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Global markets tumble, what next?

Investment event | 6 August 2024

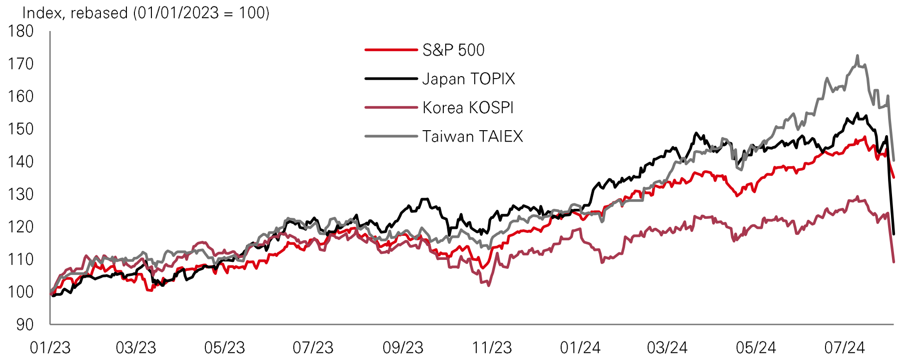
Global market volatility spikes

Global risk assets have seen dramatic moves in recent trading sessions. A process that began with mixed mega-cap tech profits results has now evolved into worries for the boarder US economy, and investor fears of recession.

By market close on 5 August, the S&P 500 has lost nearly 9% since its peak on 16 July. The VIX index – the "fear gauge" measure of implied US equity market volatility – has spiked above 60 for the first time since the covid market crisis of March 2020. And other market signals underscore investors' growth worries – the yield curve has "bull steepened" rapidly, while US credit spreads have widened.

In Asia, stock markets have had a significant correction, especially the tech-heavy indexes in Japan, Korea and Taiwan (Figure 1). The three trading sessions between 1 – 5 August represent the biggest drop in Japan's TOPIX index (-20.3%) since data began in 1949.

Figure 1: Global stock indices declining



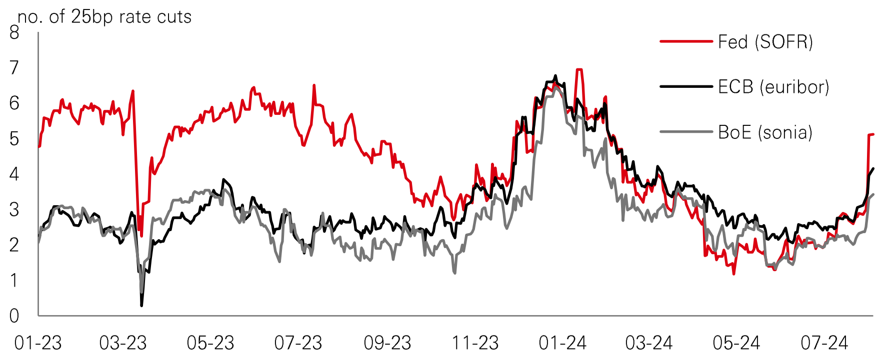
Source: Bloomberg, HSBC AM as of 5 August 2024. Past performance is not an indication of future returns.

Recession fears

In a recent Investment Event ("US Tech: Dip or blip"), we outlined some of the reasons behind investor nerves on mega-cap tech stocks: (i) stretched valuations; (ii) disappointing profits news and outlooks; and (iii) adverse geopolitical headlines in recent weeks. These issues haven't just dented confidence in the Nasdaq and Philadelphia Semiconductor Index, but also in key Asia indexes, like Korea's Kosdaq.

But the new development in recent days is investor anxiety around the US economic outlook. This has come to a head with last Friday's disappointing labour market report for July. The data has had a stunning effect; shifting the market narrative and causing a dramatic repricing of expectations for US interest rate cuts (see Figure 2). The market now expects 5 Fed cuts this year.

