Turbulence on the financial markets

On Monday, 5 August, the financial markets are experiencing severe turbulence, on top of last week's volatility, in both equities and fixed-income.

We see several reasons for this, ranging from worse-than-expected macroeconomic figures to an increasingly tense geopolitical context, to disappointing quarterly earnings reports in the case of companies heavily weighted in the world's indices.

But over the past two days, it has been the collapse in the Nikkei, the Japanese index, that has had market participants on edge.

The Japanese market has suffered a significant drop since the end of July, particularly during the session today, Monday, 5 August, in which the Nikkei 225 closed down by 12.40% at 31,458.42 points, and the Topix TOPIx lost 12.23%, at 2227.15 points. **This collapse was exacerbated by the surge in the yen and monetary policy adjustments**, which most likely led to massive unwinding of carry trades and panic selling, particularly in the most popular strategies. Banks and insurance companies, as well as industrial and tech stocks, were the hardest hit.

The carry trade is an investment strategy in which traders borrow money in a low-interest-rate currency (such as the yen) in order to invest in assets denominated in another, higher-interest-rate currency, the goal being to **exploit the interest-rate gap between the two currencies.**

Low interest rates in Japan and the ultra-accommodative monetary policy that the Bank of Japan's has stuck with for several years have encouraged some investors **to use the yen as a financing currency for these carry trades**, thus amplifying the downward pressure on the currency.

At the moment, several factors are disrupting yen-financed carry trades, thus pushing the markets downward:

- **The yen has surged** vs. the US dollar and other currencies.
- That means that **investors who borrowed in yen must repay their loans in a stronger currency**, thus raising their costs.
- This has **forced them to unwind their positions to cover their losses.**

The Bank of Japan recently raised its rates unexpectedly, while taking on a tone that the markets have deemed "hawkish"[1], regarding future key rate hikes.

This rate hike has made yen financing more costly and has flagged potential future monetary tightening, causing investors to unwind their carry trade positions.

The combination of the yen's gains and the rate hike caught many investors wrong-footed, triggering **panic selling amidst particularly imbalanced exposures**.

Investors are selling off their holdings to avoid greater losses, and that is exacerbating market drops. **The combination of these factors is exerting massive pressure on the financial markets**, causing rapid devaluation of assets and increased volatility.

Apart from the Japan factor, **investors' fears over the strength of US growth have undermined their confidence.** These fears were ratcheted up on Friday by a weaker-than-expected July jobs report. But the trend in both interest rates and equities was already being driven downward by mixed economic data and the tone of **central banks, who are preparing the markets for an initial rate hike September** in the case of the Federal Reserve, or that have already made an initial rate cut, like the Bank of England. Only the Bank of Japan, as we noted, is taking advantage of the domestic economic context to begin normalising its monetary policy. However, we mustn't overact to a single datapoint. Only broader weakness in the economy and/or a second weaker-than-expected jobs report could put bring back scenarios of more aggressive easing, such as a 50-basis point cut in September.

On the microeconomic level, US corporate earnings were mixed, revealing signs of weakened prospects. **In the euro zone**, second-quarter numbers were as expected, but **the second-half outlook is still uncertain.**

And, lastly, the geopolitical context is also undermining investor morale. **Recent events in the Middle East have revived fears** of a regional conflagration and involvement of the US, which is nonetheless doing all it can to avoid that scenario. Keep in mind that, for the moment, this concern is not priced into oil prices, which are focused more on the global economic slowdown.

Asset prices* are reflecting a typical risk-averse environment, in which government bonds outperform riskier assets significantly. Accordingly, the 10-year US yield fell by more than 40 basis points during the week, and German yields by about 25 basis points,

[1] Hawkish: this means a strict monetary policy in which the central bank raises interest rates to combat inflation

while US and European equity markets gave up between 2% and 6%, depending on the index. These declines are worsening, with the Euro Stoxx 50 closing down by 1.59%, the CAC 40 by 1.42%, and the S&P 500 at this writing down by another 2.55%, while the tech-rich Nasdaq had fallen by 3.04%.

* All data as of Monday, 5 August 2024