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Market Update

August 6, 2024

US markets (i.e., S&P 500) experienced their worst sell-off in roughly two years amid a global market sell-off. It is worth noting one likely factor in the volatile move to the downside is what is known as a "carry trade."

A carry trade is where professional investors and traders borrow via shorting[1] a low yielding currency and reinvesting elsewhere, typically a higher yielding currency. This is a means of leverage. Historically, due to the characteristics of the Japanese market, borrowing Yen to invest elsewhere has been a very popular trade. Based on a number of data points, this carry trade has increased significantly over the last few years.[2]

As can be seen in the chart below, this trade has generally worked over the last five years.

However, due primarily to a surprise increase of interest rates by the Bank of Japan (BOJ) on July 31st, the Japanese Yen has increased 10% verse the US Dollar. This has caused the carry trade to partially unravel. Since the financial crisis, banks have, rightly so, become more risk-averse resulting in tighter lending

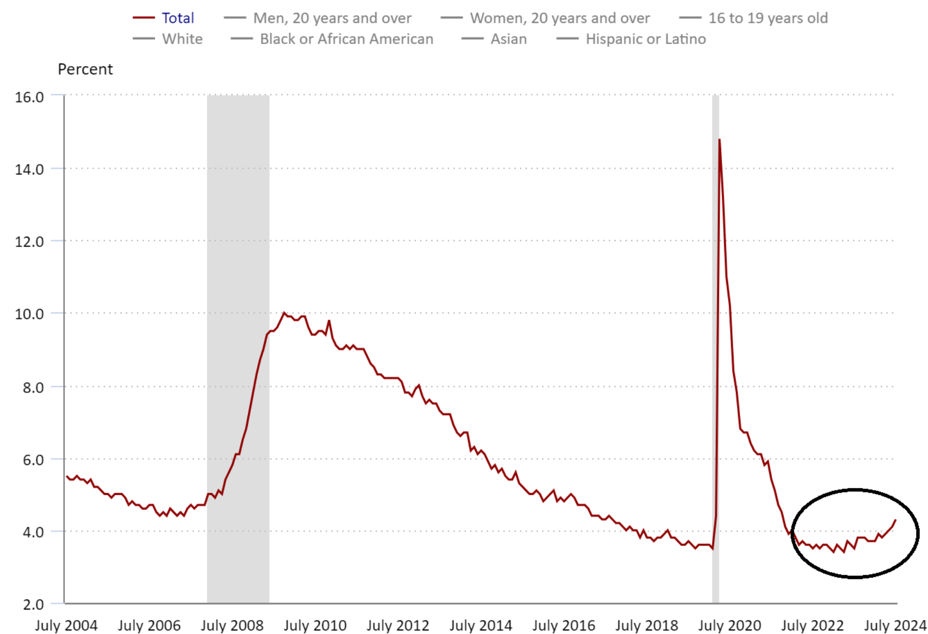
[1] When one sells a security short they collect the value of the investment but then have unlimited risk to the upside which causes the broker to demand collateral.

[2] E.g., All reporting countries - Cross-border total claims of banks with headquaters in All countries (total) vis-a-vis residents of All countries (total), all sectors (amounts outstanding / stocks, all instruments in all currencies (=d+f+u), Yen) (bis.org) – this carries the direction of the trade, though there are different participants and different goals such as hedging etc. that only points to a trend rather than conclusive evidence.

standards which results in quicker margin calls and forced closing of trades. These activities directly result in selling pressure.[3]

As a reminder, approximately a year ago, markets were nervous about employment data being too strong. Now, the markets are nervous it is too weak. Part of this story is that the actual data came in below expectations. But digging a bit deeper, one needs to read a lot into the very short-term trend to come to a conclusion that the economy is teetering on the edge based on the jobs report.

Unemployment came in at 4.3% vs an expected 4.1%. This is by no means a bad unemployment rate and is well below average as can be seen from the following chart. Are economists and investors reading the tea leaves that this is the beginning of the end for the economy?



Source: U.S. Bureau of Labor Statistics.

The unemployment rate is a volatile measure that is reliant on those actively looking for a job. We prefer to focus on the participation rate, which measures how many people are actually working ("participating" in the work force). How does that chart look?

