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Recession Fears Reignite

The yen carry trade has been a focal point in financial media over the past week, as it contributed to significant market turbulence, not only in Japan on Sunday night but also in U.S. markets at the start of the week. Japan's stock market experienced a sharp 12% sell-off during overnight trading heading into Monday, and futures for the S&P 500 and Nasdaq were down by over 4% heading into the U.S. market open. Many investors were anticipating a Monday rebound, especially after Friday's pullback following a weak Nonfarm Payroll report, a sentiment widely echoed on Twitter (which often suggests the opposite will occur). The yen carry trade was a substantial factor in Monday's sell-off, but it wasn't the only one. A confluence of other elements played a role in the market's downward movement. Markets are inherently complex, and no single data point can fully explain such significant fluctuations. The following list highlights some of the additional factors that, along with the yen carry trade, contributed to the market turmoil:

- Investors were short volatility, VIX spiked into the 60's
- Profit taking from big tech has continued
- Investors began to panic which created sellers
- Algorithms begin to sell when the broader index hits technical levels
- Growth stocks have been priced for perfection
- Fear of recession has grown

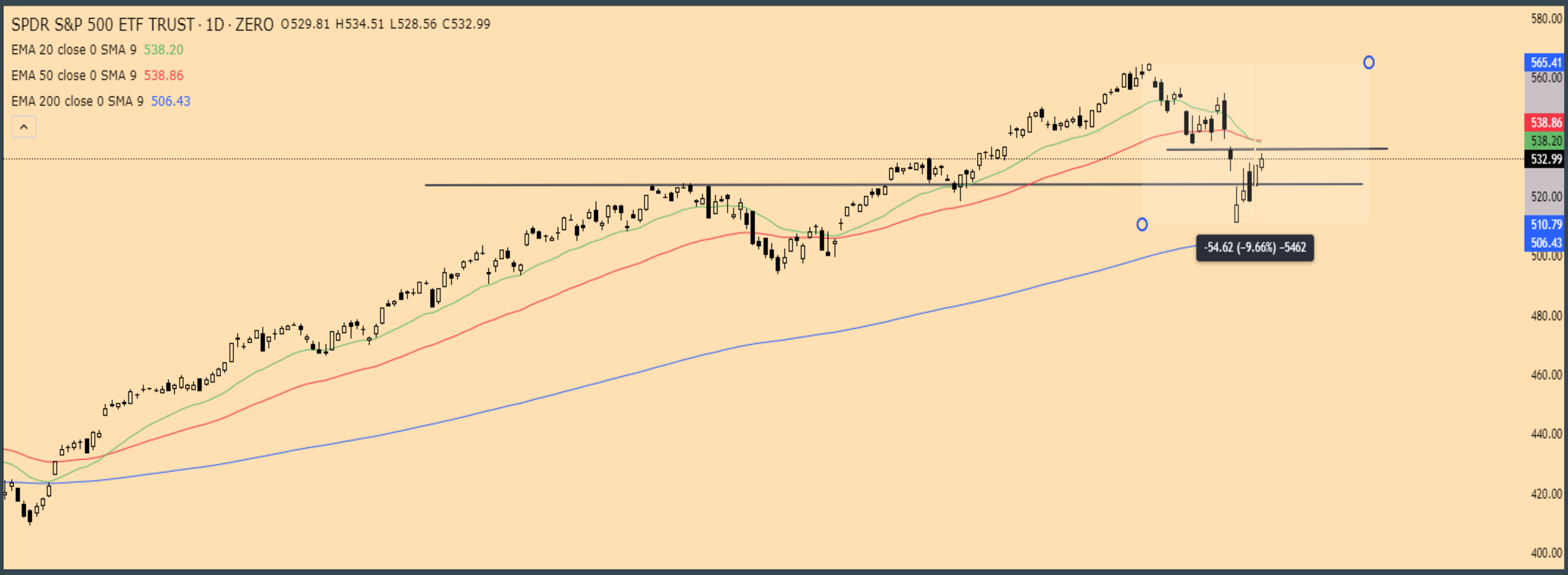
An event like the yen carry trade unwinding can initiate a wave of selling, but multiple factors contribute to the continuation of that selling. On Monday, the ISM Services PMI was released, showing positive results that helped markets find a bottom as growth fears subsided for the day. However, what didn't help was CNBC's early Monday morning interview with Professor Jeremy Siegel from Wharton, who called for an emergency 75 basis point rate cut by the Fed. Such a move would likely have only fueled further panic, exacerbating the very issue that sparked the initial selloff. To provide context, Japan announced a rate hike of 0.25% on July 31st, adjusting their policy rate from 0.00%-1.00% to 0.25%-1.00%. This led to a strengthening of the yen. Investors often engage in carry trades, where they borrow in low-yielding currencies and invest in markets with higher interest rates. The profits from these trades are then used to cover the borrowing costs, with the difference being their gain. The yen has been a popular funding currency for these trades for decades. However, the success of such trades depends on interest rate differentials remaining stable or widening, or the borrowed currency (yen) not appreciating against the currency of the invested assets (U.S. dollar). The 25 basis point hike caused the yen to appreciate against the dollar, impacting many investors who had used borrowed yen to purchase U.S. stocks. As these investors closed their positions, a feedback loop was created where the yen strengthened further, leading to more investors needing to exit their trades. This dynamic resulted in heightened volatility and swift selloffs in assets. Understanding the mechanics of the carry trade makes it clear why Jeremy Siegel's call for a 75 basis point cut was ill-advised. Such a cut would reduce the interest rate differential between the U.S. and Japan, weakening the dollar and forcing more investors to cover their yen shorts, thereby worsening the situation. From the point when the Bank of Japan announced their rate hike to Sunday night, when the Japanese stock market sold off by 12%, the yen had appreciated by 7%.

