Market Commentary

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Despite lingering concerns about the health of the global economy and macroeconomists fretting about the future path of interest rates, equity investors have enjoyed a relatively smooth ride year-to-date, with most major regions posting solid gains. Reflecting the rather benign backdrop was the VIX, a key measure of market volatility, which closed July significantly below its longer-term average.

However, investors expecting more of the same for August were to be sorely disappointed. First came July's lacklustre US jobs report, which included a surprise uptick in unemployment and a sharp slowdown in new jobs added. With unemployment rising more than 0.5% from its 12-month low, the report officially breached the Sahm Rule, a closely followed economic rule of the thumb used to predict the onset of a recession. This led markets to question the strategy of the US Federal Reserve and whether its policymakers had waited too long to start cutting interest rates. With recession concerns rising sharply, equity markets sold-off, and markets moved to price in a more rapid set of rate cuts.

Worse was to come for Japanese equity investors. Unlike the majority of developed markets, Japanese interest rates have remained relatively low, driving the hugely popular yen carry trade – investors borrow yen at a very low rate, then exchange it for a higher yielding currency, making a profit on the interest differential. This strategy works well while exchange rates remain stable, but the apparent deterioration of the US economy, coupled with a surprise rate hike by the Bank of Japan (albeit from a very low base), led to the rapid strengthening of the yen. As carry traders rushed for the exit, the yen strengthened further, and Japanese equities (many of which had benefitted from a weaker yen) sold off in spectacular fashion. Japanese large cap equities fell 20%, their largest three-day drop in history.

The events of early August serve as a timely reminder of the volatility equity investors expose themselves to, and crucially, the value in taking a long-term view. While those who sold during the market turmoil could have locked in a double-digit loss for their Japanese equities, and mid-single-digit losses elsewhere, by the end of the month markets had largely recovered. Even Japan, which had slipped to an aggregate loss of c.12% on the 5th, finished the month down just -0.9%.

Shifting focus to markets, all major regions (including Asia and emerging markets) tracked a similar trajectory through August, with steep losses early in the month followed by a gradual recovery. European equities were among the best performers, with large cap indices briefly hitting new record highs towards the end of the month. While the European Central Bank moved to cut rates ahead of other developed peers, the trajectory of further cuts has remained uncertain in the wake of less convincing macroeconomic data. But with a flash end-of-month report showing inflation falling back to 2.2%, a second rate cut now looks imminent. The UK was also marginally in the black, as positive economic momentum and lowly valuations continued to present investors with a 'cheap' alternative to other developed markets.

US equities also recovered from their early month lows but fell short of generating a positive absolute return. After a wobble in Q1, inflation began to recede once more, paving the way for rate cuts.

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Markets widely anticipate the Federal Reserve to announce a first cut at its September meeting. Despite July's unsettling data, analysts expect a slight fall in unemployment when the next report is released. As usual, company specific newsflow was dominated by one of the Magnificent Seven, with Nvidia reporting its Q2 results. Despite another (smaller) beat of analyst expectations, the share price slipped nearly 7% in after-hours trading, reflecting the sky-high expectations of investors.

Turning to emerging markets, which slipped to a small loss on aggregate. Some markets, like Taiwan, tracked closely the losses of developed markets, while others including China were more insulated from the volatility. Despite avoiding a sharp downturn in early August, Chinese equities fell to yet another sizeable monthly loss, as weak consumer sentiment and the absence of a headline grabbing policy intervention continued to weigh. Indian stocks were also broadly lower.

If there was a positive to be taken from early August, it was the return of a more rational market backdrop, in which bad news for equities generally meant good news for bonds. With investors ramping up rate cut expectations, major bond indices produced broad positive returns. Despite recession concerns, high yield was once again the best performing sub-asset class. Longer duration assets including government bonds also performed well, as markets moved to price in additional rate cuts. Analysts now expect the Federal Reserve to cut rates by 100 basis points by the end of the year.

Elsewhere, infrastructure and property assets were caught up in the early month volatility but recovered to finish the month in the black. Property, traditionally a highly rate sensitive sector, enjoyed a particularly strong end to the month, reaffirming the diversification benefit for multi-asset portfolios.

Whitechurch Investment Team
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