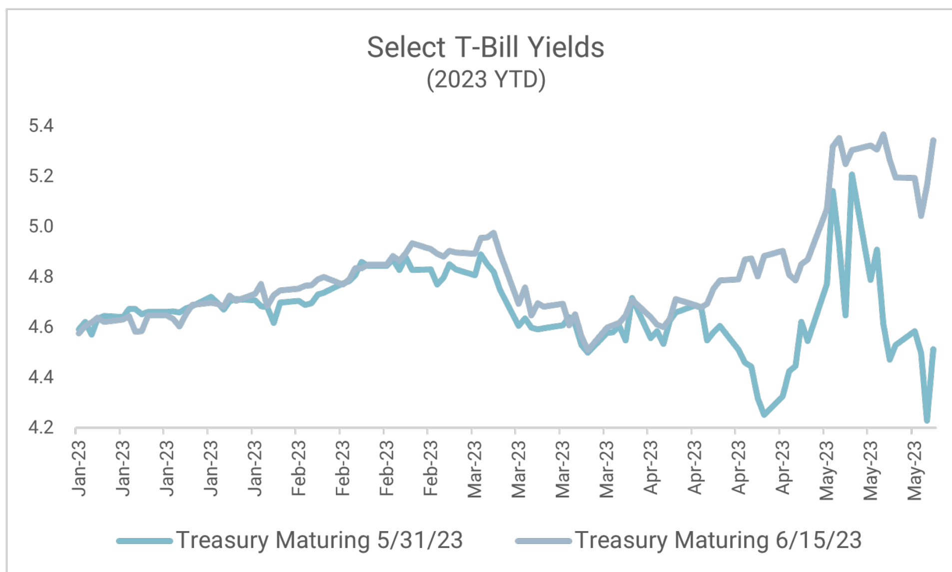
HOW FAR APART?

As President Biden sits down in Hiroshima this weekend for the 2023 G7 summit, he has to explain away a backdrop that is puzzling for non-Americans – not to mention for many Americans: the US may be on the brink of default. The debt ceiling crunch briefly looked promising mid-week, before Republicans called for a pause on Friday. Expect more twists and turns. Legislation to raise the ceiling is needed before the ceiling becomes binding on the estimated "X" date of June 1.

The vagaries of US policy making are not new for the President's closest partners and allies. And they will have been reassured by their staff and by American officials that Republicans and the White House will pull back from the brink and reach a deal, maybe within days. That is almost certainly true. But the Washington distraction does not help the White House as it pushes to lead international efforts in two key areas at the summit: Ukraine and China.

CLOUDS LIFTING?

It is almost a foregone conclusion that the debt ceiling will be raised. It always is. But this week's market movements suggested that there has been a faint cloud hanging over investors. As the Treasury Department noted, pricing of Treasury bills suggested markets saw near-term paper, maturing on June 15th (or near the "ex-date") as riskier than essentially the same security maturing 15 days earlier. As word came on Wednesday that the White House and House Republicans could envisage a deal, equities shot up by more than 1%. On Thursday, the S&P 500 reached its highest level since April 2022. After the unexpected pause in debt negotiations, it ended the week a little more than 1.5% higher. A boost for markets also came when Western Alliance, another small bank that lost deposits earlier this year, reported that deposits had risen by $2 billion so far in Q2.



Source: RockCreek, Bloomberg

US equities have been stuck in a trading range the last several weeks, while the bears were waiting for a break-down and the bulls were awaiting a break-out. The market moved slightly in favor of the bulls. You could sense investor attention turning towards the debt ceiling debate, with a US default still seen as an extreme left-tail event. Neither side of the bargaining table wants to risk a default nor has much political leverage to push the envelope (more below).

Assuming this latest hurdle passes, it will be interesting to see whether small-caps and other riskier segments of the market can close some of the gap with large-caps. While the S&P 500 is now up almost 10% on a year-to-date basis, the Russell 2000 is up just under 2%. A major determining factor will be whether the regional banking sector, down more than 25% year-to-date, can gain back investor confidence. Intriguingly, there has been a notable spike in call option purchases on the iShares Russell 2000 ETF, indicating that options traders are betting on small-caps making gains.

The S&P 500 was not the only index to break through a notable milestone. Japan's TOPIX beat that by a mile earlier this week when it reached its highest level in 33 years. That's how long it's taken for the index to recover fully from Japan's 1989 crash. We mentioned in last week's letter how Japanese earnings were surpassing market expectations, leading Japan to outpace the US and Europe this year. Investors have taken notice of Japan's gradually improving corporate governance culture. Buybacks surged to an all-time high of ¥9.7 trillion ($71.4 billion) for the 1-year period ending March 31st. With much more trepidation felt on the part of institutional investors towards investing directly into China, Japan, with its better rule of law, is being seen increasingly as a suitable proxy to gain exposure to China's reopening. According to Bank of America's latest survey of global fund managers, portfolios are still 11% underweight Japan on an overall net basis, indicating there could still be considerable dry powder for Japanese equities to continue to outperform.

NOW BACK TO FED WATCHING

Putting aside a possible US debt default, the economy and the Federal Reserve's interest rate actions are still the main event. Ahead of the next blackout period starting June 3, many Fed officials took the opportunity this week to lay out their views. Luckily, that included Chair Jerome Powell who gave a clear steer after mixed messages from others. Speaking alongside his predecessor but one, Ben Bernanke, Chair Powell reinforced his message from the policy meeting in early May: a pause in rate hikes in June is likely. "Having come this far, we can afford to look at the data and the evolving outlook and make careful assessments," he remarked.

