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Mr Market will offer you a price, you don’t have to take it

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Over the course of a few days’ investors have experienced significant volatility in global financial markets. The Japanese equity market’s TOPIX index fell by over 12% on Monday, marking the largest drop in this major index in 37 years, before bouncing back by over 9% on Tuesday.

This turmoil followed weak US economic data last week, which, combined with significant currency movements, triggered a global financial market shake-up, affecting equities, currencies, cryptocurrencies, gold, and oil.

Explaining the precise causes of these market events is always challenging but market commentators have pointed to the yen carry trade and fears of a US recession as key culprits.

The yen carry-trade involves borrowing in yen at Japan’s low interest rates to invest in higher-yielding assets. This trade has become less attractive after the Bank of Japan raised interest rates on 31 July, thus reducing the gap between US and Japanese borrowing costs. In addition, the yen had begun to appreciate against the US dollar in early July and this accelerated after the interest rate rise. This appreciation of about 12% against the US dollar sparked a rapid institutional exit from this so-called carry-trade.

Another factor is the high valuations and recent pullback in leading US large cap technology stocks, with investors favouring these stocks more recently for their future profitability and cash generative characteristics, over the broader US market.

Additionally, weak US labour market data has fuelled concerns that the Federal Reserve has been too slow to cut interest rates, potentially leading to a US recession. It is interesting to note the movement in the US Treasury yield curve recently. For over two years now, the yield curve has been inverted. Typically, it is a sign that the Fed’s policy is too restrictive and tends to be a negative signal for financial markets.

With the Fed hinting at early cuts in interest rates and last week’s data highlighting economic risks, the bond market began to anticipate a more aggressive easing cycle, leading to a sharp rise in bond prices and a fall in yields. In this environment US bonds are much more attractive than Japanese bonds. In the US, investors can expect short-term yields to fall faster than long-term yields, which will help the yield curve to normalise, lower the cost of capital and support asset prices.

Japanese bond prices will likely be falling as US bond prices are rising, adding to the stampede out of the carry trade. Equally, US equity markets don’t generally fall into an easing cycle; they are much more exposed at the top of the business cycle before interest rates rise.

During market upheavals, it’s crucial for equity investors to remember that they are investing in businesses and the cashflows that they generate, not “the market.”, and that reacting to market panics can lead to poor decisions. Focusing on “the business” as a business owner would do helps put market volatility in perspective.

Over the last 12 months, we have generally held an underweight allocation in equity risk assets compared to our peers, across all our investment strategies. We also held no direct Japanese equity exposure. We have favoured defensive growth assets such as global high yield corporate bonds and undervalued Asian and Emerging Market equities, which are rewarding investors with attractive running yields now rather than speculating on future capital appreciation.

At the same time, our longer duration stabiliser assets have also performed well, reminding us of their important role as a dampener to overall portfolio volatility in a well-diversified multi-asset portfolio.

After many decades of experience through multiple “Bull” and “Bear” episodes we know it pays to ignore the noise and to focus on long-term value creation. Market volatility can be unsettling, and it can sometimes push investors to react emotionally. Investing for the long term means that one must accept short term volatility, and that trading reactively often results in missing out on the upside, when prices finally settle after the noise has subsided.

As Warren Buffett has said many times, “Everyday Mr Market will offer you a price, you don’t have to take it!”

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