RATHBONES | Incorporating Investec Wealth & Investment (UK)

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Market commentary

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Overview

In the last monthly commentary we alluded to the fact that markets can sometimes act like a coiled spring being released. In that instance, we were referring to an aggressive rotation out of some of the market leaders into the laggards and, more specifically, the selling of mega-cap technology shares in favour of more cyclical small caps. That turned out to be a prelude to a more widespread equity market sell-off in the first few days of August, a sell-off which required us to introduce a few extra paragraphs into the commentary. We were correct in our opinion that the episode was not the beginning of a more serious downdraft but have to admit to being somewhat surprised by the ease and speed of the subsequent recovery, following which the majority of indices have regained most of their lost ground, with some making new all-time highs. Now that the dust has settled, at least for the time being, it is worth digging a little deeper into the driving forces of that setback and also to ask what it tells us about current market structure and investor psychology.

Sudden shifts in investor behaviour tend to require fuel and a catalyst – think of those as dry tinder and a match. The tinder, in this case, was largely composed of extreme positioning, complacency and a degree of overvaluation. The positioning element was widespread, with different groups of investors having historically high exposures to a number of trades. The key one was the "yen carry trade", in which yen are borrowed at very low interest rates and invested in assets ranging from higher-yielding currencies to more speculative equities around the world (in this case there seems to have been a particular emphasis on US technology stocks). Returns were further enhanced by a declining yen. Although it is impossible to put an exact number on the exposure, industry estimates suggested somewhere in excess of $500bn.

Other pockets of extended positioning included: "momentum", which saw traders being most exposed to the best-performing shares, as well as most short of the laggards; "volatility control", whereby low levels of volatility (see below) allowed greater leverage to be applied to the funds; and leverage in general, either through borrowing or using options.

Complacency was evident in low levels of both implied and realised volatility. Volatility is often expressed through the VIX Index, which is calculated by reference to the price of call and put options on the S&P 500 Index. It had been anchored in low double digits for some time. To give that some context, as a rule of thumb you can divide the VIX Index by 16 to infer what the market is pricing in as the average daily move for the S&P 500 Index over the next thirty days. Thus, anything below 16 implies sub-1% daily swings, which is a pretty benign background. The long-term average of VIX is around 20 (although lower in recent times, depressed by various structures that allow investors to sell volatility to enhance income). It tends to be a mean-reverting Index, and so there was always a risk of it rising again at some point. However, timing such mean-reversion has always proved impossible in the past and so betting on it can lead to missing out on good returns.

The valuation argument centred largely on US equities and especially the mega cap technology leaders. They undoubtedly trade at a premium to the overall market and an average price/earnings ratio in the high 20s looks punchy, but it does acknowledge strong underlying growth trends combined with exceptionally high margins and cashflow generation. We have consistently pushed back against the concept of these companies being in "bubble" territory, whilst also recognising that they might be vulnerable to any hints of a slowdown in growth.

Taking all of those factors into account, the raw material for a conflagration was assembled, but who would bring the flame? As it turned out, a box of Swan Vestas materialised. We alluded last month to a couple of papers that had been published questioning the returns that could be generated on the huge investment in generative artificial intelligence, and so that was already smouldering. The next factor was the Bank of Japan's (BoJ) decision on the last day of July to raise interest rates by 0.25%. This might not seem like much, but it was a lot more than the 0.1% increase that was expected by economists and signalled higher interest costs for all those yen carry traders. There was also some evidence of the BoJ and the Ministry of Finance intervening in markets to support the yen.

Things might have calmed down had it not been for a very weak US employment report on 2 August, a release which not only increased fears of a US recession but also, crucially, increased the probability of interest rate policy being loosened more aggressively by the US Federal Reserve (Fed). You can imagine that rising yen rates and falling dollar rates is not a recipe that is conducive to maintaining a yen carry trade.

If these were the primary catalysts, there were also a few inconveniently timed additional ones. These included: an increase in hostilities in the Middle East and in Russia/Ukraine; a positive swing in the electoral fortunes of the Democrats in the US thanks to the substitution of Kamala Harris for Joe Biden as the party's Presidential candidate – the Democrats are deemed to be less market-friendly, especially in terms of their desire to raise corporate tax rates; and news over that weekend that Warren Buffet's Berkshire Hathaway had unloaded a large portion of its stake in Apple, thus cementing the idea that there was limited value left in the shares. And to top everything off, this all came to a head just as we were heading into the peak summer holiday period, which tends to see lower liquidity in financial markets.

