

Quick Take

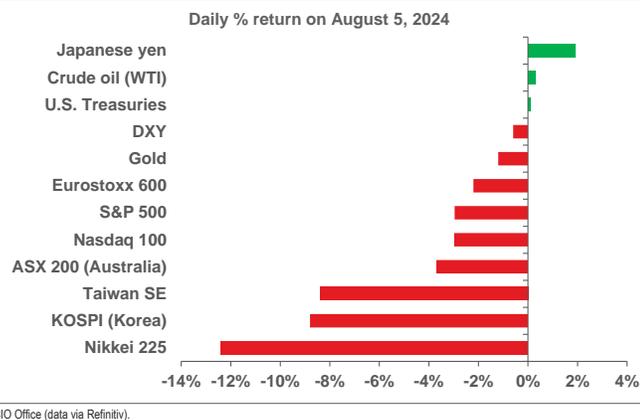
CIO Office | August 5, 2024

Market shakeout

The financial markets have been showing signs of turbulence for some weeks now, but the situation worsened today, with the S&P 500 down 3.0%.

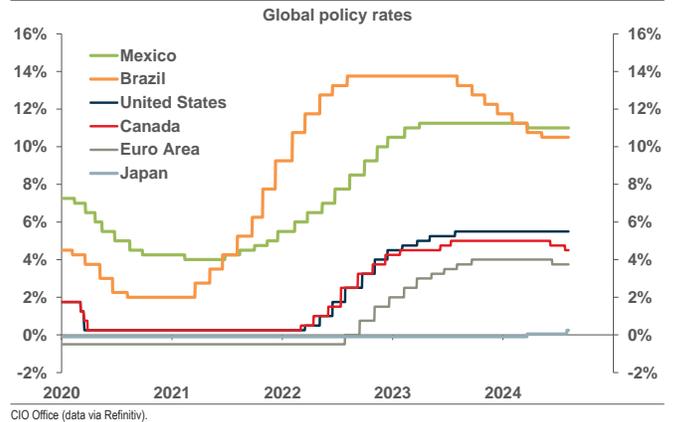
On closer inspection, today's tremors seem to have Japan at their epicentre, as evidenced by the appreciation of the Japanese yen, the daily drop of over 12% in the Nikkei 225 and the relatively sharper losses of the equity markets geographically closest to Japan (**Chart 1**). But what exactly is going on, and how did we get here?

1 | Volatile market action



The story begins in 2021-2022, when almost all central banks around the world were forced to rapidly raise interest rates in the face of post-pandemic inflation, the exception of course being the Bank of Japan (**Chart 2**). Not surprisingly, the Japanese yen is the currency of choice for carry trade investors, an investment strategy that essentially involves borrowing in a low-interest currency and using the funds to invest in assets denominated in a higher-interest currency. But this type of leveraged strategy is not without risk, quite the contrary; the carry trade is often described as the equivalent of "picking up pennies in front of a

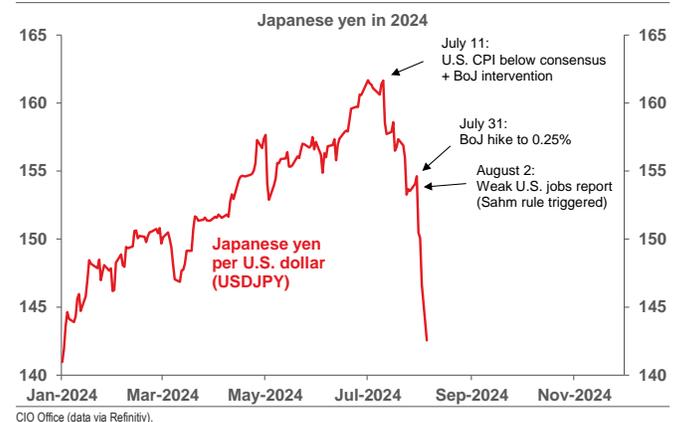
2 | Japan stands apart



steamroller"¹, since the risks of a sudden reversal are non-negligible.

And that's exactly what happened over the past month, as a perfect storm of macroeconomic events caused the Japanese yen to reverse its trend (**Chart 3**). Firstly, on July 11, U.S. inflation came out much lower than expected, allowing markets to anticipate a more dovish Federal Reserve and causing the yen to appreciate against the U.S. dollar. Then, on July 31, the Bank of Japan startled investors with a surprise rate hike to 0.25%.

