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Market volatility

7th August 2024

Equity markets have stabilised somewhat in the past 24 hours after substantial falls in the preceding days. We reflect on the drivers of these moves and whether investors should brace for more volatility.

What happened and why?

Market volatility in recent days started with a tumble that turned into a significant fall in equity markets and a strong flight to 'safe haven' assets like government bonds, whose yields have fallen substantially. Overall, the moves were indicative of a broad de-risking of positions after markets had been priced for a soft economic landing and falling inflation, which would allow for rate cuts and be supportive of continued strong corporate earnings growth. This was questioned last week amid somewhat weak economic data, hawkish central banks and lacklustre Q2 corporate earnings, leading to concerns of a growth slowdown.

Concerns initially rose after weak July labour market data in the US on Friday, which added to recent data pointing to slowing growth. Moreover, last week's Fed meeting suggested the Bank was in no rush to reduce rates. As a result, fears began to build that continued tight monetary policy amid slowing activity could result in recessionary conditions. At the same time, disappointing Q2 earnings and guidance from big tech companies in the US, which have driven equity markets to multiple all-time highs this year, weighed on sentiment too.

The market de-risking was illustrated by an unwinding of the carry trade, which is a trade where investors borrow at low interest rates in one country and invest in higher rates in other countries. A typical way of doing this has been to borrow in Japanese yen and invest in US dollars. However, with the Bank of Japan hiking rates last week and the Fed expected to cuts rates later in 2024, this trade looked less attractive and this pushed investors to close out these positions. As a result, US dollars were sold and the yen was bought, leading to a rally in the latter that pushed the Nikkei 225 index down by 12.4% on Monday, its largest one-day fall since 1987.

What does it mean?

The heightened volatility is likely indicating a shift in investor focus from inflation concerns, which have been front and centre over the past two years, towards growth concerns. As a result, growth sensitive areas may have a higher bar to meet in order to justify somewhat lofty valuations. This is particularly the case for big tech companies, with increasing questions around vast capex investment related to AI and when and how those investments will be monetised.

For fixed income, the focus is likely to be on how far growth might fall and how much central banks will have to ease policy, with markets already pricing in much more aggressive monetary easing in 2024 than even a week ago, again indicating increased concerns around growth. This is something we wrote about in our Multi-Asset 2024 Strategic Insights here in March, as we stated that "bonds could provide better offence as well as defence within multi-asset portfolios."

Bottom line

Continued volatility is likely in the current environment. However, a multi-asset approach can help investors navigate this as it can take account of downside risk while also ensuring investment portfolios are broadly diversified. Falls in asset markets are not unusual over the course of a year, with a 14.2% average intra-year decline in the S&P 500 since 1980. Despite this, annual returns were still positive in 33 of the past 44 years, so staying invested remains important for wealth accumulation over the long-term.

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