

# PALOS

## The Palos Perspective

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*A Macro Market View by Hubert Marleau*

## The Market May Stall Temporarily Near Record Highs

On Friday last week, the Iranian foreign minister declared the Strait of Hormuz "Completely Open" and the S&P 500 responded with a whopping weekly gain of 4.5%, convincing many that the stock market was totally irrational and crazy. How can Wall Street ride high on the coattails of a war in Iran and imposition of tariffs, which both negatively affect the supply of energy and the free flow of international trade, thereby raising inflation to new highs, while sapping disposable income, diverting consumer spending and undercutting sales of cheap industrial imports: things that nobody wants?

The University of Michigan April consumer sentiment index was 47.6 - a 10.7% drop from March and the lowest in its history - at a time when financial and economic guardrails are weaker than they have been in ages. The spirit of cooperation among countries and central banks has weakened to combat a widespread global economic downturn, rectify numerous global trade imbalances, and address the huge global debt load because government finances are stressed with unaffordable social contracts, subsidies to contain the fallout of higher prices and defence spending. In an increasingly fractured world, countries in the rest of the world may have more problems than the US and Europe, having been hit harder, making it even more difficult to finance their deficits.

This is why the rebound from the March 30 lows needs to be explained. Yes, it partially reflects the effect of mechanical flows reflecting Middle East headlines, but there is also a fundamental underpinning. Consensus estimates for S&P 500 EPS have never wavered during the conflict; on the contrary they have moved higher throughout the period because the Weekly Economic Index (WEI) - a real-time "nowcast" of the US economy, which has been steady around 2.5% for the past year - has risen to 2.8% lately. Nor has the US economy run out of fuel: there is no recession in sight because it looks like it can live with \$100 oil; because futures are still signalling a sharp decline over the next

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12 months and for the time being the trade balance is actually benefitting from rising exports of natural gas and oil.

JPMorgan revised upward its S&P 500 SPX forecast to 7,600 by year-end, with 8,000 possibly in play as a blue-sky scenario, where investors are betting on the long-term consequences of the technology revolution on all sectors of the economy. Interestingly, the rebound in the S&P 500 to a record of 7,138 took place because of higher earnings and not from higher valuations. Analysts now expect S&P 500 companies' aggregate earnings over the next year to rise 18%, up from 15% a few months ago. Indeed, valued as a multiple of the next 12 months' earnings, the index is 5% cheaper than it was at the start of the year, according to LSEG.

Yet it is plausible, in my judgement, that this record-breaking rally might enter a short-term consolidation phase because investors may need a more supportive background. There is some froth in specific areas like semiconductors, and, above all, the US-Iran peace talks remain in limbo as the two countries concerned are engaged in a high-stakes game of chicken. In this regard, investors may want to make sure that the new consensus estimates for earnings do pan out and that their upward revisions, which have been entirely concentrated in the energy and technology sectors, broaden to other ones without negating the re-distributional impact of crude price fluctuations in a new higher range between \$80 and \$100 a barrel, along with the powerful tailwind of AI spending.

### **P.S. 1 – The Senate Banking Committee's Congressional hearings**

In a tactically opaque manner, Kevin Warsh told the Senate Banking Committee diplomatically that he values the independence of the Federal Reserve and that he wouldn't do Trump's bidding, saying that he hasn't cut a deal to get the job, but mentioning that a rejigging of the Fed's model is needed because the economy has changed dramatically, especially on the supply side, where technological innovations and AI are producing a "productivity-enhancing wave" that is structurally disinflationary.

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In this connection, the Fed may end up promoting unit labour cost (ULC) as the underlying inflation rate in the labour market, which is highly correlated to the consumer price index. There is a conundrum here: while he's pushing the idea that productivity growth should lower the neutral interest rate, most economists would disagree with this because productivity tends to attract large amounts of money to finance technology capital spending.

He added that forward guidance should end, speaking engagements should be reduced to a minimum, and press conferences should deal only with important news and the Fed's focus should be on its 'core mandate' of price stability, emphasising that he strongly preferred interest rate adjustments as his primary policy tool over large-scale asset purchases.

He said: "Milton Friedman had a statement that always stayed with me. He always worried about government officials that lured and hung around with what he called 'the tyranny of the status quo.' Status quo practices and policies are especially harmful when the world is changing this fast. I believe a reform-oriented Fed can make a real difference to the American people."

The bottom line is that Warsh's intent is to reconfigure the current monetary regime and redefine the role of the Fed, a perspective not shared by his predecessors (Volcker, Greenspan, Bernanke and Yellen), bringing an uncomfortable sense of uncertainty. I hope that some clarity will come forward so that the right narrative will be deployed.

### P.S. 2 – Dollar Supremacy

I read in the Financial Times that Kevin Warsh indicated the Fed will support the Treasury's geoeconomic statecraft agenda, led by Scott Bessent and Marco Rubio, including using dollar swap lines to promote American dominance and reward allies, potentially politicizing financial regulation and weaponizing dollar supremacy. This could become problematic because they are used to calm global financial disruptions in periods of stress. Incidentally, some see this as an opportunity for

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China to step in to fill a potential vacuum by offering loans and currency swaps. China has signed more than 80 contracts with foreign central banks since 2020.

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