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What really drives market volatility?

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Market volatility is often driven by various negative factors coinciding. This time is no different. The key question for us as investors is whether the current volatility is driven by a change in the broad economic outlook and more importantly the impact this may have on the valuations and cash flows of the equities that we own in our strategies.

Strangely, in our view, the key factor at play currently is not related to Nvidia or Donald Trump. The factor driving market pricing in the short term is actually the sudden sharp appreciation in the US$ over the past six weeks, which started prior to the US midterms and the current Nvidia scandal.

A sudden rise in the US$ often coincides with equity declines worldwide because it tightens global financial conditions, reduces risk appetite, and lowers the dollar value of foreign assets and earnings. The effect is strongest in emerging markets, where dollar funding and dollar-denominated debt are more prevalent.

The US$ is the principal global funding and reserve currency. When it strengthens suddenly, borrowers outside the United States, especially firms and governments with dollar debt, face higher repayment burdens in local currency, while dollar credit can become scarcer and more expensive. IMF research finds that dollar appreciations raise financing costs, depress consumption and investment, and produce negative real-economy spillovers that are deeper and longer-lasting in emerging markets.

This tightening can also coincide with wider credit spreads. Investors then demand greater compensation for risk, compressing equity valuations and making it harder for companies to refinance debt.

A sharp dollar rally is frequently a symptom of a “risk-off” shock: investors sell equities, commodities, and emerging-market assets and move into liquid US Treasuries. Analysis by the Bank for International Settlements (BIS) finds that a stronger US$ reduces global investors’ willingness to hold local-currency emerging-market bonds and equities in the short term. The mechanism is partly a balance-sheet effect: when the dollar rises, dollar-based investors’ foreign holdings are worth less in dollar terms, reducing their risk appetite and encouraging further withdrawals.

For US multinationals, a stronger US$ reduces the dollar value of overseas sales and profits, creating an earnings headwind even if foreign operations are unchanged. For non-US companies, it can hurt export competitiveness and squeeze firms reliant on imported dollar-priced inputs or dollar financing.

Thus, sudden dollar strength is more than a currency move. It can simultaneously tighten funding, trigger capital outflows, reduce valuations, and weaken expected earnings, which explains why global equities often fall together at times like this.

So, some of the factors that led to very strong returns until the summer: a weak US$, the AI trade, low starting valuations, low ownership of non-US equities, and falling inflation rates have reversed in the short term.

The focus for us is to stick to our investment philosophy during periods such as this and review the holdings we own in the context of the short-term price moves. Has the recent price volatility given us an opportunity to buy assets that we thought were expensive before? Having materially reduced our exposure to the AI trade over the summer due to valuation concerns, our focus now is on what comes next rather than panicking. Now remains a time to be patient, especially if you have only recently invested.

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