

Manic market not a reason for investors to panic

In the Loop
August 2024

Key Insights

- Risk-on sentiment and positioning heading into the recent sell-off were extreme.
- Weakness in U.S. economic data was the proximate cause of the pullback. However, not all recent data have been disappointing.
- The dislocations that occur during periods of indiscriminate selling can create compelling investment opportunities.



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Market volatility spiked during the trading session on Monday, August 5. Weakness in Asia's equity markets, headlined by a more than 12% decline in Japan's Nikkei 225 Index (in local currency terms), also showed up in U.S. and European markets.

The CBOE Volatility Index, or VIX, which measures the expected volatility in the S&P 500 Index based on options pricing, surged to its highest level since November 2020.

Market turbulence was extreme, but so were the risk-on sentiment and positioning heading into the sell-off. The Asset Allocation Committee and other investment professionals at T. Rowe Price had flagged these factors as a possible cause for caution:

- A long-running yen-funded “carry” trade that sought to take advantage of Japan's low interest rates to fund the purchase of a wide range of risk assets; and

- The S&P 500's strong returns in the first half of the year stemming from a handful of mega-cap stocks and excitement about the value that advances in artificial intelligence could create.

What caused these elongated springs to snap back?

Recent developments in the U.S. suggested that recession probabilities may be higher than the market had priced in a couple of weeks ago.

Inflation data released in July showed signs of softening and bolstered the view that the Federal Reserve would reduce interest rates in September. Then, last week's run of weaker-than-expected economic data prompted markets to question the consensus view of a soft landing for the economy.

Nonfarm payrolls data showed that the economy created fewer jobs than expected in July, and the unemployment

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rate jumped unexpectedly to 4.3% from 4.1%. Meanwhile, the Institute for Supply Management's (ISM's) gauge of manufacturing activity fell to its lowest level since last November.

These signs of weakness in the U.S. economy forced the market to consider the possibility that the Fed could be behind the curve and would need to ease monetary policy potentially faster than expected. And this possibility, combined with the Bank of Japan raising rates, raised questions about the popular yen/dollar carry trade.

Why we're not hitting the panic button

Technical factors, such as excess optimism in positioning that built up before the sell-off, seem to be behind a lot of the market volatility.

And let's remember that not all the economic data have been concerning.

U.S. gross domestic product surprised to the upside in the second quarter, while the latest reading of ISM's measure of activity in the services side of the economy remained at levels that indicate expansion.

It feels to me like the market is saying "crisis," but I'm not sure there's an actual crisis. The risk, as always, is that this kind of market action can be self-fulfilling.

However, the dislocations that occur during periods of indiscriminate selling can create compelling investment opportunities for thoughtful asset allocators.

The same goes for bottom-up stock pickers who are willing to take a longer view and are guided by a deep understanding of individual companies and industries.

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