BNY

iFlow

MACRO MORNING BRIEFING

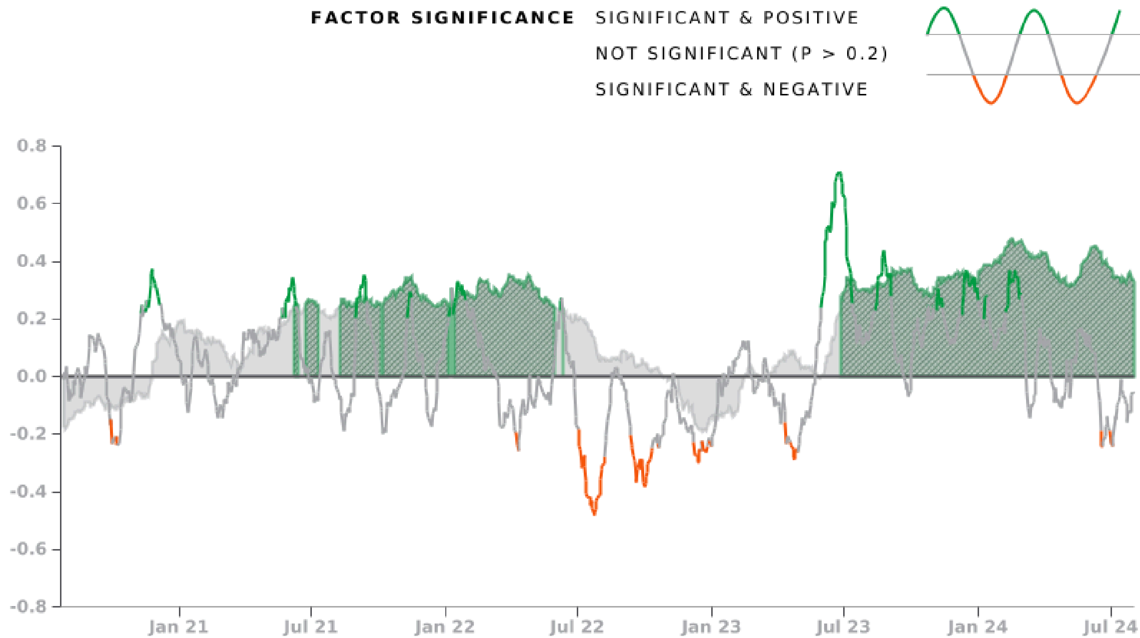
August 5, 2024

Untangling Volatility With iFlow

Expecting more from the Fed to save markets is unrealistic. The price action today suggests we need more consolidation and position de-risking. The current state of markets can be understood by the volatility levels from the S&P 500 VIX fear gauge trading from 65% to 32% today, near 4-year highs, to the bond volatility MOVE index back to just April levels while the FX CVIX index trades back to March 2023 levels. The uncertainty of the present starts with equities, shows up in FX and is calmed by bonds with the hope of FOMC easing. Using our client holdings and flows from the iFlow data, we can see that the fear of a global recession is overblown, that carry trades and the unwind risk continues, that credit concerns have just started to show up as a driver for risk, while the geopolitical fears are not fully priced, while the fixed income markets appear too sanguine about the US election ahead.

- **We see the current market risk for a 10% correction** as ongoing as our holdings show long positions in global shares. Some of this is a hangover from years of portfolios biased toward equities over bonds. Some of this is a reflection of the trend factors dominating in the last year.
- **We see the bond markets as overdone in playing for a recession**. The duration holdings of our clients suggest they are prepared for the FOMC easing cycle. G10 Government Bill buying highlights that many of our clients are liquid and back to cash.
- **We see the FX markets as still vulnerable to further carry unwinds with CHF and JPY buying ongoing**, while some emerging markets are still vulnerable. Adding to the noise in FX markets is the hedging positions linked to carry, such as long Taiwan chip sectors versus shorting TWD. APAC may be more vulnerable to FX noise than others. MXN remains the most liquid and most likely FX pain trade.

