BNY

iFlow

MACRO MORNING BRIEFING

August 16, 2024

Understanding August Volatility

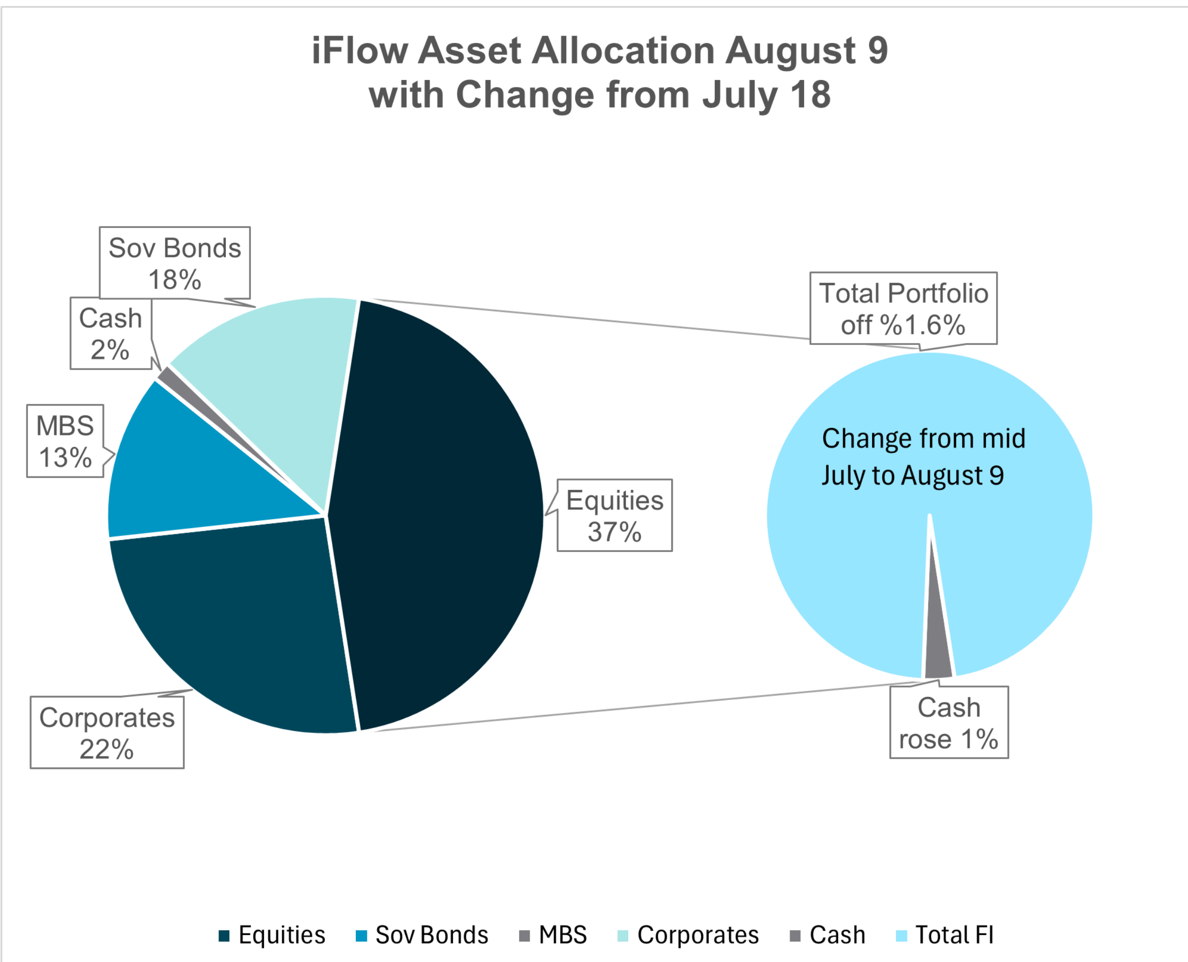
Commodities and global demand are back in focus as we grind through summer. The role of commodity FX as a measure of inflation fears and growth dynamics has faded. But the geopolitical concerns are not gone. Concerns about an escalation of the war in Ukraine show up in CEE currencies, while the price of oil has risen throughout the last week along with natural gas. Markets have clearly been focused on the duality of geopolitical risks rising at the same time as worries about growth beat out inflation. The focus on US jobs over CPI dominated the last two weeks of price action across risk markets. In trying to understand the August 2-5 crash, there have been many explanations – from a technical volatility shock to a JPY carry trade unwind to a mid-year rotation for all asset classes. However, all agree that the price action is different and could be a harbinger of further troubles ahead.