Figure 2: Market expectations of 2024 central bank policy easing



Source: Bloomberg, HSBC AM as of 5 August 2024

Global markets have experienced a turbulent few trading sessions as concerns over the US mega-cap tech sectors have extended to the general health of the US economy

With activity data in the three main blocs of global economy surprising to the downside, recession risks are now clearly higher than widely appreciated only a few weeks ago

Our view:

The soft landing is not yet guaranteed – especially if this latest labour market data are right

This has been an important part of the rationale for a defensive portfolio positioning, as described in our "Playing the Yield" mid-year investment outlook

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Recent events represent another rapid shift in the market narrative, something investors are increasingly becoming accustomed to this year. There are several additional macro consequences:

- **Bond markets have rallied strongly as the scenario for the Fed is re-assessed**. And the US yield curve, now inverted for 24 months, has bull steepened abruptly. A rapid yield curve "dis-inversion" is material since historically it tends to coincide with recession periods. US high yield credit spreads have widened significantly from close to multi-decade tight spreads in June and July.
- **In stock markets, the "great rotation" (that we had begun to see in July) has faltered**. This dynamic represented a broadening out of equity market leadership, away from "quality growth" sectors and "momentum", toward left-behind "value", "defensives" and "low volatility". Elements of this survive but, in the recent sell-off, it is notable that US small cap stocks (i.e. the Russell 2000) have been badly hit.
- And **in currency markets, we have seen a rapid unwinding of carry trades**. The US dollar has weakened versus the Japanese yen, which itself has been boosted by Bank of Japan policy normalisation and FX intervention from Japanese authorities. That creates some challenge to the profits outlook for Japanese exporters. And it initiates a broad unwinding of yen-based carry trades. These trades typically buy higher-yielding currencies (such as the Mexican peso), but they may also have funded positions in other risk assets.

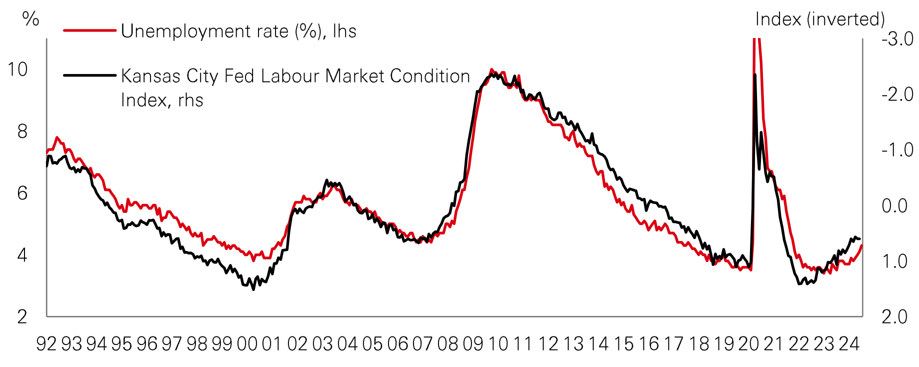
Reflections on the global economic picture

July's disappointing US labour market report was a watershed moment for investor psychology. The US unemployment rate rose by more than expected to 4.3%, triggering the so-called "Sahm Rule" (historically, a gold-standard recession early-warning signal). Meanwhile, a broader measure of underemployment - "U6" – jumped 0.4% percentage points to 7.8% and non-farm payrolls were weaker than expected, growing at +114k in July.

It's important to bear in mind two caveats when interpreting this disappointing data. First, Hurricane Beryl may have temporarily boosted unemployment, although the Bureau of Labor Statistics claims this has had no effect. Second, there are question marks around the quality of employment data at present; immigration inflows to the US are strong (and may be masking trends), while statistical collection samples are also falling.

Nonetheless, **the broad gamut of data shows the US labour market is cooling**, and potentially faster than the Fed had hoped for. Even before Friday's numbers, the Kansas City Fed Labour Market Conditions Index (a broad index of labour market trends) had pointed to a deteriorating picture for unemployment (Figure 3).

Figure 3: US labour market indicators

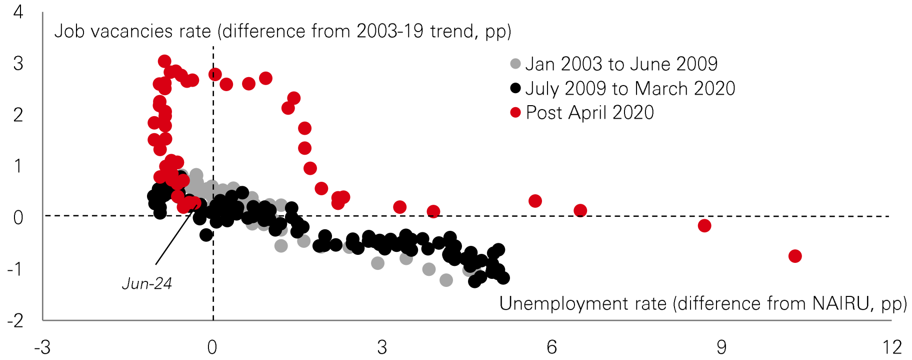


Source: Bloomberg, HSBC AM as of 5 August 2024

For the time being, the story is one of weak new hiring and not one of firing. The question for economists is how long will that last? The evidence shows that firms have been hoarding labour up to this point. Figure 4 shows the "Beveridge Curve" – the trade-off between job vacancies and the unemployment rate. It implies that any further decline in labour demand will now flow-through into a rise in the unemployment rate.

