ACG Insights: August 2024 Market Volatility

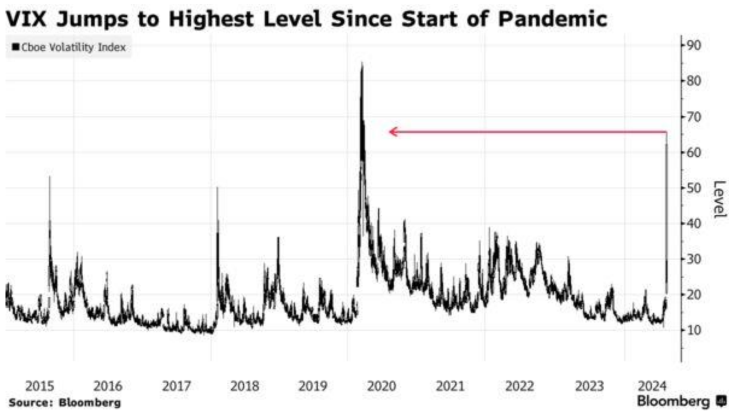
Executive Summary

- **Multiple factors coalesced during the first few days of the month to send markets across the globe into turmoil.**
- **The Fed signaled a willingness to begin cutting rates in September, but market participants are beginning to wonder if they are behind the curve.**
- **Markets in Japan sold off significantly as their central bank decided to raise rates and the "carry trade" of borrowing Yen to buy higher-yielding currencies began to unwind.**
- **Geopolitical instability has spooked the markets with uncertainty around the timing and scale of Iran's likely response to Israeli actions against Hamas and Iran's proxies.**
- **Despite volatility, the U.S. economy and corporate earnings remain on solid footing.**

Equity Volatility

After a red hot first half of 2024 and a positive month of July, equity markets quickly became volatile in the first few days of August. A confluence of events all seemed to capture investor attention in the span of a few days, as the VIX index rose to the highest level since the pandemic in 2020 (Exhibit 1).

Exhibit 1: VIX Index[1]

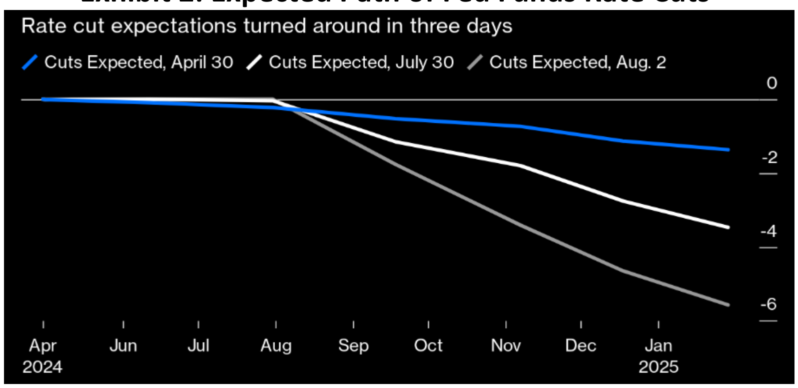


[1] Source: Chicago Board of Options Exchange, Bloomberg

The Fed and the Economy

The Federal Open Market Committee (FOMC), which sets Fed policy rates, met in July and signaled that they are getting closer to achieving their inflation targets. The market reacted by pricing a first rate cut by September. Then, the employment report from Friday, August 2nd showed the unemployment rate continuing to trend higher and a smaller-than-expected increase in non-farm payrolls. Market participants interpreted the data as a sign that the economy is slowing more than expected, and that the Fed may be too late in cutting rates to head off deterioration in the job market. By the time the weekend hit, market implied rate cut expectations were predicting multiple Fed cuts in excess of the standard 25 basis points (Exhibit 2).

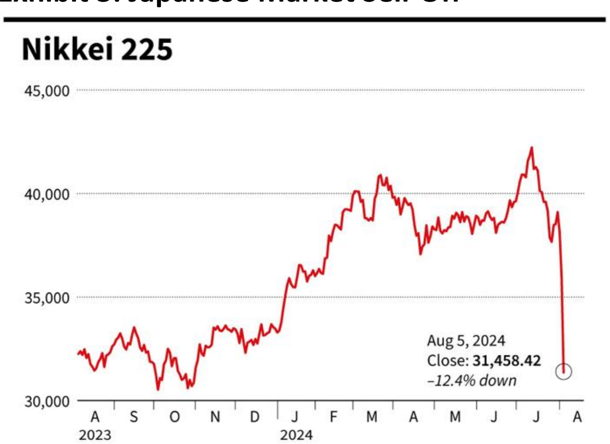
Exhibit 2: Expected Path of Fed Funds Rate Cuts[2]



Japanese Yen and The Carry Trade

Many investors have been participating in the so-called "carry trade." The carry trade occurs when an investor borrows the currency of a country where interest rates are low, like Japan, and uses it to invest in a currency where interest rates are higher, like Mexico or Brazil. Typically, this trade yields a consistent small risk premium. Because the risk premium (or yield carry) is so low, these types of strategies are often implemented with a great deal of leverage.