The relationship between the Nasdaq and the yen becomes evident when charting the two together, revealing that the Nasdaq was one of the assets being financed through borrowing in Japan. This connection helps explain why, in the futures market heading into the open, the Nasdaq was the hardest hit, down 6%.

The Nikkei 225 Index, Japan's benchmark stock market index, has since bottomed and rebounded by 11%, but the peak-to-trough drawdown was a substantial 26%. The index reached an RSI of 18, indicating it was massively oversold. The stabilization of the Nikkei and the potential for another leg lower will largely depend on the movement of the yen.

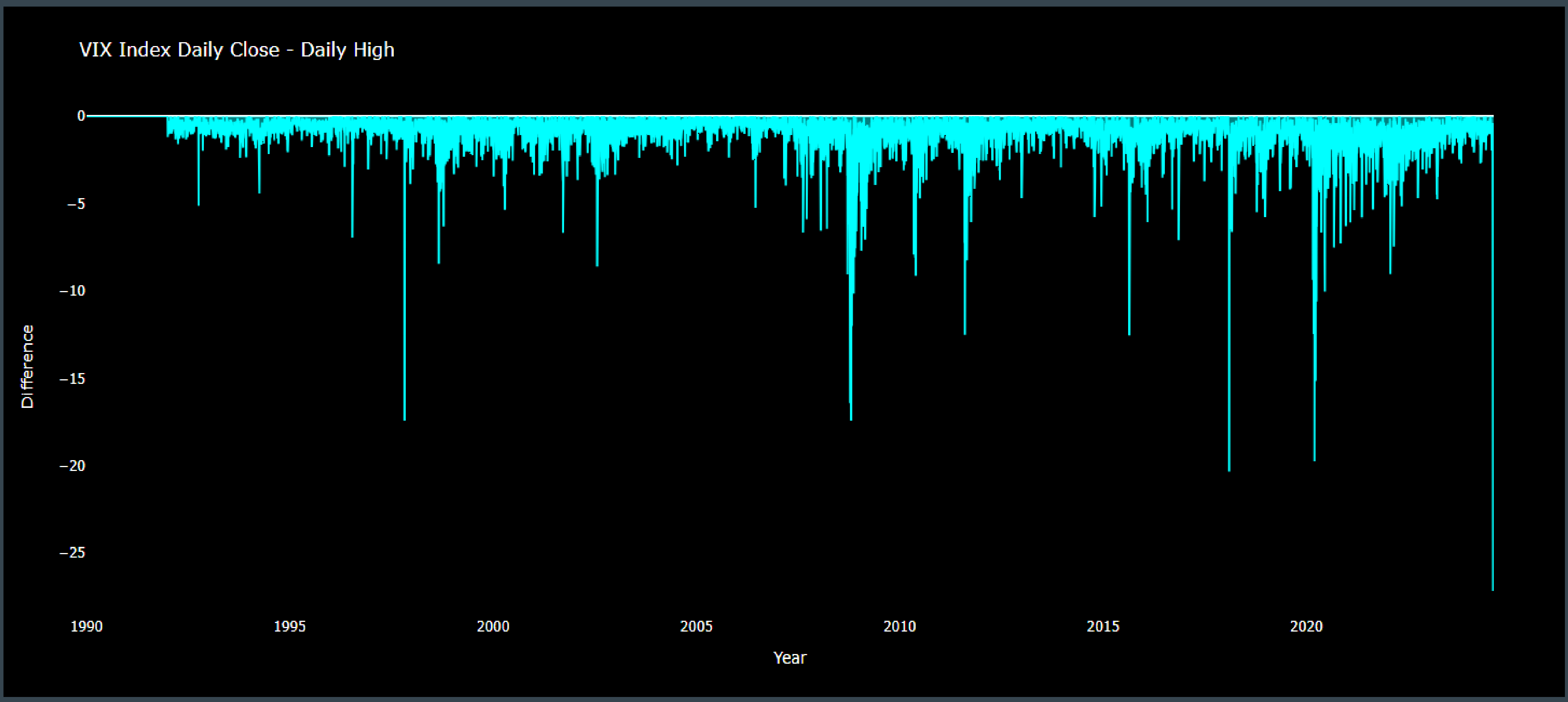
Japan generates over 20% of its GDP through exports, making the strengthening of the yen particularly impactful on its economy, especially over such a short time frame. A rapidly strengthening yen significantly increases the prices of Japanese goods for foreign importers, which could lead to a sharp decline in exports and a subsequent drop in the earnings of Japanese companies. In response to the volatility, the Bank of Japan (BOJ) acted swiftly on Wednesday, with Governor Shinichi Uchida making it clear that there would be no additional tightening measures as long as markets remain unstable. Japan finds itself in a challenging position; they cannot afford to raise rates further due to their substantial debt levels and the adverse effects a stronger yen has on U.S. markets. This issue is not confined to the BOJ alone; it has also become a critical concern for the Federal Reserve. Cutting rates in the U.S. would weaken the dollar against the yen, potentially reigniting the unwinding of the carry trade—a process that is not yet fully complete. Conversely, a stronger dollar places continued stress on the global economy, as many countries are short dollars. This could force international sellers to offload U.S. assets to raise dollars, creating upward pressure on the dollar in a potentially self-reinforcing spiral.

The S&P 500 found a bottom on Monday just above 5,100. It didn't quite reach correction territory like the Nasdaq, which experienced a 10% drawdown, but the index was down 9.49% from its peak. Since then, it has rallied by about 4%, ending Friday at 5,320.

