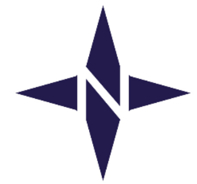
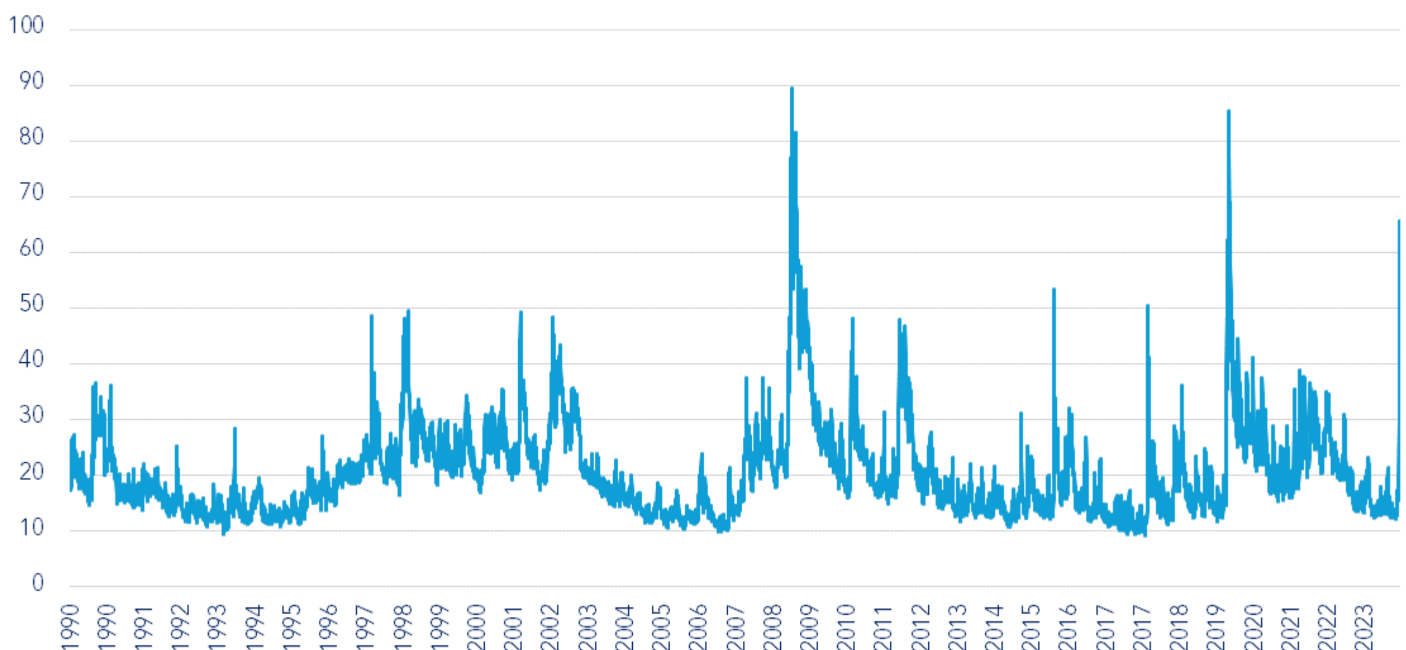
Market Volatility

Latest views from the investment team



Stock market volatility has spiked

"The VIX" is an index that measures volatility of the US stock market. It spiked yesterday to levels consistent with the Global Financial Crisis in 2008 and the Covid-19 pandemic in 2020, as shown in the chart below. This sharp rise in volatility has been felt in global stock markets. Yesterday, in Japan, stock indices fell 12%, the worst day since 1987 and, today, rose 10%, the largest gain since 2008. Other global markets also felt the pain with US stocks closing yesterday down 3%, and intraday declines were as much as 6%. At the time of writing, US stocks are up 1% today. There has been some softening in economic data, but not a dramatic shift in the outlook that explains such sizeable moves in asset prices. Changes in investor positioning and sentiment have been triggered, amidst summer markets with constrained liquidity, as explained below.



