

# PALOS

## The Palos Perspective

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*A Macro Market View by Hubert Marleau*

## In Profits We Trust

Last week I wrote: "I'm still maintaining my year-end 7,925 target for the S&P 500 on the grounds that the bears have overreacted to the rise in bond yields, creating an opportunity for the bulls to regain the pole position. This promises more winning streaks for three good reasons. First, the Fed's policy rate is about 100 basis points below the neutral rate, suggesting that the monetary stance is still accommodative, creating the availability of credit to feed economic expansion. Second, traders are currently pricing in an 84% chance that policymakers hold rates steady, versus just 31% a week ago. Third, the 12-month forward earnings for the S&P 500 (5.30%) are roughly 3.00% higher than the expected rate of inflation (2.30%), a gap that has held steady all year."

### The Week of October 4:

Stocks were set for a softer open on Monday morning, ahead of the October earnings season, which was expected to beat consensus once again, as a dissatisfied American electorate was headed into the final weeks of the midterm elections campaign and as bullish traders took some of the sting out of the Fed's threat to hike rates.

A record number of S&P 500 companies issued third-quarter forecasts that were better than Wall Street's expectations. According to FactSet, 116 S&P 500 companies had put out earnings-per-share outlooks for the 3rd quarter, of which 72 came in above analysts' estimates, the highest number in 20 years.

Republicans are not buying the polls, yet an AP-NORC poll released a few days ago found 82% of Americans disapprove of Trump's handling of the cost of living, and 73% disapprove of the handling of the economy, heading into the midterm elections, in which the Republicans are battling to keep their majority in both houses of Congress.

Meanwhile, chances of a 25-bps hike in the Fed's policy rate at the October 27-28 FOMC meeting are only 22%, with odds of two hikes by December at just 3%, in part because the economy, in affordability terms, might not be in the best of shape to withstand any interest rate increases.

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### **The Bond Market Tells:**

Efforts to tame the volatility of the 10-year Treasury yield, the most important number in global finance, have failed for two reasons:

- 1) A dramatic change in the composition of bond buyers from insensitive foreign reserve managers to sensitive private investors like hedge funds and carry-trade international players, has occurred, stemming from the weaponizing of the US dollar and out-of-control fiscal spending.
- 2) A huge amount of international money has flowed into the AI trade, virtually making it the new US capital market. The ratio of US net international investment position (NIIP) to the sum of all rest-of-world net creditor nations' NIIP has surged to 80%- a clear gauge of the concentration and allotment of the world's savings that has been sucked into dollar investments.

This has impacted the momentum of the bond market beyond what conventional theory would normally have figured, and it's reflected in the bullish performance of the US dollar, which is perching at 102-ish, its highest level since last spring, even though the near-term hike narrative has become less threatening. Moreover, the US Treasury's 30-year bond auction passed a crucial test of confidence on Thursday, with a bid-to-cover ratio of 2.54 to 1. This helped to calm the fixed-income market, reflecting trust in the government's long-term financial stability, even though the U.S. budget deficit reached \$1.993 trillion in fiscal 2026, 12% above 2025, surpassing 6% of nominal GDP. As a matter of fact, bond traders are betting big on a drop in yields, using call options on long-dated bonds and utilities stocks.

### **The Stock Market Outlook:**

Despite October's gruesome fame, it's actually one of the best months for stock returns. So far, the S&P 500 is green, but not immune to the rising cost of money. The economy has slowed down, but still remains in expansion territory as reflected by the September ISM index, which rose to 54.9 with higher prices received for goods and services, guaranteeing a 3% growth factor for Q3 and beyond and a positive outlook for corporate profits. (Incidentally, the latest third quarter GDP growth estimate, generated by the Atlanta Fed, is 3.6% and 2.8% for Q4.)

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Without much else, a handful of AI mega-cap companies, firing on all cylinders, drove the S&P 500 to a new record high of 7,819 on Tuesday. Suddenly, all hell broke loose on Wednesday and Thursday. Oil prices surged as war was about to resume in Iran, the cost of money rose in response to the FOMC's view that the current monetary policy is not restrictive, there was talk of a potential French debt crisis not being far off for Les Misérables, and the rapid weakening of the yen, combined with rising Japanese interest rates, accelerated the unwinding of the yen-carry trade, sparking fresh selling in both bonds and stocks. Nonetheless, the S&P 500 held up remarkably well for the week as a whole, up 1.0% to close at 7811, despite this collection of forces, which is difficult to dismiss as mere background noise.

What is most important is that the AI boom remains powerful, accelerating the expected year-over-year increase in S&P 500 earnings per share for Q3 to 27%, after registering blockbuster gains of 30% and 25% in Q1 and Q2, respectively, while fabulous earnings are broadening across corporate America. Analysts expect all 11 S&P 500 sectors to deliver positive y/y growth in both revenues (11.6%) and earnings (30.6%). And this phenomenon is not about to stop, according to Yardeni Research, which came out this week with its earnings-per-share prospects for the S&P 500 over the remainder of the decade, projecting \$450 per share in 2028, \$475 in 2029, and \$500 in 2030, which supports a S&P 500 target of 10,000 before the end of 2029. It should be added that the street is more bullish on earnings per share, forecasting \$419 in 2027 and \$489 in 2028. These elevated long-term growth assumptions are enough for me to keep my year-end target of 7,925 and 8,700 for 2027.

Take note that avoiding a recession is critical for a bull market. Truist's economists expect economic growth of 2.2% in 2026 and 2% in 2027.

#### **On Politics:**

George Orwell said: "If people cannot write well, they cannot think well, and if they cannot think well, others will do their thinking for them."

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