Yardeni Research

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Morning Briefing

The Almost Everything Global Panic Selloff

Check out the accompanying chart collection.

Executive Summary: We've been making the case against a hard landing of the economy, as recessions invariably result from financial system crises and the credit crunches they cause. Could the unwind of the yen carry trade and the subsequent global rout in financial markets precipitate such a crisis? We don't think so, but are closely monitoring credit conditions on both sides of the Pacific. How will the Fed respond? We're sticking with our one-and-done rate-cut forecast for this year. How much longer will the stock-market pain continue? The bleeding could stop this week.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

Strategy I: From Carry Trade to Margin Call. Until last week, there was a global bull market in almost everything. Since Friday, it's turned into a global bear market in almost everything. Extreme "risk on" has flipped into extreme "risk off" in global financial markets. We attribute most of this abrupt reversal to margin calls on carry trades.

It all started when Japan's Finance Minister warned on June 26 that Japan will take appropriate action as needed to defend its currency as it watches out for sudden, one-sided moves. Finance Minister Shunichi Suzuki told reporters that after the yen slid to the lowest level versus the dollar since 1986 (*Fig. 1*). Back then, the Japanese currency slumped to as low as 160.87 per dollar, blowing past levels at which officials intervened in the market earlier this year.

The yen hit a 38-year low of 161.96 per dollar ahead of the July Fourth holiday. In response, Japanese officials swiftly responded with two landmark moves. On July 31, Japan's Ministry of Finance *disclosed* that it had intervened with 5.53 trillion yen ($36.8 billion) to shore up the currency for the period from June 27 to July 29. In late May, the Ministry had *confirmed* its first foreign currency intervention since October 2022.

The Bank of Japan (BOJ) decided to hike short-term rates to around 0.25% from 0.10% at the July 30-31 meeting, having recently exited negative territory. The yield on 10-year Japanese government bonds (JGBs) quickly climbed above 1.10%, a stark increase from its sub-zero levels just a few years ago (*Fig. 2*). It has since sunk as Japanese investors have rotated out of the Nikkei 225 and into JGBs but remains at decade-highs.

Following the rate hike in July, BOJ Governor Kazuo Ueda did not rule out another increase this year and stressed its readiness to keep hiking borrowing costs to levels deemed to be neutral to the economy, presumably 1.00%-1.50%. As for inflation, the risk balance is tilted to the upside for fiscal 2024 and 2025 (ending March of 2025 and 2026) largely because the y/y change in import prices turned positive and "moves to raise wages have been spreading," *according* to the BOJ. The bank's monetary policy will further tighten with a planned decrease in its JGB holdings of roughly up to 8.0% by 2026 (*Fig. 3*).

The yen rebounded to 142.56 per dollar on Monday, hurting carry traders who were effectively short the yen. Over the past few days, the abrupt reversal in the BOJ's monetary policy and in the yen forced carry traders who had borrowed yen at near zero interest rates to sell the assets that they had purchased around the world with the borrowed funds. As these asset prices plunged, panicked carry traders scrambled to sell more of their assets.

That explains why asset prices were hard hit around the world in recent days. Posting among the biggest declines was Japan's Nikkei stock price index, which had rallied strongly earlier this year as the yen weakened, thus boosting the earnings of Japanese exporters (*Fig. 4*).

The latest market rout, which began just a couple of days after the BOJ's rate hike decision, raises the question of whether the central bank can proceed with further raising rates. Finance Minister Shunichi Suzuki said on Monday that authorities were watching market moves closely after the Nikkei stock average plummeted in its biggest rout since 1987.

The buying pressure on the yen needs to stabilize for the financial markets to regain their footing. Absent BOJ intervention or communication in the next couple days, the selling pressure should ease anyway as margin calls are met, shorts are stopped out, and the swath of short volatility trades in the market are covered. But if the yen keeps moving higher, that might take out even more leveraged players.

Alternatively, weaker US economic data would also keep the flogging going. However, as the ISM NM-PMI report and the Fed's *Senior Loan Officer Opinion Survey* for evidenced on

Monday, the US economy still looks resilient. We are keeping an eye on how Japanese banks and US credit spreads trade to determine whether any of this market turmoil might be prolonged further than a few days.

Strategy II: Fed Put to the Rescue? A few of our accounts asked us whether the global rout of the carry trade might be the credit crisis that leads to a credit crunch and a recession in the US. We've observed that US inflation came down this year and last without a recession in the US partly because China has been exporting deflation to the US and the rest of the world to offset the depression in its property market. So a recession in China has effectively eliminated the need for a recession in the US to lower inflation.

