The week in seven charts

Chart #1
The week began with a bloodbath on Japanese markets
Read more on page 2 - Image ©iStock/

Chaos in Tokyo

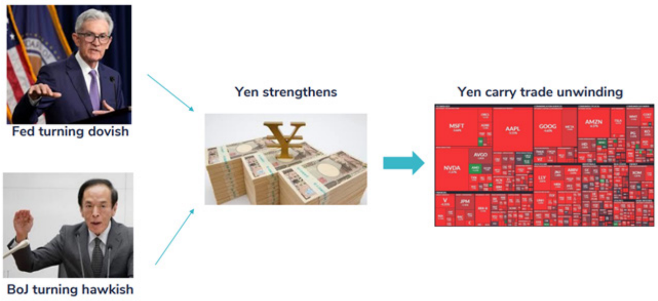
The week began in total chaos on Japanese markets as the 'yen carry trade' unwound, triggering a sharp rise in US equity volatility. Each week, the Syz investment team takes you through the last seven days in seven charts.

Charles-Henry Monchau
Chief Investment Officer

Chart #1

The week began with a bloodbath on Japanese markets

The Nikkei index fell 12% on Monday, sending Japan's index into bear market territory (-25% from peak). How can such a drop be explained in a single session? The main reason seems to be the unwinding of the yen carry trade. The previous week, the US Federal Reserve had sent a signal to the financial markets that it was ready to cut interest rates at its September meeting. A likely rate cut was corroborated by poor employment figures on Friday, with an unexpected rise in the unemployment rate. In the same week, the Bank of Japan surprised the market by raising rates from 10 to 25 basis points. These two events combined to send the yen sharply higher, triggering margin calls on carry trades (see next point).

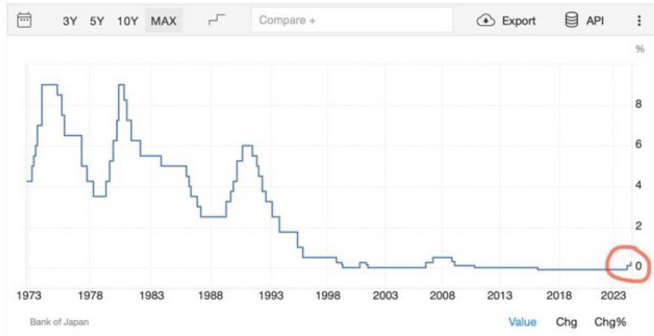


Source: Bank Syz Ltd

Chart #2

What is the « yen carry trade » ?

1. For the past thirty years, Japan has pursued a policy of 0% or even slightly negative interest rates.
2. During this period, investors and speculators from all over the world borrowed in yen at no cost and reinvested these amounts in high-interest assets (money market investments in dollars, Australian dollars, Brazilian reals, Mexican pesos, etc.), but also in risky assets such as US technology stocks, Japanese equities, crypto-currencies, etc.
3. On Thursday August 1st, Japan's central bank raised interest rates from 0.10% to 0.25%, raising the prospect of further rate hikes.
4. As a result of the rise in interest rates and the signal sent to the market, investors now fear that money borrowed free of charge will no longer be and, consequently, many are unwinding their carry trades to repay their yen loans prematurely.
5. These unwindings led to the liquidation of yen-financed investments - which explains the weakening of many currencies (US dollar, Australian dollar, Brazilian real, etc.) but also the decline in risky assets. The magnitude of last Monday's decline is reinforced by the fact that many systematically managed funds were heavily invested in these risky assets. Algorithms and low liquidity, traditionally observed in August, also amplified the downward movement. Japanese equities not only suffered from the unwinding of carry trades but were also affected by the strengthening of the yen (many Japanese companies are exporters, and therefore see their share prices fall when the yen strengthens).
6. The estimated size of these carry trades is over $4,000 billion!

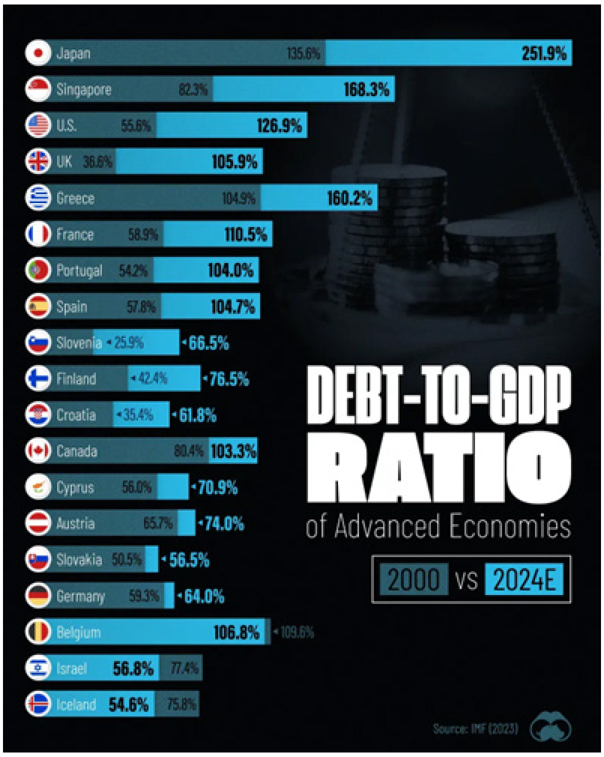


Source: Bank of Japan, Sina 21st Capital on X

Chart #3

Here's why the yen could soon weaken again

Although the yen could continue to appreciate for some time, it seems unlikely that this will be the case in the long term. Indeed, the fundamentals point to a long-term downtrend for the Japanese currency. The reason: a colossal debt burden that leaves Japan's central bank little choice: even in the event of a surge in inflation, Japan cannot afford to pay high interest rates on its debt, which today stands at over 250% of Japan's GDP. A world record.