[3] Wall street is unforgiving. It is an aggressive game. If a bank forces a selling of securities, they do not care about price, they care about collateral, which results in aggressive selling. Liquidity providers in the marketplace recognize when this is happening and make sure to take full advantage. I used to be a liquidity provider.

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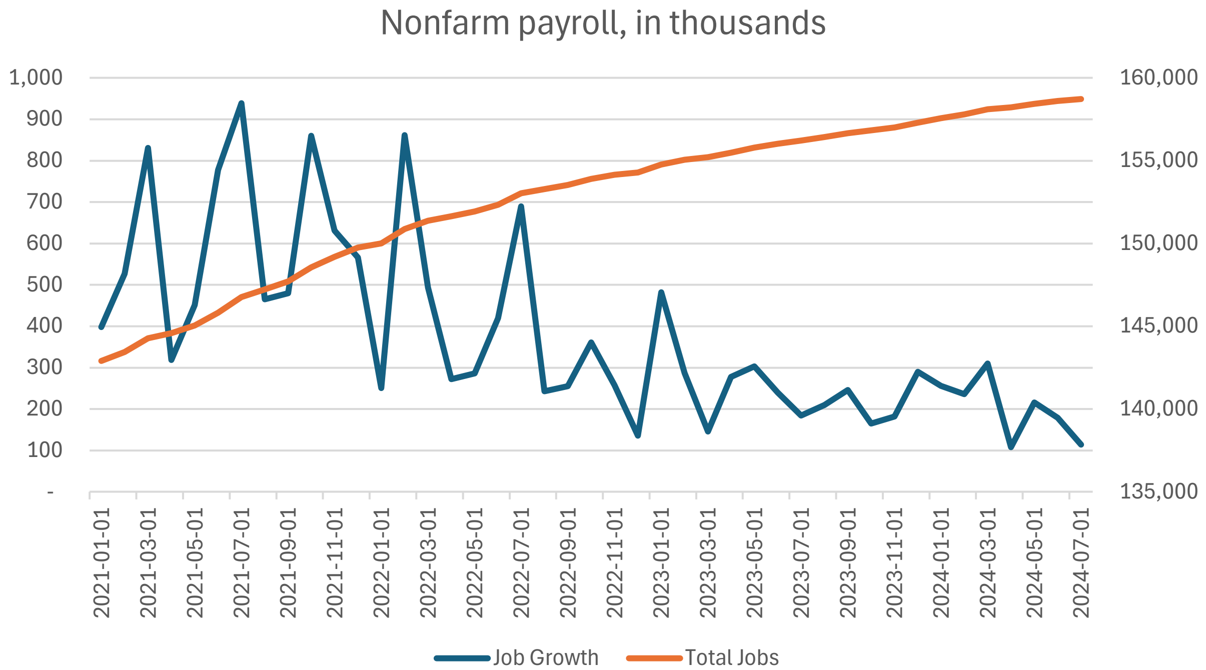
Source: U.S. Bureau of Labor Statistics.

As can be seen, it is near recent highs, telling a bit of a different story as compared to the unemployment rate. Which one should we believe?

The economy *only added* 114,000 jobs last month, well below the expected 175,000 new jobs. This is another data point that is quite volatile, as can be seen by the wild monthly variations (in blue) and therefore hard to estimate. Note that we continue to add jobs and that total non-farm jobs are at highs. In our opinion, this particular data makes it difficult to assume that we are in the beginning of a material slump. Again, it is worth noting that markets were on edge roughly a year ago about tight labor conditions which would result in increased inflation.



[4]

In conclusion, while we (nor anyone else) can predict market action, the carry trade is a short-term factor worth appreciating in that we believe it is adding significant volatility and downside momentum to financial markets. The carry trade is noise that creates fear that should have minimal effect on actual long-term market returns. Meanwhile, it is hard to point to the most recent economic data and conclusively point to a material softening of the economy. In both directions (market ups and downs) there is simply a lot of noise that does not directly correlate with how the global and US economy is actually expected to perform in the long term.

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[4] Source: Bureau of Labor Statistics