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Are the financial markets overreacting?

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Key messages

- We see two reasons for the current market turmoil: the Bank of Japan's unexpected hawkishness and the weak job data in the US.
- We see no reason to change our outlook for a gradual economic recovery over the coming quarters and we maintain our current allocation. We still expect equities to perform positively over the coming months.
- The correction could lead to buying opportunities. However, we recommend letting the dust settle. Further communication will follow.

The BoJ surprised markets...

While most market participants were anticipating a gradual rate hike by the Bank of Japan (BoJ) from around September, the BoJ surprised the markets by hiking rates at the end of July, a period characterised by thin liquidity due to traders being on holiday.

Governor Ueda believes that inflation is moving towards the 2% target and that real policy rates (excluding inflation) are significantly below their neutral levels, which the BoJ estimates to range from -1% to 0.25%. Hence, the BoJ intends to "continue to raise the policy interest rate and adjust the degree of monetary accommodation". This hawkishness surprised markets.

Currently, after the rate hike, the real interest rate is around -2%, significantly below the BoJ's estimated range, which suggests further rate hikes to come. We expect the BoJ to proceed with rate hikes until the policy rate is arguably neutral.

Assuming a 2% inflation rate and the most conservative estimate of the real policy rate of -1%, we think that the BoJ will hike rates relatively quickly until the nominal rate reaches about 1%, and then slow down the hiking pace thereafter.

We expect the next 25bps rate hike to come in October, when the BoJ's Outlook Report is published, followed by further hikes in January 2025, April 2025, October 2025, and April 2026, when the policy rate reaches 1.5%. This represents a substantial change from our previous forecasts of a more gradual rate normalisation, where we projected the policy rate to reach 0.25% by the end of 2024 and 0.75% by the end of 2025. We therefore expect two additional rate hikes than before.

...and the Sahm rule was triggered

The Sahm rule suggests that the initial phase of a recession has started when the three-month moving average of the US unemployment rate is at least 0.5% higher than the 12-month low. This is now the case with the July data.

However, the founder of the rule, Claudia Sahm is not yet convinced, saying that the US is not in a recession now, that the momentum is going in that direction but that the recession is not inevitable. We agree with this view, especially as we believe that the significant deceleration in payrolls was to some extent influenced by hurricane Beryl. We do not think a recession is likely at the moment. We expect the Fed to cut rates in September. We are reviewing our scenario, which could include a second rate cut this year.

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Sharp appreciation of the Japanese currency

The Yen has seen a sharp appreciation over the past few days. The first move from around 160 to 150 (value of one dollar) was seen even before the surprise move of the Japanese central bank. Indeed, the rising expectations of rate cuts in the US already suggested a decrease in the interest rate differential. This made the yen more attractive. The two key events reinforced the expected fall in the interest rate differential. First, we had the surprise rate hike from the Bank of Japan, which took most investors by surprise. Second, we had a weaker-than-expected US jobs report and rising fears of recession coming back. That is probably why the market is now pricing more than 5 rate cuts this year. Both changes in interest rate expectations point to a smaller rate differential and that is why the value of one dollar against the Yen (USDJPY) saw another sharp fall from around 150 to 142. The change in rate expectations in the US, however, seems largely exaggerated given that we do not expect a recession in the US. We keep our 3-month outlook for the USDJPY at 150, and 140 in 12 months.

"Carry trades" and "deleveraging"

The sharp rise in the Yen was probably reinforced by the reversal of so-called "carry trades". These trades imply that an investor borrows in a currency with very low interest rates (typically the Japanese Yen) and invests in assets with high interest rates (for example New Zealand bonds). Reversing such positions leads to an appreciation of the funding currency and a depreciation in the other. The reduction of borrowing to invest in financial assets (so-called "leverage") has probably been a more general trend. This "deleveraging" probably explains at least partially the sharp fall in highly speculative assets such as Bitcoin.

Other financial market reactions

The change in Fed rate cut expectations led to a sharp fall in 2- and 10-year yields. In the US, the fall was somewhat bigger for longer-dated bonds. In Germany the reverse was true. Long-dated US bonds often act as a "safe heaven" asset.

Equities were down, especially in Japan. Other markets also recorded losses but much smaller. Technology and small cap stocks fell a bit more relative to the large cap stocks. Commodities were generally down over the week, especially those related to the economic cycle, such as industrial commodities and oil.

Conclusion

The current market reaction is quite typical when negative news takes the markets by surprise in an environment with low liquidity. Indeed, when investors want to trade, they do not easily find a counterparty and the price variations can be exceptionally large. As discussed, the two main triggers were the earlier-than-expected rate hike in Japan and the weaker-than-expected US labour market data for July (triggering the Sahm rule). As mentioned, we do not think that these events change our base-case macroeconomic outlook, and we do think that the market reactions are exaggerated. We still expect equities to perform positively over the coming months and we keep a positive view on this asset class. This includes Japan, because the key reasons to be positive are structural and remain largely in place (improvements in corporate governance, shareholder-friendly policies and expected share buybacks). Other regional and sector preferences also remain unchanged. More details can be found in our Investment Strategy Focus for August.

We think that the current corrections could offer buying opportunities especially for the assets for which we have a positive opinion and where we have witnessed the sharpest corrections. We do however recommend letting the "dust settle" to have better visibility and to see whether technical support levels hold and look for a gradual normalisation of liquidity. We will monitor this over the coming weeks and further communications will follow.

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