Monthly market update
September 2024

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Investment Markets

August 2024 snapshot - Will the V-shaped recovery hold?

Causes of the downturn

1. The unwind Outlook of the Yen carry trade
2. Mixed results from the Magnificent 7*
3. Fears of US recession

Catalysts for recovery

1. The Bank of Japan (BoJ)
2. Hardening of interest rate cut expectations
3. Liquidity and "buying on the dip"
4. US economic data
5. Inflation
6. Q2 2024 company earnings
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Executive summary

- This month we discuss the causes of the early August sell-off and the two key reasons behind this (the role of the Yen carry trade unwind** and fears about a US recession). Turning then to the V-shaped recovery that unfolded.
- We analyse the current key economic data - leading us to the view that a global economic slowdown is coming. We stop short of calling a recession, given the scale of interest rate cuts that the central banks can deploy and the momentum that remains in company earnings.
- But the months ahead may be more of a period of consolidation for markets as opposed to outsized gains as made earlier in 2024. Bouts of volatility may also become more of a feature.
- We conclude with the view that a conservative stance is best for investors as the risk-reward trade-off is less certain now than was the case twelve or even six months ago.

* Apple, Alphabet, Amazon, Meta, Microsoft, NVIDIA, and Tesla.
** Carry trades are a process in which an investor borrows in a low cost currency and buys a higher yielding/performing asset).

Warning: Past performance is not a reliable guide to future performance.

Will the V-shaped recovery hold?

A downturn began in markets in mid-July but was followed by a V-shaped rebound, with August an extraordinary month by recent standards.

What happened in August?

- The first week saw market volatility spike up in a way not seen since the Covid-19 pandemic and in a matter of just 5 days global equities had shed almost 8%.
- The Magnificent 7 stocks, whose performances have been so dominant for most of the past two years, shed even more, with a drop of nearly 10% at one point to add to the losses from July.
- But then began a V-shaped recovery, which saw markets rebound by almost 8% by the end of August, effectively a round trip for the month and almost back to the July highs (as can be seen on Figure 1).

Both the causes of the downturn and the catalysts for the following recovery can help investors understand a lot about what may lie ahead for the investment environment in the months to come. In short, they summarise the current tensions in markets. At the top of the list, is to address what direction the US economy is heading,, in particular, the US consumer. Answering this will tell us a great deal about how markets are expected to behave during the rest of 2024. However the spark for the volatility came mostly from elsewhere, most particularly Japan.

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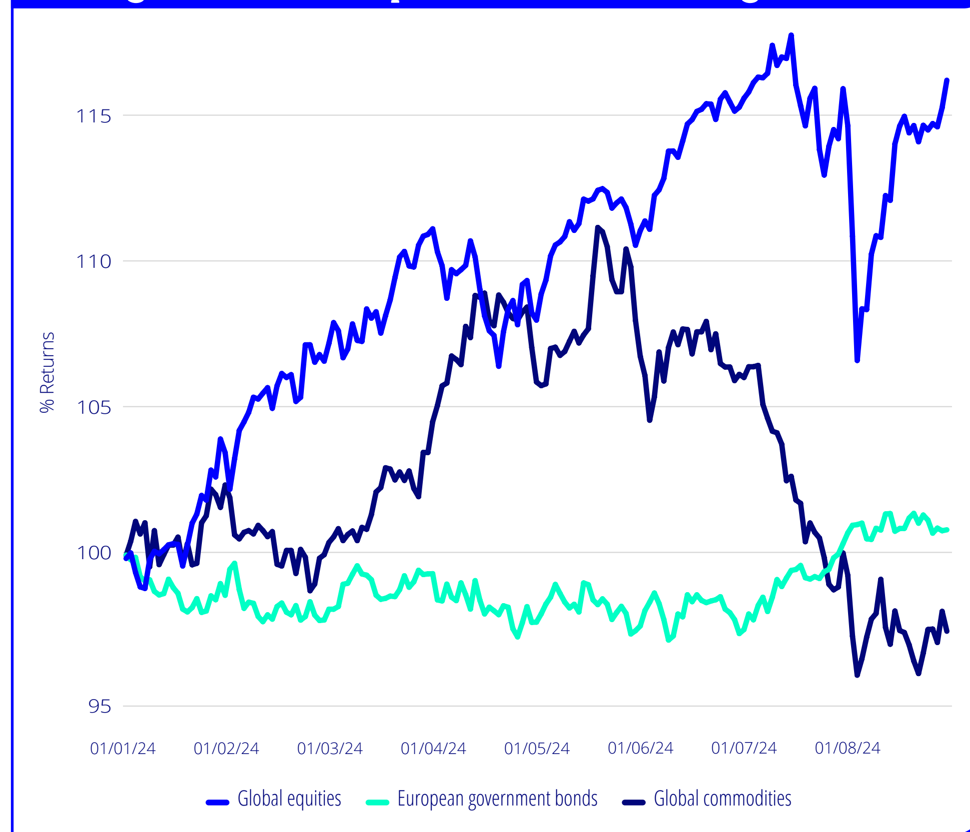

Source: Bloomberg 02.09.24

Performance to 30.08.24

	August 2024	YTD 2024	2023
Global equities	0.2%	15.7%	18.1%
Global bonds	1.0%	1.7%	7.2%
Commodities	-2.6%	-2.5%	15.3%

Source: Bloomberg 02.09.24

August in review

Causes of the downturn

To look for the main cause for the rapid downturn seen in early August we have to look to the mechanics of markets more than to the economy. That is in no way to become complacent about the economy, as the challenges in here may yet happen. Instead, it serves to illustrate what can happen when markets become overly concentrated in a sector or theme or indeed use borrowings excessively.

