



Market Watch

Growth concerns return

Summary

Global cyclical assets pulled back sharply over the past week, especially after a weaker-than-expected US job market report. Developed Market government bonds and haven currencies such as the JPY and CHF have been the main beneficiaries.

Bank of Japan's surprise rate hike and hawkish guidance also led to an unwind of the so-called FX carry trades and a rush for havens. However, the broad USD index (DXY) could see a corrective bounce as it approaches the bottom of its 100-107 range.

With the Fed funds rate at a 23-year high, our base case is that the Fed has significant capacity to ease policy to help the US economy achieve a soft landing. Money markets are pricing almost 50bps of Fed rate cuts by September and almost 115bps of cuts by year end. Also, US large corporate earnings and balance sheets remain healthy, despite scepticism about AI.

While our technical model has turned bearish on the S&P500 index for the first time in two years, the return of negative correlation between stocks and bonds underscores the benefits of a diversified foundation allocation. The Nasdaq 100 and S&P500 indices have immediate supports around their 200DMAs.

Background

Global risk assets were poised for a pullback due to excessively optimistic investor positioning. Our 12 July Weekly Market View warned investors not to chase the US equity market rally. Our monthly Global Market Outlook (2 August) reiterated near-term risks.

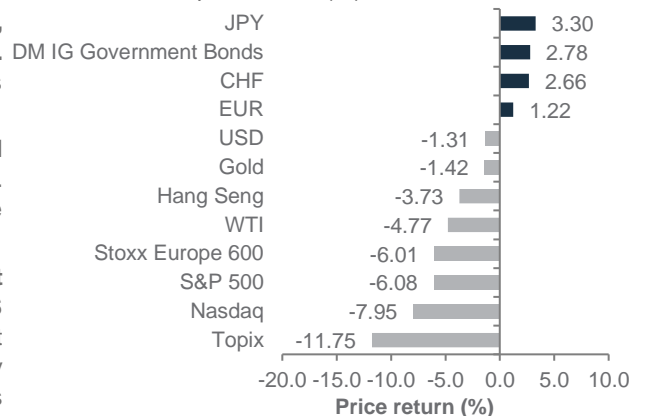
A weaker-than-expected US job market report and scepticism about AI provided the catalyst for the sell-off. The US jobless rate rose to above-expected 4.3% in July amid rising labour participation. Monthly net new jobs slumped to 114,000 vs. 175,000 expected.

Some US recession indicators we closely follow have been triggered following the latest job report. This includes an indicator developed by BCA Research which tracks the unemployment rate of permanent job losers. Historically, when the 3-month moving average of this rate rose more than 20bps from the past 12-month's low, a recession started. Nevertheless, an unusual rise in labour supply in this cycle due to a surge in immigration could distort the signal.

The risk-off sentiment was fuelled by an unwind of the so-called FX carry trades. The JPY and CHF were popular sources of global liquidity due to low borrowing costs. The BoJ's surprise rate hike and hawkish guidance last week led investors to sell leveraged positions in cyclical assets, especially US equities, to reduce JPY borrowings.

Havens such as Developed Market government bonds and JPY and CHF have benefitted the most from the sell-off in risk assets and unwind in FX carry trades this month

Month-to-date price return (%)



Source: Bloomberg, Standard Chartered; 31 July close to 5 August close

One of our closely watched US recession indicators was triggered after the recent jump in the jobless rate

3-month moving average of US unemployment rate of permanent job losers minus its 12-month low



— US unemployment rate of job losers not on temporary layoff: current - 12-month minimum

Source: BCA Research, Bloomberg, Standard Chartered

What does this mean for investors?

Staying diversified across stocks and bonds amid negative correlation. The correlation between stocks and bonds, especially in US markets, is again turning negative as government bond yields plunged amid rising US economic growth concerns. This implies that gains in government and investment grade corporate bonds are helping to partly offset declines in equities within a diversified portfolio. This supports our broadly diversified asset allocation stance in our foundation portfolio, with a slight tilt towards US equities.

