WELLS FARGO
Investment Institute

Institute Alert

FIRST ANALYSIS

News or events that may affect your investments August 5, 2024

Darrell L. Cronk, CFA
Chief Investment Officer, Wealth & Investment Management

That escalated quickly — Top 10 things to know about the global market selloff

Key takeaways

- We review our top 10 insights for why global markets have been selling off, and why now.

What it may mean for investors

- We see near-term uncertainty ahead, fueled by the unwinding of levered trades and the potential for escalating conflict in the Middle East, and we believe it will take some time for markets to work through this period of volatility and uncertainty.

---

1. Broad move: Market concerns have escalated rapidly, and volatility has been across the board, resulting in an old-time fear-driven, risk-off move over the past several trading sessions.
2. Catalyst: Bad economic data and disappointing earnings started this move downward, but leveraged short selling accelerated it, beginning August 1 and carrying into early this week. Specifically, Japanese central bank officials came to the table more hawkish than expected, pushing the Japanese yen higher and forcing the unwinding of leveraged carry trades[1] that had been used to fund long positions in technology stocks, small-cap stocks, and Financials. This unwinding of leveraged trades has continued to feed on itself over the past several trading sessions, leading to a global market selloff.
3. U.S. equities: U.S. Small Caps (as measured by the Russell 2000) were nearly 7% lower last week and down 13% from July highs, and major equity indexes breached key technical support levels on the downside. As of Monday morning, August 5, the technology-heavy NASDAQ 100 had fallen fully into correction territory — down 16% from July highs — and the recent market-based July trades that aggressively added to U.S. Small Caps and Financials have been hit hard in this latest selloff.
4. International equities: Japan's Nikkei 225 Index sold off over 12% overnight on August 5, the largest single-day drop since 1987; that puts the index down more than 20% from March highs, creating an official Nikkei bear market. European equities broadly are down 10% from May highs, entering correction territory. Emerging Market Equities (as measured by the MSCI Emerging Markets Index) peaked in July and are off 6 – 7% currently. China specifically is off about 8% from May highs.

1. A carry trade is a strategy where an investor borrows at a low interest rate to fund the purchase of a higher-yielding asset.

5. **Volatility:** The CBOE Volatility Index (VIX) opened this week over 50, a level not seen since the March 2020 pandemic and suggests to us that volatility may persist for the rest of this week as concerns remain elevated.
6. **Fixed income:** Interest rates have fallen considerably from early July highs to the lowest levels across the curve since mid-2023. The 2-year to 10-year yield curve — inverted for more than two years — briefly un-inverted the morning of August 5. We believe the bond market is not only telling the Federal Reserve (Fed) that it needs to cut interest rates, but that it may already be behind the curve given the lag effect of monetary policy. However, Fed rate policy changes between meetings have historically been uncommon, occurring just seven times since 2001. We see a low probability of an emergency Fed rate cut before its next meeting September 17 – 18. We expect that markets will be carefully watching the Fed's Jackson Hole Economic Symposium August 22 – 24, which although not a policy meeting of the Fed Open Market Committee, will loom large on the calendar as an important milestone to gain insights into the Fed's thinking.
7. **Commodities:** West Texas Intermediate crude oil is down 18% from its April peak and flirting with bear market territory. Copper is down 24% from May highs on further China weakness and global growth concerns. Agricultural commodities (as measured by the Bloomberg Agriculture Subindex) are down 15% from May highs. Meanwhile, gold has held up nicely as a risk-off buffer to portfolios.
8. **Economy:** We have clearly shifted the recent economic narrative from "bad news is good news" (markets rising in anticipation of more Fed rate cuts) to "bad news is bad news" (markets falling in reaction to concerns about weaker jobs market and recession/hard landing). To be clear, we do not see strong evidence today that the economy is heading over a cliff, not with unemployment below 5% and the recent second-quarter 2024 first reading of U.S. gross domestic product at 2.8%. What is clear to us is that economic data is softening and could push growth levels down dangerously close to stall speed, leaving the U.S. economy vulnerable to shocks. We suggest investors watch key labor market data, as we believe this will be the focal point for assessing the outlook for consumer strength — and whether the consumer will remain resilient enough to uphold the soft-landing narrative.
9. **Geopolitics:** The recent escalation of the war in the Middle East, potentially drawing in Iran more directly, looms in the background. Markets and traders are anticipating Iran's response to the recent assassination of key Hamas and Hezbollah officials. In our view, it remains likely that the timeframe for retaliation may be a short week or two away. From there, the key will be the materiality of the retaliatory strikes and whether the war intensifies from there.
10. **Key areas to watch:** It will be important for the Japanese yen to stabilize its recent aggressive rally as a near-term sign that the short-covering exhaustion has largely played out. Also, key areas of focus will be any rising strains in the real estate investment trust (REIT) and private credit markets; any further widening of high-yield spreads as a sign of credit deterioration; further cryptocurrency/Ethereum selling beyond the recent 30 – 35% decline (through August 5) from recent highs; and any signs of emerging-market currency weakness.

Bad economic data initiated the selling, in our view, but leveraged short selling threw gasoline on it. Forced unwinding of levered positions is not something investors want to do, but something they have to do. We believe this is going to have to stop on its own with the winding down and ultimate exhaustion of levered trades.

Risks Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. Investments in **gold** and gold-related investments tend to be more volatile than investments in traditional equity or debt securities. Such investments increase their vulnerability to international economic, monetary and political developments.
Real estate has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions.

Definitions

Bloomberg Agriculture Subindex is a commodity group subindex of the Bloomberg Commodity Index. It is composed of futures contracts on coffee, corn, cotton, soybeans, soybean oil, soybean meal, sugar and wheat. It reflects the return of the underlying commodity futures and is quoted in USD.

CBOE Volatility Index (VIX) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets.

NASDAQ 100 Index consists of the 100 biggest companies listed on the NASDAQ Composite Index. The list is updated quarterly and companies on this Index are typically representative of technology-related industries, such as computer hardware and software products, telecommunications, biotechnology and retail/wholesale trade.

Nikkei 225 Index is the leading and most-respected index of Japanese stocks. It is a price-weighted index comprised of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange. The Nikkei is equivalent to the Dow Jones Industrial Average Index in the U.S.

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index. The Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

An index is unmanaged and not available for direct investment.

General Disclosures

Global Investment Strategy (GIS) is a division of Wells Fargo Investment Institute, Inc. (WFII). WFII is a registered investment adviser and wholly owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo & Company.

The information in this report was prepared by Global Investment Strategy. Opinions represent GIS' opinion as of the date of this report and are for general information purposes only and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally. GIS does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

The information contained herein constitutes general information and is not directed to, designed for, or individually tailored to, any particular investor or potential investor. This report is not intended to be a client-specific suitability or best interest analysis or recommendation, an offer to participate in any investment, or a recommendation to buy, hold or sell securities. Do not use this report as the sole basis for investment decisions. Do not select an asset class or investment product based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon. The material contained herein has been prepared from sources and data we believe to be reliable but we make no guarantee to its accuracy or completeness.

Wells Fargo Advisors is registered with the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority, but is not licensed or registered with any financial services regulatory authority outside of the U.S. Non-U.S. residents who maintain U.S.-based financial services account(s) with Wells Fargo Advisors may not be afforded certain protections conferred by legislation and regulations in their country of residence in respect of any investments, investment transactions or communications made with Wells Fargo Advisors.

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, separate registered broker-dealers and non-bank affiliates of Wells Fargo & Company. PM-02052026-6863816.1.1