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The Palos Perspective

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A Macro Market View by Hubert Marleau

Investors are Watching Oil, Geopolitics and AI, but Mostly Growth

Last week I wrote: "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 3 months left to go in 2026. I've also pushed my previous 2026 target of 8,400 to next June."

The week of September 20:

Stock futures climbed on Sunday as oil prices and bond yields eased, soothing nerves and boosting market sentiment ahead of the anxiously scheduled Trump address on geopolitical issues at the UN General Assembly, whose agenda included the presence of the Iranian leader in New York and the powwow between President Trump and his Chinese counterpart, intent on opening two diplomatic channels: one to de-escalate the war in the Middle East and the other to ease trade and AI tensions. First, fighting words from both President Trump, threatening to annihilate Iran if it does not abandon its nuclear program, and President Masoud Pezeshkian, rejecting any pressure from the US to abandon it, make the Middle East conflict intractable, with no possible breakthrough, for Iran is determined not to bow its head or bend at the knee. Yet there is a speck of hope for a truce, as opposed to a deal, because the popularity of the war is very low in the US, and Iran is suffering from an acute economic crisis, a weak currency and high inflation.

Second, the red-carpet treatment of Xi's arrival in Washington was met with pageantry and fanfare, and a lavish state dinner party: an event where schmoozing masked tensions in the hope that a peaceful coexistence would prevail in order to create stability. In this regard, expectations that President Trump would attend the Asia-Pacific Economic Cooperation forum in Shenzhen and that Xi would be present at the G20 in Miami in December rose.

Nonetheless, extravagant pomp camouflaged the existence of geopolitical issues like the trade war, the Iranian war, the technology war and conflicting differences over Taiwan, all underscoring the complex and strained relationship between the two superpowers, thereby yielding few tangible gains for either. The two world leaders left AI where it actually is, and extended the Busan trade war truce to January 2027, while neither walked away from competing for world dominance.

Despite the apparent importance of these two events, oil, AI, and growth remained at the centre of the macro conversation, being the main transmission channel to interest rates. Put simply, they were able to strip away a sizable chunk of inflation pressure and challenge somewhat the recent strengthening in rate hike expectations, allowing the AI trade, alongside energy and minerals, to drive a weekly increase of 1.0% in the S&P 500 to 7,704, without the assistance of the broader market.

The Bond Market:

This week the yield on 10-year Treasury notes surged to 5.15%, a 2-decade high, reflecting expectations for stronger economic growth rather than higher inflation, giving reason for the Fed to risk an October rate hike. The CME Group's FedWatch indicated that the likelihood of such a move had risen to 70%.

The S&P Global Flash U.S. Composite PMI, a survey based on services and manufacturing firms, showed that business is growing at the quickest pace in more than five years, with job growth at its fastest in more than four years, consistent with the economy expanding at an annualised rate of more than 5%. Actually, the Atlanta Fed's economic tracker assumes that growth rose at an annual rate of 5.1% in Q3 2026. This raging pace of business growth is not likely to stop because rising new orders, backlogs and prices received for goods sold usually strain operating capacity that always leads to business capital formation.

The all-important, decisive 5-year swap market supports this argument. Since the street started to ponder whether the Fed would raise its target rate to 4.00% on September 4, real rates rose from 2.14% to 2.68%, mirroring vigorous growth, while inflation expectations fell from 2.41% to 2.36%. Viewed another way, inflation is expected to run at the annual rate of 2.5% in one year's time, slowing to 2.3% down the road.

The Stock Market Outlook:

Stocks have the habit of climbing a wall of worry because investors have been watching analysts raise their earnings expectations considerably faster than stock prices have been rising. At this point, however, their optimism seems rational because the price of Brent crude oil fell below $100 a barrel and 10-year Treasury yields are where they ought to be, between 4.75% and 5.25% and below the 5.50% pressure point where yields escape the neutral zone. The best way to rationalise this assumption is to track the percentage increase between nominal GDP and the 10-year bond yield. Currently, the latter is running at an annual rate of 6.50% versus 5.15%, forming a bullish gap of 135 bps, roughly double the long-term average. Investors should note that the 10-year Treasury yield averaged around 6.50% throughout the 1990s, a decade in which equities still generated substantial positive returns.

Thus, it isn't a miracle that stocks have held up as well as they have. Nonetheless, for now I'm keeping my revised 2026 target of 7,925, since the behaviour of retail traders has been narrower and more tactical. Interestingly, Morgan Stanley's Michael Wilson thinks the mid-term elections will create contradictory political promises, which could temporarily put the near-term risk scenario for the S&P

500 at 7,100, while maintaining his year-end target at 8,100. Put simply, the mid-term election could cause a mid-cycle bull market correction, thereby producing a buying opportunity because the destination remains constructive.

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