- **The volume of stocks was notable** in the selling and has been much more modest in the buying. Our flows have seen significant volatility and some sector selling that merits explanation. Consumer discretionary sector buying is at odds with the calls for a higher recession ahead.
- **Our flows show cash and ST cash-like instruments returned to favor** from August 2 and have not gone away despite the recovery of equities. Asset allocation shows a shift from July to August 6, with bonds increasing 2% at the expense of stocks.
- **The equity flows and holdings we see suggest more relative value allocation shifts** than new risk as we see consumer discretionary buying over financials and consumer staples – this is not a setup for a recession as much as waiting out volatility shocks.
- **The FX markets are rushing back to carry trades**, as we see in our flows, with a special focus on LatAm high yielders and Central European Emerging currencies with

the conflict in Ukraine making headlines again and now positions in PLN and HUF finding short-covering demand.

The iFlow data show an increase in cash and cash equivalents for clients starting on August 2 when the US unemployment report surprised, with a 4.3% result driving up recession worries. The rally in bonds led to a modest 1% increase in fixed income and a drop in equities in the week that followed. Volatility rose to 62% on the VIX before falling back to 16% in the same period. The shift in cash was notable and suggests a shift in risk appetite. We can see similar pressures in credit between high-yield and investment-grade flows. What this means for the commodity cycle and other markets remains a key question for how the rest of the summer trading season plays out.

