Market flash

5 August 2024

The Japanese market falls: what's going on?

The Japanese market has experienced a significant decline since the end of July, particularly during session on Monday, August 5, 2024, where the Nikkei 225 closed down 12.40% at 31,458.42 points, and the TOPIX dropped 12.23% to 2,227.15 points. This downturn is exacerbated by the rapid rise of the yen and adjustments in monetary policies, likely leading to massive liquidations of carry trades and panic selling, especially in the most popular strategies. Banks and insurance companies, as well as the industrial and technology sectors, are particularly affected.

This extreme volatility is mainly due to the rapid appreciation of the yen and adjustments in monetary policies, which have led to liquidations of carry trade positions, exacerbating panic selling in the markets. The main factors influencing the decline are:

Macroeconomic factors

➔ Strong and Rapid Appreciation of the Yen

The yen has appreciated significantly recently, gaining over 8% against the US dollar last month, and continued to rise significantly on August 5, 2024. This rise reached around 143.10 yen per dollar, putting considerable pressure on Japanese exporters and increasing volatility in the foreign exchange market.

➔ Interest Rate Hikes by the Bank of Japan

The Bank of Japan recently surprised markets with an unexpected interest rate hike, signaling a possible continuation of this policy.

This action increased investor concerns about financing costs and economic stability.

➔ Concerns about Global Economic Growth

- Global growth is slowing, particularly in China, where growth is forecasted at 4.5% in 2024, its lowest level since 1990 (excluding the COVID-19 period). This slowdown affects economies dependent on trade with China.

- Weak economic data in the United States, such as the drop in the ISM manufacturing PMI index to 46.8 in July (48.8 expected), have heightened fears of a recession. The unexpected rise in the unemployment rate to 4.3% has also contributed to economic uncertainty.

- The release of employment data last Friday* in the United States was a major catalyst, crystallizing growth fears and leading investors to abruptly revise their rate scenario from the US Federal Reserve. Rate cuts are now expected at upcoming Fed meetings, which has led to a new episode of yen appreciation, amplifying the snowball effect seen in previous sessions on the currency.

Liquidation of Carry Trade Positions

The carry trade is an investment strategy where traders borrow money in a currency with a low-interest rate (like the Japanese yen) to invest in assets in another currency offering higher interest rates. **The goal is to profit from the interest rate differential between the two currencies.**

The level of interest rates in Japan and the ultra-loose monetary policy of the Bank of Japan maintained for years have encouraged some investors to use the yen as a funding currency for these carry trades, thus amplifying the downward pressure on the currency.

The liquidation of yen-financed carry trade positions has led to panic selling. Investors had to sell assets to cover their losses, which exacerbated the devaluation of financial markets. Losses were amplified by the strength of the yen and rapid position adjustments.

Factors disrupting yen-funded carry trades:

- *Rapid Appreciation of the Yen*: The yen has significantly appreciated against the US dollar and other currencies. This means that investors who borrowed in yen must repay their loans with a stronger currency, increasing their costs. This situation leads to forced liquidations of positions to cover losses.

- *Interest Rate Hikes by the Bank of Japan*: Interest rates unexpectedly rose. Making yen financing more expensive and signaling potential future monetary tightening, prompting investors to reduce their carry trade positions.

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The combination of yen appreciation and rate hikes caught many investors by surprise, causing panic selling in a particularly unbalanced market context. Investors are massively selling their assets to avoid larger losses, which exacerbates market declines.

Stress situation on the markets

➔ Suspension of Futures

- Due to extreme volatility, Nikkei 225 and Topix futures were temporarily suspended, increasing investor panic.
- This measure aimed to stabilize the market but also highlighted the severity of the situation.

➔ Poor Performance of Key Sectors

- The banking and insurance sectors have suffered significant declines as of August 5,2024 , with examples like Chiba Bank (-21.12%), Tokio Marine Holdings (-19.70%), and Mitsubishi UFJ Financial Group (-19.43%).
- The industrial and technology sectors have also been heavily impacted, adding to market pressure.

➔ Panic Selling

- The rapid market movements caught many investors by surprise, causing panic selling.
- Investors have massively liquidated their positions, amplifying asset devaluation and market volatility.

A context of uncertainty prevails

➔ Geopolitical Tensions

- Conflicts in Ukraine and the Middle East continue to disrupt energy and trade markets.
- According to Brookings on January 17, 2024, an escalation in the Middle East could increase oil prices by 30%, which would have inflationary impacts and could weigh on global growth.

➔ Global Monetary Policies

- The tightening monetary policies of major central banks, such as the US Federal Reserve and the European Central Bank, have created stricter financial conditions.
- This increased volatility is due to uncertainty about future monetary policies and interest rate adjustments.

➔ Political Risks

- Uncertainty surrounding the 2024 US presidential elections adds additional risks to the markets.
- The policies proposed by the candidates could have significant implications for economic growth and fiscal policy.

➔ Financial Stress in Emerging Markets

- The rapid rise in global interest rates, the highest in 40 years, is putting pressure on developing economies and emerging markets.
- This financial pressure adds to global market instability.

In summary, a combination of geopolitical tensions, global economic concerns, restrictive monetary policies, currency market volatility, disappointing economic data, political risks, and financial stress in emerging markets has contributed to the sharp decline in financial markets.

The valuation of the TOPIX index has returned to levels observed during the first half of 2023, before the upward movement in the stock market began. It is now below the average observed over the past fifteen years, despite very different macroeconomic conditions (primarily the change in the inflation regime) and a deep reform of corporate governance. This likely reflects an excess of short-term pessimism, even though technical factors could continue to weigh on the Japanese stock market. The evolution of the currency and macroeconomic data in the United States will be key in the coming weeks, alongside the release of corporate earnings.

* All data as of Monday, 5 August 2024

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