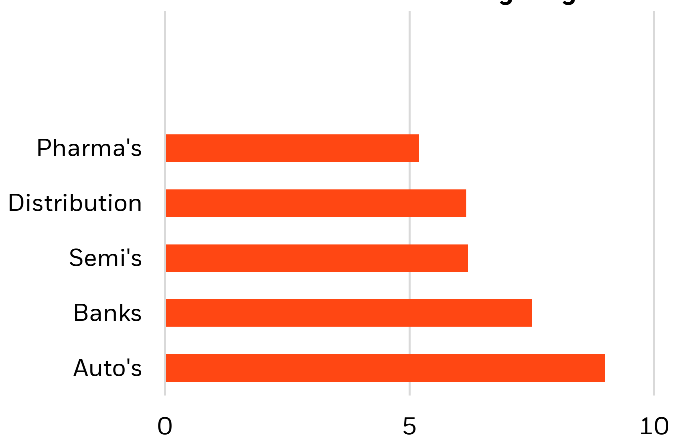


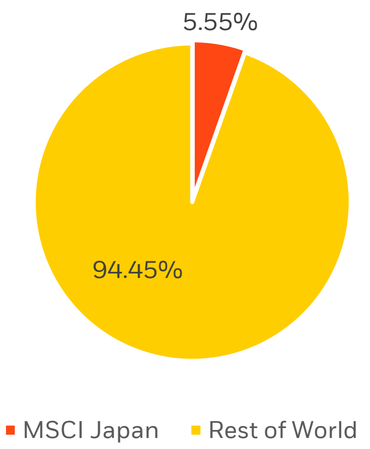
Chart 5: MSCI JP Sector Weightings



Source: MSCI as of March 31, 2024. Indices are unmanaged and used for illustrative purposes only and are not intended to be indicative of any fund's performance. It is not possible to invest directly in an index.

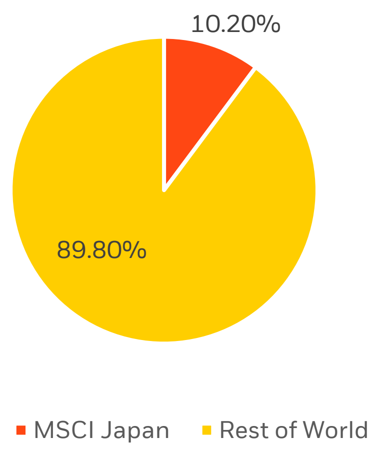
To illustrate the strategic case for Japan, we calibrate - through a robust optimization using our capital market assumptions – a standalone allocation to Japanese equities in a multi-asset portfolio. The portfolio allocates around 10% to Japanese equities whereas the MSCI ACWI index has Japan as simply a constituent part. This results in a slightly higher expected return with a slight reduction in risk[12].

Chart 6: Current Japan Weighting in MSCI ACWI



Expected Return: 6.3%   Risk: 16.3% [12]

Chart 7: Optimised Japan Weighting in MSCI ACWI



Expected Return: 6.5%   Risk: 15.8% [12]

This information is not intended as a recommendation to invest in any particular asset class or strategy or as a promise - or even estimate - of future performance. Forecasts are not a reliable indicator of future performance. Source: BlackRock; Feb 2024; time period: 10 years. Return assumptions are total nominal returns. Asset return expectations are net of assumed fees. Fees and alpha are estimates for illustrative purposes only and do not represent any actual fund performance. Indices are unmanaged and one cannot invest directly in an index. These portfolios represent a sample of the various possible solutions on the efficiency frontier. BlackRock has not considered the specific needs of the client and is not making any recommendation of any particular option. You should consider the most appropriate allocation for your needs.

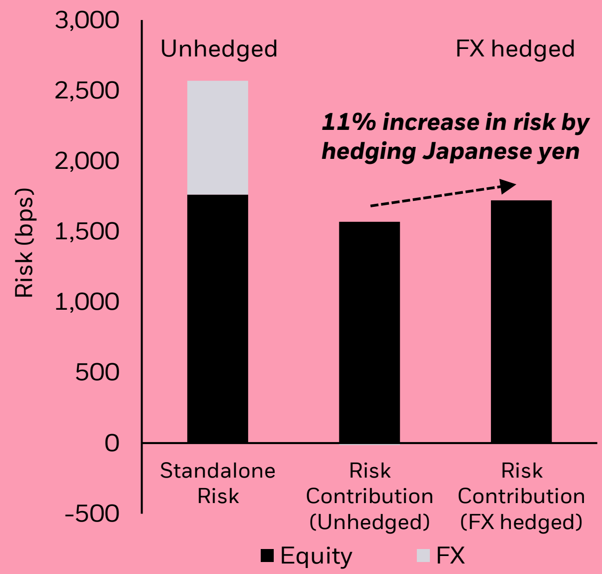
11 BlackRock Investment Institute Capital Market Assumption as of Feb. 2024. 12 BlackRock Portfolio Analysis as of March 31, 2024

To hedge or not to hedge?

In the short term, we see a case for hedging yen exposure due to the carry on offer and low hedging costs – although directionally, we see more two-sided risks for the yen after its substantial depreciation, especially as the BoJ has exited NIRP and communicated its willingness to intervene should the currency weaken much beyond current levels. On a strategic asset allocation basis, we favour unhedged exposure, given that it has traditionally cushioned to the downside in times of market stress. It's also worth noting that, while Japanese equities are broadly negatively correlated with the Japanese yen, this correlation has become weaker since 2020. As a result, the direction of the yen may no longer have such a strong influence on equity market returns.

Another reason behind our preference for an unhedged allocation: yen exposure can provide additional diversification benefits in portfolios. Hedging yen exposure has often added risk, especially when incorporating local equity and FX correlations. As shown in the chart hedging JPY has actually historically increased volatility by 11%.

Risk contribution of hedging the yen vs. unhedged



Source: BlackRock, April 2024.

How to access Japanese equities

We look across the spectrum at ways to access Japanese equities:

Broad beta: Large and mid-cap, market-weighted funds & ETFs offer simple access to Japanese equities, providing diversification benefits and serving as a core portfolio building block for those seeking to track the broader market. Given their inclusion in international/global equity benchmarks, we expect these indices will remain the most popular way to invest in the region.

Granular: This strategy screens for companies that not only provide substantial dividend income but also exhibit quality characteristics. It leans towards a value investment style and has a greater allocation to the financial sector, which will likely benefit from a rising JGB yield and relatively weaker Japanese Yen environment.

Active: Style leadership in Japanese equities changes frequently, a feature that may lend itself to an active management style that is able to exploit frequent rotations in market leadership. Funds that combine bottom-up and top-down thematic approaches may be well-positioned to identify the winners from economic shifts. Given that Japan is a highly macro-sensitive market, a balanced and risk-controlled approach is crucial, in the pursuit of stable alpha.

Discover more about unlocking Japan

Read more of our insights by visiting:
www.blackrock.com/corporate/insights/investing-in-japan

Important disclosures

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