

PALOS

The Palos Perspective

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The Show Is Still on the Road

Last week I wrote that: "Given the blistering 15% gain for the S&P 500 in the second quarter of 2026, at a time when concerns about the valuation of infrastructure companies and potential impact of higher interest rates are widespread, speculators and traders are understandably wondering if a cycle top is near, powering past Iran worries. I say no. According to Deutsche Bank, second-quarter S&P 500 earnings-growth expectations stood at 26.2%, even after registering a first-quarter of 25.2%. Thus, the explosion in stock prices has to do more with earnings than valuations.

This phenomenon will likely continue, because the symptoms that brought it about are still present. Moreover, these are now supported by retreating oil prices, which have fallen \$50 per barrel in the past few months; by a near-perfect balance in the supply of and demand for labour, as job openings (7.618 million) are nearly equal to unemployed workers (7.307 million); and falling inflation expectations, exemplified by what bond traders think it will be one year away, from 5.0% in March, 4.0% in April, 3.0% in May, 2.0% in June, and 1.5% today.

Consequently, there is significantly less urgency on the part of the Fed to risk disorderly tightening conditions, even though the signs of economic resilience have not abated. Indeed, according to the CME's Fed Watch tool, odds for a rate hike dipped to 18% on Thursday after the June job report, compared to 30% a week ago. With no red monetary flags on the horizon, low recession risks, and relentless gains in productivity, which according to my numbers probably rose again at an annual rate of 1.4%+ in Q2, the outlook for profitable economic growth continues to be promising."

The week of July 5 was characterized by renewed Middle East tensions. Iran dangerously violated the ceasefire by attacking three commercial oil tankers, undermining the freedom of navigation in the Strait of Hormuz. In this connection, the United States retaliated with a wave of strikes, imposing heavy costs on several Iranian coastal assets, including a bridge and rail track in the north of the country and revoking sanction waivers that allowed Iranian oil in the open market for 60 days. The Islamic Revolutionary denounced the strikes as a "blatant act of aggression," threatening a "crushing

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response,” warning that Tehran would not tolerate any U.S. interference in the management of the Strait, and targeting sites in Bahrain and Kuwait. Trump responded at the NATO summit in Ankara, blasting the people in charge as sick people being liars, cheats, vicious and violent, that would use a nuclear weapon if they had one. On Thursday, the U.S. doubled down, hitting 90 Iranian military sites and so did Iran, which is suspected of wanting to depose Trump.

Despite these brutal exchanges, a war without an endgame, a limited docket of macro-economic data, and jittery market sentiment, the S&P 500 managed to partially brush off these impediments, registering a weekly gain of 1.4%, ending the week at 7,575. Of the many reasons why it bucked the belief of many market observers that the situation could have been disastrous for stocks, I can think of three big ones.

Back to the Negotiating Table to Fix the MOU:

Few people in the Middle East want a return to a full-blown war, and especially in the U.S. and Israel as both countries are facing elections this fall. In that regard, there will be no boots on the ground, just more talks, even though President Trump said that the ceasefire is over.

As a matter of fact, he left the door open to a diplomatic solution, letting J.D. Vance, Steve Witkoff and Jared Kushner negotiate some sort of a deal to fix a language ambiguity about control of the Strait of Hormuz. This led to a dispute: the Iranian interpreted the poorly-worded clause as granting it exclusive control of the Strait, while the U.S. and its allies believed it meant free navigation. The bottom line is that the so-called Memorandum of Understanding basically demanded Iran’s unconditional surrender, allowing both sides to pursue their war aims by other means. The risk of an escalation to all-out war level is nonetheless low because it is in the interests of Washington to keep the conflict manageable without calling for a disaster scenario, thereby limiting market damage and containing the geopolitical risk premium.

The Fed is Not About to Raise Interest Rates:

The latest FOMC minutes confirmed a concern about inflation, but they showed that members were hesitant to raise rates. It appears that the Fed had distinguished between temporary price increases

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that are either tariff- or war-related, as opposed to entrenched inflation stemming from money supply, true inflation data or wage rates. The world money supply has decelerated over the past three months to a negative annual rate of 0.4%; the Truflation CPI Index, which harnesses modern consumer and spending data along with cutting-edge technology, is up only 1.8% y/y; and the Atlanta Wage Growth Tracker is in steady decline, up only 3.6% y/y versus 2.5% for productivity. Moreover, there is no reason to upset the labour apple cart when hires and quits, along with unemployment and job openings, are in near balance.

The U.S. Economy Chugs Along:

The Atlanta Fed's GDPNow model's estimated growth for Q2 is only 1.4%. This is because the huge trade deficit caused by sharp increases in AI-related imports, which are outpacing large increases in U.S. exports of crude oil and petroleum products, dragged growth down by 1.3%. According to Yardeni Research, the reality is that actual final sales to private domestic purchasers, which strip trade and inventory swings, is tracking 2.9%. Moreover, the New York Staff Nowcast for Q3 is 2.4%.

The Short-Term Outlook for the Stock Market

Financial market history is conclusive that geopolitical crises are usually good buying opportunities for stock pickers, especially when the paths of both interest rates and economic growth appear intact, as they do now. Interestingly, the time-weighted average of weekly estimates for the S&P 500 earnings per share over the next 52 weeks rose to a record \$373.73, putting the forward P/E multiple at 20.15 times, for an earnings yield of 4.96%, versus a 5-year inflation expectation of 2.30%. That is a good enough reason to stay put.

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