1 The unwind of the Yen carry trade

Carry trades are a process in which an investor borrows in a low cost currency and uses those borrowings to buy a higher performing asset in another currency. If interest rates in the low interest rate currency begin to rise, investors begin to sell out of the assets invested in to pay off borrowings. The Yen has been the most popular currency for this activity because of Japan's ultra-low interest rate regime. When Japanese rates began to rise in July, investors sold out of foreign assets to pay off Japanese loans – resulting in August's unwind of the Yen carry trade.

There is little data available on the scale of this kind of borrowing, although the Bank for International Settlements estimates that non-national borrowing in Yen is over $1 trillion[1], so this is an influential part of the mechanics of the market to say the least. J.P. Morgan suggested just after the August sell-off that somewhere around 50-60% of the Yen carry trade had been unwound[2]. When decisions to close positions were made in August, the most likely shares to be sold were the highly liquid and popular Magnificent 7 stocks. These stocks were hit hardest in August.

One of the other consequences of interest rate increases in Japan at a time when certainty about upcoming US interest rate cuts has hardened, is the drop in the value of the US dollar (as shown in Figure 2 overleaf). This was one more reason for US dollar-based investors not to want to hold Japanese debt, it was becoming too expensive.

[1] Source: Bank for International Settlements 23.08.24
[2] Source: Bloomberg 06.08.24 "JP Morgan says carry trade unravelling only half done"

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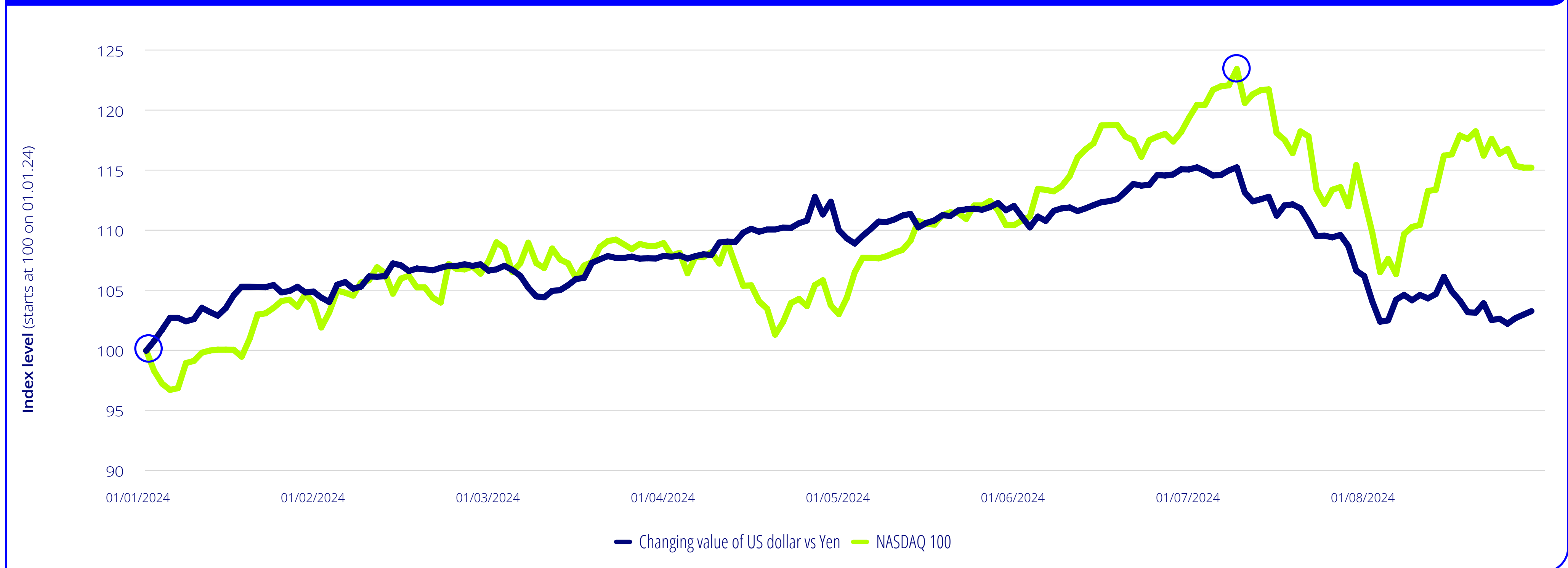
August in review

1 The unwind of the Yen carry trade (Cont'd)

Figure 2 below shows how the value of the US NASDAQ market, an index that measures the returns of US technology stocks, fell significantly as the Yen rose in value compared to the US dollar.

Figure 2: The Yen vs US dollar & the NASDAQ



Source: Bloomberg 03.09.24

An additional feature of the period in the run up to the sell-off was investors using more borrowings to chase the momentum in markets in the belief that volatility would remain subdued. Data from banks' show that it was these borrowings that made the sell-off so steep as hedge funds had been increasing their use of borrowed money to invest and quickly had to unwind this[3].

[3] Source: Bloomberg 02.09.24

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August in review

2 Mixed results from the Magnificent 7

The Magnificent 7 have been the powerhouse behind the exceptional returns in the equity market in recent times (see Figure 3).

Q2 2024 earning results from the group, for the most part, continued to strengthen but markets were non-plussed about the outcome. Amongst the seven, the market was disappointed with Tesla, Alphabet, Microsoft and Amazon, was okay with Apple's release and was happy with Meta's results.

