Markets have sold off sharply; what's next for investors?

5 August 2024

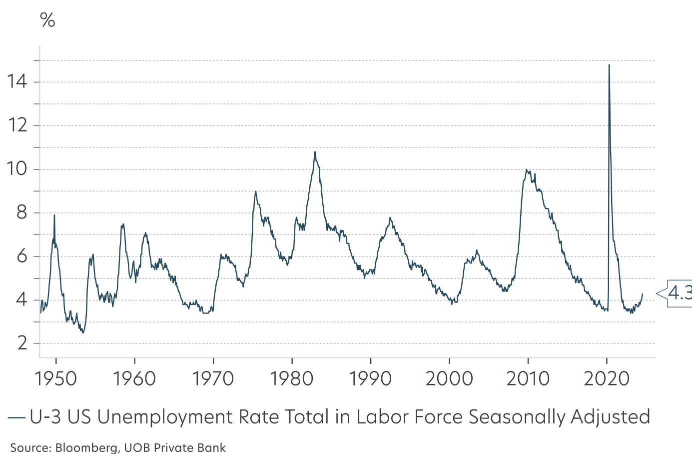
Overview

- Weak US data reignite fears of a harder landing
- Global stock markets sold off sharply and bonds rallied
- We view the sell-off to be a technical correction, rather than the start of a late-cycle bear market
- Hawkish BOJ triggered a huge sell-off of Japanese equities
- Recommend investors to buy Japanese stocks into weakness, especially in selected domestic areas

What happened?

Global stock markets sold off sharply and bonds rallied after a string of weak US data reignited fears of a harder landing than previously anticipated. One of the key data that spooked hard-landing fears is the unemployment rate, which rose from 4.1% to 4.3% **(Fig. 1)**. Historically, once the unemployment rate rises, it tends to continue rising until the economy gravitates into a recession. The set of weak data has led some banks to revise Fed's policy rate to a 50bp cut in the September meeting and another 50bp in November.

Figure 1: US unemployment rate edges higher



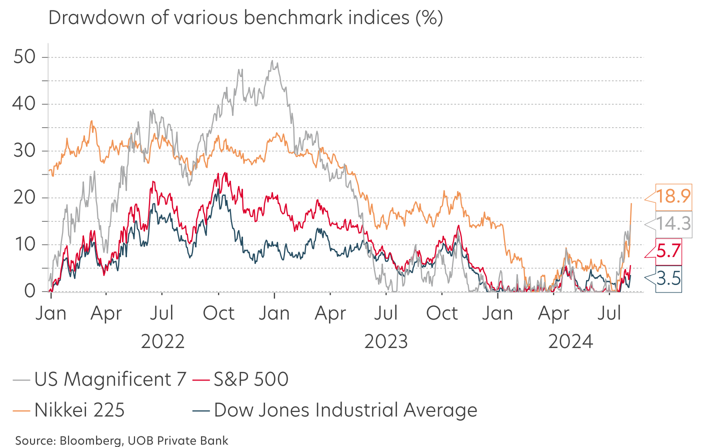
Source: Bloomberg, UOB Private Bank

Why is hard landing unlikely?

The weak payroll data of 114,000 is likely to be distorted by weather effects (Hurricane Beryl). Moreover, the cooling in the labour market probably reflects the slower employment of the large influx of immigrants than a weak underlying employment trend. Household balance sheet is in a relatively good shape, helped by income gains and a rise in household balance sheet. Furthermore, US corporates are not overly leveraged.

The rally in technology buoyed by AI has led to a massive price appreciation of the Magnificent-7 stocks, which has rose sharply since the start of 2023. The recent sell-off was concentrated in such sectors as seen in the larger drawdown as compared to that of Dow Jones Industrial Index **(Fig. 2)**.

Figure 2: Drawdowns are concentrated in the winners



Source: Bloomberg, UOB Private Bank

We are of the view that the sell-off reflects a technical correction, rather than the start of a more entrenched late-cycle bear market usually associated with an economic recession. **Hence, we continue to advocate investors to diversify out of the usual large-caps, and use derivatives to accumulate at lower levels. An interest rate cut is likely to be supportive of markets in the absence of hard-landing risks.**

What to do about Japan's stocks?

Japanese stocks underwent a more material sell-off of 20% triggered by a hawkish BOJ, against the backdrop of a likely dovish pivot by the Fed. As a result, the Nikkei's advance year-to-date has been totally wiped out. This has also caused a 10% appreciation of the Yen against the USD.

While the Yen move is certainly negative for Japanese corporate earnings, the investment thesis for Japan goes beyond a weak currency. The inflation dynamic is likely to catalyse an investment cycle, while corporate governance reforms will re-rate Japan's ROE higher overtime.

While the BOJ is sounding hawkish, core inflation remains at 2.2% and the economy is not overheating. Hence, it is likely that the BOJ's rhetoric is targeted at a very rapidly declining currency. With a significant correction in USDJPY, it is unlikely that interest rates will have to be hiked that much.

In our view, the risk-reward for Japan's equity market has turned markedly more attractive after the sell-off, even though there could be further short-term weakness. The JPY carry trade is being flushed out; this will set a healthier tone for the market. **Hence, we recommend investors to buy Japanese stocks into weakness, especially in selected domestic areas.** Notably, banks have underperformed but they are likely to benefit from a more normalised interest rate environment and are more insulated from a strong JPY.

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