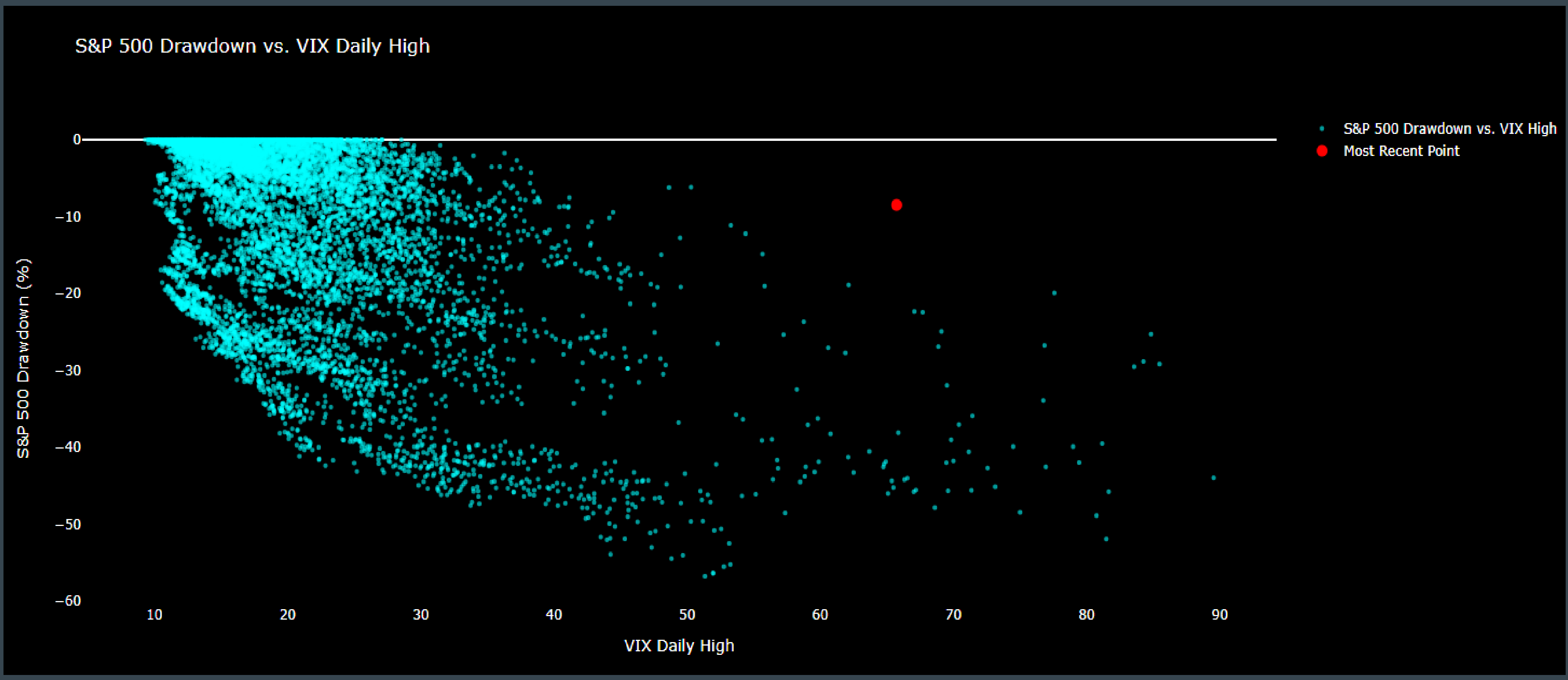


The selloff on Monday coincided with yields falling across the curve as investors sought the safety of bonds. Interestingly, the U.S. dollar also declined along with yields, signaling that this was not a liquidity event, which could have escalated the pullback into something much more severe. In true crisis events, like the Global Financial Crisis (GFC), when a selloff occurs, the dollar typically strengthens as yields fall because investors scramble to secure more dollars as liquidity dries up. The fact that we didn't see this pattern on Monday was a key indicator that the situation, while serious, would likely not turn into something larger.

