

Good morning,

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What's in this week's Report:

- Three Key Market Variables to Watch
- Thoughts on the Appellate Court Decision (Why It's Not a Positive for Stocks)
- Weekly Economic Preview: "The Big Three" Reports Are Due This Week
- Why Didn't President Trump's Firing of Fed Governor Cook Impact Markets?
- Breakeven Inflation Rates: Powell Has a "Price Problem"

U.S. stock futures are tracking global equity markets lower this morning as bond yields rise and gold hit fresh record highs amid a fresh sense of macroeconomic uncertainty.

Economically, the EU's Narrow Core HICP Flash (CPI equivalent) held steady at 2.3% vs. (E) 2.2% in August, which was not a big "miss" but is continuing to keep inflation worries elevated.

Looking into today's session, there are no Fed officials scheduled to speak, but two economic reports to watch with the ISM Manufacturing PMI (E: 48.7) and Construction Spending (E: +0.1%) data both due to be released.

Additionally, the Treasury will hold 6-Week, 3-Month, 6-Month, and 52-Week Bill auctions simultaneously at 11:30 a.m. ET. The wide range of Bill durations being auctioned could shed fresh light on the market's outlook for Fed policy between now and year-end, as well as in H1 '26.

Finally, some late-season earnings continue to be released, with quarterly reports due from both ZS (-\$0.02) and SIG (\$1.21) today.

Bottom line, if economic data is "Goldilocks" and supports the case for a soft-landing and Treasury auctions go smoothly (healthy demand), pointing to a September Fed rate cut, equities could recover early losses as focus turns to labor market data due out later in the week. If not, we could see a volatile start to September today, but follow-through selling is unlikely ahead of the key jobs report on Friday.

<u>Market</u>	<u>Level</u>	<u>Change</u>	<u>% Change</u>
S&P 500 Futures	6,413.75	-59.00	-0.92%
U.S. Dollar (DXY)	98.46	0.78	0.80%
Gold	3,550.42	34.32	0.98%
WTI	65.69	1.68	2.62%
10 Year	4.299%	0.053	1.25%

Stocks

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

Stocks rallied to all-time highs last week, as “OK” NVDA earnings overshadowed the latest Trump vs. Fed drama as well as simmering geopolitical tensions. However, disappointing earnings from AI-focused companies leading into Friday sparked a heavy wave of selling in tech, leaving the S&P 500 down 0.33% on the week.

Equities started last week with a modest pullback as investors further digested Powell’s Jackson Hole commentary amid mostly quiet newswires. A partial retracement of the Jackson drop in yields led to the S&P 500 falling 0.43%.

The market bounced back on Tuesday as tensions between the Trump administration and Fed Governor Cook picked up amid allegations of mortgage fraud; however, a better-than-feared Consumer Confidence print and positioning into NVDA earnings helped the S&P 500 end Tuesday higher by 0.41%. Stocks continued to drift higher on Wednesday, with “Fed independence” jitters being pushed to the back burner. At the same time, the geopolitical backdrop deteriorated modestly amid fading prospects of an imminent ceasefire deal between Russia and Ukraine. The outlook for AI overshadowed those lingering macroeconomic negatives ahead of NVDA’s earnings, leaving the S&P 500 to climb another 0.24%.

NVDA earnings and revenue largely met estimates; however, guidance was slightly disappointing, and uncertainty about future AI chip sales to China saw NVDA shares pull back in overnight trade on Wednesday. NVDA’s CEO Huang revealed he is in talks with the Trump administration about a deal that would permit the sale of sophisticated AI chips to China, and the stock recovered from overnight lows with the tech sector and “rest of the market” following suit. More evidence of thawing trade tensions between the U.S. and China helped the mood on Wall Street, and the S&P 500 closed up 0.32% at an all-time high above 6,500.

Selling pressure picked up meaningfully on Friday after disappointing tech and AI-sensitive earnings saw DELL and MRVL shares drop nearly 9% and 19%, respectively, while NVDA declined more than 3%. The broader market held up relatively well as a September rate cut remained largely priced in despite Core PCE firming to 2.9%, matching a 17-month high. The S&P 500 dipped 0.64%.