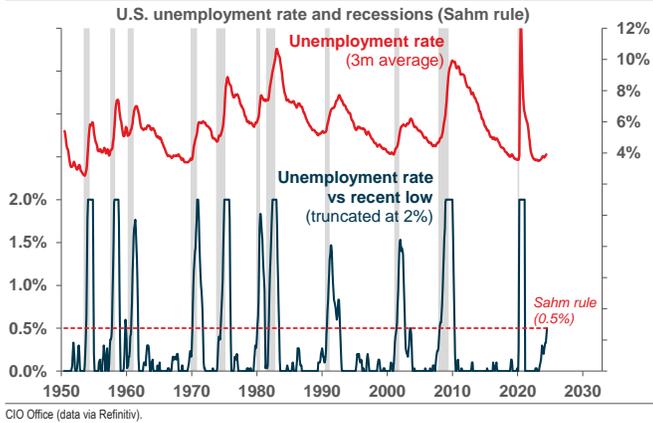
3 | Yen appreciation: a perfect storm



¹ Expression popularized by Nassim Taleb in his book "The Black Swan".

Finally, the straw that broke the camel's back came last Friday, August 2, with the release of the U.S. employment report showing an increase in the unemployment rate large enough to trigger the Sahm rule (**Chart 4**), an indicator that historically coincides with the start of a recession.

4 | The Sahm rule has officially triggered



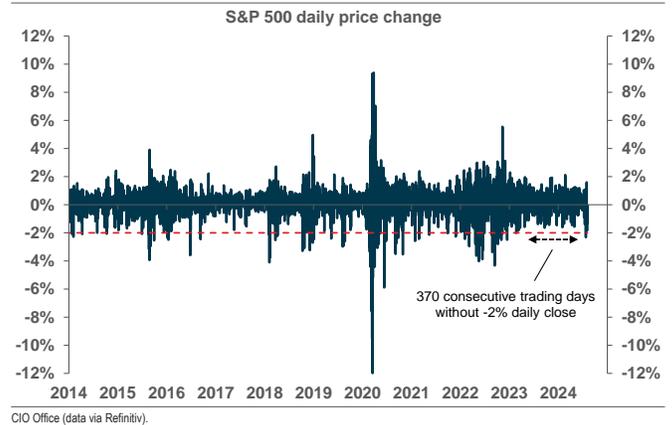
Now back to today, the yen's spectacular appreciation continues apace, and the shakeout seems to be stronger for the year's best-performing assets. The Magnificent Seven are a striking example, with these seven U.S. tech giants peaking on exactly the same day as the Nikkei and the Japanese yen, while the rest of the S&P 500 fared much better over the same period (**Chart 5**).

In any case and whatever the cause, it's worth remembering that periods of higher volatility are part of the nature of markets. As an example, since 2014, there have been an average of 9 days with a daily decline of 2% for the S&P 500 per calendar year. We haven't had one in 17 months (**Chart 6**), the longest period since 2007 (**Chart 7**).

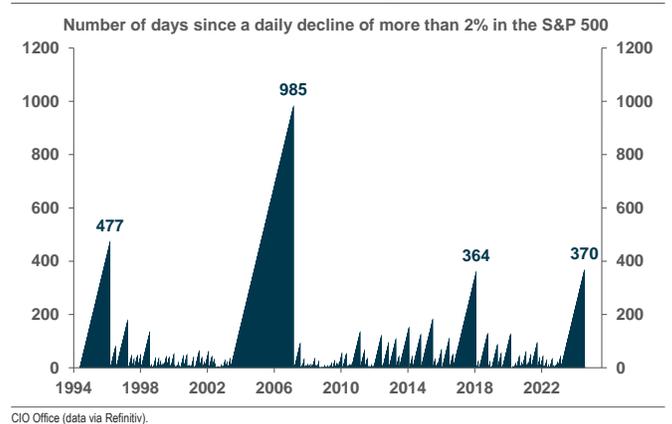
5 | Coinciding peak for Mag 7 and Nikkei



6 | A particularly quiet year and a half...



7 | ... with 370 consecutive days without a 2% loss



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