The Four Horsemen of the Next Market Shock: Short Sellers, Middle East, Japan’s Yen, and the 2026 Midterms

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Abstract

The U.S. equity market is staring down a convergence of four major risks: rising short interest, escalating Middle East conflict, a fragile yen carry trade now subject to historic intervention, and the political uncertainty of the upcoming 2026 midterm elections. While any of these risks on their own might be manageable, their intersection could amplify volatility and stretch market resilience to the limit. This paper examines how these forces interact, spotlights the scenarios investors need to prepare for, and identifies the critical indicators to watch.

Introduction

Financial markets rarely face a single, isolated threat. More often, risks collide and compound, making outcomes less predictable and the stakes far higher. As 2026 unfolds, four distinct forces are converging on U.S. equities: aggressive short selling, volatility in the Middle East, a tectonic shift in the yen carry trade, and the uncertainty of midterm elections. The real danger isn’t in any one of these, but in how their feedback loops could accelerate instability (IMF, 2026a).

Short Sellers: Increased Exposure Amid a Bull Market

We’re living in a paradox. Equity prices remain strong, yet short interest has surged. U.S. short interest ballooned from $958 billion in 2023 to $1.5 trillion by the end of 2025 (S3 Partners, 2024, 2025). The Russell 3000 index alone saw notional short interest climb from $1.2 trillion to about $1.5 trillion, even as the index itself rose. Average short interest as a percentage of float jumped from 5.0% to 6.3% (Pierson, 2026).

Short interest isn’t always a bearish signal, it can amplify moves in both directions. Tech stocks have been the prime target, with $269 billion in average short interest in 2024 and sector-wide short seller losses over $71 billion (S3 Partners, 2025). Short interest has soared 50–60% in just a few years, even as major indices reached new highs.

Middle East Conflict: Oil Shock and Stagflation Threats

The ongoing U.S.-Iran conflict has sent shockwaves through energy markets, upending inflation expectations worldwide. Roughly 20 million barrels of oil, about a fifth of global daily consumption, pass through the Strait of Hormuz each day (IMF, 2026a). Hostilities have pushed Brent crude to peaks of \$119–\$120 per barrel, settling in mid-2026 at \$90–\$100, well above the pre-war average of \$72.

High inventories blunted the first oil shock, but those buffers are finite. A prolonged disruption, and inventory depletion, could force much sharper adjustments in price and consumption.

Inflation expectations remain stubbornly elevated. The real risk isn't just price spikes, but their persistence. A brief surge is one thing; prolonged high prices threaten stagflation, squeezing growth while inflation rises. The IMF estimates a persistent 10% oil price hike adds about 40 basis points to global inflation and subtracts 0.1–0.2% from output (IMF, 2026c). Stubbornly high oil prices shrink central banks' room to maneuver and cut into corporate profits.

Japan's Yen Intervention: The Carry Trade Is No Longer a One-Way Bet

Perhaps the most consequential shift beneath the surface is happening in Japan. In 2026, Tokyo moved decisively from verbal warnings to large-scale, direct intervention in the FX market, backed openly by Washington. The scope is historic: between July 30 and August 26, Japan's Ministry of Finance spent ¥15.399 trillion (about \$96.5 billion) to support the yen. Reuters called it a record operation, following a coordinated U.S.-Japan action at the end of July.

This isn't just an effort to smooth currency swings. It could mark a fundamental change in the global interest-rate and liquidity regime. For years, the yen has been a favored funding currency, Japanese rates remained near zero, so investors could borrow cheaply in yen and pour the proceeds into higher-yielding assets abroad, building up the highly leveraged yen carry trade.

But when the yen strengthens, especially if Japanese rates rise, that trade becomes dangerous. Investors who borrowed yen must repay in yen, so a stronger currency or higher yields can force them to unwind positions across equities, credit, and emerging markets all at once.

The August 2024 episode showed how quickly this can unfold. The Bank for International Settlements documented the market turbulence as the carry-trade unwound, with exposure estimated at tens of trillions of yen, and likely more once derivatives are included.

The Yen Has Already Produced a >2% Move

This summer, the yen made a sharp move, appreciating more than 2.5% over two days on expectations of a Bank of Japan rate hike and speculation about further intervention (Reuters, 2026). Why does this matter? Because a stronger yen can set off a self-reinforcing cycle: liquidation of carry trades requires buying yen, which drives the currency higher, forcing leveraged investors to cut positions elsewhere. It's a nonlinear feedback loop that can turn a Japanese currency story into a global risk event.

Japanese Bond Yields Are Sending an Equally Important Signal

Meanwhile, the yield on 10-year Japanese government bonds has pushed above 3%, its highest level in decades. This isn't just about a simple "2% rise since 2006"; the key point is that yields are now at multi-decade highs, changing the investment landscape for Japanese capital.

Japan is the largest foreign holder of U.S. Treasuries, with roughly $1.117 trillion as of June 2026, and a vast external portfolio. Higher domestic yields in Japan make it harder to justify taking on currency risk and lower returns abroad. If Japanese investors bring capital home, the impact on U.S. Treasuries could matter more than the currency intervention itself.

Washington's Interest Is Bigger Than the Yen

On August 31, U.S. Treasury Secretary Scott Bessent met Japan's finance minister; both governments stressed the importance of an orderly yen market for global stability. The United States has a direct stake in preventing an uncontrolled yen adjustment, not just to avoid currency volatility, but to prevent a wave of forced asset sales and repatriation that could destabilize Treasury markets and global fixed income.

July's intervention was unusually coordinated, with the U.S. reportedly considering how to provide dollar liquidity to Japan without forcing a fire sale of Treasuries. The goal is not just to "defend the yen" but to stabilize it without risking a global dollar or Treasury liquidity event.