European investors awoke on Monday 5 August to a gut-wrenching 12% fall in Tokyo's main equity indices, the worst one-day fall in their history. The VIX Index traded as high as 65, which, referring to the previous arithmetic, suggested outsized 4% daily moves for the S&P 500 for the next month. This triggered a massive deleveraging event which saw the MSCI World Index fall by 3.5% on the day. It's cumulative loss over the first few days was 6.4%, making an 8.25% fall from its July peak.

Given the recovery that has taken place since, with the World Index making a new all-time high by the end of August, it seems remarkable to recall that some were calling for the Fed to step in with an emergency interest rate cut. There was a real sense of panic. That was the point at which we made a judgement that there had been no material change in the underlying economic outlook and that neither was there an immediate threat of the falls in risky assets being transmitted to the wider financial sector and triggering any sort of financial crisis. We also noted that government bonds had fulfilled their role as "insurance" assets. We elected to hold on tight and weather the storm, which, thankfully, blew itself out within days.

Indeed, the investment sky has turned quite blue since then. Economic data from the US (which remains the key driver of market sentiment) has turned out to be more resilient (although, admittedly, not booming either) but more importantly, the Fed has indeed signalled that it will begin to cut interest rates in September. This message was transmitted by Chairman Powell during his speech at the annual symposium of central bankers held in Jackson Hole, Wyoming, in which he said that the Fed's policy focus would now shift from suppressing inflation (which it sees as heading towards target) to supporting the labour market (and broader economy). We will check in on other regions' economies and interest rate outlook in the sections that follow.

Despite the rebound in sentiment, this episode provides clues as to what investors are worried about and also offers some insights into market structure. Whereas we spent much of the last couple of years concerned about high inflation, it does now appear that the emphasis has shifted decisively towards the sustainability of growth. Inflation is on a cyclical downward trend pretty much everywhere (with the notable exception of Japan, where they have been trying to increase it following decades of deflation – which is why Japan is so out of synch in terms of interest rate policy). The fact that central bankers are acknowledging this is comforting. We have already seen interest rates cut in the eurozone, the UK, Canada and Australia.

But that comfort blanket does not provide complete insulation. The world's second largest economy, China, continues to grapple with the aftermath of the bursting of its real estate bubble, with GDP growth forecasts under continued downward pressure. Many countries around the world racked up huge deficits during the Covid pandemic (having never paid off the debts incurred during the Global Financial Crisis), suggesting less fiscal generosity to come - at least not without testing bond investors' patience à la Liz Truss. Geopolitics remains an ever-present threat, whether it be potentially disruptive elections or more serious physical hostilities.

As for the structural issues, we are somewhat resigned to the fact that carry trades, herd behaviour and increasing degrees of leverage and speculation are part and parcel of today's market landscape. It will mean that at times the levels of markets and individual securities will appear to be divorced from what we might call "fundamentals". At such moments it is important that we submit neither to F.O.M.O (fear of missing out) nor panic, although we will always need to pay some respect to benchmarks, such is the nature of our industry.

Markets – US

The S&P 500 Index rose 2.4% during August, having at one point been down 7%. What is, perhaps, more informative is the performance of its underlying sectors. There had been some fear that without the leadership of a handful of mega cap technology companies, the market would have been more vulnerable. However, with Information Technology (+1.2%), Communications Services (+2.2%), which contains Alphabet and Meta, and Consumer Discretionary (-1.1%), dominated by Amazon and Tesla, all lagging, it was Consumer Staples (+5.8%) and Health Care (+5%) which took up the running. These are traditionally seen as more defensive sectors, and so could betray some fear about the health of the economy, but Staples had been a massive laggard so far this year, seen by hedge funds as a useful source of cash to fund more bullish trades. These sectors were supported by beneficiaries of lower interest rates such as Real Estate (+5.6%), Utilities (+4.3%) and Financials (+4.4%). The Russell 2000 small cap index, which we think offers some value and which is also sensitive to interest rates, gave up all of July's gains during the turmoil but has since regained most of the losses, although it still remains around 10% shy of its late-2021 peak. At the end of July, the futures market was projecting that the Fed Funds (base) rate would be 4.6% at the end of 2024, a figure that dropped to 4.3% by the end of August. Even so, and as we have pointed out in the past, investors should be careful what they wish for. Interest rate cuts forced on the Fed owing to a recession tend to lead to lower equity returns, while "voluntary" cuts based on receding inflation fears have more positive outcomes. So far, the market is reading the imminent cutting cycle as of the latter variety. But there are very credible economists who believe that there will soon be a tipping point in terms of labour demand which will send the unemployment rate sharply higher. We remain vigilant for such a development.

