Summer storms and underlying trends

One more year, following the prevailing trend in most months of August, we witnessed a new episode of volatility in the markets at the beginning of the month. The pattern is well known: just as the summer is prone to extreme weather phenomena when pockets of cold air coincide with very warm temperatures on the sea surface, August is also often a tumultuous month for the financial markets, as the effect which unexpected announcements in the macroeconomic data, in corporate earnings or in the geopolitical sphere have on asset prices can be amplified by low levels of liquidity in the markets.

This time the spark was an unexpected rate hike in Japan, which caused a sharp appreciation of the yen, triggering the closure of carry-trade positions (low-cost financing denominated in the Japanese currency used to invest in higher-yielding assets in other locations). This thus entailed the sale of assets in the US, the euro area, etc. In addition to this sudden shift in financial flows, the US employment data for July fell short of expectations, increasing fears of a recession in the country, as did the earnings reported by some tech firms, which are beginning to reflect the time lag between the enormous investments required to avoid falling behind in the AI race and its monetisation.

All of the above provided a perfect breeding ground for corrections in the stock markets, which were at high temperatures following the gains recorded in the first seven months of the year (+11% between January and July), with the additional potential instability posed by the significant accumulation of leveraged positions during the spring in a low-volatility environment. The cumulative fall from peak to trough recorded in the stock markets was 8.2% in developed economies and 9.3% in emerging markets. Most notably, some of the big tech firms, such as NVDIA and TESLA, experienced corrections in excess of 25%, while Japan's Nikkei 225 index suffered the biggest setback (12.5%) in a single session recorded in recent decades. The good news is that, after the storm, calm has returned, now that the economic activity data published throughout August has once again revealed that the soft-landing scenario is currently the most likely, while inflation on both sides of the Atlantic is making progress on its path towards 2%.

This normalisation of the financial situation following the summer storms has also been facilitated by the clarification of the prospect of monetary easing in the US, after Jerome Powell confirmed in Jackson Hole that the Fed will begin to cut rates from September. In his speech, the chair of the American central bank pointed out that, now that progress has been made in the battle against inflation, it is time to focus on economic activity and employment, and that means that the current tone of monetary policy is excessively restrictive, so it is time to begin returning to neutral territory. In our opinion, this will mean placing interest rates in the 3%-3.25% range by mid-2026, and along the way the Federal Reserve will take the opportunity to review its monetary policy strategy, which has been somewhat stagnant since its last update in 2020. A similar exercise will be carried out by the ECB, although Lagarde has already stated that there will be no adjustment of the target this time. In the case of the euro area, we believe that, following the structural changes of recent years, the neutral interest rate will lie in the 2%-2.25% range. This is thus the theoretical medium-term terminal rate, subject to any new surprises that may arise on the horizon.

Therefore, with the yo-yo movement in the markets in August, it has once again become evident that in the absence of any changes in the underlying trends, it is best not to overreact to spikes in financial instability but rather to rely on the soundness provided by portfolios that are well-diversified in terms of both assets and regions. In fact, an investor returning from an idyllic holiday destination without any access to the internet or social media (if that still exists) would have seen good returns on a 60/40 portfolio, avoiding the scare of the first week of the month.

In short, having overcome the traditional financial cold drop of the summer, the underlying trends in the business cycle will continue to play a key role, and these will be determined by the central banks' ability to finish the work of the last two years without causing a sharp adjustment in economic activity. For now, the data continue to support the soft-landing hypothesis. However, this does not mean that we will be immune from potential turbulence in the markets over the coming months, given the high levels of geopolitical risk and the fact that monetary policy will remain in restrictive territory for some time to come. In the meantime, we will be preparing the popcorn or coffee for the long night of 5 November.

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