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Three Drivers of *Recent Market Volatility*

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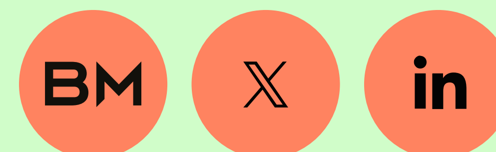

Over the last few days, equity markets have experienced heightened volatility levels and a correction in prices, with a culmination of events coming to the fore. Recently, the economic data from the US has been mixed, which has challenged the hoped-for 'soft landing' scenario of tamer inflation coinciding with reasonably robust economic growth.

This tied in with investors becoming more discerning towards companies beating or missing earnings expectations, along with some structural policy shifts in Japan, which have reassessed investors' risk appetite. These changes are all coming at a time when geopolitical risk remains at elevated levels.

Japan's recent policy shift

Firstly, the recent policy shift in Japan has been a significant and unexpected development. Policymakers increased interest rates, strengthening the Japanese yen and its relative attractiveness. The dramatic upward move of the Japanese yen caused a sizeable fall in equity markets, as the two are inversely correlated. We have recently seen a major reversal in equity performance – with the Japanese market losing close to 20% of its value at one point. This, though, has not been the only catalyst driving investor concerns.

This action by the Bank of Japan surprised markets. It led to the rapid unwinding of the 'carry-trade', a strategy where hedge funds borrowed yen, which had no yield and invested in Japanese stocks. The surprise rate hike has caused some forced selling by quant funds and discretionary macro hedge fund strategies as they look to rapidly close their short yen position. Price-insensitive computer algorithms will mostly have caused these. The stock market volatility in Japan has breathed oxygen into the flames of a more risk-averse investor in the West who has become increasingly nervous for a number of reasons.

A rise in US unemployment

Recent data from the US has been mixed and challenges the markets' perception of a 'Goldilocks' scenario, which refers to an economic environment where growth is strong enough to keep unemployment low but not so strong that it leads to inflation. The most recent US unemployment data was disappointing, with fewer jobs created and the headline unemployment rate rising to 4.3% from 4.1%. That led the US Federal Reserve, as expected, to leave policy rates unchanged, inferring that both growth and inflation were at levels that meant no policy stimulus was needed. Given the recent softer consumer and employment data, the market is challenging this narrative.

That said, while the headlines are undoubtedly disappointing, this is not the first month of 2024 when job creation was this low; the revised number in April of 108,000 was even lower. Furthermore, this data is likely to have been strongly influenced by the recent US hurricane season, which kept significant numbers of people away from work and caused a surge in temporary layoffs.

Mixed earnings announcements

The third driver may have been recent corporate earnings announcements. Similar to the economic backdrop, corporate earnings have been mixed, and the market has challenged companies that have disappointed and rewarded those that have exceeded guidance. Some areas of the market, and some specific stocks, have been trading at stretched valuations, and profit-taking was clearly a risk as volatility increased.

Looking more closely at corporate fundamentals, we are most of the way through the Q2 company earnings reporting season. According to FactSet, around 75% of the companies in the S&P 500 have reported, and the number of companies beating earnings estimates is above historical averages (although the margin by which they have beaten is lower than average). Earnings growth has been the highest since 2021, and operating margins are still strong. While the headlines may be dominated by a few companies releasing disappointing results, the earnings data has been good on the whole. Despite the recent sell-off, we are encouraged by the broadening out of the market away from a handful of companies trading on elevated valuations.

Outlook

Unsurprisingly, equity market volatility has recently spiked, but this has likely been exacerbated by low volumes, given that it is peak summer holiday season. We have expected a market rotation and ensuing volatility to come sooner or later as the market dominance by AI winners has become extreme. Market volatility is unnerving, especially when it is seen at these levels, and the media enjoys hyping it up.

Our biggest concern in markets over recent months has been market concentration, and we continue to expect a rotation of leadership at some point, as mean reversion is a powerful force. July saw the equally weighted S&P 500 deliver its strongest return in 3 years relative to the S&P 500. The 'Magnificent 7' stocks are c. 33% of the S&P 500 but just 1.4% of the equally weighted index, and this is perhaps the clearest way to see that mean reversion unwind. A rotation was always likely to cause volatility, but we believe that diversification and a balanced approach are the best ways to position portfolios for the longer term.

Against this backdrop, at Brooks Macdonald, we continue to believe that inflation can be brought closer to target levels without causing a global recession. We are encouraged by the broadening out in equity markets, which has occurred over the last month or so and is supportive of the US small & midcap exposures we added to portfolios earlier this year. We also note that after a sustained underperformance by UK equities, given current attractive valuations and ongoing merger and acquisition activity, there are durable tailwinds for large, mid and small-cap UK equities.

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