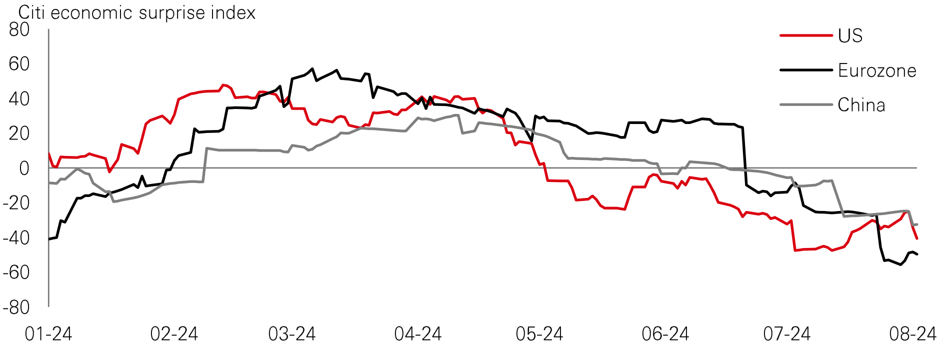
Nominal growth is already cooling. Figure 5 shows how economic surprise indicators have now moved into negative territory. US macro data have been surprising to the downside since early May and the same has recently started to happen in the eurozone and China.

Figure 4: US "Beveridge curve" – vacancies versus unemployment



Source: Bloomberg, HSBC AM as of 5 August 2024

Figure 5: Citi economic surprise indices



Source: Bloomberg, HSBC AM as of 5 August 2024

What happens next?

What comes next is highly uncertain.

Our central scenario has been for a "soft-ish" landing in H2 2024 and early 2025, characterised by growth falling below trend and inflation returning to target. This scenario still left plenty of scope for profits to grow and stock market performance to broaden-out to laggard sectors and styles (including value stocks). A mild recession had always been part of our calculus when thinking about the distribution of risks. After all, a combination of tight monetary policy and neutral fiscal policy was never going to offer a repeat of 2023's positive growth surprise. But markets gave the recession risk short-shrift during most of 2024.

Recession risks are now clearly higher than anticipated only a few weeks ago. With activity data in the three main blocs of global economy surprising to the downside, it is not obvious where the growth boost will come from. And the impact of policy tightening by western central banks is still likely to be feeding through to the real economy. We also need to consider the potential for "negative feedback loops" stemming from recent market action, which can dampen business and consumer confidence.

At this stage, it is hard to say with conviction whether the US economy will lapse into a recession or simply experience a period of below-trend growth, as we originally envisaged. After all, **corporate and household balance sheets are in good shape**. That could have the important effect of preventing the typical pre-cursors of recession (such as large-scale layoffs or marked slowdowns in consumer spending).

Who is at risk from a US downturn?

A sharp US downturn would create spillovers to the rest of the world, especially given ongoing weak nominal growth trends in China.

More trade-dependent economies will be most exposed to a US shock. In Asia, **Taiwan and Korea look most at risk**. However, corporate profits trends in both markets remain strong for now, and there may be some sustained momentum from strong AI-related semiconductor and technology demand.

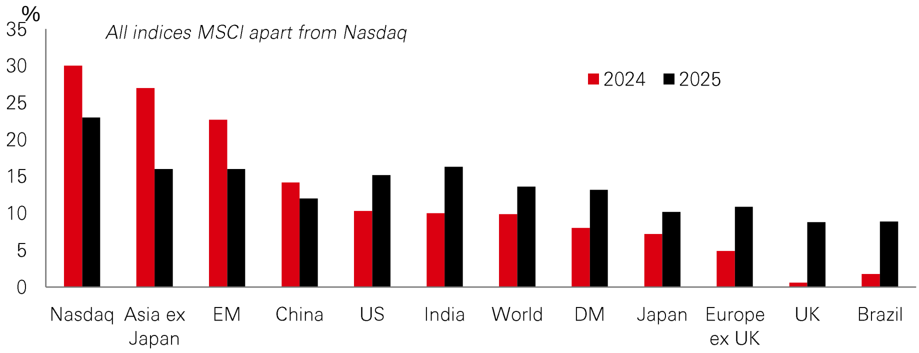
The more domestically-oriented Asia economies – such as **India and parts of ASEAN – should fare better**. These tend to be lower beta stock markets. And they also have the benefit of less restrictive monetary policy than in western economies.

