Markets Heat Up as Global Relations Cool

It turns out that the bulls had every right to be Dancing in the Street as stocks posted a very strong week (even the Russell 2000 and regional banks participated). Friday's jobs data seemed to put the nail in the coffin on rate hike fears. **The market has decided (rightfully so) that we are almost done with rate hikes and unless we get disastrous inflation data, any future hikes will be too small to act as a headwind.**

Could the Fed jawbone their way to more hikes? Possibly, but does anyone really think that we need to get to 6%? Maybe we could get talked into 5.5%, but markets should be able to withstand this (probably quite easily). **So, the fear of further rate hikes has been nullified as a bearish argument.** It should mean that inflation data will have a reduced impact on markets unless we get some extreme readings pointing to a rebound in inflation (which has not been the case, nor is it likely to be).

That only leaves "recession" fears as a potential stumbling block. As discussed on Friday, markets ran with the strong headline jobs numbers and chose to ignore the much weaker Household data (it does play second fiddle to the Establishment data, which is used to determine the unemployment rate). **Oil** surged on Friday signaling reduced recession fears (or some optimism regarding global growth). **The 2s vs 10s spread became more inverted** and closed the week at -81 bps. It has only closed at a more inverted level on 12 days in the past several years (such as in March 2023 when "hard landing" was handily beating "soft landing" in most forecasts). It is interesting that no one is talking about inverted yield curves anymore (thankfully, as it often attracts far more attention than it deserves). However, this reversal to so much inversion (it was "only" -41 bps a month ago) is at least somewhat interesting.

While markets traded as though positioning was very short, basic sentiment indicators like AAII, CNN Fear and Greed, and the simple RSI (Relative Strength Indicator) all point to neutral or even overbought conditions.

As a bear (who is worried about the economy), I'm the most nervous about being wrong as I've been at any time in the past two months. The S&P only increased a "whopping" 1.3% from April 3rd to May 31st (a number that seems to surprise many as it feels like we've been in a bull market the whole time). This explains why the **VIX** is all the way back to 14.6 (**the lowest since February 14th 2020)**. The lowest VIX since the pandemic started is also something that deserves attention. However, it averaged 14.9 from February 2019 to February 2020 (with a low of 11.5), so maybe it is just finally normalizing after the traumatic experience of COVID and ZIRP.

We get a lot of economic data this week. Away from the jobs data (excluding the nasty little Household survey), the economic data was not strong last week. However, I fully expect to be in a "good news is good and bad news is bad" mentality as the Fed should now only play a small role in the markets. **It is really refreshing to write that and I hope that this is correct.**

Across the Globe

Regarding the U.S. and China, we see the following:

- Signs that possibly both sides (certainly the U.S.) want to make sure that the tension doesn't derail the "necessary" trade and links between the two countries.
- Some efforts to offer olive branches (or at least fig leaves) to reduce the tension. The handshake at the Defense Forum in Singapore (for example) creates the hope that things can improve.
- What I struggle with the most is how many conversations start with "China needs us more than

we need them, so it makes sense for them to want to normalize the relationship". I believe that the phrase "China needs us more" is usually just an assertion rather than a statement backed up by a litany of facts. Without a doubt there was a time when China needed us as much or more than we needed them, but I continue to suspect that this time has passed (note the shift from "Made in China" to "Made by China").

- This article on the China jet caught my attention. I'm not in a rush to board a COMAC plane (Commercial Aircraft Corp of China Ltd.), but the maiden flight with passengers seems like a noteworthy milestone. This story fits with the view that China is in various stages of shifting from "just making things for us" to "trying to sell their own brands".
- The yuan has now become a topic of conversation with almost every one of our clients. Not just in terms of hedging it, but we are also seeing companies using it to their advantage. While the dollar remains the reserve currency, we've seen a noticeable and serious increase in the attention paid to the yuan as it develops into a currency used for trade.

I remain cautious on China/U.S. relations.

Japan continues to benefit from tensions in the Asia Pacific region.

It has been a year or more in the making, but Japan does seem to be a beneficiary of what is going on across the globe. The Nikkei is up 21% this year. We also see continued interest in companies in Japan. Our theory has been that:

- First tariffs and then COVID lockdowns had companies rethinking China as their manufacturing hub and as a result, other countries in Southeast Asia are gaining traction.
- Since Putin invaded Ukraine and we've seen the ability of China to effectively blockade Taiwan, people have been casting their eye towards Japan and their presence on the global stage. Japan's powerful (and growing) military offers a degree of "safety" that might not be achievable by other smaller economies in the region.

We also continue to see interest in India growing. India remains the "inflation wildcard" in my "surprise" scenarios for inflation and rates.

The one thing that I think we can say for certain regarding **Russia and Ukraine is that the world is growing weary of the war**. Of note, we can also add Indonesia to the list of countries tossing out "peace" proposals. However, there is no obvious peace in sight (see May's Around the World for our latest comprehensive update on the war). Sadly I'm not sure that a peace deal would do much for global markets as we seem to have accepted the status quo. It is clear (at least from this seat) that trading relationships have permanently changed around the globe and won't go back to where they were before the invasion.

It should be an interesting week and I'm looking forward to jumpstarting the week as a "guest" host on Bloomberg TV and radio from 7am ET to 8am ET on Monday morning!

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