Exhibit #1: Asset Allocation Shifts Modest

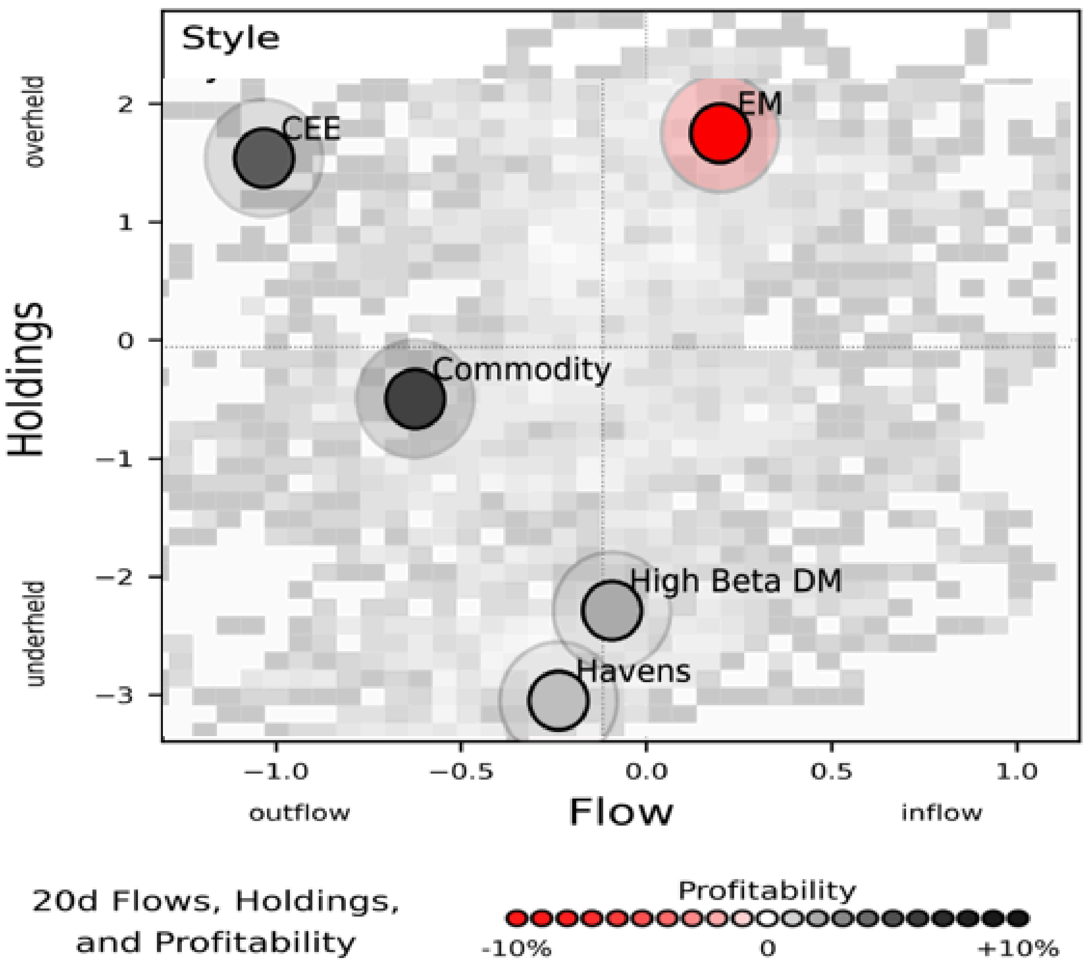


Source: iFlow, BNY

The return of the carry trade in markets stands out in the last week as well, despite the headlines of JPY panic buying following the BOJ hike and Nikkei correction. The current selling of safe havens and buying of high yielder extends with MXN and TRY vs. TWD and

JPY notable in our flows. While this move makes sense given the collapse of volatility back to "normal" in equities, it still does not match fears in rates and FX. The recession doubts remain in play. Commodity FX is an anomaly as demand for commodities is divergent and uneven – with gold, natural gas and oil at odds with grains and industrials – the tiebreaker in metals is copper.

Exhibit #2: FX Styles Show Carry Trade Returns, Commodity Doubt



Source: iFlow, BNY

Looking at the commodities that matter most to FX and global growth and inflation is a good place to start when thinking about how last week changed investors' thinking. The correlations between commodities and commodity exporter FX rates are clear, but the relationship of semiconductors and nickel reflects the new themes of AI and green vs. carbon energy and traditional industrial demand. The role of China in the commodity markets stalled super-cycle in 2024 stands. But alongside that is a shift in thinking about how China and its high-tech government investment plans combined with the US Inflation Reduction Act (IRA and other acts have changed the underlying relationships of commodity currencies to the global economic cycle. Commodity currencies are out of favor – we have seen outflows even as holding remain high. All of this reflects the lowered inflation focus of investors.

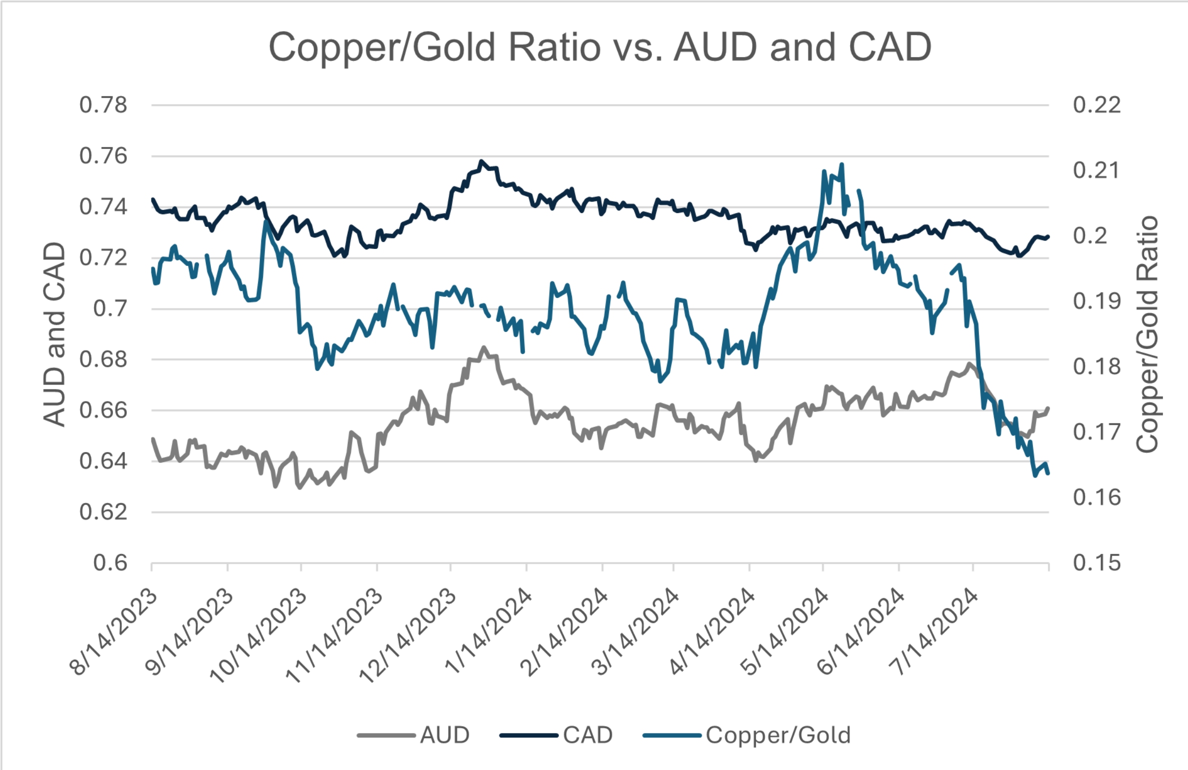
Exhibit #3: Correlations Show Rise of Semiconductors and Inflation Fears

