BlackRock

Japan: Back in Business

How (and why) to invest in the theme.

1. Macro

Durable inflation, positive growth, and normalizing monetary policy have laid the groundwork for an environment that is supportive for equties

2. Micro

Shareholder friendly corporate reforms and improved margins and earnings expectations have contributed to a rally in Japanese equities.

3. Positioning

A new tax scheme to incentivize investing could prompt domestic investors off the sidelines. The deployment of that cash is also attracting foreign investors who see further upside potential.

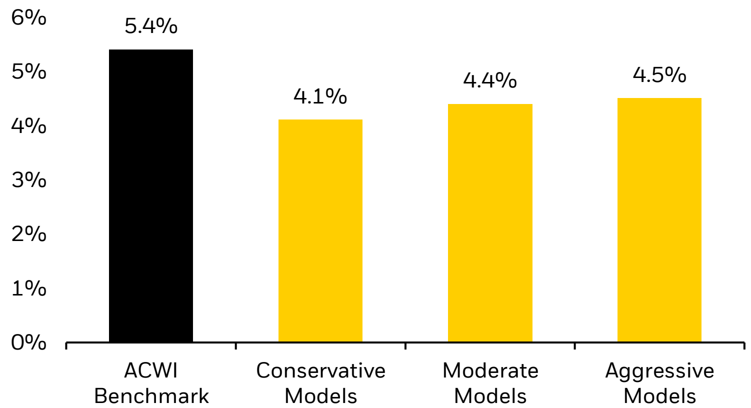
Japan is benefitting from a trio of tailwinds: a positive macro backdrop, a slate of shareholder friendly micro reforms, and a positioning impulse that has the potential to attract buyers both domestic and foreign.

The macro and micro cases for Japanese equities are explored in depth in our recent paper, found here. While recent equity market performance certainly reflects a newfound optimism around the region, still-light positioning suggests that the trade may not have yet run its course.

According to data from Japan's Ministry of Finance, foreign institutional flows have clawed their way out of negative territory, but still sit far below recent averages.

Notably absent in foreign flows, however, is the U.S. advisory community. Our data shows that asset manager model portfolios currently hold Japan at a 4.4% weight within their respective equity sleeves, well below the 5.4% in MSCI ACWI.[1] If advisors were to close that underweight, it could result in up to $15bn of flows to the region, in addition to the $3.5bn of ETF flows seen in the first quarter.[2]

Japan Allocations in U.S. Wealth Models



[1]Source: Asset manager models as defined by Cerulli. As of December 31, 2023.

Coupled with the nearly $7 trillion worth of domestic savings, current positioning points to a rally with legs and potential longer-term support.

> "Japan is benefitting from a boom on three fronts. While positive developments in both the macro and micro are widely appreciated, we believe that light positioning in Japanese equities is the fuel that can keep the rally going from here."
>
> **Gargi Pal Chaudhuri**
> Chief Investment and Portfolio Strategist, Americas

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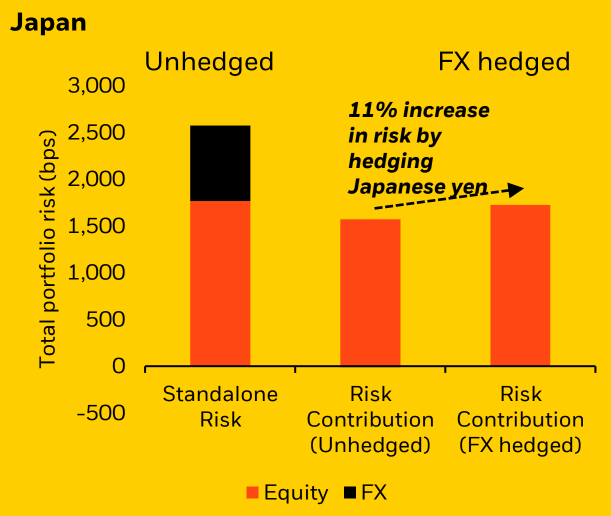
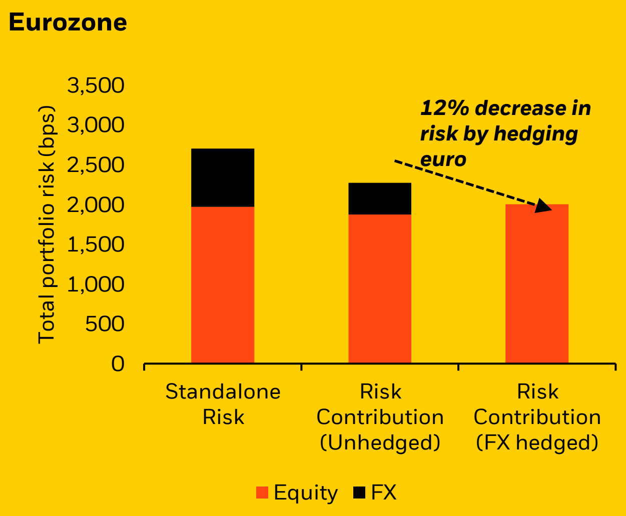
FX HEDGING: Not every hedge reduces risk