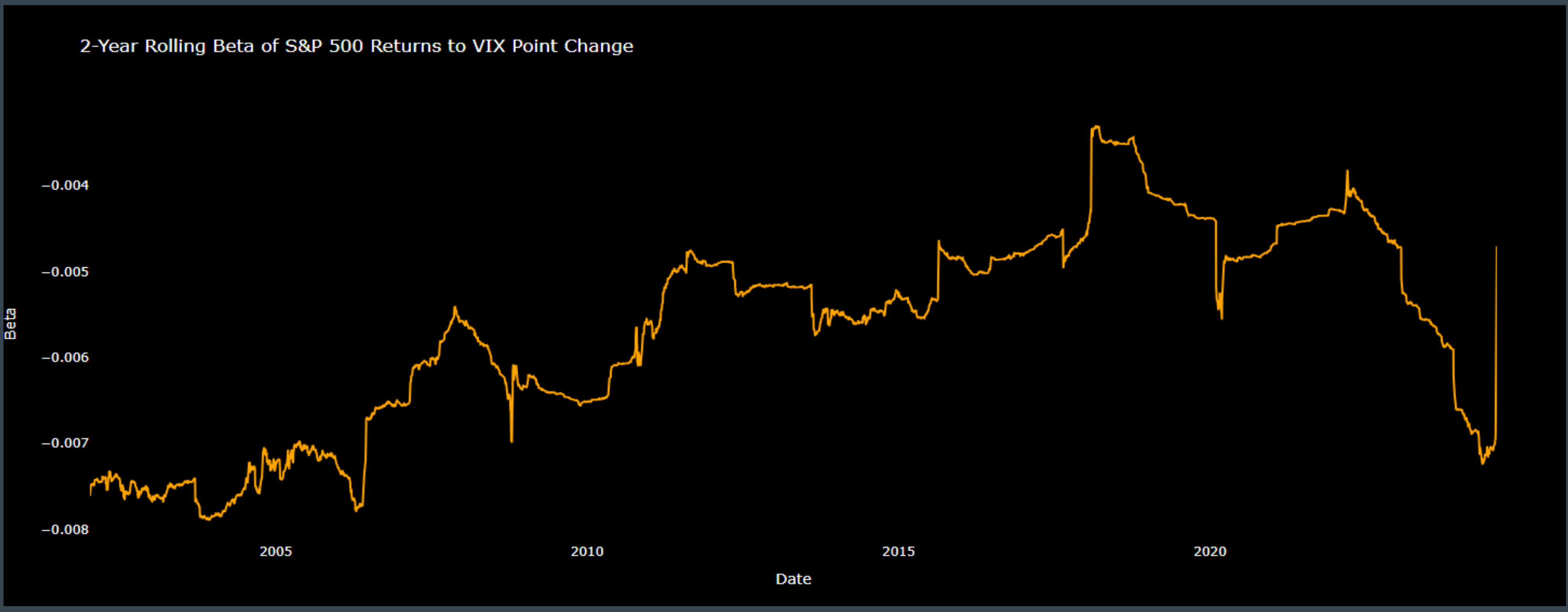
What was unusual about Monday's selloff was the behavior of the VIX relative to the broader market. The VIX spiked to levels in the 60s, approaching record highs. The only time we've seen it higher was during March 2020, when it reached the 80s. Typically, such spikes in the VIX coincide with much larger market drawdowns, far beyond just a few percentage points. However, upon examining the data, we discovered that the VIX