



Investment Views

SEPTEMBER 2024

Dealing with unexpected summer storms

Thunderstorms are a natural phenomenon. As air heats up it rises, turning moisture into gas. The gas cools and eventually the vapour condenses, turning back into water. If this happens quickly, a cloud forms, the droplets fuse together and freeze, forming hail. As hail falls, the ice crystals rub against each other and produce electricity. The electrical charges make a beeline for the Earth's surface, and when strong enough come together to form lightning. This lightning strike gives off a tremendous amount of heat, causing the air around it to expand very quickly, creating a shockwave or thunder "clap".

In the UK, the Met Office compiles a list of names for any storms that occur during the year. Summer storms, however are not named because they are much harder to predict. We know what conditions are necessary for these storms, but we do not know exactly when and where they will hit. Particularly with summer storms, it can feel as though the event is over almost as soon as it has begun. Skies brighten, the weather becomes cooler and everything goes back to normal. There may be a bit of rain on the ground, but it is almost as if the storm never happened and everyone can get back to getting on with their lives.

Why are we talking about this? Well, we witnessed a surprise summer storm in early August, this one in the markets. Not caused by weather patterns, but rather by the temporary unwinding of the yen carry trade, a strategy where investors borrow in low-interest-rate currencies like the yen to invest in higher-yielding assets elsewhere. As traders quickly unwound their positions, it set off a hailstorm of forced selling in everything from tech stocks to the Mexican peso. Once the financial storm was unleashed, volatility returned with a bang, just like the thunderclap.

During a six-week period the yen weakened to a historic low of Y161 per dollar before sharply reversing course and surging more than 10% - very big moves in the currency world. The Japanese stock market climbed to an all-time high before enduring its biggest ever one-day crash, at one point falling 12% intra-day. The interconnectedness of global markets meant that the sell-off in one region quickly spread to others; first, other Asian markets such as South Korea's Kospi index, then European and American markets too. When thunder is low and rumbly it means the lightning is far away; if loud and sharp, it means it's closer. This one was certainly getting closer. What had started as the unwinding of a few carry trades risked becoming a full-blown crisis.

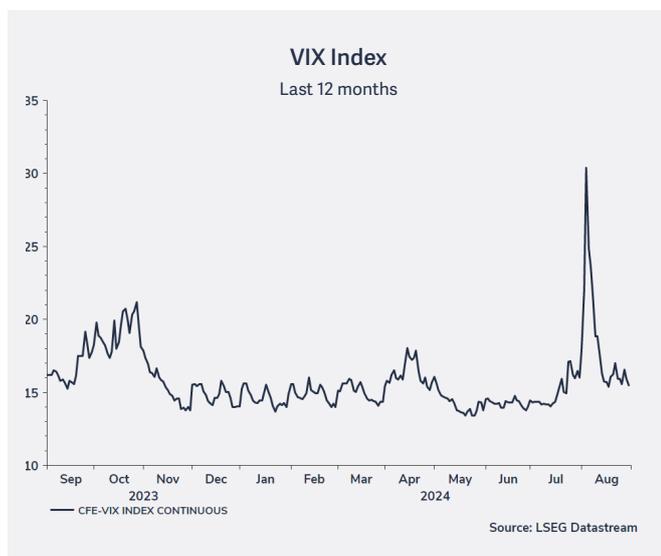
Then, seemingly out of nowhere, markets turned around. Once Wall Street opened for business, the panic started to ebb. In fact, in the 18 days between August 5th and August 23rd the S&P 500 recovered \$4 trillion in market cap. Just a few weeks on from the worst volatility blow-up since the pandemic, levels of conviction are soaring across assets. Exchange-traded funds tracking government debt, corporate credit and equities have risen in unison for four straight months, the longest stretch of correlated gains in over 15 years. The S&P 500 actually rose 2.3% in August. It is almost as if the storm never happened. Almost.

So what caused the storm, however fleeting? Certainly, the unexpected decision by the Bank of Japan to raise interest rates by 25 basis points was a significant move, not least because Japan had maintained near-zero or negative interest rates for nearly two decades. The rate hike led to a sharp appreciation of the yen, taking many market participants by surprise, and the ripple effect had begun. It took the deputy governor to come to the rescue by ruling out further increases while markets are "unstable", a great illustration of how global indebtedness is allowing markets to set policy rather than the other, more usual way around.

The situation spiralled with weak economic data from the United States. Only 114,000 jobs were added in July, far below the forecasted 175,000, giving an unemployment rate of 4.3%. This disappointing figure raised concerns about the health of the world's largest economy, suggesting it was closer to a recession than many had thought. Earnings reports from major tech companies like Amazon and Intel were also less than stellar, indicating that huge capital outlays into areas such as AI have so far produced only small boosts to revenues, further dampening investor sentiment. In addition, Warren Buffett sold a big chunk of his Apple stake to bolster his cash pile, increasing market jitters about future growth expectations.

Attention then turned to whether the Federal Reserve was being too slow to lower interest rates, still at their highest level in years. The delay in adjusting monetary policy potentially risked unduly punishing the U.S. economy and raised questions about whether the Fed was “behind the curve”, adding regulatory uncertainty into the mix. Perhaps an emergency rate cut would be needed?

Then there were geopolitical tensions too, particularly in the Middle East. Investors remembered that if anything, these had risen recently, with the potential to escalate further and disrupt global trade and economic stability, contributing to sustained inflation and higher-for-longer interest rates, neither of which markets need.



Next, of course, there was the matter of valuation. Or at least, the over-concentration in a few mega-cap growth stocks, making the market vulnerable to sharp corrections. In the two years since ChatGPT was unveiled, Nvidia has added \$3 trillion in value, so perhaps the sell-off was also partly a result of rotation away from these overvalued stocks as investors sought to hastily rebalance their portfolios.

This combination of interest rate changes, negative economic data, geopolitical tensions, and policy uncertainty led to a temporary loss of confidence among investors once the ball had been set rolling. Forced or panic selling further drove down market prices. The surge in the Cboe Volatility Index (VIX), often referred to as the “fear gauge”, indicated just how quickly heightened market anxiety can become contagious.

Technical factors and algorithmic trading will no doubt have contributed to the sell-off. Automated trading systems, programmed to respond to market signals, can amplify market movements during periods of high volatility.

So the market sell-off in August 2024 did not have any one single cause. Rather, it was the result of a number of factors that unexpectedly converged, much like an unpredictable summer storm. While the sell-off caused significant short-term pain for investors, it also highlighted the importance of understanding the complex dynamics that drive financial markets and the speed with which today’s markets react. And, of course, it reinforced the importance of “time in” the market as opposed to “timing” the market. Very few traders, if any, will have sold out at the right time and then got back in at the right time too. You need to be right on both occasions. Time is actually one of the very best assets that investors have, if they use it wisely. Just like during a storm, staying put until it passes is usually the best advice.

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