

PALOS

The Palos Perspective

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CONTENTS

Slower growth Is Coming	1
Disclaimer	5

A Macro Market View by Hubert Marleau

Slower Growth Is Coming

Last week I wrote: "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."

The Week of September 27:

Stock futures slid Sunday evening, ahead of a crucial, jam-packed docket of inflation prints and labour market releases. President Trump and Iranian leaders traded insults and criticism over the state of their discussions, in a long shot bid to revive negotiations to avoid all-out war in the Middle East, instead triggering higher oil prices, pushing bond traders to lower bond prices.

A Macro Market View by Hubert Marleau

However, the geopolitical environment changed abruptly as the oil markets found ways to circumvent difficulties in the Persian Gulf and the Red Sea through remarkable adaptations: tankers are moving, exports have recovered and supply routes are being improvised, while the threat of sanctions and the pressure campaign by the US have left Iranian vessels adrift in Asian waters. The bottom line is that the Strait is effectively wide open, suggesting that oil prices have a lot to do with market psychology shaped by social media. The point is that 12-month futures are currently discounting \$90.00 oil prices by as much as \$15.00 a barrel.

This change of events has calmed down the bond market somewhat, thereby allowing the latest calendar of economic data to signal directly that the booming 5% annual growth pace of the economy should slow down, but not enough to excite recessionary concerns, as illustrated by Micron's exceptional fourth-quarter's earnings and revenue statement and spending guidance for fiscal 2027, which were well above consensus, reinforcing the case that the AI buildout still has plenty of runway. Indeed, the latest GDPNow estimate for real GDP growth in Q3 is now 3.7%, down from 5.0% on September 25, which is attributable to the widening trade deficit. In this context:

First, the Conference Board reported on Tuesday that Americans were deeply dissatisfied with the economy, citing disruptive politics, the employment situation, trade policies, the war with Iran and the affordability crisis as the reasons why the consumer confidence index had collapsed by 6.7 points to 81.9, a 12-year Covid low.

Second, the Bureau of Labor Statistics' JOLTS for August showed a 256,000 drop in job openings, a 5-month low (and close to a 10-year low), while hiring edged up by 46,000 and layoffs fell by only 61,000, a historically low number. The labour market is fine, but clearly in a "low hire, low fire" mode, which makes workers reluctant to leave their current jobs.

Third, the Redbook indicated that same-store sales had risen 8.2% y/y during the week ended September 25, remaining above the 2025 average of 5.8%, a situation that should last because labour demand, using the sum of employment plus job openings, has exceeded the labour force for four straight months, suggesting that wage growth, which rose 4.1% in August, is bound to keep consumer spending healthy.

A Macro Market View by Hubert Marleau

Fourth, on Wednesday, the Bureau of Economic Analysis reported that closely watched the Fed's preferred inflation measure being a time-tested accurate barometer of inflation trends, had risen 0.2% in August, cooler than expected, keeping the y/y unchanged at 3.0%, right at the top of the Fed's zone of tolerance. ADP, meanwhile, reported that hiring had improved, but without breadth, supporting the argument of New York Fed's John Williams, and the Federal Reserve's Vice-Chairs Philip Jefferson and Michelle Bowman, that there may be no need to raise the cost of money at this time, potentially preferring to be patient until December before acting.

Fifth, the natural rate of growth in monthly employment is 55,000. As it turns out, nonfarm payrolls grew by only 29,000 in September, raising the unemployment rate to 4.2%, far short of consensus expectations of 88,000. Moreover, the BLS' two-month Payroll Net Revision trimmed 60,000 from the previously estimated tally for July and August.

The Bond Market Tells:

What worries the street right now is whether the significant rise in long-term bond yields has come to a full stop. I believe that it has.

The 10-year Treasury yield, the global benchmark, rose 0.87 percentage points in the September quarter, the highest quarterly gain in 30 years. Interestingly, this increase had nothing to do with inflation expectations or the term premium, which have hardly budged, suggesting that the US bond market has defied gravity, focusing instead on strong growth prospects, thereby explaining why US long-term bond yields (5.25%) are on average roughly 150 bps higher than comparative yields (3.75%) in other major industrial economies.

Additionally, the US dollar has been relatively stable throughout the piece, proving that the dollar-debasement funeral is again being postponed. In Bloomberg's John Authers words: "There's no obvious reason to price in what hasn't happened yet."

A Macro Market View by Hubert Marleau

Consequently, the next phase of this cycle will depend on whether the steep decline in the personal savings rate, and slower speed of the money supply growth, will keep the US's own growth pattern in check, ending the course of rising government bond yields. I think it will, making government bonds look cheap.

The Stock Market Outlook:

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, promising 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 S&P 500 was up 0.7% on Friday, closing at 7,723.

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