experienced its largest intraday pullback on record. This indicated a surge in panic as investors rushed to hedge, but the widespread selling that usually accompanies a VIX spike of that magnitude did not materialize. This divergence suggested that while there was significant concern, it wasn't the beginning of a market crash.



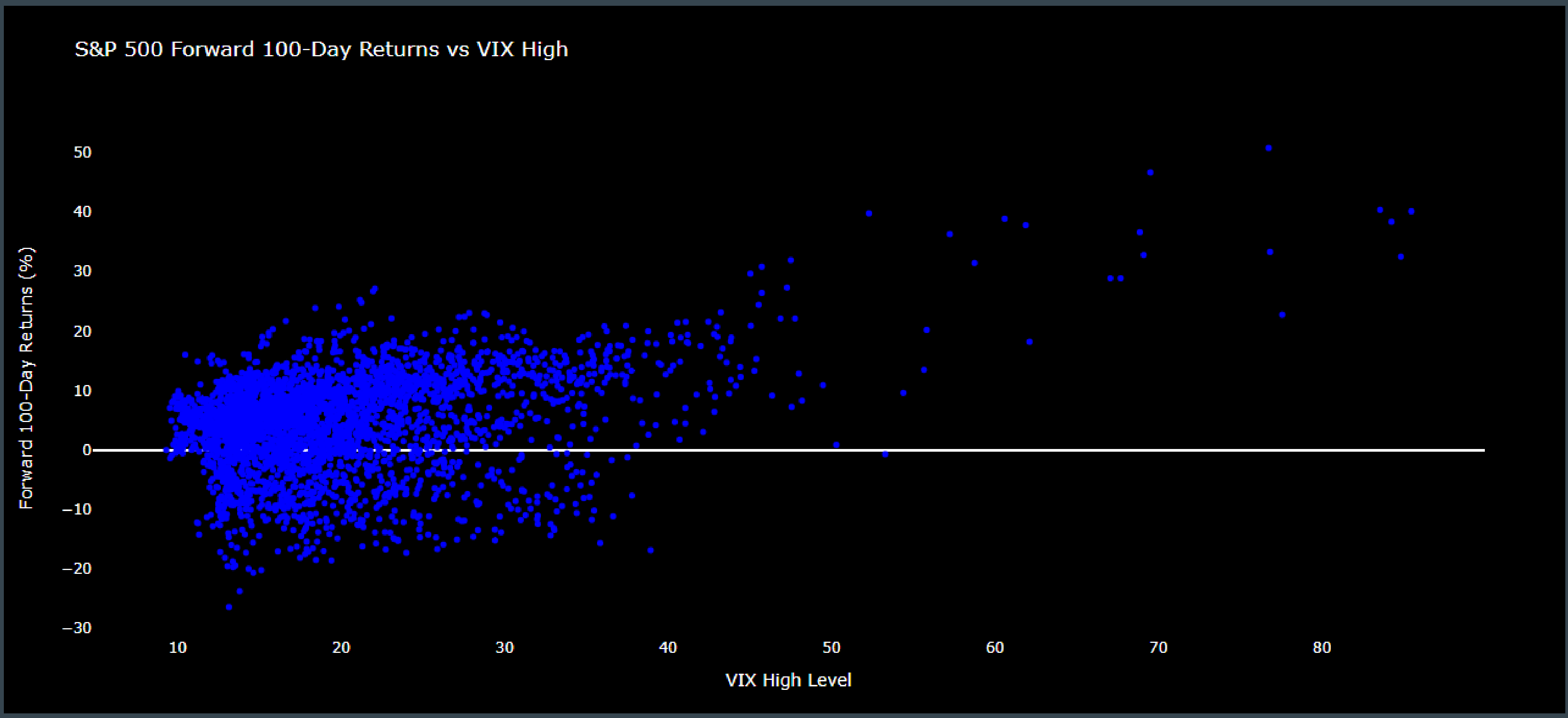
We reached the highest VIX level on record without being in at least a 20% drawdown in the S&P 500.



