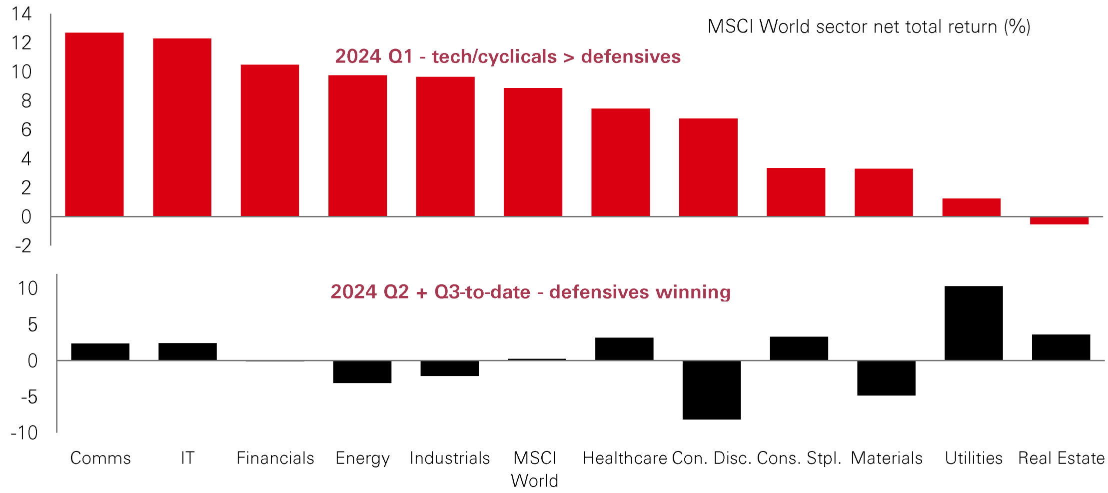
HSBC

Investment Weekly

12 August 2024

Chart of the week – Regime change in markets



Last week started with rapid drawdowns in many global equity indices, and some historic daily moves in Japan – both down and up. The VIX spiked to above 60 on Monday, a level last seen in the Covid market crisis of March 2020. And while markets regained their composure later in the week – the VIX fell back below 30 and the S&P 500 stabilised – **there is still major uncertainty** on how developments might pan out in the coming weeks.

As the recession risks are now clearly higher than anticipated only a few weeks ago, we need to consider the potential for "negative feedback loops" stemming from recent market action, which can dampen business and consumer confidence. With valuations in pockets of the risk asset universe still looking stretched (mega-cap tech, global high-yield credits) we think it makes sense to be cautious.

Meanwhile, defensive parts of the stock market (consumer staples, healthcare, and utilities) could be safe harbours. And real estate – although cyclically sensitive – is helped by falling rate expectations. With uncertainty still high, defensives remain in focus.

Economy →

What the 'three doctors' say about the economic outlook

Volatility →

Exploring the technical forces behind market moves

Private Equity →

Why the prospect of falling rates could give PE a boost

Market Spotlight

Mixed experience for Asian markets

Last week's sell-off in global risk assets had a mixed impact on emerging markets across Asia. Much of the **pain was felt in trade-dependent economies like Taiwan and South Korea**, where in-demand sectors like semiconductors are sensitive to a slowdown in US growth. The region's chipmakers have surprised to the upside on earnings this reporting season, suggesting still-solid demand for chips. Yet July's US tech sell-off had already had a chilling effect on stock prices. From year-highs in mid-July, Korea's Kospi index was down as much as 16% amid the volatility.

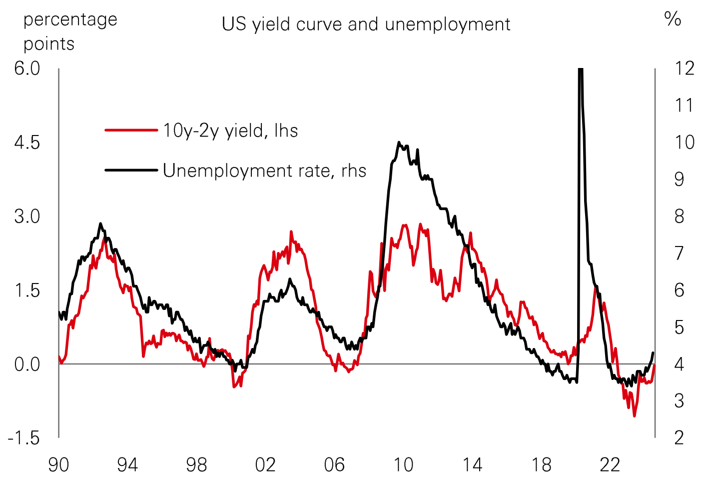
Mainland Chinese stocks have been under pressure all summer but held up better than most last week. In part that was because its stocks have relatively low overseas exposure versus global peers. There are also signs that analysts are feeling more optimistic about them, with 12-month forecast earnings picking up since early Q2. And in India, stocks experienced only mild drawdowns, outperforming regional peers despite relatively rich valuations. That was helped by recent earnings trends that have been broadly in line with expectations.

