

Good morning,

What's in this week's Report:

- The Two Specific Reasons Stocks Dropped Last Week
- Weekly Market Preview: Will Oil Keep Rising? (The Sooner the Strait of Hormuz Reopens, the Better)
- Weekly Economic Cheat Sheet: CPI in Focus on Wednesday (Markets Need a Tame Number)
- The Key Variable to Watch in the U.S./Iran Conflict

Futures are sharply lower amid surging oil prices (oil is above \$100/bbl) as there has been no progress on a ceasefire between the U.S. and Iran or on reopening the Strait of Hormuz.

Iran selected the Ayatollah's son, Mojtaba Khamenei, as supreme leader, confirming that the hardliners are still in charge and reducing hopes of a near-term ceasefire.

Iran damaged a desalination plant in Bahrain, continuing attacks on a neighbor's energy and general infrastructure (this is contributing to the rise in oil).

Today, there are no economic reports so that the focus will remain squarely on Iran. Any headlines that imply de-escalation should trigger a solid rebound from the early lows, while any new attacks on energy infrastructure will boost oil prices and weigh on stocks.

Market	Level	Change	% Change
S&P 500 Futures	6,671.50	-72.50	-1.08%
U.S. Dollar (DXY)	99.31	0.32	0.32%
Gold	5,110.24	-48.46	-0.94%
WTI	102.89	11.99	13.19%
10 Year	4.171%	0.038	0.92%

## Stocks

### **Last Week (Needed Context as We Start a New Week)**

Historically elevated geopolitical tensions between the U.S. and Iran, paired with mixed global economic data that rekindled stagflation fears, left volatility elevated as most major equity benchmarks fell towards, or to, YTD lows. The S&P 500 ended the week down 1.99%.

Volatility gripped markets from the start last Monday as oil futures opened the electronic session "limit up" amid the material escalation in tensions between the U.S. and Iran, including news that a U.S. missile strike killed Iran's Supreme Leader Khamenei. The market stabilized in morning trade; however, as dip-buyers stepped in after the February ISM Manufacturing PMI topped estimates, easing growth worries. The S&P 500 recovered to close higher by an incremental 0.04%.

Monday's intraday rebound was more than erased on Tuesday as a continued surge in oil, "warming" EU inflation data, and no end in sight for the U.S.-Iran military conflict in the wake of an Iranian attack on the U.S. embassy in Riyadh, Saudi Arabia. Combined, those developments sent stocks tumbling with the S&P 500 testing the 6,700 mark before dip-buyers returned amid emerging hopes the geopolitical tensions would subside sooner than feared. The S&P 500 ended the day down 0.94%.

The relief rally off the early Tuesday lows continued on Wednesday, with stocks testing their early-week highs as U.S. military officials announced progress in controlling airspace and ground locations around Iran, which bolstered hopes for a ceasefire. A modest ADP payrolls print and a stronger-than-expected ISM Services Index, paired with news that OpenAI's newest model would have "extreme reasoning" capabilities, all helped stocks rebound, with the S&P 500 closing higher by 0.78%

Volatility picked up again on Thursday as rising geopolitical angst overshadowed stronger labor market data and strong AI-sector earnings from AVGO. Multiple "warm" U.S. inflation data points kept selling pressure on into the afternoon, before less-aggressive rhetoric from both U.S. and Iranian leadership saw stocks bounce into the close. The S&P 500 still fell 0.56%.

Stocks continued to fall on Friday as the BLS reported a surprise drop in non-farm payrolls in February (-92K vs. E: +60K). The print was the second-largest monthly job loss in over a year, and the BLS's uptick in wage growth led to a sudden resurgence of stagflation fears that roiled markets. The S&P 500 largely stabilized near 6,750 before news broke in the afternoon that OpenAI and ORCL had canceled plans to expand a sizeable AI data center in Texas, which further pressured tech and dragged the S&P 500 towards the week's lows, with the index falling 1.33%.

#### Two Specific Reasons Stocks Dropped Last Week

Stocks dropped last week in response to a spike in the price of oil, which surged to a multi-year high thanks to 1) The effective closure of the Strait of Hormuz and 2) Iranian attacks on neighbors' energy infrastructure (think tankers, shipping/transfer equipment, etc.) and that caused investor fears to spike thinking that the war could cause a downturn in stocks. So, I wanted to address 1) the latest events and 2) what type of decline we can expect if global oil production is materially disrupted for numerous weeks.

First, it's important to remember that amid all the noise surrounding the U.S./Iran war, the key market driver is global oil production and transport. Specifically, the "war" isn't making stocks drop. Instead, it's those two specific events, the inability of ships to transit the Strait of Hormuz and Iranian attacks on energy infrastructure in neighboring countries, that hit markets.

