

The unwinding of the Yen Carry Trade: A healthy correction or something bigger?

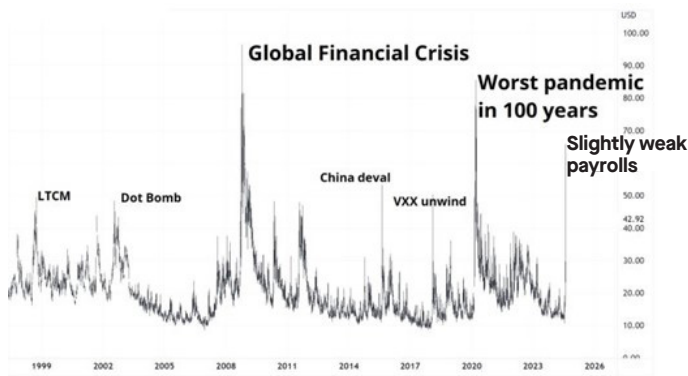
Key takeaways

- We believe that the current market correction is driven by technical factors rather than macro and fundamentals. The unwinding of the yen carry trade was an accident waiting to happen (see our June 2022 FOCUS note “Has Japan’s central bank created a monster?”). The heavy net long positioning by CTAs, the traditional low liquidity of August and the high valuation ratios of some crowded trades (e.g Mag 7) created the perfect “summer cocktail” for pullbacks of major global equity indices and a spectacular spike of the VIX.
- As explained in our FAQ, there is no reason to panic as macro and fundamental conditions remain favourable to equity markets. Still, history shows that stock markets remain bumpy in the 4 to 6 weeks which follow a spike in the VIX. As such, we’re keeping the current equity allocation unchanged (neutral vs. SAA) and adding some long duration bonds to portfolios as a diversifier.

THE BIG PICTURE

In our H2 market outlook (“Normalisation ahead”) and in our latest Asset Allocation Insights (“Volatility and rotation ahead”), we highlighted the risk of some market turbulence during the summer, which led us to slightly reduce our global equity allocation back to neutral in our client portfolios.

Over the last few days, global equity markets pulled back aggressively: the Nikkei index fell 12% on Monday, sending Japan’s index into bear market territory (-25% from peak). In the US, technology and growth stocks are leading to the downside, as the Nasdaq 100 has now entered correction territory (-15% from all-time-high at the close on Monday). A very spectacular move was observed on the VIX (or “fear index”) which recorded on Monday its 2nd largest daily increase ever (+65%).



Source: Bloomberg, RBC

Meanwhile, bond yields are declining aggressively especially on the front end, leading to a steepening of the yield curve. Gold remains steady, while cryptos are tumbling.



Source: Bloomberg, www.zerohedge.com

What are the reasons behind the sell-off in risk assets? Should we consider this move as a healthy correction or is it the start of something bigger? How are our clients’ portfolios positioned and should we envision any change in our tactical asset allocation at this stage?

FREQUENTLY ASKED QUESTIONS (FAQs)

FAQ #1

What has triggered the current market meltdown?

Several factors contributed:

Geopolitics: In July, markets started to anticipate a landslide victory of Donald Trump and the Republicans at the upcoming US elections. This news was rather bullish for equity markets given their pro-business and pro-markets stance. But since Kamala Harris has been endorsed as the democrat candidate, the incumbent party has closed the gap with Trump and the race has equalised. Meanwhile, tension remain elevated in the Middle East as Iran’s leader orders attack on Israel for the Haniyeh killing.

An “AI fear”: There is a sudden realisation by investors that their expectations of future efficiency had departed massively from reality. While most of the “Mag 7” stocks reported strong Q2 earnings, investors are starting to question the return on investment of the huge dollar amounts spent on Artificial Intelligence projects and capital expenditures. Given the expensive valuation ratios these large-cap tech stocks are trading on and the lofty earnings growth expectations baked in the stock prices, investors fear that the downside risk is much more elevated than initially thought.

The end of the liquidity bonanza. We need to keep in mind that markets have enjoyed a remarkable rally since 2022 through. After the initial recovery of global risk assets in H1 2023, the switch of Treasury auctions from long duration bonds to T-bills enabled the Treasury to throw another \$2 trillion of liquidity into the market over the last 9 months. But this tailwind is now abating. And with equity valuations at elevated levels and excessive net long positioning by CTAs and long-only mutual funds, markets are becoming more vulnerable to any bad news.