Could it be that the collapse of the global carry trade with its epicenter in Japan will have the same impact on global credit markets as did the Great Financial Crisis of 2008? We've been saying that a recession is unlikely in the US unless it is proceeded by a financial crisis that causes an economy-wide recession. Perhaps the carry trade calamity is such a financial crisis and will cause a credit crunch and a recession?

We don't think so. However, we are closely monitoring credit conditions in the US. We are watching the yield spread between US high-yield corporate bonds and the 10-year US Treasury bond. It widened only slightly on Friday to 375bps (*Fig. 5*). It is highly correlated with the S&P 500 volatility index (VIX) (*Fig. 6*). The latter jumped from 23.4 on Friday afternoon to 65.0 on Monday morning and was back down to 32.9 by early Friday afternoon. It closed at 37.0 on Monday.

Across the Pacific, we're monitoring conditions in Japanese banks and insurers. The Topix Bank index is down 28% from its post-2007 high of $366.08 on July 4, while the Topix Insurance index has lost 34% from its record high on July 10. The overall Topix is off 24% from its record high on July 11 (*Fig. 7*).

The question is how the Fed and the BoJ will respond to these developments, which mostly transpired after the Federal Open Market Committee met last Tuesday and Wednesday and after Fed Chair Jerome Powell's *press conference* on Wednesday afternoon.

Powell certainly didn't have an advance insight into Friday's employment report. Here is how he described the labor market last Wednesday at his presser:

"In the labor market, supply and demand conditions have come into better balance. Payroll job gains averaged 177,000 jobs per month in the second quarter, a solid pace but below that seen in the first quarter. The unemployment rate has moved up but remains low at 4.1%. Strong job creation over the past couple of years has been accompanied by an increase in the supply of workers, reflecting increases in participation among individuals aged 25-54 years and a strong pace of immigration. Nominal wage growth has eased over the past year and the jobs-to-workers gap has narrowed. Overall, a broad set of indicators suggests that conditions in the labor market have returned to about where they stood on the eve of the pandemic—strong but not overheated."

Eric and I don't think that Friday's weak payroll employment report should have materially changed Powell's assessment of the labor market considering that inclement weather might explain most if not all the weakness. Nevertheless, he and his colleagues might be inclined to be more dovish than our take suggests they should be.

As of Friday, the markets seem to be leaning toward a 50bps cut in the federal funds rate in September and two more cuts of 25bps each in November and December (*Fig. 8*). Over the next 12 months, the federal funds rate futures market is anticipating eight rate cuts of 25bps each, or the equivalent of that many cuts (*Fig. 9*). For now, we are sticking with our one-and-done rate-cut forecast—one in September and done for the rest of this year.

Given the carry trade debacle, of course, Fed officials might feel a need to cut interest rates more aggressively than we think is necessary. We will change our minds if the incoming data confirm that the labor market is weaker than we believe and that the carry trade unwind has the potential to cause a credit crunch.

Strategy III: Other Perspectives. We asked Joe Feshbach for his take on the stock market from a trading perspective: "[T]he biggest concern that I've had with the market lately is the level of the sentiment measures. It's not just that they had been reflecting too much bullishness but that they had reached what I believe were excessive levels witnessed at important tops. Couple this with the parabolic nature of the technology charts, and we get a problem market. I still believe it's best to be defensive here and be patient for the sentiment indicators to work themselves back into territory indicating some degree of concern. While this process unfolds, I still think the tech stocks remain the most vulnerable."

We asked Michael Brush for an update on insider trading activity: "Insider buying was light in the selloff on Thursday and Friday. That might not be the full picture. Some of Friday's buying could still be filed over the next two days. Many insiders remain on earnings season lockdown. Insiders overall remain cautious, judging by buy-sell ratios, though there have been several actionable purchases in the transport sector."

Calendars

US: Tues: Trade Balance -$72.5b; Atlanta Fed GDPNow 2.5%; Weekly Crude Oil Inventories. **Wed:** Consumer Credit $11.5b; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production. (FXStreet estimates)

