

Good morning,

What's in this week's Report:

- Weekly Market Preview: Does Fed Commentary Back-up Rate Cut Expectations?
- Weekly Economic Cheat Sheet: Fed speak is the key with no government data this week.
- What the Government Shutdown Means for Markets & the Economy
- When We'll Know If the Labor Market Is a Problem
- Takeaways from OpenAI's Latest Secondary Offering

Futures are solidly higher, thanks to strength in Japanese stocks following a surprise election outcome, despite no progress on resolving the U.S. government shutdown.

The Nikkei surged more than 4% after the ruling Liberal Democratic Party elected Sanae Takaichi to be the new Prime Minister, a mildly surprising outcome that's seen as positive for more economic stimulus from the BOJ.

Politically, there was no progress in resolving the U.S. government shutdown over the weekend. However, markets continued to ignore the shutdown (and likely will for another two weeks or so, should it last that long).

Today, there are no economic reports, so the focus will remain on any progress on resolving the shutdown. There is also one Fed speaker today, Schmidt at 5:00 P.M. ET, but his comments come after the close and shouldn't move markets.

Market	Level	Change	% Change
S&P 500 Futures	6,792.50	28.50	0.42%
U.S. Dollar (DXY)	98.33	0.61	0.62%
Gold	3,956.00	47.10	1.20%
WTI	61.47	0.59	0.97%
10 Year	4.164%	0.044	1.07%

Stocks

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

Stocks churned sideways early last week before the major indexes surged to record highs, as investors shrugged off the news of the government shutdown and instead continued to embrace dovish Fed policy expectations and a broad sense of enthusiasm for AI. The S&P 500 rallied 1.11% on the week.

Markets were on edge to start the week last Monday amid the imminent threat of a potential government shutdown, but a solid Pending Home Sales print and news that high-level Congressional meetings were underway helped the S&P 500 eke out a gain of 0.26%.

The tentative rally continued on Tuesday, despite the lack of any progress towards a spending deal, as investors instead focused on soft Consumer Confidence data (dovish) and a slightly better-than-expected JOLTS release (easing worries about the labor market). The S&P 500 ended the third quarter with a daily gain of 0.41%.

Stocks rallied to fresh all-time highs on Wednesday and Thursday, despite the government shutdown, as the soft ADP jobs report (the worst in over two years) was viewed as unfavorable data, making rate cuts even more likely. AI enthusiasm also contributed to the rally thanks to OpenAI's latest insider stock sale, which left the company with a value of ~\$500B, making it the largest start-up company in the world (surpassing SpaceX).

Investors continued to shrug off the government shutdown on Friday, thanks to an unexpectedly weak ISM Services PMI in the U.S., which was the latest data point to shore up October rate-cut expectations. Mixed tariff news and a less dovish tone from Fed speakers saw stocks roll over, and the S&P 500 ended flat (up 0.01%).

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

Last Week

The most notable economic report from last week wasn't what we expected it to be, as the ADP jobs report surprisingly turned negative, at -32k jobs lost, the worst reading in over two years. To boot, the August data was revised from 50k to -3k, making it two consecutive months of job losses! Now, ADP isn't directly correlated to the monthly jobs report. Still, they do travel in the same direction mostly, so that raises the prospects of a negative September jobs report when it's released once the government reopens. Bottom line, ADP has boosted concerns about the labor market, although for now, investors are viewing that bad data as being "good" for markets, given that other growth metrics remain generally solid.

The second most important economic report from last week was also disappointing, as the ISM Services PMI dropped to 50.0 vs. (E) 51.6. ISM Manufacturing PMI is already below 50, and while the Services PMI stayed at 50.0, that's still uncomfortably close. Both the ISM Manufacturing and Services PMIs printing below 50 for more than two months are a very reliable signal of an economic slowdown. So, while Friday's ISM Services PMI doesn't meet that threshold, it does remind us that broader growth is still losing at least some momentum.

The final notable economic report from last week, the ISM manufacturing PMI, slightly beat estimates at 49.1 vs. (E) 49.0. That number largely comports with the "slowing-not-stalling" economic narrative. Yes, that's still below 50, but the metric has been below 50 for most of the past three years, and the economy has held up just fine. Importantly, we are not seeing the type of sudden deterioration that would imply growth is suddenly slowing.

