PALOS

# The Palos Perspective

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## US Monetary Policy

After a barrage of insults from Trump, Jerome Powell said: "We haven't been through a situation like this, and I think we have to be humble about our ability to forecast it." Personally, I'm confident to say that if it weren't for: the probable inflationary repercussions of Trump's tariffs, whose present average effective rate is 15.8% and 6 times higher than they were; the fallout in foreign demand for US Treasuries (foreigners sold $41 billion worth of Treasuries in May alone); and the latest disruptive 20% surge in oil prices with their side effects on the relative exchange value of the dollar, rate cuts would be in order.

First, the policy rate is 50 bps above the so-called neutral rate - one that is neither hot nor cold and supposed to keep the economy in a natural equilibrium.

Second, the money supply is growing at an annual rate of 4.5%, a growth factor that is insufficient to satisfy the 6% y/y increase needed for inflation (2%), growth (2%) and liquidity (2%).

Third, inflation expectations year-by-year for the next 5 years are heading south toward the 2.0% target, averaging around 2.2%.

Fourth, the inflation content of the misery index, which is the addition of inflation and unemployment rates, has declined dramatically.

Fifth, the entire yield curve, from 4.35% (3 months) to 4.89% (30 years), is on average 200 bps above the going annual rate of inflation (2.4%).

Put simply, once all of these aforementioned uncertainties are behind us, I think the process of bringing rates down will begin.

*A Macro Market View by Hubert Marleau*

**So What Went On Last Week, Ended June 20?**

On Monday, the stock market bounced back from Friday's steep side in the wake of Israel's attack on Iran. The S&P 500 rose 0.9% to 6033 as Wall Street looked through the conflict because WSJ reported that Iran had urgently conveyed that it sought an end to hostilities even though it was denied categorically on Al Jazeera by a senior Iranian official and a regional diplomat. Nonetheless, the upward movement in stock prices wasn't without doubts: the Skew Index, a reliable measure of perceived and potential tail-risk in the S&P 500, jumped 14% to 157 from 138 the week before.

On Tuesday, the S&P 500 decreased 0.8% to 5983 as a docket of weak economic prints showed that the economy had lost steam in May. Meanwhile, home builders sentiment fell to its lowest level since the pandemic; retail sales dropped 0.9%, significantly more than expected; and industrial production nudged down for the second time in three months. The Atlanta Fed's GDPNow Casting model now predicts that GDP growth for the 2nd quarter will only be 3.4%, versus a previously forecast high of 4.8%. Additionally, investors were also plagued by a surge in oil prices as US rhetoric on the Middle East intensified when Trump declared that he would consider among a range of options a major strike against Iran if it failed to surrender unconditionally.

On Wednesday, the stock market was broadly subdued after the Fed decided hawkishly to hold interest rates steady, but indicated with its so-called "dot plot" that two rate cuts could still come in 2025. What was interesting here was that the monetary officials presented a deteriorating macro picture, with economic projections that highlighted lower GDP growth, higher unemployment and higher inflation at the end of 2025, 2026 and 2027. The S&P 500 hardly budged, closing at 5981. However, the Skew Index, a tail-risk gauge, remained elevated at 148.50, drawing attention to the risk that the Israeli and Iranian exchange of air bombardments offered little hope of de-escalation.

US financial markets were closed on Thursday for Juneteenth.

On Friday, however, it was quadruple "witching day" with all the risks it usually brings, especially when investors have no shortage of news to react to. Right now, we have geopolitical strife in the Middle East, a Fed which is sounding the alarm about growth and inflation, and trade wars. Given that contracts tied to stocks, ETFs and indices that had came due totalled more than $6 trillion, the largest sum on record, a lot of volatility could have easily erupted. Fortunately, Iran's military capabilities have been so degraded that Tehran's ability to fight back against Israel's military superiority has been seriously compromised. In this connection, the ultimatum that was sent to Iran by President Trump gave hope for quick resolution. The S&P 500 decreased 0.15% marginally to 5968.

**The Near-Term Stock Market Outlook:**

Last week I wrote: "Several momentum stocks are showing signs of exhaustion, which could bring about pullbacks and choppiness, making the near-term summer outlook uncomfortable, given the warlike situation in the Middle East. However, the broad index appears to be in a strong primary uptrend, suggesting that dips could lead to buyable opportunities. Indeed, the lower exchange value of the dollar, the reduced cost of capital, the forthcoming easing of the monetary stance, the current run up in the money supply, the fast adoption of AI across many industries, and the expected decrease in taxes, are all ingredients that are likely to keep the economy away from a recession. In this connection, I think that there is a 75% subjective chance the S&P 500 will reach 6600 by June 2026 versus only 25%, for a fall to 5500. The team at Citigroup has also turned bullish last week, pushing its S&P 500 target to 6300 by the end of 2025."

It is odd that during the barrage of missiles between Israel and Iran, the effect on the various financial markets was so unnaturally dissimilar. For the most part, US benchmark crude prices jumped $13 to $75.75 over a short 2-week period. Meanwhile, the price of gold and bitcoin, traditional havens in times of conflict, fell 2.9% and 5.2% respectively. It is tempting to gloss over this, but the oddity reveals that investors are expecting this brawl to end fast. As a matter of fact, the 12-month futures oil contracts are selling at huge historical discounts, supporting the argument that stock investors should stay put and stay focused on earnings.

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