FOR INSTITUTIONAL, PROFESSIONAL, WHOLESALE, QUALIFIED INVESTORS AND QUALIFIED CLIENTS IN OTHER PERMITTED COUNTRIES

BlackRock.

Investment perspectives
Strategic asset allocation
May 2024

Why we favor Japan in strategic portfolios

We hold an above-benchmark allocation to Japanese equities in long-term portfolios as a benign macro backdrop brightens the outlook for corporate profits.

BlackRock
Investment
Institute

BIIH0524U/M-3557601-1/6

Summary

- **Japan is back in the global spotlight.** A blistering stock market rally and a rise out from decades of deflation or no inflation has brought the attention of investors across the world back to Japan's potential.
- **We think the stable macro outlook – with mild inflation feeding higher wages and stronger corporate pricing power – reinforced the upbeat outlook for equity returns on strategic horizons of five years or longer. That means Japanese stocks warrant a higher allocation on such horizons than the benchmark would suggest.**
- **Japan's macro backdrop is conducive for taking risk – unlike in other developed market economies with higher-for-longer interest rates – in our view.** The Bank of Japan raised policy interest rates in March to around zero, the first hike in nearly two decades, as part of ending its unprecedented monetary easing over the past decade. Yet we see it normalizing policy cautiously to help protect the return to inflation and wage growth.
- Inflation's long-awaited comeback in Japan brightens the outlook for corporate profits: companies can raise prices on products and services, while rising wages are set to support consumer spending and higher inflation. Ongoing corporate reforms aimed at boosting shareholder value are another positive.
- **We also see mega forces – big structural shifts like demographic divergence and digital disruption like artificial intelligence – shaping investment returns now and over the long term.** An aging population has focused Japanese authorities on unlocking productivity gains via technological innovation. And efforts to move to a lower-carbon economy point to an infrastructure spending surge that could provide potential investment opportunities.
- **The granular investment opportunities tied to mega forces and the interplay between them reinforces why we think active strategies – those aiming to deliver above-benchmark returns, including dynamic approaches to indexing – may have a bigger role to play in equity allocations to Japan now compared with the past.**

Authors

Vivek Paul
Head of Portfolio Research — BlackRock Investment Institute

Ben Powell
Chief Investment Strategist for APAC — BlackRock Investment Institute

Lora Qian
Portfolio Research — BlackRock Investment Institute

Simona Paravani-Mellinghoff
Chief Investment Officer of Solutions – BlackRock Multi-Asset Strategies & Solutions

Yuichi Chiguchi
Head of Multi-Asset Strategies & Solutions and Chief Investment Strategist in Japan – BlackRock

Lilla Petroczki
Portfolio Research — BlackRock Investment Institute

Contents

A brighter outlook **3**

Taking an active approach **4**

Appendix **5**

A brighter outlook

We hold an above-benchmark allocation, or overweight, to Japanese equities in our strategic views – with a preference for an unhedged exposure vs. currency hedged. See the bars in the chart on the left. Our overweight is supported by a benign macro backdrop of a return to inflation and rising wages that we believe bodes well for the outlook for corporate profits and margins. On top of this, we see ongoing corporate reform lifting profitability in the coming years and are watching for signs of a structural inflows into Japanese equities from domestic savers given the overhaul to the country's tax-exempt investment vehicles.

The Bank of Japan (BOJ) made a landmark policy shift in March – raising interest rates for the first time in 17 years, ending an era of negative interest rates. The key reason? The BOJ judges that a virtuous cycle of wages and inflation – missing for decades – has arrived. Pay gains topping 5% in March's annual wage negotiations were the largest since the early 1990s according to trade union group Rengo – and an important contributor to the BOJ's confidence in a return to sustained inflation, supported by a revival of wage growth. On top of this benign backdrop, we think the BOJ will raise rates gradually to avoid choking off growth and derailing Japan's return to inflation.

This macro backdrop – unlike in several other developed economies – remains broadly supportive of risk. Importantly, we think it could serve as an inflection point for the earnings and margins outlook for Japanese companies. Why? After years of forced cost discipline due to ever declining selling prices, companies are now able to push through price increases for their products – and offset pressure on margins from rising wages. At the same time, we believe rapid wage growth will likely support consumer spending – completing the virtuous cycle between wages and inflation Japanese policymakers have long sought.

