

PALOS

The Palos Perspective

Issue No. 28 | July 18, 2025

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Micro-Economic Theory Is Less Contradicting than Macro

Many marvel at how the US stock markets have shrugged off dramatic geopolitical and geoeconomic events, stemming from left- and right- wing populism that may well topple the global trading system in favour of an expansive vision of national security.

The conventional explanation for this conundrum is the high level of corporate earnings and promise of artificial intelligence. Nonetheless, based on experience, there isn't a single macroeconomic theory that has been able to explain what is now going on. Today, there are only specifics.

That is why investors are now much more interested in specifics that micro-economics can bring forth, like consumer and business behaviour, which undergird the economy. Put simply, macro models have become less reliable as a predictor of what is next, because they have a hard time to draw definitive conclusions, whereas micro-economic ones have been able to validate them with empirical evidence.

The internet has enhanced the use of surveys, broadened public opinions and brought forward casual approaches, allowing forecasters to make educated guesses about the investment effect of monetary, financial and economic policies. Indeed, investors now rely less on macroeconomic models and big questions to formulate investment decisions and strategies. Instead, they put a lot more emphasis on smaller answerable, specific questions by making use of accessible data from the internet and of straightforward definitions that AI can easily provide. This has played well for avant-garde investors by guiding them where the puck will be.

By taking such an approach, they can then focus on industries that matter; find where tailwinds are situated; and avoid the adverse effects of tariff policies. Right now, the surplus of dollars that stem from US budget and trade deficits are, and will be, flowing where productivity growth is located (AI),

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where major infrastructures are needed (LNG, pipelines), and where critical minerals are situated (copper, rare earths, nickel, and niobium). In this connection, Canada is a good bet, because it sports massive private and public pension funds that would be only too pleased to finance the aforementioned projects with their extra amount of greenbacks.

What Took Place in the Week ended July 18?

The market started Bastille Day sluggishly as Donald Trump dialed up trade tensions, announcing more tariffs on imports from allies like Canada, the EU, and Mexico, and from a bunch of non-allied, but friendly nations. Nonetheless, the S&P 500 held up, nudging up 0.1% to finish at 6269. Perversely, the foreign exchange value of the dollar edged up while the price of gold and oil edged down on the announcement that Trump would impose 100% « secondary » tariffs on countries that import material from Russia, including oil and gas flowing to China, India and the EU. This hasn't stopped the price of bitcoin from reaching an all-time high, celebrating « crypto week » as Congress was getting ready to pass a raft of crypto-centric bills to make the U.S. the world's « crypto capital » by tying digital currencies to tangible assets, and counting them as commodities, preventing the Fed from making its own. This has reassured investors that it was safe to enter the fray.

On Tuesday, the S&P 500 fell 0.4%, despite an Nvidia-led surge, because consumer prices jumped in the wrong direction, accelerating faster than anticipated even though the effects of higher tariffs have not yet gained momentum. In this regard, inflation will likely remain acute and stall at around 3.0% for the rest of the summer, dashing all remaining hopes that the Fed will cut interest rates at the forthcoming FOMC meeting.

On Wednesday morning, stock futures rose and Treasury yields declined after fresh economic data showed wholesale inflation was flat in June. That reaction did not last long, as market-based inflation expectations climbed when the market realized that the PPI excluded imports, thereby predicting that consumer prices would climb to 2.9% in 1 year's time from the current pace of 2.7% that the Cleveland Fed's model is tracking.

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Meanwhile, the political theatrics were elevated over the fate of Federal Reserve Chair Jerome Powell, with financial markets roiled by conflicting headlines about whether Trump was going to fire him or not. In the end, the President said he had no plans to remove Powell when Bank CEOs came out en masse fighting for Fed independence, fearing that a forced exit would likely bring about a drop of at least 3% to 4% in the trade-weighted dollar, as well as a 30 to 40 basis-point fixed-income selloff, according to Deutsche Bank AG's George Saravelos. The S&P 500 snapped back as a result, rising 0.3% to close at 6264, as the dip-buyers downplayed the drama and stepped into the market.

Thursday was busy with sturdy economic prints that investors cheered. First and foremost was the June rebound in retail sales, rising 0.6%, having apparently shrugged off trade wars, as consumers spent more on cars, clothes, and dining out. Adding fuel to the fire was the fall in jobless claims by 7,000 in the week ended July 12 to 221,000, the lowest level since April, and a surprise uptick in the June's industrial production. The S&P 500 rose 0.5% to finish the day at 6297, even deeper into record territory, rising 0.5%.

On Friday, housing starts and consumer sentiment readings closed out the week with moderately positive prints, which brought more stock market gains. The S&P 500 finished at 6298.

The Near-Term Stock Market Outlook:

Two weeks ago, I wrote that for the first time in more than two years, the S&P 500 had scored a bullish "golden cross," a popular and reliable indicator used widely by technical analysts as a gauge of momentum, which activates when the 50-day moving average crosses above the 200-day moving average. Craig Johnson, chief market technician at Piper Sandler, says: "Put that occurrence together with broadening participation and breadth, and we're setting up for a strong second half of the year." History shows golden crosses have faithfully and accurately presaged further gains, according to Dow Jones data. Market Watch wrote: "After a golden cross, the S&P was higher one year later more than 71% of the time, with an average one-year return more than 10%, according to data going back to 1928. By comparison, the average 12-month return for the index during any 12-month period since

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1928 has been about 8%. Returns following the past 20 golden crosses have been even stronger, on average: In this sample, the 1-year advance rises to more than 13, with a hit rate of 85%.”

While the aforementioned technical analysis has made me confident that my 6600 S&P 500 target will be attained before the year ends, a July Wall Street survey of professional forecasters gave me additional courageous assurance. On average, they expect real GDP to grow continuously over the next 12 months with a lower chance of a recession (33%) than at previous odds of 45%, the point being that, except in the housing sector, the economy is doing just fine, as illustrated by solid Q2 bank earnings and good employment numbers. In fact, the Atlanta Fed’s GDPNow estimate for Q2 real GDP is 2.4%. Moreover, productivity is on a steep upswing, which in turn is protecting high corporate profit margins. Indeed, since the advent of big data, AI and automation, S&P 500 companies’ revenue per worker expressed in 1986 dollars has risen 15% in the last 3 years from \$18.25 to \$21.00., according to the BofA.

Perhaps investors should shy away from economically sensitive issues like indebted companies, very small micro caps and discretionary stocks, and focus on those benefitting from productivity instead.

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