UK

The FTSE 100's volatility in August was dampened by its big exposure to Healthcare and Consumer Staples and its limited weighting in Technology and the index ended the month higher than where it started. Given the headwind of the pound rising around 3 cents vs the US dollar, that was a good performance. Illustrating the point made above, the leading points contributors were AstraZeneca, Glaxo SmithKline and Unilever. Given a background of reasonably positive economic data compared to other regions, there was not the same degree of movement in interest rate expectations as in the US, with the December 2024 future moving from 4.65% to 4.5%. Bank of England Governor Andrew Bailey has also been much more cautious about the potential for rate cuts in his statements than his US counterpart. The Labour government is getting settled in, and the Prime Minister and the Chancellor have voiced increasing concern about the poor state of the UK's finances. This lays the ground for Rachel Reeves's first Budget on October 30th, an event which seems to guarantee increased taxes, with the potential for much of the burden to be placed on investors (via higher CGT rates and/or less generous pension contribution treatment, if reports are to be believed).

Europe

August was rounded off by a positive set of inflation readings around much of Europe. This frees the hands of the European Central Bank to cut interest rates more aggressively, something that might be required given still lacklustre growth, especially in Germany. Futures markets are pricing in further quarter-point cuts at each of the three remaining ECB Governing Council meetings this year. France, having basked in the glory of perhaps the most scenic Olympic Games in history, has still to settle its local political difficulties, with President Macron yet to appoint a new Prime Minister while he continues to try to build a centrist coalition in Parliament. The fact that aggregate European equity indices are back to their highs suggests that investors have got over the political shock and are more focused on the benefits of looser monetary policy.

Emerging Markets

Emerging Markets fell and then rallied in August alongside their developed market peers, but, in aggregate, remain well short of the 2021 peak – around 24%, in fact, mainly on account of the weakness of Chinese equities over that period. The CSI 300 is -43% since February 2021, in stark contrast to India's Nifty 50 Index, which has risen by 65% in the same timeframe. This has reduced China's dominance in the MSCI Emerging Market Index, with its weighting now at 24%, vs 20% for India and 18% for Taiwan (of which around half is attributable solely to Taiwan Semiconductor, which means that the local index correlates more with the NASDAQ and Nvidia than anything else).

Fixed Income

Global bonds continued their recovery in August, with the Bloomberg Global Aggregate Index of investment grade bonds having gained more than 5% since the end of June. This has mainly been driven by expectations of lower interest rates, which have been themselves driven by a combination of positive factors (signs that inflation is under control) and more negative ones (lingering concerns about weak economic growth). It was good to see government bonds rediscovering their role as “insurance” assets when equity markets fell sharply early in the month, something that we had been more confident could happen as investors’ fears were more about too little growth than too much inflation, especially now that yields are more attractive. Even so, if inflation turns out to be more structurally sticky in the post-Covid world, then we will have to more flexible in our choice of equity risk diversifiers.

All UK Gilts have delivered a total return of +3.6% over the last three months and +6.8% over the last year. Index-Linked Gilts returned +1.7% and +2.3% over the same respective periods. Emerging Market bonds produced a total return of +1.8% in sterling over the three months to end August (+15.2% over 12m). Global High Yield bonds delivered +4.5% (+12.8% over 12m) in sterling.

Conclusion and Outlook

Early August provided a test of investors’ nerves. Although many of those exposed to carry trades and leverage were forced to run for cover, those with a longer-term perspective, ourselves included, were able to ride out the storm. It has been important in recent times to know when not to panic. Earlier examples include the Truss/Kwarteng budget (September 2022) and the bankruptcy of Silicon Valley Bank (March 2023). Many investors remain scarred by the Tech Bust (2000) and the Global Financial Crisis (2008), but we continue to believe that neither event is about to be repeated. That’s not to say that the returns will be risk-free, but a background of subsiding inflation, steady but unspectacular growth and some space for central banks to cut interest rates should continue to offer acceptable returns for balanced portfolio investors.

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