

Good morning,

What's in this week's Report:

- Why the Bullish Argument Got Slightly Weaker Last Week
- Weekly Market Preview: Does Goldilocks Data Keep the Rally Going?
- Weekly Economic Cheat Sheet: The "Big Three" Monthly Economic Reports this Week
- More Bubble Signs? OpenAI and NVDA Partnership

Futures are solidly higher following a quiet weekend and despite no progress on averting a government shutdown.

Chances of a partial government shutdown starting Wednesday are rising, and if that occurs, the most significant impact for markets will be via delayed data (possibly including Friday's jobs report).

There were no material economic reports overnight.

Today, the focus will be on any progress on averting a shutdown (a shutdown wouldn't be a material market negative, but it's definitely something the market could do without).

Economically, the only notable report is Pending Home Sales (E: 0.2%), while there are several Fed speakers: Hammack (8:00 a.m. ET), Musalem & Williams (1:30 p.m. ET). Bottom line, solid data and dovish Fed speak is what the market needs, not just today, but all week, to rebound from last week's declines.

Market	Level	Change	% Change
S&P 500 Futures	6,724.00	27.50	0.41%
U.S. Dollar (DXY)	98.01	-0.14	-0.14%
Gold	3,857.80	48.80	1.28%
WTI	64.51	-1.21	-1.84%
10 Year	4.150%	-0.037	-0.88%

Stocks

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

Stocks hit record highs last Monday amid renewed enthusiasm for AI, thanks to more mega-cap tech investment, before cautious commentary from Fed leadership prompted profit-taking late in the week. The S&P 500 dipped 0.30% on the week.

U.S. equities stumbled to start the week as investors continued to mull the Fed's September rate cut and digest less negative economic data and a less dovish tone from multiple Fed speakers. NVDA's announcement of a \$100B investment in OpenAI sparked a fresh wave of risk-on money flows, driving tech shares to record highs. The S&P 500 notched a 0.44% gain last Monday.

Volatility began to increase on Tuesday as Fed Chair Powell delivered a luncheon address in Rhode Island, during which he acknowledged that "there is no risk-free policy path ahead," citing the combination of risks to both sides of the FOMC's dual mandate. That poured cold water on a market that had already become heavy in the wake of a solid Composite PMI report, and the S&P 500 bled lower to end the day down 0.55%.

The market attempted to stabilize on Wednesday, with stocks gapping higher at the open thanks to another burst of AI optimism after BABA announced a \$50 billion investment in AI-focused infrastructure. However, there was no follow-through, and the wave of profit-taking resumed, with the S&P 500 ending down 0.28%.

The selloff persisted on Thursday with a moderate increase in urgency as the major indexes gapped lower at the opening bell, as traders digested a string of strong economic releases, including a big upside revision to Q2 GDP, low and falling jobless claims, and a sizable upside beat in August Durable Goods Orders. The S&P 500 declined as Treasury yields tested their September highs. The index closed 0.50% lower.

Stocks opened with tentative gains Friday as a favorably in-line PCE print kept Fed rate-cut hopes alive and helped offset negative news of U.S. tariffs on pharmaceuticals and semiconductors. Stocks turned lower at 10 a.m. when the latest UofM Consumer Sentiment Survey was released with a weak headline. After consolidating the early pullback and "gap-fill" to Thursday's close, the S&P 500 closed up 0.59%.

Why the Bullish Argument Got Slightly Weaker

Stocks declined modestly last week and rightly so, as two of the most significant supports for the YTD rally had to digest some slightly negative news, and given lofty expectations and valuations, it weighed modestly on markets.

Starting with the Fed, rate-cut expectations have been key to this rally since early summer, peaking two weeks ago when the Fed met expectations, cut rates, and signaled two more cuts this year. But the Fed is divided on those two remaining cuts, so last week's better-than-expected data (especially jobless claims and Q2 GDP) slightly reduced expectations for two more cuts (Fed Watch now has two cuts at a 65% probability, down from after the Fed meeting).

The problem for markets isn't that the Fed became less dovish (none of the data last week will determine what happens in a month or in December). Still, investor expectations are significantly elevated, leaving the market vulnerable to small disappointments, as we saw last week with the strong growth data. Since rate-cut expectations helped fuel the rally, the mild reduction in those expectations caused a slight decline.

Turning to AI, we all know that AI enthusiasm has been a major contributor to the rally not just this year, but for the past two-plus years. However, as monumental amounts of money are spent to build out AI infrastructure (computing power, electricity, networking, etc.), the focus is now turning to the expected return on investment of these hundreds of billions in capital expenditures, and investors are starting to become skeptical.

Case in point, last Monday's NVDA-OpenAI announcement, where NVDA pledged to "invest" up to \$100 billion in OpenAI, as long as OpenAI uses that money to buy NVDA products. Announcements like these are becoming more common, and they raise some questions about why these companies have to keep giving each other money to build out more infrastructure, and when all these investments will start to have a positive return (and not need suppliers to fund their biggest customers).

Stepping back, while there were incrementally negative headlines about rate cuts and AI last week, they need to be taken in context. Neither was particularly negative, and last week's news should, for now, be filed in the "not every week can be positive" folder. Point being, the Fed is still cutting rates, and AI enthusiasm remains very strong; these are two bullish forces on the markets. However, the mild disappointment last week reveals the very elevated expectations, and those elevated expectations leave the market vulnerable to mild disappointments.

If the Fed backtracks on further rate cuts (and makes the September cut a "one and done") or we start to doubt the ultimate ROI on AI cap-ex, those would be two serious negative events (especially if investors begin to question the "magic" of AI). And in those instances, stocks would likely fall hard.

