BRINKMANSHIP

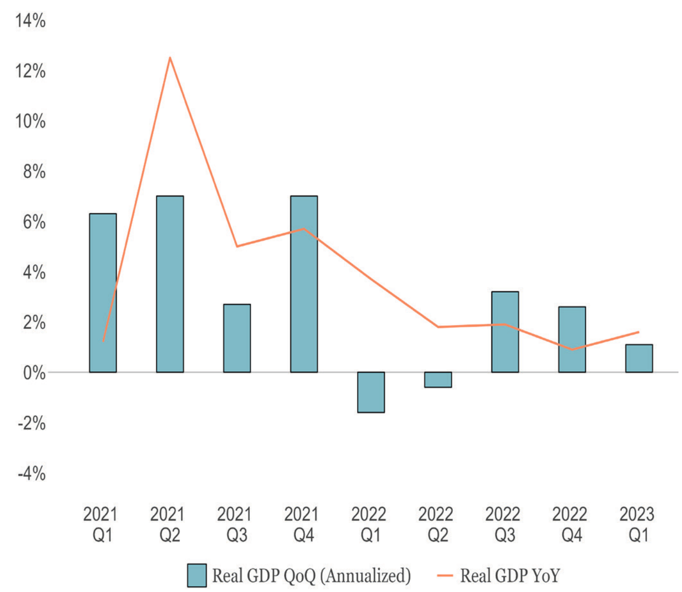
It may not be surprising that a looming debt ceiling crisis has garnered little attention amid all the confusing news of this week.

That news included slowing growth, but a still mostly strong consumer and better than expected earnings in Q1; and unsteady smaller banks, with one clearly on the edge of collapse. Investors have plenty to think about. Is a soft landing still possible? Will the renewed crisis at First Republic bank, whose share price cratered this week, with trading temporarily halted on Friday, lead the Federal Reserve to hold back at its meeting next week? Or, more likely, will this week's evidence that inflation appears stuck at a level far above the Fed's 2% target mean at least one more rate hike, or even two?

On inflation, it may not be necessary to get all the way down to the 2% goal for the Fed to declare victory. But showing "credible downward progress" is needed. And on that, this week's data was not helpful. Wage and benefit costs rose a little more in Q1 than in the previous three months, while the Fed's preferred measure of inflation showed core prices rose by 4.6% in March from a year ago.

Investors should also begin paying attention to developments in Washington. This week showed how difficult it will be for Congress and the Biden Administration to come together on a timely agreement to avoid default on US government debt. That almost unthinkable outcome would make other investor concerns pale in comparison. The recession that has, so far, been kept at bay would no doubt arrive, amid market turmoil.

Real GDP is slowing but remains positive
2021 Q1 - 2023 Q1



Source: RockCreek, Bureau of Economic Analysis.

It is still the best bet to assume that the debt ceiling crunch – when the government will run out of money to service its debt and pay bills that it has already incurred – will never arrive. But uncompromising rhetoric by both Republicans, who control the House in Congress, and the White House showed brinkmanship is still the order of the day, even as the deadline looms nearer.

It might seem a step forward that this week the House passed a bill to raise the debt ceiling. House Speaker Kevin McCarthy scored an important victory, pulling together his Republican colleagues to win passage of the legislation. But the bill contained spending cuts and other measures that Democrats – notably President Biden – will never support. The President declared it "dead on arrival." He reiterated that he will not negotiate over raising the debt ceiling. The White House argues that discussions on spending and the deficit should be separate from agreement to allow the government to borrow enough to pay its bills. That position may be understandable. But at some point, those in power on Capitol Hill and in the executive need to step back from the brink, or risk a very unpleasant summer.

NO RECESSION – YET?

As we noted in our quarterly report this week, the world is (still) waiting for recession. The rapid run-up in interest rates in the US and around the world was widely expected to deliver a global recession. A slowdown is underway. But growth continues to be positive on both sides of the Atlantic, even if just barely in the biggest European economy, Germany.

In the US, preliminary data show Q1 growth of 1.1%. This is a slower pace than had been expected and less than the 2.6% in the final quarter of 2022. But the headline numbers exaggerate the slowdown. It was largely driven by a drop in inventory build-up, a volatile component of GDP. Excluding that element, the economy notched up a growth rate of 3.4%.

