

Good morning,

What's in this week's Report:

- What the U.S./Iran Conflict Means for Markets
- Weekly Market Preview: Does the Conflict Stay Contained?
- Weekly Economic Cheat Sheet: An Important Week for Growth (Jobs Report on Friday)
- Understanding the Two Sources of AI Anxiety

Futures are moderately lower on geopolitical concerns following the U.S./Israeli attack on Iran over the weekend.

Oil (up 7%) and gold (up 3%) are sharply higher, while global stocks are lower, as markets price in greater geopolitical risk. But the moves are in line with expectations (so no worse than feared).

Economically, the UK Manufacturing PMI slightly missed estimates (51.7 vs. 52.0), while the EU reading met forecasts (52.0). Neither number is moving markets.

Today's focus will be on geopolitics and specifically whether the U.S./Iran conflict widens. If the conflict does start to widen (bringing in other countries and expanding the number of combatants on both sides), that will be an incremental market negative.

Away from geopolitics, this is an important week for economic data, and the first key report comes today via the ISM Manufacturing PMI (E: 51.8). Simply put, the stronger this number, the better, as markets need solid growth more right now than they need an earlier-than-expected rate cut.

Market	Level	Change	% Change
S&P 500 Futures	6,811.50	-77.50	-1.12%
U.S. Dollar (DXY)	98.51	0.90	0.92%
Gold	5,401.99	154.09	2.94%
WTI	71.78	4.76	7.10%
10 Year	3.996%	0.038	0.96%

## Stocks

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

The stock market continued to swing violently between gains and losses, with indexes holding broad trading ranges as AI-disruption fears, mega-cap tech earnings, and geopolitical tensions drove intraday money flows. The S&P 500 ended the week down 0.42%.

After a flat open, stocks sold off hard last Monday as traders digested Trump's alternative tariff policy announcement from the weekend, which saw multiple major trading partners, including the EU, "freeze" trade deals with the U.S. Deteriorating sentiment regarding U.S.-Iran tensions, hawkish Fed speak, and China's DeepSeek announcing the imminent release of its new AI model all weighed on the S&P 500, which ultimately closed with a loss of 1.04%.

The market turned higher on Tuesday thanks to the combination of Goldilocks domestic economic data and a slew of mega-cap deal announcements involving AMD, META, MSFT, and Starlink. Additionally, Claude's parent company, Anthropic, released 10 new "plug-ins" for MSFT Office, which helped tamp down general AI-disruption fears and supported a relief rally, with the S&P 500 ending higher by 0.77%.

The midweek rally continued on Wednesday as Trump's new federal retirement program, announced during his SOTU speech Tuesday evening and notably including a government match of up to \$1,000/year, bolstered sentiment. A "cool" EU inflation print, paired with news that the U.S. and UK resumed work on the "Tech Prosperity Deal" and cooperation from Mag-7 names regarding commitments to build out their own respective electricity supply to power data centers, helped markets grind higher into NVDA earnings. The S&P added 0.81%.

Volatility reared its head again on Thursday amid a sell-the-news reaction to NVDA's solid earnings as investors grew concerned about the sustainability of the company's rate of growth. Hawkish money flows on the back of strong jobless claims didn't help, nor did an elevated sense of geopolitical uncertainty surrounding U.S.-Iran talks. News that progress was made towards a nuclear deal between the U.S. and Iran saw stocks reverse in afternoon trade, and the S&P 500 ended well off session lows, but still down 0.54%.

The market gapped lower at the open on Friday, with the S&P 500 testing the early-week lows around 6,800 as selling pressure resumed on AI names. At the same time, money flows were generally risk-off after a warm PPI headline (0.5% vs. E: 0.3%), amid ongoing geopolitical angst and simmering concerns about private credit markets. The S&P 500 found support at 6,850 by midmorning, with dip buyers and end-of-month positioning flows helping the market stabilize amid less-aggressive comments on Iran by President Trump. The market drifted higher into the close, ending towards session highs, but still down 0.43%.

### What the Iran Conflict Means for Markets

The U.S and Israel launched a large-scale attack on Iran aimed at regime change, and the operation adds more geopolitical uncertainty to the global markets. However, unless the situation deteriorates, we do not expect it to be a material influence on stocks.