Disappointing US data: The Citigroup Economic surprises index has been in the red for quite some time now. But last week several macro data seemed to be indicating that the US economy is slowing down more aggressively than expected. The Institute for Supply Management’s (ISM’s) gauge of July manufacturing activity fell unexpectedly to 46.6, its lowest level since last November and marking nearly two years of almost continuous contraction in the sector. Meanwhile, US payroll numbers for July fell short on every metric except labour participation rate. US added just 114k jobs in July down from +206k in June and below consensus forecast of 175k, signalling a broadening slowdown in the labour market. Unemployment rates hit 4.3%, their highest level since October 2021, driven partly by a higher participation rate. Average hourly earnings were up 3.6% in July YoY – above recent pace of inflation, but the smallest gain since May 2021. The slowdown of the US economy is pushing upward

the number of rate cuts expected by the market in 2024. Interest rate futures now have a BASE CASE of a 50-basis point interest rate cut at the September Fed meeting. Markets are now pricing in 4.8 Fed cuts in 2024 (with only 3 meetings left). Consequently, the dollar is weakening against most currencies, including the yen (see next point).



Source: Convera, Macrobond

The unwinding of the yen carry trade: The sharply hawkish tone adopted by Bank of Japan governor Kazuo Ueda after last Wednesday's meeting and market expectations for US Federal Reserve rate cuts have led to a spectacular appreciation of the Yen. As a result, investors are forced to unwind yen-funded carry trades (see next FAQ). This unwinding has compounded the upward move in the yen, leading to more unwinding, and so on.

FAQ #2

What is the yen carry trade? Why is the dollar-yen so important?

1. For 30 years Japan has had 0% interest on their currency.
2. As a result, for 30 years investors have borrowed YEN at no cost and invested it globally. They invested in T-Bills abroad and a basket of risk assets including the Nasdaq.
3. For the first time in many years, the BoJ increased interest rates last week by 0.25%. This was almost unprecedented.
4. As a result of the increased interest rates and the signal to the market, investors are now concerned that the money they borrowed for free is no longer free and therefore they are unwinding their trades and sending the funds back to Japan.
5. Which assets are the most at risk of being sold due to the unwinding of the carry trade and margin calls? Basically, the most overcrowded and the most liquid, i.e. US stocks and the Mag 7 in particular. This also includes the Mexican peso, Brazilian real and Australian dollar.

FAQ #3

Why didn't gold spike on Monday?

Despite a weakening dollar, rising tensions in the Middle East, the second biggest daily increase of the VIX ever and the Nikkei 225 closing down -12% on Monday, gold actually pulled back (-1.5%) on August 5th.

While this may sound counter-intuitive, when margin calls happen, even safe havens such as gold can be sold as investors usually sell the most liquid assets. This is probably what those facing margin calls did by selling their gold ETFs or gold futures.

FAQ #4

Did credit spreads widen on the back of the surge in the VIX?

There were indeed some credit spreads widening in US Investment Grade and US High Yields, but returns didn't suffer much as the drop in benchmark yields helped offsetting the credit spread widening.

We note that the spread widening is significantly less pronounced than in previous periods of market stress. This is a rather positive sign.

FAQ #5

Are bonds and equities moving together?

Unlike previous market corrections or the 2022 bear market, government bonds and the performance of equities been diverging, which means that the correlation between the two main asset classes has turned from positive to negative. Long duration bonds thus proved to be an effective portfolio hedge during Monday's turmoil.

FAQ #6

Could this technical correction (in US stocks) have some macroeconomic impacts?

The short answer is yes. As explained by Gavekal research, the US equity sell off eats into US household net worth. This affects households of all classes, poor as well as rich. This is because during Covid, all households increased their investment in US stocks, with many people taking to stock trading for the first time when they received their stimulus checks. As household wealth takes a hit, consumers - the biggest driver of the US economy - grow cautious and spend less.

And the harder the economy gets hit, the more the Fed will need to cut rates, leading to further dollar weakness (and a stronger yen), triggering more carry trade unwinding, more pain for the US consumer and so on.

There is thus a risk of a negative feedback loop unfolding. And unlike other market stress situations, aggressive rate cuts by the Fed might not necessarily have a positive effect on markets (see FAQ #8).

That being said, we believe that fundamentals remain solid (see FAQ #9) and that the collateral damages to the economy will be limited.

FAQ #7

What could end the unwinding of the carry trade?