What is causing these moves?

Sharp moves in financial markets are not always caused by rapid changes in the economic outlook. The most recent moves in asset prices have been triggered by large investor positions which aim to exploit the gap between very low interest rates in Japan and higher rates in the US. These positions have been built up over many years.

Policy rates in the US are over 5%, having increased from zero in the aftermath of the pandemic. Rates were increased sharply to tackle elevated inflation. Meanwhile, policy rates in Japan are much lower. Inflation in Japan did not jump as much as in other regions over recent years - peaking at just over 4% in January 2023 (compared with over 9% in the US) – and was viewed as welcome rather than problematic. Last Wednesday 31st July, the Bank of Japan raised rates to 0.25%, the highest level since 2008 and the second increase this year. They have been vocal about a desire to support the Japanese Yen which, a few weeks ago, had weakened by more than 40% over three years and 15% year-to-date. A weak currency helps bolster exports, but the extent of the depreciation had become unpopular amongst consumers suffering higher prices for imported goods. Japanese inflation has now been above the 2% target for over two years; thus, prompting the Bank of Japan to hike policy rates. Polls show that, despite some encouraging economic data, the timing of this was not expected by investors.

The interest rate differential between the US and Japan has, for many years, put downward pressure on the Japanese Yen. This has encouraged risk-taking investors to borrow using the Japanese Yen to buy US dollars and earn a higher interest rate. This trade has extended from investing for the uplift in interest rates to investing in popular assets such as AI stocks. The investors participating in this trade range from domestic Japanese investors to global hedge funds and asset managers. The trade, often referred to as the 'Yen carry trade', works well if the Japanese Yen depreciates, or, is at least stable.

In July the Japanese Yen appreciated more than 6% against the US Dollar, creating problems for investors borrowing in Japanese Yen. This was catalysed by factors in both Japan and the US. Japanese authorities intervened by using foreign currency reserves to buy their currency and softer US economic data (in particular, US inflation data released on 11th July) increased expectations for US rate cuts. Since the end of July, the Japanese Yen has made further gains, as much as 5% in just a few days. Last week, the Bank of Japan raised rates while the US Federal Reserve left rates unchanged, and the US unemployment rate increased more than expected. While these events are clearly not on the scale of importance as the 2008 Global Financial Crisis or the Covid-19 pandemic, the change of direction for the Japanese Yen has triggered unwinding of the popular 'Yen carry trade', pushing down global stock markets as positions are neutralised and exacerbating the appreciation in Japanese Yen. A sharply stronger currency is viewed as a headwind for Japanese stocks, particularly exporters.

What next?

Although some aspects of US economic data have softened lately, we do not view the current outlook as consistent with a near term recession. US unemployment has risen to 4.3% - this is still low in a historical context but has risen nearly 1% from the low. The upcoming election may also weigh on sentiment. However, purchasing manager surveys indicate ongoing expansion and earnings season has, so far, demonstrated corporate strength. GDP data also remains robust with 2.8% real growth in Q2, a strong number and consistent with growth over the last couple of years. Inflation has declined close to target (the Federal Reserve's preferred measure is now at 2.5%) so interest rate cuts are expected to commence soon, likely in September.

The overall size of the Yen carry trade is unknown and further unwinds may occur over the coming days and weeks, possibly triggering further volatility. It is also possible that such volatility in markets has induced significant losses at a financial firm that has yet to be announced. For example, negative returns for US government bonds spurred a failure of US Silicon Valley Bank in March 2023. In this case, the US Federal Reserve responded quickly by offering a new lending facility to alleviate pressure, and the adverse impact on stock markets was short-lived. However, this serves as an example that markets may remain chaotic in the short-term.

Bottom line

These volatile episodes in asset markets can change the psychology of investors, prompting more caution and elongating the time frame of recovery. However, historically, as the VIX has subsided from large spikes, it coincides with rises in stock markets. Therefore, we maintain our base case of a positive outlook for asset returns.

For more information, please contact your adviser.

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