

# PALOS

## The Palos Perspective

Issue No. 34 | August 30, 2025

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*A Macro Market View by Hubert Marleau*

## State Capitalism Is Risky Business

Frederic Bastiat was a French economist known for advocating free markets and classical economics. He's famous for his book "The Law", where he argues that the latter should protect individual rights, not enable the plundering of other's property, while opposing protectionism and socialism. In this connection, he concocted the theory of "opportunity cost", which basically claims that the real cost of something is what you must give up to get it. He emphasized the concept of the "seen and unseen", urging people to consider the hidden consequences of economic decisions made by governments and others: ideas which should really make us think twice about what's happening beneath the surface.

During the Second World World, Professor Hayek, a Nobel-awarded economist, wrote another type of a book, "The Road to Serfdom", which contains a deeply felt and sincere indictment of the overplanned economy. He argues that businesses operating in free markets are better at determining what to produce, and in what volume, because price signals are given by the law of supply and demand; and that when governments start to interfere, as history has shown, they cannot stop themselves, setting in motion an inner necessity that forces them to expand it, defeating prosperity. To him, capitalism is defensible because it delivers goods and services competitively and efficiently, while preserving liberty and private property.

Another big champion of capitalism was Joseph Schumpeter, the beloved economist of disruptors in Silicon Valley. In his own book, "Capitalism, Socialism and Democracy", he argues that the engine of growth and rising living standards is brought about through a process of success and profitability called "creative destruction" where the new replaces the old.

Milton Friedman, the third patron saint of neoliberalism, in a fourth book "Capitalism and Freedom", described the concentration of government power as "the great threat to freedom": a libertarian animus against federal spending and regulation, the latter of which, in his opinion, touches totalitarianism - a notion that has a lot of support from business interests. Above all, this Nobel

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laureate economist was the father of the policy doctrine known as “monetarism” where the trade-off between inflation and unemployment is deemed always temporary for as long as policymakers ensure a slow and steady growth in the money supply to keep inflation anchored.

Which brings me to the U.S. Administration’s flagrant attempt to commandeer U.S. monetary and industrial policies through “State Capitalism”. This is risky business. As a traditional conservative free-marketeer, I fear the abridgement of democratic capitalism will serve only the privileged few to enjoy Trump’s new golden age, dooming less fortunate aspirants from enjoying similar fruits of libertarian economics, which in turn is very un-American. In this regard, I’m not surprised that the only true critics of “State Capitalism” are the libertarians, the true right wing elements of the GOP: as cases in point, The Reason, the Cato Institute and Scott Sumner, and John Tamny who has himself incidentally written a book - this one brand new-, entitled "The Deficit Delusion": a very good read. I trust that their effort will convince all conservatives to reclaim their free-market roots.

### **On Monetary Policy:**

I have opined on several occasions in these missives that the rejection of Fed independence, on which low inflation depends, to set rates based on non-political economic judgements would not only seriously undermine the U.S. central bank's credibility, but make it an arm of politicians for personal advantage, and - more seriously - upend a pillar of the global financial system.

Like all other such central banks, the Fed has always been a punching bag for politicians to hide behind their mistakes, deflecting blame for anything in the economy that voters don’t like; but it has not as a rule politicised it. This is par for the course, in which the Fed should not pick a fight with elected officials because it cannot win a political battle against them.

Yet when it comes to standoffs, showdowns, chaos and uncertainty, that introduction of volatility makes it very hard for monetary officials to make monetary policy work. The whole thing is paradoxical: Trump’s populist agenda demands easy credit and at the same time rages against the

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creation of fiat money, favouring crypto currencies. Little wonder why Bitcoins are trading well above \$100,000.

### **On Industrial Policy:**

The U.S. government is intervening in the free market on the dangerous pretext that “patriotism and dirigisme” is what is needed to guarantee national security and counter the rise of China. It has already taken a 15% stake in MP Materials with a floor price for its products; another 9.9% in Intel; and a “golden share,” this one controlling, in U.S. Steel; and is considering buying big stock positions in the defence industry as well. This is to flirt with socialism, if you believe, like I do, that the working definition of it is government ownership of the means of production. Senator Bernie Sanders, who describes himself as a socialist, applauds this zeitgeist shift toward a mercantilist, state-run vision of capitalism regime, which scares free-market evangelists if not C-suiters who are often driven more by fear and greed.

The issue here is that socialism has failed everywhere it has been tried because it prevents management from making decisions based on market forces, profit outlooks and the taking of risks in launching new products, with their attendant R&D. Free market competition presses firms to improve technology, produce better products, lower costs, free capital and shoot for productivity.

