

Putting the sell-off in context

Ron Madey, CFA®, Chief Investment Officer
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Optimism gone awry

Equity investors tend to be optimists. Sometimes, they get disappointed but stay invested and optimistic. Other times, they get disappointed, rethink their optimism, and sell. From August 1st to the 5th, we have experienced the latter. Whether we bounce back quickly or slowly will depend on upcoming economic data and the Fed.

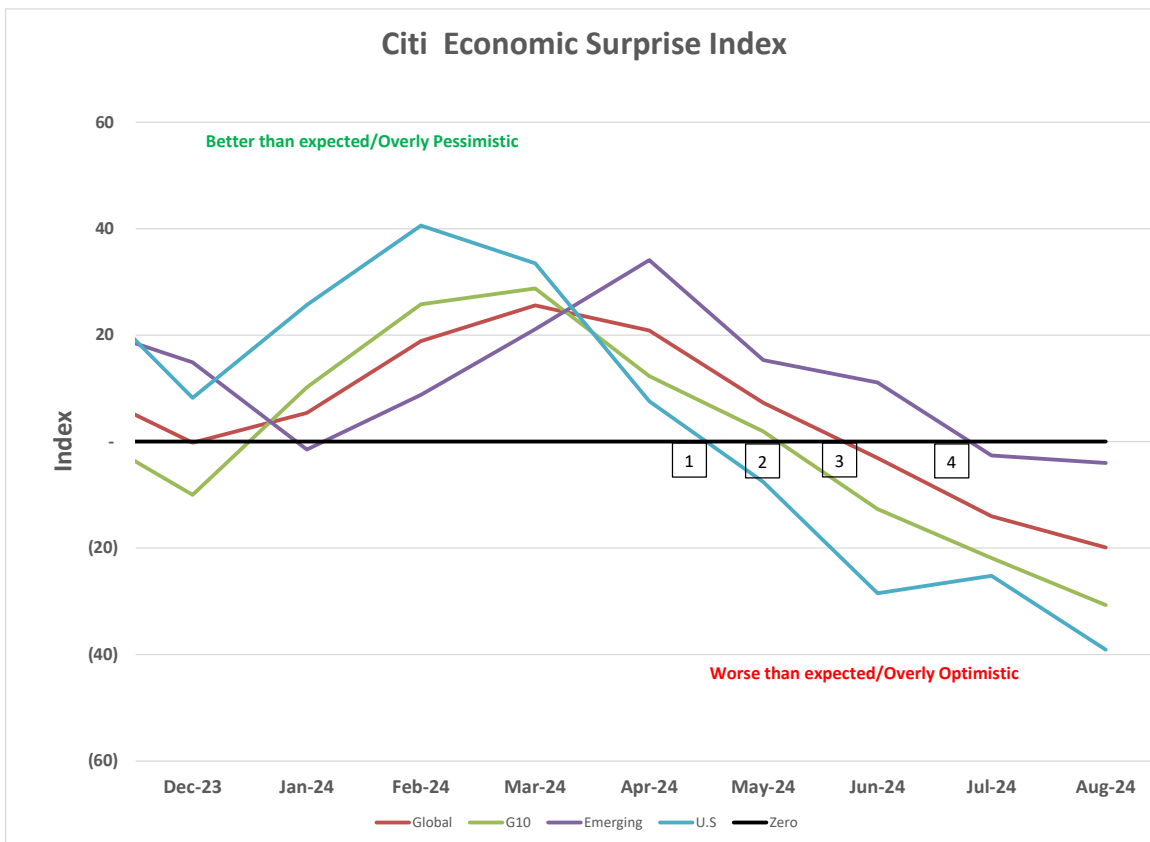
On Thursday, August 1st, the S&P 500 opened and quickly made an intraday high, just a little less than 2% below its all-time high. The positive open at 9:30 AM ET was likely driven by ongoing positive sentiment and the much better than expected productivity report at 8:30 AM. However, shortly after the open, at 10 AM, we had a series of worse than expected economic reports, including construction spending and the Institute of Supply Management surveys of purchasing managers. Needless to say, the intraday high did not last. Peak-to-trough intraday, the S&P fell by 2.8%.

On Friday, it fell by 1.8% from the previous close, primarily based on a disappointing payroll report. Pretty much all the economic reports on August 2nd were disappointing, as shown below:

- 8/01: Nonfarm Productivity Better than expected (much better, up 2.3%)
- 8/01: Construction Spending Worse than expected
- 8/01: ISM Manufacturing Worse than expected
- 8/01: ISM New Orders Worse than expected
- 8/01: ISM Prices Paid Worse than expected
- 8/01: ISM Employment Worse than expected
- 8/02: Change in Nonfarm Payrolls Worse than expected (big miss by 88K jobs)
- 8/02: Unemployment rate Worse than expected
- 8/02: Average Weekly Hours Worse than expected
- 8/02: Factory Orders Worse than expected
- 8/02: Durable Goods Orders Worse than expected
- 8/02: Capital Goods Orders ex Air, Def Worse than expected

On Monday, August 5th, the market had a panic open, with the S&P falling by more than 4% before closing down by 3.0% on the day. Why? The yen carry trade, but more on that later.

