

Weekly commentary

May 13, 2024

BlackRock

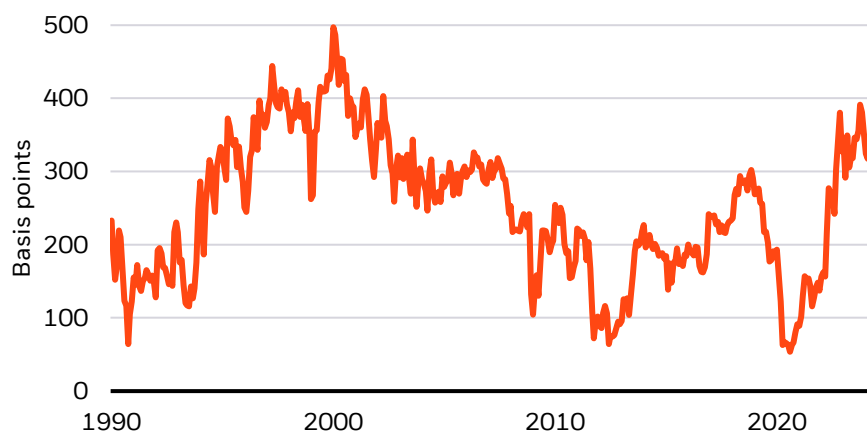
Weak yen unlikely to end Japan's rally

- A weak yen is unlikely to end the positive momentum in Japanese equities. The drivers of the recent rally remain, so we stay overweight Japanese stocks.
- The S&P 500 neared its 2024 highs last week, supported by strong Q1 earnings. In Japan, authorities appear to have intervened to bolster a weak yen.
- We're eyeing U.S. CPI inflation this week to gauge if it will keep coming in hot. We see the Federal Reserve keeping rates high for longer given sticky inflation.

Twelve-month returns for the MSCI Japan are near 14% in U.S. dollar terms. We don't see the recent slide in the yen to 34-year lows versus the dollar derailing this momentum. Why not? Japan's growth outlook remains positive, corporate reforms are taking hold and rising wages can support consumer spending. Ultimately, yen weakness is mainly due to the gap between Bank of Japan and Fed policy rates. The yen could recover once the Fed cuts. We stay overweight Japan's stocks.

A growing gap

Difference between U.S. and Japan 10-year bond yields, 1990-2024



Past performance is not a reliable indicator of current or future results. Source: BlackRock Investment Institute, with data from LSEG Datastream, May 2024. Notes: The chart shows the difference between U.S. and Japanese 10-year government bond yields. A positive number means U.S. 10-year bond yields are greater than Japan's.

At the end of April, the yen tumbled to near 160 to the dollar – its lowest in 34 years. The Japanese authorities appear to have intervened by buying U.S. dollars, warning investors betting against the yen and helping slow its slide. Any near-term drivers aside, we think the yen's weakness is caused by the gap between Fed and Bank of Japan (BOJ) policy rates. The Japanese currency started depreciating in 2022 as the Fed started hiking rates rapidly. Its fall accelerated in April as the BOJ affirmed it would not rush to unwind its loose policy, while markets pared back their pricing of Fed rate cuts for this year given sticky U.S. inflation. Government bond yields for the U.S. and Japan reflect that gap in the market's monetary policy expectations. Ten-year U.S. Treasury yields have surged above Japanese government bond yields, with the difference close to two-decade highs. See the orange line in the chart.



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Yet we think that gap between U.S. and Japan 10-year yields could narrow again as BOJ and Fed policy rates begin to move closer to each other. Sticky U.S. inflation may mean the Fed will keep interest rates high for longer, but we still see it starting to cut them later this year. And the BOJ is likely to hike rates again as it cautiously normalizes its emergency policy of negative interest rates. That should ease pressure on the yen. That said, should the yen weaken significantly between now and then, it could stoke inflation as the cost of imported food and energy rises. The BOJ could respond by tightening policy more rapidly. But we think that's unlikely as it would risk threatening an improving growth outlook, and victory in its decades-long battle against no or low inflation is not yet assured. We see government subsidies on food and energy as a more likely response.

A weak yen affects Japanese firms differently. Manufacturers with higher input costs may see lower earnings. Yet as Japan's goods become cheaper for foreign buyers, that will benefit the exporters that make up over half the market capitalization of Japan's TOPIX index. As recent wage negotiations lead to higher wages, a strong consumer could support some sectors.

Japanese stocks have surged, based on the excess yield that investors receive for the risk of holding them over bonds. But we stay overweight Japanese stocks on a six- to 12-month, tactical horizon. The rally is a sign investor confidence is perking up. And a weaker yen doesn't change the reasons behind our positive stance. The return of inflation in Japan means companies can raise prices and expand their net profit margins. Plus, shareholder-friendly corporate reforms are taking root, with more firms joining the Tokyo Stock Exchange's list of those with plans to improve their governance. Government initiatives to encourage more domestic savers to invest could boost flows into Japanese stocks. These shifts are playing out over time. We also see mega forces – big structural shifts driving returns – creating long-term opportunities in Japan. For example, Japan's population has been aging for many years. That has propelled efforts to adopt automation to boost productivity.

