November 2024

Shocks and Reversals

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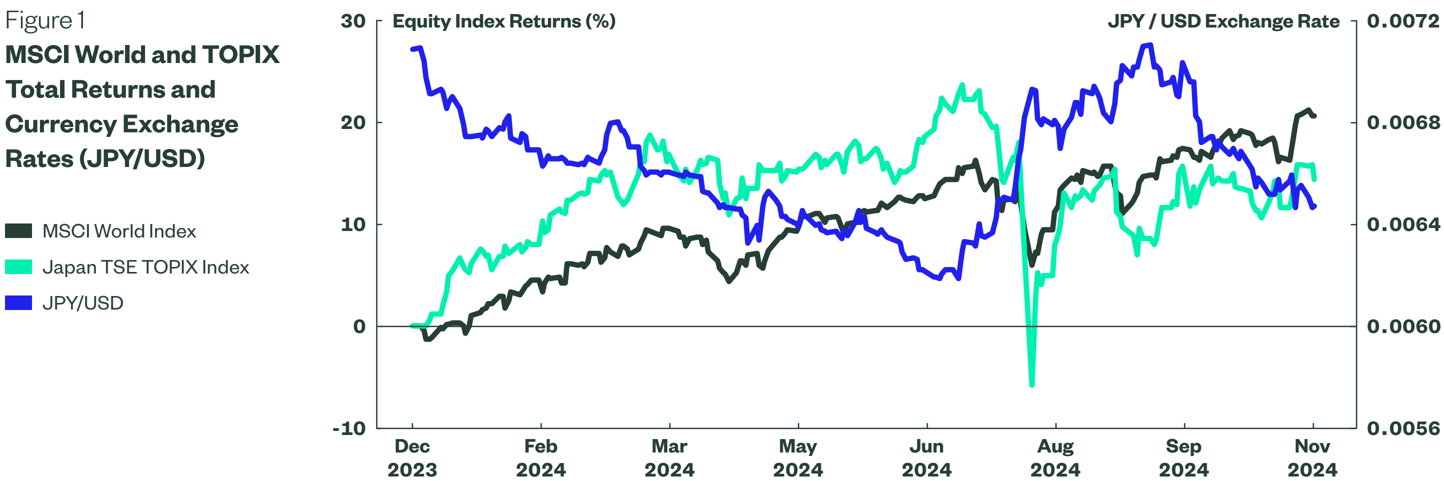
Recent shocks in global macro policy and politics have caused substantial moves in equity markets, only for the effects to shortly thereafter simmer down and reverse rapidly. We drill down into two of the most recent episodes and consider what this may mean as we head into the future.

Japan's Roller Coaster

In late July and early August 2024, the Japanese equity market hit unexpected turbulence. While we don't generally favor ex-post rationalization of market moves, the prevailing narrative starts with the Bank of Japan raising its benchmark interest rate from 0.1% to 0.25% on July 31. A subsequent weak jobs report in the US increased speculation around the Federal Reserve cutting its interest rate sooner, and by more than expected. The resulting shift in interest rate differentials led to a rapid unwind of the hugely popular yen carry trade (borrow in yen and buy higher yielding currencies such as the US dollar, Australian dollar or Mexican peso, depending on one's risk appetite). These changes in the currency markets and interest rates quickly found their way into the stock market and Japanese shares plummeted.

Figure 1
MSCI World and TOPIX Total Returns and Currency Exchange Rates (JPY/USD)



Source: State Street Global Advisors, MSCI, Tokyo Stock Price Index (TOPIX), FactSet. Data as of November 8, 2024.

