EM MARKET COMMENT

QUICK TAKE: THIS IS NOT PANIC STATION

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GlobalEvolution

GLOBAL EVOLUTION

THIS IS NOT PANIC STATION

Goldilocks seems so much yesterday as August kicked off with spiking volatility and risk appetite slumping. The negative market action is centering around a sell-off in Japanese currencies and equities as well as US tech stocks. While we believe a mild recession is the most likely path forward, we would also caution against extrapolating recent market patterns.

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Summer doldrums - what happened?

Until recently, markets have weathered negative news remarkably well. Over the last few days, however, the negative newsflow seems to have reached a critical mass, triggering a spike in volatility and a sell-off in risk assets. The market impact is widespread, but centers around areas such as Japanese currencies and equities as well as US tech stocks. What has changed, causing this shift in the market mood? We see four key reasons for the recent sell-off:

1. Payrolls report fueling a recession narrative: The US job market report for July has been weak, but not awful. Monthly job growth stood at 114 thousand, potentially held down by bad weather. However, Sahm's famous recession rule was triggered as the 3-month moving average of US unemployment rate has now risen by 0.5%-pt. above its 12-month low[1]. This has historically been a strong recession indicator and rhymes with our long-held expectation of a mild recession in the US, starting within the next 6-9 months.
2. Policy divergence: Historically, where the Fed goes, other central banks follow – but not so much this time around. The Bank of Japan recently hiked rates and signaled further hikes, while Fed chair Powell put a rate cut on the table for the September meeting. Policy divergence always has the potential to create market disruptions. In Japan's case, the impact is widespread as Japan traditionally is a provider of liquidity through yen-funded carry trades. Higher Japanese rates implies that these carry trades (e.g. borrow in Yen and investing in higher-yielding EM bonds) have become less profitable and are now being unwound to some degree. Further, a strong Yen is hurting Japanese exporters, contributing to a historic decline in Japanese equities (see figure 1).
3. Poor Liquidity: Summer and August, in particular, is often a period of poor market liquidity, amplifying any potential market move. On top, short-term Dollar liquidity has taken a turn for the worse. US bank's reserves at the Fed – a crude measure of Dollar liquidity provision to the wider financial sector - last week showed the first year-over-year decline since August 2023[2].
4. Positioning unwinds: The abovementioned policy divergence has been exacerbated by the unwind of big short positions in the Japanese Yen, further pulling the rug from under Yen-based carry positions. In the equity space, negative earnings news combined with crowded positioning have triggered a big sell-off in tech equities. Tech stocks have been darlings of the equity investor community, which naturally increases the vulnerability to any negative news amid very crowded positioning and elevated valuations.

Road ahead: Mild recession, but not panic stations

The market narrative has shifted at record speed from being dominated by goldilocks hopes to recession anxiety . Our long-held view has been that the US is heading for a mild recession, triggered by the lagged impact of past interest rate hikes and a reversing fiscal impulse on GDP growth. In other words, the signals from the US labor market must be taken seriously. Consequently, the medium-term market direction is one of lower core yields and wider credit spreads. All being said, we do not think this is panic stations and would caution against extrapolating recent market moves.

[1] Source: U.S. Bureau of Labor Statistics (BLS)
[2] Source: The Federal Reserve System, Bord of Governors

First, the market rout is not broad-based enough to create a panic-mode that risk feeding on itself. Case in point, while tech stocks are beaten up, the equal weighted S&P 500 index is has been performing much better. In the EM space, some classic carry currencies like the Mexican Peso are suffering big losses. However, the decline in broad EM FX is nothing out of the ordinary (see figure 2). The Euro – despite its procyclicality - is actually up versus the Dollar over the past few days. If panic reigned and investors were seriously worried about the global economy, the Euro should also depreciate.

This brings us to our second point: The real economy. While we have expected a mild recession for some time, there's nothing on the data front suggesting it's time to run for the hills as a severe recession is not on the cards. Take the recent US job report. Unemployment is suggesting a recession ahead. But a job growth of more than 100.000 per month is signaling a gradual slowdown, not a sudden stand-still. In addition, inflation has cooled somewhat in the US, finally allowing the Fed to cut interest rates at a relatively early stage of the slowdown. Markets are pricing 125 basis points of Fed rate cuts over the coming three meetings at the current juncture and a better than equal probability of an emergency cut in the very near-term. This seems a bit overdone. However, a cutting cycle is likely to start in September, in itself limiting the downside risk to the global business cycle.

The EMD perspective

In other words, there are good reasons not to extrapolate the recent short-term market moves. Nevertheless, the cyclical backdrop is weakening. We therefore believe a defensive bias in our overall EMD asset allocation and within our main strategies is warranted. In the blended EMD asset allocation strategy, we have been overweight higher-rated segments like EM corporate debt for some time, We have held an underweight position in EM currency risk throughout the year. Within Global Evolution's local currency strategy, we prefer relatively defensive currencies within the high yielding segments like the Peruvian Sol, while being underweight e.g. Mexican Peso. In hard currency space, we have reduced our exposure to low-rated credit. Frontier markets as such have a relatively low beta given a large domestic investor share compared to the other main segments of EM debt, limiting the vulnerability to current market hick-ups.

Figure 1: Japanese equities rout unfolding...

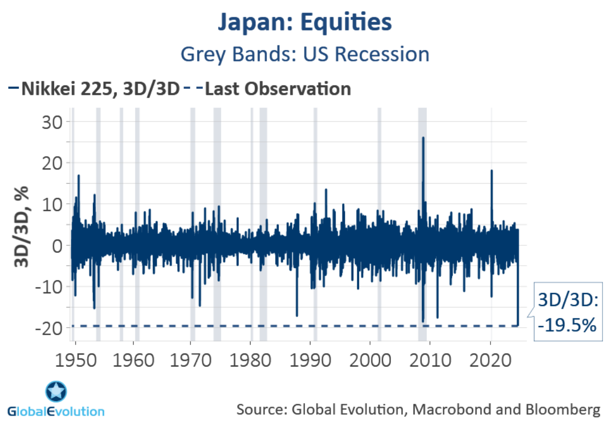
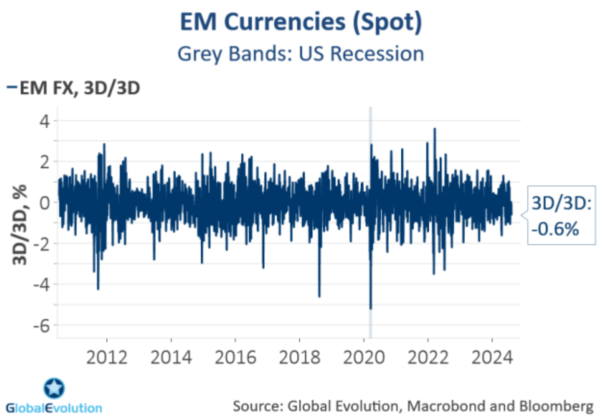


Figure 2: ...but limited declines in aggregate EM FX



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