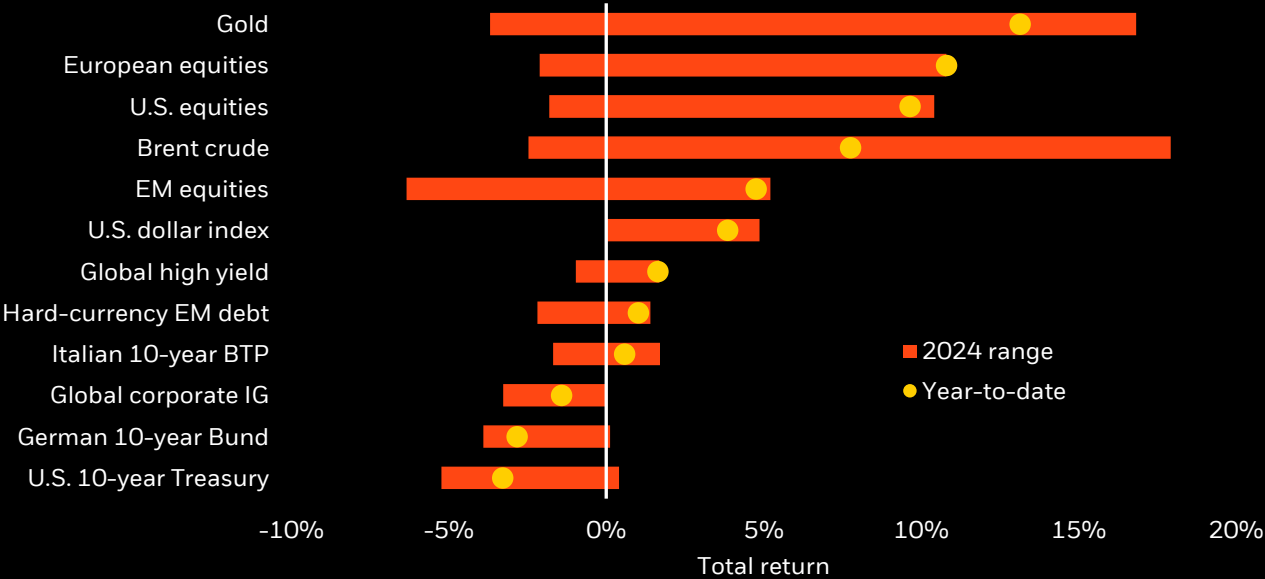
Bottom line: We see diverging monetary policy driving the slide in the yen, but we don't see the pressure persisting. We stay overweight Japanese stocks given ongoing corporate reforms and eye opportunities created by structural shifts.

Market backdrop

The S&P 500 climbed higher last week, approaching its 2024 highs. U.S. 10-year Treasury yields hovered around 4.50%. Given structurally higher interest rates, the onus has fallen on earnings to sustain U.S. equity strength. U.S. Q1 earnings have cleared a high bar thus far, showing strong results and signs of broadening. Japanese equities and 10-year government bond yields were flat. A historically weak yen, near 34-year lows versus the U.S. dollar, prompted suspected currency intervention.

Assets in review

Selected asset performance, 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 LSEG Datastream as of May 9, 2024. Notes: The two ends of the bars show the lowest and highest returns at any point year to date, 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, LSEG 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.

Week ahead

May 14	UK employment data	May 16	U.S. Philly Fed Business Index; Japan GDP data
May 15	U.S. CPI	May 10-17	China total social financing

We await U.S. CPI inflation data this week as some components have recently been higher than expected. We’re eyeing whether that will carry on. Supercore services inflation excluding food, energy and housing is particularly in focus as it will determine where inflation ultimately settles. We’re also watching core goods given their bumpy post-pandemic normalization. After softer-than-expected U.S. payrolls and wages, markets are again expecting a September rate cut.

Big calls

Our highest conviction views on tactical (6-12 month) and strategic (long-term) horizons, May 2024

Tactical	Reasons
U.S. equities	<ul style="list-style-type: none">Our macro view has us neutral at the benchmark level. But the AI theme and its potential to generate alpha – or above-benchmark returns – push us to be overweight overall.
Income in fixed income	<ul style="list-style-type: none">The income cushion bonds provide has increased across the board in a higher rate environment. We like short-term bonds and are now neutral long-term U.S. Treasuries as we see two-way risks ahead.
Geographic granularity	<ul style="list-style-type: none">We favor getting granular by geography and like Japan equities in DM. Within EM, we like India and Mexico as beneficiaries of mega forces even as relative valuations appear rich.
Strategic	Reasons
Private credit	<ul style="list-style-type: none">We think private credit is going to earn lending share as banks retreat – and at attractive returns relative to public credit risk.
Inflation-linked bonds	<ul style="list-style-type: none">We see inflation staying closer to 3% in the new regime on a strategic horizon.
Short- and medium-term bonds	<ul style="list-style-type: none">We overall prefer short-term bonds over long term. That’s due to more uncertain and volatile inflation, heightened bond market volatility and weaker investor demand.