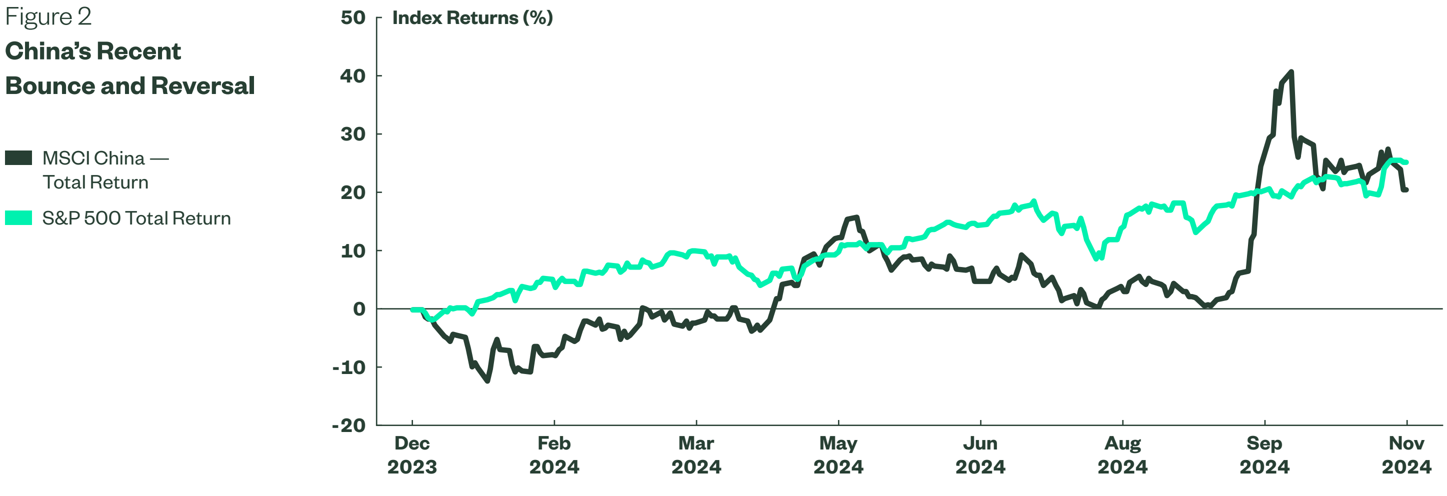
The price action in Japanese equities and currency was substantial. On August 5, the Tokyo Stock Price Index (TOPIX) tumbled by 12% (Figure 1). The ripple effects globally were much lighter with the MSCI World Index only falling by 3%. Just over a week later, however, both Japanese and World equity indices had completely recovered from the early August routing.

China's Reverse Course

Over the past few years, the Chinese equity market has significantly lagged its counterparts across both developed and emerging markets as we have written about in a previous commentary (refer to Ripples From China). Stimulus measures announced at the end of September resulted in a sizable re-rating of the Chinese equity markets, soon followed by a subsequent dip in early October (Figure 2).

In the aftermath of the knee-jerk reaction, markets started to digest the economic impact of the announced stimulus measures and saw equity markets reverse. A further set of measures publicized in November, which still fail to address issues such as the state's high debt levels, problems in the real estate sector, and weak domestic demand, were also unenthusiastically welcomed. Further market weakness ensued.

Figure 2
China's Recent Bounce and Reversal



Source: State Street Global Advisors, FactSet, MSCI, China Securities Index Company. Data as of November 8, 2024.

