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Weekly commentary

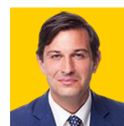
BlackRock

Oct. 14, 2019

Japan equities: don't chase the rally

- We maintain our underweight on Japan equities, yet see the recent rally as a preview of their potential if trade tensions were to fade.
- Signs that weakness caused by the protectionist push is spreading beyond manufacturing have cast a shadow on the growth backdrop.
- China's third-quarter gross domestic product (GDP) growth data due this week is expected to show a slight decline.

Mike Pyle
Global Chief Investment Strategist — BlackRock Investment Institute



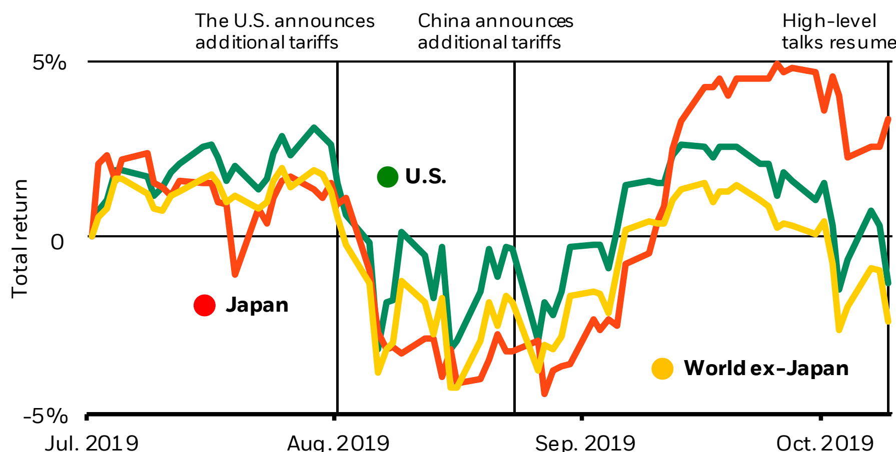
Ben Powell
Chief Investment Strategist for APAC — BlackRock Investment Institute

Scott Thiel
Chief Fixed Income Strategist — BlackRock Investment Institute

Japanese equities outran their global peers in September in an exaggerated response to a temporary thaw in U.S.-China trade tensions. We maintain our underweight on Japanese equities, as they are still particularly vulnerable to a growth slowdown in China and we see no sustained letup in the protectionist push. Yet the September rally offers a preview of the potential upside in Japanese equities if trade tensions were to fade substantively and growth to reaccelerate.

Chart of the week

Total return of Japan, U.S. and world ex-Japan equities, July-October 2019



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.
Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, October 2019. Notes: The indexes used include MSCI Japan, MSCI USA and MSCI World ex-Japan indexes, in U.S. dollar terms.

Japan has been the best performer in major equity markets since midyear. The MSCI Japan index has led both U.S. and global markets (ex-Japan) after a significant climb in September, as the chart shows. The main driver? A perceived easing in U.S.-China trade tensions that led to a shift by investors into unloved assets such as value equities, including beaten-down Japanese stocks. We do not see this rotation having staying power though. In the near term we see potential for further bouts of market volatility, as fallout from the trade war is reflected in weak economic data. See an earlier weekly commentary for details. Yet the recent rebound in Japanese equities offers a preview of the potential market reaction should the global economy reaccelerate in 2020. Japanese equities' cheapness could exaggerate any such move. The price-to-earnings ratio of the blue-chip Nikkei 225 Index has fallen to a historical low of 12.

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Trade disputes and geopolitical frictions have become key drivers of the global economy and markets, as we outlined in the recent update to our Global investment outlook. Trade dynamics play an outsized role in Japanese equities: As much as half of the revenues of Nikkei 225 companies come from international sales, even though exports' contribution to Japan's GDP is at a much lower 15%. China is the largest market for Japan's exported goods, and orders from China for machines and electronics parts have collapsed since November 2018. We see a lull in China's growth due to the fallout of U.S. tariffs. China's policy stance is likely to ease further to help stabilize growth, yet an incremental boost to growth seems unlikely, in our view. Japan's leverage to global trade leaves it vulnerable to any further downdrafts tied to the protectionist push.