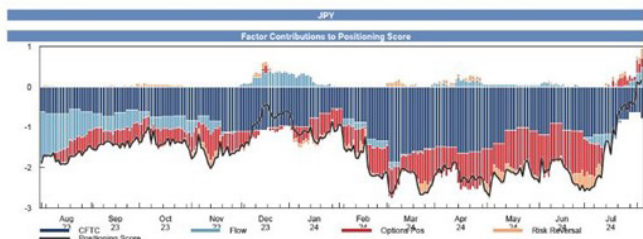
There are several developments which could stop or at least slow down the current forced selling of risk assets.

Firstly, the Japanese government might step in to stop the rise of the yen. A few weeks ago, the Japanese government was desperately trying to stem the depreciation of the yen. But given the speed of its recent appreciation, it is conceivable that the finance ministry could order the BoJ to intervene in the foreign exchange market to slow the currency's rise. And even a temporary halt in the yen's appreciation could break the immediate doom loop, providing markets with a much-needed breather.

Secondly, signs that the US economy is slowing down but at more moderate pace than the market currently fears. On Monday afternoon, a solid rise in ISM Service dampened growth scare in markets a bit and provided additional sign that we are currently facing a technical / positioning driven correction instead of one led by hard landing fears. The main ISM services index and new orders showed a strong rebound. Meanwhile, the Employment Index is at the highest level of the year. As we outlined in our H2 outlook, we believe that the US will go through a soft landing rather than a hard one. A few positive economic reports might thus be enough to end the dollar weakness and put a stop to the carry trade unwinding.

Thirdly, all the yen-funded carry trades get unwound. It is hard to know the size of yen-funded carry trades out there, but the estimated size of this trade is over \$4 trillion! The other question that remains is how aggressive the unwinding will be. Goldman Sachs provided some good news on Monday evening, that the JPY FX positioning has moved from heavy Net short (as of the end of July) to Net long as of Monday evening. This shows that the unwinding has been quite brutal and could come to an end soon.

Our positioning indicator shows that JPY FX positioning has finally flipped net long after the largest 1mth short unwind since our records began in 2015.



Source: GS MarketStrats (FICC and Equities) as of 2 August 2024.

Finally, an exogenous event (geopolitical shock?) leading to a rise in the dollar as global investors seek safe-haven currencies. However, while this could stop the appreciation of the yen, this might not end the decline of equities.

FAQ #8

Will the Fed aggressively cut rates?

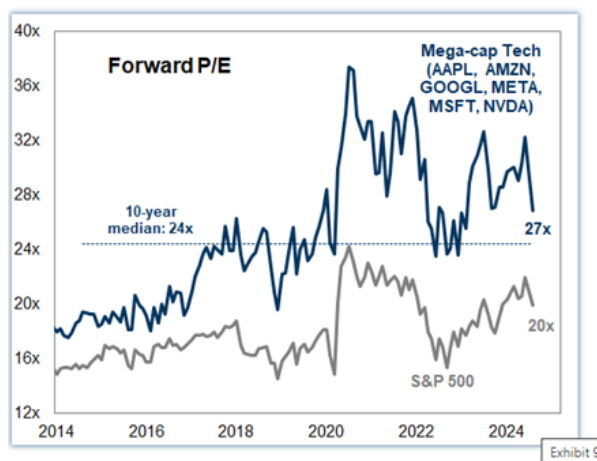
As previously mentioned, the market is currently pricing in aggressive rate cuts for 2024, with a 50bps cut now being the base case for September and a high probability of a cut before the September FOMC meeting. While we believe that the Fed will start to normalise monetary policy before year-end (see our H2 outlook), we don't believe the Fed will cut as aggressively as the market is anticipating. Firstly, because the economy does not seem to be heading into a hard landing. Atlanta Fed GDPNow model nowcast of real GDP growth in Q3 2024 currently stands at 2.5%, in-line with the soft landing scenario. US private sector balance sheets are healthy. Credit spreads are tight. And despite the early August pull back, markets are still deeply in the green on a year-to-date basis. Aggressive rate cuts could thus lead to more bubbles and create upside inflation risks. Last but not least, cutting rates too much could weaken the dollar and thus create another wave of JPY carry trade unwinding. This could prove to be counterproductive.

FAQ #9

What are the risks for this correction to prolong into a bear market?

Equity markets have enjoyed a strong bull run and Mega-cap tech stocks are currently expensive, even after the last few days pull-back (see chart below). As mentioned in our H2 outlook, volatility has been abnormally low in the first half of the year and a pick-up in volatility and market correction was long overdue.