Security	CAD	NOK	DXY	BRL	AUD	GSCI	HG/Gol	SOX	Nickel	G-Infl	China IP	JPY
CAD	1.00	0.75	0.70	0.50	-0.78	-0.56	0.40	-0.41	-0.31	-0.47	-0.52	0.25
NOK	0.75	1.00	0.73	0.54	-0.78	-0.61	0.32	-0.43	-0.37	-0.58	-0.42	0.36
DXY	0.70	0.73	1.00	0.46	-0.71	-0.30	0.16	-0.32	-0.31	-0.65	-0.35	0.62
BRL	0.50	0.54	0.46	1.00	-0.54	-0.47	0.11	-0.26	-0.29	-0.38	-0.33	0.27
AUD	-0.78	-0.78	-0.71	-0.54	1.00	0.46	-0.38	0.50	0.43	0.54	0.23	-0.37
GSCI Spot	-0.56	-0.61	-0.30	-0.47	0.46	1.00	-0.49	0.28	0.34	0.18	0.17	0.03
Copper/Gold Ratio	0.40	0.32	0.16	0.11	-0.38	-0.49	1.00	-0.36	-0.27	0.03	-0.42	-0.22
SOX Index	-0.41	-0.43	-0.32	-0.26	0.50	0.28	-0.36	1.00	0.19	0.53	0.75	-0.12
Nickel	-0.31	-0.37	-0.31	-0.29	0.43	0.34	-0.27	0.19	1.00	0.30	-0.38	-0.25
World Inflation Index	-0.47	-0.58	-0.65	-0.38	0.54	0.18	0.03	0.53	0.30	1.00	0.61	-0.55
China IP	-0.52	-0.42	-0.35	-0.33	0.23	0.17	-0.42	0.75	-0.38	0.61	1.00	0.07
JPY	0.25	0.36	0.62	0.27	-0.37	0.03	-0.22	-0.12	-0.25	-0.55	0.07	1.00

Source: Bloomberg, BNY

The correlation chart (Exhibit #3) is a 10-year monthly calculation of returns. Highlights show up in how AUD/nickel are correlated, but none of the other traditional commodity FX pairs. Also of note is how important the S&P/GSCI commodity spot index is in the traditional currencies – with oil the biggest part of that index making clear carbon-linked energy still matters. The relationship of copper to gold to equity risk and back to AUD stands out as well-worn barometers for overall mood. The JPY related selling of AUD last week has reversed but given the RBNZ rate cut after a hawkish hold from the RBA, AUD will be an important risk barometer for the weeks ahead as it captures the relationship to China commodity demand and global growth. The upside risk to China into the end of 2024 seems underpriced just as the USD downside for growth overpriced. Recession risks for the US usually show up when copper/gold drops below 0.15.

