

PALOS

The Palos Perspective

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The Misery Index Should Take Centre Stage

The Misery Index is an economic indicator calculated by adding the unemployment rate to the inflation rate, and is used to measure the economic well-being of a country, with higher values indicating greater economic distress and lower ones less economic pain. There is officially no set "optimal" number, because that depends on economic context and policy objectives, making it a balancing act. Nonetheless, I'm of the firm opinion that the magic number is 6.0 - 2.0% for inflation and 4.0% for the unemployment rate - suggesting that inflation should be around $\frac{1}{3}$ of the number concerned. Currently, the index stands at 6.9 - 2.7% for inflation and 4.2% for unemployment - with inflation accounting for 39% of the calculation. Given that the Fed's official estimate for full employment ranges between 3.5% and 4.5%, inflation would need to fall quite a bit to entice the FOMC to cut its policy rate in September.

As a matter of fact, traders currently see no chance that the Fed will acquiesce to Bessent's preference for a 50-basis point reduction next month. Jim Bianco made the point with the lamentable observation that, in the last 40 years, the Fed has only once cut rates when the core was above 3% and the 3-month change was greater than 0.3%, and that was between October 1990 and March 1991, when the economy was sliding into recession. In this regard, it is very difficult for the policymakers at the Fed to ease their current monetary stance, especially if they accept the Atlanta Fed's estimate that the economy is tracking an annual growth rate of 2.5% for Q3, and the NY Fed's Nowcast model is at 2.1%. Presently, the Fed is moderately restrictive, given that the effective policy rate (4.33%) is about 60 bps above the neutral rate (4.73%) - a rate that is neither hot nor cool.

While it is true that headline consumer inflation held steady at 2.7% y/y in July, and fared slightly better than expected as cost pressures have diffused broadly through the supply chains, it remains that it's still too early to call the mission accomplished.

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1. Prices, excluding food and energy categories - the so-called core measure economists watch, the better to capture inflation's underlying trend - rose 3.1% over the past 12 months, above forecasts for a 3% increase.
2. There are definite signs that some tariffs are now passing through to consumers, such as furniture, tires, toys, pet products, household wares, recreation goods, footwear and appliances.
3. Many retailers were initially reluctant to raise prices until they had exhausted inventories acquired when tariffs were low.
4. A sharp drop in energy and food prices helped to offset rising costs elsewhere, which kept the headline inflation in check. Indeed, outside of these two categories, US prices are picking up again: excluding energy, everything else is at 3%. Core services minus shelter - the so-called "supercore": a priority for the Fed - had an unambiguous turn upward, rising to 3.2% from 2.7% in June.
5. The really bad news is that the Atlanta Fed's sticky-price consumer price index - a weighted basket of items that change prices slowly - rose to 4.6% on an annualised basis, registering a y/y increase of 3.4%.
6. With inventories run down, many companies may be less prepared to eat the tariffs, with ensuing impact on profit margins.

On Thursday, the market got confirmation that tariff-related inflation had accelerated in July. Both headline and core wholesale prices, where rising inflation tends to show up first, came in 0.9% higher, taking them to 3.3% and 2.8% year-over-year respectively from 2.7% and 2.5% in June.

Incidentally, the comment from Scott Bessent, the US Treasury Secretary, that "if you look at any model for the Fed funds rate, it suggests that we should probably be 150, 175 basis points lower" is my opinion about changing the course of monetary history and the basic tenets of monetary theory.

John Authers, a reputable Bloomberg commentator, wrote a breathtaking remark: "With the current effective fed fund rate at 4.33%, Bessent is suggesting that it should be about 2.6%. Over the last 70

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years, the rate has never been that low, with inflation as high as it currently is, with the core reading above 3.0%. So apparently ‘any’ model shows that US monetary policy has been misguided throughout the entire period and needs to be changed.” This leaves nothing for real growth, which is now running at the annual rate of 2.0%. WOW!

There can be only three reasons to hold that opinion: the wish for a lower dollar, the fear of a forthcoming recession, hope for a lower funding cost for the Treasury, or a combination of all three, which means pedal-to-the-metal fiscal and monetary stimulus. It sounds like another “impossible trinity,” like the Trilemma, namely control of value, supply and money at the same time and so-called Triffin’s Dilemma, in which it is difficult for a nation to issue a reserve currency without a trade deficit, thereby accepting the possibility of incurring issues like debt and inflation domestically.