Exhibit 3: Japanese Market Sell-Off[3]



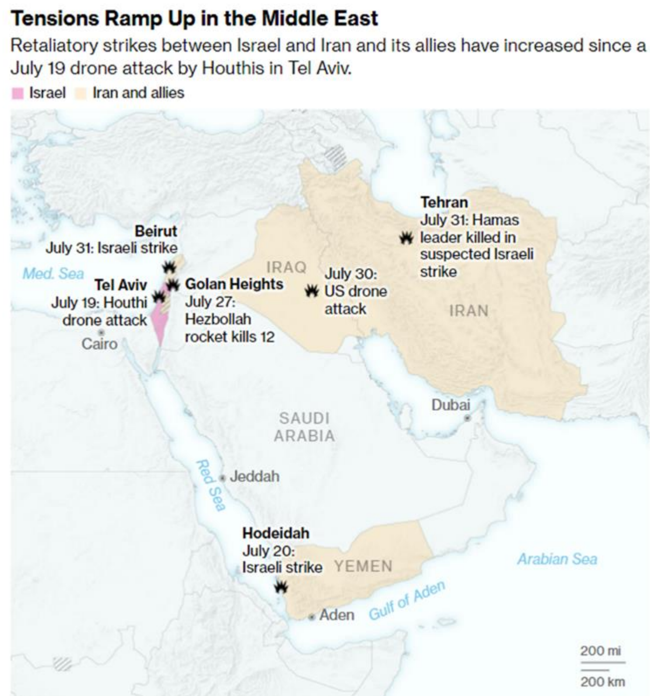
When the trade is working this helps boost yield or return. When the trade goes the other way and investors must unwind the trade, it can lead to outsized volatility due to the leverage. As investors unwind the trade, they are forced to buy the low yield currency and can exacerbate the issue as they simultaneously run for the exits. The carry trade works when rates on the borrowed currency are low. The Bank of Japan, however, recently hiked rates at a time when the U.S. Federal Reserve is looking to cut. A strengthening Yen as traders covered short positions set off a cycle of selling in Japanese equities that saw the Nikkei 225 down more than 12% on Monday alone (Exhibit 3).

[2] Source: Bloomberg
[3] Bloomberg

Geopolitics

In addition to the market-based stress currently taking hold, geopolitics has added an additional layer of uncertainty that markets tend to hate. The ongoing conflict between Israel and Hamas is threatening to expand into a larger regional conflict, as Israel recently assassinated a Hamas leader within the Iranian capital city of Tehran. Iran has vowed some sort of retaliation as the U.S. and G-7 countries seek de-escalation. Markets have generally been quick to brush off tensions in the Middle East. This time will likely be no different from a market perspective, but any additional layer of uncertainty in a market that was priced to perfection can exacerbate selling pressure.

Exhibit 4: Tensions Rising in the Middle East[4]



Corporate Earnings

Stocks are subject to short-term noise and flashes of panic due to human nature. Over the intermediate and longer-term prices will follow corporate earnings. One of the big reasons for continued optimism, at least regarding the outlook for U.S. stocks, is that estimated earnings growth remains strong (Exhibit 5). Analyst estimates call for continued earnings growth for the S&P 500 through the end of 2024 and into the latter half of 2025. These estimates are obviously subject to revision and would be pressured if the economy meaningfully slows. For now, stocks have a strong support mechanism in strong earnings.

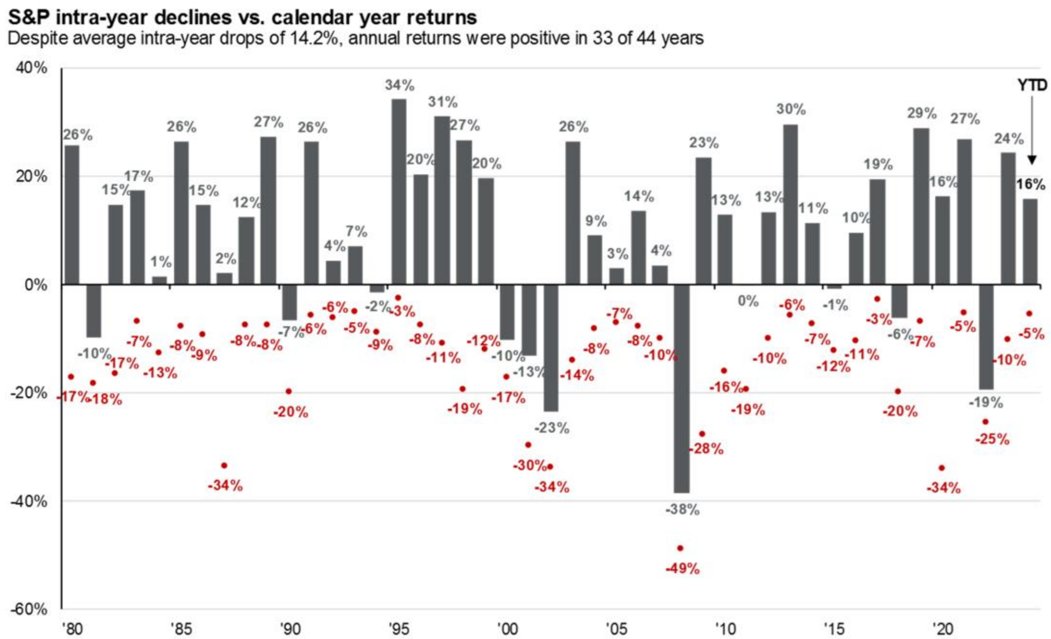
Exhibit 5: Corporate Earnings Estimates[5]

[4] Bloomberg
[5] FactSet

Conclusion

It’s always easy to find reasons to worry in markets. The past few days have seen more reasons than normal, in a market where there have been a few extremely successful trades that were possibly due for a pullback (Yen carry trade, AI/Tech stocks, for example). Whatever the reasons for the recent bout of volatility, the fact remains that investing can be a bumpy ride to get to an end destination. The chart below from JPMorgan shows some of the drawdowns that the S&P 500 endures year-to-year, even during strong performing calendar years. Almost every year sees a pullback of at least 5% and a majority of years see a pullback of at least 10% looking back through history. Volatility never feels good in the moment but is rarely, if ever, a reason to get out of the market.

Exhibit 6: Calendar Year Returns and Drawdowns[6]



[6] JPMorgan

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