Thoughts on Market Volatility

The last couple of weeks have seen significant market volatility across global equity, fixed income, and currency markets. During this period the S&P 500, Nasdaq, and Russell 2000 were down 9%, 14% and 10%, respectively. US equity markets have since bounced back and are now only a couple percentage points off their all-time highs reached in early July. The VIX (which measures how much investors are willing to pay for a month's worth of downside protection) spiked to as high as ~65, but has since normalized to ~15. Additionally, the 10-Yr US Treasury yield is down to ~3.8%, after having reached 4.7% in late April, on significant bull steepening of the yield curve.

In this edition of our Thinking Man, we will provide perspectives on some of the factors that set-off this bout of volatility. We would note that it is not any one of these factors in isolation that has contributed to this episode, but rather their simultaneous timing (plus the weak liquidity conditions of the summer months).

Economic Growth Outlook

At the outset of the year, we had a series of CPI/PCE prints that suggested that inflation was proving sticky around 3% yoy. Those concerns led to the Fed communicating the need for more disinflationary evidence before it could start normalizing policy. Subsequently, over the spring and early summer, we received inflation prints that were below expectations, thus providing the confidence to line up rate cuts into the last three FOMC meetings of the year.

What was unexpected were the increases in the unemployment rate, jobless claims, and weaker manufacturing PMIs. To some, these seemed to suggest that the economy was already in a sort of clandestine recession, and that the Fed was already behind the curve, even prompting calls for an intra-meeting emergency rate cut. Ultimately, these fears proved to be unfounded as the services PMI (which accounts for 75% of the U.S. economy), retail sales, and corporate earnings have all come in stronger than expected. Though the U.S. consumer is certainly feeling the pinch of higher prices and financing costs, none of the traditional measures of consumer or corporate distress are flashing red. Though the unemployment rate is close to a full percentage point higher than it was at the end of 2022, at 4.3% it is still comfortably within the range of the "natural rate of unemployment" for a growing economy.

The Thinking Man's Approach

August 2024 | Series #104

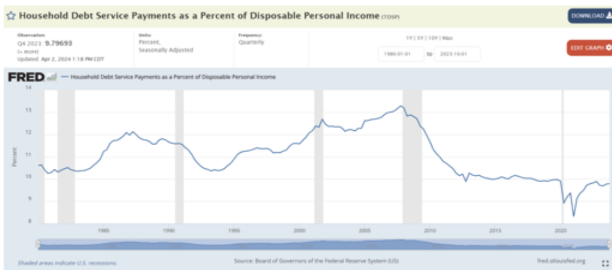
Rene Negron | *Senior Analyst*

- Concerns about an imminent recession are unfounded, though probability of a recession is higher today than one year ago
- Though unemployment has crept up, it is still in the range that one would expect for a growing economy
- Unwinding of the Japanese carry trade was the result of the perception that US and Japanese monetary policies would converge faster than anticipated
- Yen leverage unwinding resulted in a US equity correction, because many investors were borrowing in yen to buy US tech stocks
- Trade policy outlook continues to be a dominant factor in the market outlook, given importance of the AI theme to earnings growth, and the interconnected nature of the AI supply chain
- We are likely to see similar bouts of volatility into year end, given uncertainty of the election, geopolitics and US/China relations

For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners.com

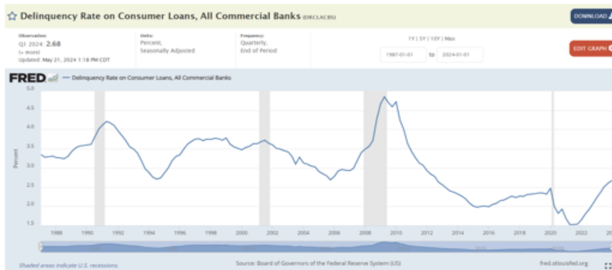
We should also note that we have officially triggered the much talked about Sahm Rule, which says that we are in a recession *"if the average unemployment rate over the last three months is 0.5 percentage points above its lowest value during the previous twelve months."* Nonetheless, we would side with Claudia Sahm herself in noting the unique changes we have seen since the pandemic, which make historical patterns less relevant to the present economic diagnosis. Recession risks are no doubt elevated prior to a year ago, yet the consumer remains healthy and most leading indicators are not in a clearly dangerous territory.