As Richmond Fed President Tom Barkin noted, the Fed now has "optionality." There is a "plausible story" that demand is softening, and inflation will cool just because of what has already happened: rate hikes, dwindling consumer savings, waning fiscal stimulus and the probable squeeze on credit from well-publicized bank failures. That could lead to a "soft landing" without more rate increases. If inflation stays high – May's consumer price report will be released as the Fed starts its next meeting on June 13th – there could be support from some on the Fed's policy making committee for another tap on the brakes. Chair Powell's remarks suggest a bias to let more time play out to see if that is indeed called for.

Market pricing reflects this optionality, with the odds of a June pause now put at about 80% and a 25 basis point rate hike at 20%. There remains a disconnect between the view of the

market and the Fed on what happens next. Fed officials do not expect to be ready to cut rates until 2024. The market is pricing two 25-basis point cuts later this year.

The market's optimism on rate cuts could reflect optimism on inflation – or pessimism on the path for the economy. Buoyant labor markets suggest that the US economy continues to expand. Jobless claims this week reinforced the picture of a strong labor market.

G7: GEOPOLITICS AND...

The first G7 summit was held in 1975 as a forum for discussions on the global economy and exchange rates among the leaders of the world's biggest economies. Times have changed. With China now the second largest economy and other emerging markets becoming global economic powerhouses, the G20 summit, which includes these nations, increasingly takes the lead on economics.

Growing global geopolitical tensions make that broader gathering ill-suited for addressing political issues. India will host G20 leaders in the fall for the 2023 summit. Already, there have been tussles about whether the war in Ukraine should feature on the agenda. Meanwhile, G7 nations have moved to feature more political and security discussions – especially since Russia was pushed out in 2014 after its initial incursion into Ukraine.

This year, the G7 remains united in support of Ukraine. On the first day of meetings in Japan, more military aid was agreed. In addition to military support from the US and some others, all have stuck to the tightening sanctions regime. Washington would like Japan and Europe to go further, to limit exports to Russia and to cut off imports of Russian diamonds and other precious metals. That has been a harder sell.

On China, the Biden Administration is playing a complex game. It has worked hard, and with considerable success, to bring allies on board with its restrictions on high tech exports. But it is also trying to dial down US-China tensions. National Security Adviser Jake Sullivan spent two days on the way to Japan in talks with his China counterpart. The US would like to reinstate planned visits to Beijing by Cabinet Secretaries Antony Blinken, Janet Yellen and Gina Raimondo. At the same time, the Administration is continuing to work on potential curbs on US investment in China. Sullivan admitted recently that these are difficult to craft narrowly – hence the delay in announcing. Such restrictions would also likely feed Beijing's fears that America just wants to inhibit its growth.

G7: WHO ARE THE GUESTS?

Summits offer an opportunity for host nations to shape the agenda and show their leaders in a good light. Japanese Prime Minister Fumio Kishida has taken world leaders to his hometown of Hiroshima. After decades of underperformance, Japan's economy is now recovering unexpectedly strongly from Covid. The inflation that has worried central bankers around the world has been welcomed in Japan, where disinflation has undermined economic growth and prospects. As described above, investors have taken note, pushing the Japanese market finally back to its peak of more than three decades ago.

G7: SHOWCASING JAPAN

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DEBT CEILING DYNAMICS

The signs before the weekend were promising. But nothing is simple.

Negotiations began between senior White House officials and a trusted representative of House Republican speaker Kevin McCarthy. Both sides spoke about the possibility of a deal. As the possible pause suggests, don't expect a smooth ride from here to there.

Neither side has much room to maneuver. The House bill to raise the debt ceiling contains spending cuts that the White House and Senate democrats will not agree to. They would eviscerate the President's legislative achievements on infrastructure and climate. At the same time, it is not clear how much sway Speaker McCarthy will have over the House radicals in his caucus who say this is the minimum they can accept. It could yet fall to the Senate to craft a compromise. Majority Leader Chuck Schumer allowed senators to go on a 10-day recess, but he warned them to be ready to come back.

EMERGING MARKETS

It was a mixed week for equities in emerging markets, with North Asian markets largely outperforming their peers. Taiwan markets, in particular, had a strong run, led by a double-digit rally in TSMC, despite the headlines around the Oracle of Omaha, Warren Buffet, exiting his stake in the semiconductor behemouth. After only 6 months, the decision to exit TSMC left investors a bit befuddled, although it served as a reminder of how geopolitical concerns continue to play an outsized role in investment decision making.

Nonetheless, investor spirits were assuaged by news that other notable investors were stepping in to fill the void. They are betting that the semiconductor industry will recover strongly next year, boosted by demand for chips in areas like artificial intelligence, cloud computing, and data servers. Indeed, as industries and investors continue to uncover some of the myriad applications of AI systems like ChatGPT, North Asia's technology ecosystem is well placed to benefit.

Outside of Asia, markets were muted and wrestled more with the ever-see-sawing nature of economic data coming out of developed markets. The will-there-won't-there be a US recession debate has created additional uncertainty for emerging markets, with implications for decision making at EM central banks, many of whom are looking to ease rates without triggering a devaluation of their currencies. Indeed, inflation in emerging markets has largely turned for the better, but interest rates remain in a holding pattern. The risk is that a delay in monetary easing could trigger local recessions.

With more to come,
Team RockCreek