Exhibit #1: Carry unwind has further to go

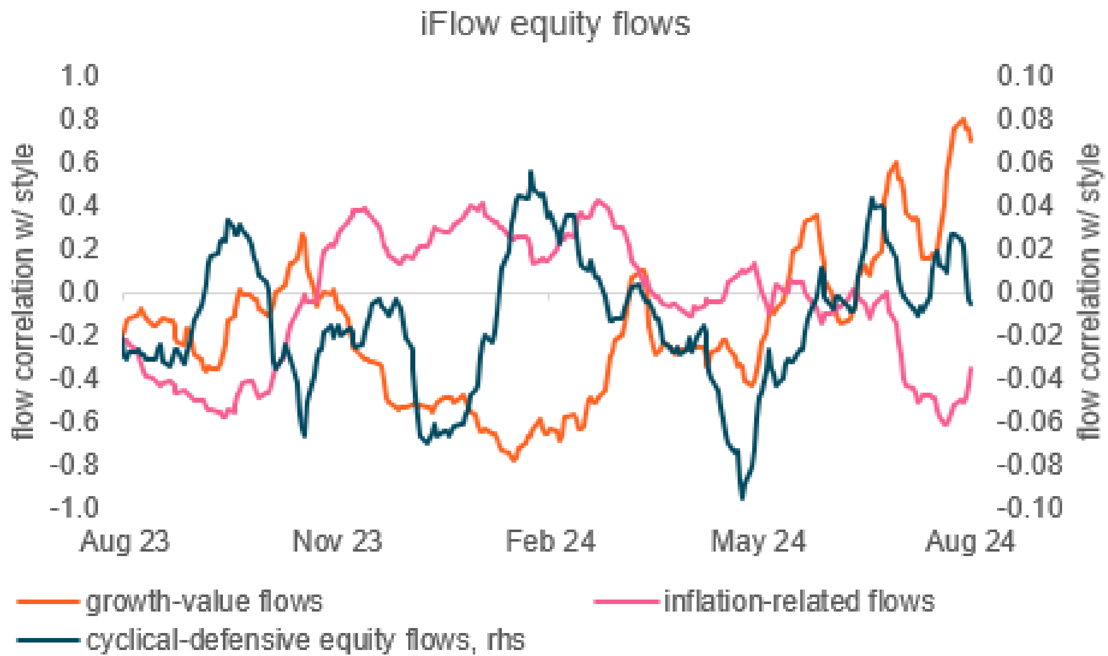


Source: iFlow, BNY

Our iFlow equity styles data can provide a guide as to how our custody flows have been digesting the current market outlook through the end of last week. In Exhibit #2 below, we plot inflation-related flows, cyclical vs. defensive equity industry flows, and growth vs. leverage flows. We can see that there is less fear and more tactical trading when it comes to our clients in the US markets. Recent iFlow movements provide some interesting insights.

- **Inflation is not really a concern**. Flows are going into those equity industries which are either uncorrelated with inflation, or which outperform with lower inflation (pink line). This has been evident since the beginning of this summer.
- **Cyclical-defensive equity flows suggest ambivalence about the economic cycle** (blue). While there had been optimism on the cycle in early summer, things have settled down to fairly neutral preferences between the cyclical and defensive trades. This metric bears watching from here, as a deterioration in flows to a more defensive posture would indicate increasing pessimism.
- **Growth flows have been steadily outpacing value** flows since late spring, as concerns about stocks' earnings have grown. When growth is scarce, it gets bid up, and this appears to be what's happening now.

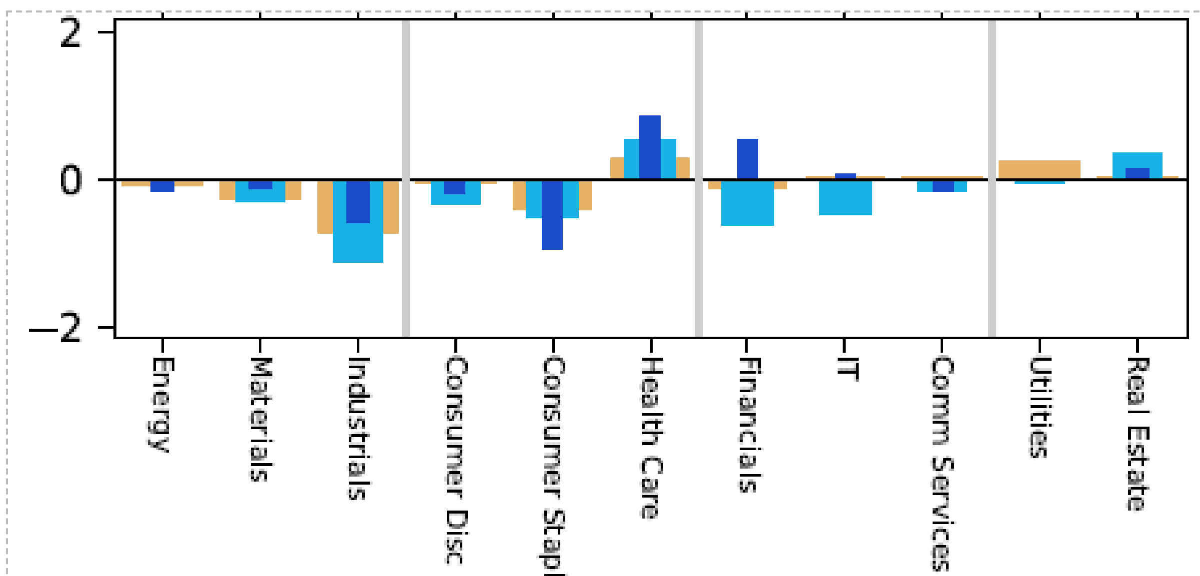
Exhibit #2: Equity styles suggest markets prepared for trouble