Bottom line, economic data softened last week. For now, the market is viewing this data as positive for stocks because it increases the chances of two Fed rate cuts and, maybe, three rate cuts before year-end. While that's ultimately short-sighted (we do not want a slow economy in exchange for lower rates), it will boost stocks to a certain point (but we haven't reached it yet).

Important Economic Data This Week

The government shutdown muddies the economic calendar this week, making an already slow week even slower. However, given the soft ADP report and concerns about the labor market, the data we receive still needs to be closely monitored.

Given the lack of government data (as it stands right now), the key event this week will be Wednesday's FOMC minutes, as they will give us additional insight into just how divided the Fed is over two more rate cuts (remember the median dot showed two cuts, but the Fed is split over the decision). If the minutes imply that more Fed members are open to multiple cuts than the market currently expects, that will be an additional positive. Conversely, if the minutes reveal many Fed members are worried about inflation, that will reduce expectations for two cuts and be at least a mild headwind on stocks.

Staying with the Fed, the next important event this week is Powell's comments on Thursday. It's unclear at this point how much the Fed chair will discuss policy, but markets will be closely tuned in to see if he sounds more nervous on the labor market following last week's soft ADP data. Additionally, investors will want to see how Powell addresses the lack of economic data right now, and how that could impact the October rate decision (the market expects a 25-bps cut, while a hint of a 50-bps cut would be a new positive).

Special Reports and Editorial

What the Government Shutdown Means for Markets & the Economy

The government shutdown for the first time since 2018 at midnight on Tuesday night, but while this will receive a lot of media attention, it's unlikely to have a materially significant impact on the economy or markets (although it will induce some temporary volatility over the coming weeks).

From an economic standpoint, it's unlikely the shutdown will impact growth, and it will not make an economic slowdown any more likely than it was before. I say that mainly because all federal employees who are not paid during the shutdown will be paid retroactively once the government reopens.

There have been reports that the Trump administration will use the shutdown as an opportunity to fire large numbers of federal employees, although it's unclear if this is legal. It will undoubtedly be challenged, if it occurs at all. Regarding critical payments from the federal government, such as Social Security and Medicare/Medicaid, these will remain unaffected by the shutdown. Bottom line, barring a very extended shutdown (i.e., one lasting several months), it's unlikely to impact the economy.

From a market standpoint, the most significant impact will come from delayed economic data. Important Federal agencies, such as the Bureau of Labor Statistics, will not produce economic data (there was no jobs report released on Friday). While this isn't a disruption in the short term, it could be in the weeks ahead.

I say that because while the Fed dots showed two more rate cuts in 2025, that remains an uncertain proposition. That means important labor market data, which is the Fed's primary concern on the economy, has been delayed. In fact, if the shutdown lasts until the Fed's decision on October 29 (unlikely but possible), they will have to decide whether to cut rates or not without entire swaths of economic data.

Then, when the data is released once the government is open, it may paint the picture of a labor market that's much weaker than expected, or stronger—further complicating the Fed's decision, and more importantly for markets, what investors expect from the Fed.

Bottom line, the shutdown isn't going to alter the economic outlook or cause any sustainable market volatility, and it won't undermine the core bullish ideas of 1) Solid growth, 2) Falling rates, 3) AI enthusiasm, and 4) Stable inflation.

It will, however, cause delays in the data, and given labor market weakness and uncertain rate cuts, this will inject potentially unneeded volatility into markets, especially if the shutdown lasts for four or five weeks (and it could make November and December more volatile and stressful than they otherwise needed to be).

When We'll Know If the Labor Market Is a Problem

Wednesday's soft ADP jobs report heightened concerns that the labor market is deteriorating, and if it continues, it could lead to broader economic weakness. For now, markets are confident enough that the "bad" economic report was "good" for stocks as falling yields helped the markets rebound. The outlook for the labor market, which was already complicated, has been further complicated by the government shutdown, as markets did not receive government labor data. When the government reopens, we could experience a data deluge.

About a month ago (September 8), I identified levels in key labor market indicators that would indicate whether the labor market is becoming a risk to the broader economy, allowing us to cut through the noise and recognize when the data is flashing a warning sign. I'm reproducing that research here as a courtesy, amid increased anxiety about the job market.

