



Market jitters and economic uncertainty

Description

Ioannis Tirkides*

When the Bank of Japan raised its key interest rate from a range of zero to 0.1% to 0.25%, arguably to stem the yen's slide against the US dollar, markets were jittery. Volatility spiked at the start of the month and many assets, including equities, fell, some very sharply. While this may prove to be a temporary blip, markets are responding to several influences at once, including rich valuations, monetary and fiscal policy constraints, changing economic prospects, civil unrest and more war. All of these factors are long term, but sticky and have yet to work their way through the system. So, a period of weakness and directional change may be upon us.

Enter the yen carry trade

Markets can fall for fundamental or technical reasons, and sometimes for both. Fundamentals have to do with valuations, the overall economy and its growth trajectory. The technical factor in the recent market crashes was related to the yen carry trade.

A currency carry trade is when investors, funds and institutions alike, mostly using leverage in their portfolios, borrow where money is cheap and invest where yields are high. In the yen carry trade, investors borrow in yen at extremely low interest rates and invest in other currencies, especially the US dollar, where yields and returns are much higher. This trade of borrowing yen at a near-zero yield and buying dollar assets, in the United States at 4% or more, has by and large been going on for a long time.

But a carry trade is risky. If the yen appreciates, as it has after the Bank of Japan raised interest rates to just above zero to contain inflationary pressures, investors will be forced to put up more collateral for the assets they sold short to acquire the yen in the first place, putting pressure on the trade. This leads to the unwinding of the carry trade, where investors sell their respective dollar positions and buy back the appreciated yen. This whole messy business can lead to some wild moves in the markets as we have seen. The whole process can be further exacerbated by the introduction of artificial intelligence by brokers and traders, where you have a bunch of machines running algorithms and jumping on the trend of the moment to buy and sell.

But there is more to this market reaction than just the yen carry trade.

The fundamentals

There are many forces at play in the global economy at any given time. We know that the European recovery, particularly in the northern core, has been weak since the start of the war in Ukraine. In the US, economic data has been stronger for longer, until the July employment report, which was well below expectations.

We have had a sharp market reaction, and it seems that the markets are finally coming to the realisation that we may indeed have a landing and even a recession. For the time being, we can only expect more underwhelming data for the foreseeable future.

Markets have been toying with the idea of a soft landing for quite some time. But what the recent market volatility has told us is that investors are not really pricing in a soft landing for the US economy, but rather a no landing. No landing is when the economy is growing close to potential, which is 2% for the United States and less than 1% for Europe as a whole. A soft landing is when the economy is close to stagnating, but still not in recession. A hard landing would be an absolute contraction, negative growth.

If equities are as expensive as they are, that wouldn't be consistent with a soft landing and certainly not with a hard landing. What is an expensive market and what is not is not

so simple, it would depend on a lot of variable factors. But historical precedent would suggest that a price/earnings multiple of over 20x for the US S&P500 is quite expensive. That multiple would suggest a very optimistic outlook for the economy forever, which is not sustainable. In short, equities are not cheap at current levels, even after the recent sell-off. And at higher valuations, markets are more vulnerable to negative shocks, rising geopolitical risks or prolonged and deepening economic weakness.

Policy constraints

Fiscal policy in the United States and Europe may be, or in many cases is becoming, unsustainable. This happens when debt levels are high relative to the size of the economy and interest payments on the outstanding debt consume an increasing share of the budget, forcing cuts in other areas and fuelling inflation and higher interest rates in a potentially destabilising dynamic.

Bond markets can sometimes be a barometer of debt sustainability. If the markets no longer want to hold your debt, that is a bad sign. Two things will then happen: yields will rise, making the debt even more unsustainable, or the monetary authority will be forced to monetise more of the debt, which will be inflationary.

Following the global financial crisis in 2008, monetary policy has been very accommodative for quite some time. Interest rates have fallen to zero or close to zero, and in some cases have been negative. Central bank balance sheets were bloated after successive rounds of quantitative easing and remain very large. The scope for further non-inflationary easing may not exist.

More importantly, high levels of government debt make it more difficult to manage the long end of the yield curve. As interest rates rise, debt service rises, and government spending has to rise further to avoid austerity. As government debt becomes less attractive, reduced demand for it puts upward pressure on interest rates. When the central bank accommodates the government's financing needs, it increases inflationary pressures. In the long run, interest rates, like inflation, move in long multi-year and sometimes multi-decade cycles. From 1981 to 2020, interest rates were in a downtrend for almost 40 years. Interest rates are now in an uptrend. Interest rates will fluctuate, they may even fall in the short term, but on average over the long term, and we cannot say a priori how long this will take, long-term interest rates will rise and stay higher.

Slowing growth

Global economic activity may be slowing more than expected. Growth in the United States may have risen from 1.3% in the first quarter to 2.4% in the second, but there is a reversal in the trend. This can be seen in the contracting money supply and rising unemployment. Manufacturing activity has been in recession for about two years, as reflected in the Purchasing Managers' Indices, which have deteriorated below 50, the expansion-contraction benchmark. The services sector has been more resilient but has also started to slow.

Conclusion

The understanding that economies fluctuate in a self-correcting mode, that there are automatic corrective factors that move the economy in the opposite direction, from recession to recovery and vice versa, is not always true. What this understanding ignores is the starting position of an economy after a recession or after a recovery. Typically, in most cases, every recovery after a recession starts with a higher level of debt, both public and private. If this process continues, a point will eventually be reached where an economy is at its debt carrying capacity. While debt can be a positive factor at relatively low levels, it is a drag at high levels. Each recovery since the 2008 global financial crisis has been weaker and the distribution of income more unequal. Debt is an overhead in essence, paid by the economy as a whole, by the vast majority of indebted households and companies, to a minority of creditors.

The wider context is that the debt overhead cannot be paid without a transfer of income and wealth from debtors to creditors. That is why the economy is polarised, with the top percentiles of the income distribution narrowing to 10% or 1%.

**Ioannis Tirkides is the Economics Research Manager at Bank of Cyprus and President of the Cyprus Economic Society. Views expressed are personal.*