Global: Tues: Eurozone Retail Sales -0.2%; Germany Factory Orders 0.7%; RBA Interest Rate Decision 4.35%. **Wed:** Germany Industrial Production 1.0%; Japan Leading Indicators 109.3; China Exports & Imports 10.4%/3.3%y/y; McCaul; Bullock. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): LargeCap's forward earnings rose 0.3% w/w to a new record high. It has achieved new record highs for 31 straight weeks and in 42 of the 47 weeks since mid-September; last week now matches the lengthiest string of record-high forward earnings for LargeCap in six years (since the March 16 week of 2018, when it hit record highs for 34 straight weeks). MidCap's fell 0.3% w/w to 2.2% below its record high in early June 2022, but has risen in 17 of the past 20 weeks. SmallCap's rose less than 0.1% w/w to 9.6% below its mid-June 2022 record, but has posted gains in 16 of the past 21 weeks. Through the week ending August 2, LargeCap's forward earnings has soared 17.4% from its 54-week low during the week of February 1, 2023; MidCap's is 6.5% above its 55-week low during the week of March 10, 2023; and SmallCap's is 4.6% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrends since mid-2022 have been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Their forward earnings momentum has improved from three-year lows just over a year ago, but LargeCap's is improving faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (10.0%, 14.8%), MidCap (0.9, 17.6), and SmallCap (-5.8, 19.5).

S&P 500/400/600 Valuation (*link*): Valuations were lower during the August 2 week for these three indexes, but remain at near recent multi-year highs. LargeCap's forward P/E fell 0.4pt w/w to a 13-week low of 20.2. That's down 1.2pts from a 30-month high of 21.4 during the July 12 week, but is up 3.2pts from a seven-month low of 17.0 during the October 27 week. It's now up 5.1pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E fell 0.6pts w/w to a four-week low of 15.1 from a 17-week high of 15.7. That's down 0.9pts from a 27-month high of 16.0 at the end of March and up 2.8pts from a 12-month low of 12.3 at the end of October. It's now up 4.0pts from its 30-month low of 11.1 at the end of September 2022; these compare to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E dropped 0.3pts w/w to 14.6 from a 32-month high of 14.9. It's up 4.0pts from its 14-year low of 10.6 in September 2022 and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 25% discount to LargeCap's P/E is up from a 25-year-low 29% discount during the July 5 week. It had been at a 19% discount during the March 2, 2023 week, which was near its best reading since October 14, 2021. SmallCap's 27% discount is up from a 24-year low 34% discount during the July 5 week. That compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. The SMidCap's P/Es had been mostly above LargeCap's from 2003 to 2018.

US Economic Indicators

US Non-Manufacturing PMI (*link*): The US service sector moved back into expansionary territory in July, bouncing around 50.0 for the past four months. It had dropped below 50.0 in April (49.4) for the first time in 16 months. July's *NM-PMI* rose to 51.4 after falling from 53.8 in May to 48.8 in June. The *business activity/production* (to 54.5 from 49.6) moved back above the breakeven point of 50.0 in July, climbing back toward May's 18-month high of 61.2, while the new orders (52.4 from 47.3) gauge also swung from negative to positive. Meanwhile, the *employment* (51.1 from 46.1) measure moved above 50.0 for the first time since the start of this year. The *supplier deliveries* (47.6 from 52.2) measure returned to contractionary territory—indicating "faster" supplier deliveries—in July, following two months in "slower" territory. (Supplier deliveries is the only ISM component that is inversed—with a reading above 50.0 indicating slower deliveries, which is typical as the economy improves and customer demand increases.) On the *inflation* front, the price index (to 57.0 from 56.3) accelerated in July, after easing the prior two months from 59.2 in April to 56.3 in June; it was at a recent high 64.0 at the start of this year. Its record high was 84.5 at the end of 2021.

Global Economic Indicators

Global Composite PMIs (*link*): Global economic growth eased for the second month in July, as the upturn in manufacturing slowed, though overall growth remained among the best registered over the past year. The global *C-PMI* eased to 52.5 in July from May's 12-month high of 53.7, signaling expansions in each of the past nine months, although July's reading was the weakest since April. The global NM-PMI edged up from 53.1 in June to 53.3 in July and has signaled expansion the past 18 months, while the global M-PMI fell below the breakeven point of 50.0 for the first time this year, sinking to 49.7. The report notes that of the 13 countries for which combined manufacturing and services PMIs were available, all but three—Germany, France, and Australia—saw output expand. Growth was led by India, followed by Brazil and the US, while three counties—the UK, Brazil, and Kazakhstan—recorded faster rates of increase during the month. Meanwhile, Japan and Rusia returned to growth in July, following recent contractions. The Euro area overall showed little growth. *Optimism* for the year ahead fell to an eight-month low in July, holding below the survey's long-term average for the second successive month, with developed markets (on average) more positive about the future than emerging markets. *Looking at pricing*, *input* price inflation accelerated to a 10-month high in July, with service sector costs the fastest since March and remaining above manufacturing purchases prices for the 27th successive month. While some of these costs were passed on to clients in the form of higher charges, the rate of *selling price* inflation was the lowest since October 2020. The rate of increase in global manufacturing remained below the service sector.

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