What does market stress mean for the economy?

Unio Global Macro Committee Outlook

August 2024

What has been happening in markets?

2024 has up until very recently been a strange year in stocks in that the distribution of market returns has been compressed – there have been relatively few 'big' days to the upside, and even more remarkably, not a single two per cent drop in the S&P 500 index for over four hundred days. Such periods of calm typically end with extreme volatility, as markets reassert a more normal distribution of returns.

In that regard, the recent sell-off in equities is overdue, and helps to make valuations and the risk outlook more 'normal'. Yet, the fact that the VIX volatility index hit levels (on Monday) that have only been exceeded in the global financial crisis and COVID sell-offs will worry investors and has triggered some commentators to herald a recession and call for emergency interest rate cuts. Our view is that this episode is much more of a portfolio crisis than an economic crisis in the sense that it is motivated more by the de-risking of portfolios, than a reaction to a worsening macroeconomic outlook.

Notably, in recent months the performance of AI centric large cap stocks have markedly outstripped that of the broad market, to the extent that market concentration has become extreme (the top 10 stocks in the S&P 500 made up 75% of its value), and in some cases valuations became extended. At the same time, low interest rates in Japan have encouraged a carry trade (borrowing in yen to 'invest' elsewhere), which will prove detrimental, possibly fatal, to some hedge funds.

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In this respect, with an eye on our portfolios, there are two important considerations – interest rates and the business cycle.

Interest Rates and the Business Cycle

On the latter, our view is that we are in the midst of a mild slowdown in the US economy. Here, unemployment is rising, lead indicators are pointing downwards (notably manufacturing more so than than services) and some segments of the housing market are weak. The corporate sector is relatively strong however. In this context, the upside is that a good number of the factors that have spurred inflation, are now in retreat. In Europe, where economies have been much weaker in the past year, there are signs of a mild rebound, and indeed, scope for an upturn in the credit cycle.

In general, this macro climate, together with the anxiety caused by market volatility, gives us reason to think that there is scope for interest rates to fall, but not dramatically so. We do not agree with the view that the Federal Reserve should make an emergency rate cut, and from a moral hazard point of view it would be very unwise to do so. That said, the emphasis in coming meetings will change to a more dovish tone. Additionally, within the coming days we expect that the Bank of Japan will publicly address the volatility in the yen, and try to curb its fall.

Likely Scenarios

Scenario #1 – Credit spreads remain muted in the US, Europe and Asia, and market volatility begins to ebb, with a small number of rate cuts priced into markets. The overall macro impact is low (and indeed we may see large private equity investors use the lower rate environment to invest cash).

Scenario #2 – Credit spreads widen, market volatility persists and passes to other sectors like financials. This would be more damaging for the real economy, and would ultimately necessitate a bigger policy response.

In summary, our sense is that volatility (and risk taking) will reset to a level commensurate with a disorderly world, and in the context of lower rates, investors will be more judicious in seeking out opportunities. This has already been our approach for much of this year. We have for example added exposure to cheaper European equities, rather than chase momentum in US tech stocks. In addition, our fixed income oriented portfolios are performing well.

Dublin Head Office

2 Sandyford Busienss Centre
Burton Hall Road
Sandyford
Dublin 18
D18 XK37
T: +353 (0) 1 662 1200

Cork

No 6. Lapps Quay
Cork
T12 VY7W
T: +353 (0)21 435 8533

Dublin

Block 3
The Oval
Shelbourne Road
Ballsbridge
Dublin D04 T852
Tel: +353 (0) 1 237 5500

Limerick

The Gallery
13 Bedford Row
Limerick
V94 VY47
T: +353 (0) 61 633777

Galway

Odeon House,
7 Eyre Square,
Galway.
H91 YNC8
T: +353 (0) 91 335 587

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www.unio.ie