Bond yield curve likely to steepen further. The US 2-year bond yield has fallen faster than the 10-year yield over the past week, turning the 10-year vs 2-year bond yield premium close to positive again. This benefitted our call for a steeper yield curve. This move suggests markets are pricing sharper Fed rate cuts in the coming months (reflected in the 2-year yield) amid a worsening outlook for long term growth (signalled by the 10-year yield). While the window for the Fed to achieve an economic soft-landing is narrow, rate cuts in the mid-1990s steered by the then Fed Chair Alan Greenspan helped avoid a recession. Nevertheless, we need to watch the 10-year bond yield closely - a sustained break of the 10-year yield below last December's low of c. 3.8%, coinciding with further decline in stocks, would signal heightened risks of a US recession. This would drive sharper Fed rate cuts, steepening the yield curve further.

Fed comments, high-frequency job market data likely to be the most important drivers of markets in the coming weeks. The Fed funds rate, at 5.5%, is at a 23-year high, affording the Fed significant latitude to ease policy to prevent a sharp deterioration in the US economy and job markets. Money markets are already pricing 50bps of rate cuts by the next scheduled Fed meeting on 18 September, with rising probability of an earlier rate cut if high-frequency job market data deteriorates. US weekly jobless claims are rising. Several Fed policymakers are due to speak in the coming days. Indications of sharper Fed rate cuts should support risk sentiment.

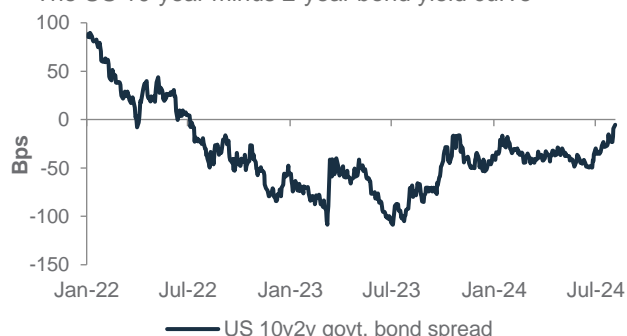
Our longer-term quantitative models remain modestly bullish equities; earnings estimates remain robust. Our technical model, however, highlights near-term risks, particularly in US equities. It has turned bearish on US equities for the first time in two years as momentum and volatility indicators worsened. The Nasdaq and S&P500 indices have immediate technical supports around their 200DMAs (1-3% below Monday's close). Also, US Q2 earnings and revenue have beaten estimates. LSEG I/B/E/S consensus estimates S&P500 index earnings to rise 6.8% y/y and 13.9% y/y in Q3 and Q4, although those estimates have been lowered in recent weeks. Our technical model remains bearish on Japan and China stocks.

FX carry trade unwind likely near final stretch. The two haven currencies – JPY and CHF – benefitted the most after the weak US jobs data and the Bank of Japan's surprisingly hawkish stance. USD/JPY and USD/CHF are not far from testing their December 2023 lows of close to 140 and 0.83, respectively. We closed both our short USD/CHF and USD/JPY trades this week. Aided by JPY's strength, USD/CNH has fallen more than 2% since mid-July. Currency strength could create room for the PBoC to ease policy further in the coming months, especially if the Fed starts cutting rates.

Corrective USD rebound likely. While market bottoms are hard to time, especially during rapid moves, the broad USD index (DXY) remains well within its 100-107 range since late 2022. It will likely take a deep US recession, warranting deeper Fed rate cuts, for the USD index to fall below 100. As such, there is rising chance of a near-term corrective rebound in the USD. Currency volatility has risen out of recent ranges – another indicator to watch closely in the coming days.

The US 2-year bond yield is once again close to falling below the 10-year yield as the market prices in sharper Fed rate cuts to prevent a recession

The US 10-year minus 2-year bond yield curve



Source: Bloomberg, Standard Chartered

The S&P500 index has near-term technical supports before a major support around the 200DMA

S&P500 index and key near-term technical support levels



Source: Bloomberg, Standard Chartered

USD/JPY has fallen close to its December 2023 lows of 140; further downside is likely limited unless the US economy plunges into a deep recession

USD/JPY



Source: Bloomberg, Standard Chartered

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