Yardeni Research

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Morning Briefing

On The Carry Trade, Japan & Earnings

Check out the accompanying chart collection.

Executive Summary: The recent carry-trade unwind triggered unnerving market declines that weren't warranted by asset fundamentals. But Dr. Ed and Eric don't think investors need to worry about a repeat performance. Carry trades continue, but positions are less extreme now. And if Friday's statements by Fed Chair Powell and BOJ Governor Ueda are less dovish and more dovish, respectively, the yen would weaken against the dollar—also helping to avoid another carry-trade unwind. … Also: Melissa reports on Japan's remarkable economic revival. … And: Joe's data suggest a chance that 2024 could be a rare year of rising earnings, revenue, and profit margin estimates.

Japan I: Yen Carry-Trade Update. The rapid unwind of the carry trade, or at least the most overleveraged positions, sent global risk assets lower and risk indicators higher over the past couple of weeks. Speculators had borrowed yen at near-zero interest rates in recent years and speculated on the Nikkei and other assets in other currencies. It worked great until the yen stopped falling and started rising in Japan.

The unwind started on July 31, when the Bank of Japan (BOJ) hiked short-term rates from 0.10% to around 0.25%, and Japan's Ministry of Finance disclosed that it had intervened in currency markets to protect the yen. This exacerbated markets' pain from the soft June US CPI release a few weeks earlier. Two days later, weaker-than-expected July payroll employment raised the odds of a Fed rate cut substantially.

The yen rebounded as the BOJ was tightening, while the Fed was set to ease. The yen carry-trade blew up in Japan and rapidly caused a tsunami that spread the damage to the financial markets in the US and other countries:

From July 31 through August 5, the yen rose 2.7% against the dollar, the S&P 500 fell 6.1% to 5,186, the S&P 500 volatility index (VIX) rose to 65, the 10-year Treasury yield fell from 4.10% to 3.78% and the high-yield US corporate bond spread above Treasuries rose from

3.25% to 3.93%. The Nasdaq entered a correction. The Nikkei 225 fell 26% from its July 11 high.

Amid the macro maelstrom, Eric and I concluded that the selling pressure was not fundamentally driven but driven by overleveraged investors' need to meet margin calls—selling the assets they had purchased with yen borrowed at near-zero rates to cover their short positions on the yen. As asset prices fell, the fallout expanded, accelerating the selling.

In our opinion, the nonfarm payroll report was unduly weak owing to Hurricane Beryl, and employment indicators would rebound in the coming weeks. We maintained our stance that the Fed's first cut of the federal funds rate (FFR) would be 25bps in September, rather than an emergency intra-meeting 75bps cut. We also expected that the BOJ would prioritize sound markets over sound monetary policy and revert to its ultradovish baseline.

In short, we recommended that investors relax, just be "zen on the yen," as nothing fundamental had happened to justify the markets' extreme reactions.

Well, here's how the markets have been performing since August 5:

The S&P 500 is up 7.9% to 5,597 (just 1.2% from its record high), the VIX is below 16, the Nikkei 225 has rebounded 21%, the 10-year Treasury yield is trading at 3.81%, the high-yield US corporate bond spread is back down to 3.21%. The Nasdaq Composite's 11-day correction was its shortest since 2011.

Many of our accounts are wondering whether the risk has mostly been washed out or potential selling pressure from carry-traders remains in the event of another bout of volatility We don't believe investors should worry. Here's why:

(1) *Carry trades live on*. The yen carry trade emerged from investors selling yen to go buy US large-cap tech stocks, Mexican pesos, and other high-yielding currencies and assets. Many investors (domestic and abroad) looking to bet on the Nikkei 225's surge to new records also borrowed yen to add leverage (*Fig. 1*). But even as Fed policy is set to loosen, the differential between Treasury and Japanese government bond yields remains wide (*Fig. 2*). This fundamentally supports a weak yen relative to the dollar and therefore encourages carry trades.