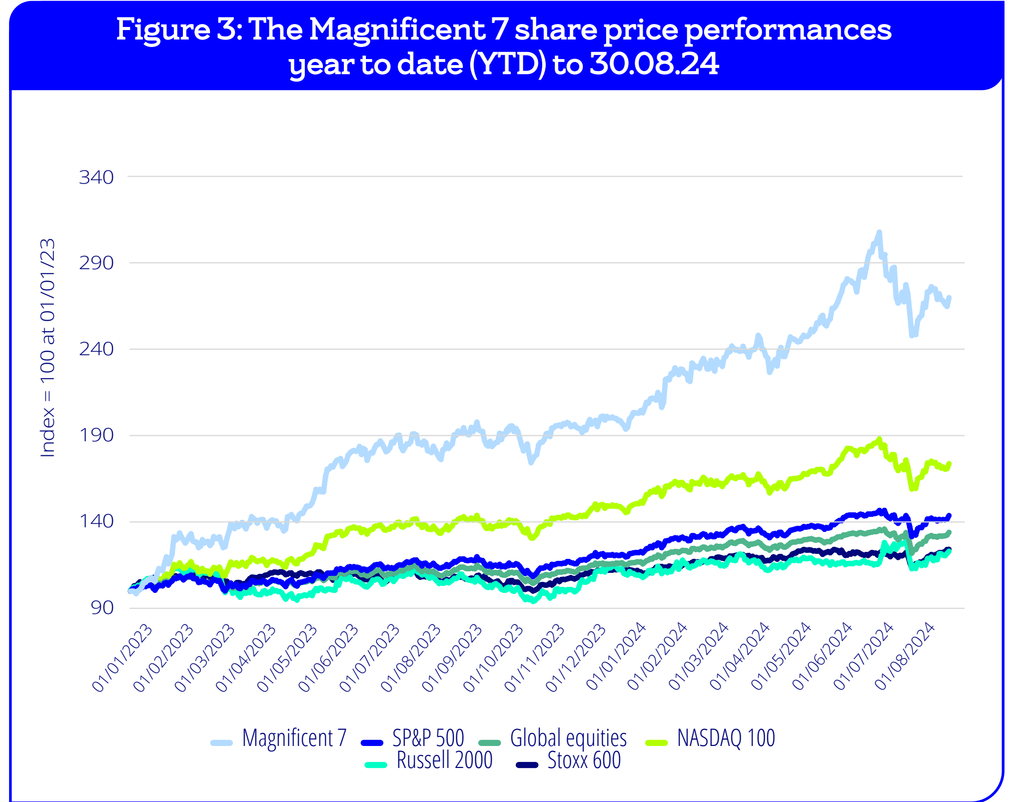
The cause of the market's underwhelmed response was less about current performance but more due to the much larger capital spends that the firms are having to deploy to turn artificial intelligence (AI) into reality. The market is unhappy that they have not explained how they will monetise this significantly higher than expected expenditure.

NVIDIA

NVIDIA was the last to report and very much the representative of the bunch. Its results were better than expected again, beating an already high hurdle in expectations. However, it was a case of the very good not being good enough as markets, which have become used to dizzying outperformance from NVIDIA, were somewhat non-plussed.

- Both Q2 and Q3 (so far) forecast revenue topped average expectations but were below the highest estimates.
- Q2 revenue came in at $30 billion (bn) and ahead of expectations which stood at $28.9bn.
- The Q3 revenue estimate is at $32.5bn compared to an average forecast of $31.9bn but lower than the highest of the range $37.9bn (still an 80% year-on-year (y/y) growth)[4].

This suggests that there's good reason to believe that the Magnificent 7's leadership of the market, to the extent that has been happening over the past couple of years, may now be behind us. Not that these companies won't go on to thrive and continue to be massively influential, rather that the days of significantly outsized gains may have passed, at least for the moment.



Source: Bloomberg 03.09.24

[4] Source: Bloomberg 02.09.24

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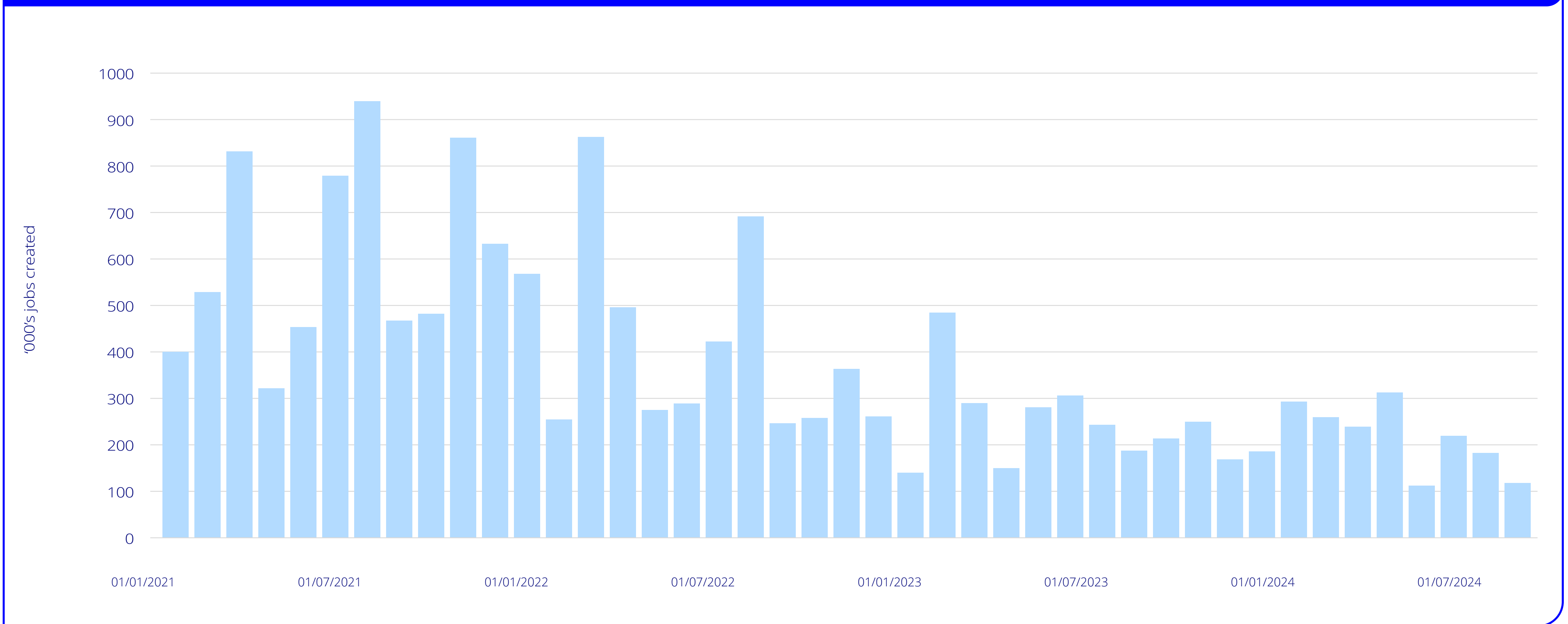
August in review