Thoughts on the Appellate Court Decision (Why It’s Not A Positive for Stocks)

On Friday night, the U.S. Court of Appeals upheld the lower court ruling invalidating the administration’s tariffs, which were enacted using the IEEPA law. This includes virtually all reciprocal tariffs and other discretionary levies (like those against Brazil and India). This outcome was largely expected and not a substantial market surprise.

Practically, this shouldn’t have much impact on markets for two main reasons. First, the tariffs remain in effect until the Supreme Court hears the final appeal and issues its ruling. So, practically speaking, nothing changes despite the appeals court ruling. Second, the administration has been working diligently to find other laws to justify its tariff regime, including Section 232 (which was used for Chinese tariffs and steel and aluminum tariffs during the first administration). We should expect that if the Supreme Court invalidates the tariffs, the administration will apply them again using other legal means.

Bottom line, this is going to be a lengthy and protracted legal battle. Still, the administration is committed to this tariff policy, so it's unlikely that the market will see final tariff relief anytime soon (although if it did, it would be a decided positive for stocks as it would drastically reduce any stagflation concerns).

Three Key Market Variables To Watch

With Labor Day behind us, trading desks and offices will be full again, and investors will re-focus on these markets after summer holidays and leisure. As we begin the final third of the year, I would like to focus on three key market variables that will help determine market performance between now and year-end.

Variable One: Stagflation or Not? Recent price data have clearly shown that tariffs are pushing up goods prices, and this trend is expected to continue between now and year-end. But rising inflation doesn't mean stagflation. We could have a "run hot" economy where there's a temporary jump in inflation while economic growth remains stable (or accelerates). In that instance, it'd be a market positive that favors the "rest of the market" over tech (similar to what we've seen the past two weeks). Conversely, if higher prices persist into year-end, that will not be temporary, while any slowing of growth will spike inflation concerns.

Variable Two: One Fed Rate Cut or the Start of a Cycle? The Fed is almost certainly going to cut rates in September, but that's not what the market wants. Instead, the market wants the start of a rate-cutting cycle that leads to another cut this year and then four or five cuts in 2026. That's why stocks have rallied on rate cut optimism—not because of a September rate cut but because of six to eight total cuts over the next year. In September, the Fed could signal the start of that rate-cutting cycle, or it could simply give markets an "insurance" cut (one-and-done). The former would validate rate-cutting hopes, and the latter would dash those hopes (and hit markets).

Variable Three: Tech Outperformance. Tech and tech-aligned sectors (tech, consumer discretionary, and communications) have led this market, and we and others have documented how a few stocks have accounted for more than half of all YTD gains. AI-linked expectations have surged (again), but over the past two weeks, results have largely underwhelmed (NVDA/DELL/MRVL).

If doubts begin to creep in about all the market positives associated with AI (including massive cap-ex spend by the largest tech companies), that will cause relative tech underperformance. If it's modest, the "rest of the market" can outperform and rise. If doubts emerge about the validity of AI expectations, however, the decline in tech will likely pull the entire market lower.

Bottom line, as we begin the final run-up to year-end, these are the major issues facing markets, and if they meet current positive expectations, the market will close higher than current levels. If they don't, then a pullback or worse can't be ruled out.

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

Last Week

Economic data was sparse last week, but what data we got was Goldilocks, as it showed generally stable inflation and solid growth metrics. The data did not push back against expectations for a September rate cut nor raise concerns about stagflation.

The key report last week was Friday's Core PCE Price Index, which met expectations, rising 0.3% month-over-month (m/m) and 2.9% year-over-year (y/y). In the wake of the hot CPI from earlier in August, there was some anxiety that the Core PCE Price Index would pop back above 3.0% y/y, complicating the September rate cut outlook. However, that did not happen, and while the 2.9% year-over-year (y/y) Core PCE isn't close to the Fed's 2.0% target, it's not moving up quickly enough to make a September rate cut any less likely than it was before, which will help support stocks.