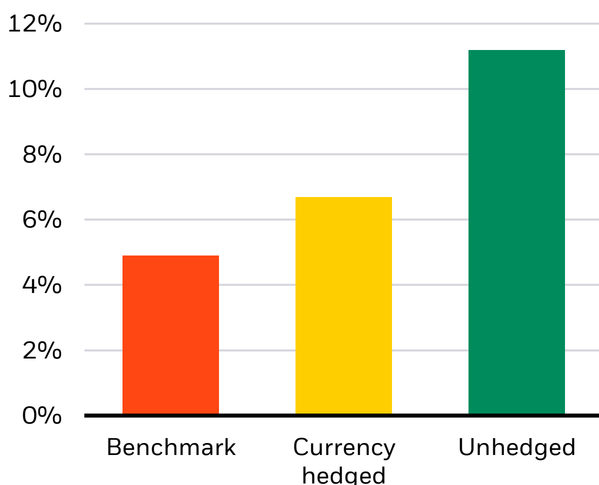
The left bar on the right chart shows our annualized estimated returns for Japanese equities over the next five years. We see earnings growth as the biggest contributor, followed by stable dividend growth into the medium-term driving returns, with valuation re-rating accounting for a small portion. The other two bars show how our estimate may change in two other scenarios: one where the boost to earnings is short-lived and another where demand for Japanese stocks from investors is higher and they require less risk premium – the compensation for risk – to buy Japan equities.

Operating margins at Japanese firms have broadly been stuck in a range of roughly 14% to 19% for the past two decades, according to Bloomberg data as of April 2024. Currently we assume flat operating margins at 17% but see higher sales growth over the next 10 years – 6% compared with about 4% earlier, based on pre-2000 trends and our estimates for future GDP growth. Meanwhile, Japan's equity risk premium (ERP) – our preferred valuation gauge that accounts for estimated interest rates and earnings growth – has historically been higher than other developed markets. Why? Investors typically demanded extra compensation to own Japanese equities given relatively low economic growth.

One development that could lower the ERP: a sustained pickup in equity buying driven by the introduction of tax-exempt investment accounts aimed at encouraging households to shift retirement savings from cash into financial assets. That would potentially help lower the overall cost of capital and the ERP for Japanese stocks, bumping up our overall expected returns. See last bar in the chart on the right below. For now, we keep our expected ERP unchanged while closely monitoring the progress of these big investment changes in coming years.

Japan for the long term

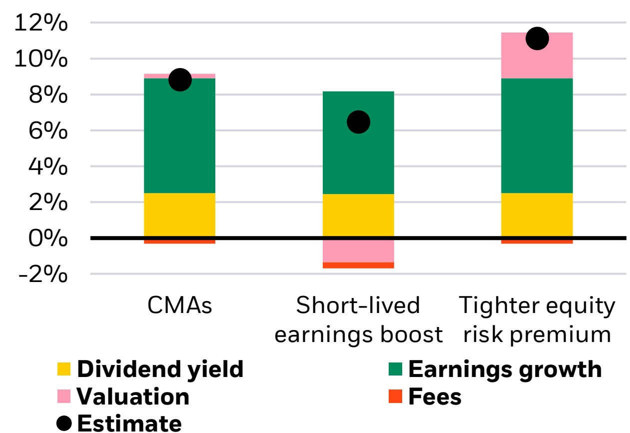
Hypothetical strategic allocation to Japan equities



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. Source: BlackRock Investment Institute, May 2024. Notes: The chart shows our hypothetical allocation to Japanese equities as a percentage of the overall equity in a strategic portfolio with a long-term investment horizon of 10-years relative to their weights in respective benchmarks, on both a currency hedged and unhedged basis. We use the MSCI ACWI for equities.

Return scenarios

Estimated five-year return for Japanese equities



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. It is not possible to invest directly in an index. Index performance does not account for fees. Source: BlackRock Investment Institute, May 2024. Notes: The chart shows our estimate of Japanese equity five-year annualized returns and its components in three scenarios. The left bar represents our current estimate. The middle bar assumes the boost to corporate earnings is short-lived by reducing the total earnings in our models based on discussions with BlackRock investors. The right bar assumes the equity risk premium – the extra compensation investors demand for investing in stocks – shrinks based on how the premium has changed over the last year. Index proxy: MSCI Japan.