Japan also is faced with a number of domestic challenges. A recent sales tax increase could weigh on consumer spending and growth. The Bank of Japan (BoJ) may be running out of policy space. After years of ultra-loose monetary policy, the central bank's asset holdings have exceeded the country's total GDP – making the BoJ the biggest asset owner among key developed market central banks. We see room for only a modest rate cut by the BoJ at its policy meeting in late October. A potential wildcard: BoJ Governor Haruhiko Kuroda has spoken of the potential for greater coordination between monetary and fiscal policy, echoing the theme of our recent piece *Dealing with the next downturn*. Any growth slowdown induced by the hike in Japan's sales tax could be met with a fiscal stimulus in early 2020.

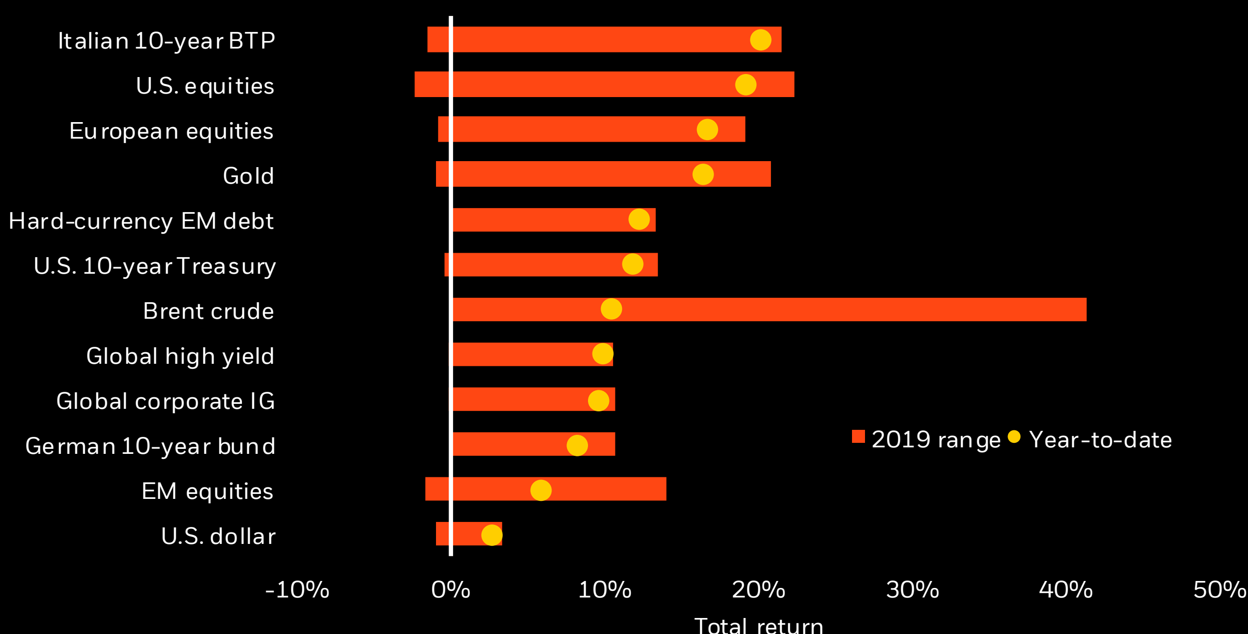
We remain underweight Japanese equities for now. We still expect weakness in global growth data over the next few months, as easier monetary conditions slowly filter through to benefit the broader economy in the next six to 12 months. But if a prolonged trade truce between the U.S. and China were to take place and global manufacturing activities bottomed out, we would need to reassess our view on Japanese equities. Their close correlation with the health of global manufacturing activities and China's growth, as well as their beaten-down valuations, could make them attractive. Another positive in the background: Japanese firms are gradually improving their corporate governance, reflected in increased payouts to investors in the form of dividends and share buybacks.

Market backdrop

Signs that the drag on economic activity from the global protectionist push is spreading beyond manufacturing have cast a shadow on the growth backdrop. Major central banks have taken a dovish stance — the Fed has cut rates in line with market expectations, following the European Central Bank's broad stimulus package. We expect a pickup in global growth in the next six to 12 months, yet see limits to how much monetary easing can be delivered in the near term. Monetary policy is no cure for the weaker growth and firmer inflation pressures that may result from sustained trade tensions.

Assets in review

Selected asset performance, 2019 year-to-date and range



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index. Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, October 2019. Notes: The two ends of the bars show the lowest and highest returns versus the end of 2018, and the dots represent 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, MSCI USA Index, the ICE U.S. Dollar Index (DXY), MSCI Europe Index, Bank of America Merrill Lynch Global Broad Corporate Index, Bank of America Merrill Lynch Global High Yield Index, Datastream 10-year benchmark government bond (U.S. , German and Italy), MSCI Emerging Markets Index, spot gold and J.P. Morgan EMBI index.