The three doctors

Markets have had a health scare – call the doctor! Or better, call three of them (Dr Yield-Curve, Dr Credit-Spread and Dr Sahm) who are often used to diagnose recessions.

What do these doctors say? First, the yield curve is dis-inverting via a 'bull steepening' (i.e. short-term interest are rates falling faster than long rates). Second, credit spreads are now rising, although not quite yet to historically concerning levels. Finally, on the real-economy side, the Sahm rule, which tracks the change in the unemployment rate, has breached a key threshold after July's bad labour market data. While several special factors – including Hurricane Beryl – could have temporarily boosted unemployment, a wide range of labour indicators highlight the jobs market is cooling.

The US economy could disappoint overly-optimistic market expectations from mid-2024, with growth dropping below trend, which requires close monitoring.



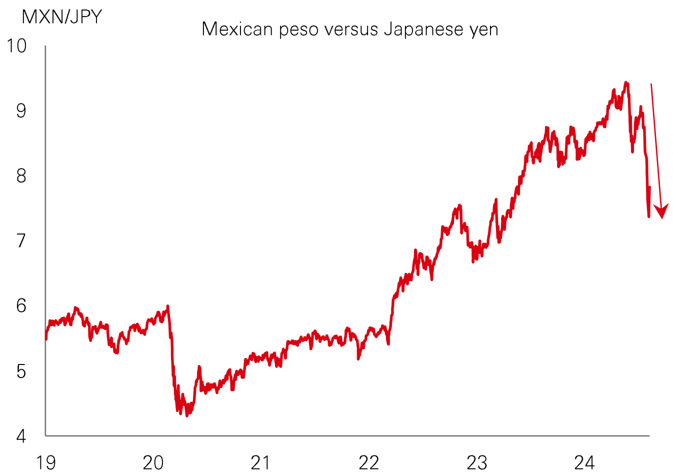
Amplification mechanisms

Economists have tended to focus on fundamental triggers for the market tantrum. But technical forces – especially the unwinding of carry and dispersion trades – have amplified the bad macro news, creating a major volatility (VIX) shock in markets.

Carry trades need a cheap funding currency to sell (e.g. yen) and high-yielding currencies to own (e.g. Mexico). While volatility stays low, you can pocket the rate differential. Dispersion trades sell volatility on an index (e.g. S&P 500) and buy volatility on index constituents. While correlations are low, profits follow.

But crisis dynamics weed out leveraged players. **Bad macro news and rising volatility began an unwinding of these trades, and soon enough it was a cascade, amplifying volatility**. In the last week, we had a vicious cycle as the risk averse are forced sellers.

What breaks the cycle? Some market stability helps. Evidence shows that most of the yen 'excess shorts' are now unwound. And last week's BoJ-speak has been dovish. Meanwhile, lower numbers on the VIX and VVIX indices are welcome news. But, ultimately, global markets will remain sensitive to the US economic data-flow.

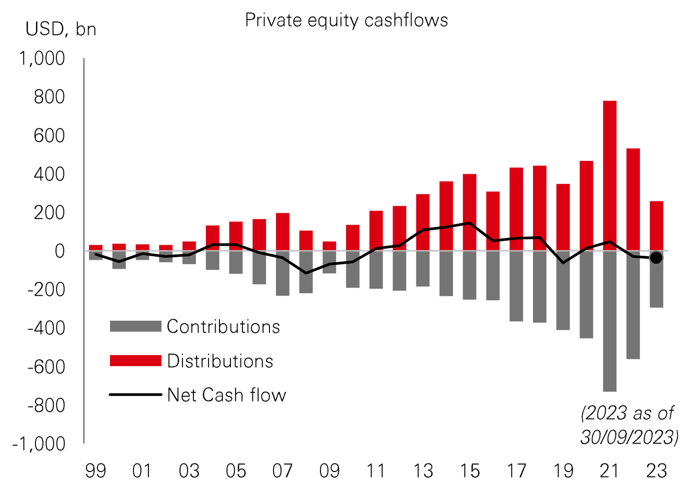


Silver lining for private equity

A backdrop of elevated rates and economic uncertainty has been challenging for the private equity asset class in recent years. Higher borrowing costs and a difficult environment to sell investments has meant that private equity investors have put more in (via capital calls by funds) and got back less (in distributions) – resulting in negative cash flows since 2023.

