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More bang for your buck

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Over the past several weeks, the tone of global equity markets has changed, with several breaking uptrends from last autumn. Many attribute this to a combination of restrictive policies of the Federal Reserve in the face of weakening jobs data, along with the technical unwind of the Japanese carry trade, where billions of dollars of leveraged exposure were hiding in plain sight but mostly ignored. While the Japanese equity markets bore the brunt of the unwind, many asset prices were likely inflated by this leverage. So, what now?

Financial markets in variably want to have their cake and eat it too. Recent US activity-based data, including the weaker-than-expected July US Employment report, has promoted recession concerns, albeit from a low base, generating calls for the Fed to ease policy, some even suggesting an emergency interest rate cut. This call was supported by the view that downward pressure on risky asset prices simply tightens financial conditions, thereby pressuring the real economy even further.

Markets have started to re-price that reality, telling the Fed they are too tight and need to cut more aggressively than what they have guided, with 2-year Treasury yields at some stage having fallen by around 50 basis points in the last month, almost 150 basis points below the Fed Funds rate. However, investors looking for signals might remember that the US Treasury and interest rate futures markets have been badly wrong in their expectations of Fed policy over the past few years. In January, markets were discounting as many as seven cuts in 2024. Now some are expecting cuts at the remaining three Federal Open Markets Committee (FOMC) meetings this year, starting with a 50-basis point cut next month.

The dilemma for the Fed and investors is that the next FOMC meeting is five weeks away, a lifetime for an impatient and at times volatile market. The case for an emergency Fed cut remains unconvincing, particularly when comparing current circumstances to other instances of inter-meeting policy rate reductions in 2020 and 2001. The Fed is not prone to over-reacting, as this is often counter-productive. An abruptly dovish move by the Fed may work against market stabilisation. Second, it is not clear that cutting rates will do much to change the economic data since bond markets have already done the cutting for the Fed this year to little avail. Mortgage rates have fallen 100 basis points, and housing activity has not improved.

In contrast, BoJ (Bank of Japan) monetary policy has been disproportionately accommodative for many years; both in terms of interest rate setting and the size of the BoJ's balance sheet. Escaping the zero-bound policy rate is less than straightforward, as demonstrated by previous attempts by the Fed. The sudden appreciation of the yen presents problems for Japanese equities and the economy, which was in a technical recession during the second half of 2023. The market reaction following the BoJ raising its policy rate to 25 basis points on July 31, as well as announcing the halving of its monthly bond purchases, has seemingly forced a policy pause. BoJ Deputy Governor Uchida Shinichi announced a pause on interest rate increases due to volatile financial markets. This would, therefore, imply no policy rate increase in September, when the Fed is expected to cut.

In conclusion, it looks like the broader US economy is decelerating but not in recession, as the tighter monetary policy of the past two years finally gains traction. The deceleration as taken longer than it normally does, probably due to the unusual nature of COVID-19 lockdowns and reopening, the massive amount of monetary stimulus pre-tightening, plus the unusual expansion of the federal budget deficit last year. US monetary policy will remain data-dependent, and the Fed will wait for more incoming data to formulate an appropriate response.

The start of the process of normalising Japanese monetary policy has come in seasonally poor liquid markets promoting volatility and questions over the stretched positioning in the yen carry trade. However, the yen carry trade involves a wide range of investors who have different risk appetites towards unhedged exchange rate exposure and, consequently, deploy varying risk management strategies. The US-Japanese interest rate differential will continue, an outcome that could sustain the yen carry trade, particularly if the BoJ decides to postpone further policy rate increases for a prolonged period.

Clearly, seasonality has generated increased volatility for markets with crowded trades and rich valuations. The question for investors is, are there cyclical factors also at play in this volatility increase and can central banks who are changing course, promote stability when some of their previous actions have created the conditions for that instability.

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