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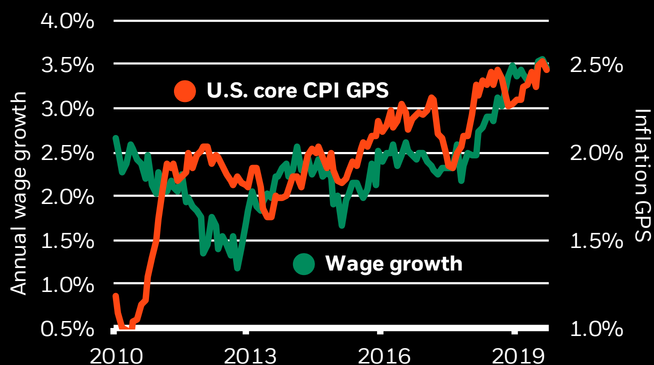
Macro insights

The protectionist push has led to a dent in global industrial production. This is now showing up in weaker U.S. economic activity amid slowly rising inflation. Inflation should be underpinned by a healthy jobs market and still-improving wage growth. Headline hourly earnings declined in September, driven by a drop in managerial compensation. Yet wage growth for production and non-supervisory employees — a broader measure relevant for overall consumer spending — grew at 3.5%, close to the cycle peak seen in July. This points to support for higher prices. Our Inflation GPS for the U.S. core CPI also suggests upside risks remain to the actual core CPI. Higher inflation – the result of a strong labor market and some tariff impact – could complicate the Federal Reserve's "mid-cycle" policy easing. We expect the Fed to trim rates a third time this month yet also believe markets may be pricing in too much additional easing in the year ahead.

On the rise

BlackRock Inflation GPS and wage growth, 2010-2019



Sources: BlackRock Investment Institute, with data from the US Bureau of Labor Statistics and Markit, October 2019. The chart shows the annual growth in average hourly earnings for US production and non-supervisory employees (green line) and the BlackRock US Core Consumer Price Inflation GPS. The inflation GPS shows where core (excluding food and energy) CPI may stand in six months' time. Forward-looking estimates may not come to pass.

Investment themes

1 Protectionist push

- U.S.-China trade delegations resumed talks.
- Revived hopes for a Brexit deal before a crucial European Council meeting lifted the pound. Uncertainty is still high but our base case is for a short extension to the Oct. 31 deadline, followed by a UK general election.
- Persistent uncertainty from protectionist policies is denting corporate confidence and slowing business spending, hurting the global industrial cycle — a key reason for our global growth downgrade.
- The longer-term risk from protectionism: The unravelling of global supply chains delivers a supply shock that saps productivity growth, reinforces a slowdown in potential output and leads to higher inflation.
- **Market implication**: We favour reducing risk amid rising protectionism, including raising some cash.

2 Stretching the cycle

- The record-long U.S. economic expansion looks unlikely to morph into a deeper downturn any time soon, supported by healthy household spending.
- The Fed cut rates by a quarter-point for a second time yet stopped short of bolder actions, supporting our view that the market's easing expectations are excessive. We do not see the Fed's move to expand its balance sheet as a revival of QE as it is aimed at alleviating short-term funding pressures not shaping long-term rate expectations.
- The trade war is bad for growth, but we still see potential for U.S. inflation to rise in the near term due to the direct impact of tariffs and in the long term due to the hit to production capacity, complicating the case for policy easing.
- We believe policymakers should lay the groundwork for a credible plan to navigate the next economic shock that includes unprecedented coordination between monetary and fiscal measures. We lay out the contours of such a framework in *Dealing with the next downturn*. Absence of a credible plan is contributing to market anxiety, and adding to the rush into the perceived safety of government bonds.
- Chinese authorities have cut bank reserve requirements, lowered private sector borrowing costs and boosted infrastructure spending – yet the stimulus remains limited with a focus still on shoring up the financial system.
- **Market implication**: We like U.S. equities and EM debt. We are overweight eurozone government bonds: a relatively steeper yield curve brightens the appeal even at low yields. We are neutral European equities and credit.

