August 14, 2024

Taking stock on the recent market sell-off

Following the market meltdown that occurred at the beginning of August, we wanted to provide a recap of events for our clients and outline how we approached the situation.

WHAT HAPPENED?

The turmoil originated in Japanese markets. With the yen continuing its rebound against the dollar, reaching around 13% of its July low, Japanese equities underwent a significant and ferocious correction. The currency's sharp appreciation did not only affect the domestic stock market, but it rattled global markets, as it upset countless investment strategies based on the Yen carry trade [1]. The acceleration of movements continued to take investors by surprise, hurting everyone from small stock and currency traders to large hedge funds and institutions. Investors essentially judged that the Bank of Japan had made a historic policy mistake after it surprised the markets with the level of firmness with which it raised rates on July 31.

Across the Atlantic, developments in the US economy added to fears. Until recently, incoming data suggested that the so-called soft landing scenario was playing out. Inflation appeared to be cooling while activity was holding up. However, a weak nonfarm payrolls report coupled with a bleak ISM manufacturing PMI, lathered up fears that the Fed might be behind the curve and the US economy could be heading for recession.

What's more, some booming stocks ran out of steam because while company earnings were good, they were not good enough to overcome the high hurdle set by expectations. Investors began to question how and when companies will monetise huge investments in AI.

Low summer liquidity also exacerbated market movements.

OUR INVESTMENT STRATEGY

- We entered this storm with an underweight position in Japanese equities, having reduced exposure mid-July following a 23% rally over 2024.
- In July, we had also reduced portfolio risk by cutting high-yield bond exposure and reinvesting the proceeds in Treasuries.

Our balanced allocation between equities and bonds, which favours quality over risk, meant that we were not overly affected by the market decline, although it did not prevent us from giving up some of the returns generated in the previous quarter.

On August 6th, we decided to use the sell-off as an opportunity to add further equity exposure in the High risk profile, bringing the overall weight to 90% (achieved by increasing US and European exposure by 3.5% each).

WHY DID WE DECIDE TO ADD EQUITIES?

Markets reacted strongly to recent US macro data and fears of an imminent recession were heightened. These fears appear to be misplaced. The rise in unemployment in July was largely attributed to an increase in labour supply, as reflected in the higher participation rate. The report also showed a significant number of temporary layoffs, which could potentially be reversed in the coming months, keeping the employment-to-population ratio stable, especially for prime-age workers.

While we believe economic growth is likely to slow, it is unlikely to contract sharply as fundamentals and corporate balance sheets remain resilient. In our view, the market reaction was overdone, exacerbated by the usual summer liquidity squeeze and the impact of the yen-funded carry trade.

We expected the market to normalize, although volatility is likely to remain. Indeed, since the trough, the S&P 500 has rallied by over 4% and the Topix by over 14%.

The Fed is expected to start cutting rates in September, equity valuations have come down significantly, and corporate earnings remain resilient. This combination should support equity markets in the last part of the year if our macro scenario is correct.

We stick to our mantra of staying invested for the long-term, not being afraid of short-term volatility and focusing on macro and micro fundamentals.

[1] The carry trade is a financial strategy where investors borrow Yen, which typically has a low-interest rate, and then use it to buy assets in US dollars or other currencies offering higher yields.

Data as of 13/8/24

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