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CONTENTS

We've Just Had a Crucial Tech Wreck 1

Disclaimer 5

A Macro Market View by Hubert Marleau

We've Just Had a Crucial Tech Wreck

Last week I wrote: "The stock market has entered a complicated phase, as the neocloud growth model is a serious enigma for investors. However, market auto-stabilizers like lower Treasury yields, hope for softer oil prices, and monetary policy certainty might be enough for traders to absorb the risk of another burst of disappointment. Indeed, the tech downturn may have already ended because long positions held by momentum tech traders and commodity advisors, who are under tight risk limits and constituted the bulk of the market turnover, have been unwound, while high demand for computing power and the tech sector's financing surplus should mitigate potential disruptions. In the view of JPMorgan, demand for compute is so high that the passing of financing costs through to end customers is very possible and the tech sector overall is running a financing surplus of around $400 billion in 2027 because cash flows are exceeding capex. Meanwhile, according to UBS, the equity rally will continue into 2027."

The Economic Week of October 25:

US stocks nudged up in cautious trading on Sunday evening, ahead of 180 S&P 500 companies reporting Q3 earnings, as Anthropic, Alphabet, Microsoft, SK Hynix, Intel and Amazon stepped into the spotlight to inform Wall Street if the 3-week pullback of 2.5% caused by a tech wreck was just a healthy cut in an overextended AI trade or bad economics for buying growth. Investors were additionally wondering what the FOMC's 2-day meeting would have to say, given that it was expected to sit tight, with oil back above $100 a barrel and 5-year Treasury yields below 5.00%; whether the Commerce Department's first GDP annual growth estimate of Q3 would be as robust as the 3.3% predicted by the Atlanta Fed; and whether a Democratic Congress was indeed a worrisome fundamental shift as some economists assumed.

Wall Street got some of these points of contention answered this week.

A Macro Market View by Hubert Marleau

AI is Profitable: Anthropic's IPO filing revealed strong profitability, along with SpaceX, Meta Platform, CoreWeave, Microsoft, and Amazon, which all beat street revenue expectations hands down, suggesting convincingly that AI monetisation was not as challenging as feared by non-lovers, squashing fears that debt and equity investors would hold the bag as optimism unwound, and creating a feeling that the hyperscalers were about to win a potential $40 trillion technology arms race. The bottom line is that cloud revenue supports cloud capex.

The Fed's Judicious Pre-Election Pause: The monetary officials did exactly what the market expected, holding their interest rate target at 3.75%-4%, even though economic and monetary conditions dictated that they should have raised it by 25 bps. In my judgement, the decision was politically motivated. Under President Trump, monetary policy has been politically sensitive. In this connection, raising rates right before an election would have been a mug's game that would have certainly enraged Trump and the entire Republican Party. Better to wait for a December increase when political passion should have cooled. According to the FedWatch tool, the odds of a rate hike in December are at 85%, with two more bumps likely in the first half of 2027.

The Economy is Indeed Powerful: The US Commerce Department reported that the economy grew at an annual rate of 3.4% in Q3 with remarkable momentum despite high energy prices, supercharged by a massive increase in productivity, stemming from an intensive use of capital equipment, a surge in entrepreneurship, and a broadening of AI applications across many industries, as Kevin Warsh testified at the October FOMC meeting. In fact, the economy would have been stronger still without mass deportation and tariffs. The latest batch of economic prints were all bullish surprises forcing the Atlanta Fed's economic trackers to lift their estimated annual growth rate to 3.2% in Q4 while the NY Fed projected 2.9%. This explains why the consumer confidence index jumped to 91 in October, surpassing expectations of 81: a huge beat that marked the highest level since June.

Crude Price tops $110: Oil prices are carrying a war premium between $15 and $25 a barrel, in spite of the fact that oil is gushing out of the Persian Gulf. What is needed is an end to the U.S.-Iran conflict, removal of attacks on shipping routes and a restocking of oil inventories. There are political, economic and cost reasons to resolve the war premium before the energy bill as a percentage of US nominal GDP crosses 3.50% for any length of time. Presently the ratio stands at 3.17%. Its usual ratio

A Macro Market View by Hubert Marleau

is around 2.0%. Nonetheless, investors should note that it appears higher energy costs have not had their normal negative effect on real growth because productivity and wealth gains have effectively camouflaged it.

A Blue Wave is Inevitable: Whether this expected outbreak will translate into a large Democratic majority in both the House and the Senate has raised many unanswered questions that have created some market concerns about how tax, debt, geopolitical, social and tariff issues are going to be dealt with. While these topics are important, history shows that they usually go away in an election aftermath, especially when there is gridlock under a lame duck President.

The Bond Market Tells:

In spite of the drama of last week's tech wreck and the Fed's hawkish pause, the bond market has not suggested anything different than it did in the previous one: the neutral rate dipped to 4.72%, inflationary expectations were stable around 2.35%, and real rates nudged down to 2.58%. Miraculously, Baa credit spreads have hardly budged, suggesting that deterioration in the corporate bond market was totally concentrated in the wobbly tech debt and junk sections. Indeed, the gap between B and CCC credit spreads is nearly 8%, suggesting that fringe junk bond players, traders and investors were forced to sell into an illiquid market.

The Stock Market Outlook:

The S&P 500 registered a small weekly fall of only 0.6%, in spite of a $900 billion rout over soaring AI spending, which has eaten all the hyperscalers' cash flow and left them burning cash, with Microsoft a notable outlier, along with fears that Democratic control of Congress could hamper the current freewheeling approach of President Trump and his Republican-controlled Senate. This feels like a knee-jerk reaction, for they have not missed estimates, haven grown by leaps and bounds, and have not been able to bring in new data centres fast enough to satisfy demand for AI. Nomura's Charlie McElligott argued that hedge funds entered the tech earnings season with exceptionally high

A Macro Market View by Hubert Marleau

exposure to the Magnificent 7, leaving little tolerance to drawdowns, estimating that $34.6 billion in leveraged ETFs was sold on Friday alone.

If indeed dealers, volatility-control models and margin accounts directly caused the tech wreck, then I'm encouraged, from a contrarian point of view, to think that numerous retail tech lovers and traders, who have gone into cash over the past few weeks, will soon step in.

The bull market is not finished, according to Morgan Stanley, who have remained upbeat on the broader stock market, with an S&P 500 year-end target of 8,000 and 8,300 as a base case within 12 months.

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