"Keep calm & carry on": In this article Westminster Asset Management Investment Strategist, Peter Lucas, discusses recent market turmoil and draws similarities and lessons from previous periods of extreme global volatility. Peter suggests current moves could pave the way to better times ahead.

In the last five weeks commodities (ex-gold) have plunged, equity markets have experienced their biggest correction this year and US bond yields briefly hit a 14-month low. At one point the Nikkei 225 was 26% below its July high, at least in yen terms. None of this was in the script. Well, not mine anyway. At the end of June, sentiment was elevated, but not excessively so; US recession risk was rising but was not yet a major concern; the US inflation and growth models were both in accelerating mode. Overall, this was a combination that had historically supported reasonable returns from equities, if not other assets. In this article, I explore why markets have been in disarray and consider the question of whether this represents the start of a deflationary bust, as the markets seem to be suggesting.

So why have markets failed to conform to expectations? It could be, of course, that the economic indicators were giving me a bum steer. It is fair to say that this cycle, which started with an unprecedented *self-inflicted* recession, is quite unlike any we've ever seen before. Furthermore, recent employment and growth data has been undershooting their projections. However, I am reluctant to dismiss them entirely.

Although sentiment was not in *sell* territory, it was elevated, leaving markets vulnerable to unexpected bad news. And we've had plenty of that: a hike in Japanese interest rates, leading to a sharp rise in the yen and a dramatic closing in yen-funded carry trades; worse than expected US economic data and a return of recession worries; political paralysis in France following the recent parliamentary elections; and a loss of momentum in highly valued large cap growth stocks. However, none of the events look life-threatening for the economy and equity markets.

Research company Gavekal often say that economic shocks are like fishing with dynamite; it can take weeks for the big victims (the 'whales') to float to the surface. However, thus far, the yen shock doesn't appear to have claimed any major victims. In addition, the Bank of Japan has backed off on its rate-hiking rhetoric. Calm is returning. US economic data has disappointed, but the recession evidence remains patchy at best. France is in disarray, but paralysis might be better than the alternative. US large-cap growth does appear overvalued, but the macro environment (most notably low/falling inflation) is broadly supportive. Furthermore, the lesson of history is that, even when bubbles burst, it can take weeks for the top to fully form. A retest of the recent high is not only possible but is probably something we should expect.

What are the indicators telling us now? Sentiment is now pretty bombed out and at levels that normally produce a decent short-term bounce. The economic growth indicator has softened but is still in accelerating mode. The inflation indicator has also softened and is now *neutral*. The recession indicator remains below the trigger level. There have only been three months in the past four decades in which we have seen this combination and in all three cases, bonds and (particularly) equities produced strong positive returns. It is also worth mentioning that whatever the outcome of the Presidential election, fiscal policy is not going to remain supportive for the foreseeable future.

Overall, the environment that reminds me most of the one we are currently going through is 1987. Back then, a normal market correction was exacerbated by program-selling of index futures, much as the bursting of the yen carry trade has exaggerated recent market moves. In 1987 the authorities over-estimated the negative impact of the crash and the underlying strength of the economy and in doing so, let inflation back out of the bag. It seems likely that rates will soon be cut (see also recent LinkedIn post: "Rate cut ahoy!"). In 1987 the first cut in rates was greeted with dismay and a retest of the low by equities soon followed. However, that proved to be a fantastic buying opportunity, and the market and the economy went on a tear for the next few years until rising inflation came to spoil the party. That is not a million miles away from what I am expecting in the period ahead.

Before I sign off, a few words about Japan, which has been badly beaten up in the last few weeks, undeservedly so in my view. The fact that interest rate policy is being normalized is a positive sign, much as it has proved in America. The yen may have rallied but it is only back where it what at the start of the year and remains unbelievably cheap by international standards. What's more, Japan is in the most vibrant region of the world. The recent drop has taken valuations down to attractive levels and the Nikkei's relative versus world markets back to the top of its old trading range. Remember that Japan was the consensus favourite at the start of the year, but I am sure that has changed dramatically in recent weeks. This looks like a great buying opportunity to me.

Peter Lucas – August 2024