3 Fears of US recession

In early August, US labour market data (non-farm payrolls[5]) came in significantly below estimates (see Figure 4 below). The survey indicated that just 114,000 jobs had been created in the US economy compared to expectations that this number would be as high as 175,000. This was seen by many as a signal that the US economy was slowing faster than anticipated and that the US Federal Reserve (Fed) had been too slow to begin cutting interest rates.

Figure 4: US non-farm payrolls January 2021 to July 2024



Source: Bloomberg 03.09.24

[5] US non-farm payrolls measure the change in the number of people employed during the previous month, excluding the farming industry.

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August in review

3 Fears of US recession (Cont'd)

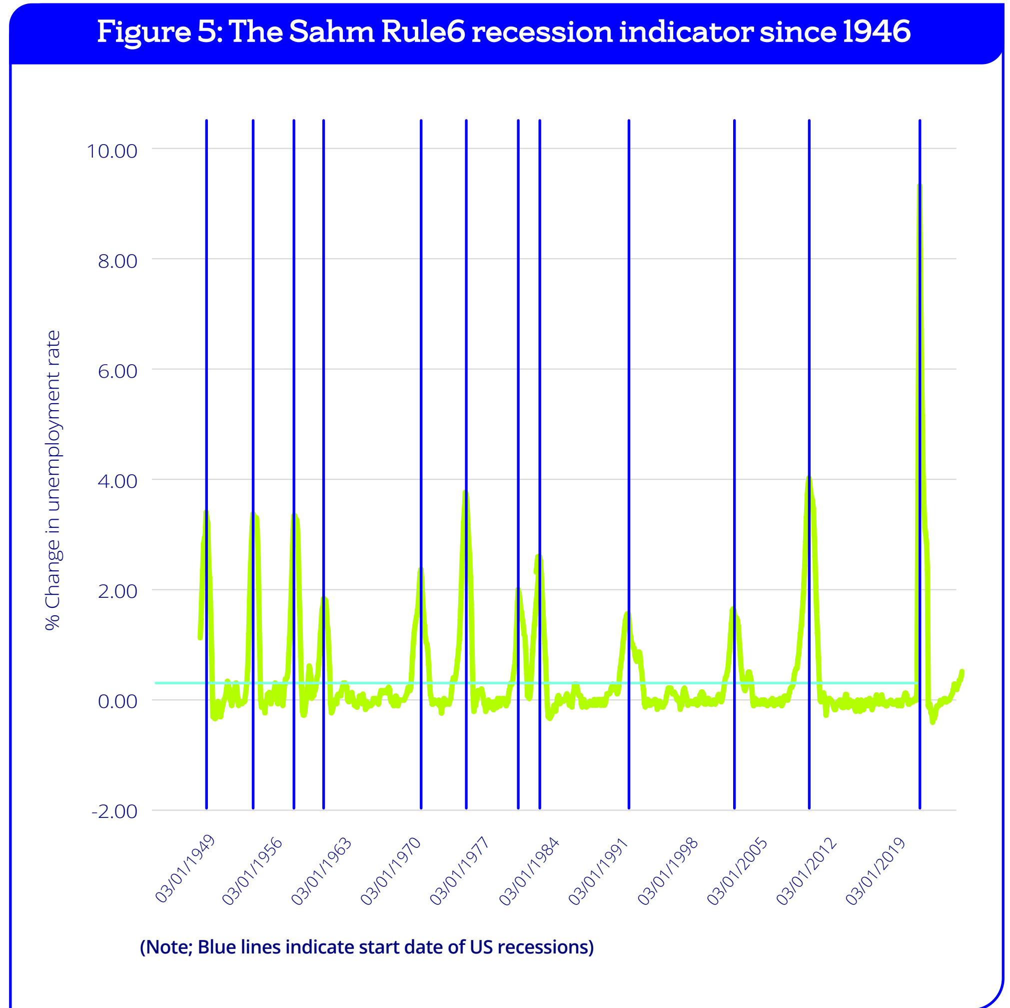
Markets are also currently focused on a series of more technical economic indicators which historically have given signals that a US recession was imminent. Two have garnered particular attention:

1. Whether longer dated bond yields*** will go higher than their shorted dated counterparts (the so-called "normalisation of the yield curve.")
2. The pace of US unemployment increases.

Both indicators have reached levels that suggest there is a US recession imminent. This latter indicator, called the "Sahm rule[6]" (see Figure 5), has predicted 100% of US recessions since the second world war. That's not to say it will repeat but it has garnered quite a bit of attention in financial media recently.

