westwind capital

“The Cacophony of the Carry Trade”

As summer begins to wind down, the noise in the media is beginning to heat up. With the presidential elections just around the corner, geo-political unrest in the middle east, and the Federal Reserve’s tightening cycle coming to an end, the media noise is getting louder. Yesterday, selling pressure in Japan trickled into the domestic markets and suddenly, according to the media, the proverbial sky was falling. Whether listening to financial news stations, national news, or local news it can be challenging to tune out the noise when you hear about 1000-point declines in the domestic markets.

Successful investing necessitates level heads and calm thinking. Joining the herd, listening to the media and acting on fear can be very, very costly to investors. When the media stokes the emotional fires of investors, we go to work. First, we go to the history books: what do past market cycles and similar historical events tell us about the current situation? The “Asian Contagion” in 1997 has some similarities to the current situation in Japan when financial imbalances in Southeast Asia spread to the rest of the world as high levels of debt and speculative investments had to be quickly unwound. Last week was a culmination of events abroad and domestically that triggered similar unwinding; on July 31st, the Bank of Japan (BoJ) increased its key interest rate to “around 0.25%” from the previous range 0.05-0.1% while the United States Federal Reserve indicated a rate cut was likely eminent at the next Federal Open Market Committee meeting in September.

Many clients have asked why the BoJ increasing rates in Japan is significant to our domestic stock market. The increase in rates by the BoJ was the second interest rate increase since 2007. The first-rate hike occurred on March 26, 2024, when the BoJ ended the country’s long-held negative interest rate policy of minus 0.1%. Japan’s extremely low rates were important to many international companies as well as money managers who could borrow in Japanese Yen because the rates have been more favorable than other developed economies such as the United States or the European Union. This type of borrowing was known as "the Japanese Carry Trade" and has been popular since approximately 1997.

While generally multi-national companies that earn revenue in Japanese Yen don't have to worry about the foreign exchange rate, those who do not can be subject to more risk if they are borrowing in Yen. Since the beginning of 2022, when United States interest rates began to rise, those hungry to lock up lower rates or needing to roll over debt have sought to issue debt in Japan. At the beginning of 2022, the Japanese Yen was approximately ¥114 per U.S. Dollar. As U.S. Treasury bonds attracted more capital and demand for selling their own currency favored the Dollar, the Yen depreciated to almost ¥162/USD. That means for every $1 million borrowed in early 2022, only around $700,000 of principal was outstanding.

Starting in early July, Japan's Finance Minister, Shunich Suzuki, warned investors the BoJ might need to take action as needed in the foreign exchange market. The warning had the effect of appreciating the Yen back down to approximately ¥152/USD. Only later to announce that in the month of July, they did just that, the Ministry of Finance intervened and purchased ¥5,534.8 billion ($36.8 billion in USD). Since that announcement, the Yen has continued to appreciate and following last night's historic equity selloff, now sits at approximately ¥144/USD. Those money managers borrowing in Japanese Yen to increase portfolio leverage at cheap rates have are being squeezed. As the “carry trade” has gotten more expensive they have had to find liquidity around the various global markets and sell securities and typically, the US markets offer the most liquidity. Many of these managers that were faced with liquidity issues found their solution in the domestic markets where several large technology company stocks had racked up tremendous gains. Similarly, in 1997, managers needing liquidity turned to the US markets. The S&P 500 fell 6.8% on October 27, 1997. However, the S&P 500 finished 1997 up 31%.

After we check the history books, we check the current data. As the BoJ was raising rates the Federal Reserve concluded its two-day meeting indicating a likely cut in rates in the future. A cut in interest rates signals a slowdown in the domestic economy and stimulus is needed to keep the economic engine going. Now, the question being asked is are we headed into a recession? According to the National Bureau of Economic Research GDP would have to have two consecutive quarters of negative growth for a recession to be declared. GDP = Consumer Spending + Investment + Government + Net Exports.

Looking at the components of GDP, we first look at consumer spending. As of the August payroll data, the U.S. job market shows the following trends: 1. Unemployment rate is around 4.2%, indicating a relatively stable market with moderate levels of joblessness. 2. The economy added approximately 200,000 jobs in July 2024, reflecting continued but slowing job growth when compared to earlier months in 2024. Industries such as healthcare, technology, and education saw notable increases while sectors like manufacturing experienced slower growth. 3. Average hourly earnings have risen by 3.6% year over year. Wage growth continues to be strong though not as rapid as it was at the peak of the pandemic recovery. 4. Labor force participation rate is 62.5%, which is slightly higher than previous months but not yet back to pre-pandemic levels. 5. There are approximately 9 million job openings, indicating solid demand for workers. This type of jobs data typically supports higher consumer spending and consumer confidence with increasing employment and wages.

The second component of the GDP equation is corporate investment. When the noise gets louder, we revisit our business models with a keen eye on corporate investment. We are wrapping up second quarter earnings season, which is the time period in which most of our companies have released their second quarter results, commentary and guidance. This is a great opportunity every quarter to gauge the performance of our companies relative to their peers, to ensure management is on track with their profitability goals and to understand the industry tone and customer health. We closely review and adjust our financial models for any changes, especially borrowing costs for those exposed to Japanese interest rate moves. As companies move into the third quarter, they are doing so with revenue growth of the S&P 500 averaging 11.5% year-over-year in the second quarter. This revenue growth leads to increased capital expenditures such as purchasing new machinery, upgrading technology, or constructing new facilities. After reviewing these

earnings reports and management commentary, we are not seeing much slow down between now and year end in corporate investment.

The last component is Government Spending – enough said! Both Presidential Candidates are pro-government spending. Deficits have been generally high in non-war time scenarios as both parties favor more investment in infrastructure. Monies that have been appropriated but have yet to be spent from the Inflation Reduction Act, Infrastructure or Chips Act are still working into the engine of our economy.

Finally, with historical perspective and current data points like GDP components in view, we review seasonal patterns and valuations. According to NYSE trading data, the weakest months of the year tend to be January, February, June, August and September. The summer is notoriously lighter on trading volumes and market moves can easily be exacerbated by this light volume. The current S&P 500 price to earnings ratio, a common valuation metric used by investors, is 27.45 up from 24.79 last quarter and up from 23.46 one year ago. This is a change of 10.76% from last quarter and 17.03% from one year ago. For the last 15 years, with the exception of the "Great Recession" in 2008, the P/E ratio has averaged approximately 19.4. In other words, valuations in general may have gotten a bit ahead of themselves, and a resetting is normal and healthy market activity.

Overall, the Japanese interest rate changes resulted in significant selling pressure on global markets as well as tremendous noise in the media. When borrowing costs in Japan changed dramatically, some managers and lenders were forced to sell other assets to cover. For many, domestic common stocks have racked up tremendous gains and offer an easy solution when faced with liquidity issues. Events like these can be an excuse to hit the "refresh" button and start selling domestically as some technology stock valuations pushed too hard too fast.   As of August 5th, the S&P 500 is down 9.1% from highs after a 38% run since October of 2023. Since the BoJ rate increase the Japanese NIKKEI 225 has fallen 20%. For levelheaded investors, who can keep historical events and current data at the forefront of their thinking, can appreciate seasonal patterns and valuation levels and then apply it all to great businesses with strong competitive moats, such loud noise can create terrific opportunities.