FROM THE DESK OF THE
CHIEF INVESTMENT STRATEGIST

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# Round and Round

At this week's meeting the Fed left the funds rate alone and three of the 12 voters dissented. Chairman Warsh then spent most of an hour explaining why doing nothing was not the same as doing nothing.

One line stuck with us. "Market participants are learning to play the ball, not the referee." He was describing what happens when a central bank stops publishing its own view of where rates are headed: investors quit trading the Fed's commentary and start trading the data. He called it a change for the better.

It also describes the market more broadly. Three of the shortcuts investors lean on have stopped working at the same time. The Fed has withdrawn its forward guidance. This administration will not disclose its strategy in Iran, on the defensible grounds that you do not hand your adversary your plan. And the S&P 500, usually decent shorthand for what is happening to stocks, no longer describes what is happening underneath it.

Fewer shortcuts, more volatility and a good deal more work for investors.

## Hawkish without hiking

The Fed did not raise rates, but that may not be as friendly an outcome as it appears.

Between the June and July meetings, US Treasury yields rose across the curve, with the 30-year reaching a 19-year high[1]. Warsh put the size of that move in roughly the top decile of the past two decades and, notably, welcomed it. Financial conditions tightened without the committee lifting a finger.

He suggested his response depends more on the direction of underlying inflation than on any particular level of the policy rate. By that logic a bond market doing the tightening on its own is a real substitute for Fed action, and he said as much: market pricing is "certainly not saying all clear," but it is "working in concert to keep us on our toes."

The long end of the Treasury market sold off while short-dated Treasuries rallied, steepening the yield curve. Curves usually steepen that way when investors think a central bank is behind the inflation problem and will have to make up ground later. Late does not mean never. Late can mean larger, later.

A steeper curve is also not especially good for the economy, because long rates set the price of borrowing for houses and capital spending. Mortgage rates are creeping back toward 6.7%[2]. But it is possible that some of this is the point. If you would rather not raise the policy rate into a war and a capital spending boom you do not fully understand, letting the bond market do the work is a reasonable second choice.

The odds of a September policy rate increase have come down since the meeting. We would not yet celebrate that. Warsh has borrowed credibility against a hike not yet made, and he has to be right about the inflation path for it to work. He was clear that he is not finished, using a phrase we liked: this is "a period of watchful thinking, not watchful waiting." There is risk it is the beginning of the tightening rather than the end.

When the referee stops commenting, every print matters more. As Warsh put it, with some justification, "the historic problem with data dependence is the data and the dependence."

Source: [1]fred.stlouisfed.org, [2]factset.com, [3]cboe.com

### What the volatility market is telling us

One good piece of evidence for the stress underneath a calm-looking index goes almost unwatched outside options desks.

The VIX, the widely quoted measure of expected volatility for the S&P 500 as a whole, fell to 15 earlier this month and now sits near 21[2]. The VIXEQ, which measures expected volatility in the individual stocks inside the index rather than in the index itself, reached almost 51 and now sits near 48[3].

The gap between them tells you how much investors expect those stocks to move together. Wide means low correlation, stocks going their own way on their own news. Narrow means everything moving at once, which is what a macro-driven selloff looks like.

The spread hit nearly 34 points earlier this summer and is 27 now[3], against a 15-year average of roughly 14. That implies average correlation of about 19%, well below normal. Individual stocks are expected to move a great deal; they are just expected to move in different directions, which keeps the index quiet. And since the VIXEQ is weighted by market value, most of that expected movement sits in the largest companies.

The catch is that correlation can rise quickly, and index volatility rises with it even if nothing else changes. That has generally been a sign of stress. We would rather see this gap close slowly.

### A tale of two markets

July's damage was severe if you owned what everyone else owned, and almost invisible if you did not.

Many crowded positions have seen major losses for the month. The US momentum factor, which tracks the stocks with periodic rising prices, is down 15.6%.[2] The Nasdaq 100 is off about 10%[2].