Exhibit 9: Mega-cap tech valuations have declined but remain above 10-year median



Source: FactSet, Goldman Sachs Global Investment Research

Exhibit 9

As mentioned earlier, the current negative feedback loop (equity markets weakness weighing on US consumer balance sheets) has created downside growth risks. There is also a risk of negative earnings revisions as analysts could start to reflect the risk of hard landing into their perspectives. A contagion of equity market turmoil into credit markets could also create the conditions of another downside leg.

That being said, we do believe that this is a technical correction rather than a fundamental one and this for the following reasons:

- › The global economy and the US economy are in very decent shape.
- › Corporate balance sheets are healthy.
- › MSCI World earnings per share are expected to grow by 10% in 2025 and we are not seeing any material downward revisions to 2024 and 2025 earnings expectations.
- › US labour market is normalising but unemployment rate is low and wage growth remains above 3% yoy.
- › Disinflation trend is well in place and opens the door to a normalisation of monetary policy.
- › Excluding the Mag 7, equity market valuations are not expensive.
- › There is \$7 trillion currently sitting into money market funds. Once the Fed starts cutting rates, some of this dry powder might be deployed into risk assets.

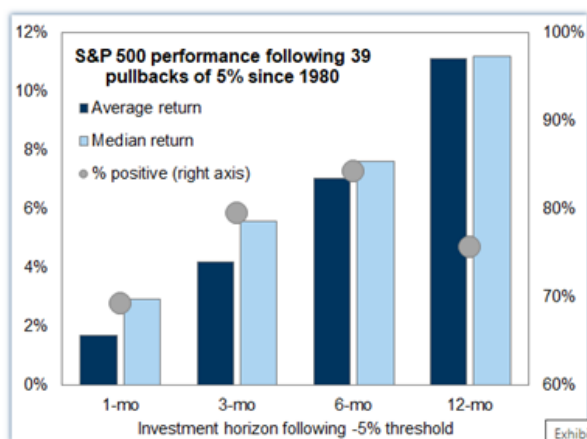
FAQ #10

Should we buy the dip?

TS Lombard’s analysis of previous volatility events indicates that, on average, equities require 4 to 5 weeks to start a sustained recovery. Markets tend to rebound on oversold conditions such as the current ones, but investors often sell into that strength, which can lead to a relapse. This is what happened, for instance, in 2018, an episode that bears strong similarities to the current one.

While markets pull-backs have historically provided attractive buying opportunities (see chart below), it might be too soon to aggressively come back into equities. There is also no guarantee that the next uptrend in equities will be led by the same leadership than the last leg of the bull market. Indeed, we still believe that some rotation in sectors, style and countries can take place in the second half of this year.

Exhibit 2 : S&P 500 returns following 5% pullbacks



Source: Goldman Sachs Global Investment Research

THE WEIGHT OF THE EVIDENCE

Our asset allocation preferences are based on 5 indicators including 4 macro and fundamental indicators (leading) and 1 market dynamics (coincident). The weight of the evidence suggests a neutral allocation to equities. Below we review the positive and negative factors for each of them.

Indicators review summary - our five pillars

There is no change in the rating of our 5 pillars.

On the Macro side the picture has somewhat flipped with growth turning neutral/negative while the pressure building up on the Fed means liquidity is turning more positive with intra-meeting cuts now priced at a 60% probability.

Equity Earnings and Valuations are still holding at decent levels. We keep a close eye on any changes but for now, the two pillars still reflect a neutral stance.

Market indicators have oscillated around the neutral point with Symphony Allocation in the 50% to 75% range.