It's a marked change from 2021, when cashflows were positive. Back then, cash calls grew on a boom in post-Covid dealmaking, and distributions back to investors surged to a high watermark of almost USD 750bn – up from USD 462bn in 2020.

Some investment specialists think that following that surge in activity, a period of relative quiet was inevitable. Consequently, industry data suggest private equity firms are sitting on more than USD 2tn of 'dry powder' - committed but unallocated capital. But there is optimism, as central banks face pressure to reduce rates. **The prospect of a lower rate environment could help private equity dealmaking to bounce back**.



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Key Events and Data Releases

Last week

Date	Country	Indicator	Data as of	Actual	Prior
Mon. 05 August	US	ISM Services Index	Jul	51.4	48.8
Tue. 06 August	AU	RBA Cash Target Rate	Aug	4.35%	4.35%
Wed. 07 August	GE	Industrial Production (m-o-m)	Jun	1.4%	-3.1%
	CN	Trade Balance ($bn)	Jul	84.7	99.1
Thu. 08 August	MX	Headline Inflation (y-o-y)	Jul	5.6%	5.0%
	MX	Banxico de Mexico, Overnight Lending Rate	Aug	10.75%	11.00%
	IN	RBI Repo Rate	Aug	6.50%	6.50%
Fri. 09 August	CN	CPI (y-o-y)	Jul	0.5%	0.2%
	MX	Industrial Production (mom)	Jun	-	0.7%
	BR	CPI (y-o-y)	Jul	-	4.2%

US – United States, AU – Australia, GE – Germany, CN – China, MX – Mexico, IN – India, BR – Brazil

Upcoming weeks

Date	Country	Indicator	Data as of	Survey	Prior
Mon. 12 August	IN	CPI (y-o-y)	Jul	3.7%	5.1%
Wed. 14 August	US	CPI (y-o-y)	Jul	2.9%	3.0%
	JP	GDP (q-o-q)	Q2	0.5%	-0.7%
	UK	CPI (y-o-y)	Jul	2.3%	2.0%
	NZ	RBNZ Official Cash Rate	Aug	5.50%	5.50%
Thu. 15 August	UK	GDP, Prelim (q-o-q)	Jun	0.6%	0.7%
Tue. 20 August	SW	Riksbank Rate	Aug	-	3.75%
	TU	CBT Weekly Repo Rate	Aug	-	50.00%
Thu. 22 August	KO	Bank of Korea Base Rate	Aug	-	3.50%
	EZ	HCOB Composite PMI, Flash	Aug	-	50.2
Fri. 23 August	JP	CPI (y-o-y)	Jul	-	2.8%
Fri. 30 August	EZ	HICP, Flash (y-o-y)	Aug	-	2.6%
	IN	GDP (y-o-y)	Q2	-	7.8%
	US	PCE Price Index (y-o-y)	Jul	-	2.5%

Q – Quarter **IN – India, US – United States, JP – Japan, UK – United Kingdom, NZ – New Zealand, SW – Sweden, TU – Turkey, KO – Korea, EZ – Eurozone**

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Market review

Global risk assets continued to sell off sharply early in the last week as July's correction in US tech stocks evolved into a broader market rout driven by signs of faster than expected cooling in the US economy. An unwinding of yen-funded carry trades – triggered by the previous week's surprise rate hike by the Bank of Japan – added to the volatility. The worst of the impact was felt in equities, but the S&P 500 and small-cap Russell 2000 both regained composure later in the last week. Major EM indices were more resilient, with China's Shanghai Composite index finishing slightly lower, India's Sensex flat, and Brazil's Ibovespa staging a strong relief rally. In core bonds, US Treasury yields arrested recent falls to finish higher. In commodities, oil prices rose on growing supply concerns in the Middle East. Gold recovered from a mild correction early in the last week to finish with a modest decline.

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