ASSET MANAGEMENT VIEWPOINTS

CARY STREET PARTNERS

AUGUST 5, 2024

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Volatility Spike

Culprits

Root cause number one of volatility: labor reports that lead some to conclude that US GDP will precipitously decline and that the Fed has stayed too long with a very restrictive rate policy. The increase in the unemployment rate for July triggered the Sahm Rule, developed by Claudia Sahm at the Fed. It predicts a recession if the three-month moving average for unemployment rises by more than ½ percent from its lowest three-month moving average over the last 12 months. The current reading is now .53%. Claudia Sahm herself does not think the current reading is accurately predicting a recession. We agree. Household real income is growing across all income cohorts, supporting consumer spending. One of the few certainties in life: if Americans have income they will spend it. It's important to understand the data. Labor numbers have some very different features than past cycles. We have gone from labor shortages, with people dropping out of the labor force, to a surge in immigration, i.e., a swing in labor supply. These big swings show up in unemployment rate changes.

Root cause number two: the unwinding of the Yen carry trade. Many market participants have been caught off guard by the speed of the Yen rally. The Yen carry trade is loosely defined as investors borrowing in a low-interest-rate currency and investing in US assets with higher rates of return. It has been in place for years and is substantial in size. The Yen has skyrocketed over the last month, gaining about 8%, due to a hawkish BOJ. The core of a strategy such as this is stable exchange rates. Borrowing in the weaker currency that then strengthens versus the currency in which assets are bought is not the outcome you are looking for; debt must be covered by selling assets that have depreciated by 8% due to currency conversion alone. Yen appreciation of this magnitude and speed acts as a margin call on this trade, forcing selling US assets to repatriate capital to cover debt.

Growth is slowing, but not slow.

Fear can come from many unpredictable sources. These are the culprits over the last week.

Outlook

Fear and volatility have spiked, as seen in the CBOE Volatility Index (VIX) trading as high as 29 on Friday, currently quoted at about 60. We are back in a higher volatility regime following several quarters of low volatility. That said, as indicated by the VIX transactional price, sentiment is now at a bearish extreme, a contrarian positive. The VIX spike could signal that near-term lows are in. Bearish sentiment extremes support a market putting in lows. Sentiment can stay at extremes for some time. Consequently, bearish extremes do not always call for an immediate rebound. Equities could go lower or consolidate for some time; this is an exercise in odds, not certainties, but at the least, a sizable chunk of the tide is out. The NDX is already in correction territory, down over 10%, and the SPX is down 5.6% from its high. Overseas markets are worse, Japan worst of all, off 12% today. Seasonality works against the market here through the end of September, although there are still some key mega cap Q2 earnings to come, which could be helpful.

Positioning Recommendations

Use the current correction to re-balance and improve positioning. Do not try to buy falling knives in the previously hot momentum names; investors are almost invariably overweight those names already. Valuation, which is not a tactical help but is longer term in nature, greatly favors smaller caps in equities. It also favors value sectors in large caps relative to the S&P. For investors needing greater risk management, we continue to recommend equity hedging strategies that will result in a smoother ride.

Fixed Income is working very well. There is a flight to safety in the Treasury market. See the Asset Management Viewpoint on this subject from May 2nd - Another Chance to Bite into Bonds. Longer duration is working particularly well. Be careful chasing this dynamic in the short term, but be cognizant that money market yields will likely become much less appealing. We could easily have a 200-bps decline in Fed funds, taking money market yields from 5% to 3%.

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Fixed income investments have several other asset-class specific risks. Inflation risk reduces the real value of such investments, as purchasing power declines on nominal dollars that are received as principal and interest. Interest rate risk comes from a rise in interest rates that causes a fixed income security to decline in price in order to make the market price-based yield competitive with the prevailing interest rate climate. Fixed income securities are also at risk of issuer default or the markets' perception that default risk has increased. CSP2024138