In addition, we have seen measures such as the US savings rate, credit card delinquencies and multi-family apartment delinquencies rise significantly[7] all of which suggest a slowdown and possibly recession is now more likely.

Figure 5: The Sahm Rule6 recession indicator since 1946



(Note; Blue lines indicate start date of US recessions)

Source: Federal Reserve Economic Database (FRED) September 2024

*** Yield refers to the earnings generated on an investment, expressed as a percentage of either the current value of the security (as is the case here) or the face value of the security.

6 Source: The Sahm rule signals the start of a recession when the three-month moving average of the national unemployment rate rises by 0.5% or more relative to the minimum of the three-month averages from the previous 12 months. The rule is named after economist Claudia Sahm who worked at the US Federal Reserve and the White House.

7 Source: Bloomberg/NBER 02.09.24

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August in review

Catalysts for recovery

In the days after the rapid early August sell-off, the market recovered quickly in part because of the belief that the Yen carry trade-related selling was over. In the weeks that followed, data about the economy and increased certainty about how central banks are now positioning themselves led to a V-shaped recovery. As a result, markets managed to finish August near the all-time highs set in July (although early September has been somewhat weaker again).

1 The Bank of Japan (BoJ)

Bank of Japan Deputy Governor Uchida, in the aftermath of the August 5th sell-off indicated that they would not be raising interest rates again while markets were unstable. This statement appeared to calm markets, at least for a short while. However, when the BoJ published the minutes of their July meeting, there was further confusion. The minutes indicated they intended to bring about a number of rate hikes to keep inflation from over-shooting. It appears in the near-term that this risk may have faded but there will be more from the BoJ to contend with at some point.

2 Hardening of interest rate cut expectations

US

Weak US labour market data was met by the market belief that the Fed would now be likely to increase the pace of interest rate cuts.

By the start of September, the belief was that up to circa (c.) 1.25% in interest rate cuts would happen in the US before the end of 2024 – meaning the market is expecting at least one of the cuts to be a 0.5% cut. This again looks ambitious and could disappoint.

Eurozone

Renewed weakness in the eurozone, particularly in the German economy, whose manufacturing sector is struggling more than anticipated, has also made the path to rate cuts more straightforward for the European Central Bank (ECB).

On September 12th, the ECB cut interest rates by 0.25% as expected. The expectation is that they will make further cuts in December, with a chance that they could also cut in October[8] (see Figure 6).

[8] Source: Bloomberg 12.09.24

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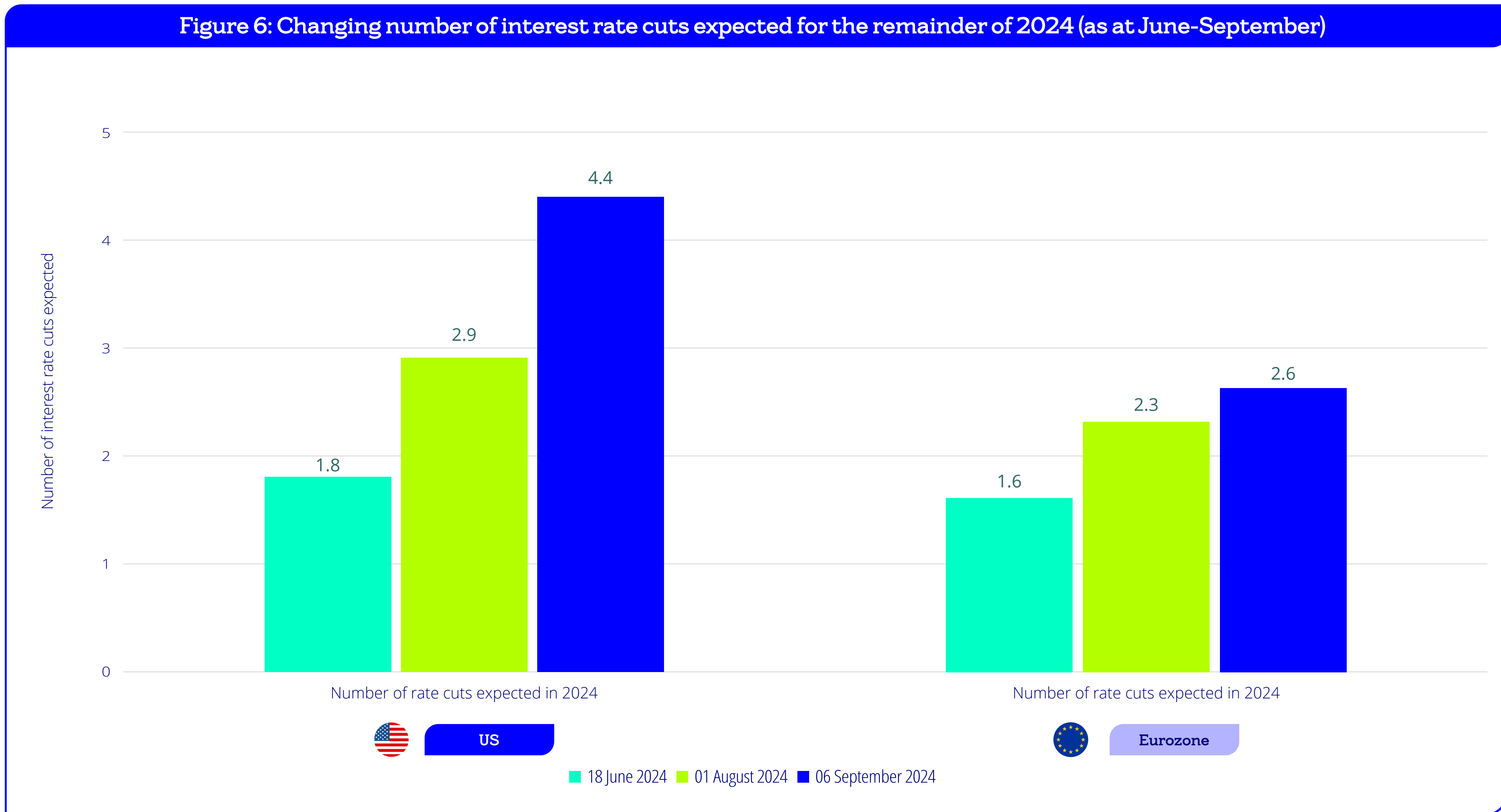
August in review