Strong revenue and earnings results from Meta late Wednesday helped spark a turnaround for stocks this week. Meta's better-than-expected numbers were powered by surprisingly resilient ad spending, an improvement in daily active users, and significant cost cuts. This came on the back of solid results from Microsoft and Alphabet as well. Microsoft's price gain was particularly notable, given that it coincided with the UK's Competition and Markets Authority's decision to block the company's planned acquisition of Activision. Growth from Microsoft's gaming business has been an ancillary part of investors' bull thesis as attention has centered much more on the company's fortification of its cloud business and its efforts to take the lead in generative AI. The Activision deal is almost an afterthought at this stage, demonstrating the growing importance of these other technology trends relative to the video gaming industry.

As of Thursday's close, 235 of the companies in the S&P 500 had reported Q1 results with 79% surprising to the upside. Nevertheless, companies like Cloudflare, Snap, and Pinterest were punished quite severely for missing revenue expectations or issuing negative guidance. Amazon's shares initially rallied when the company beat Street expectations but retrenched as soon as management guided to a slowdown in its AWS segment.

The fact is, we're in an earnings recession and this will likely be the third straight quarter of lower earnings. Combining actual results reported thus far with current forecasts for those yet to report points to an estimated 4.2% drop in overall earnings this quarter.

CONSUMERS STILL SPENDING – ?

As earnings reports suggest, and the GDP report confirms, the American consumer has continued to power the economy. But spending may be losing steam going into the second quarter. This week's GDP report showed consumption rose by a robust 3.7% in Q1, led by a nearly 17% jump in durable goods spending – likely autos as supply shortages eased. But new monthly data showed that spending was flat last month.

More than a year into the Fed's sharp monetary squeeze, consumers may finally be losing some of their resilience. Business investment has already been hit. Apart from inventories and construction, business spending fell by more than 7% at an annual rate in Q1. Interest rate hikes have also impacted the housing market. Residential investment dropped by just over 4% in Q1.

THREE YEARS ON

With Covid 19 moving further into the rear-view mirror, can we now understand better what impact the pandemic – and the policy response – had on the global economy? We know that millions of deaths and illnesses led to terrible suffering around the world. According to Centers for Disease Control figures, in America, more than 1.1 million people have died from Covid-19; there are still 190 people dying every week from the disease.

Looking at just the economic impact, inflation is higher worldwide. For many poorer countries, the debt burden from borrowing to ease the pandemic casts a shadow over future growth and calls urgently for action. But in the US, strangely, the real economy now seems back on the path envisaged in early 2020. Economic output, employment and the components of growth, are close to the levels then projected by the nonpartisan Congressional Budget Office (CBO). What has been affected – apart from prices – is our understanding of what is going on.

INFLATION STILL STICKY

Consumer strength has of course been linked to the buoyant jobs market. Next week will give a full read on the April labor market – with the payroll and unemployment data released just after the Fed's policy meeting. Earlier in the week, we will learn what happened to labor turnover and vacancies in March. The Fed sees the JOLTS report as an important indicator of the pressure on wages which policymakers fear will keep inflation high. So far this year, there have been some signs of loosening in the "very very tight" jobs market, as it was characterized by Fed Chair Jerome Powell in 2022. Vacancies have edged down and claims for unemployment insurance have edged up. But both are still indicative of a strong market.

In line with that, inflation remains high – and in today's jargon "sticky". The best measure of labor cost pressures comes only every quarter, with the Employment Cost Index. Friday's release showed wages and salaries for private sector workers up in March by 5.1% from a year earlier and running during the quarter at the same 4.8% rate as reported in December. In Q1, underlying, or core, inflation experienced by consumers – the core Personal Consumption Expenditure (PCE) index – remained well above 4%. It was lower than a year earlier, but it too has only moved sideways in the last several months. There is further to go.

LONG COUNT FOR FIRST REPUBLIC

The Fed and the Biden Administration are sparring, yet again this week, with banking instability. In boxing, when a fighter is knocked down, they are given to a count of ten to return to their feet. While nominally reflecting ten seconds, a referee's count will typically extend a bit longer to give a viable fighter a chance to continue. First Republic Bank is getting the long count, but it looks like the bank is collapsing back to the mat following their quarterly earnings released on Monday.

In the report, First Republic disclosed that deposits declined 41% during the quarter – 58% if you exclude the $30 billion one time deposits contributed by eleven larger banks – which was at the bottom end of analyst expectations. EPS declined 39% from a year prior and net interest margins fell to 1.8% from 2.5% at the end of 2022. Management tried to remain optimistic though, indicating that it would stabilize the business during Q2 through reductions to executive compensation, condensing office space, and cutting 20-25% of its workforce, while stabilizing the balance sheet by adding insured deposits, decreasing loan balances, and reducing their reliance on short-term borrowings. Despite these reassuring statements, management declined to take questions following the conference call, further discouraging analysts.