What Happened: The U.S. and Israel launched a widespread and aggressive missile attack on Iran over the weekend, destroying numerous military sites and killing several of Iran's leaders, including Ayatollah Khamenei. Iran retaliated by targeting U.S. assets across the Middle East.

At this time, the operation is expected to be carried out mostly by air, with a small number of troops on the ground, and most expect it will last several days to a few weeks.

What Does It Mean for Markets? In the near term, the market reaction should be 1) Higher oil and energy prices (including gold) and 2) Lower stock prices on rising geopolitical risks. However, based on current expectations (namely, that the operation is limited to mostly air attacks and lasts only a short time), I do not think the conflict will sustainably raise oil prices or be a material negative for stocks.

I say that for several reasons. First, it's unlikely the attacks will dramatically reduce global oil supplies. Iran is a marginal producer on the global stage, and OPEC announced an increase in production over the weekend.

Now, the effective closure of the Strait of Hormuz (tankers will avoid the area for the foreseeable future) is a near-term negative, but the fact remains that the world is well supplied with oil currently. And, without any sustainable increase in oil prices, the conflict is unlikely to impact stocks because there won't be any significant knock-on effects to higher inflation or weaker margins.

*What Would Make the Situation Worse?* Further escalation. If 1) The U.S. or Israel announces an invasion (so boots on the ground) or 2) The conflict widens and brings in other countries, then that would be a bearish game-changer and likely create sustainable upward pressure on oil prices, which would be negative for markets.

*What Would Make the Situation Better?* Quick resolution. If the operation were to end in the next few days with Iranian military capabilities materially reduced, markets would breathe a relative sigh of relief as fears of further escalation would be removed. Additionally, if there is regime change in the country, that would open the possibility of Iran ultimately returning to the global oil markets, which would increase supply and further pressure prices (good for stocks).

*Bottom Line:* Despite the dramatic headlines of the weekend, the main influence on stocks remains AI Anxiety, and barring any further escalation in the Iran conflict, that will remain the case. Now, clearly, the conflict isn't positive for markets, and it does add to already rising investor concerns. And at a minimum, we can expect more volatility in the near term. However, at its current state, the Iran conflict is not a bearish game-changer (despite any short-term drop), and the medium-term direction of this market is still being determined by 1) AI sentiment, 2) Economic growth, and 3) Fed rate-cut expectations.

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

### Last Week

There was minimal economic data last week, and it largely met expectations and didn't change the current outlook of solid growth and elevated inflation. Jobless claims were the only notable economic report. They basically met expectations at 212k vs. (E) 215k. That reading continues to imply 1) A stable labor market and 2) Generally solid economic growth, and since markets already expect that, jobless claims didn't impact them on Thursday.

Turning to inflation, Friday's PPI was the key report, and it was hotter than expected. January headline PPI rose more than expected, and more importantly, Core PPI also jumped 0.7% vs. (E) 0.3% and 4.2% from 3.7% y/y, giving markets the most disappointing inflation reading in a few months (although it will have to be confirmed by CPI to really increase inflation anxiety).

We also got the Case-Shiller Home Price Index because declines in the HPI have been driving CPI lower over the past few months, and investors want to see that continue, so we get rate cuts in June or July. However, that only partially happened as the Case-Shiller HPI rose 0.5% vs. (E) 0.3% m/m, although it was in line at 1.4% y/y. Bottom line, these aren't "bad" numbers, and they won't make anyone think inflation is rebounding.

However, it also implies that the benefit from the moderation in housing inflation may already be baked into the CPI, and, as such, that downward pressure may be easing. If that's the case, then CPI would stay elevated, and that, in turn, would keep a summer rate cut in doubt (and if there's no cut, it'll be a market negative). Bottom line, the reality is that

last week's data didn't alter the economic outlook, which remains that of 1) Solid growth and 2) Elevated (but not rising) inflation, and that is generally supportive for stocks.

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

This week contains the "Big Three" monthly economic reports, as well as a look at consumer spending. It will help to either 1) Reinforce that economic growth is solid (positive for markets) or 2) Inject some concern about the state of growth (which would not be good for markets, giving ongoing AI Anxiety).

The key report this week is Friday's jobs report, and the key here is that the number stays Goldilocks, meaning we see solid job adds but not so good that it pushes back rate-cut expectations. The bottom line is that there are two-sided risks to this jobs number, given Fed members push back against near-term cuts, so markets will want a "Just Right" number to continue supporting the broader indices.