Taking a more active approach

Japanese equities have been among the best-performing developed markets since the start of 2023, with the Topix up 45% in yen terms, according to LSEG data as of April 2024. That has been fueled by strong earnings growth, a relatively benign macro backdrop and momentum behind shareholder-friendly corporate reforms. Yet under the surface, dispersion within the market has picked up – partly driven by how investors are assessing the various reform measures – allowing for active strategies to thrive. We define active returns as above-benchmark returns that can't be explained by static exposures to macro and equity style factors. The chart on the left below shows the interquartile range of active returns – or the difference between the top 25% and the bottom 25% ranks – for Japanese equity managers is at its highest in more than a decade. That means the gap between the top-performing and worst-performing managers is much greater now.

This finding is consistent with our view that active strategies have a bigger role in the new regime or greater macro and market volatility – and skilled alpha-seeking managers acting more frequently on their insights are being better rewarded. On a strategic horizon of five years and beyond we think mega forces – the structural drivers of returns now and in the future – are a useful investment lens for alpha-seeking managers to put their skills to work. These forces – demographic divergence, geopolitical fragmentation, digital disruption and artificial intelligence (AI), the low-carbon transition – are reshaping economies worldwide. Japan is at the forefront and crosscurrents of some of these mega forces. We think understanding how Japan's macro revival dovetails with the far-reaching impact of the mega forces will be key to harnessing granular sectoral opportunities where active strategies can thrive, in our view.

Take demographics. Japan's aging population and shrinking workforce has been well documented. It is the world's oldest population, with a median age above 48 years compared to the global average of 30 years, according to 2022 United Nations World Population Prospects. Yet markets are slow at pricing these structural shifts. Over the last three decades, the value of Japan's healthcare stocks relative to the broader market have risen broadly in step with the growth of its retired population, as measured by the dependency ratio. See the right chart. Japan's healthcare sector is still seeing consistent earnings growth. Earnings for the MSCI Japan healthcare are seen growing 15% and 19% this year and next, per Bloomberg as of April 2024. That's well above the average over the past 20 years and is set to outpace the broader market's 8.5% and 11.8% earnings growth in fiscal years 2025 and 2026, also per Bloomberg.

Countering the impact of demographic challenges is compelling Japanese authorities to place a strong emphasis on productivity gains via technological innovation, such as automating manufacturing and other activity with robots. The latest Development Bank of Japan survey of major Japanese firms pointed to a second consecutive increase in planned capital spending for the fiscal year ending 2023 of 21%, focusing on digitization (particularly decarbonization and railways), semiconductors (for use in manufacturing sectors such as machinery, materials and chemicals) and electric vehicles. That reflects how a capital spending revival intertwines with mega forces.

Japan's efforts to decarbonize are also closely linked to bolstering energy security in a world of geopolitical fragmentation. Japan's historical focus and leadership on energy efficiency have driven down its energy intensity per unit of GDP by around 30% from 2000 to 2020, per the International Energy Agency's May 2021 report. The country has targets to reduce greenhouse gas emissions by 46% by 2030, achieve net zero by 2050 and plans to ramp up nuclear power back up to 20-22% of electricity generation by 2030 from about 6% now, according to its New Basic Energy Plan. That points to an infrastructure spending surge that could provide investment opportunities, in our view.