Latin American economies are typically exposed to the US cycle or China via commodities, the global trade cycle, and the US dollar. A weaker US economy and the recent fall in commodity prices present a headwind for the region.

Much **weaker US demand would be a challenge for European economies**, although the UK and eurozone have some cushion in terms of relatively high household saving rates. That could limit the impact of negative confidence effects on spending. In fact, our macro scenarios from our recent Mid-Year Investment Outlook projected a sequential improvement in European growth heading into 2025.

One good piece of news, is that **the global corporate profits picture looks significantly less concentrated and lop-sided for the second half of 2024 and ahead into 2025**. This could be an important data point to track. If sustained, "the great rotation" theme could yet return to stock markets (Figure 6).

Figure 6: Global profits growth broadening out



Source: Datastream, HSBC AM as of 5 August 2024. Past performance is not an indication of future returns.

How should investors be positioned now?

The recent jolt to global markets follows an extended period of very subdued market volatility amid hopes of an economic "soft landing" – or something even better – for the global economy. The AI hype story added further layers of optimism to this rosy view. But increasingly stretched valuations in many parts of the investment universe meant risk assets had been "priced for perfection". As such, recent less-than-perfect developments have surprised investors, and catalysed a violent price reaction.

It's possible to dismiss recent market repricing as an overreaction. Liquidity is thin during the summer months, exacerbating the extent of moves. Macro data can be noisy. And the AI megatrend is here to stay. In Japan, tailwinds from corporate governance reforms remain intact, while recent profits releases have been better than the market consensus.

Nevertheless, the soft landing is not yet guaranteed – especially if the latest labour market data are right. Placing a nil probability on recession materialising always looked overly optimistic. For us, this has been an important rationale for maintaining a defensive positioning in risk assets over the past year (Figure 7), including a range of hedges in our multi-asset solutions, including an allocation to gold.

Figure 7: Stocks versus bonds and US unemployment

Source: Bloomberg, HSBC AM as of 5 August 2024. Indices used: MSCI World Net Total Return USD Index, Bloomberg US Aggregate Total Return Value Unhedged USD. Past performance is not an indication of future returns.

If the recent weakness in macro data is shown to be a blip, investor confidence can recover quickly. Our investment team remain open and agile to respond should this eventuality materialise.

A more dovish Fed can also help restore investor confidence on the economic outlook and provide an important boost to valuations via lower discount rates. **The so-called "Fed put" could make a comeback as growth worries overtake inflation risks**. The market is now pricing a 50bp cut for the September Fed meeting. Some economists are suggesting this could be delivered before then as an inter-meeting measure. This is possible. But it would require risk assets to remain under significant pressure. However, in the absence of further material and rapid market declines, we think the Fed will prefer a more measured approach.

At this stage, **back-to-back 25bp rate cuts at the remaining three meetings this year and further reductions in 2025 to take the funds rate to around 3.50% by next summer** seems the minimum the Fed could do, given the risk facing markets and the economy. If the downside recession risks crystallise, more aggressive policy easing will be needed.

Overall, **we continue to expect a more volatile phase for investment markets during the second half of 2024, as described in our recent mid-year investment outlook ("Playing the Yield")**. In that paper, we argued that a number of economic and political uncertainties were coming to the fore in H2, which would create a more turbulent journey for investors. These risks included the chance of a faster cooling of US growth, but also election uncertainty, geopolitical stress, and a possible policy error. More than anything, recent events have validated our house view.

We continue to have a preference for **high-quality fixed income** (global Investment Grade, and Asia within global High Yield) and for **defensive parts of the stock market** (consumer staples, healthcare, and utilities), which we think will be relative outperformers amid a slowdown in the US economy. From a factor perspective, that would extend to more multi-factor, multi-sector approaches, rather than making portfolios over-reliant on momentum exposures.

And, despite their exposure to the global economic cycle, left behind parts of the market such as **real estate, infrastructure, and many parts of the EM universe** (including China stocks, and local currency EM bonds) may still perform relatively well given their attractive valuations.

We continue to monitor developments closely, and will communicate further in due course.

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