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Reality check? Why markets are reassessing risk

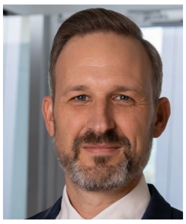
Global markets were looking for weaker US data to justify rate cuts by the Federal Reserve. But when faced with the reality of weaker numbers – in the form of Friday's US jobs report – they took fright. It comes amid overall tech sector weakness that the Bank of Japan's rate tightening did nothing to alleviate. While the sell-off may be overdone in the medium term, investors will want to adjust for the fall-out.

Several factors conspired to spark a major sell-off in Japan. While these factors may not be wholly related, any market reaction can become self-fulfilling following a strong recent run in markets and amid a low-liquidity environment during a vacation month. In addition, sudden spikes in volatility from ultra-low levels will force certain risk-based investors to retreat.

We think these are the factors to watch:

- The US jobs report released on 2 August showed an unexpected uptick in unemployment – but we don't think the data makes a US recession inevitable. In our view, the report further reduces the probability of a so-called no landing – where the economy continues to expand despite the central bank's best efforts to dampen inflation – and increases the chances of either a soft landing or recession. Our base case scenario for now remains a soft landing, but we remain cognisant of the risk of recession. Some investors were not positioned for the probability of recession (as evidenced by recent ultra-low volatility) and recent market activity signals a healthy reassessment of the outlook. The reassessment of risk helps explain why the VIX index, known as Wall Street's "fear gauge", reached its highest level since 2022.

- The lack of supportive news from China's recent Third Plenum – a five-yearly deep dive on social and economic policy – also reinforced a less certain outlook. While the declaration alluded to measures to support consumption, there were few details.



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Navigating Rates

- On the face of it, the latest US data supports rate cuts by the US Federal Reserve (Fed) – all things considered, a positive for markets. In this environment, however, bad news is now bad news. Markets are ignoring – at least for the moment – the potential for good news in the form of impending rate cuts and lower inflation risk. Even so, we will be watching any US data for confirmation that our soft-landing scenario remains in place and the probability of a recession is under control. While "micro" data on the US consumer is not especially good (travel, restaurants, etc), it is not dramatically poor. In fact, it fits rather well with a controlled slowdown of the US economy. Even with Friday's data, US unemployment remains at a very low level. If we see further negative data, a larger reallocation from equities to bonds might take place, but after a recent yield rally the potential seems limited.

- Reported earnings by the Magnificent Seven tech stocks were not that bad – the problem is that expectations were high. Indeed, a Bank of America survey pointed to very long tech exposure by market participants, and so short-term profit taking is normal. We think the long-term investment case for tech remains in place, amid an AI revolution and digital Darwinism.

- In our view, the most critical – and potentially overlooked – factor impacting global financial stability is the Bank of Japan's decision last week to raise its key interest rate. Many investors were using JPY for financing/carry due to the currency's predictable volatility. The bank's unexpected intervention effectively "broke" these trades and the result is large reallocations by investors closing them out. Beyond the Japanese equity market, this shift will also likely impact emerging markets such as the Mexican peso and could also partly explain Nasdaq weakness.

How should investors respond?

Even if we are seeing a market reaction to weak data – rather than any strong shift in fundamentals – investors will need to consider the implications of this environment:

- With the correction overdone, and an appreciating currency, we think it is too late to reduce Japan equities. Rather, the question is whether to add to the yen as a safe haven, if further appreciation in the currency sparks more market volatility.

- On US equities, we favour only modest long positions in our fundamental multi asset portfolios and will be watching for the next US economic data and, of course, the path of the US elections.

- Any further rally in yields will depend on US economic news in the longer term. Yields could undershoot in the short term if market uncertainty persists due to equity market reversal and the fact that many investors are still long cash and neutral bonds. In our view, curve steepeners should be kept in place for the time being.

- Watch credit markets. While the Fed is likely to be relatively sanguine about equity market volatility – which is part of its financial model – it is more likely to step in if credit markets appear vulnerable. This action would likely take the form of other types of market intervention rather than a rate cut between meetings.

- The US dollar could weaken further if the Fed cuts an anticipated 100bps in 2024, which is also a critical factor for emerging market debt. The latter could also have trouble digesting the latest news from China.

Bottom line: longer-term investors currently on the sidelines will likely want to wait several days before seizing the opportunity to re-enter as forced selling could continue on rising volatility.

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