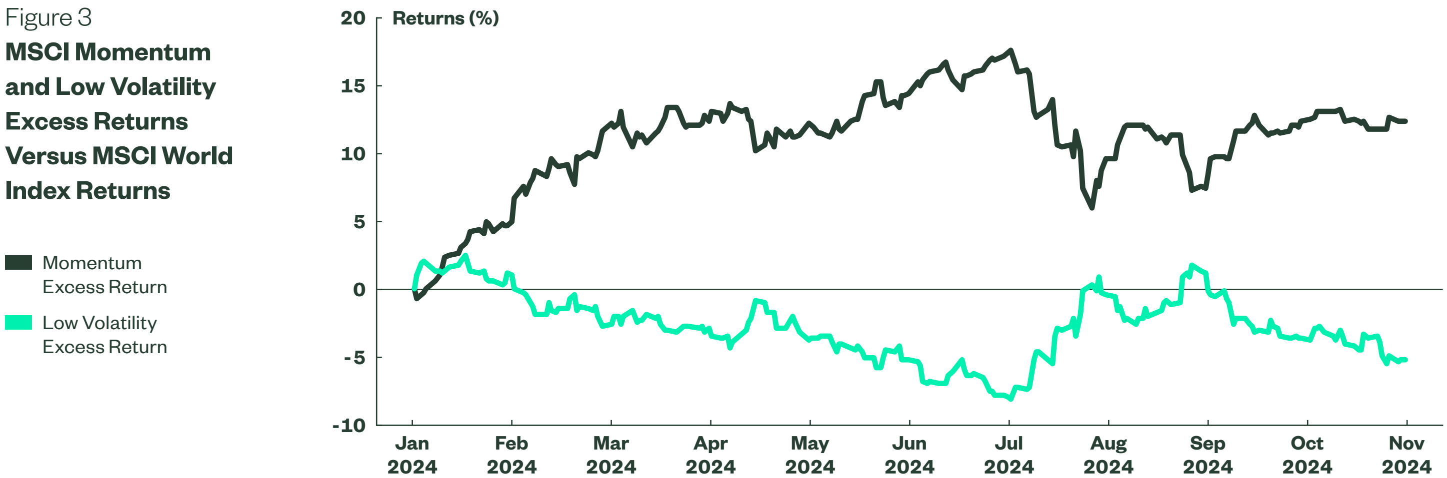
Shocks as Drivers of Momentum and Volatility Returns

At a factor level, Momentum has been one of the strongest performers through the course of 2024. Lower risk stocks have underperformed this year, apart from a brief rally over the course of the summer months.

Although Momentum is often thought to reverse at turning points, or in times of market shock, the data shows that its low point since the year-to-date high of July 11 was on August 5 (Figure 3). This similarly coincides with the best of the returns from low volatility stocks versus high volatility. That particular market event served merely to disrupt what looked like a newly establishing trend, and reverted back to its prior themes.

In contrast to the Japan events mentioned above, the Chinese stimulus event barely caused a ruffle in the path of Momentum or Volatility.

Figure 3
MSCI Momentum and Low Volatility Excess Returns Versus MSCI World Index Returns



Source: State Street Global Advisors, FactSet, MSCI. Data as of November 8, 2024.

The Bottom Line

Over the past few months we have started to see a pickup in volatility in equity markets. This volatility is associated with idiosyncratic events as noted above, as well as the unknowns leading to the US elections. Equities in aggregate remain expensive compared to their history. With valuations at lofty levels and uncertainty persistent as global economies look for a landing, we believe that volatility is here to stay.

The outcome of the US election has been one of the largest uncertainties of late. The equity market reaction to the recent US election has been stark. In the first six days since the election outcomes have been known, the US equity market is up 4%. In contrast, Europe is down by 2% and emerging markets (EM) have fallen by 3%. This EM dip is led by an almost 5% decline in China, a nation which faces the headlights of trade wars and tariffs.

Predicting outcomes from politics, policy or elections is a challenging exercise. Critically, we do not try to forecast these events within our investment process. Predicting the reaction to these outcomes may be even harder as the dust settles from an initial knee-jerk reaction to events.

Ultimately, we wait to see the longer-term effect on fundamentals for companies, rather than focus on the immediate surge in US stocks after the election. We favor setting our course over a longer horizon, taking account of both risk and return in our investment process and refraining from overreactions to short-term noise.

About State Street Global Advisors

For over four decades, State Street Global Advisors has served the world's governments, institutions, and financial advisors. With a rigorous, risk-aware approach built on research, analysis, and market-tested experience, and as pioneers in index and ETF investing, we are always inventing new ways to invest. As a result, we have become the world's fourth-largest asset manager* with US $4.73 trillion† under our care.

* Pensions & Investments Research Center, as of December 31, 2023.
†This figure is presented as of September 30, 2024 and includes ETF AUM of $1,515.67 billion USD of which approximately $82.59 billion USD in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.