That's why Japanese banks still have roughly ¥95 trillion of short-term net foreign liabilities on their balance sheets, as collateral and deposits to fund other purchases (*Fig. 3*).

(2) *But the positions are less extreme now*. There are signs that many carry-trade tourists piled in just as the gains surged. Spooked by the turmoil, they've exited their positions, at least for now. Investors who shorted the yen through futures and options have completely unwound their biggest net short position in six years to now a *net long* position (*Fig. 4*). In our opinion, this suggests that quant funds are no longer short the yen after the trend and volatility blew up in their faces.

(3) *Short volatility trades are reemerging*. One reason that the sell-off was so stark was that other carry trades got taken out too. The short volatility trade (the financial epitome of picking up pennies in front of a steamroller) was crushed as the VIX rose to 65 and remained above 30 for a couple of days. The ProShares Short VIX ETF has already retraced much of its steep decline, however, as the VIX has subsided to the mid-teens (*Fig. 5*).

The Investors Intelligence Bull/Bear Ratio also fell quickly, from 4.3 to 2.1; this drop leaves room for the bulls to reenter the stock market (*Fig. 6*).

(4) *Central bankers to share*. Our ears will be attuned on Friday to what Fed Chair Jerome Powell says at the annual gathering of central bankers at Jackson Hole, Wyoming and what BOJ Governor Ueda testifies to Japan's parliament regarding the decision to raise interest rates and the market turmoil that followed.

We expect a less dovish Powell and more dovish Ueda to weaken the yen against the dollar, averting a renewed carry-trade unwind panic. A repeat of the panic that the markets just underwent is unlikely, as the US economy remains strong and market memories aren't that short, since risk limits will remain under pressure. With respect to Japan, having finally achieved growth and inflation after a long spell with weak nominal GDP, Japan's parliament may lean on Governor Ueda not to whisk away punch bowl as people start arriving to the party.

Japan II: Economic Revival Amid Quakes. Despite a New Year's *earthquake* and summer *production halts* in Japan's auto industry due to certification scandals, Japan's economy has revived this year after years of stagnation and deflation. The world's third-largest economy is now enjoying robust domestic consumption and business investment.

However, uncertainties loom, including recent earthquake *advisories* and a seismic demographic shift toward an aging population that could lower labor force participation. Japan's political leadership also faces a shakeup, with Prime Minister Fumio Kishida to step down in September. The new leadership is expected to maintain current economic policies but must address Japan's towering debt and the potential impact of further monetary tightening (*Fig. 7* and *Fig. 8*).

With these uncertainties in mind, let's review Japan's latest economic indicators, all stable currently:

(1) *GDP signals robust recovery*. In Q2, Japan's economy expanded at an annualized rate of 3.1%, rebounding from a 2.3% contraction in Q1, according to preliminary government data (*Fig. 9*). This marks the most significant yearly growth since Q2- 2023, driven by a strong recovery in private consumption and improvement in business investment.

(2) *Labor market strengthens*. Japan's labor market has improved notably. The unemployment rate, calculated as a 12-month moving average, fell from 2.9% in April 2021 to 2.5% in June 2023, where it has remained through June 2024 (*Fig. 10*). This coincided with a rise in the labor force participation rate to 63.1% currently (*Fig. 11*). The labor force participation gains reflect reskilling initiatives to adapt an aging workforce and family policy reforms that have boosted female labor force participation, as a 2023 International Monetary Fund *article* discussed (*Fig. 12*).

(3) *Wage growth surpasses inflation*. In June 2024, Japan's contractual wages rose 4.6% y/y, the most since March 1991. This wage growth outpaced the country's core CPI inflation (excluding fresh food) by 1.9ppts. Earlier this year, y/y wages growth exceeded the y/y rate of inflation for the first time since early 2022 (*Fig. 13*). Japan's annual "*shunto*" wage negotiations resulted in the most substantial wage increases for many employees in more than three decades, *reported* the *Financial Times*.