2 Hardening of interest rate cut expectations (Cont'd)

Figure 6: Changing number of interest rate cuts expected for the remainder of 2024 (as at June-September)



Source: Bloomberg 06.09.24

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August in review

3 Liquidity and "buying on the dip"

The mood in markets over recent months has been "risk-on" based on a belief that a soft-landing would be engineered by the Fed in the US and that company earnings would continue to grow.

Equally, despite the interest rate rises of the past couple of years, liquidity* has remained abundant. That risk-taking mood music resumed very quickly after the early August blip with some commentators suggesting the Yen carry trade was quickly being resumed[9] as (mostly institutional) investors "bought on the dip".

4 US economic data

As highlighted, most forward-looking indicators for the US economy are suggesting a slowdown is coming. The speed and depth of decline and whether it reaches a recession is what will be at the heart of the debate and the labour market will be the critical determinant of this. But it's not happened yet and the US economy has proven a great deal more resilient than most expected throughout this year.

- This was repeated again in the latest US economic growth data, published in August, which was revised up for Q2 2024 to 3.0%, 0.2% higher[10] than the previous estimate. This primarily reflects a large upward revision to consumer spending. However, this should be read with caution as the US consumer, having depleted their Covid-19 savings and spent a lot on credit cards, will have to rein this in later this year.
- The so-called GDI indicator ("Gross domestic income"), a measure of a nation's economic activity based on money earned for all goods and services produced during a specific period, grew at a more modest 1.3%, a pace more consistent with a cooling in the labour market[11].

* Liquidity is the ease with which an asset, or security, can be converted into ready cash without affecting its market price.
[9] Source: City Index 08.08.24
[10] Source: Bloomberg 02.09.24
[11] Source: Bloomberg 29.08.24 "Second quarter GDP overstates momentum in US economy"

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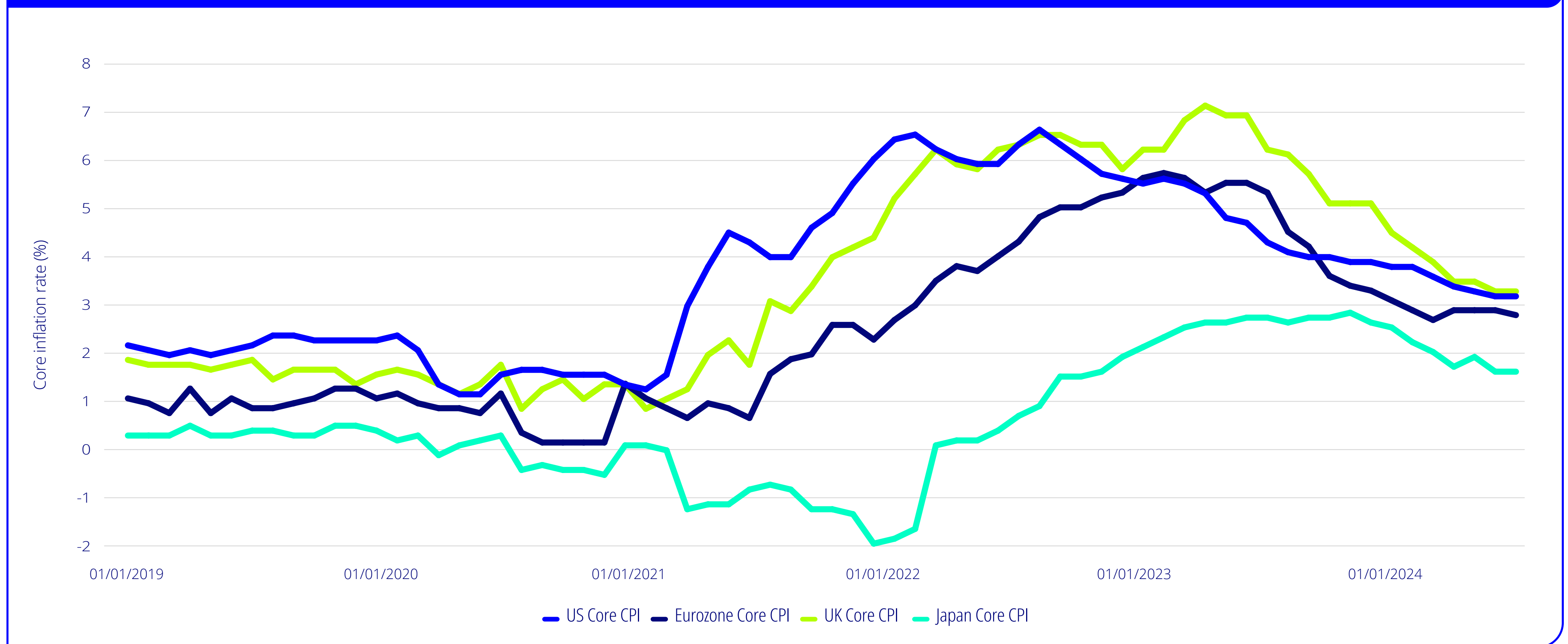
August in review

5 Inflation

For a long time, inflation has been the number one problem for households, central banks and markets.