Source: The Visual Capitalist, IMF

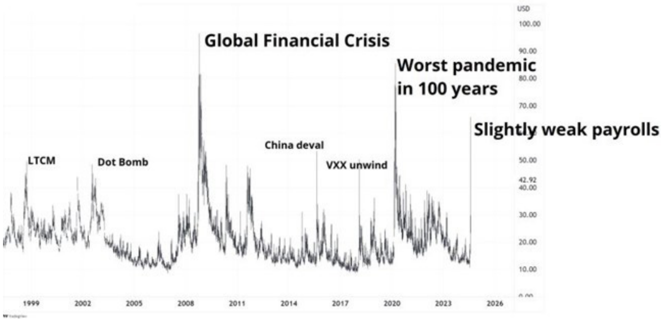
Chart #4

Japan's plunge triggers sharp rise in US equity volatility

The collapse of the Japanese market has had repercussions far beyond its borders. In the United States, the Nasdaq 100 index - which has been declining for 4 consecutive weeks - fell sharply on Monday. This index, heavily represented by large-cap technology stocks, is now down 15% from its July highs.

The VIX (also known as the "fear index") made a very spectacular move on Monday, recording its second-highest daily rise (+65%) ever.

The VIX also reached the 3rd highest level in history. Only the great financial crisis of 2008 and the pandemic of 2020 generated VIX levels higher than those seen on Monday.



Source: Bloomberg, RBC

Chart #5

Are the US elections also having an impact on the recent behavior of US equity markets

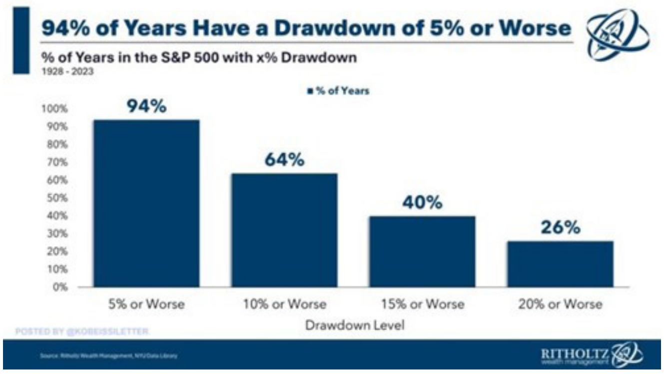
Coincidence or not, the Nasdaq index (yellow curve below) seems to be correlated with the probability of Donald Trump's re-election. The former tenant of the White House seems to inspire the equity markets. However, his chances of re-election (white curve below) have been plummeting since Kamala Harris became the Democrats' new nominee for the November election...

Source: Bloomberg, Bastien Chenivesse

Chart #6

Corrections are a fact of life in the financial markets

Stock market corrections are commonplace: Since 1928, the S&P 500 has declined by 5% or more in 94% of the years. A correction of 10% or more has occurred in 61 of the last 96 years. A larger decline of 15% or more occurred in 40% of the years between 1928 and 2023. Finally, a bear market with a drop of 20% or more has occurred in 25 of the last 96 years. Stock market downturns are a fact of life for investors. It's up to them to take advantage of them.



Source: Ritholtz Financial, The Kobeissi Letter

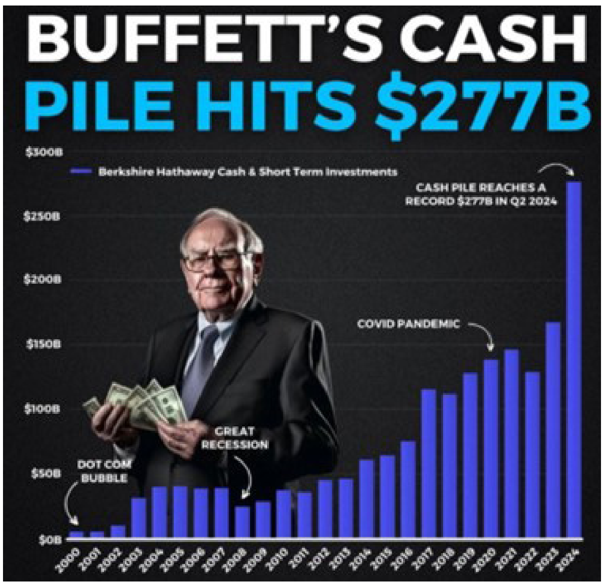
Chart #7

Warren Buffett sits on a mountain of cash

In times of market correction, investors are fortunate to have cash on hand to deploy in order to profit from falling share prices. Such is the case with Warren Buffett and his holding company Berkshire Hathaway.

The previous weekend, the company had announced its 2nd quarter results, while at the same time revealing details of its portfolio. The latter is flush with cash. Indeed, the conglomerate held $277 billion in short-term investments in Treasuries at the end of the second quarter, i.e. almost 4% of the stock of Treasuries issued to the public... Another noteworthy piece of information: Berkshire Hathaway now holds more Treasuries than the US Federal Reserve ($277 billion vs. $195 billion).

This precious liquidity cushion can be reinvested in the equity markets when bargains present themselves...



Source: Carbon Finance

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