(4) *Inflation steady amid uncertainties.* Japan's annual headline inflation rate increased to 2.8% y/y in June due in part to the end of energy subsidies. Core inflation held near 2.0% y/y in June (*Fig. 14*). The Producer Price Index increased by 3.0% y/y in July, the highest since August 2023. The BOJ *forecasts* the Consumer Price Index will rise 2.5% in fiscal 2024 (ending March 2025) and around 2.0% in fiscal 2025 and fiscal 2026, noting uncertainties related to global economic conditions, commodity prices, and financial markets.

(5) *Retail sales and consumer confidence rise*. Japan's retail sales increased 3.8% y/y in

June, driven by rising wages and strong consumer spending (*Fig. 15*). The country's retail sales index (indexed to 2019) is at a two-decade high (*Fig. 16*). Its consumer confidence index reached 36.8 in July, up from a recent low of 29.4 in November 2022 (*Fig. 17*).

(6) *Large firms to boost capex*. Japanese businesses are poised to increase investments, according to the BOJ's June 2024 Tankan *report*. Large firms plan an 11.1% increase in capital expenditures this fiscal year, up 6.0ppts from the previous forecast.

Strategy: Will This Be an Atypical Year of Rising Estimates? With Q2 earnings season winding down, this is a good time to take stock of how the analysts following S&P 500 companies have adjusted their forecasts so far this year. We'll be looking at revenues, earnings, and the implied profit margins for the S&P 500 and its 11 sectors in aggregate, both for 2024 and for 12 months ahead (i.e., "forward" data, captured by time-weighting the analysts' consensus estimates for the current and following years).

Analysts typically lower their consensus forecasts steadily as years progress. Only eight years since 1995 have been exceptions (2004-2006, 2010-2011, 2018, and 2021-2022) (*Fig. 18*). Will 2024 be another year that analysts end up raising their earnings forecasts? Maybe so, suggests Joe's data:

(1) *2024 revenues forecast up a tad ytd, earnings down a tad.* The S&P 500's consensus aggregate 2024 revenues forecast has risen 0.1% ytd. However, just four of the 11 sectors lead the gain: Health Care (3.1%), Communication Services (1.9), Financials (1.3), and Information Technology (0.8) (*Fig. 19*). But even the biggest lagging sectors are down only marginally: Consumer Discretionary (-2.1), Utilities (-2.0), and Energy (-1.7).

The S&P 500's similar forecast for 2024 earnings hasn't kept pace with the gain in revenues so far this year; however, more sectors' earnings than revenues are outperforming the S&P 500's: Six sectors have higher 2024 earnings forecasts ytd and are ahead of the S&P 500's 0.6% decline in that measure (*Fig. 20*). Here are the leading sectors and their 2024 earnings forecast change: Financials (4.5%), Communication Services (4.2), Information Technology (3.5), Real Estate (3.3), Consumer Discretionary (2.0), and Utilities (0.4). Among the biggest laggards are Energy (-12.4), Health Care (-8.2), Materials (-6.4), and Industrials (-4.9). Since Q2 ended, most of the winners have continued to improve as the laggards generally dropped further behind.

(2) *Forward revenues and earnings broadly up.* The consensus forward forecasts typically move higher as the year progresses and more of the following year's (typically higher)

estimate gets folded in. The S&P 500's aggregate forward revenues forecast has gained 3.8% ytd as all sectors' forward revenues except Energy's have moved higher (though Energy's is down only 0.9%). These four top the list by this measure: Information Technology (9.9%), Communication Services (6.4), Health Care (6.3), and Financials (4.3) (*Fig. 21*).

Looking at the forward earnings for the S&P 500 and its 11 sectors, Energy was the unfortunate outlier again, the lone sector with forward earnings down ytd (*Fig. 22*). The S&P 500's forward earnings has risen 9.3% ytd, more than its usual 6.0%-7.0% by this point in the year. The leading sectors: Information Technology (17.3%), Communication Services (15.2), Consumer Discretionary (11.3), and Financials (10.3).