Understanding that distinction is important because 1) If both of those events stop, and even if the war continues, then stocks will rebound. And there are hints that progress is being made here. Specifically, over the weekend, Iranian President Pezeshkian apologized for Iranian strikes on neighboring countries, while also saying that the Strait of Hormuz was safe to transit for non-U.S. and non-Israeli tankers and cargo ships.

However, reflecting the chaotic situation, those comments were refuted by other Iranian officials (demonstrating the chaos in leadership in the country, which is its own problem), and on Sunday, the Iranian Revolutionary Guard attacked a desalination plant in Bahrain, showing that attacks on neighboring infrastructure haven't stopped.

Ultimately, what this means for investors is that it's still unlikely the conflict raises energy prices to levels that, by itself, would end this stock rally. However, clearly, hopes that this conflict would be quick and limited are diminishing.

The longer the Strait of Hormuz stays closed and the longer Iran attacks neighboring infrastructure, the more of a weight this will put on stocks. If markets begin to think that oil prices will rise to, or above, \$100/bbl for several weeks, or even months, then that will hit stocks, and the recent lows near 6,720 in the S&P 500 will be broken and, more importantly, I'd expect the November lows of 6,534 will be tested. A decline to that level would represent a 7% drop from the 2025 highs, and that is a reasonable expectation if markets determine oil will stay elevated for weeks.

For stocks to drop far below that level, however, we'd need to see 1) Belief that oil prices are higher longer, 2) AI Anxiety continues to rise, and/or 3) Trouble in private credit continues to grow.

Point being, barring something extreme, it's unlikely that rising oil prices will end this bull market, although the chances of a solid pullback (5%-10%) are rising the longer oil stays elevated.

## Economic Data (What You Need to Know in Plain English)

### Last Week

Economic data last week mostly pointed towards continued solid economic growth, although Friday's jobs report provided a substantial negative surprise that offset the rest of the positive data.

Friday's jobs report was decidedly negative, showing -92k jobs lost vs. (E) +50k. That's the worst level since December, and it caused a spike in concerns that the labor market is weakening. Looking at the report, jobs adds badly missed, the unemployment rate rose to 4.4% vs. (E) 4.3%, while wages slightly beat estimates at 3.8% y/y vs. (E) 3.7%. The jobs report caused an immediate negative reaction in stocks, as futures fell further on Friday morning, while yields dropped amid slowdown concerns.

However, while the jobs report was bad, it needs to be taken with a grain of salt. First, none of the other labor market indicators is showing weakness. Claims remain low, ADP isn't collapsing, and JOLTS and Challenger layoffs aren't sustainably weaker. Even the employment indices in the ISM PMIs are stable. Point being, the monthly jobs report appears to be an outlier. Second, there was a strike in January that cut 31k jobs, which ended (so the actual number was -61k). Third, the severe winter weather in late January could have impacted the data.

Bottom line: this was not a good report, but for now, it should be considered an outlier. Although it does reinforce the need to continue watching the labor market closely, if other readings show similar weakness, concerns about economic growth will rise, and that's not what this market needs right now!

The other notable report on Friday was Retail Sales, which beat expectations and showed continued resilient consumer spending. Headline retail sales were slightly better than expected at -0.2% vs. (E) -0.3%, but the more important "Control" group (retail sales less gas, autos, and building materials) rose 0.3% vs. (E) 0.0%, and there was a positive revision to the December data, to flat from -0.1%. Bottom line, there was nothing in consumer spending in January that implies it is slowing (and that's good for the economy).

Looking further at growth, the two big reports from last week, the ISM Manufacturing and Services PMI, were both stronger than expected and implied no slowing of momentum (a good thing). The ISM Manufacturing PMI increased to 52.4 vs. (E) 51.7 (comfortably above 50 for the first time in years), while the ISM Services PMI (which is the more

important of the two because it reflects the majority of economic activity) leapt to 56.1 vs. (E) 53.5. That's the highest levels since 2022!

Additionally, details of both reports were also positive, as New Orders, the leading indicator in each report, rose to 55.8 in manufacturing and 58.6 in services. Bottom line, the best look at economic activity in February showed acceleration, and that's positive right now, because the price data wasn't enough to push back on rate cuts, and given rising headwinds on stocks (Iran, AI Anxiety), growth is now an important support for markets.

Speaking of the price data, the clear disappointment from the price standpoint last week was the ISM Manufacturing Price Index, which surged to 70.5 from 60.6. That fueled fears of an inflation rebound early last week, though it was thankfully countered by a better-than-expected ISM Services Prices Paid Index, which fell to 63.0 from 66.6.

### **Important Economic Data This Week**

The key report this week is Wednesday's CPI, and given the recent uptick in some inflation metrics, markets will want to see an in-line or better-than-expected number; otherwise, headwinds will increase on stocks and bonds. Last month's Core CPI rose 2.5% y/y, slightly more than expected, and markets want to see that number stay flat or, ideally, drift lower towards the 2.0% target. This is important because if CPI starts to move towards 3.0%, especially given what's happening with commodity prices in the wake of the U.S./Iran war, expectations for a June/July rate cut will drop, and that will, in turn, add upward pressure to yields (which isn't needed now).

