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Hymans Robertson Investment Services (HRIS)

Market update – recent volatility

6 August 2024

- Asset volatility has increased significantly over the last week.
- Causes of this include a reduction in enthusiasm for AI-sensitive stocks, a stronger yen and weaker US economic data.
- The Japanese equity market and tech stocks globally have seen the most volatility.
- We believe this movement is a market overreaction and should ease.

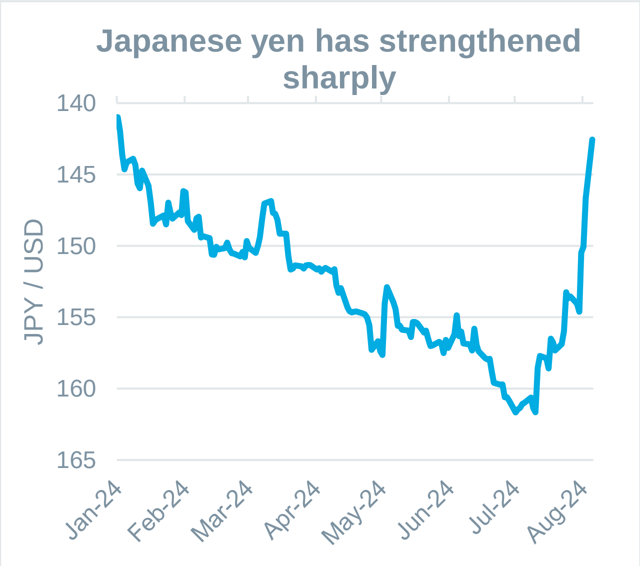
The last week or so has seen a pickup in volatility in markets with some asset prices falling as a result. As with most market selloffs, there is not one trigger, but a few interlinked dynamics and themes along with a shift in market sentiment.

Some of the contributing drivers include:

- A reversal of fortunes for AI-sensitive stocks.
- A Bank of Japan interest rate hike and accompanying strengthening of the yen.
- Weak US economic data.

First to AI. A large part of the equity market performance so far this year has been driven by the mega cap tech stocks commonly referred to as the Magnificent 7 (Apple, Microsoft, Nvidia, Amazon, Alphabet, Meta and Tesla) and other semiconductor producers. Most of the Magnificent 7 companies had earnings releases over the past two weeks and to say expectations were high is an understatement. The earnings data were mostly good but not amazing, which is what the market wanted, leading to hits to share prices. Nvidia in particular has been extremely volatile - last Tuesday it fell 7%, followed by a 13% increase and then another 7% decrease.

Secondly, there has been large swings in the value of the yen and Japanese equity prices. The Japanese stock market closed down 12% on Monday 5 August. The background to this theme is that, even as other central banks around the world have been rapidly hiking interest rates over the past two years, the Bank of Japan has kept interest rates rock bottom. This has caused the yen to tumble in value over the past few years, from around 110 to the dollar to 160 at the start of July, as other high-yielding economies have been a more attractive place for global capital. However, this has reversed dramatically over the past month or so and accelerated last week when the Bank of Japan raised rates for a second time to 0.25%. Yen-dollar is now around the 143 mark, around 9% stronger than a month ago. The rapid strengthening of the yen has hurt Japanese companies who tend to be quite export heavy. What might have exacerbated things for global assets is the unwinding of the "carry" trade. Here, investors have borrowed yen at cheap interest rates, exchanged them for dollars and bought higher yielding US assets. As the dollar falls and the yen rallies, investors will have to close out these positions, to avoid more losses, creating a rapid self-fulfilling selling cycle.



Source: Thomson Reuters

The third key trigger was a couple of weak US economic data points last Thursday and Friday. Firstly, the manufacturing PMI on Thursday. This is a survey of senior managers in the manufacturing sector which came in far weaker than expected, especially the employment part of the survey. The following day, unemployment data showed this increased 0.2% to 4.3% with separate data showing the US economy only added 114k jobs in July when 175k were expected. This sparked fears of a US economic slowdown and increased expectations of the Federal Reserve cutting interest rates fast. This weakened the US dollar further against the Japanese yen, feeding back through to the above theme.

Overall, after a lot of volatility, global equity markets were down 1.6% last week. However, the FTSE was down another 2.3% on Monday and the US market was down around 3%. The positive is that bonds, especially government bonds, are doing their jobs and dampening downside risk and portfolio volatility. Bond yields have been falling, pushing up prices, as investors rotate into less risky assets. Gilts returned over 2% last week. As part of our 2024 investment strategy review, we increased our duration i.e. the portfolio's interest rate sensitivity, to help support the portfolios under this kind of scenario. Japanese equities remain a fairly small allocation, around 3% for a medium risk portfolio.

There are reasons not to fear a prolonged selloff though. Yes, some parts of the AI market looked overvalued and was due a shakeout but most of the Magnificent 7 companies are well diversified across many products. The Japanese theme was quite a technical led selloff, driven by rapid changes to currencies, interest rate expectations and an unwinding of leveraged investors, as opposed to concerns over a fundamental weakness. With the US data, the couple of data points were weak, but these are just some data points in an otherwise strong looking (but yes, slowing) economy. At the moment, this looks more like a growth normalisation rather than a recession. Investors should remain calm at moments like these and assess the landscape for opportunities. It is also worth remembering how strong a rally we have seen over the past year, as of last Friday global equity markets were still up around 20% over the last 12 months.

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