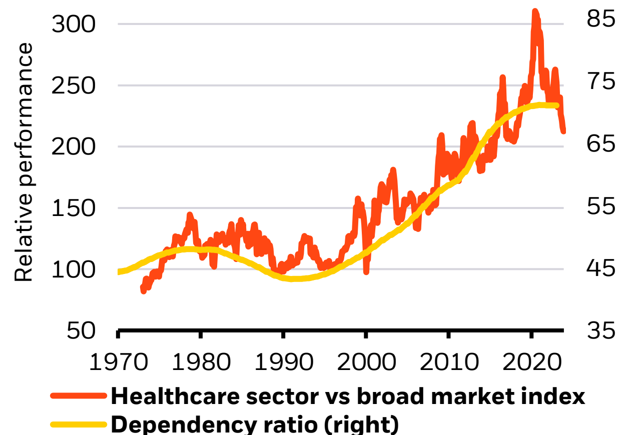
Widening skill gap

Interquartile range of Japan equity active returns

Past performance is not a reliable indicator of future performance. This information should not be relied upon by the reader as research or investment advice regarding any funds, strategy or security in particular Source: BlackRock Investment Institute, with data from eVestment, May 2024. Notes: The charts show the difference between the top quartile (top 25% rank) and bottom quartile (bottom 25% rank) of active returns generated by alpha-seeking managers across Japan equities from the eVestment universe for Japanese equities. Active returns are gross of fees – we assume a median fee of 0.6% based on a fee range from a global survey of asset managers. We use regression analysis to estimate the relationship between alpha-seeking manager performance and market conditions. Regression analysis is backwards-looking and is only an estimate of the relationship. The future relationship may differ. See more in the Limitations section of the Appendix on page 5.

Slow to price in aging

Japan healthcare outperformance vs. dependency ratio



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. Source: BlackRock Investment Institute, United Nations, Reuters, with data from LSEG Datastream, March 2024. Notes: The red line shows the ratio of the performance of Japan's healthcare equity sector vs. the overall market index, indexed to 1990. We use total market indices constructed by Datastream.

Appendix

Our framework

As we outlined in our 2022 update to our framework, we believe alpha – returns delivered by managers beyond market benchmarks – falls into two categories: 1) returns that can be replicated systematically and cost-efficiently by broad market and factor indexes seen in the factors section of our return taxonomy below, and; 2) returns that are driven by true investment skill and cannot be systematically captured through an index. Our views:

Factors: Macro and equity style factors are important drivers of returns. It is important to separate this source of return from any manager's excess return relative to a benchmark to understand the return that is an investor pays for.

Returns and fees: What matters are returns net of costs. Product fees cut into returns and can reduce or, in some cases, eliminate the alpha an investor receives. Yet these fees vary widely and change over time. Some index and factor products can also have large fees. Investors should fully account for fees in portfolio construction**.**

Governance costs: Governance costs – those required to find and manage managers – are an essential consideration. We believe manager selection and oversight are vital to achieve alpha.

Methodology

We use time series regression analysis to strip out the impact of macro and equity style factors, and other market indices from excess returns to estimate the underlying active returns directly attributable to manager skill. We go beyond the usual Ordinary Least Squares technique to reduce overfitting and use Ridge regression analysis instead. While none of these approaches can completely eliminate overfitting – explained in the limitations section below – and will only produce approximate estimates of active returns, Ridge regression aims to minimize the impact of overfitting.

Assumptions

For equity, we use both style factors and account for currency hedging in our analysis.

Fee assumptions	Index or beta	Alpha-seeking
Equities	0.15%-0.5%	0.4%-0.8%
Government bonds	0.15%-0.3%	0.2%-0.25%
Investment grade credit	0.1%-0.3%	0.2%-0.25%
Sub-investment grade credit	0.4%-0.5%	0.4%-0.5%
Private markets	N/A	0.5%-5.0%

Source: Mercer Global Asset Manager Fee Survey, 2017. Morningstar, BlackRock estimates. Note: Fee assumptions are given as ranges given the wide range of asset classes, currencies and datasets we consider in our calculations.

Limitations

Our regression technique cannot completely eliminate overfitting – where including too many potential explanations (our explanatory variables) for the nature of a relationship can overstate or understate the impact of the variable on the relationship we're observing. For example, in the case of this paper, overfitting would be considering too many variables for manager performance – and it could overstate or understate the impact some of those variables have on manager performance. Regression analysis is backwards-looking and complex – it may not reliably predict the future relationship between manager performance and market conditions. Expert judgement from a manager research team on an individual fund managers could bring better clarity on how they performed. In-depth and practical manager research can improve on econometric techniques and analysis, like regressions, to build a better picture of how a fund manager might perform in the future.

BlackRock Investment Institute

The BlackRock Investment Institute (BII) leverages the firm's expertise to provide insights on the global economy, markets, geopolitics and long-term asset allocation – all to help our clients and portfolio managers navigate financial markets. BII offers strategic and tactical market views, publications and digital tools that are underpinned by proprietary research.

