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The Palos Perspective

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The Inflation Reckoning

Last week I wrote: "While I cannot be certain what will happen next, there are good chances for optimism around a quicker end to the war, a rollback of tariffs, and a stop to massive deportations. Moreover, polls show that people are not against data centres per se, but their unregulated spread. The AI buildout has not died. It will be welcomed by jurisdictions that may want the tax revenues that come with it. Indeed, it can be built elsewhere. For example, Canada could be interested on a quid pro quo basis. This is why I believe that the selloff, which pushed the Nasdaq into correction territory below its 200-day moving average, represents a buying opportunity for I'm sticking with my 7,850 year-end S&P 500 forecast."

The Week of November 8:

Stock futures were wobbling on Sunday night after a violent week of ups and downs over future capex spending on AI data centres under the incoming Democratic-controlled Congress and Democratic-led state governments. By Monday morning, they were trading on a much firmer footing on hopes that the Cleveland Fed's milder forecast for inflation would materialise. It did not. Consumer inflation had run amok. Fortunately, CoreWeave's extraordinary earnings report gave the AI trade a second wind, despite Jensen Huang, CEO of Nvidia, falling from grace for having had an expensive romantic relationship with a suspected Chinese spy. By Thursday, the media changed the narrative, insisting that Huang's extramarital affair might have put the Central Bank of Nvidia in jeopardy and the centre of the AI boom at risk.

What's Happening in the Economy:

On Tuesday, the BLS reported that in October, consumer prices had risen 0.4%, with a 0.3% increase, excluding volatile food and energy, extending the trail of headstrong inflation. Over the past three months, prices have now increased at a 5.7% annualised rate, 4.0% higher than a year ago and significantly above the Fed's 2% target. In this connection, a December half-point rate hike or an

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increase through back-to-back rate hikes of 25 bps in December and January are definitely on the table.

The Bond Market Tells:

The Treasury market, meanwhile, underwent an abrupt reversal that has more to do with questions about how much money borrowers will need to finance their spending; whether corporations will be able to service their obligations; how governments will fund certain sectors; whether corporate borrowers will be able to service their obligations; and indeed whether the government can finance their own spending without tax increases. It was about another uncomfortable CPI and PPI print, both showing that inflation was not confined to a handful of trouble spots, neither offering any evidence of softening inflation.

Thus, while all eyes were on Nvidia, 10-year Treasury yields pushed through 5.15%, reflecting higher oil prices as President Trump dismissed the need for an Iran deal, the 2-year Treasury yield rose to 4.88%, reflecting the Fed's inclination to keep its foot on the monetary brake, and the dollar index rose abruptly to 103.19, reflecting the sell-off in commodity prices. The CME FedWatch saw a December hike as a virtual certainty, with two additional 25 bps increases by June.

The Stock Market Outlook:

Despite all of this brouhaha about sticky inflation, the scary height of bond yields, the Fedspeak's hawkish rhetoric, and turmoil over Nvidia, the S&P 500 still managed to rise 2% to close at 7,510 on Friday. The impressive resilience of world growth has convinced the strategists at Goldman Sachs to predict that the S&P 500 will advance 14% in 2027 after a sell-off in the biggest technology companies left their valuations historically cheap, given that the AI investment boom will still have another powerful year ahead. The New York Fed's economic tracker is predicting an annual growth rate of 2.9% in Q4.

P.S. There will be no commentaries for the next two weeks as I take some time to travel and recharge.

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