

Good morning,

What's in this week's Report:

- Understanding Where the "Bubble" Is in AI
- Weekly Market Preview: Does the Fed Start a New Rate-Cutting Cycle?
- Weekly Economic Cheat Sheet: Fed is Key, but There's Important Growth Data This Week, Too

Futures are slightly higher following a mostly quiet weekend and despite negative tech news and economic data from China.

China declared that NVDA had broken anti-monopoly laws, escalating existing tech tensions between China and the U.S. (although this move isn't a total surprise).

Economically, Chinese data underwhelmed as Retail Sales rose 3.4% vs. (E) 3.8% while Industrial Production gained 5.2% vs. (E) 5.6%.

Focus today will be on the first economic reading of September, the Empire Manufacturing Index (4.3), and markets will want to see stability to further push back on slowdown concerns.

Market	Level	Change	% Change
S&P 500 Futures	6,665.00	20.00	0.30%
U.S. Dollar (DXY)	97.32	-0.23	-0.24%
Gold	3,678.90	-7.50	-0.21%
WTI	62.93	0.24	0.38%
10 Year	4.052%	-0.007	-0.17%

Stocks

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

Stocks rallied to fresh records last week, thanks to a combination of strong mega-cap tech earnings and rising optimism that imminent Fed rate cuts between now and year-end will result in a soft economic landing. The S&P 500 gained 1.60% on the week.

U.S. equities rallied modestly on Monday as soft export data from Germany/China weighed on growth expectations. At the same time, a stagflationary NY Fed Survey of Consumers was taken in stride with dovish money flows persisting. Lower yields helped the S&P 500 rally 0.21%.

The choppy rally continued on Tuesday as traders digested sizeable downward revisions to the BLS payrolls data through Q1'25, as well as a mixed NFIB Small Business Optimism Index release. AI semiconductor giant, NVDA, revealed a new chip system geared towards video and software development, which served to offset the economic uncertainty, and the S&P 500 ended up 0.27%.

The equity rally persisted on Wednesday after blowout guidance numbers from legacy tech-giant ORCL reinforced optimism surrounding AI as a source of material earnings and revenue growth in the quarters ahead. At the same time, a cooler-than-feared PPI report eased worries about renewed inflation pressures and bolstered dovish Fed policy bets. The S&P 500 rose another 0.30%.

Stocks accelerated higher on Thursday on the back of a CPI report that showed a modest uptick in inflation pressures in August, but a mild increase that was no worse than expected, while a spike in initial jobless claims left dovish market-based Fed policy rate expectations intact (despite the rise in headline CPI). The S&P 500 jumped 0.85% to a fresh record high just shy of 6,600.

After four days of gains, the record-breaking stock market rally experienced some degree of exhaustion on Friday as the latest Consumer Sentiment headline fell to the lowest level since May, while 5-Yr-ahead inflation expectations picked up to 3.9% from 3.5%—topping estimates of 3.4% (another whiff of stagflation). A modest profit-taking pullback late in the day saw the S&P 500 close down 0.05%, just shy of the week's latest records.

Understanding Where the "Bubble" Is in AI

Last week, tech mega-cap stock ORCL exploded higher by 40% after it revealed more than 300% growth in its order backlog (called RPOs in the earnings report), boosting expectations for greater profits in the year ahead. But late last week, it was revealed that one customer, OpenAI, was responsible for \$300 billion of the backlog increase by itself!

ORCL gave back some of Wednesday's big gain on that news, and for valid reasons. First, RPOs aren't actual money. They are promises of orders that can be cancelled. Second, having one relatively new AI company responsible for that amount of backlog introduces concentration risk, and ORCL slid on Thursday appropriately.

But the revelation that OpenAI was responsible for the majority of the backlog also provides a near-perfect example of what's happening in the AI industry and why it matters to markets.

Put simply, the ORCL results and OpenAI news illustrate this point: If there is a bubble in the AI space, it's a cap-ex bubble.

I have generally pushed back against the idea that major AI-driven tech stocks (MFST, NVDA, AVGO, AMZN, META) were in a bubble. The main reason is that those AI darlings were seeing actual earnings explode higher. Semiconductor companies (NVDA, AVGO, etc.) were seeing massive increases in chip orders as AI companies/Mag 7 rushed to secure semiconductor capacity. MSFT, AMZN, and other cloud-computing giants saw demand for cloud capacity explode as AI companies, such as OpenAI, rushed to secure server space, boosting their revenues. Networking and database companies, such as ORCL, saw earnings surge as these same companies rushed to secure computing capacity and storage space for their data.

All the while, the P/E ratios of many of these companies have actually declined despite significant price increases, because *earnings are growing much faster than the price can appreciate*. So, even with the massive rallies in these stocks, many of these names are trading at lower valuations than before. If we get even more granular and examine the 11 sectors of the S&P 500 on a price-to-earnings-to-growth (PEG) ratio, the tech sector is one of the cheaper sectors in the market.