(3) *Forward profit margin recovery also broad.* It has been a very good year so far for forward profit margins. The S&P 500's profit margin has improved 5.2%, powered by gains for six sectors: Consumer Discretionary (9.1%), Communication Services (8.3), Information Technology (6.7), Financials (5.8), Real Estate (5.4), and Utilities (5.2). Only the forward margins of Health Care (-1.7) and Energy (-3.3) have fallen ytd (*Fig. 23*).

Here are the ytd percent changes in forward revenues, earnings, and profit margin forecasts: S&P 500 (upward revisions of 3.8% to revenues estimates, 9.3% to earnings estimates, 5.2% to profit margins), Communication Services (6.4, 15.2, 8.3), Consumer Discretionary (2.0, 11.3, 9.1), Consumer Staples (2.1, 3.7, 1.5), Energy (-0.9, -4.2, -3.3), Financials (4.3, 10.3, 5.8), Health Care (6.3, 4.5, -1.7), Industrials (2.8, 5.1, 2.2), Information Technology (9.9, 17.3, 6.7), Materials (1.4, 4.9, 3.5), Real Estate (3.5, 9.2, 5.4), and Utilities (1.1, 6.3, 5.2).

Forward revenues and earnings are higher ytd for the S&P 500 and 10 of its 11 sectors, all but Energy (both down). For all but one of the 10, forward earnings gains outweighed forward revenues gains, boosting forward profit margins. For Health Care, slower-rising forward earnings than forward revenues lowered its forward profit margin.

Calendars

US: Wed: MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; FOMC Meeting Minutes. **Thurs:** Initial Claims 233k; Existing Home Sales 3.92mu; S&P Global M-PMI & NM-PMI Flash Estimates 49.8/54.0; Kansas City Fed Manufacturing Index; 30-Year TIPS Auction; Jackson Hole Symposium. (FXStreet estimates)

Global: **Wed:** Japan M-PMI Flash Estimate 49.8; Canada PPI -0.5%; Canada RMPI -0.9%. **Thurs:** Eurozone, Germany, and France M-PMI Flash Estimates 45.7/43.444.2; Eurozone, Germany, and France NM-PMIs 51.7/52.3/50.2; Eurozone Consumer Confidence -13.0; UK M-PMI & NM-PMI Flash Estimates 52.1/52.7; UK Gfk Consumer Confidence -12; Japan Core CPI 2.7% y/y; ECB Publishes Account of Monetary Policy Meeting. (FXStreet estimates)

Global Economic Indicators

Eurozone CPI (*link*): The *Eurozone CPI* was 2.6% y/y in July, up from 2.5% in June and holding near the recent low of 2.4% in April and March—which was its lowest rate since summer 2021. Meanwhile, the *core CPI* remained at 2.9% in July, matching the rates in both May and June, and up from 2.7% in April, which was the lowest since February 2022. Both are down sharply from their recent peaks of 10.6% in October 2022 and 5.7% in March 2023. Looking at the components, the *services* rate dipped to 4.0% y/y in July, from 4.1% in both May and June and above April's 3.7%—which was the lowest percentage since July 2022—while the rate for *energy* (1.2%) prices accelerated from gains of 0.2% and 0.3% in June and May, respectively—after a string of declines. Meanwhile, the rate for *food, alcohol & tobacco* eased again in July to 2.3%, slowing steadily from April's 2.8%, while the rate for non-energy industrial goods was at 0.7% for the third month. Among the four *largest Eurozone countries*, rates in Germany (2.6% y/y from 2.5% y/y) and France (2.7 from 2.5) accelerated a bit in July, while Italy's (1.6 from 0.9) rate rose noticeably and Spain's rate (2.9 from 3.6) eased noticeably.

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