CIO View
CIO Flash
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Marketing material

Largely justified correction

Markets may remain choppy for some time but we don't expect a bear market

IN A NUTSHELL

— Global financial markets experienced sharp price fluctuations towards the end of the week
— The main trigger is likely to have been the combination of poor economic data, increased geopolitical uncertainty and a softening on the consumer side around the globe
— Although we do not expect a bear market, we would not be surprised to see heightened volatility in the next months

Markets were priced for perfection

Anticipating a market correction is tricky business, nevertheless we would claim that some sort of pullback was to be expected. Markets had simply been priced for perfection.

The global industrial cycle seems to lose momentum again. European hard data such as industrial production and incoming orders have been soft for some time. Recently, however, sentiment indicators have weakened again, following a period of stabilization, like the German IFO index or manufacturing purchasing-manager indices (PMIs) from all over the place. While markets have been pricing in the narrative of a soft Chinese economy for some time, the Caixin manufacturing PMI dropping by 2 points to now below 50 added to these concerns. Thursday's U.S. manufacturing ISM confirmed the picture, with employment and orders components in particular painting quite a weak picture. The labor market was key for keeping the U.S. out of recession so far. While jobs growth remains positive, Friday's U.S. labor-market report was clearly an additional sign of weakness in the United States.[1]

Among the big economies, Germany is particularly exposed to a weakness in the industrial sector, with manufacturing accounting for 19% of gross domestic product (GDP), with Japan coming second among the G7 countries. Meanwhile, tech-heavy countries like Taiwan and South Korea still look robust from our perspective.

Up to now, stock markets were supported by two reasons:
For one, the tech- and AI-related capex spending expectations have outweighed concerns about the weakness on the industrial side. Secondly, the market has ignored weaker economic data, focusing on the positive interpretation that a weaker economy would dampen inflation and clear the way for rate cuts. While the reported official inflation rates have slowed down on their way to 2%, there are plenty of indications that the underlying inflationary pressure is easing. Hence, the first U.S. Federal Reserve (Fed) cut should only be a matter of weeks.

From a market perspective, however, it remains a fine line between economic indicators that are weak enough to justify rate cuts and at the same time do not weaken too much to be pointing at a recession. The differentiation between the two sides is whether the

[1] Source for all market data is Bloomberg Finance L.P. as of 8/2/24

market takes bad (economic) news as good news or as bad news. After months of a “bad-news-is-good-news attitude,” bad news are now starting to worry the market, despite the prospect of imminent rate cuts. There are now more voices raising concerns that the Fed might fall behind the curve. As Thomas Schüssler, DWS Global Co-Head of Equity, puts it: "The faster the Fed has to cut rates, the more dangerous it becomes for the stock market."

We also acknowledge that geopolitical tensions are on the rise, especially with regards to the situation in the Middle East. Seasonality plays a role as well. Up to mid-July, the S&P 500’s 2024 performance almost spot on tracked 2023 (with the exception of last year’s Silicon Valley Bank turbulences). Just like in 2023, the air seems to become thinner now.

Asset-class implications

For sovereign bond markets, the turbulences contributed to yields trading lower and curves dis-inverting and steepening. We expect the prospect of central banks cutting rates to continue to support bond markets.

For equities, we are seeing a “largely justified correction,” as David Bianco, DWS CIO Americas, puts it. While the earnings season was good enough, there were clear warnings about a softening on the consumer side. We would not be surprised if markets were to remain choppy for the weeks to come, however, we don’t expect a bear market.

The sell-off in Japanese equities was particularly severe, with Japanese indices entering correction territory after Friday’s drop. In addition to all the factors outlined before, the strength of the yen after Wednesday’s Bank of Japan (BoJ) rate hike also played a role. Nevertheless, Ivy Ng, DWS CIO APAC, believes: “The medium-term fundamentals haven’t changed. Unless the yen were to strengthen much more, the market should stabilize again soon.”

Glossary

The Bank of Japan (BoJ) is the central bank of Japan.
Technically, a bear market refers to a situation where the index's value falls at least 20% from a recent high.
Capital expenditure (Capex) are funds used by a company to acquire or upgrade physical assets such as property, industrial buildings or equipment.
A correction is a decline in stock market prices.
The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.
The Group of 7 (G7) consists of the finance ministers and central-bank governors of the seven major advanced economies as reported by the International Monetary Fund: Canada, France, Germany, Italy, Japan, the United Kingdom and the United States. They meet to discuss primarily economic issues.
The ifo Business Climate Index is a highly regarded indicator of economic sentiment in Germany.
Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.
The ISM Purchasing Manager Index, published by the Institute for Supply Management, measures economic activity by assessing the sentiment among purchasing managers. It is an important indicator of the economic health.
The Japanese yen (JPY) is the official currency of Japan.
The Purchasing Managers' Index (PMI) is an indicator of the economic health of the manufacturing sector in a specific country or region.
A recession is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.
The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.
The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

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