RBC BlueBay
Asset Management

Market Commentary

A summertime moment of madness

Volatility driven by market technicals, not fundamental valuations

Key points:

- Financial markets experienced substantial price volatility, sparked by more hawkish-than-expected Bank of Japan (BoJ) rate hike.
- Volatility was further fuelled by a softer-than-expected US jobs report.
- Broadly speaking, US data are consistent with a softish landing and the view of the US labour market remains healthy.
- In Japan, the BoJ communicated that they would not plan further policy tightening during periods of elevated market volatility.
- We look at periods of volatility when markets overshoot as offering us opportunities as active investors.

9 August 2024 (London) - Financial markets experienced substantial price volatility in the past week, with bond yields and equity markets falling sharply, before bouncing back. Market moves were originally initiated by a rally in the value of the yen in FX markets, in the wake of a somewhat more hawkish-than-expected Bank of Japan (BoJ) rate hike.

This triggered stop losses in some large macro and systematic funds, leading to further yen buying and additional stops being triggered. As this occurred, carry trades were unwound and a flight to quality was established, with rates rallying and risk assets under pressure.

As these moves came at a time of year when liquidity is thin, with many investors away from their desks, price action was exaggerated and a softer-than-expect jobs report at the end of last week further compounded this.

CTA positions had also been long equity risk after a prolonged rally, and short volatility. These were also pushed through loss levels, causing aggressive selling of stocks, adding further momentum to the downside.

Consequently, at the end of a brutal trading day in Asia on Monday, the Nikkei average had fallen by more than 12% in value, in just 8 hours.

Market developments were accompanied by calls that the US economy had tipped into recession. However, this seemed wide of the mark in our opinion.

Broadly speaking, US data are consistent with a softish landing and there is little evidence to back up a recessionary claim. Looking at an array of statistics on the US labour market, the picture remains healthy.

The unemployment rate rose last month, but there were hurricane-related distortions in this figure.

Data for job openings, jobless claims, net jobs added and diffusion indices within the ISM survey all remain at positive levels, even if the pace of activity is undeniably softer than what was seen earlier in the year.

Meanwhile, the Atlanta Fed Nowcast GDP forecast for the current quarter GDP stands at 2.9%, and there is little to change the FOMC assessment of the economy at this point – unless a further material drop in equity prices were to bring about a notable tightening of Financial Conditions.

Consequently, we continue to believe that the Fed is likely to cut rates by 25bp at its September meeting, with similar sized cuts in December and Q1 possible, just as long as inflation data is benign.

This view on rates stood in stark contrast to market pricing, which earlier this week projected as much as 140bp of easing in the coming 6 months, with markets running well ahead of what we (and the Fed themselves) are discounting.

In this regard, we see echoes of market pricing of rates back in March 2023, when stop-loss trades were triggered in the wake of the SVB bank collapse.

Now, as then, we feel that pricing has been driven by market technicals and has become detached from fundamental valuations. Consequently, we moved short in duration, booking profits on US curve steepening trades and selling short-dated rate futures.

Looking ahead

Noting that the market moves which triggered events this week originated in the Japanese yen, an analysis of performance data suggests to us that a number of large funds have now closed these positions.

Without the catalyst of further stop losses being triggered, we have hoped that volatility can subside and markets recover.

Therefore, we have also extended credit exposure by reducing credit hedges so that we are more exposed to market directional risk. However, we need to remain attentive to a renewed deterioration, especially if retail investors appear unenthusiastic to buy the dip in US stocks this time around.

In Japan itself, the BoJ communicated that they would not plan further policy tightening during periods of elevated market volatility.

To be honest, it is hard to think of times when policy was actually been tightened when this is the case, and we continue expect policy normalisation to lift cash rates in Japan to 0.50% at the end of this year.

JGB yields have fallen in line with other markets, but we still see the trend higher. We also note the wide yield gap between 10-year and 30-year JGBs as highlighting room for Japanese yields in the 10 year to rise as BoJ Rinban purchases diminish.

On the back of this we maintain a short stance in Japan rates, and have added to this a 10/30 curve flattening trade, as we have started to think that 30-year valuations look too cheap relative to the rest of the Japanese yield curve.

We look at periods of volatility when markets overshoot as offering us opportunities as active investors. In a world where much money is passively managed, a lot of fast money in today's markets are effectively controlled by machines, whose models tend to favour momentum as a factor.

This can lead to periodic volatility events and flash crashes taking place, but this will create an attractive entry point for those prepared to take a contrarian view.

Ultimately, the reason why market pricing on rates is very likely to be wrong, is that policymakers will be focused on what is happening in the real economy. In this respect there is little new to see.

However, we often observe that in periods when markets move, some commentators will feel obliged to fit a fundamental narrative to explain, and to justify, the price action.

In this context, seeing some banks changing their calls on the Fed and the economy in the wake of market moves serves to remind us of the limited information content in this analysis.

For us, the truth is that the past week has all been about market technicals, not fundamentals.

Whilst central banks will always be concerned about market function, at the end of the day, in filling their policy mandate, the focus will be on the economic data. It is the economy after all!

It’s not just markets that appear stupid. If you are looking for really stupid behaviour, you don't need to look far from home, reflecting on the actions some of the moronic idiots protesting immigration in the UK this week.

Summertime madness indeed!

Notes to Editors
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