General disclosure: This material is intended for information purposes only, and does not constitute investment advice, a recommendation or an offer or solicitation to purchase or sell any securities to any person in any jurisdiction in which an offer, solicitation, purchase or sale would be unlawful under the securities laws of such jurisdiction. This material may contain estimates and forward-looking statements, which may include forecasts and do not represent a guarantee of future performance. This information is not intended to be complete or exhaustive. No representations or warranties, either express or implied, are made regarding the accuracy or completeness of the information contained herein. The opinions expressed are as of May 2024 and are subject to change without notice. Reliance upon information in this material is at the sole discretion of the reader. Investing involves risks.

In the U.S., this material is intended for Institutional use only, not for public distribution. **In Canada**, this material is intended for institutional investors only. **In the UK and Non-European Economic Area (EEA) countries:** this is Issued by BlackRock Investment Management (UK) Limited, authorised and regulated by the Financial Conduct Authority. Registered office: 12 Throgmorton Avenue, London, EC2N 2DL. Tel: + 44 (0)20 7743 3000. Registered in England and Wales No. 02020394. For your protection telephone calls are usually recorded. Please refer to the Financial Conduct Authority website for a list of authorised activities conducted by BlackRock. **In the European Economic Area (EEA)**: this is Issued by BlackRock (Netherlands) B.V. is authorised and regulated by the Netherlands Authority for the Financial Markets. Registered office Amstelplein 1, 1096 HA, Amsterdam, Tel: 020 – 549 5200, Tel: 31-20-549-5200. Trade Register No. 17068311 For your protection telephone calls are usually recorded. **For qualified investors in Switzerland:** This document is marketing material. This document shall be exclusively made available to, and directed at, qualified investors as defined in Article 10 (3) of the CISA of 23 June 2006, as amended, at the exclusion of qualified investors with an opting-out pursuant to Art. 5 (1) of the Swiss Federal Act on Financial Services ("FinSA"). For information on art. 8 / 9 Financial Services Act (FinSA) and on your client segmentation under art. 4 FinSA, please see the following website: www.blackrock.com/finsa. **For investors in Italy:** This document is marketing material: Before investing please read the Prospectus and the PRIIPS available on www.blackrock.com/it , which contain a summary of investors' rights. For information on investor rights and how to raise complaints please go to https://www.blackrock.com/corporate/compliance/investor-right available in Italian. **For investors in Israel:** BlackRock Investment Management (UK) Limited is not licensed under Israel's Regulation of Investment Advice, Investment Marketing and Portfolio Management Law, 5755-1995 (the "Advice Law"), nor does it carry insurance thereunder. **In South Africa**, please be advised that BlackRock Investment Management (UK) Limited is an authorized financial services provider with the South African Financial Services Board, FSP No. 43288. **In the DIFC** this material can be distributed in and from the Dubai International Financial Centre (DIFC) by BlackRock Advisors (UK) Limited — Dubai Branch which is regulated by the Dubai Financial Services Authority (DFSA). This material is only directed at 'Professional Clients' and no other person should rely upon the information contained within it. Blackrock Advisors (UK) Limited -Dubai Branch is a DIFC Foreign Recognised Company registered with the DIFC Registrar of Companies (DIFC Registered Number 546), with its office at Unit L15 - 01A, ICD Brookfield Place, Dubai International Financial Centre, PO Box 506661, Dubai, UAE, and is regulated by the DFSA to engage in the regulated activities of 'Advising on Financial Products' and 'Arranging Deals in Investments' in or from the DIFC, both of which are limited to units in a collective investment fund (DFSA Reference Number F000738). **In the Kingdom of Saudi Arabia** Issued by BlackRock Saudi Arabia (BSA), authorised and regulated by the Capital Market Authority (CMA), License No. 18-192-30. Registered under the laws of KSA. Registered office: 29th floor, Olaya Towers – Tower B, 3074 Prince Mohammed bin Abdulaziz St., Olaya District, Riyadh 12213 – 8022, KSA, Tel: +966 11 838 3600. The information contained within is intended strictly for Sophisticated Investors as defined in the CMA Implementing Regulations. Neither the CMA or any other authority or regulator located in KSA has approved this information. **In the United Arab Emirates** this is only intended for natural Qualified Investor as defined by the Securities and Commodities Authority (SCA) Chairman Decision No. 3/R.M. of 2017 