Bottom line, a Core CPI reading that moves closer to 2.0% will be welcomed by stocks and imply the economy remains at least in a partially "Goldilocks" phase with solid growth and stable inflation. That would be a needed positive for stocks, not that it will stop the geopolitical volatility in the short term, but it would help generally support stocks and limit downside.

## **Special Reports and Editorial**

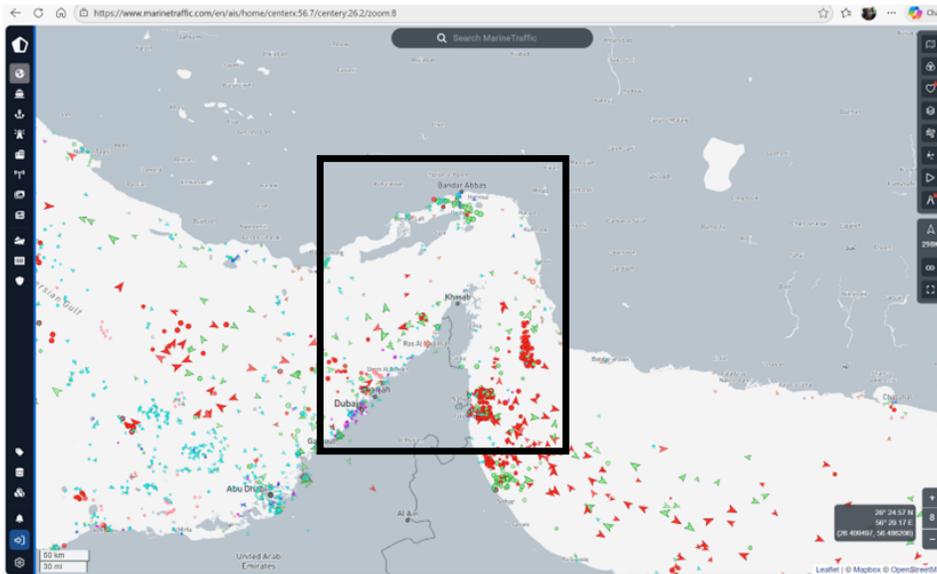
### **The Key Variable to Watch in the U.S./Iran Conflict**

Over the 30+ years I've produced newsletters, I've covered numerous geopolitical conflicts, and for each one, I've stressed the same point: While people care about politics and collateral damage, markets only view these conflicts through the prism of oil. And the reality is that if the conflict makes oil prices sustainably higher, it'll hit markets hard. If it doesn't, regardless of what else is happening, then the conflict will not impact markets beyond the very short term.

For the U.S./Iran conflict, it is no different. Because of that, the Strait of Hormuz is now the critical variable to watch as early as possible to determine whether this conflict could put sustainable downward pressure on stocks.

The impact of oil prices on markets is clear: Sustainably higher oil prices (above \$80/bbl) mean 1) Increased inflation risks (bad for markets because it means higher rates), 2) Higher transportation costs (bad for markets because it decreases margins, which negatively impacts corporate earnings), and 3) Reduced consumer spending (because costs of energy-driven essentials such as gasoline and electricity go up, which eat away at disposable income).

All of those events would be negative for stocks, as higher rates reduce the market multiple and margin pressure reduces expected earnings growth.



*The black box is the Strait of Hormuz and traffic through it has been minimal since the start of the conflict.*

However, that would only occur if oil prices remained sustainably high for several weeks or more. That makes the Strait of Hormuz very important. Iran only produces about 3 million barrels of oil per day, less than 5% of global supply. And it's entangled in widespread sanctions that make selling that oil difficult. Point being, the oil market won't really care if Iranian production is offline for a long time.

However, nearly 20 million barrels of oil pass through the Strait of Hormuz each day. If that flow is materially interrupted and reduced for an extended period (think more than a week with no end in sight), oil prices will rise substantially.

On March 1 (Sunday), only 2.8 million barrels of oil transited the Strait with many tankers dropping anchor to assess the situation. The sooner they can transit the Strait, the better for markets. Importantly, the U.S. knows the potential negative impact of the extended closure of the Strait, and that's one of the main reasons the U.S. aggressively targeted the Iranian Navy (to diminish its capacity to actually close the Strait).

Additionally, oil transit doesn't have to return to pre-conflict levels for the market to be "ok" with it, because there are pipelines that can move oil to the Red Sea through Saudi Arabia, which could help somewhat offset the load. Bottom line, the conflict matters to the market because of oil, and if oil prices sustainably rise above \$80/bbl and head towards \$90, that will be a new market negative (if it's believed to be sustainable).

The key to answering that question is Strait of Hormuz traffic so that we will be watching daily ship traffic. And the sooner we see more ships transiting the Strait, the better for markets.

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