

PALOS

The Palos Perspective

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CONTENTS

Employment Is in a Healthy Balance	1
Disclaimer	3

A Macro Market View by Hubert Marleau

Employment Is in a Healthy Balance

Last week, I wrote that “Acknowledging that the White House stands behind Warsh, the uncertainty thus relies on how he will interpret the current nature of inflation and how he will react to it. There are three ways to look at the causes of inflation. Is it caused by a one-time accounting effect like a change in the sales tax or tariff rate; a price signal showing an item has run out of supply; or a broad, generalised price increase stemming from too much money? Interestingly, both the world and US money supply is running at an annual rate of 5.5% and has been for months on end, suggesting that today’s inflation has little to do with too much money, but with exogenous factors that are not related to monetary policies, which explains why the CBOE FedWatch Tool is giving only a 30% chance that the Fed will lift the Federal funds rate on July 29. Moreover, it is possible that if the Fed could engineer one “tap-on-the-brakes rate hike” to prove its independence without fracas from the Administration, such a move would not slow the undergoing economic expansion. As a matter of fact, reliable economic NowCasting models are tracking growth of 2.5% for both Q2 and Q3, with a 15% recession risk that a contraction could occur within 12 months. On Friday, the University of Michigan revealed that consumer sentiment rose 5 points in June, with expectations improving far more than views of current conditions: a sign of optimism about the economy.

Based on the aforementioned scenario, the stock market should regain its footing, given that the equity risk premium has shrunk, the oil geopolitical premium has vanished, the dollar debasement story has abated, and Micron Technology’s blowout forecast reaffirmed the bull case for the AI trade, thereby returning some excitement to the market, even though it does not feel as strong as it once did, but carrying the S&P 500 nonetheless forward to my 8,000 target by the end of 2026.”

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

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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 increase 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) 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 FedWatch 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.

This past week the S&P 500 rose 1.8%. It would have been much better if the technology sector, which is getting cheaper day by day, had just held up. The market has been strong. Interestingly, advances are beating declines and new highs are outstripping new lows on both the New Stock Exchange and NASDAQ by noticeable margins.

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