The rolling 2-year beta of the S&P 500 to the point change in the VIX reveals that since 2020, the S&P 500's response to movements in the VIX has been more muted compared to historical norms. This shift has prompted numerous studies examining the impact of 0 DTE (zero days to expiration) options on this relationship. The question arises: if investors are increasingly using shorter-term options as hedges, does the VIX index still serve as an effective gauge of market fear and volatility? We believe that the VIX remains a valuable indicator, but there's no doubt that the rise of 0 DTE options has significantly influenced this dynamic.

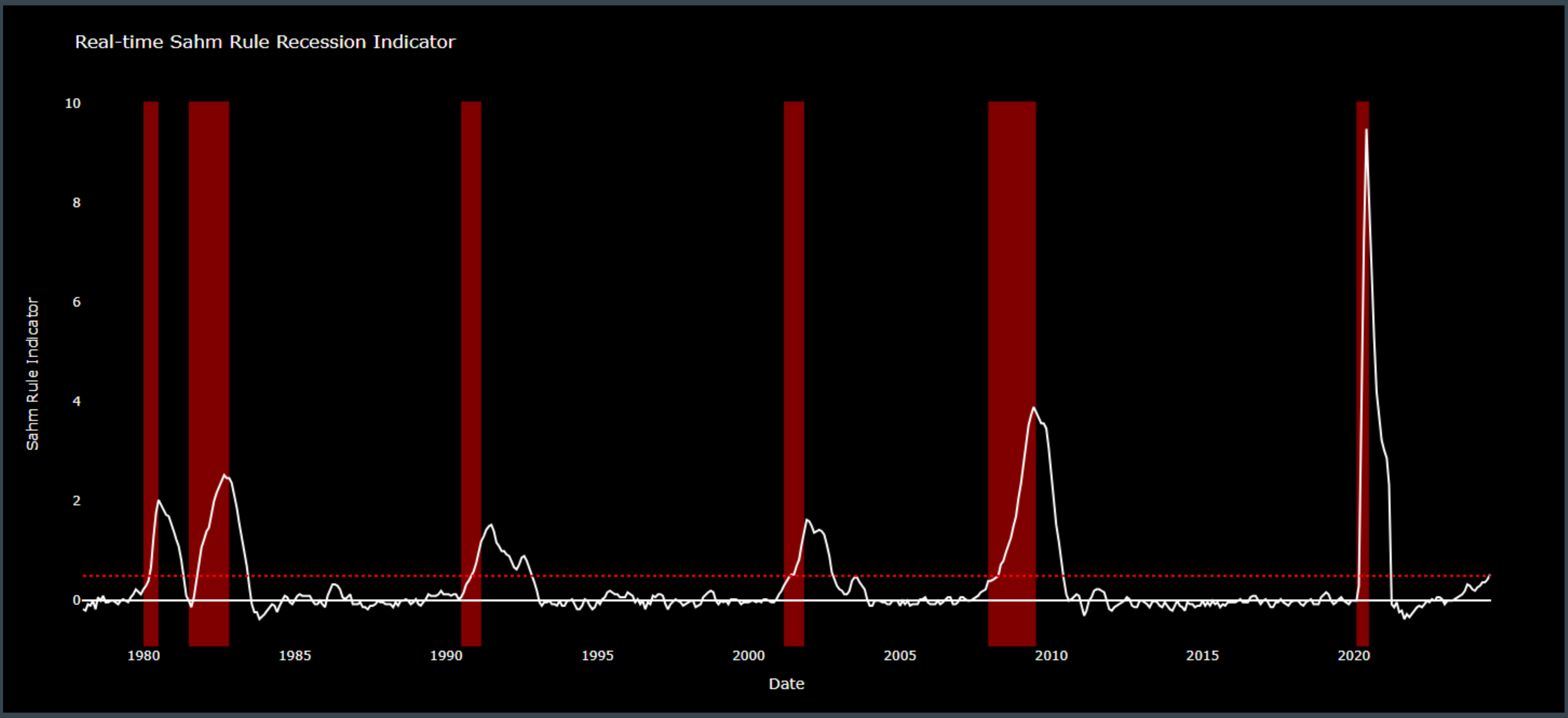


The forward 100-day returns of the S&P 500 relative to current VIX levels suggest that the market is likely to move higher. However, given that volatility has been muted for an extended period and considering the seasonal patterns of volatility, which typically persist through October, we are cautious about relying too heavily on this signal. While the chart indicates potential upside, the unusual conditions and expected volatility in the coming months make it less reliable as a predictor of near-term market performance.



There appears to be a noticeable shift in market sentiment where bad news is once again being interpreted as bad news. Previously, negative economic data often led to expectations of rate cuts, but the economy wasn't weak enough to raise serious concerns, so the market moved higher. However, the recent payrolls report has altered this narrative. Moving forward, portfolio positioning will likely hinge on whether you believe in a soft landing or a hard landing for the economy. For those in the soft landing camp, the recent pullback presents a buying opportunity, as we may be entering a seasonally soft period that trends sideways through the end of October that leads to a year end rally to highs. This view is supported by the seasonality patterns observed in the S&P 500, Nasdaq, and Russell 2000, all of which align with expectations of a choppy but relatively stable market in the coming months.

