Market Commentary 8/15/24

An Oxford Harriman & Company Market Commentary

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Stocks fell hard on Monday of last week, with the S&P 500 closing down 3%. However, a better-than-expected jobs report on Thursday, which saw weekly initial jobless claims fall to 233,000 from 250,000 the week before, led to the S&P 500 rallying 2.3%. This rally was the biggest gain in nearly two years, and the rebound resulted in the S&P 500 being basically flat for the week.

As we have mentioned in previous commentaries, the many variables facing investors have led to volatile markets. Indeed, the CBOE Volatility Index, a well-referenced measure of market uncertainty, spiked to a high of 65 on Monday before returning to the low 20s at the end of the week. For comparison, throughout the month of July, this Index was in the mid-teens. Monday's market decline was attributed to an unwinding of the "Yen-carry trade."

The Yen-carry trade is a trading strategy used by hedge funds and other institutional investors that involves borrowing Japanese Yen at a low interest rate and using the funds to invest in assets that offer a higher return. This strategy capitalizes on the interest rate differential between Japan and other countries, aiming to generate profits from the difference in interest rates.

This strategy works as follows:

1. Borrow Yen
Traders borrow in Japanese Yen, benefiting from Japan's historically low interest rates. The Bank of Japan (BoJ) has maintained these low rates to stimulate economic growth and combat deflation.

2. Convert to Higher-Yielding Currency
The borrowed Yen is then converted into a foreign currency from a country with higher interest rates, such as the US dollar, Australian dollar, or Euro.

3. Invest in High-Yield Assets

Traders then invest the converted currency in higher-yielding assets like government bonds, stocks, or even savings accounts in the foreign country. The goal is to earn a return that exceeds the cost of borrowing the Yen

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Additional gains can be realized if the foreign currency appreciates against the Yen. However, investors were surprised when the Bank of Japan unexpectedly hiked its benchmark interest rate. This forced many to quickly unwind their Yen carry trades. This sudden unwind created a short-term panic and is attributed as the primary reason for Monday's stock market sell-off.

Concurrent with the market decline came increased calls for the Fed to cut rates, either through an "emergency cut" (which we don't agree with) or a larger 50bp rate cut in September. We will close this note with a review of how investors typically behave at the onset of interest rate cuts.

When the Federal Reserve cuts interest rates, it signals a shift in economic policy aimed at stimulating growth. As we have mentioned in previous commentaries, the S&P 500's performance in 2024 has been narrowly focused. If interest rate cuts do stimulate economic growth, leading eventually to positive earnings surprises, investors may begin to recognize the relative value of companies whose businesses (and balance sheets) benefit from lower rates. As the Fed eases, market gains may be broader based.

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In a low-interest-rate environment, high-dividend stocks become appealing as alternatives to fixed-income investments. Sectors like utilities, telecommunications, and consumer staples tend to offer stable dividends and are less sensitive to economic cycles. Small-cap stocks have also historically outperformed during rate-cut cycles. Lower interest rates reduce the cost of borrowing, which can benefit growth-oriented companies, particularly in the technology sector. Investors often look to capitalize on the potential for higher earnings growth driven by increased investment in innovation and expansion.

When the Fed cuts rates, the yield on short-term bonds and money market funds should decrease. Investors may start locking in longer-term rates, going farther out on the yield curve. Indeed, current CD rates already reflect a September rate cut.

By understanding the historical context and identifying current investment themes, investors can better position their portfolios to take advantage of opportunities that arise in a lower interest rate environment. Whether it's leveraging growth stocks, seeking high dividend yields, or extending bond maturities, it is important to understand what can occur as the Fed adjusts its monetary policy.

Have a great week ahead,

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