The Palos Perspective

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A Macro Market View by Hubert Marleau

The Fed Spoke Loud and Clear

Last week I wrote: "Investors are never bearish at the top of a bull market like they are now, thus what lies ahead might be a contrarian face-ripper rally.

"The market has absorbed a substantial tightening in the Fed's predictable monetary stance, suggesting knee-jerk corrections that practically always follow its rate hikes had already run their course, because for all intents and purposes yields on 2-year Treasury notes have risen exactly 25 bps to 4.57% in the last two weeks, about when street talk on Fed policy first began. Moreover, it also felt that the mechanical causation between oil prices and bond yields may have played out, suggesting that with oil at $100 a barrel consumers were not at the breaking point because the US energy bill as a share of N-GDP was 3.17%, up from 2.65% from a month ago, but below the 4.50% recession tipping point."

The Week of September 13:

Stock futures declined on Sunday evening, falling victim to four macro risks without the safety of earnings, which faced a stretch of no quarterly corporate profit reports. First, traders were putting odds of 86% that Kevin Warsh would risk the wrath of President Trump and deliver a rate increase ahead of the Fed's interest rate decision, fearing that it could be the start of a long cycle rather than a pump of the brakes: Fed funds futures were implying two rate hikes of 25 basis points each over the next six months, with four of them over the next twelve. Second, speculators were afraid that instability in the Middle East could widen as a Houthi offensive in Yemen could put a second vital energy corridor in the region under the sway of Iran and its allies, opening a new front. Third, investors were spooked after leaders of big artificial-intelligence companies said advances in AI should be slowed because of safety concerns that could lead to a slowdown in AI model development, thereby crimping potential-earnings-per-share revisions. And fourth, there was plenty of apprehension about November's midterm elections, in which the Republicans could lose both the

House and Senate, eliminating the hope of a political gridlock that usually favours the stock market. By the end of the trading day on Wednesday, the S&P 500 had weakened to 7,552, 3.1% lower than its all-time high, as the Fed in a hawkish manner raised interest rates by 25 basis points to 4.00% and pencilled in another hike before the end of the year to curb inflation, defying President Trump's call to lower them. By the end of the week things got better - oil prices fell, bond prices rose and the benchmark rose to end the week at 7,651.

The Fed's Monetary Stance:

While it is absolutely true that the Fed has removed a dose of accommodation, nonetheless the monetary stance is still helping the financial markets, giving traders newfound practical clarity on Warsh's new principles for the Fed, in which he advocates the importance of stable, low inflation and real economic growth. This suggests that the monetary authorities should concentrate on aggregate demand growth consistency, believing that the latter means 2% for inflation, 2% for growth and 1% for liquidity. In this connection, Fed watchers will need to monitor nominal GDP growth, the performance of the money supply, the gap between the neutral and the policy rate, and the Taylor Rule estimate.

1) Presently, the GDPNow model of the Federal Reserve Bank of Atlanta estimate for real growth in Q3 is 5.1%, while the Federal Reserve Bank of Cleveland is projecting an inflation rate of 3.3%, placing the annual rate of increase in nominal GDP at 8.4% for the period under review. This is a far cry from a policy rate of 3.875%, the midpoint of the 3.75% to 4.00% range.

2) Presently, the US money supply is running at an annual rate of 5.4% higher without any contribution from the Fed's monetary base, which is $215 billion less than it was a year ago, pointing to the fact that money has been created entirely by the banking and financial systems. This makes a lot of sense because credit spreads have already budged since the beginning of the year, Baa bond yields (6.50%) being roughly 150 basis points above 10-year Treasury yields (5.00%)

3) Presently, the new policy rate (3.875%) is 100 bps less than the neutral rate (4.86%), which means that the Federal Funds Rate would have to be 1.00% higher than it is now to effectively define the stance as tight.

4) Presently, the classic Taylor Rule, which uses specific inflation and employment gaps, is prescribing an interest rate estimate of 4.50% to 4.75% as a policy rate, sitting 75 bps above the policy rate, suggesting that tighter monetary settings are warranted.

The Bond Market:

There is no magical round number in the bond market, but 5.25% yield on 10-year Treasury notes is a critical area because it is the point where stocks and bonds tend to move mathematically in the same direction. Why?

First, the 10-year real yield, which strips out expected inflation, is 2.6%, leaving 2.4% for inflation - pretty much where long-term productivity gains and price pressures stand. Second, the consumer spending growth path is bound to fall some over the coming months, because Americans have considerably reduced their personal savings rate to 3.0%, been unable to match inflation with higher wage rates, and been subjected to a $100 billion surge in fuel costs and a 50 bps increase in the cost of money. These additional costs, estimated to be around $300 billion, are small relative to the more than $22.2 trillion in personal-consumption expenditures, thereby not enough to cause a recession, but enough to chip away at some discretionary disposable income. These are factors that may prevent any further increase in real bond yields, which has been the main cause of their recent rise.

Given that the Fed has restored the institution’s inflation-fighting bona fides, bond traders will continue to hold 5-year, 10-year and 30-year inflation expectations in the swap market around 2.3%, which they have most of the time, I strongly suspect that the new trading yield range for 10-year Treasury notes will be 4.75% to 5.25% - this wide perhaps because the new buyers are price-sensitive hedge funds and private investors, but nonetheless a tolerable territory for stock pickers to operate in.

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The Stock Market Outlook:

For sure, the market has been wacky of late. Nonetheless, investors should remain sane and not confuse uncertainty, which is always present, with risk, which is solely a probability function. Aware of this difference, they should favour the likelihood (risk) that the economy is likely to chug along at a more normal pace, but without a recessionary interruption, in this spirit, I'm not changing my 2027 S&P 500 earnings per share forecast of $425, and am still comfortable with this view, considering that Wall Street is currently projecting $420. However, the recent rise in bond yields has made me a bit more cautious, forcing me to adjust the P/E downward to 18.6 times. In this connection, I've reduced my year-end S&P 500 target to 7,925 - still a 3.5% increase from Friday's close - with only three months left to go in 2026. I've also pushed my previous 2026 target of 8,400 to next June.

Disclosure:

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