

PALOS

The Palos Perspective

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CONTENTS

The Pause Might Be Here at Last	1
Disclaimer	4

A Macro Market View by Hubert Marleau

The Pause Might Be Here at Last

Last week, I wrote: "Stocks started the week on the upside, and continued to march upward throughout the week, refusing to submit to the barrage of critics who claim that the market is overvalued and due for a sharp fall. Instead, the S&P 500 roared upward, registering a few new all-time highs, ending the week on a strong note. While I still expect that the market needs to take a short break to inhale all the stuff that is going on, not for lack of fundamentals but for technical momentum reasons, the recent rally was not due to valuation expansion but to earnings growth. In fact, the PEG ratio, which is the forward P/E divided by long-term earnings growth, supports the aforementioned argument. It currently stands at 1.03x - a historic low as it rarely falls below 1.00x - down from 1.45x a year ago, and perhaps the reason why the RBC raised its 12-month forward S&P 500 price target to 7,900. In the words of Michael Wilson, the main strategist at Morgan Stanley, corporate earnings led by a buoyant tech sector and a resilient economy are overshadowing the Middle East conflict."

The week saw the S&P 500 notch several record highs but ended on a sour note on May 15, as a high 3.8% annual inflation reading on Tuesday and the failure of the China-U.S. summit to force a reopening of free navigation in the Strait of Hormuz on Friday, which pushed the international price of oil close to \$110 a barrel, led to a global bond selloff. The benchmark 10-year yield surged to 4.60%, and policy-sensitive 2-year notes climbed to 4.07% - enough to raise the odds of one rate hike in 2026 near 50%, even though the recent spell of inflation, which is driven by oil prices, is not internally structural. In this connection, it wouldn't be surprising to see some profit-taking by both speculators and traders, bringing about the awaited market pause that I suggested last week.

This past week the S&P 500 recorded its 18th all-time high since 12/2025 versus a 70-year average of 18.5 a year. This situation throws up a seldom-seen negative technical market momentum signal that supports the idea that a consolidation might be in the making. The rally has brought about a

A Macro Market View by Hubert Marleau

reduction in the real equity risk premium to a level that should require tangible proof that another bout of solid earnings in Q2 will materialise.

In this connection, however, the expected consolidation will likely be short-lived because the economy keeps rolling up. Economists have shaved their 12-month U.S. recession probability to 25% as economic activity has held up well as both boomers and high-income earners intend to keep on spending and business capital expenditure plans are sturdy. Indeed, on May 14, the Atlanta Fed raised the second quarter GDP growth estimate to 4.0%, up from 3.7% on May 8. Meanwhile, the Citigroup economic Surprise Index - the difference between actual economic releases and Bloomberg surveys - confirms that the business performance of the US economy keeps on beating market expectations. The index has been in positive territory since June 2025 and rising briskly for the past 6 weeks.

Goldman Sachs has a Risk Appetite Indicator (RAE) that uses high-frequency data across five primary headings: bond, equity, liquidity, commodities and credit. It's been a useful contrarian tool when a sharp fall occurs, as it has lately, suggesting that traders might become too cautious in the short-term, thereby inciting investors to step in, ensuring an eventual resumption of the S&P 500 rally that Wall Street estimates will end the year around 8,000 because AI will have expanded the pie fast and broad enough to beat the earnings beyond the tech sector.

P.S.: A Symbolic Summit: Appeasement but no Breakthroughs

Donald Trump, with an entourage of billionaires, headed to China last week for 36 hours, where he met an emboldened Xi Jinping for a summit that had little ramification for their economies. It didn't bring any breakthroughs other than generating optimistic headlines and symbolic messages. Trump wanted a detente and rapprochement, while Xi wants Taiwan, being very clear with blunt remarks about not messing around with it, thereby puncturing an otherwise cordial stack. President Trump

A Macro Market View by Hubert Marleau

departed with the appearance of having restored some stability and appeasement, but without any major deal announcements and no firm commitments made public. Thus, concerns about a “Thucydides Trap” bringing a potential conflict remain, because differences still abound.

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