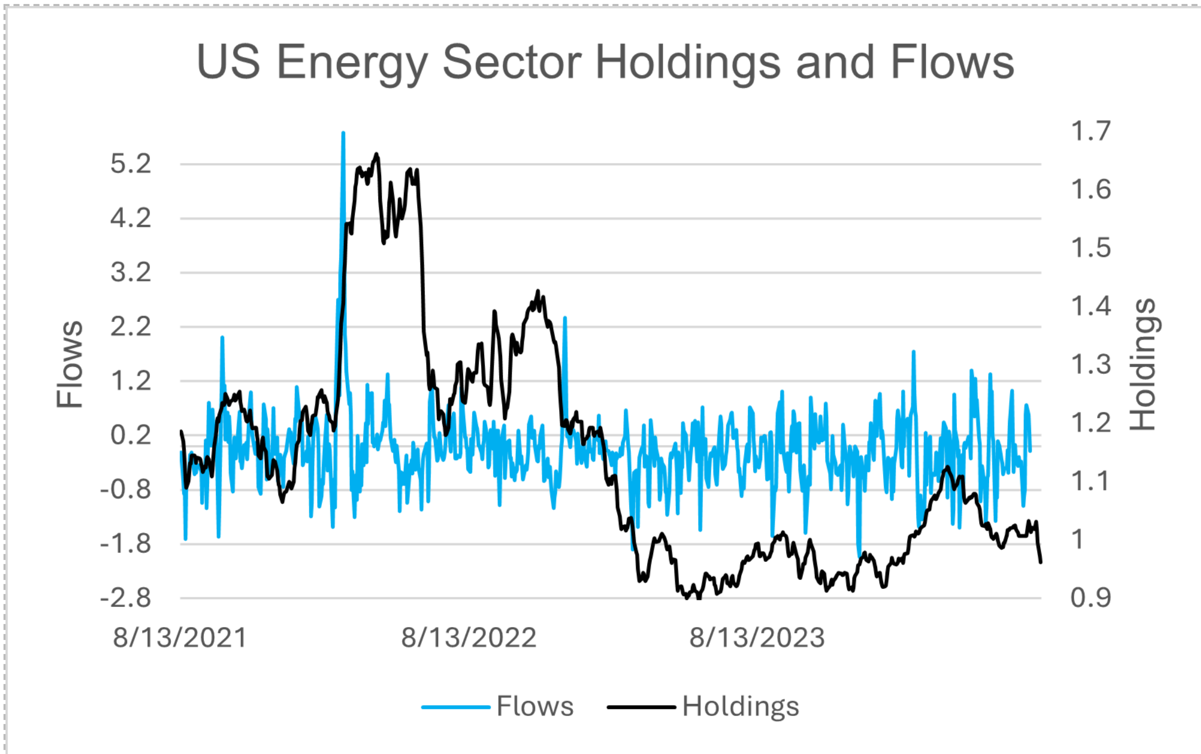
Exhibit #4: Copper/Gold Ratio Is Not Matching AUD and CAD Rally Back



Source: Bloomberg, BNY

US energy sector flows and holdings – average flows -0.08 over the last three years, while holdings long 1.14 – something has changed with energy markets as the fear of geopolitical risks has not delivered the squeeze back in prices many clearly expected. The last week did see further energy sector buying but it has not changed the overall holdings drop over the year-to-date. The relationship between energy and the economic cycle vs. the relative value price movement contrasts with the movement in US materials sector, where holdings have increased over 15% in the last year. The shift in holdings between energy and materials is at odds with the fears of a recession.