concerning Promoting and Introducing Regulations. Neither the DFSA or any other authority or regulator located in the GCC or MENA region has approved this information. **In the State of Kuwait,** those who meet the description of a Professional Client as defined under the Kuwait Capital Markets Law and its Executive Bylaws. **In the Sultanate of Oman**, to sophisticated institutions who have experience in investing in local and international securities, are financially solvent and have knowledge of the risks associated with investing in securities. **In Qatar**, for distribution with pre-selected institutional investors or high net worth investors. **In the Kingdom of Bahrain**, to Central Bank of Bahrain (CBB) Category 1 or Category 2 licensed investment firms, CBB licensed banks or those who would meet the description of an Expert Investor or Accredited Investors as defined in the CBB Rulebook. **In Singapore**, this is issued by BlackRock (Singapore) Limited (Co. registration no. 200010143N) for use only with institutional investors as defined in Section 4A of the Securities and FuturesAct, Chapter 289 of Singapore. This advertisement or publication has not been reviewed by the Monetary Authority of Singapore. **In Hong Kong**, this material is issued by BlackRock Asset Management North Asia Limited and has not been reviewed by the Securities and Futures Commission of Hong Kong. This material is for distribution to "Professional Investors" (as defined in the Securities and Futures Ordinance (Cap.571 of the laws of Hong Kong) and any rules made under that ordinance) and should not be relied upon by any other persons or redistributed to retail clients in Hong Kong. **In Taiwan**, independently operated by BlackRock Investment Management (Taiwan) Limited. Address: 28F., No. 100, Songren Rd., Xinyi Dist., Taipei City 110, Taiwan. Tel: (02)23261600. **In South Korea**, this information is issued by BlackRock Investment (Korea) Limited. This material is for distribution to the Qualified Professional Investors (as defined in the Financial Investment Services and Capital Market Act and its sub-regulations) and for information or educational purposes only, and does not constitute investment advice or an offer or solicitation to purchase or sells in any securities or any investment strategies. **In Japan**, this is issued by BlackRock Japan. Co., Ltd. (Financial Instruments Business Operator: The Kanto Regional Financial Bureau. License No375, Association Memberships: Japan Investment Advisers Association, the Investment Trusts Association, Japan, Japan Securities Dealers Association, Type II Financial Instruments Firms Association.) for Professional Investors only (Professional Investor is defined in Financial Instruments and Exchange Act). **In Australia & New Zealand**, issued by BlackRock Investment Management (Australia) Limited ABN 13 006 165 975, AFSL 230 523 (BIMAL) for the exclusive use of the recipient, who warrants by receipt of this material that they are a wholesale client as defined under the Australian Corporations Act 2001 (Cth) and the New Zealand Financial Advisers Act 2008 respectively. Refer to BIMAL's Financial Services Guide on its website for more information. **In China**, this material may not be distributed to individuals resident in the People's Republic of China ("PRC", for such purposes, not applicable to Hong Kong, Macau and Taiwan) or entities registered in the PRC unless such parties have received all the required PRC government approvals to participate in any investment or receive any investment advisory or investment management services. **For Other APAC Countries**, this material is issued for Institutional Investors only (or professional/sophisticated/qualified investors, as such term may apply in local jurisdictions) and does not constitute investment advice or an offer or solicitation to purchase or sell in any securities, BlackRock funds or any investment strategy nor shall any securities be offered or sold to any person in any jurisdiction in which an offer, solicitation, purchase or sale would be unlawful under the securities laws of such jurisdiction. **In Latin America**, for institutional investors and financial intermediaries only (not for public distribution). This material is for educational purposes only it is your responsibility to inform yourself of, and to observe, all applicable laws and regulations of your relevant jurisdiction. **In Mexico**, these materials are being shared in the understanding that the addressee is an Institutional or Qualified investor as defined under Mexican Securities (Ley del Mercado de Valores).

©2024 BlackRock, Inc. All Rights Reserved. BLACKROCK is a trademark of BlackRock, Inc., or its subsidiaries in the United States and elsewhere. All other trademarks are those of their respective owners.

FOR INSTITUTIONAL, PROFESSIONAL, QUALIFIED INVESTORS AND QUALIFIED CLIENTS IN PERMITTED COUNTRIES.

BlackRock.