- The eurozone ('Flash estimate')* data for August showed headline inflation had fallen to 2.2%, considerably lower than the 2.6% of just a month before[12]. Core inflation, which excludes energy and food prices, eased to 2.8% after three months at 2.9%.
- In the US, the Fed's preferred measure of inflation, the Core Personal Consumption Expenditure ("PCE") index, rose by 2.6% y/y for July (see Figure 7).

Figure 7: Core inflation in major developed economies



Source: Bloomberg 02.09.24

[12] Source: Eurostat 02.09.24

* An early estimate for an economic variable of interest over the most recent reference period.

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August in review

6 Q2 2024 company earnings

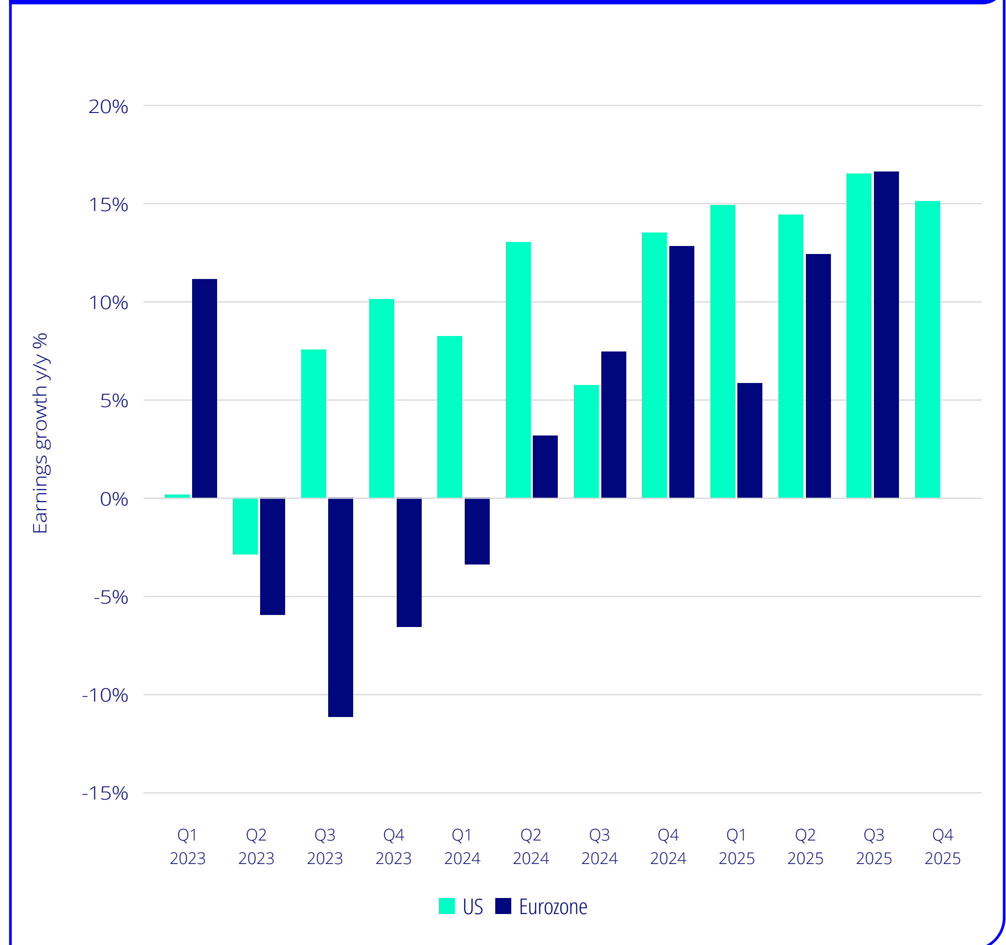
Another factor that remains stubbornly supportive of the equity market and returns is what's been happening with US company earnings.

- Q2 2024 results for the Magnificent 7 may have created new concerns for markets, but the wider picture remained very solid.
- For the S&P 500, earnings growth stands at 13% y/y, and with 493 companies having reported, 79.3% have beaten expectations, (which is considerably ahead of the long term average of 66%).
- Revenue growth was however more modest at 5.5%[13].

Looking out over the next few quarters, there has been a slight revision for the coming six months, but after that expectations have been upgraded and continue to strengthen (see Figure 8).

The eurozone was a little less impressive with 52.8% of European companies beating expectations so far (compared to a long-term average of 54%).

- Revenue in Europe has grown by 3.1% y/y.
- Expectations for European earnings growth are for an improvement into the rest of 2024 (see Figure 8).



Source: LSEG I/B/E/S 30.08.24

[13] Source: US Bureau of Economic Analysis 02.09.24

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August in review

7 Annual Jackson Hole Economic Symposium

Governor Powell's speech at the Fed's annual "think-in" at Jackson Hole (23.08.24) marks an important pivot in US monetary policy.

As was anticipated, he announced "The time has come for policy to adjust"[14] i.e. interest rates would be cut in September even if he didn't give away the extent of cut. That much was fully anticipated by markets and any less would have result in another sell-off. So no surprises there.

He also gave a much more detailed insight into the Fed's thinking about the US economy, in particular how they view what's been happening in the US labour market. The pivot that the Fed is now making is to focus on the other part of its mandate, namely maintaining full US employment. Markets will now begin to pay a lot of attention to labour market data.

Some commentators have argued that the rise in unemployment, now at 4.3% in the US (see page 7 & 8), is a precursor to a recession, as it has been so many times in the past. Governor Powell's speech suggests otherwise.

