PALOS

The Palos Perspective

Issue No. 27 | July 4, 2025

CONTENTS

A Macro Market View by Hubert Marleau

Blending Fiscal and Monetary Policies

By now all investors are aware of Trump's disdain for Jerome Powell in his effort to pressure the monetary officials of the Fed to cut interest rates by undermining Powell's role as Chair. This is not, however, working out in Trump's favour because that institution is a completely independent agency. As a result, there is a serious movement in Washington to install Scott Bessent as Treasury Secretary and Fed Chair simultaneously. This looks like the Administration is willing to go for broke by pumping the economy into a huge boom via lower interest rates, bond yields and exchange rates to get the government out of debt. Put simply, take the gambit of doing whatever it takes, as long as it takes, to make sure growth in nominal GDP outpaces that of debt.

By installing a friendly Treasury Secretary as Fed Chair, it could be possible to impose a policy mix, called "Fiscal Dominance," that would subordinate the Federal Reserve to the needs of the Treasury. Eliminating the issuance of long-dated treasuries would tend to decrease bond yields upon which business capital spending is dependent but increase the issuance of short-dated debt such as T-Bills, whose yield could be kept low with an aggressively easy policy rate. Such a policy mix would theoretically accomplish the aforementioned goal of reducing the budget deficit through lower funding cost.

If one drinks enough Kool Aid, one may not see either what is hidden or the unintended consequences of such a course. It is true that a policy rate kept under its neutral level is stimulating, but kept there for too long it will lead to a lot more inflation than intended and defeat its objectives, because in the end the price of long-term debt is not determined by short-term rates but by inflation expectations and default-risk premiums. Given the tenacity of Powell's character and apparent support of the FOMC, however, investors will likely have to wait until next May, when his term ends, to see if such an abstruse monetary plumbing will come about.

A Macro Market View by Hubert Marleau

Perhaps it will, but not completely. The Federal Reserve is presently conducting a review of its operation focusing on two specific areas: “Statement on Longer-Run Goals and Monetary Policy Strategy,” which will sketch out its Fed’s board approach and communication tools, probably returning to flexible inflation targeting, thereby responding forcefully to deviations of inflation and from maximum employment in both directions, but retaining the option to use use make-up strategy by introducing alternative interest rate projections that correspond to the staff’s alternative economic scenarios, thereby allowing the public to see how each participant thinks the fund rates should be set at under such an economic forecast. This review is due by late summer.

So What Went On Last Week, Ended July 4?

US stock-market futures rose on Sunday, perhaps because things were looking up after two victories: one for the White House and another one for Congress.

First, Canada decided to rescind an unpopular 3.0% digital-services tax (DST) on big tech firms such as search engines (Google), social-media platforms (Meta) and online marketplaces (Amazon), totalling $2.7 billion, in a bid to salvage trade discussions after Trump had broken off all negotiations on the basis that the DST was egregious and a direct and blatant attack on the U.S. Prime Minister Mark Carney said cutting the tax “will support a resumption of trade talks in anticipation of a mutually beneficial trade agreement towards the July 21 timeline.”

Second, Congress made a significant decision to remove the hugely unpopular Section 899 clause from the “One Big Beautiful Bill” act aimed at retaliating against OECD governments that imposed unfair foreign taxes on U.S. companies, a major relief for asset allocators. Bessent satisfied the lawmakers because he had reached an agreement with finance ministers from the Group of Seven countries to exempt U.S. companies from the most onerous part of the OECD tax system.

On Monday, the stunning stock rally kept on going, through trade optimism and confirmation from the Federal Reserve’s annual stress test that banks would remain sound in the face of a simulated

A Macro Market View by Hubert Marleau

recession. The fresh bill of good health pushed the S&P 500 up another 0.5% to close at a new all-time high of 6205.

On Tuesday, US equity futures were tickling lower, reflecting some investors' anxiety on trade talks and wrangling over the "Big Beautiful Bill." Perhaps it's a cliche, but the reality is that the outlook is cloudy right now. On the one hand, partially because of a decline in immigration levels, and because the JOLTS job opening rebound unexpectedly to 7.8, its highest since last November, thanks to a pick-up in the quit rate and a decline in the layoff rate. On the other hand, the ISM manufacturing report is still in contractionary territory, including the employment index at 45. What was more important than the economic prints, however, was the overwhelming Senate vote to strike out the moratorium on AI regulation that would have banned states from enforcing limits on technology for at least 5 years, as a result of which the S&P 500 fell 0.1%, as traders rotated out of mega-cap tech names into cyclical sectors amid growing belief that the Fed might capitulate in July with a further rate cut.

On Wednesday, The Senate passed Trump's tax and spending megabill by the narrowest possible margin, 51-50, requiring Vice-President JD Vance's tiebreaker vote. The Budget Lab at Yale, a research centre, concluded that the bill parcels out benefits disproportionately away from low-income Americans to the rich, by extending the 21% corporate tax rate, making the pass-through tax deduction permanent, creating new tax breaks, and spending more money on defence and border enforcement, while withdrawing money from safety-net programs, the clean-energy industry and Medicaid. It should be noted that the ADP data added more confusion, giving a gloomy tone to the labour market as privately run businesses reduced payrolls by 33,000 in June. By the end of the day, the S&P 500 notched another gain to 6227 on a technology rebound and optimism that the U.S. had reached a Vietnam trade agreement.

