Fall in August

Last week's weakness in global equity markets accelerated into a rout as exchanges opened across the world on Monday, August 5.

While investors had grown prickly in recent weeks on signs of wavering economic momentum in the US, a disappointing jobs print on Friday appeared to kick concerns over the soft-landing narrative into overdrive. A few general observations:

- The newly hawkish bias of the Bank of Japan (BOJ) stands in sharp contrast with the dovish leanings of other central banks like the Federal Reserve, and has caused the yen to strengthen. The abrupt repricing of fed funds rate expectations following the weak jobs report last week supercharged this move and served as a lighting bolt to the carry trade. The generationally low valuation of the yen made it highly elastic to this sort of change in relative expectations.
- Japan's Nikkei 225 shed more than 12% on Monday, its biggest one-day decline since the Black Monday crash in October 1987.[1] The Japanese equity market, in our view, is arguably undervalued relative to cash flows and assets. Japanese policy makers face tough choices unwinding their extremely accommodative monetary and fiscal policy settings; while this risk may be better priced following recent market drawdowns, the path forward will be a function of unpredictable policy evolution and geopolitical developments.
- Big tech names were another hard-hit segment, with the "Magnificent Seven" at one point having shed about $750 billion in market capitalization; yet, this cohort remains sharply higher year to date.[2] Earnings reports over the past few weeks generally have been underwhelming, and investors who have bid up the prices of these stocks for several years now may be growing impatient for tangible results from massive AI-related expenditures. That said, equity markets overall appear to merely have corrected from overbought levels; we have not seen the type of drawdown that would suggest a seasoned bear market.

1. Source: Reuters; data as of August 5, 2024.
2. Source: *The Wall Street Journal*; data as of August 5, 2024.

All comments are as of August 5, 2024.

- There is usually a tight relationship between equity market implied volatility and high yield credit spreads. In this selloff, however, equity market volatility spiked considerably more than credit spreads.[3] This suggests to us that there are either technical pressures leading the equity volatility market to be oversold, or that equity volatility markets (along with the yield curve) are signaling recession risk that will ultimately be reflected in higher credit spreads. Either way, the risk-reward in high yield credit has become relatively less attractive, in our view.
- As we have seen in previous incidents when liquidity first begins to get tight, the yen and US Treasuries rallied, the CBOE Volatility Index spiked and the gold price eased. Perhaps this is not surprising given short-term interest rates at cyclical highs in absolute terms and relative to softening wage inflation.[4]

In the view of the Global Value team, certain exposures like cash, gold and more defensive sectors like consumer staples—while not immune to market drawdowns—may provide some element of resilience compared with tech-heavy, broad market aggregates. We believe today's "shock" market move is a good reminder of the importance of respecting the inherent uncertainty of markets by investing in resilient assets.

Soft US Jobs Report Reverberates Globally

For some time now, market sentiment has appeared to be closely tied to expectations around the Fed's ability to engineer a soft landing for the US economy. Friday's job report appeared to flip a switch in the prevailing narrative and serve as a catalyst for Monday's sharp selloff, but it's not the first sign of economic fade we've seen this summer. Despite a range of economic data—from PMI reports to loan activity to consumer balance sheets—suggesting heightened cyclical risk, markets have been pricing in a soft landing and continued earnings growth.

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Traders now expect a 50 basis point cut in the federal funds rate at each of the central bank's next two meetings in September and November, and another nearly 50 basis points in December.[5] However, Fed officials—including Chicago Federal Reserve President Austan Goolsbee on Monday—have rushed to caution against overreacting to one month's numbers.[6] Indeed, the Fed will get another set of labor market data before the September meeting, and there are reasons to believe the hurricane that hit Texas may have impacted the July readings. Another bad report in August, however, likely would cause the Fed to act aggressively come September. Current market volatility is unlikely to prompt an inter-meeting cut by the Fed, as it is well aware that repricing was to be expected in certain markets where valuations appeared stretched.

Bank of Japan Charts Its Own Course

On July 31, the BOJ raised its policy target rate to 0.25%, the highest level since 2008, and presented a comprehensive plan for quantitative tightening. The BOJ also indicated that it would issue a series of hikes to bring policy rates toward neutral, assuming its forecasts are being met; this suggests rates in Japan could exceed the pre-global financial crisis peak of 0.5% and highlights the significant changes taking place in Japan's economy and policy settings.[7]

3. Source: Bloomberg; data as of August 5, 2024.
4. Source: FactSet; data as of August 5, 2024.
5. Source: CME FedWatch; data as of August 5, 2024.
6. Source: Reuters; data as of August 5, 2024.
7. Source: Bloomberg; data as of August 1, 2024.

Shrinking interest-rate differentials as a hawkish BOJ contrasts with the dovish leanings of other central banks like the Fed exerted upward pressure on the yen, which was exacerbated by the swift repricing of fed funds rate expectations following the soft jobs report last week. The yen rally has been further supported by traders unwinding their carry trades (i.e., where investors borrow money in economies with low interest rates to finance investment in higher-yielding areas).

Markets no longer expect additional BOJ rate hikes in 2024. In our view, it makes sense for the BOJ to be more cautious given the currency and equity volatility, as well as growing concerns about the health of the US economy. However, reading the minutes of July's BOJ meeting, officials appear to believe that a durable, virtuous cycle between wages and inflation is developing; once market volatility subsides, it would make sense to expect a gradual tightening in policy by the BOJ next year.[8] We continue to believe the yen is undervalued and would expect it to appreciate over the medium term, though nearer-term moves are more difficult to forecast given sensitivity to developments in the US.

Selloff Highlights the Importance of Building Resilience from the Bottom Up

Markets feel more rationally priced today than they felt a few weeks ago, but it would be unwise to assume things only can get better from here; we've long observed that markets can deliver a lot of pain to a lot of participants before arriving at fair prices. This is among the reasons why the Global Value team spends far less time obsessing over the macroeconomic and political variables that drive short-term performance than we do seeking opportunities in quality businesses that we believe can demonstrate resilience across multiple states of the world.

Assets promising growth have been assigned premium valuations by the market for some time now, but the market may start to value potential resilience should the investment backdrop remain volatile—if the soft-landing scenario fails to play out, or sovereign debt concerns promote a broad repricing of government paper, or if any one of the global military hotspots ignites into broader conflict. Resilience has traded at a premium in the past; in our view, there's no reason to believe it won't do so again under the right circumstances.

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8. Source: Reuters; data as of August 5, 2024.

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All investments involve the risk of loss of principal.

A principal risk of investing in value stocks is that the price of the security may not approach its anticipated value or may decline in value. "Value" investments, as a category, or entire industries or sectors associated with such investments, may lose favor with investors as compared to those that are more "growth" oriented.

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Bear market refers to a period during which a market experiences a prolonged decline in price.

Federal funds rate is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis.

Magnificent Seven refers to a group a seven very large tech-related stocks, including Alphabet, Amazon, Apple, Microsoft, Meta Platforms, Nvidia and Tesla.

Yield curve measures the spread between yields on short- and long-term bonds; an inverted yield curve occurs when longer-dated bond yields are lower than short-dated bond yields.

CBOE Volatility Index (VIX) measures the 30-day expected volatility of the US stock market. It is based on the prices of options on the S&P 500 Index and is calculated by aggregated weighted prices of the index's call and put options over a wide range of strike prices.

Nikkei 225 Index is an unmanaged price-weighted equity index that consists of 225 stocks in the first section of the Tokyo Stock Exchange.

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