For those in the hard landing camp, it's likely that the market highs for the year are already in, and the strategy should be to sell on rallies. After a sharp move lower like the one we just experienced, it's important to be cautious of trapped longs. The rapid decline didn't allow institutions enough time to fully exit their positions, so as the market approaches significant technical levels during a rally, institutions are likely to sell, causing the market to roll back over. This scenario seems probable as the market attempts to revisit its previous peaks. Additionally, the Sahm Rule was triggered in the latest payrolls report, something we highlighted two months ago. At that time, we did the math and noted that a rise of 10 basis points in the unemployment rate through June and July would activate the rule, and it's now making headlines across financial media. This past week, Claudia Sahm herself conducted several interviews, explaining that the rule serves as a warning sign for policymakers to consider loosening policy. However, she suggests that the recent trigger is more a result of new entrants into the labor force rather than people losing their jobs, implying it might not signal a recession this time. Despite her view, it's concerning that 96% of those who entered the labor force over the past year have not found jobs, indicating that the labor market is far from healthy. Moreover, the Sahm Rule has triggered before each of the last six recessions, which does not bode well for her argument that this time might be different.



A more technical dismissal of Claudia Sahm's argument is rooted in the fact that her rule functions as a momentum indicator, and the real issue with employment is its convex nature. As shown in the chart below, once the unemployment rate rises by 50 basis points from its 12-month low, it tends to accelerate sharply, often leading to significant increases before peaking. Similarly, after the U-3 unemployment rate hits a trough, we frequently see moves of 300+ basis points as the rate climbs higher. Given that the U.S. economy is 70% consumption-based, even a small increase in unemployment can have a disproportionate impact. When people lose their jobs, they cut back on spending, which in turn impacts business earnings. This reduction in earnings can prompt further layoffs, creating a downward spiral of compressed margins, lower earnings, more layoffs, reduced consumption, and so on. So, what also does not favor her argument is convexity.

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