Note: Views are from a U.S. dollar perspective, May 2024. 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.

Tracking five mega forces

Mega forces are big, structural changes that affect investing now – and far in the future. As key drivers of the new regime of greater macroeconomic and market volatility, they change the long-term growth and inflation outlook and are poised to create big shifts in profitability across economies and sectors. This creates major opportunities – and risks – for investors. See our [web hub](#) for our research and related content on each mega force.

- 1. Demographic divergence:** The world is split between aging advanced economies and younger emerging markets – with different implications.
- 2. Digital disruption and artificial intelligence (AI):** Technologies that are transforming how we live and work.
- 3. Geopolitical fragmentation and economic competition:** Globalization is being rewired as the world splits into competing blocs.
- 4. Future of finance:** A fast-evolving financial architecture is changing how households and companies use cash, borrow, transact and seek returns.
- 5. Transition to a low-carbon economy:** The transition is set to spur a massive capital reallocation as energy systems are rewired.

Granular views

Six- to 12-month tactical views on selected assets vs. broad global asset classes by level of conviction, May 2024

Our approach is to first determine asset allocations based on our macro outlook – and what’s in the price. **The table below reflects this and, importantly, leaves aside the opportunity for alpha, or the potential to generate above-benchmark returns.** The new regime is not conducive to static exposures to broad asset classes, in our view, but is creating more space for alpha.

Underweight

Neutral

Overweight

● Previous view

Asset		View	Commentary	
Equities	Developed markets			
	United States	Benchmark	<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>	We are neutral in our largest portfolio allocation. Falling inflation and coming Fed rate cuts can underpin the rally’s momentum. We are ready to pivot once the market narrative shifts.
		Overall	<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>+1</div>	We are overweight overall when incorporating our U.S.-centric positive view on artificial intelligence (AI). We think AI beneficiaries can still gain while earnings growth looks robust.
	Europe	<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>-1</div>	We are underweight. While valuations look fair to us, we think the near-term growth and earnings outlook remain less attractive than in the U.S. and Japan – our preferred markets.	
	UK	<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>	We are neutral. We find attractive valuations better reflect the weak growth outlook and the Bank of England’s sharp rate hikes to fight sticky inflation.	
	Japan	<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>+2</div>	We are overweight. Mild inflation and shareholder-friendly reforms are positives. We see the BOJ policy shift as a normalization, not a shift to tightening.	
	Emerging markets			
	China	<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>	We are neutral. We see growth on a weaker trajectory and see only limited policy stimulus from China. We prefer EM debt over equity.	
	Fixed Income	Short U.S. Treasuries	<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>+1</div>	We are overweight. We prefer short-term government bonds for income as interest rates stay higher for longer
		Long U.S. Treasuries	<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>	We are neutral. The yield surge driven by expected policy rates has likely peaked. We now see about equal odds that long-term yields swing in either direction.
U.S. inflation-linked bonds		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>	We are neutral. We see higher medium-term inflation, but cooling inflation and growth may matter more near term.	
Euro area inflation-linked bonds		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>	We are neutral. Market expectations for persistent inflation in the euro area have come down.	
Euro area govt bonds		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>	We are neutral. Market pricing reflects policy rates in line with our expectations and 10-year yields are off their highs. Widening peripheral bond spreads remain a risk.	
UK gilts		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>	We are neutral. Gilt yields have compressed relative to U.S. Treasuries. Markets are pricing in Bank of England policy rates closer to our expectations.	
Japanese govt bonds		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>-2</div>	We are underweight. We find more attractive returns in equities. We see some of the least attractive returns in Japanese government bonds, so we use them as a funding source.	
China govt bonds		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>	We are neutral. Bonds are supported by looser policy. Yet we find yields more attractive in short-term DM paper.	
U.S. agency MBS		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>	We are neutral. We see agency MBS as a high-quality exposure in a diversified bond allocation and prefer it to IG.	
Global IG credit		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>-1</div>	We are underweight. Tight spreads don’t compensate for the expected hit to corporate balance sheets from rate hikes, in our view. We prefer Europe over the U.S.	
Global high yield		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>	We are neutral. Spreads are tight, but we like its high total yield and potential near-term rallies. We prefer Europe.	
Asia credit		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>	We are neutral. We don’t find valuations compelling enough to turn more positive.	
Emerging hard currency		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>+1</div>	We are overweight. We prefer EM hard currency debt due to its relative value and quality. It is also cushioned from weakening local currencies as EM central banks cut policy rates.	
Emerging local currency		<div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div><div></div></div> <div>Neutral</div>	We are neutral. Yields have fallen closer to U.S. Treasury yields. Central bank rate cuts could hurt EM currencies, dragging on potential returns.	

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