The Warsh Problem: Jackson Hole Changed the Debate

Federal Reserve Chair Kevin Warsh's Jackson Hole speech in late August marked a turning point in U.S. monetary communication. Warsh made it clear that the Fed's 2% inflation target is non-negotiable and that inflation is proving sticky. With PCE inflation running at 3.7% year-over-year and 4.1% over six months, Warsh argued that price stability must come first.

Markets got the message: the probability of a September rate hike jumped from about a third to two-thirds after his remarks. The upcoming August PPI (September 10) and CPI (September 11) releases will be a real-time test of whether Warsh's hawkish stance is justified by ongoing inflation pressure.

Is Warsh Under Pressure?

It might be tempting to say Warsh simply caved to political or market pressure, but that misses the nuance. Warsh has shifted toward a more hawkish Fed, but his messaging stresses that policy decisions should be based on actionable, up-to-date data. The real story is whether the inflation data in September will vindicate this new stance, and whether the market buys it.

The political context is impossible to ignore. President Trump keeps pushing for lower rates, while Treasury Secretary Bessent must juggle high long-term yields, the dollar-yen dynamic, and global capital flows. The policy triangle is awkward: the Treasury wants stability and manageable borrowing costs; Japan wants a stronger yen without crashing its bond market; the Fed wants to keep inflation expectations anchored. These goals don't always align.

The Dangerous Intersection

The biggest danger isn't just "Japan intervenes" or "the Fed hikes." It's what happens when the two collide. A stronger yen squeezes carry trades. Higher Japanese yields lure money home. A narrowing U.S.-Japan yield gap makes financing global investments with yen less attractive, and a rapid reversal can force investors to buy yen and dump foreign assets, all at once.

If the Fed keeps rates high, the U.S. will keep attracting capital, but that puts even more pressure on Japan to tighten, to keep the yen from weakening again. The result? A feedback loop: intervention strengthens the yen, carry trades unwind, global assets sell off, volatility spikes, Japanese repatriation hits Treasuries, global yields rise, and central banks face calls for more tightening.

In short: the yen is no longer just a currency story. It's a global liquidity variable. As the BIS showed in 2024, small shifts in funding conditions can trigger outsize moves when leverage is high and positions are crowded.

What Markets Should Watch Now

The next few weeks could be pivotal. Investors should track:

1. **USD/JPY:** Sudden drops signal carry-trade liquidation risk.

2. **10-year and 30-year JGB yields:** Rising yields could drive Japanese capital home.
3. **U.S.-Japan yield differentials:** The engine of the carry trade.
4. **August PPI and CPI:** Will the inflation data back up Warsh's stance?
5. **U.S. Treasury market liquidity:** Simultaneous volatility in JGBs, yen, and Treasuries would be a big red flag.

The key question: Can Japan, with U.S. support, engineer a stronger yen without setting off the very carry-trade unwind that Washington is desperate to avoid? The answer may decide whether this intervention stabilizes the system, or triggers a much bigger repricing of global risk.

2026 Midterms: Political Uncertainty as a Volatility Multiplier

While U.S. midterms rarely cause outright crashes, political uncertainty can spike risk premiums and volatility, especially when fundamentals are already shaky (Pastor & Veronesi, 2013). A divided government could mean gridlock and less fiscal flexibility, just as food, energy, and housing affordability are flashpoints (Financial Times, 2026).

Amplification Risk: The Four-Way Stress Test

The real threat isn't any single risk, but their interaction. The IMF warns that geopolitical shocks, leveraged positions, carry-trade unwinds, and equity concentration can combine in unpredictable ways, driving volatility even higher (IMF, 2026a).

Scenario Analysis: Possible Market Outcomes

Investors shouldn't bet on any one outcome. The best approach is probabilistic. Three scenarios stand out (IMF, 2026a; Aquilina et al., 2024):

1. **Controlled Normalization:** Middle East de-escalates, oil falls, yen stable, equities rally, VIX declines, risk-on.
2. **Persistent Stress:** Oil holds at \$90–\$110, yen rises gradually, equities drop 5–15%, VIX at 25–40, choppy, rotational market.
3. **Multi-shock Deleveraging:** Oil surges above \$100, Hormuz disrupted, sharp yen rise, carry trades unwind, equities drop 15–25%+, VIX above 40, liquidity shock and forced asset sales.

Key Indicators to Watch

- **USD/JPY:** Big moves signal deeper trouble.

- **Brent crude:** Sustained prices above $100 could reignite inflation.
- **U.S. inflation expectations:** Breakeven rates and swaps.
- **Treasury yields:** Drops in both stocks and bonds are a warning.
- **VIX:** Spikes above 30–40 suggest deleveraging.
- **Short interest as % of float:** Rising shorts alongside falling equities could signal regime change.
- **Credit spreads:** Widening spreads tend to precede equity weakness.

Correction or Regime Change?

Not every shock is a bear market. In August 2024, yen-driven volatility faded once positions unwound and policy direction cleared up (Aquilina et al., 2024). For 2026, the core question is whether we're in for another volatility spike or a fundamental shift in market regime. That depends on oil, the yen, and interest rates (IMF, 2026f).

Conclusion: Preparing for Nonlinear Risks

A total collapse may be unlikely, but sharper corrections, sector rotations, and "risk-off" episodes tied to the yen and geopolitics look probable. Tech earnings and profits might shield the market, until they don't. Valuations are stretched, and if multiple risks break at once, stability can quickly turn to crisis. Markets are especially sensitive to leverage built on assumptions of stable inflation, low volatility, a weak yen, reliable energy, and strong tech. If those assumptions crack, resilience could evaporate fast.

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