Now the other market. The equal-weighted S&P 500, which treats the smallest company in the index the same as the largest, is up on the month. Health care, consumer staples, financials, and energy are having a good July.

That combination does not describe an economy rolling over. Defensive sectors, financials and energy do not all work at once in a growth scare. It describes a crowded set of positions being unwound in a market that is otherwise functioning. We would hold that view loosely, since an unwind this size can turn into something more if it runs long enough to force selling of things people actually wanted to keep. So far, it has not.

### The earnings almost nobody is discussing

Underneath the noise, the second quarter has been unusually good.

Analysts expected roughly 23% year-over-year earnings growth for the S&P 500 when the quarter began[2]. The current figure is near 38%[2]. A large piece of that came from Alphabet, which booked a sizable gain on an investment markup, and gains of that kind do not repeat. Strip Alphabet out and the consensus estimates for the quarter still grew about 26%[2]. That is real growth.

The revisions matter more than the level. Full-year 2026 earnings estimates now stand at $342.52, against $310.84 at the start of the year. The 2027 figure sits at $400.97, up from $357.83. Those are large upward moves for seven months' work, and they explain why the market has absorbed higher long rates without much complaint [2].

Valuation is becoming less of an obstacle. The forward price-to-earnings multiple is about 19.5 times, modestly above the ten-year average of 19.0 and down from more than 21 earlier this year[2].

So why does the market feel so unstable? The answer is where the growth is concentrated. For 2026, energy earnings are expected to grow 70%, communication services 50%, and information technology 49%, according

Source: [1]fred.stlouisfed.org, [2]factset.com, [3]cboe.com

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to FactSet[2]. Those three sectors are also where many pieces of unresolved news live: the Iran conflict, the scale and payoff of infrastructure spending, and the risk that open-source models compress the economics of the AI build-out.

Investors are being asked to underwrite the fastest growth in the index and the largest uncertainties in the world, in the same handful of securities. Volatile trading is what that produces. It is not evidence that something is broken.

## Round and Round

Which brings us back to Iran, where we and everyone else have become a broken record. It remains the risk.

The war is in its sixth month. The pattern since spring has been a pause, then fighting, then a pause, then fighting; tough talk, soft talk, tough talk, soft talk. A June memorandum set a 60-day negotiating window and lasted three weeks. The most recent halt in strikes lasted five days. The issues, including enrichment, the Strait of Hormuz, and reparations, have not moved since April. The scenery keeps changing and the scene does not.

Brent is near $90, roughly 25% above where it started the month [2]. That is the transmission line. Oil is an inflation input, inflation is what Warsh says will determine his next move, and so the Fed's path and the Strait of Hormuz are now wired together in a way neither party chose.

The rhetoric is becoming less useful as a guide. Negotiators on both sides have described themselves as inches away since April, and the tough talk and the soft talk have alternated often enough that nobody is sure what to believe. Investors have largely stopped trading it, which is probably the right instinct.

A settlement still looks likely to us, eventually. The costs on both sides keep mounting, and neither party has an obvious way to improve its position by continuing. But we cannot put a date on it, and that is the problem for markets. Nobody takes the risk premium out of oil on a probability. They need to see something signed.

## Where this leaves us

Less is being explained, so more has to be worked out. More volatility in bonds and stocks is likely.

We also think it is a better market. When prices move on commentary, everyone owns the same handful of things. When they move on results, the work pays. Earnings are growing faster than almost anyone forecast in January, and the multiple is only modestly above its ten-year average. That is a reasonable place to start from, although it is not a promise. Concentrated growth, an unresolved war, and a bond market still repricing can undo a good start quickly.

Volatility and risk are not the same thing. July was painful if you owned what the crowd owned, and close to uneventful if you did not.

Play the ball. There is more of the game worth watching than there has been in a while.

Source: [1]fred.stlouisfed.org, [2]factset.com, [3]cboe.com

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