The Palos Perspective

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A Critical Week

Last week I wrote: "Thirty years ago, the then Fed Chairman Alan Greenspan introduced the idea that a good way to judge whether stocks were overvalued or undervalued was to compare the 12-month S&P 500 forward earnings yield to the 10-year US Treasury bond yield, where a zero difference was regarded as fair value. On Thursday, the benchmark closed at 7,641, with Yardeni's forward earnings forecast for the next 12 months of $391 per share, generating an earnings yield of 5.12% versus a 4.70% closing yield for 10-year Treasuries.

"Based on these numbers, the S&P 500 is undervalued for as long as 10-year Treasury yields remain below 5.12%. In this connection, 8,300 for the S&P 500 is still a rational prediction. On Friday, the S&P 500 rose 40 points to close at 7,675 on its way to target.

"In this connection, S&P 500 forward earnings per share, which are currently at $400, should progress toward $415 by the end of 2026 and then to $484 by the end of 2027. Assuming that 10-year Treasury yields will range between 4.50% and 5.00%, I think that by the end of this year it is highly probable that the benchmark could touch 8,300 as a minimum."

The week of August 23:

The final days of the summer holidays are usually uneventful. Not this year. The arrangement between Tehran and Muscat to establish a joint shipping corridor, and the dark crossing of millions of barrels of oil through the Persian Gulf, have drained the war premium for crude oil by about $8.00 a barrel, obliging investors to focus their attention on fresh inflation and growth data; Nvidia's fiscal second-quarter earnings and guidance report; and Federal Reserve Chair Kevin Warsh's speech at Jackson Hole, each critical for the market.

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A Rate Hike is Still in Play:

First, the Core PCE index that strips out food and energy, an accurate measure of inflation trends used by the Fed as its main inflation gauge in setting interest rates, rose 3.3% y/y in July, well above the Fed's 2% target.

Second, the U.S. economy grew at a stable annual rate of 1.5% in Q2 but was held down by a big increase in the trade deficit and a slower increase in unsold goods. In fact, real final sales to the private sector that sums up consumer and business spending - a more meaningful measure of economic growth - grew at a very solid annual rate of 4.2%, a number which is expected to reach 4.6% in Q3, according to the Atlanta Fed's GDPNow tracking model.

Interestingly, these two factors were not enough for the CME's FedWatch - a tool that tracks the probabilities of changes to the Federal funds rate - giving only a 36% chance that the monetary authorities would implement a rate hike at the next FOMC meeting in September until Warsh raise the possibility that the Fed's next move could mark an increase, raising the odds to 55%. However, it's a possibility that does not worry me because trimmed-mean and real-time measures put underlying inflation much closer to target, and a meaningful share of the current inflation is entirely supply-driven, a situation that the Fed cannot do much about.

In Nvidia We Trust:

Not only did Nvidia report blockbuster results in the quarter ended July 2026, producing year-over-year revenue increases of 106% and earnings growth of 126%, but it also boosted the extraordinary demand for advanced computer chips that AI will extend into 2028 in a broadening fashion, and forecast 70% revenue growth next fiscal year that would be even higher if supply constraints were less severe.

Wall Street bought into Jensen Huang, the irrepressible CEO of Nvidia, whose narrative, guidance and belief that AI is a once-in-a-generation opportunity stands because he was gambling $279 billion

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on his own predictions in order to secure components for Nvidia's AI chips, while using his balance sheet to get supply-chain commitments with chipmakers, memory providers and security companies. Immediately, traders drove the stock up 8.7% and a bunch of analysts raised earnings expectations, resetting the average price target at $330. The bottom line is that there is no let-up in the AI boom.

Monetarism Is Making a Comeback at the Fed:

At the annual economic policy symposium, hosted by the Federal Reserve Bank of Kansas City, Chairman Kevin Warsh said that monetarism is relevant, and will be considered as an important economic theory, emphasizing the role the monetary base, bank loans and financial markets play in the creation of the money supply, which in turn influences inflation and employment. Presently, the US money supply (M2) is running at an annual rate of 5.4%, an increase sufficient to feed the growth of the economy without affecting the slow downward slope of core inflation

The Short-Term Outlook:

There is way too much unjustifiable pessimism about peak fear, thinking that bond yields are going higher, earnings exuberance is inflated, and AI is not producing the promise of productivity growth. What the pessimists are not embracing is the fact that the characteristics of all major economies have suddenly shifted from a demand-driven regime to a supply-constrained one. In this connection, profits are made where scarcity lies, which translates into higher corporate profit margins and higher corporate revenues, hence higher corporate profits. This explains why analysts keep on raising earnings estimates, with S&P 500 forward operating earnings per share now at $415.

Applying a valuation ratio of 20, an 8,300 year-end target is not only doable, but 7.7% higher than where the benchmark stood at Friday's close (7,711).

P.S. Many bearish strategists believe that the bull market will be arrested by the upcoming U.S. midterm elections. Prediction markets are favoring a Democratic House of Representatives and indicating a 50% chance that the Republicans could lose Congress - both the House and the Senate. The prospects of a Democratic Congress would make affordability and lower inflation more important than lower taxes and regulation could become problematic for the stock market. But perhaps not. History shows that markets can handle political gridlock rather well, especially when a bull market is essentially about productivity. This is exactly what AI has so conveniently brought to the markets, and it has nothing to do with either the Democrats or the Republicans. It's about innovation, entrepreneurs and capital. Put simply, business.

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