	(+)	(-)	WEIGHT OF THE EVIDENCE
MACRO CYCLE	Global economic growth remains in solid expansion. The US economy is still supported by domestic consumption, helped by fiscal policy. Europe & China growth have recovered from 2023 lows. There are short-term upside risks on inflation but medium-term prospects still point to disinflation.	Some signs of weaker sentiment across US households point to potential downside risks. Domestic demand remains subdued in China and prevents a stronger recovery. Tighter financing conditions could ultimately impact growth.	POSITIVE
LIQUIDITY	Financial conditions remain on the “easy side”. Central banks are still expected to cut rate in the second half of the year to avoid maintaining unnecessarily restrictive financing conditions as inflation gradually slows down. The pace of US Quantitative Tightening is slowing down, easing pressures on USD liquidity.	Central banks, especially the Fed in a context of lingering inflationary pressures, might continue to keep interest rates at elevated levels for few more months. Quantitative Tightening is still ongoing in the US and Europe.	NEUTRAL
EARNINGS GROWTH	Q1 earning season has been slightly ahead of expectations and led to upward revisions in the US and Europe. In the US, a broadening of earnings growth is expected in 2025. A resilient global economy should support forward earnings growth.	The bar of expectations is high, and companies must deliver the earnings and outlook to support these valuations. Downside risks around US consumption warrant to be monitored.	NEUTRAL
VALUATIONS	Ex Mag-7, valuations in the US and abroad are not expensive. Valuation is contrasted across regions, with China standing out with below historical median valuations.	S&P 500 12-months forward P/E is back above 20x. Expectations are relatively high in both earnings and valuation. Equity risk premium remains elevated as bond yields have been on the rise. There is competition from cash and bonds.	NEUTRAL
MARKET FACTORS	The recent market rebound has re-confirmed the positive stance of trend indicators. Market breadth turned negative at some point as new highs in the market were made with lower participation. It has however improved recently.	Technical indicators are back in the “overbought” territory which means a “reduce” signal from our contrarian models. Market sentiment is now neutral (from complacent).	NEUTRAL

INVESTMENT CONCLUSIONS

- We believe that the current market correction is driven by technical factors rather than macro and fundamentals. The unwinding of the yen carry trade was an accident waiting to happen (see our June 2022 FOCUS note “Has Japan’s central bank created a monster?”). The heavy net long positioning by CTAs, the traditional low liquidity of August and the high valuation ratios of some crowded trades (e.g Mag 7) created the perfect “summer cocktail” for pullbacks of major global equity indices and a spectacular spike of the VIX.
- As explained in our FAQ, there is no reason to panic as macro and fundamental conditions remain favourable to equity markets. Still, history shows that stock markets remain bumpy in the 4 to 6 weeks which follow a spike in the VIX. As such, we’re keeping the current equity allocation unchanged (neutral vs. SAA) and adding some long duration bonds to portfolios as a diversifier.

TACTICAL ASSET ALLOCATION (TAA) DECISIONS– 05.08.2024

TAA Balanced moves

We started the year with an allocation to equities which was close to our Strategic Asset Allocation (SAA). Due to market effects, the allocation has been rising progressively to OVERWEIGHT throughout the first half of the year and we didn't sell into strength.

However, during our July Tactical Asset Allocation Committee, we decided to rebalance portfolios towards a NEUTRAL allocation to equities, which means that we effectively reduced our exposure to equities in our clients' portfolios. We did so by rebalancing our US Equity exposure towards SAA neutral point (e.g. this implied a 2% reduction in balanced accounts). Regarding Fixed Income, we also made some minor rebalancing moves within portfolios. For instance, in a balanced account we reduced the underweight of High Yield bonds, while staying slightly underweight vs our SAA across all 4 currencies (+1%). The two aforementioned changes resulted in an increase in cash (typically +1% in balanced accounts).

On the back of recent market moves, an ad-hoc Tactical Asset Allocation meeting was held on 5th of August.

As mentioned earlier, our stance on equities remains neutral but we expect market volatility to stay elevated for a while. We also note that the correlation between equities and bonds is turning negative, which improves the diversification characteristics of government bonds.

As such, the committee agreed to continue the move further toward neutral on the Fixed Income side by moving the long end government bonds back to neutral while holding our equity allocation at neutral.

Matrix of preference moves (see below)

Fixed Income moves to neutral (from negative)

→ Government bonds 10+ moves to neutral (from negative)

Equities remain neutral but some preferences are adjusted to reflect allocation drift within portfolios due to market effects:

→ US equities moves to neutral (from positive)

→ EU equities moves to neutral (from positive)

ASSET ALLOCATION GRID

TACTICAL POSITIONING: OUR ASSET ALLOCATION MATRIX

	--	-	NEUTRAL	+	++
Portfolio Risk			Cash ⊖ Fixed Income Equity Alternatives		
Fixed Income		HY (local or global hdg) EM Debt	⊖ Govies 10+ (local) Corporate IG (local)	Govies 1 - 10 (local)	
Equities		Emerging Markets	United States ⊖ Euro Zone ⊖ United Kingdom Switzerland Japan		
Alternative Investments			Hedge Funds		
Commodities				Gold Commodities	
Forex (vs USD)		EUR CHF GBP JPY EM currencies			

Change from last month: More attractive ⊖ Less attractive ⊖

Source: Investment strategy group - 5 August 2024

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