Source: iFlow, BNY

The price action in the last 3 days is historic. We have seen a wholesale "de-risking" in Asia. The view in Europe and US markets is more "healthy correction." The panic in Asia started with the surprise of the BOJ hiking to 25bps – something that many domestics didn't expect. The other risk component that is clearly in play but not knowable is in the Middle East with many on call for escalation fears between Israel and Iran – this isn't new, but it complicates views on oil and supply chains and therefore inflation getting to target.

Exhibit #3: APAC developed market flows by sector



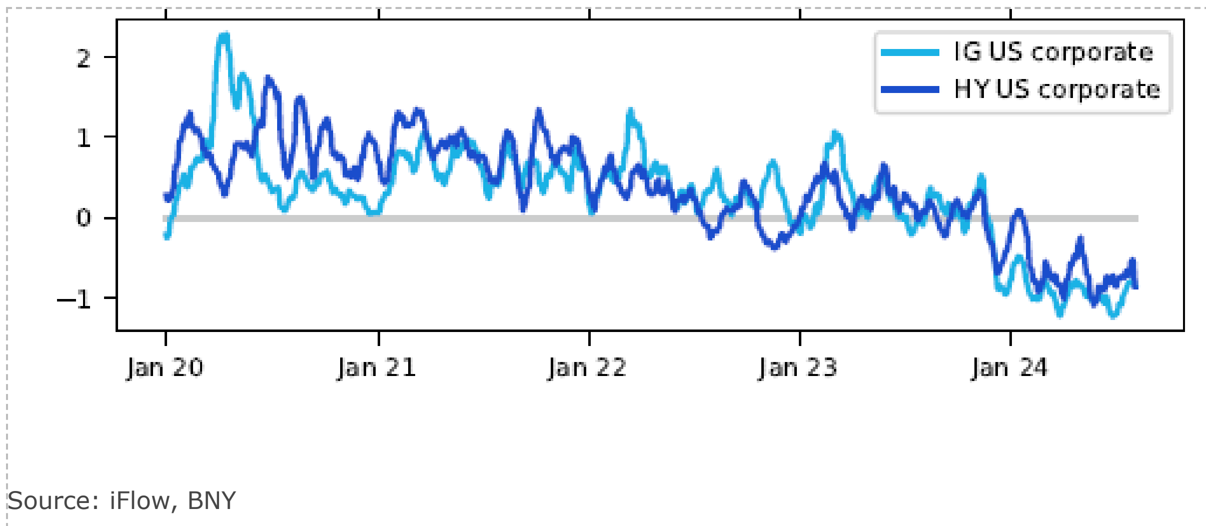
Source: iFlow, BNY

This chart shows that the APAC risk reducing trade in the last quarter was in industrials and consumer staples while IT / Financials were tentatively bought Friday, while Utilities – a safe haven for equity sectors – has outperformed in the region. The gold box reflects quarterly flows, the light blue monthly and the dark blue weekly. Overall, we see a client bias to be defensive for the last month – with the IT/Bank moves Friday suggesting a tactical test for buying this dip.

APAC holdings in Equities, like that of the US, is long – the selling out of Taiwan, Korea, Japan is cutting back not going short. This matters as the market flip from bullish to bearish isn't over until holdings get to flat or benchmarks reflect the new reality. The chart of APAC flows in developed markets (Japan, Korea, Singapore) shows a defensive posture into Health Care – but most tellingly, Friday we saw IT and Bank buying for the first time in the region – this puts tomorrow's report into focus as that nascent sector buying for tech is unlikely to last. The lack of panic in our client flows Friday is interesting and makes the unwind in Japan and regional equities a warning shot for calling a bottom. The risk of further fear contagion to Europe and US markets will pivot on what happens to Asia this week.

