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In this week's update, Kevin Quinn discusses:

- Japan & the background to the carry trade unwind
- European Central Bank (ECB) interest rate cut
- US, German & French inflation
- UK & Japanese gross domestic product (GDP)
- The US presidential debate
- Apple & UniCredit S.p.A
- Chinese exports

Latest update from markets (to 12.09.24)

	1 week	YTD
Global shares	1.5%	14.4%
US shares	2.2%	18.7%
European shares	0.0%	10.1%
European government bonds	0.5%	1.8%
Global commodities	1.0%	-2.9%
Magnificent 7*	3.5%	37.4%

Source: Bloomberg, 05.09 to 12.09.24. All returns expressed in euros.

*Apple, Alphabet, Amazon, Meta, Microsoft, NVIDIA, and Tesla.

The long and short

Investing requires a long-term focus but shorter term events can take most of our attention. In this series of updates, we place current events into a longer term perspective.

The long...

Japan, inflation, interest rates & the carry trade

Japan was once a colossus in global equity, fixed income and real estate markets. Rooted in the 1980s boom and its much vaunted productivity, the Imperial Palace was once worth more than the whole of California. The Japanese business model was studied in western business schools and in here in Dublin, in the very early days of my career at an asset manager, I recall the Japanese equity analyst at the firm explaining to me why "Japan was different".

At its height, the equity market accounted for circa (c.) 50% of the value of global equities and 15 of the 20 highest value companies globally were Japanese¹. The Bank of Japan (BoJ), in an effort to control speculation and inflation, raised interest rates, sparking a sell off in Japanese assets, and a banking crisis. This was followed by a deep crash in the 1990's from which it would take Japan's market 30 years to recover. Since then, the economy stagnated despite central bank's efforts to stimulate via an unprecedented level of quantitative easing*, including negative interest rates. As its economy stagnated, so too its share of world stock markets declined down to about 6%.

Over the last couple of years, at least for Yen denominated Japanese investors, the Tokyo equity market has been a more profitable place to be. Since January 2022, Japan's equity investors saw gains of 23.4% per annum (p.a.) compared to 17.3% p.a. for the world equity market. For overseas investors exposed to the weakening Yen, the journey has been far less pleasant with euro denominated returns dropping to 15.1% p.a. for the same period.²

Japan's long-standing deflation problem, which had kept interest rates at a negative level for many years, finally broke in September 2021, and the BoJ has been unwinding its unconventional monetary policy since then.

Why all of this is relevant to today's situation is the "Yen carry trade", a practice amongst many, particularly hedge funds, to borrow in Yen because of its low interest rates and use the proceeds to purchase higher yielding assets such as US Treasuries or higher performing assets such as Tech stocks.

With the BoJ's surprise decision in August to raise interest rates, the carry trade began to unwind. Margin calls by brokers had to be met by asset sales by many. The most liquid and most traded assets such as the Magnificent 7 were first in the queue to be sold, leading to the downturn in August. Japanese markets were hit hard by the unwinding of leveraged positions and carry trades. On 05.08, the TOPIX lost 12% and the Nikkei volatility index spiked to a level typically seen only during crises. Losses and volatility spread to other markets through the day. The Eurostoxx fell by 1.7%; the S&P 500 lost another 3.0%; the MSCI Asia Pacific Index saw its worst drop in a year; meanwhile in off-hours trading, the VIX spiked to levels above 60. In Japan, bank and insurance company stocks were hit especially hard. Markets then stabilised almost as quickly. By 09.08, the S&P 500 had recovered all the losses incurred since 05.08, while the TOPIX had recovered most of them, and the VIX receded to much lower, albeit still somewhat elevated levels.²

The scale of the Yen carry trade is largely unknown. The Bank for International Settlements estimate that there is about a \$0.5 trillion in cross border loans originating in Japan³ while Reuters suggest⁴ its twice that scale J.P Morgan estimated that about 50-60% of the carry trade had been unwound during early August.

* A form of monetary policy in which a central bank, purchases securities in the open market to reduce interest rates and increase the money supply.

Source¹: Schroders "Back in vogue; Japan's stock market renaissance" August 2024

Source²: Bank for International Settlements "The market turbulence and carry trade unwind of August 2024"

Source³: Reuters 09.09.24

Source⁴: Bloomberg 06.09.24

The short...

Market news



ECB interest rate decision saw interest rates cut again by 0.25%, in line with market expectations. This much anticipated move comes on the back of headline inflation in the eurozone falling to 2.2% in August. Following the ECB press conference (12.09), markets reduced expectations of a cut in October although expectations remain that there will be a further cut in December.



US inflation saw headline CPI (consumer price inflation) drop to 2.5% year on year (y/y) the fifth straight month that the annual measure has eased, influenced by a fall in energy prices. However, in the first "upside surprise" since March, Core CPI, which excludes energy and food, rose to 3.2% y/y, which is dampening expectations around the September interest rate cut being more than 0.25%. Equities reacted negatively as it was seen to reduce the odds of a 0.5% cut happening next week. The swaps market also reduced the chances of a 50 basis points (bps) cut on the news.



US Presidential debate has been largely seen as a victory for Kamala Harris as she baited former President Trump into defending his felony convictions, his wealth and his role in the change in abortion rights in the US. The former president who had been clawing back previous gains by Harris in polls may have lost ground again, but the election still remains highly dependent on a small number of swing states.



Apple lost its court battle over a €13 billion (bn) tax bill in Ireland following the EU Court of Justice's backing of a 2016 decision that Ireland broke state-aid law. This follows a lower court ruling in 2020 that had overturned that decision.



UniCredit S.p.A has built a 9% stake in German lender Commerzbank making it the second largest stakeholder behind the German state, which has announced plans to exit its holding. As UniCredit already owns HypoVereinsbank, any takeover of Commerzbank would make the Italian lender a powerful force in European corporate banking.



UK GDP monthly growth stalled in July for a second month, versus an expected 0.2% growth. This comes on the back of very strong growth in the first 6 months.



Japanese GDP grew at 2.9% p.a. in Q2, slightly below the government's initial estimate, while still advancing enough to keep the Bank of Japan on track to raise interest rates later this year.



Chinese exports grew at 8.7% y/y to \$309bn in August for the fifth straight month. In contrast imports inched up just a 0.5% to \$218bn, leaving the country with a widening trade surplus, up 34% on a year ago.



German inflation (preliminary readings) have come in at 1.9% p.a. for August with energy prices down 5.1% while prices for services remained higher at 3.9% compared to last year. It's the first time in three years that inflation has fallen below the target 2%.



French inflation dropped to 2.2% in August from 2.7% in July, largely due to lower energy prices, although this too was offset by rising services prices.

Source: Bloomberg 09.-12.09.24

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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%
Russell 2000	28.9%	9.8%	26.3%	-17.0%	13.2%
Magnificent 7	57.7%	102.2%	62.7%	-41.9%	100.4%
Unicredit	34.5%	-41.3%	79.6%	3.7%	94.8%
Apple	92.7%	67.5%	44.6%	16.2%	44.2%
Commerzbank	-1.8%	-4.6%	27.0%	32.1%	24.4%

Source: Bloomberg 12.09.24. All returns expressed in euros.

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Warning: If you invest in these funds you may lose some or all of your investment.

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