The two next most important numbers this week are today's ISM Manufacturing PMI and Thursday's ISM Services PMI. Both of these numbers have rebounded lately and remain comfortably above the important 50 level, so they are not signaling a near-term economic slowdown. However, they reflect the run-hot economy, and investors will want to see in-line readings (so above 50 but not surging) along with some moderation in the price indices.

This week also brings the Retail Sales report (also on Friday), and the importance here is clear: Consumer spending drives the U.S. economy, so investors will want to see stable retail sales. What we do not want to see is a sudden, surprising decline in core discretionary consumer spending, as that would imply consumers are pulling back, and if that's the case, the chances of a slowdown will rise quickly. Positively, that is unlikely as retail sales have been consistently solid and markets will welcome another in-line reading.

Finally, we also get our other looks at the labor market this week via ADP on Wednesday and Challenger layoffs and jobless claims on Thursday. Together with Friday's jobs report, we will get a comprehensive view of the labor market, and as long as it shows a stable labor market (so, not too hot to pressure wages and definitely not surprise weakness), then the economy will continue to be an unheralded support for the markets amidst current AI Anxiety.

### **Special Reports and Editorial**

#### **Understanding the Two Sources of AI Anxiety**

AI anxiety remains the single most important influence on this market in the near term, and concerns about AI damaging markets are rising. Because of that, I want to clearly explain the two primary causes of AI anxiety and why they are impacting markets.

AI Anxiety Source 1: Sector Disruption. The initial view of AI was that it would be a massive productivity booster across virtually all market sectors, but especially for professional services. That "productivity" boost was really just finance speak for "AI would let offices reduce payroll expense (lay people off) and use a computer program to replace them, thereby increasing margins, profit, and earnings." And because of this potential productivity and profit/earnings boost, companies would be aggressively paying for AI services. That's a main part of the bullish thesis behind the AI boom.

However, now investors fear it'll go too far. Put simply, the concern now is that AI will boost productivity so much that it won't just lead to reduced headcount, it will lead to the elimination of the entire company and business! And while that is "positive" for the economy from a productivity standpoint, the collateral damage of eliminating entire companies would be negative for the markets (and eventually for the economy, as the unemployment rate surged).

These fears are best demonstrated by what's happening in software. Six months ago, AI was a godsend for SaaS names, as AI agents could replace actual people (programmers/implementation specialists, customer service) at a fraction of the cost, leading to an earnings explosion.

Now, thanks to Claude Cowork and others, fears are spiking that AI will replace the entire program with a native app, allowing each company to have a tailored version of something like Salesforce, Workday, or ServiceNow. That's why that sector has collapsed.

Similarly, fears that AI efficiency gains could lead trucking companies to operate on virtual skeleton crews as AI plans all the logistics hit the Dow Transports recently.

Even financials aren't immune, as fears that AI could eliminate the need for most intermediary and custody services hit those stocks.

Here's the point: One main reason AI is suddenly negative for stocks is that investors now fear that AI won't make most sectors more productive and boost profits; instead, AI will eliminate the need for companies in those sectors entirely!

AI Anxiety Source 2: Collapsing Free Cash Flow. The second driver of AI Anxiety is the collapse of free cash flow from major, heavily weighted tech companies.

For most of the past three years, investors have viewed AI as a major positive for large tech companies such as Microsoft, Google, and Meta. The thesis was that these companies would 1) Develop native AIs that customers would pay for because they were such productivity boosting offerings, driving direct revenue, and 2) Implement AI to improve existing business (like search, social media advertising, content prediction, etc.)

Well, that's not what's happened.

Instead, those massive companies (MSFT, ORCL, GOOGL, META, AMZN) are spending hundreds of billions to build out massive AI infrastructure, and it's drastically reducing their free cash flow (FCF).

For context, many of the major tech companies were some of the biggest generators of FCF in the markets. Companies such as GOOGL, META, MSFT, ORCL, and others had proverbial "money printing machines" that threw off billions in FCF for years. Well, much of that FCF is being spent on AI infrastructure, and not even these massive companies are immune to investor concerns, as FCF nosedives.

Bottom line, AI spending is damaging the financial footing of the biggest tech companies in the markets. With no end to spending in sight, investors are nervous that FCF from these companies will be depressed for years, all on the massive bet that the population will widely and aggressively adopt AI.

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