Labor Market Levels That Indicate Trouble: Jobless Claims - First Level: 260k. A break of that level would imply a more than 20% jump from the lows around 210k-220k, indicating a real deterioration in the labor market—warning **level: 300k.** A break above 300k on the four-week moving average would signal a labor market that's likely contracting. **Unemployment Rate: Key level: > 4.5%.** A move above 4.5% (so, 4.6% or higher) is consistent with labor market deterioration, and at that point, a move towards 5.0% is likely (which is consistent with economic slowdowns). **JOLTS: < 6.5 million.** During economic slowdowns, JOLTS drops to 5.0 million. JOLTS haven't been below 6.5 million in years, and a decline below that level implies that companies are slashing hiring and "hunkering down" on expenses (which will put a headwind on the economy).

How Would A Bad Labor Market Impact Markets? It would be substantially negative. Usually, a decline in the jobs market is a lagging economic indicator, as employers only slash jobs after the economy has already slowed. But I believe it's more coincidental this time around (meaning, happening at the same time as the economy slows). Here's why... Full employment has been the silver bullet to higher interest rates and tariff uncertainty. People are dealing with higher prices, and consumers are still spending because they have jobs. If layoffs occur en masse and those labor market indicators are impacted, then consumer spending will sharply decline, exacerbating any economic slowdown.

Bottom line, the labor market is not in bad shape; however, it is losing momentum, and this is something we need to watch closely. If the labor market goes, then so too will the economy (and that's a bearish game-changer for stocks).

Takeaways from OpenAI's Latest Secondary Offering

The tech sector, semiconductor stocks, and anything AI-related caught a solid morning bid Friday on the news that OpenAI's latest secondary stock offering period, during which employees were permitted to sell up to \$10B in personal equity holdings on the secondary market, resulted in a sizeable valuation of ~\$500B for the AI startup. The question facing investors after the latest valuation round is whether this secondary stock event has shored up confidence in the AI narrative or suggests that "AI froth" is reaching extreme levels that could lead to a potential "AI bubble" popping in the not-too-distant future.

In the “Pro AI” column of this OpenAI valuation news, it was noted that the internal statistics of the latest secondary offering revealed a high degree of confidence among employees that growth prospects remain strong. If that were not the case, we would have almost certainly seen upwards of this round’s limit of \$10B offered by employees to outside investors seeking exposure. Instead, only \$6.6 billion of the \$10 billion of equity permitted to be sold was ultimately offered, which bodes well for OpenAI’s future outlook from within the company.

Second in the “Pro AI” column was that this was not a new funding sale to raise capital for expansion, but rather a liquidity event for employees. The fact that the valuation jumped as much as it did suggests that outside investors remain optimistic about the AI benchmark’s growth prospects after H1’25 revenue surpassed 2024 revenue.

While OpenAI’s revenue growth is currently rapid (roughly doubling year over year in 2025 from 2024), the company faces a growing number of hurdles to reach profitability, including economies of scale, sector competition, and rising R&D costs. It is not unusual for a promising startup company to trade at 25X expected annual revenue (\$500B valuation = 25X expected 2025 revenue of \$20B). However, leadership will have to prove the ability to monetize growth into profitability sooner rather than later to justify such a rich valuation.

Overtaking a well-established private business, such as SpaceX, as the most valuable private startup was not unreasonable given the expected revenue of OpenAI (set to outpace SpaceX by an estimated \$4B in 2025). Yet SpaceX has proven profitability channels and government contracts, which are more established than OpenAI’s business models, as support for the high valuation argument.

Risks and Caveats

- Scalability for AI products from early adoption to sustainable enterprise demand isn’t proven yet, and any hiccups/unforeseen challenges are a risk to OpenAI’s latest valuation.
- Rising costs in high-functioning model training could pressure profit margins when moving to implementing big business operating/execution solutions.
- Competition from “second mover” (legacy mega-cap tech companies) is a risk to “first mover” startups, as companies with established cash flow and long-term contracts/customers are better positioned to overcome growth challenges in the pursuit of profitability. Rivals: MSFT, GOOGL, META, Anthropic, etc.

Bottom line, the OpenAI news initially sparked a fresh wave of risk-on AI optimism in big-tech stocks. However, the “fade” from the opening highs in staple AI names, such as NVDA, and the fact that SOX (semiconductors) ended with a solid gain but closed below its opening level, suggest there is growing hesitation to chase the AI trade from its historically expensive levels meaningfully. And the risk that we see the AI narrative challenged in the weeks/months ahead is rising and has the potential to spark a meaningful profit-taking pullback in tech and the broader equity market.

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