This makes it very different than the tech bubble of 25 years ago. 1990s tech darlings weren't making more money! Instead, it was the hope that more money would be made that prompted the massive increase in share prices and bubble reality. P/E's of internet-linked tech companies exploded higher because it was all based on the promise of growth, not actual money!

Major tech companies that have powered this rally in the S&P 500 are thriving because they are actually generating significantly more revenue than they did before. But, as ORCL's backlog increase showed us (which was powered by one AI company), the increased earnings are because AI-focused companies (like OpenAI, CoreWeave, etc.) are spending hundreds of millions and billions to build out AI infrastructure! If there's a bubble in anything, it's in AI-linked Capital Expenditures (cap-ex)! That's important to us because the pace of AI-linked cap-ex must continue; otherwise, the entire AI-driven rally risks unraveling because AI-linked earnings for the Mag 7 and others will begin to decline!

The perfect example of this is ORCL last week. OpenAI pledged \$300 billion in future orders. According to various reports, the entire market cap of OpenAI is between \$300 billion and \$ 500 billion. And it's hemorrhaging cash. Yet this company has pledged to buy \$300 billion worth of tech infrastructure from ORCL over the coming years, and ORCL's stock surged 40% in a single day on the news.

As long as OpenAI is actually able to 1) raise capital to fund these purchases and 2) execute properly to turn ChatGPT and other AI models into actual profitable enterprises, then the rally in ORCL is legitimate, and this stock will go higher because other companies will likely follow in OpenAI's footsteps.

But what if OpenAI cuts the orders? What if they can't find financing at attractive terms to fund this R&D? What if AI adoption proves to be a disappointment? What if the majority of the population ultimately views ChatGPT and others like Alexa or Siri—something that's fun and cool, but not something anyone's going to pay for?

If that's the case, then AI companies and major tech firms will cut AI-linked capital expenditures, and the "bubble" will begin to deflate, just like Oracle shares would drop sharply if OpenAI announced it was cutting its orders.

Bottom line, AI isn't in a valuation bubble. If it's a bubble, it's a cap-ex bubble. The gargantuan pace of cap-ex from AI tech firms must continue and not slow; otherwise, earnings expectations will fall, the Mag 7 will drop, and they'll take the S&P 500 with it.

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

Last Week

The focus of last week's data was inflation, and those readings helped to slightly reduce inflation worries, while labor market data continued to point to a cooling in the jobs market.

The key report last week was Wednesday's CPI report, and it largely met expectations and, when taken in combination with the PPI report (more on that below), painted a largely "status quo" view on inflation, which kept Fed rate-cut expectations intact.

CPI rose 0.4% m/m vs. (E) 0.3% and 2.9% y/y, meeting expectations. That wasn't a great number, but the headline didn't rise above 3.0% y/y, which was a positive. Core CPI stayed at 3.1% y/y, meeting expectations. As for PPI, it was better than expected as it declined -0.1% vs. (E) 0.3% and the YoY gain slipped to 2.6% from 3.3%. PPI is loosely viewed as a leading indicator for CPI, and the fact that PPI popped in July and didn't translate to a jump in CPI was a positive. Plus, with PPI declining in August, there is hope that CPI will see some relief in the coming months.

Bottom line, CPI and PPI were seen as the last potential barriers to a rate cut this week and multiple rate cuts over the next few months, and neither made that less likely. As a result, they were positive for markets.

Turning to growth data, the only notable report last week was the weekly jobless claims, which jumped to 263k, the highest level since 2021. This further reinforces the notion that we are seeing deterioration in the labor market. But weekly jobless claims are volatile, and for it to signal more significant deterioration in the labor market, we'd need to see claims stay above 260k for several weeks (so that the four-week moving average rises above that level). Until then, the pop-in claims are notable, but it's not something that should make us more concerned about growth.

Important Economic Data This Week

This week is a busy one on the Fed and data front (with the most important event being Wednesday's FOMC decision). For this Fed meeting, the key isn't if they cut 25 bps or 50 bps (likely, 25 bps, but 50 bps isn't impossible); instead, it's whether the Fed clearly signals this is the start of a rate-cutting campaign that will send rates sharply lower over the coming months and quarters. The meeting will include updated "dots," which need to show two more rate cuts in 2025 and several cuts in 2026 to meet lofty market expectations. If they do not, investors will be disappointed (and stocks may drop regardless of whether the Fed cuts rates or not).

Turning to economic data, consumer spending remains a key pillar of support for the U.S. economy, and it has been remarkably resilient. That will need to carry on if we're going to see the economic data continue to push back on slowdown concerns.

Finally, jobless claims on Thursday just became much more interesting. Last week, claims jumped to 263k, the highest level in nearly four years. In the past, one-time jumps in claims were reversed either the next week or a few weeks later. That should be our base case expectation. However, suppose claims don't reverse in the coming months. In that case, that will be another, more substantial signal that the labor market is starting to deteriorate, which will increase concern about an economic slowdown meaningfully. Bottom line, claims are important this week.

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