Household Debt Service as % of Personal Income

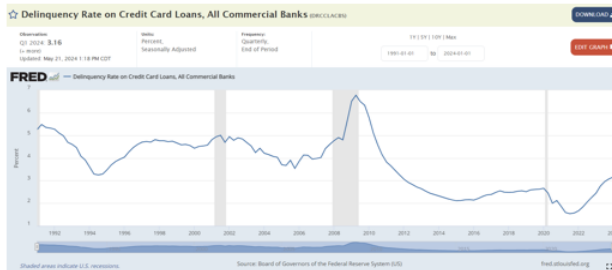


Consumer Debt Service as % of Personal Income

Delinquency Rates on Consumer Loans



Delinquency Rates on Credit Card Loans



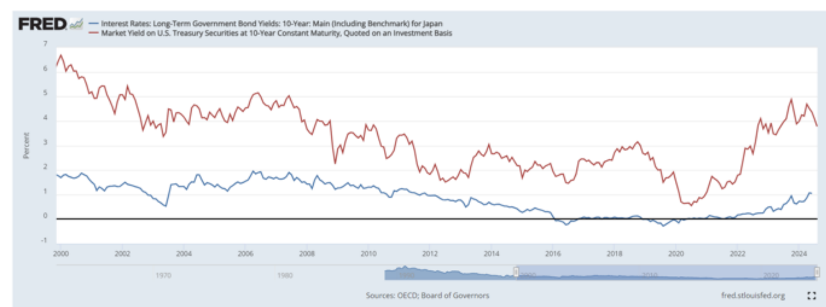
Unwinding of the Japanese Carry Trade

As has been covered extensively in the financial news media, much of the recent bout of market volatility has been the result of the partial unwinding of the Japanese carry trade. This unwinding was the result of the Bank of Japan deciding to increase interest rates + announcing a schedule for the tapering of their longstanding sovereign bond purchases. This had the effect of prompting massive strengthening in the yen. As mentioned, the large intraday volatility was really the result of the simultaneous timing of the announcements. As the BoJ became more hawkish, the Fed became more dovish resulting in a compression of perceived forward interest rate carry.

As a refresher, a carry trade is an attempt at creating a positive return by exploiting the differences in interest rates between two countries, combined with an expectation of future exchange rates between the currencies of those two countries. As an example, an international investor could borrow Japanese yen at 1%, convert those yen into dollars and invest them in U.S. Treasury securities earning 4%. If the USD / JPY exchange rate were to remain constant, the investor would pocket a "positive carry" of 3%. In the case of Japan, many international investors exploited the fact that Japan was the only developed economy that had not meaningfully increased interest rates over the last couple of years. Principally because, while the rest of the world has been battling high inflation, Japan has been battling deflation for the better part of three decades.

The amount of positive carry in these trades is ultimately dependent on two factors: 1) how high the spread is between expected interest rates in two countries, and 2) what the exchange rate outlook for the two currencies is. If either of those outlooks materially change, then investors are forced to unwind the trade. That appears to be exactly what happened. The BoJ positioned itself more hawkishly (i.e. suggesting rates would rise faster than expected) while the Fed and market, seemed to suggest a faster pace of cutting (given the moderation in inflation and rising unemployment).

U.S. vs. Japanese Interest Rates



JPY to USD

The surprising element that came to light in this unwinding, is that much of the money that had been financed in yen, was not invested in U.S. Treasuries and fixed income, but in U.S. equities. It has even been suggested that the massive up-moves in AI and tech stocks in the first half of 2024, was itself, in effect, the Japanese carry trade in full force. Going forward we believe that we have not yet seen the end of this episode, as there are still likely significant yen shorts that would be forced to cover should U.S. and Japanese policy rates continue to converge. Where that money is invested, and how orderly the unwinding would be, are the key questions.

Election, Policy Outlook, and AI

It goes without saying that this has been one of the most eventful election years on record, starting with President Biden's disastrous debate performance on June 27th, followed by the Trump assassination attempt on July 13th, and culminating with President Biden's withdrawal from the race and endorsement of Vice President Kamala Harris on July 21st. To be sure, election-induced uncertainty is a feature of every election year, but it does seem to be particularly acute this year, given how many times the perceived front-runner has changed, and given how different each Party's policy visions appear to be.