Looking at last week's growth data, the two notable numbers were Durable Goods and Weekly jobless claims, both of which beat expectations, underscoring that economic growth remains broadly stable. Headline Durable Goods fell less than expected (-2.8% vs. (E) -4.0%) while the most important New Orders for Non-Defense Capital Goods ex-Aircraft (NDCGXA) rose 1.1% vs. (E) 0.3%, underscoring that business spending and investment remain solid despite tariff turmoil.

Turning to jobless claims, they were slightly better than expected at 229k vs. (E) 230k, declining from last week's 235k. Continuing claims also dipped but remained broadly elevated, reflecting the fact that companies are not actively laying off workers, yet aren't actively firing them either. Last week's data largely reinforced that inflation remains mostly stable and economic growth is solid. While stocks were primarily driven by earnings last week, the macroeconomic data were broadly supportive of stocks.

Important Economic Data This Week

This week brings the "Big Three" monthly economic reports, and the stakes here are clear: If the data shows that growth (and inflation) are broadly stable, that will support the broad markets. However, if economic data increases stagflation concerns, either through weak growth data, high inflation readings, or both, that will be an additional headwind for markets, and we should expect declines.

The key report this week is Friday's jobs report, and the key here will be stability. We do not want to see a repeat of the August jobs report, where 1) The headline reading is weak and 2) We see massively negative revisions to the previous data, further erasing the idea that job growth has been solid this year. Bottom line, an in-line to strong jobs report will be an important positive for this market, as it will push back on the growing notion that the labor market is weakening (because if that is true and the labor market contracts, recession chances will rise sharply, and that'll be a negative for stocks, especially at these levels).

The next two important economic reports this week are the ISM PMIs. The manufacturing PMI is released today, while the Services PMI is released on Thursday. The key here for both is 50. The ISM Manufacturing PMI dropped to 48.1 last month, and if it moves farther away from 50, that will be a market negative as it'll imply deterioration in the manufacturing sector. The service PMI, meanwhile, sits at 50.1, and if it drops below 50, that will be a negative signal. To be clear, we will need to see two to three months of sub-50 readings for it to signal a looming economic slowdown, but obviously, the direction of the Services PMI (lower) is something we need to monitor.

This week's "Big Three" economic reports will give us the latest updates on growth, and solid data that pushes back on stagflation concerns will help support stocks (especially the "rest of the market" if tech remains sluggish). In contrast, soft data will increase stagflation anxiety (and likely pressure markets).

Special Reports and Editorial

Why Didn't President Trump's Firing of Fed Governor Cook Impact Markets?

Last week, President Trump announced he was firing Fed Governor Cook over allegations of mortgage fraud. In doing so, he upped the political pressure on the Fed broadly as the administration continues to pursue a sooner-than-later rate cut.