The market reacted accordingly as shares in the bank have dropped about 75% from Monday's closing price and are now down more than 95% year-to-date.

From a macro point of view, the banking troubles, illuminated a month ago with the sudden collapse of Silicon Valley Bank and Signature Bank, are more likely to play out over months rather than days. Unless the crisis flares beyond First Republic in the coming days, we do not expect the Fed to change its monetary policy of continued tightening at next week's meeting. But over time, a building credit crunch will weaken the economy and put downward pressure on inflation. That would make the case for pausing rate hikes sooner than later.

SUPERVISORS AT FAULT

As attention is back on banking instability, the Federal Reserve has blamed its own decisions and supervisors for the sudden collapse in March of Silicon Valley Bank.

The Fed released a sharply critical report of itself on Friday, that blamed both a 2019 decision to relax rules around supervision of mid-sized banks and a failure by supervisors to follow up on concerns that they had expressed over a period of time. The next steps will be to tighten the rules – and to change the culture? The swift completion of the autopsy on SVB is commendable. In time, the Fed should also undertake a review – perhaps with outside help – of what went wrong with monetary policy that led to the jump in inflation that they are still dealing with today.

GEOPOLITICS STILL RISKY

As we wait for the Spring offensive against Russia promised by Ukraine, attention has shifted back to China. President Xi Jinping finally reached out this week to President Volodymyr Zelensky. Xi may have felt the need to appear helpful, given the uproar in Europe caused by China's Ambassador to France stating that former Soviet countries don't have "effective status in international law." That included Baltic states that are now members of the European Union, as well as Ukraine. The US, which was not aware of President Xi's call to Zelensky ahead of time and has criticized Xi's earlier "peace plan," nevertheless said it was a good thing that the two leaders spoke.

Efforts by the Administration to mend at least some fences with China continued this week, but without much success. There is still no high-level visit to China agreed, although Secretaries Blinken, Yellen and Raimondo are ready to go. In a major speech on the Administration's international economic policy, President Biden's National Security Adviser Jake Sullivan said that the US does not want to contain China's economic growth and prosperity. He called for a "small yard with a high fence" to determine restrictions on trade and investment and noted, as RockCreek did recently, that China is a major US trading partner. But the steps Sullivan laid out for a new American Industrial Strategy rested on the premise that the "China shock" had damaged the US economy and hurt American workers.

In the meantime, one measure of today's security tensions – military spending – is clearly ramping up. A new report from the Stockholm International Peace Research Institute calculated that total global military expenditure increased by 3.7% in real terms in 2022, reaching a new high of $2.24 trillion. Military expenditure in Europe saw its steepest increase, year-on-year, in more than three decades. And the three largest spenders on defense – the United States, China, and Russia – accounted for 56% of the global total last year.

The spending boom is "a sign that we are living in an increasingly insecure world," Dr Nan Tian, SIPRI Senior Researcher, said. "States are bolstering military strength in response to a deteriorating security environment, which they do not foresee improving in the near future."

EMERGING MARKETS

RockCreek team members recently in China noted that while the country has indeed reopened, it is still a far cry from the hustle and bustle of activity before the pandemic. The general consensus among local investors was cautiousness. While the majority expect earnings and margin expansion to materialize, most also took issue with the idea that China and the Chinese consumer would experience some kind of V-shaped recovery.

Like a patient coming out of the ICU, the recovery will be slow and potentially painful. In keeping with the medical analogy, it's also unclear what, if any, lasting damage has been inflicted on the country's economy. It does not help that China's demographics point to a tougher future no matter how well a recovery takes place in the short term. For now, the official first quarter numbers on GDP growth and economic activity, as well as recent market performance, seem to reflect the apathetic nature of the post-pandemic recovery.

Despite the gloomy picture in the face of higher expectations, there is a sense that strong alpha can still be generated in China – it's just not as obvious as it used to be. Gone are the days of betting on sectors benefiting from obvious tailwinds. It's worth repeating – as we have before – that stock selection is paramount and the partnership with local experts has never been more relevant as an investment philosophy.

Both China and India, the two largest energy importers in the world, experienced a tough week and are now down on a year-to-date basis. While the commodity heavy markets of Saudi Arabia, the rest of the GCC countries, and Indonesia experienced a strong week, helped by the rising price of crude, and are some of the better performing markets this year. We view this dichotomy as untenable amid a global slowdown, with a soft landing or a global recession.

With more to come,
Team RockCreek