3 Raising resilience

- Most government bonds play an important role in building portfolio resilience – even at low yield levels – both on a tactical basis and in long-term portfolios.
- Last month's sharp reversals in the momentum and value factors show the importance of minimizing portfolio exposure to pockets of the market where pricing appears stretched.
- **Market implication**: We prefer U.S. Treasuries over German bunds for portfolio diversification on a strategic basis. The recent underperformance of bunds relative to Treasuries in recent risk-off events suggests core euro area government bond yields are approaching their perceived effective lower bound.

Week ahead

Oct. 14, 15 and 18 – China is due to release data including trade, inflation and retail sales. The focus: the third-quarter GDP. Consensus expects growth to decline slightly –but still above 6%. We see the additional uncertainty stemming from the U.S.-led protectionist push filtering into business planning, threatening to weaken economic activity globally.

Oct. 16 -17 – U.S. September retail sales and industrial output are both expected to contract slightly. We see the resilience in U.S. consumer spending as helping offset manufacturing weakness amid heightened macro uncertainty.

Asset views

Views from a U.S. dollar perspective over a 6-12 month horizon

Asset class		View	Comments
Equities	**U.S.**	▲	A supportive policy mix and the prospect of an extended cycle underpin our positive view. Valuations still appear reasonable against this backdrop. From a factor perspective we like min-vol and quality, which have historically tended to perform well during economic slowdowns.
	Europe	—	We have upgraded European equities to neutral. We find European risk assets modestly overpriced versus the macro backdrop, yet the dovish shift by the European Central Bank (ECB) should provide an offset. Trade disputes, a slowing China and political risks are key challenges.
	Japan	▼	We have downgraded Japanese equities to underweight. We believe they are particularly vulnerable to a Chinese slowdown with a Bank of Japan that is still accommodative but policy-constrained. Other challenges include slowing global growth and an upcoming consumption tax increase.
	EM	—	We have downgraded EM equities to neutral amid what we see as overly optimistic market expectations for Chinese stimulus. We see the greatest opportunities in Latin America, such as in Mexico and Brazil, where valuations are attractive and the macro backdrop is stable. An accommodative Fed offers support across the board, particularly for EM countries with large external debt loads.
	Asia ex-Japan	▼	We have downgraded Asia ex-Japan equities to underweight due to the region's China exposure. A worse-than-expected Chinese slowdown or disruptions in global trade would pose downside risks. We prefer to take risk in the region's debt instruments instead.
Fixed income	**U.S. government bonds**	▼	We remain underweight U.S. Treasuries. We do expect the Fed to cut rates by a further quarter percentage point this year. Yet market expectations of Fed easing look excessive to us. This, coupled with the flatness of the yield curve, leaves us cautious on Treasury valuations. We still see long-term government bonds as an effective ballast against risk asset selloffs.
	U.S. municipals	—	Favorable supply-demand dynamics and improved fundamentals are supportive. The tax overhaul has made munis' tax-exempt status more attractive. Yet muni valuations are on the high side, and the asset class may be due for a breather after a 10-month stretch of positive performance.
	U.S. credit	—	We are neutral on U.S. credit after strong performance in the first half of 2019 sent yields to two-year lows. Easier monetary policy that may prolong this cycle, constrained new issuance and conservative corporate behavior support credit markets. High-yield and investment-grade credit remain key part of our income thesis.
	European sovereigns	▲	The resumption of asset purchases by the ECB supports our overweight, particularly in non-core markets. A relatively steep yield curve – particularly in these countries – is a plus for euro area investors. Yields look attractive for hedged U.S. dollar-based investors thanks to the hefty U.S.-euro interest rate differential.
	European credit	—	Renewed ECB purchases of corporate debt and a "lower for even longer" rate shift are supportive. European banks are much better capitalized after years of balance sheet repair. Even with tighter spreads, credit should offer attractive income to both European investors and global investors on a currency-hedged basis.
	EM debt	▲	We like EM bonds for their income potential. The Fed's dovish shift has spurred local rates to rally and helped local currencies recover versus the U.S. dollar. We see local-currency markets having room to run and prefer them over hard-currency markets. We see opportunities in Latin America (with little contagion from Argentina's woes) and in countries not directly exposed to U.S.-China tensions.
	Asia fixed income	—	The dovish pivot by the Fed and ECB gives Asian central banks room to ease. Currency stability is another positive. Valuations have become richer after a strong rally, however, and we see geopolitical risks increasing . We have reduced overall risk and moved up in quality across credit as a result.

▲ Overweight — Neutral ▼ Underweight

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