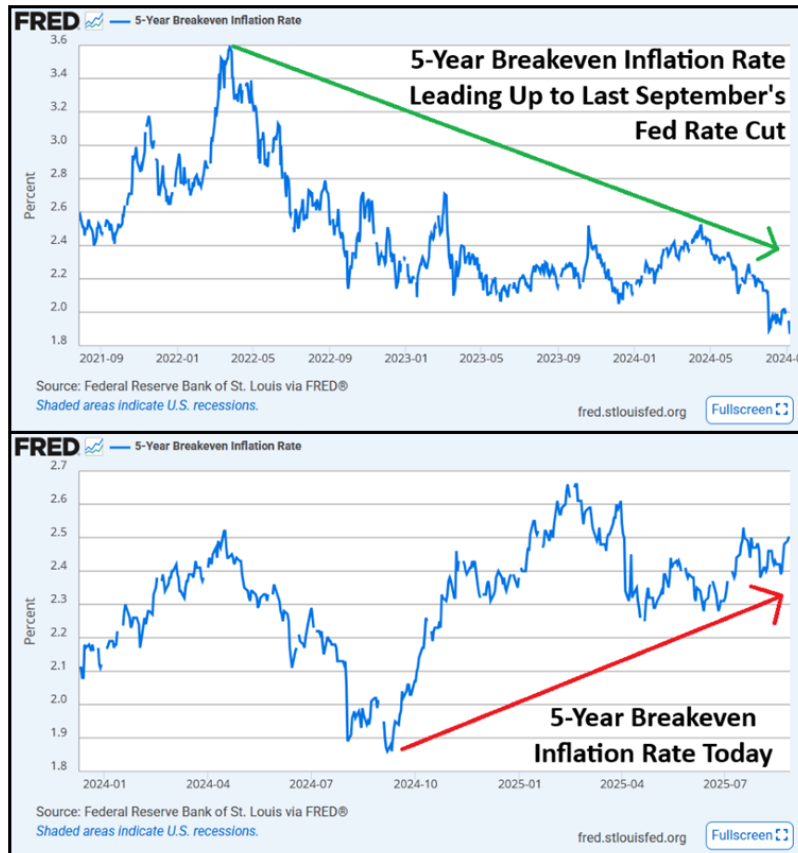
This news dominated the financial media coverage and rightly so, as this is the first time in Fed history that a sitting president has tried to fire a Fed governor. This raises more questions about the long-term outlook for the perception of the Fed's independence. But while those are all worthwhile debates, markets don't deal in the theoretical, so they largely ignored the news for two main reasons: First, even if Cook is fired, it won't change the reality that we're likely to get a rate cut in September. Second, it's not legally clear if Trump can fire Cook for just an allegation of wrongdoing. As such, we can expect another lengthy legal fight between Governor Cook and the president.

The one way this could potentially impact markets in the near term is if the administration views the Fed as non-compliant in its response to Trump's firing of Cook, the president could try to use that as "cause" to fire Fed Chair Powell, sparking yet another lengthy legal battle and opening yet another new front in the struggle of perceived Fed independence. But barring an escalation of that type, I do not think the Trump vs. Cook battle will impact markets, mainly because it won't affect policy (in the end, that's what markets are focused on).

Breakeven Inflation Rates: Powell Has a "Price Problem"

In hindsight, the Fed's decision to react aggressively to last summer's downturn in labor market data, initiating an accommodative easing cycle with a 50-bps September rate cut proved timely and well executed as the additional two 25-bps cuts in H2'24, which brought the total reduction in policy rates during the fall easing cycle to an even 100 bps, appeared to steady the labor market without triggering a meaningful rise in inflation, and subsequently left the soft-landing narrative intact. Importantly, soft landing expectations remain one of the most important pillars supporting this equity market rally as the summer comes to an end as an economic downturn is not priced into the S&P 500 at all-time highs trading at a historically rich forward earnings multiple.

While interest rate markets continue to price in a September rate cut with a strong degree of confidence (over 87%), multiple Fed officials have made it clear that inflation is still a concern, and the data released between now and the mid-September FOMC meeting will be critical in making a final decision on whether to cut rates next month.



If that is the case, then some of the lesser-followed corners of the Treasury market are suggesting that the recently dovish money flows and strong bets in favor of a September cut may be unwarranted. Specifically, the 5-Yr Breakeven Inflation Rate (the difference between the 5-Yr Treasury Note yield and the 5-Yr TIPS yield), which offers a real-time market-based measure of inflation expectations in the years ahead, is trending higher and fast approaching the highest levels since the Q1'25 peak. The higher-trending 5-Year Breakeven reading is notably in stark contrast to the decisively lower-trending 5-Year Breakeven Inflation Rate observed leading up to the Fed's fall 2024 rate-cutting cycle. At the same time, cracks have emerged in labor market statistics, much like we saw this time last year before the Fed moved to cut rates.

The Fed is facing a troublesome and delicate policy dilemma this fall, as there is potential that initiating another rate-cutting cycle next month prompts "runaway inflation" like we saw in the 1970s. At the same time, choosing to wait to cut rates to avoid such a resurgence in inflation could very well "break" the labor market and tip the economy into a recession, sparking volatility across asset classes. Notably, the bond market is currently pricing in the latter scenario with a yield curve that is *Bull-Steepening* rather than *Twisting-Steeper* as we would expect to see if "Fed error" risk was favoring 1970s-style inflation.

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