

PALOS

The Palos Perspective

Issue No. 9 | March 23, 2026

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The Outlook for Stock Prices

The S&P 500 closed at 6,606 on Friday, tumbling 6.8% from the high of 6,978 registered on January 28, about when realpolitik, real tension, and real threats between the U.S. and Iran began, soon to turn into a deadly conflict that closed the Strait of Hormuz, preventing 20% of the global supply of oil from reaching scheduled destinations.

In the last 51 days, the international benchmark price for oil has surged 50% to close at \$105 a barrel on Friday last, hastily forcing traders and economists to recalculate growth prospects, inflation predictions, and risk assessments. Specifically, energy's total share of world GDP, which is based on Brent, Newcastle coal, and a mix of US natural gas and Korean LNG, all grossed up to 100% of the whole primary energy mix, rose to about 7.5% from 4.2% three months ago, absorbing savings, reducing discretionary spending, and raising pessimism, not only pricing out GDP and elevating the one-year recession risk from 25% to 35%, but also raising one-year inflation expectations to 4.9% from 2.5%.

The flashing of this dangerous combination of bearish signs - the risk of stagflation and the prospect of a 2026 interest-rate hike - brought about a bear-flattening yield curve, which made stock market operators nervous with the possibility of no happy ending.

For all intended purposes, the S&P 500 has entered correction territory, with technical indicators suggesting that the pullback could have another 3.0% to go, because it is now below its 200-day moving average, snapping the 214 trading sessions preceding it. Indeed, according to reports released by MarketWatch, long-only hedge funds dumped billions in stocks, with few of them finishing the week above their 50-day moving average. There are also signs of capitulation in the options market, as put and call ratios have been spiking, suggesting that the market might be oversold, as these are very bullish from a contrarian perspective. The point may well have been reached where the dippers are likely to stampede into the stock market.

A Macro Market View by Hubert Marleau

Bank of America's Michael Hartnett argued over the weekend that when 88% of equity indices trade below their 50- and 200-day moving average, a major opportunity for global markets usually arises.

We are near enough to start picking stocks that are in the energy, critical minerals, chip, and consumer sectors. As a matter of fact, many other Wall Street strategists are also viewing the selling as a great buying opportunity, calling for the S&P 500 to end the year higher. J.P. Morgan has a target of 7,200 for 2026. The S&P 500 earnings yield is presently 5.00%, 370 bps higher than the real yield of 5-year Treasury notes, handsomely covering 5-year inflation expectations.

Nonetheless, the "Goldilocks market" might be over. However, some clarity on how high oil prices might go, and at what price level they need to be to cause a recession, is emerging. According to a survey conducted by the WSJ, crude oil prices would have to rise above \$138 a barrel for an average duration of 14 weeks to tip the U.S. economy into a recession. West Texas Intermediate closed at \$98.85 on Friday, but there are good reasons to believe that the oil shock will probably not derail the U.S. economy. The U.S. is a net petroleum exporter and a major exporter of liquefied natural gas. Moreover, a series of measures have been put in place to alleviate pressure in the global energy complex: 1) temporary waivers on U.S. shipping law and sanctions on Russian oil, plus permission to sell Iranian and Venezuelan crude; and 2) unlocking strategic oil reserves and finding alternative shipping routes and energy substitutions, explaining the backwardisation pattern of the oil market, where long-forward prices are substantially below spot.

Put simply, even though the swap market is giving pretty good odds that the policy rate could be raised, it's highly improbable that the monetary authorities would succumb to the temptation of doing so, given that the business sector is undergoing a productivity renaissance. Currently, both Atlanta and N.Y. Fed economic models are predicting 2.0%+ real growth for Q1 and Q2.

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