The Palos Perspective

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The September Chill

Last week I wrote: "Currently, the year-over-year increase in the money supply is around 5.25% without any increase in the monetary base or a yield curve inversion, suggesting strongly that the economy could easily absorb a 25 bps increase in the Fed's policy rate, given that the latter (3.75%) is 75 bps below the neutral rate (4.50%).

"…Meanwhile, I may have turned temporarily cautious, but am not saying that the bull is dead because I maintain that long-term bond yields have landed. For as long as the price of bonds does not exceed yield of 5.25%, it holds mathematically well that the blistering pace of corporate earnings should ensure the continuation of the bull run."

The week of September 6:

As the dog days of summer turned slowly into a seasonally weak autumn, the macro debate revolved around inflation because the CPI and PPI reports will be critical in determining if the Fed can afford to see through the inflation spurt, given that the stagflation narrative died with the barnburner employment report of the previous week. In this regard, traders entered the week with equities near record highs, without a clearly telegraphed policy rate conclusion, and without any indications that the re-escalating US-Iran conflict was about to abate with no diplomacy in sight, suggesting a long war. As a result, international oil prices surged past $105 a barrel, raising the probability of a rate hike above 85%, which, in turn, spooked the market for four days in a row. By Thursday's closing, the S&P 500 closed down 2.5% from its all-time high of 7,799. Global markets took a breather, however, on Friday, rising 0.9% to 7,657, as the price for Brent oil slipped from a four-month high, easing the immediate heat from the inflation trade, while offering some oxygen to weary speculators after reports that Gulf foreign ministers were preparing to meet Iranian officials in Salalah. Incidentally, the market would have performed much better if Saudi Arabia had not shut down its

East-West pipeline as a precaution after the infrastructure that was attacked several times by Iran and Houthi militia declared a maritime blockade.

Meanwhile, despite rising bond yields and rebounding oil prices, economic prints showed that the labour market was improving and that consumers were showing no sign of retrenching. Indeed, the latest NFIB survey showed that 17% of small businesses planned to increase employment in August, above the historical average of 11%, while Redbook same-store real sales rose by 8.3% y/y during the week of September 4, well above the 2025 average of 5.8%.

Fortunately, this week inflation numbers were mute, reporting no material upside surprise. First, while wholesale inflation may have aligned with expectations, producer prices nonetheless rose by 0.4% in August, accelerating the year-over-year increase to 5.4% while diesel surged 24% in a single month, accounting for more than a third of the increase in the price of goods and for most of the rise in the cost of moving them. Second, consumer inflation held steady at 3.4% in August, but, more importantly, core inflation, which strips out volatile food and energy prices, rose an unrounded 0.29%, albeit slightly, to 2.4% y/y from 2.5% in July.

The Stock Market Outlook:

Despite all the uncertainties pouring cold water on market sentiment, the backdrop for profits remains very robust, the market having absorbed a substantial tightening in the Fed's predictable monetary stance, and the mechanical causation between stock valuations and bond yields having completely played out.

During Q2, S&P 500 earnings per share rose 25%, y/y up from 19.0% during Q1. Analysts are presently projecting 23.6% for Q3 and 27.9% for Q4. As a result of these forecasts, 12-month forward earnings per share are now $401.75 on their way to $418.76 by the end of the year. Moreover, the strength in earnings is broad-based, with 85.9% enjoying positive changes in forward earnings, according to Yardeni Research.

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For all intents and purposes, knee-jerk corrections that practically always follow the Fed's rate hikes have already run their course. For example, yields on two-year Treasury notes have risen exactly 25 bps to 4.57% in the last 2 weeks, about when street talk on Fed policy first began. Put simply, the market has already adjusted to the likelihood of a rate hike next week, placing odds of interest rates staying unchanged through the end of the year at just 3%, per the CME FedWatch tool. In spite of these odds, tightening is expected to remain shallow for now in fully 8 of the 9 developed markets (the exception being Canada).

Interestingly, in the meantime, valuation multiples have contracted to 18.52, giving an earning yield of 5.40% versus 4.95% on 10-year US Treasury notes, which is normal for this business cycle as valuations have fallen back into line. What is particularly noticeable is the fact that this traditional rate transmission has not been very relevant. Viewed another way, the PEG ratio P/E (18.52) divided by Earnings Growth (25.00%) has fallen to 0.74, the lowest reading of its 30-year history. This old cyclical mechanism has not worked as well as history points out because earnings expectations have consistently risen and hyperscalers' spending has not been rate-sensitive. Anthropic's AI model has forecast that if the extraordinary growth in AI expenditures does bring the intended improvement in capacity and the expected increase in usage, it would deliver the productivity needed to boost the N-GDP to $44.4 trillion by 2030, up 35% above the $32.5 trillion registered in Q2/2026.

Moreover, investors should take note that consumers are not at the breaking point from these high energy prices, for the US energy bill as a share of N-GDP is 3.17%, up from 2.65% from a month ago, but below the 4.45% recession tipping point. In this connection, the WTI oil price would have to rise another 35% to $135 a barrel. According to Tom Lee, head of research at Fundstrat, investors are never bearish at the top of a bull market like they are now, suggesting that what lies ahead is a face-ripper rally for stocks.

Disclosure:

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