The chart that follows shows the Citi Economic Surprise Index. This index presents the sum of the difference between official economic reports and forecasts. When the sum is above zero, economic performance is better than market expectations. When the sum is below zero, economic conditions are worse than expected. The tendency is for the index to rise as economic growth accelerates and to fall as growth declines.



By the numbers:

1. The U.S. Surprise Index turned negative in May.
2. The G10 Surprise Index turned negative in June. The G10 includes the U.S., Canada, the UK, Germany, France, Italy, the Netherlands, Switzerland, Switzerland, Belgium and Japan.
3. Worldwide, the Surprise Index also turned negative in June.
4. Emerging markets turned negative in July.

So, it seems economies around the globe are softening, and expectations are still anchored to better days. This suggests more market consolidation as future economic reports test optimism.

The Bank of Japan rate hike surprise and the yen carry trade

What is the yen carry trade? Simply put, it is shorting yen and using the proceeds to buy something else. Typically, the something else is high interest rate currency, like the U.S. dollar today. Traders fund their long positions with yen because of its near zero borrowing rates.

For example, a trader sells yen, which means they borrow at yen short-term rates, just 0.1%, and use the proceeds to buy dollars and receive the 5.3% dollar lending rate. Every day they hold the position they are earning the spread of 5.2% annualized. Add the yen depreciation since the beginning of the year of 14.8%, and traders in the short yen long dollar trade are making a lot of

money. Borrowing rates in yen have been so low for so long that traders have been using yen to fund long positions in other assets including stocks.

On Wednesday, July 31st, the Bank of Japan raised rates from 0.1% to 0.25%. On the surface, that should not have meant much to the yen carry trade, but it came as a surprise, and traders were squeezed between a rising yen and falling asset prices. From the Wednesday rate hike to the Friday close, the yen rose by 2.3%, and the S&P 500 fell by 3.2%. That is more than a 5% loss in a couple of days for those in the carry trade unlevered. Of course, many traders and hedge funds had levered up the carry trade. The profit suck was too much to bear. Traders began to unwind the trade. On Monday, August 5th, the dollar fell against the yen by 1.6%, and the S&P500 was down another 3%. It is estimated that more than \$4 trillion is invested in a yen carry trade. The unwinding of this trade contributed to the Monday debacle in stocks. The trade is not completely unwound.

Revisiting equity hedge/offset strategies

Since the 2022 bond market debacle when 7-10 year Treasuries fell by more than 15%, TIPS fell by more than 12%, and the S&P500 fell by more than 18%, I have had many conversations with advisors looking for ways to offset the downside risk of stocks. The conversations typically revolved around gold, silver, and bitcoin as both inflation and equity downside hedges. Let's see how they performed in the downdraft from 8/1 to 8/5:

- The S&P500 was down: (6.1%)
- Silver (SLV) was down: (5.8%)
- Gold (GLD) was down: (1.8%)
- Bitcoin (IBIT) was down: (18.0%)
- 7-10 year Treasuries (IEF) were up: 2.1%
- TIPS (TIP) were up: 0.9%

As it turns out IEF and TIP were the best hedges. Why did they perform as hedges this time but not in 2022? Rates were abnormally low in 2022 and rose significantly as inflation rose, taking stocks down. This time, inflation was falling, and Treasuries and TIPS were more reasonably valued going into this stock market decline. It is reasonable to expect bonds to offer a better hedge during periods of declining inflation.

Gold and silver can be expected to perform better in high growth/high inflation environments.

Bitcoin is still trying to figure out what it wants to be when it grows up.

Closing thoughts

- Equities were optimistically priced.
- Traders were surprised by the employment number and the BOJ.
- The economy is clearly softening.

- We expect the Fed to cut rates by 25 to 50 basis points in September.
- 7-10 year Treasuries offer a low-cost hedge to equities with yields above 4% & inflation below 3%.
- TIPS offer a modest hedge to equities with real yields near 2% and an effective hedge against inflation, so long as the implied inflation rate priced into TIPS is well below the current inflation rate as it is today.
- Gold, silver, and bitcoin can play a diversifying role in client portfolios in modest amounts, but will falter as equity hedges when growth and inflation are in decline.
- While we can expect more the equity market consolidation, adding to stocks at current levels may feel scary today and may not be the bottom, but it will be rewarded in the long run.

Source: Bloomberg, Citigroup, Wealthcare

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Two James Center, 1021 East Cary Street, Suite 702 | Richmond, VA 23219 | 804.644.4711
WEALTHCAREGDX.COM
Contact us at investmentconsulting@wealthcarecapital.com