On Thursday, the S&P 500 touched a fresh intraday record after the latest job report defied expectations, reducing, however, the likelihood of a rate cut in July. The U.S. added a solid 147,000 jobs in June that pointed to resilience in the labour market, pushing the unemployment rate to 4.1%

from 4.2 in May. This employment update increased the Atlanta Fed GDP growth estimate for Q2 to 2.6%. Nonetheless, the pace of hiring has slowed; and of that amount the private sector only added 74.000 jobs, marking the smallest increase in 8 months, thereby suggesting that the market could still look forward to a rate cut in September. The trading session ended on a high note, the benchmark having risen 0.8% to close at 6279.

Meanwhile, a final vote on the $4.5 trillion tax cuts and spending bill was passed, as the House Republicans overcame a critical procedural hurdle overnight, holding up a key vote open for hours as Trump and his allies worked the field to win over opponents: a done deal, whose passage is a big win for the White House and Wall Street, which is sure the legislation will boost both growth and profits.

On Friday, the U.S. financial markets were closed in observance of “Born in the USA”.

The Near-Term Stock Market Outlook:

Last week I wrote: “The S&P 500 is back to its record level, adjusting to lower bond yields, which helped evaluations; cheaper oil, which reduced input costs; and a weaker dollar, which boosted foreign revenues. Given that there is no particular reason to believe that the trend of these three aforementioned factors cannot intensify, I’m optimistic that the rally will keep on going to meet my December forecast of 6600 for 2025. In this regard, I have the support of volatility-targeting models, which are poised for the biggest-ever buying spree, from the superior price-performance of sensitive industrial metals (copper and silver) than inflation sensitive ones (gold), and of Wall Street investment banking firms. Of a sampling of 14 of the latter, only 5 have year-end S&P 500 targets below 6000. Indeed, looking ahead, second-quarter earnings reports are coming in mid-July, and Wall Street sees companies in the benchmark reporting 2.8% profit growth. Generally, market strategists believe that the tariff issues will be over by the end of the summer, with little impact on the profit margin of S&P 500 companies, either because many are not big importers and have sufficient pricing power to pass tariff hits on to their customers or because of profiteering from some

AI productivity. "AI and robotics are huge growth opportunities." says Nvidia CEO Jensen Huang. Perhaps, therefore, it would be wise to be wary of bear narratives, which tend to exaggerate geopolitical issues. It's not that one should be oblivious to risk, but unless the world blows up, history tends to be on the side of the optimists."

On Tuesday last, for the first time in more than two years, the S&P 500 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 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%." This makes me confident that my 6600 S&P 500 target will be attained before the year ends.

Why Did the S&P 500 Hit a New High? Tom Essay (Sevens Report) offers four reasons:

1. The market believes the Administration will not pursue any policies that will materially hurt the economy.

2. The market believes that any inflationary effects of tariffs will be more than offset in the data by cooling housing and energy prices; and that as a result, neither the CPI nor the PCE Price index will rise materially. It also expects two Fed rate cuts in the second half of 2025 to support growth, reducing the chances of a slowdown.

3. AI enthusiasm has propelled the tech sector, a powerful force behind the rally.

4. Valuations are more reasonable because analysts have quickly pivoted to using 2026 earnings estimates, which are $295 per share versus $260 for 2025.

Morgan Stanley's Michael Wilson has four reasons on his own why the stock market has more room to run:

1. Analyst forecasts for S&P 500 earnings have improved markedly, widening beyond the popular tech names. Moreover, the weaker dollar and Trump's favourable new tax incentives for businesses will bring wider profit margins.

2. He thinks that expectations of Federal Reserve policy are shifting, and that the Fed will cut interest rates no less than 7 times in 2026, as unemployment becomes more of an issue than inflation.

3. Stocks have traditionally shrugged off exogenous shocks and the proposed 'revenge tax' has been scrapped.

4. The Treasury market's term premium has stabilised because dollar weakness has made it more attractive to foreigners.

Hardika Singh, economic strategist at Fundstrat Global Advisors has four further reasons why she thinks that "American Exceptionalism" has not left town:

1. The rise of AI technology is rapidly changing the labour markets, business models and education, and the US is the undisputed leader.

2. U.S. workers are productivity powerhouses. Since 2014 US productivity has risen 17% compared to 5% in the eurozone.

3. The US is still the best place in the world to make big money: 35% of all wealth is in the U.S., which is home to 40% of the world's millionaires.

4. U.S. companies have the knack of generating superior returns on invested capital.

Ned Davies Research, in a note to clients said that the bearish holdouts - pointing the finger at investors who are Democrats - could open the door to another rally when they finally capitulate and convert into bulls. With the current sentiment among Democrats at its lowest level since 2017, fully 48% of Democrats surveyed were very concerned about volatility.

In another survey, 89% of the respondents are now treating their investments as a form of savings. This is bound to abruptly change sentiment among Democrats as they start to realize that America is not losing its lead, and may indeed fuel the next up-leg of the stock market.

Disclaimer:

This publication may contain certain forward-looking statements that are not guarantees of future performance and future results could be materially different. Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the offering documents before investing. The indicated rates of return are the historical annual compounded total returns including changes in unit value and reinvestment of all distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any unitholder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. Palos Funds are not available for non-Canadian residents.

Palos Funds and certain separately managed account advised by Palos may have investments in the securities discussed or referenced in this publication. These investments are made based on the funds and managed account's investment policies and may change over time as market conditions evolve.

L'infolettre Palos Perspective est un aperçu hebdomadaire de la situation macroéconomique disponible uniquement en anglais. Si vous avez des questions sur l'infolettre ou des demandes générales sur Palos, veuillez nous contacter à info@palos.ca