To subscribe to our Newsletters, please send an email to info@palos.ca with subject line "Newsletter"

PALOS

The Palos Perspective

Issue **No. 31** | **September 5, 2026**

CONTENTS

A Macro Market View by Hubert Marleau

The Soupe Du Jour Is U.S. Bond Yields

Last week I wrote: "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)."

The week of August 30:

Stocks drifted lower for two days in a row (Monday and Tuesday) to 7,631, 2.0% lower than the 7,799 peak of August 13, in response to a staggering 15% increase in the international price of oil to $95 a barrel. This escalation represents a fast return of the pre-existing geopolitical premium of a Middle East war that won't end because the players are unable to find a way out of the conflict. On the one hand, Iran is in no mood to capitulate and on the other, the US midterm elections have not broken the stint. In this regard, the flaring tensions between the U.S. and Iran exacerbated inflation concerns, which, in turn, acted as the catalyst that drove 10-year bond yields up sharply to 4.80% because of the strong bond/oil correlation.

But this is not the fundamental reason.

The media has attributed this upward move to inflation and soaring term premium - a gauge that measures the extra yield investors demand to hold long-dated bonds. I disagree with their views because they are not true. Firstly, investors' expectations of average annual inflation over a 10-year period have gone nowhere since the Iran war began, hovering steadily around 2.3%. Secondly, the term premium has moved sideways over the past twelve months, suggesting that worries about fiscal sustainability and Fed credibility are not warranted.

The point is that the rise in bond yields is hardly a crisis, for it reflects the restoration of the historically usual 2-3% real interest rates on top of 2-3% inflation, making 4-6% nominal interest rates perfectly normal. This reappearance is related to a structural shift in the supply and demand for capital. Fundamentally, the US government's insatiable demand for capital to fund large fiscal deficit spending is facing fierce competition from an unusually large supply of high-grade corporate bonds stemming from the AI capex boom, as well as the growing attraction of foreign bonds and the sell-off of overseas holdings by Japanese investors to protect the yen against the rising cost of energy. All this is happening at a time when price-sensitive hedge funds, individuals, and investment funds have replaced the central banks as the major buying force.

The Stock Market Outlook:

Intriguingly, the sudden rise in bond yields has occurred without the murderous volatility shocks that usually send shivers through the stock market. The MOVE Index - a tracker of erratic and uncertainty bond movements; the VIX Index - a measure of stock market's expectation of volatility; the SKEW Index - a measure of the possibility of a market crash or a black swan event; and CNN's Fear and Greed Index - a gauge that tracks emotional drivers and market sentiment - have all been remarkably calm. What we've experienced over the past few weeks has been a much-needed orderly adjustment of interest rates. This containment of volatility superficially explains why the S&P 500 ended the week flat at 7,719, 1.0% lower than the all-time high of 7,799, the real reason for which is the resilience of the economy, which, according to the Federal Reserve Bank of Atlanta's GDPNow model, is projecting real GDP growth of no less than 4.7% in Q3. This projection will likely be raised once again to reflect Friday's barnburner jobs report, showing that the US economy had added a whopping 162,000 jobs in August coupled with upward revisions for June and from job losses to gains in July.

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, even though 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.

Disclosure:

 The views and opinions expressed herein are solely those of the author(s) and do not constitute investment advice, and they should not be relied upon as such. The information presented is current as of the date of publication and is subject to change without notice.

This publication may contain certain forward-looking statements that are not guarantees of future performance and future results could be materially different. Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the offering documents before investing. The indicated rates of return are the historical annual compounded total returns including changes in unit value and reinvestment of all distributions and do not take into account sales, redemption, distribution or optional charges or income taxes payable by any unitholder that would have reduced returns. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. Palos Funds are not available for non-Canadian residents.

Palos Funds and certain separately managed account advised by Palos may have investments in the securities discussed or referenced in this publication. These investments are made based on the funds and managed account's investment policies and may change over time as market conditions evolve.

L'infolettre Palos Perspective est un aperçu hebdomadaire de la situation macroéconomique disponible uniquement en anglais. Si vous avez des questions sur l'infolettre ou des demandes générales sur Palos, veuillez nous contacter à info@palos.ca