### **What Took Place in the Week ended August 29?**

Last Friday's S&P 500 rally fizzled on Monday because the market sobered up over the weekend, responding to two worriments. First, traders manifested anxiety over the dovish address of Powell about easing the monetary stance, wondering if a pivot in the Fed's approach to rising inflation might be too much of a gamble for it to pay off. Second, investors revealed apprehension over Trump's wish, again with the approval of Bernie Sanders, the democratic socialist senator of Vermont, to do more deals in the private sector, echoing the government's equity in Intel, which he posited as a new way of implementing industrial policy.

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On Tuesday, the markets shrugged off Trump's attempt to fire Fed Governor Lisa Cook because it did not seem to have any bearing on whether she remained on the Fed board or not insofar as the direction of monetary policy was heading - this is probably because the Conference Board August report had revealed that jobs were increasingly hard to get, and that consumer confidence had edged lower, giving ammunition to doves insisting on a September rate cut. Intuitively, gold reacted bullishly, adding fuel to the thesis that Trump's challenge to the Fed's independence had made bullion a safe haven of choice. For now, however, what's important is that the economy is doing better than the labour market because huge productivity gains are present. With the Atlanta Fed tracking model projecting a third quarter GDP growth of 3.5%, the S&P 500 rose 0.4% to close at 6466.

On Wednesday, the S&P 500 rose 0.2% to 6379, clinching a new all-time high. However, the main event came after the bell when Nvidia released its July quarterly report, which beat both top-and-bottom-line expectations, suggesting that the data centre and AI boom is still going on, and predicting that its revenue would increase 16% in the October quarter, thereby conjecturing that the US economy will keep rolling on.

On Thursday, the S&P 500 started the session in record territory and broadened as the day progressed, rising 0.3% to end at a new all-time of 6502, with only 100 points to go to reach my 2025 goal of 6600. The US economy did better than expected in Q2, rising 3.3% in real terms, which had a lot to do with productivity and capex expenditures in data centres. Yet Governor Waller called again for lower rates, saying he would support a 25 bps reduction in the policy rate in September, with additional cuts over the next 3 to 6 months.

On Friday, stocks drifted lower, exhausted from the speedy rally, as the Bureau of Economic Analysis revealed that inflation had crept higher over the summer months as the effects of stiffer tariffs had filtered into the economy. The yearly rate of core inflation moved up a tick to 2.9%, the highest in 5 months. Meanwhile, the University of Michigan's closely watched inflation expectation index revealed that respondents are anticipating prices to increase as much as 4.8% over the coming year. The S&P 500 fell 0.6% to 6460.



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

The outlook of this week is the same as last week.

Prices are rising, the job market is cooling, yet business is just doing fine. According to FactSet, companies in the S&P 500 have handily beaten earnings expectations, as reported profit has risen around 12% in Q2 from a year earlier versus analysts' 5% prediction, marking one of the greatest frequency of earnings beats on record. Remarkably, the word "recession" plummeted 84% during warnings calls, collaborating with the Atlanta Fed's NowCasting Model, which is presently tracking real growth of 3.5% for Q3. Moreover, preliminary readings on services and manufacturing activity in the U.S. produced by the S&P showed that growth is indeed running at a respectable rate even though the rise in employment is stalling, thereby suggesting that productivity is still rising; it rose 2.5% in Q2.

Thus I'm still of the opinion that we shall see 6600 on the S&P 500, even though the tech sector is getting beaten up, not because we are in a dot-com bubble all over again, but because investors are rotating into the more cyclical sectors, which usually love inflation combined with growth and lower interest rates. While I have unloaded my own positions where froth was evident, like Palantir, Credo Technology and others that have exceptionally high valuation metrics, in favour of health care, materials, energy and consumer discretionary, I have, however, kept my positions in the "Magnificent Seven," with the exception of Tesla Inc. for two reasons. First, they are very productive as long-term investments because their PEG ratios (P/E multiples/growth) are not out of whack yet. Second, the policymakers may exercise the so-called "Fed Put" at a time when the economic situation does not warrant an easing of its monetary policy, and by ricochet could cause the S&P 500 to melt up to 7000.

This week, I sold Nvidia, bought bargains like Marvel Technology Inc., Dell technologies, Osisko Metals, Bird Construction Inc, Mattr Corp., Logan Energy, Foran Mining Corp., and Newmont Corp.

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