What Took Place in the Week ended August 15?

On Monday, stocks edged up to fresh record highs in the early hours of the session, but the S&P 500 ended the day lower, declining 0.25% to 6373, as the earnings season winds down; daily tariffs started to get stale; and investors held back from placing bets ahead of inflation reports.

On Tuesday, the S&P 500 raced up 1.1% to a new all-time high of 6446 as inflation more or less aligned with consensus expectation, rising 2.7% year-over-year, bolstering speculation that the Fed is bound to adjust its policy rate lower in September because tariff effects appear to be modest so far. The odds for a September rate cut stood at 93%, based on Fed Funds futures pricing, up from 57% a month ago, and a 50% chance of 3 quarter-point cuts by the end of the year, up from 25% likelihood last month.

On Wednesday, with nothing important on the economic calendar, the S&P 500 advanced 0.3% to 6467, surpassing the previous closing by 21 points as investors got confirmation from Atlanta Fed President Raphael Bostic and Chicago Fed President Austan Goolsbee that their upcoming policy meetings would be lively.

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On Thursday, the stock market momentum stopped, as traders were blindsided by a surprise confirmation from a hot producer price index that was much higher than expected by all economists, a sizable acceleration in the cost of wholesale goods and services having been registered in July. Interestingly, futures only modestly dialled back their expectations for a September cut, even though wholesale prices suggested that inflation was far from dead. Thus, dippers made their appearance in the final hour of the session, clawing back earlier losses, and enabling the S&P 500 to notch another all-time high, rising 0.3% to 6469.

On Friday, the Commerce Department reported retail sales rose 0.5% in July, suggesting that the economy is still expanding and willing to pay more to purchase what they want before the full impact of duties is passed on. Yet fresh worries about inflation soured Americans on the economy, according to a reading of the University of Michigan's consumer sentiment survey: the index dropped to a 3-month low in August, underscoring emerging anxiety about the highest U.S. tariffs in decades and a further rise in unemployment. Investors refused to push stocks further; the S&P 500 fell 0.3% to 6450.

The Near-Term Stock Market Outlook:

Last week I wrote: "While I am still of the opinion that the S&P 500 will touch 6600 and could melt-up higher to 7000, according to many market strategists, numerous central banks around the world are cutting interest rates, which is likely to stimulate the year-over-year expansion of the world money supply beyond 12.0%, which is usually bullish for stocks and the economy. The Atlanta Fed is tracking real growth at 2.6% for the current quarter. Nonetheless, I'm cautious, avoiding the high flyers and the memes where unjustifiable valuations reside, sticking with quality attributes such as high profit margins and strong balance sheets."

Stock markets have climbed a wall of worry about inflation, growth, and valuations, but not about productivity and earnings, stemming from the application of AI across the economy and out-of-

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favoured sectors like healthcare, energy, utilities and staples, whose valuations have not kept up with their sales and profit growth.

Although Big Tech seems to be taking a back seat to other sectors, I'm keeping my cautionary bullish stance that the S&P 500 will soon rise to 6600, a number that I predicted at the end of last year. I'm even tempted to raise my S&P 500 outlook to 7000, because the odds are much better that we shall see 7000 than 6200, thanks to the outperformance and broadening of non-tech sectors. This set up is pretty good for a melt-up to 7000 for several reasons: impending rate cuts, low oil prices, rising money supply, solid earnings, and favourable corporate taxes. Above all, the AI revolution is already underway, as forward-thinking companies in sectors across the economy are harnessing it to expand profit margins and drive revenue, which could go a long way to outweighing extra costs that will come from import levies. I'm aware that the market is not pricing in the risk of potential economic damage related to the trade war, but stagflation is a rare occurrence without elevated crude oil prices, which have fallen more than 15% since the beginning of the year to \$63 a barrel. Plus, despite all the negative talk about the dollar by doomsayers, private foreign accounts are pouring big money into US Treasuries and US equities: \$1.538 trillion over the past 12 months.

P.S. In a recent Pew Research Center poll, Trump's approval rating is at 38%, with 60% disapproving of his performance. This marks a significant drop and is in line with other recent polls showing similar low approval rates. It could be that his political capital has peaked, which could lead to less influence and support within government. There are a lot of executive orders at stake here. It's too early to say for sure: politics is unpredictable, and leaders have bounced back from worse spots. Just saying.

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