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

Last Week

Economic data was solid last week, but it also ran slightly "hot" from a market perspective. Because of that solid data, yields rose, which mildly pressured stocks as investors slightly recalibrated their expectations for Fed rate cuts.

The biggest report of last week was the Core PCE Price Index (the Fed's preferred measure of inflation), and it met expectations, rising 2.9% y/y. That's elevated, considering the Fed's target is 2.0%. Still, it didn't dramatically increase, and as such, it's unlikely to make anyone on the Fed more hawkish (although it will reinforce their concerns about inflation risks). Bottom line, the Core PCE Price Index won't reduce the probability of two more rate cuts, but it didn't increase the number of doves on the Fed, either.

Looking at growth data, the results were solid. Starting with jobless claims, they dropped sharply back to 218k and, just like this time last year and several times over the past few years, claims have totally retracted a modest uptick. The weekly claims data imply that while the labor market is losing momentum, it's still in mostly solid shape (which means broader slowdown risks remain generally low).

The September flash composite PMIs, the first national report of the month, were also mostly in line with expectations. The flash manufacturing PMI slipped to 52.0 from 53.0 but met expectations, while the services PMI declined to 53.9 from 54.5 and beat the 53.5 expectation. Both numbers declined but remain comfortably above 50, implying solid, if unspectacular, activity.

Finally, the last reading of Q2 GDP was revised solidly higher to 3.8% from 3.3% SAAR. Keeping in mind that this is looking at activity from April to June (so very dated), the reality is that the economy was strong even during the tariff volatility. Again, that's not a major surprise, but it won't make people on the Fed even more apt to cut rates than they currently are.

Bottom line, the positive aspect of last week's data was that the economy remains on a solid footing, which is crucial for supporting this rally. However, because expectations for rate cuts have been a major driver of this recent stock rally, and the solid data slightly reduced expectations for rate cuts, it did weigh on markets. As we look ahead to this week's data, that's something we should keep in mind (i.e., "too hot" data will be a market headwind).

Important Economic Data This Week

This week brings the "Big Three" monthly economic reports, and given the Fed is now cutting rates, we're back to needing Goldilocks economic data to push stocks higher (i.e., not so good data that rate-cut expectations fall, and not so bad that slowdown fears spike).

The key print is Friday's jobs report, and with expectations for job additions at 51k, the key is that job growth doesn't turn negative (increasing slowdown concerns) or spike higher (reducing rate-cut expectations). In addition to Friday's report, it's also "Jobs week" with JOLTS on Tuesday, ADP on Wednesday, and Challenger Layoffs/jobless claims on Thursday. The more indicators that show a stable labor market, the more positive it is for the stock market.

The second most important economic report this week comes from the ISM PMIs. The manufacturing PMI is released on Wednesday, while the Services PMI is released on Friday after the jobs report. The key here is for both metrics to remain above 50 and continue to show solid growth. The manufacturing PMI has been below 50 for some time, but as long as it doesn't drop dramatically, that's not a problem. The Service PMI has stayed above 50 (mostly), and we'll want to see that continue to imply stability in the service sector of the economy (which is the biggest part of the U.S. economy).

Bottom line, with rate-cut expectations being instrumental in this recent rally in stocks (really, since June), the economy now needs to be Goldilocks to help support the market at these levels. Specifically, that means being good enough to reflect stable growth, but not the type of acceleration in activity that implies the Fed may cut rates less than expected.

Special Reports and Editorial

More Bubble Signs? OpenAI and NVDA Partnership

Last Monday, AI darlings NVDA and OpenAI announced a massive partnership whereby NVDA would invest up to \$100 billion in OpenAI to fund the creation of 10 gigawatts of NVDA-powered systems to run OpenAI's expanding AI-computing power, and that news caused stocks to reverse early losses and for the major averages to turn modestly positive.

This announcement is just the latest example of the massive size of AI-infrastructure investment that's acting as a private stimulus, boosting the tech sector and broader economic growth. To that point, CNBC displayed a graphic showing that technology company capital expenditures (think investment) have almost reached 4.5% of total U.S. GDP.

There has only been one other time when technology capital expenditure as a percentage of GDP was this high, and that was the late 1990s.

I'm not saying we are in an AI bubble (I don't think we are), but there are clearly pockets of excess we need to be mindful of. To that point, the NVDA announcement essentially amounts to the company paying one of its largest customers to build infrastructure that will require NVDA chips. It's essentially paying your customers to keep buying your products—and therein lies the ultimate concern with this massive AI capital expenditure.

In the late 1990s, companies invested heavily in internet firms to build out their infrastructure. However, the adoption of the internet was significantly slower than predicted, and it took decades for the internet to be utilized in the ways envisioned back in the 1990s. Because of that delay in adoption, all that investment by major firms in the late 1990s turned out to be massive money losers!

That's a primary concern for AI as well. When will AI yield positive economic benefits for the broad business community and general population? The hundreds of billions being spent on AI infrastructure have to produce a positive financial return. If it doesn't, then this money will essentially have been wasted, and we will see a similar bubble burst, as we did in the 1990s.

To be clear, I'm not saying that's happening now and we don't know if it will happen (if AI is adopted quickly, it won't happen), but the \$100 billion announcement (and subsequent rally in stocks) is a clear reminder that there are massive amounts of money being invested in AI and it's not slowing down—and that means all of this better work, otherwise there will be a late-90's style reckoning at some point.

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