Governor Powell & US employment

Essentially the Fed's argument is that if the Fed begins to cut interest rates, they are normalising policy settings rather than responding to an imminent threat of recession. The Fed offers three reasons behind this:

1. The US has seen a rising labour force due to the return to work from the Covid-19 pandemic as well as net immigration. While acknowledging that the labour market has "cooled significantly from its previously over-heated state"[16], rising unemployment has not been due to elevated layoffs but to a substantial rise in the supply of workers and to a drop in the "previously frantic pace of hiring"[15].
2. Covid-19 pandemic-related distortions to supply and demand, as well as the impact of the war in Ukraine on energy markets, are now fading.
3. Inflation expectations, known to be a factor in how inflation actually plays out, have returned to close to normal levels and no longer present a threat.

He went on to indicate that "it seems unlikely that the labour market will be a source of elevated inflationary pressures anytime soon. We do not seek or welcome further cooling in labour market conditions"[17].

For investors, there are important implications. Firstly, if the Fed's assessment of the US economy's resilience is correct, then the soft-landing scenario will play out AND we will see interest rate cuts. Secondly, if they are overly optimistic and unemployment does rise faster than they imply, their focus on the supporting the labour market suggests that they will cut further than the market now expects.

[14] Source: LSEG I/B/E/S 30.08.24
[15, 16 & 17] Source: US Federal Reserve 23.08.24

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Kevin's Outlook

The contrasting influences that have been behind the volatility in August are likely to persist in the months ahead.

To take a positive view

- Economic growth in the US has continued to hold up, despite so much that could have de-railed this. Eurozone growth has been weaker, but it hasn't dropped into a full blown recession.
- Despite the fact that the Magnificent 7 strength is weakening, overall their earnings have been better than expected.
- Rotations to under-appreciated parts of the market may happen (value stocks, small cap companies, etc).
- Demand for AI continues to be insatiable.
- Inflation is nearing the policy target level of 2%, meaning a pivot is underway in monetary policy.
- The long-awaited interest rate cuts have begun in Europe and are on the way imminently in the US.
- Usually interest rate cuts are used to fix a downturn but to judge by the Jackson Hole speech, the Fed views rate cuts as a normalisation of policy against a backdrop of a soft-landing in the economy.
- Bond markets are likely to make further gains amidst falling inflation and interest rates.
- Middle East tensions have not accelerated into a wider regional conflict.

To be more sceptical

- The US consumer, which has been behind the continued growth, is running out of ground as savings and credit cards can't indefinitely support spending in the months ahead, especially if unemployment does rise.
- Eurozone economic growth remains weak, especially in Germany.
- AI is absorbing much more capital than was first envisaged and markets have grown sceptical of future returns.
- US unemployment is rising at a pace that is consistent with recession happening.
- The US bond market is signalling a recession.
- Earnings growth looks very rosy, set against a recessionary backdrop, this could disappoint.
- The US dollar is weakening as markets see a difference in the pace of US rate cuts compared to other developed economies.
- US elections, amongst many others, present an uncertain political backdrop.
- Of course, Middle East tensions could accelerate with the impact on energy markets in particular.

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Kevin's Outlook

Conclusion

- On balance, having seen a period of very strong gains in equity markets, right now may be a period of consolidation, where we see further bouts of volatility as the market settles on which of the afore-mentioned sets of arguments gains the upper hand. To judge by market movements in early September, concerns about recession, at least for now, have been gaining the upper hand.
- An economic slowdown looks inevitable, although it seems improbable that a deep recession will occur given how much interest rate firepower central banks can use, if so required.
- The market is taking time to move on from the Magnificent 7 as a key driver but this will likely result in a rotation elsewhere in the market – that may be other parts of the tech industry but it's just as likely to be in underappreciated value stocks or other regions of the world that are cheap by historic standards.
- Bond markets have weathered the recent bout of volatility well and have been a solid diversifier for returns this time. There is probably more to come as the interest rate cuts go from probability to a reality.
- So we see this as a time to be conservative as risk-reward trade-offs look slightly less appealing than they did twelve or even six months ago.

As always, we encourage you to talk to an Advisor before making any change to your investment portfolio.

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Performance table

Table 1: 5 year historic performances

	2019	2020	2021	2022	2023
Global equities	29.0%	6.7%	27.5%	-13.0%	18.1%
US equities (S&P 500)	33.9%	8.7%	38.2%	-13.0%	22.2%
European equities (Stoxx 600)	28.0%	-1.4%	25.8%	-9.9%	16.6%
Emerging market equities	21.8%	9.1%	4.9%	-14.9%	6.6%
Global bonds	5.4%	4.9%	-2.6%	-15.1%	4.5%
US government bonds	11.4%	8.3%	-2.0%	-12.5%	5.8%
European government bonds	6.9%	4.3%	-3.7%	-18.4%	7.2%
Emerging market debt	14.5%	-3.4%	6.4%	-9.8%	5.4%
Broad commodities	7.9%	-13.1%	37.0%	20.7%	-10.9%
US corporate bonds	11.2%	7.8%	-1.9%	-17.1%	5.8%
European corporate bonds	6.3%	2.4%	-1.2%	-14.0%	8.4%
French government bond aggregate	5.4%	4.5%	-4.1%	-19.0%	6.5%
German government bond aggregate	3.0%	3.0%	-2.7%	-17.8%	5.6%
NVIDIA	80.5%	104.2%	142.1%	-47.1%	228.2%
Magnificent 7	57.7%	102.2%	62.7%	-41.9%	100.4%

Source: BOI Investment Markets/Bloomberg, 04.09.24.

For more information:

boi.com/marketwatchupdates

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