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The Palos Perspective

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The Fed Did Not Walk the Talk

Last week I wrote that: "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.

"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 hyperscalers 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, which is what the huge discounts for oil futures is suggesting, and that forward earnings will continue to climb, reducing P\E multiples."

The Week of July 26:

The week of July 26 started on a high note with a 14.0% fall in the price of an international barrel of oil from the previous high of last week, as Oman offered what appeared to be a credible diplomatic off-ramp; enough for the U.S. and Iran to suspend military responses and return to the interim ceasefire deal. It looked as if both parties had perhaps reached the caving point that the discount in future oil prices was predicting, until Iran fired overnight missiles on an American military installation in Jordan, which were successfully intercepted. The U.S. and Saudi Arabia retaliated, hitting Tehran-backed militias in the Kurdish part of Iraq near the Black Sea, abruptly ending a days-long lull in hostilities. In the Asian market WTI crude immediately jumped 5% to $83 a barrel.

Walter Russell Mead, a leading conservative expert in geopolitical affairs, called Iran a hedgehog using befuddling tactics to confuse opponents with deals accepted by the moderates then vetoed by the hard-liners; and the U.S. a fox, utilizing decoyed diplomacy and military head-fakes to obscure the state of play. In the end, however, the fox gets the hedgehog after every trick in the book has been played.

This widely held contention is keeping the market sceptical that a major breakthrough is near. In this context, oil traders, with the help of Trump's bravado and reverie announcements, will try to manage as a matter of routine the price of crude between $75 and $95 a barrel because it may take a long time for the stalemate in the ongoing war to play out, given that the democratisation of powerful weapons has allowed Iran to fight back.

With this acknowledgement and understanding, traders, speculators and investors concentrated on an action-packed week loaded with big tech earnings (Microsoft, Meta, Apple, Alphabet, and Amazon), a GDP estimate growth for Q2, the current state of inflation and a crucial interest rate decision from the Fed.

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Blockbuster Revenue:

Big tech (Google, Microsoft, Amazon and Meta) showed the market that it still has formidable earnings power and is capable of defending the largest capital-allocation adventure in corporate history, which is beginning to generate operating leverage and return on invested capital because measurable cloud and advertising revenues are accelerating. While it's true that, up until now, the deployment of about 1.1 trillion dollars into data centres, advanced semiconductors, networking equipment and electricity required to run the machine has killed free cash flows, but demand for computing power is real, cloud backlogs are growing and monetisation inside existing businesses is developing, such that eventually - and, perhaps sooner than the critics believe - the negative growth-gap between capex and revenue will disappear, followed by free-cash-flow margins and contracted demand. In the quarter ended June 2026, for example, Amazon, Apple, Meta, Microsoft, and Alphabet's total revenues rose year-over-year by 20%, 16%, 28%, 18% and 24% respectively. Voila!

Strong Growth and Stubborn Inflation:

The BEA showed that the US economy is showing both remarkable endurance and solid growth, having expanded at an annual rate of 1.5% in Q2, excluding trade and inventories, which is a much better way to judge its underlying strength, amounting to a 3.2% annual pace. Indeed, the Atlanta Fed's GDPNow forecasting model's initial third quarter estimate for real growth is a whopping 5.0%. Meanwhile, the Commerce Department printed a decrease of 0.1% in the PCE price index, reflecting the big June decline in oil prices. Excluding the volatile food and energy categories, the core PCE price index rose only 0.1%. While these new numbers look good, the fact remains that the latter PCE index, a more accurate barometer of the inflation trend, is still 3.3% higher than it was 12 months ago, and 1.3% higher than where it ought to be.

The Risk of Monetary Policy Miscalculation is High:

The Fed held the policy rate steady, even though it's around 60 bps below the so-called neutral rate. Nonetheless, 3 voting officials out of the 12 dissented, advocating for a hike to address persistent inflation stemming from geopolitical tensions, the AI boom and the residual effects of tariff-related increases on input costs. The argument for staying put rests on the view that the labour market is not the source of price pressure, nor on the notion that price increases from higher tariff rates and international oil prices are anything but one-off inflationary shocks that interest rates can do very little to correct, and rather on the realization that the effect of the complexity of AI is unobservable. That said, the abandonment of forward guidance at a time when it was most needed; the squandering of the opportunity to show the Fed's independence from the Administration; and the dodging of questions from reporters during Warsh's press conference pushed the bond vigilantes to take over the role of protector of the realm, driving inflation expectations considerably higher and bringing about a sharp steepening of the yield curve, which in turn savagely sank both the dollar and US stocks.

Put simply, Chairman Warsh agreed that inflation was bad but did nothing about it. The reaction was straightforward and brutal: the 30-year Treasury yield rose to 5.23%, hitting its highest level in 2 decades, and with the future policy and inflation paths becoming harder to anchor, the term premium rose as investors demanded greater compensation for lengthier durations.

The Summer Swoon is Over:

A negative reaction of bond and stock operators to the Fed's refusal to raise interest rates and Warsh's refusal to answer questions, reverberated. Regardless of his suffered credibility as an inflation fighter, the S&P 500 registered a weekly gain of 7 points to close at 7480, up 0.8%. Over the past week, a wave of hedge funds have de-grossed their speculative positions, including "Situational Awareness", in high-flying tech stocks, putting the market on a much better footing to appreciate the profitable, if ironic, benefits of the ongoing inflationary growth regime of the US economy, stemming from rising productivity gains and increases in the money supply, with no recession in sight.

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