The Palos Perspective

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Black Gold Gets a Crude Awakening

Last week I wrote that: "the stock market was heading 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 7610.

The benchmark fell not because the macro data points were bad—the inflation report brought relief, the big money centre banks dispatched enormous earnings, Warsh endorsed the productivity boom, the repricing of oil did not produce a shock, and the path of the economy was rolling up—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 over-extended 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."

The week ended July 24 was light on economic prints, falling inside the Fed's blackout period for Fedspeak, with hedge funds in cleaner positions, having sold 75% of their equity exposure accumulated since the April lows, according to Goldman Sachs. As a result, corporate earnings, AI jitters and rising oil prices drove the headlines rather than speculative hedging bets on specific stocks: three factors that have forced the S&P 500 to mark time, being challenged by opposite forces.

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On the positive side of the equation, the impressive resiliency of the economy and the enormous strength of corporate earnings are highly energizing tailwinds; but on the negative side, fears that Moonshot's Kimi K3 could prevent the hyper-scalers from profiting on their huge capital spending spree and AI models, and the return of Trump's wall of global tariffs on imported goods, are bad enough; but the real negative is the rising intensity of the Middle East conflict, with Yemen choosing to come to the aid of Iran by attacking Saudi Arabian oil tankers in the Red Sea, thereby creating a second choke point and forcing the U.S., in a revenge mood, to seriously consider a massive attack on Iran, which has boosted the international price for a barrel of oil to $100 at a time when Strategic Petroleum Reserves (SPR) are near a multi-decade low and crack spreads are grinding higher, making the global energy complex scary.

The situation generated a global sell-off in both the bond and forex markets, causing lots of trouble for the stock operators. Yet the S&P 500 hardly budged over the past week down only 0.6% to finish at 7,412, even though it traded below its 50-day moving average and the fear gauge moved up.

Thus, I still hold my view that the path towards higher stock prices will win out once the dog days of summer are over. The dippers and the stock operators will likely step in to take advantage of the mid-summer stall because investors are aware that these Middle East geopolitical crises have usually brought good buying opportunities, thinking that either Washington or Tehran or both will suddenly cave if a panic point is reached and that forward earnings will continue to climb, reducing P\E multiples. In this context,

1) Oil futures are trading at huge discounts to spot across all maturities, suggesting that the rise in the spot price is temporary because Rubio must find a diplomatic way to bring back the ceasefire with Iran, without which the Republicans could dramatically lose control of the House of Representatives and perhaps the Senate also.

2) Hyper-scalers like Google, Microsoft and Amazon have the muscle to overcome apprehension about their capital spending binge and AI model delays. These companies have robust revenue and cash flow growth, booming cloud computing units, a growing customer base and billions of dollars in cash, giving them a clear competitive edge over other smaller contenders.

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3) The odds that the Fed will raise its policy rate on July 29 have risen, but remain below 50%, even though the New York Fed is predicting that the GDP in real terms will probably rise solidly at the annual rate of 2.8% and 2.6% in Q2 and Q3, respectively.

P.S. There were reports late in the day on Friday that Pakistan was pushing for peace talks to renew the ceasefire between the U.S. and Iran.

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