Exhibit #5: Energy Sector Holdings Haven't Rebounded

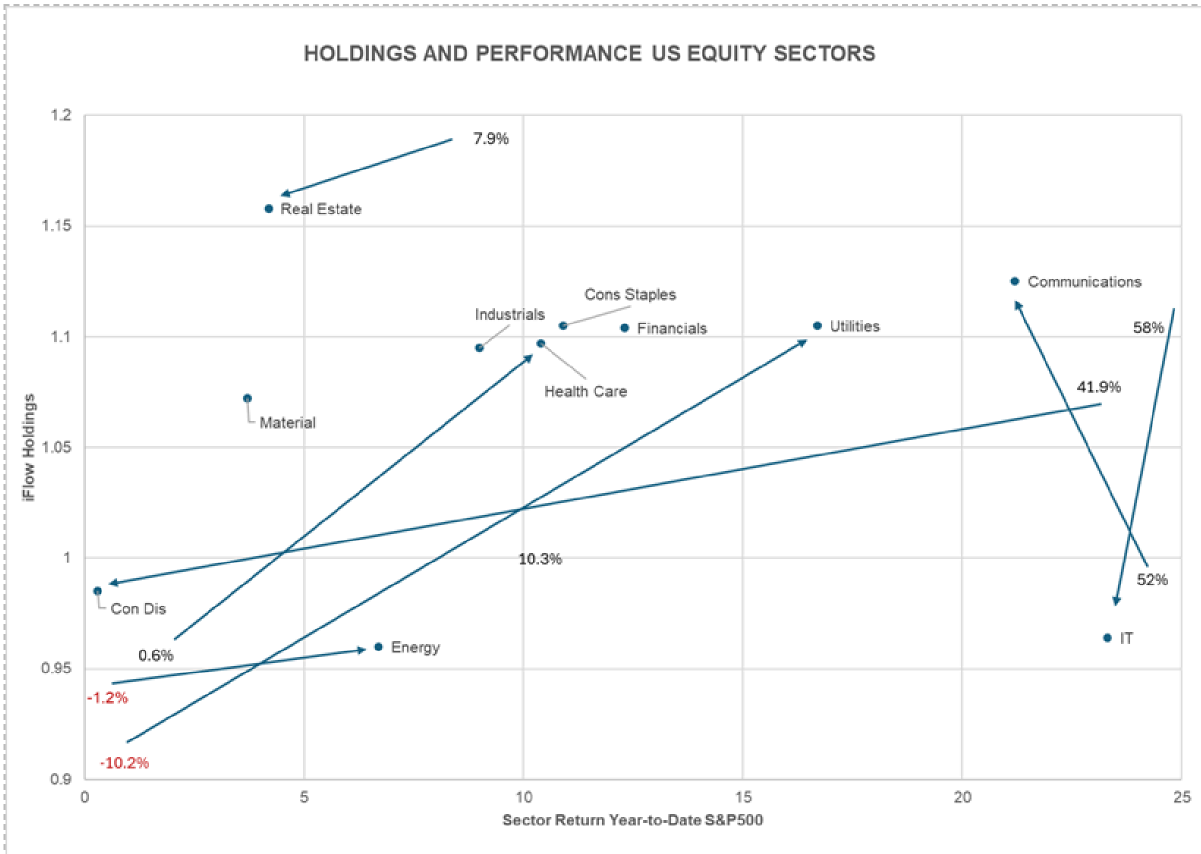


Source: iFlow, BNY

Looking at the bigger picture of iFlow data and equity sector holdings in the US, you can see that in the last week **the buying of consumer discretionary, energy and IT** was more a factor of their holdings than any larger rotational trade. The shift of theme from NASDAQ/Russell 2000 rotation during the peak of earnings season and the peak of FOMC rate cut expectations shifting stalled after the Monday equity selling. What we have seen this week and last in equities is more about positioning and technical factors rather than any one new macroeconomic cycle theme.

Bottom Line: The FX markets and the equity energy vs. material sector rotation are at odds with the current debate about US rates and US recession risks. The flip of JPY from 142 to 149 reflects the shift down in US rate cuts from 50bp to 25bp in September, while the ongoing credit and cash holdings highlight deeper doubts about the world. China commodity demand has been part of the larger backdrop for softer inflation in 2024. This may all change in the months ahead as officials there drive new policy and stimulus to get to 5% GDP in 2024. The rally back in US equities is different than that of Japan and other markets. The asset allocation pressures from the August 2-5 shock are not one-off events and foreshadow a larger rejiggering of risk ahead after the September event risks from US unemployment to the FOMC rate decision to the debate on September 10 between Trump and Harris. The volatility risks seem clear while the holding shifts from the last two weeks were modest.

Exhibit #6: Equity Sectors Shift on Holdings and Performance, Not Macro



Source: iFlow, BNY

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Please direct questions or comments to: iFlow@BNY.com

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