Under Trump we would likely see an extension of the 2017 tax cuts, a curtailment of fossil fuel regulations, a proposal to replace personal income taxes with a 10% universal baseline tariff on all U.S. imports, and a 60% tariff on imports from China (which along with the EU, Mexico and Canada remains the U.S.'s largest trade partner). Vice President Harris' recently announced economic plan is structured mostly around improving middle class affordability, and includes raising the minimum wage and establishing regulations, price caps, and supply side measures to curb real estate prices and health care costs. She has also expressed support for increasing the corporate tax rate to 28% from 21%, and for Biden's tax proposals which would tax unrealized capital gains at 25% while increasing long term capital gains taxes to 44.6%. Regardless of which policies are enacted, what we can say with confidence is that budget deficits are likely to widen,

resulting in a continued accumulation of the federal debt, an increasingly tenuous fiscal position, and a potential reacceleration in inflation.

It is also important to remember that the ease with which any policy can be implemented is ultimately the result of the balance of power between the Executive, the House, and the Senate. As of now, control of the House and Senate remains highly uncertain, with Republicans only having to flip two seats to gain control of the Senate, while Democrats need to only flip 4 seats to regain control of the House. The policy trajectory will not only be a function of who is elected President, but also of who ultimately controls Congress. The only exception to this would be on the tariff front, where Presidents effectively have the ability to impose tariffs without congressional approval when it comes to matters of national security.

Perhaps one of the few areas of overlap between both sides is a stronger stance on China, particularly when it comes to the "Chip Wars", whereby the US is using trade restrictions to maintain its technological and military superiority. Most recently, the Biden administration threatened to impose the FDPR, or foreign direct product rule, which allows the US to impose controls on foreign-made products that use even small amounts of US tech. Effectively, the mission is not only to block China's access to the latest chipsets, but to also make it more difficult to service chip equipment already inside of China.

In spite of protests from American chip companies, these policies would likely continue under either a Harris or Trump administration. Understandably, it is these policies plus the potential for a full-blown trade war, that prompted retracements in many chip stocks. What we see as particularly concerning in a trade war escalation, is the fact that though the U.S. companies possess an intellectual property edge over Chinese companies, the AI supply chain is nonetheless highly dependent on Taiwan, which the PRC continues to classify as a breakaway province. Consequently, it would be naive to think that the Chinese do not have any counter leverage in a trade war escalation.

We are of the view that should the U.S. take measures to punish Chinese exports into the U.S., while limiting U.S. chip imports into China, that it would increase the probability of an intervention in Taiwan. Perhaps not a full-scale invasion, but perhaps a naval blockade whereby the US can't access the output from Taiwanese chip fabricators. Consequently, we continue to believe that the direction of China relations is a key determinant of near-term equity performance, due to the centrality of the AI theme to the economic growth narrative. For that reason, we believe that policies that affect chip companies have consequences that are far reaching for broader markets. We will be watching closely to better separate what is a tactic from intention in communications from both candidates, and both countries.

Concluding Thoughts

In the context of this latest episode of volatility we share some concluding thoughts to consider into year-end:

1. Timing markets rarely pays off – the best days tend to follow the worst days
2. With political and geopolitical uncertainty remaining elevated, long-term investors should continue to prefer hedged exposures via downside buffers and covered call writing
3. With short term yields set to fall, locking in long term yields on high quality issuers continues to be attractive, in spite of spreads that are historically tight
4. Volatility itself will likely be volatile for the near future

Important Disclosures and Disclaimers

This material is distributed for informational purposes only and intended solely for BigSur Wealth Management, LLC ("BigSur" or the "Adviser") clientele and or other parties to whom BigSur chooses to share such information. The discussions and opinions in this document (or "report") are intended for general informational purposes only, and are not intended to provide investment advice and there is no guarantee that the opinions expressed herein will be valid beyond the date of this document. While taken from sources deemed to be accurate, BigSur makes no representations regarding the accuracy of the information in this document and certain information is based on third-party sources (e.g. Bloomberg, Factset, Wall Street Journal) believed to be reliable, but has not been independently verified and its accuracy or completeness cannot be guaranteed. Any asset allocation proposals described herein are based on proprietary ratings and categorizations which involve varying levels of subjective analysis and interpretation. The asset allocation breakdown is intended to be a summary of BigSur's view on each asset class and its risk components which includes various factors including, but not limited to: market conditions and trends, correlation of securities, volatility, interest rate and issuer risk.

