The Palos Perspective

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A Weird Cocktail

Last week I wrote that: "Despite these brutal exchanges between the U.S. and Iran, a war without an endgame, a limited docket of macroeconomic 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 When Oil Reaches $85 a barrel;

The Fed is Not About to Raise Interest Rates;

The U.S. Economy Chugs Along.

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 earning yield of 4.96%, versus a 5-year inflation expectation of 2.3%. That is a good enough reason to stay put."

In the week of July 12, the stock market headed into sessions where several dominant macro developments rarely converged—the start of the earning season, the June CPI and PPI inflation reports, the appearance of Chair Kevin Warsh before Congress, lots of economic data for macro watchers to swallow, and the repricing of oil caused by the instability of the global energy complex—making the narrative very sensitive for the S&P 500 to factor in at a time when it is meandering near its record high of 7,610.

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The benchmark fell 100 points to 7,457 this week, but not because the macro data was bad. Instead, investors were questioning if the hyper-scalers would reduce their capital expenditures on AI, as the current spending on data centres and computer access is significantly impacting free cash flow while facing fierce competition from Chinese startups. Surveys show that only 28% of them expect a capex cut this year, though nearly half see it as a potential source of a systemic credit event. Mathematically, the market is faced with a dilemma. On the one hand, hyper-scalers' earnings multiples have declined to very attractive levels for investment purposes, while on the other hand, price-to-free cash flow is very expensive. In this connection, buyers of high leverage funds and holders of overextended margin accounts are deleveraging to avoid what could be a shock, however remote such an outcome could be. Hey, ample money has been made. Let's cash in some.

Meanwhile, the legendary Howard Marks has changed his mind from thinking of AI as a possible bubble to being more impressed by its technology. In his podcast, he explained his shift: "I upgraded my opinion of AI and its potential because of its ability to talk about its own strengths and weaknesses, to use humor, to put information in the context of me, to use what it knows about me. And this is really exceptional stuff." MarketWatch wrote that Marks was referring to several qualities of AI that are "unprecedented." Looking across past technological innovations like railroads and the internet, he said there "has never been one that has had the AI's quality of autonomy."

The Inflation Report Brought Relief:

The Bureau of Labor Statistics produced a surprisingly subdued inflation report for June: on a monthly basis, headline CPI fell 0.4% while the core CPI was flat, resulting in a year-over-year increase of 3.5% and 2.6%, respectively. Interestingly, CPI - excluding food, energy and shelter, which is viewed by many economists as a clearer picture of what is really going on under the hood - is running at an annual rate of just 2.1%. I hate putting too much attention to one data point. Nonetheless, the wholesale price report confirmed the message delivered by the CPI that inflation was not accelerating. In order to have a better view of the underlying trend for inflation, many have adopted the annual performance of the CPI, which excludes energy, food and rent for shelter: it's running at just 2.1%. Goldman Sachs forecasts that the print should bring the core PCE, the Fed's favorite inflation gauge, to 3.3%. Consequently, the prediction markets have taken a July 29 rate hike off the table, which was treated as a coin toss, and trimmed the amount of cumulative tightening to next year.

As Good as it Gets for the Big Money Centre Banks:

The big Wall Street banks generated outstanding revenue and profit numbers, beating expectations by very large margins. The bonanza reflected the side-effects of gangbuster equity trading, the huge build-out of the AI infrastructure and computing boom, the deluge of equity and corporate bond issuance, the big increase in wealth management fees and widening net interest spreads. As Jamie Dimon said, "It was as good as it gets”. It's a manifestation that, at the moment, the US economy is doing well despite being in a dangerous geopolitical world.

Warsh Faced Congress:

Facing Congress, Fed Chairman Warsh did not provide any guidance on where the Fed is heading over the near term, but he did say three important things. First, he pledged that the Fed will bring inflation down and that he had no tolerance for high levels, asserting the Fed’s responsibility for controlling inflation through monetary policy. Second, he outlined an agenda for task forces that will be manned by prominent academics and business leaders to reform the central bank in order to regain public trust and ensure price stability, focusing on economic evaluation, communication, economic data quality, and its policy-setting process. Third, he endorsed the so-called Roaring 2020s narrative, revealing his enthusiasm about the AI boom as a reason to be optimistic about growth and inflation. In his judgement, “the spending on data centers, software and infrastructure should boost productivity, raise the economy’s non-inflationary growth rate and help ease inflation pressures over time, offering support to the Fed drive to price stability”.

Renewed War Repricing of Oil:

The war in the Middle East is lasting longer than widely expected as fresh tit-for-tat attacks between the U.S. and Iran have resumed, while declarations conflict over whether the Strait of Hormuz is open for business. As a result, the price of an international barrel of oil rose to $85 in a relatively subdued manner, avoiding what could have been a shock. I do not want to underestimate the risk of a prolonged war. But oil traders have not panicked, because alternative routes have been found, Chinese demand has been weak and North American oil is flowing out to the rest of the world. The thing is that they are treating crude supply as a fluid problem: oil supplies can become tight, but they can also ease quickly, explaining why oil futures tend to trade much lower than the spot price rise. In this connection, Goldman Sachs continues to forecast Brent oil at $80 a barrel in Q4 of 2026 and $75 in 2027, perhaps also because both Iran and the U.S. are sensitive to oil prices themselves. Marko Papic of BCA Research has observed that when oil prices are low, military activity ramps up and when they are high, suddenly negotiations are back on the table. Interesting, no?

The U.S. Economy Keeps on Rolling Up:

There is no stopping the economy, which keeps rolling up: retail sales are better, layoffs remain low, job openings are improving, hiring plans are rising, manufacturing activity is picking up in the New York and Philadelphia area, and business capital formation is holding. The Atlanta Fed's GDP tracking model is currently projecting Q2 real growth at 1.7% and 2.7% if AI-related imports are excluded, while the Weekly Economic index, which combines a bunch of high-frequency indicators, shows that real GDP growth of around 2.6% y/y is in the cards. The thing is that on the demand side, the economy is supported by resilient consumer spending stemming from the wealth effect of the retiring boomers, and on the supply side by productivity led by the tech boom. It partially explains the rise in inflation-protected yield, commonly called real yields, across the entire yield curve board from 5 to 30 years.

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