



China Summit Disappointment Stresses Markets

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Markets ended last week under pressure as the optimism that had been building around a potential geopolitical breakthrough faded quickly. The China summit did not deliver the progress that had been hoped for. The Boeing aircraft order was smaller than expected; there was no meaningful movement on Iran; the Taiwan issue was brought forward in a way that unsettled markets; and the hoped-for easing of tensions around the Strait of Hormuz did not materialize. I would rate this summit very poorly from a market perspective, as it removed a key source of optimism that had been supporting equities recently.

Oil remains a central risk with the possibility of moving higher if the Strait of Hormuz remains constrained. Oil pressures feed directly into inflation expectations, gasoline prices and the bond market. We saw the 10-year Treasury break above 4.50%, and I have been warning that the long bond was likely to move higher. That move is now happening. Higher oil prices and yields are doing some of the Fed's tightening for it by lifting yields and tightening financial conditions, but that does not mean the Fed can ignore the inflationary impulse if energy continues to rise.

The important distinction is that the U.S. economy itself remains strong. The New York Empire Manufacturing report was very strong, and while these regional surveys are volatile, it confirms the broader message from the data: there is still no meaningful deterioration in the economy. Jobless claims ticked up, but not in a way that changes the outlook. The engine of the U.S. economy is still running. The risk is not that domestic demand is collapsing. The risk is that an external oil shock and renewed geopolitical uncertainty take the froth out of a market that had become dependent on good political news.

That is especially true for the NASDAQ and the momentum segments of the market. A great deal of the recent run-up was based on the expectation that President Trump could secure progress with China and perhaps help move Iran toward reopening the Strait. Those hopes have now evaporated. I do not see this as the beginning of a bear market, and I am not calling for a major correction. But this is precisely the type of disappointment that can start a flat-to-down period in equities, particularly in the areas where speculation and momentum have been strongest.

The Taiwan language and posturing at the summit was also important. China's position on Taiwan has not changed, but timing and emphasis matter. Bringing Taiwan forward so prominently in a meeting with the U.S., especially with a potential arms sale to Taiwan in the background, raises the risk of retaliation through rare earth restrictions or other trade frictions. That is a negative for semiconductors, technology supply chains and investor confidence in a world exposed to geopolitical risk.

The Fed now faces a difficult but clear setup. Warsh could face a real battle with the easing bias in the Fed outlook. The upcoming Fed minutes will matter more than usual because they should reveal how many members wanted to remove that bias at the last meeting. Three dissents on that issue were highly unusual, and unless the data change materially before June, there will be a major push inside the FOMC to move away from signaling future easing. That will be awkward for Chair Warsh if he comes in under pressure from the administration to lower rates, but the committee will be looking at stronger growth, higher oil and a long bond already moving against them.

Investors must grapple with the tension between short-term geopolitical turbulence and the underlying strength of the U.S. economy. The basic positives remain in place: solid growth, resilient labor markets and an economy that is far less vulnerable to oil shocks than it was in the 1970s. But parts of the market priced in too much hope around diplomacy.

It does not stay sunny every day. We have had a great deal of good news priced into equities, and this week reminded investors that geopolitical overhangs matter. I remain constructive on the U.S. economy and on equities over the longer run, but the near-term market is likely to face more pressure until oil reverses, or at least stabilizes, yields stop rising and investors get clarity on whether the Fed is ready to abandon its easing bias.

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