Economic note by TCorp Chief Economist, Brian Redican

Learning from the recent bout of market volatility

The bout of volatility in equity, bond and currency markets at the start of August was significant in size, though hopefully will prove to be short in duration. According to Deutsche Bank, the 12% daily fall in the Japanese stock market on Monday 5 August was the second largest decline in the post-World War II period, while the 10% rebound on Tuesday 6 August was the second largest gain.

Episodes like this are like cyclones: it is impossible to predict when and where they will occur, but we know they will. And we suspect they will occur more frequently in the future due developments including the transition to net zero, friend-shoring of supply chains and geopolitics, which all have the potential to deliver negative supply shocks and lead to more frequent inflationary bursts. But getting back to the current episode, while it is important to understand what triggered the recent bout of volatility, the greater lesson is to be prepared.

The emerging consensus about the recent episode begins with the observation that investors were confident there were few risks to global economic growth, corporate earnings or a monetary policy surprise.

Then 2 developments punctured this complacency. First, the Bank of Japan pointed to a more aggressive increase in interest rates than expected. Second, surprisingly weak US employment and manufacturing surveys suggested that the US central bank might need to cut interest rates more aggressively.

The risk that Japanese and US interest rates might rapidly converge then prompted global investors to exit several popular trades, such as expecting the Japanese currency to keep falling and Japanese shares to keep rising. As investors rushed from one side of the boat to the other, asset prices moved sharply which was exacerbated by illiquid trading conditions as many investors in the Northern Hemisphere were on summer holidays, or watching the Paris Olympics rather than their Bloomberg screens.

The nature and sequencing of market movements suggests that the August volatility reflects the inability of markets to smoothly accommodate a large and concentrated shift in investor positioning, rather than a fundamental judgement that the economy is suddenly heading for a deep recession. Certainly, our view is that while the US economy and labour market will weaken, it is still on track for a relatively soft landing.

But while the base case for the US economy might not have changed, the risks around that central case have shifted. First, market volatility can affect sentiment, prompt consumers to spend less and make firms reluctant to invest. For this reason, it will be important to monitor surveys of US firms to discover whether the recent volatility does generate negative feedback effects on the real economy. Movements in Australian financial markets have been more muted than in Japan or the US and so this risk is probably smaller for the Australian economy.

Second, it is likely that the US central bank will respond to the shift in risk profile and take out some insurance rate cuts. In other words, rate cuts will occur earlier and a little more quickly, than previously expected.

Third, while retail investors can ‘look through’ periods of market volatility, financial market participants should be wary as volatility can beget volatility. Traders must scale down positions which leads to less liquid markets. Wild swings in asset prices also widens the dispersion between investment winners and losers. Firms on the losing side might face client withdrawals and be forced to liquidate other investments. And if those losing investors were leveraged, then it will have further reverberations.

A real example of these effects occurred when a regular US Treasury auction of 10-year bonds on Wednesday 7 August was met with very tepid demand from distracted investors which forced yields higher. In order to avoid this sort of outcome and minimise the impact on our clients, TCorp prepares for such periods by holding high levels of liquidity so that we aren’t forced to issue debt when conditions aren’t conducive. We also endeavour to take advantage of calm periods in markets, rather than waiting for a ‘perfect’ time to issue.

TCorp also manages financials assets on behalf of the NSW Government and the notion of ‘prepare rather than predict’ also applies here. The key is to build a resilient investment portfolio that has the best chance of meeting an investor’s objective over their nominated time horizon. The recent bout of volatility provides an opportunity for investors to check whether the different parts of their portfolio performed as they were designed to when markets are stressed, and that they were satisfied with the overall outcome. If not, then it would be sensible to consider how the portfolio should be changed.