Our flows show selling of G10 corporate bonds most of the quarter with both Investment Grade and High Yield seen as not attractive given yields. Spreads were seen as too narrow. Sovereign bonds have been bought mostly in the US, but after the Trump-Biden debate, cross-border buying of US bonds stopped and reversed. We may be in for more politically related volatility as the "Harris trade" gets defined by bond markets. The flows selling corporate bonds is part of a larger one-off shift from lower coupons to higher ones – so corporate selling around the G10 world is being swapped for higher paying new issues. The credit picture is interesting in the last week where High Yield has been net sold while Investment Grade was bought. If this unwinds, it's a liquidity event – which we are seeing a bit of in Asia but not in the US or Europe. The spread of APAC fears to the rest of world for HY-IG is something we are watching for this week.

Exhibit #4: HY and IG bonds – credit fear just starting

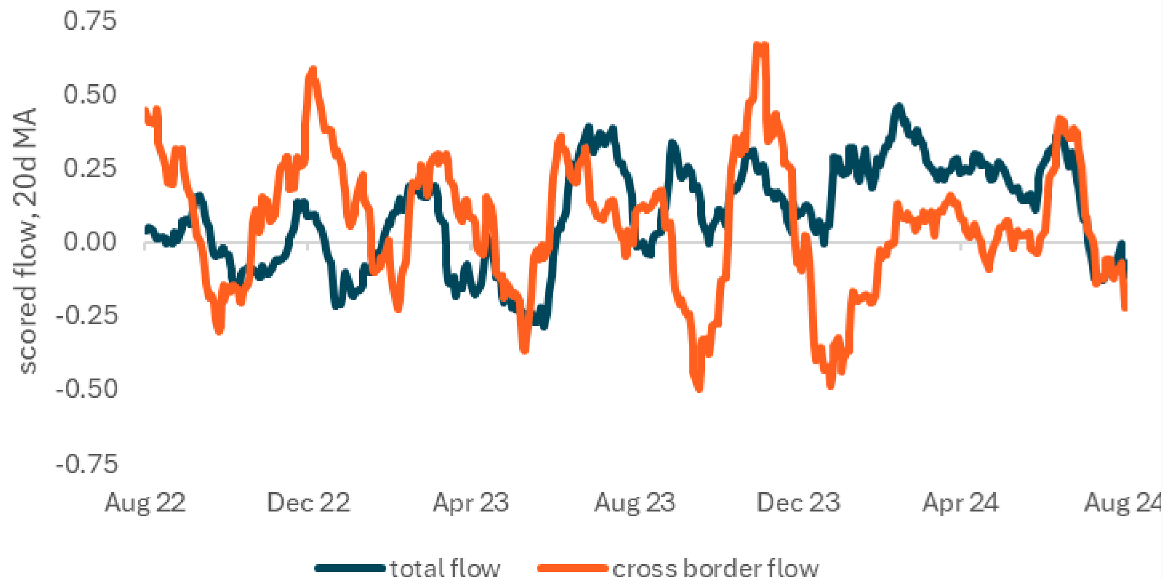


Source: iFlow, BNY

This chart (Exhibit #4) shows that in the US HY paper is being sold and IG being bought – matching the market price action that credit is back into focus. Our holdings suggest that bonds remain underheld in portfolios and that coupons are a key driver. The next chart (Exhibit #5) shows that the US bond buying by foreigners turned on the Trump-Biden debate and that the lack of US holdings may be part of the story – behind the pricing of 1.25% easing into March. The lack of foreign flows into the US and the drop back in US buying as well on political concerns should be tested in the week ahead with the supply from 3Y $58bn Tuesday, 10Y $42bn Wednesday and 30Y $25bn Thursday.

Bottom line: **The current talk of FOMC doing more than 25bps in September is out of place in our opinion** unless that data or the markets in the US unravel in the same way that Japan has seen. The "10% equity index drop in 1-day rule" would be something to watch and to expect that to lead to a different Jackson Hole tone and 50bps in September. The Fed S&P 500 put is far away from current market levels – we are still up 10% on the year. For the USD, the unwinding of carry may still drive further pain trades this week. For fixed income, the FOMC speakers will need to support the market in the pricing or face further volatility ahead. We are in for a typical August driven by noise from vacation-induced lack of conviction overlayed with legitimate uncertainty from US politics and geopolitical risks.

Exhibit #5: Cross-border flows in US bonds matter



Source: iFlow, BNY

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

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