This article is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation, and the particular needs of any specific investor. Views regarding the economy, securities markets or other specialized areas, like all predictors of future events, cannot be guaranteed to be accurate and may result in economic loss to the investor. Any strategies referenced BigSur believes may present opportunities for appreciation over the subsequent time periods. BigSur closely monitors securities discussed and client portfolios and may make changes when warranted as a result of evolving market conditions. There can be no assurance that any investment strategies and/or performance included or referenced in the article will remain the same and investment strategies, philosophies, and allocation are subject to change without prior notice.

Any specific securities or companies identified and described may or may not be held in portfolios managed by the Adviser and do not represent all of the securities purchased, sold, or recommended for advisory clients. The reader should not assume that any investments in securities and/or sectors identified and discussed were or will be profitable. BigSur may change its views on these securities at any time. There is no guarantee that, should market conditions repeat, these securities will perform in the same way in the future. Any performance illustrations shown herein have not been audited and may reflect the reinvestment of dividends, interest and other earnings. Any performance and return illustrations have not been independently verified or audited by BigSur. Returns may be estimated and may not reflect actual performance. Further, past performance and returns may be subject to revision. BigSur does not undertake to update this information, and the results discussed may change without notice.

There are many factors that an investor should be aware of when trading options which can impact their overall performance such as market volatility, interest rates, and time horizon. Investors should only engage in options trading that is best suited to their financial condition and option experience. There is the potential to lose your entire investment in options as well as suffer unlimited downside loss. The options strategy outlined in this commentary only reflects BigSur's opinion and is subject to change at any time. Before trading options, you should understand these risks and carefully review and read the booklet entitled "Characteristics and Risks of Standardized Options" which is available at www.theocc.com. BigSur can provide you a copy of this booklet as well.

Please also note that this commentary is not investment research or considered a research recommendation for regulatory purposes as it does not constitute substantive research or analysis. In discussion of any strategy, results and risks are based solely on assumptions and hypothetical examples. Actual results, performance and risks will vary depending on specific circumstances. You are urged to consider carefully whether such services in general, as well as the products or strategies discussed in this material, are suitable to your needs.

Certain public offerings of Alternative Investment products (e.g. interests in real estate, private equity and hedge funds) are generally offered in reliance upon an exemption and do not require registration under the Securities Act of 1933.

Alternative Investments, therefore, pose additional risks which are different from those inherent in traditional investments. Investments in Alternative Investments may also involve the use of leverage which involves a high degree of risk factors including substantial loss of initial investment. Alternative Investments are not required to provide periodic pricing or valuation information to investors. As such, Alternative Investments are highly illiquid and are generally not transferrable without the consent of the sponsor/issuer.

This report may include forward-looking statements and all statements other than statements of historical fact are to be considered forward-looking and subjective (including words such as “believe,” “estimate,” “anticipate,” “may,” “will,” “should,” and “expect”). Although we believe that the expectations reflected in such forward-looking statements are reasonable, we can provide no assurance that such expectations will prove to be correct. Many factors including changing market conditions and global political and economic events could cause actual outcomes, results or performance to differ materially from those discussed in such forward-looking statements. BigSur shall not be responsible for the consequences of reliance upon any opinion or statements contained herein, and expressly disclaims any liability, including incidental or consequential damages, arising from any errors, omissions or misuse.

This information is highly confidential and intended for review by the recipient only. The information should not be disseminated or be made available for public use or to any other source without the express written authorization of BigSur. Distribution of this document is prohibited in any jurisdiction where dissemination of such documents may be unlawful. Please contact your investment adviser, accountant, and/or attorney for advice appropriate to your specific situation.

For complete disclosure information please go to: https://www.bigsurpartners.com/disclosures/

BigSur Wealth Management, LLC
1441 Brickell Avenue, Suite 1410
Miami, FL 33131
Office (Main): 305-740-6777
Fax: 305-350-9998
http://www.bigsurpartners.com