For dollar-denominated investors, hedging away Japanese yen exposure is akin to hedging away a diversifier. Hedging yen exposure has often added risk, especially when incorporating local equity and FX correlations. As shown below, hedging JPY actually increased volatility by 11% while hedging the euro decreased volatility by 12%.

Having depreciated substantially, we see two-sided risks for the yen from here. The BoJ announced the end of its negative interest rate policy in March but has communicated its willingness to intervene should the yen weaken much beyond its current levels. We think certain investors could feel comfortable owning unhedged Japanese equities this year, but acknowledge there may be near term volatility as monetary policy in both Japan and the U.S. continues to normalize.





Source: BlackRock, as of March 2024. Indexes used are the MSCI Japan Index and MSCI Eurozone Index for non-hedged exposures, and the MSCI Japan Hedged Index and MSCI Eurozone Hedged Index for hedged exposures. .Risk factors were estimated using monthly data over the past 15 years. Risk contribution is the risk decomposition of the exposure by factor taking in to account the correlations between the factors and the benefits of diversification. A basis point (bps) is one hundredth of one percent (e.g. one basis point = 0.01%). **Indexes are unmanaged and one cannot invest directly in index. Past performance does not guarantee future results.**

WAYS TO INVEST

Broad Beta: Large and mid-cap, market weighted Japan focused funds have taken in the lion's share of flows to the region over the last year. Given their inclusion in international equity benchmarks, we expect they will continue to be the most popular way to invest in the region.

Japan Value: Years of negative rates impaired financials and other value sectors. Expectations of a return to normalized monetary policy has sparked a rotation away from growth, with value indexes outperforming since 2022.[3]

Japan Small Caps: Evidence of a broadening equity rally could be seen in March, with a new collection of stocks atop the leaderboard than those that had powered the index in January and February. Japanese small caps may provide more exposure to domestic consumption than their global large cap peers, providing equity returns that are less correlated with movements in the yen. As the Federal Reserve eventually starts cutting rates, a stronger USD could weigh on export focused large caps.

Active International: Style leadership in Japanese equities changes frequently, a setup which can benefit an active management style. Consistent with this, more managers are able to generate alpha in Japanese markets than in other developed markets. Investors may also prefer to take an active approach to their overall international equity allocation, delegating the management of how best to accommodate an overweight position to Japan now, and how to evolve that position from here as the Japan market evolves.

RELATED FUNDS

EWJ	**iShares® MSCI Japan ETF**
JPXN	**iShares JPX-Nikkei 400 ETF**
EWJV	**iShares MSCI Japan Value ETF**
SCJ	**iShares MSCI Japan Small Cap ETF**
MALOX	**BlackRock Global Allocation Mutual Fund**
BROIX	**BlackRock Advantage International Fund**

References to specific investments are for illustrative purposes only and are not intended and should not be interpreted as recommendations to purchase or sell such investments.

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[1]Source: Asset manager models as defined by Cerulli. As of December 31, 2023.
[2]Source: ETP Flow from Bloomberg. ETP categories from Market. As of March 31, 2024.
[3]Source: BlackRock, Bloomberg, as of March 2024. Indexes used are the MSCI Japan Index and MSCI Japan Value Net Total Return USD Index. Value outperformance measured from January 01, 2023, to March 2024.

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