

Good morning,

What's in this week's Report:

- Two Events That Could Cause a Pullback
- Weekly Market Preview: All About the Fed (Does Powell Signal A September Cut on Friday?)
- Weekly Economic Cheat Sheet: Important Growth Updates This Week (Do They Push Back on Stagflation Worries?)
- What Happens if AI Starts to Lose Momentum?
- The Hot PPI Threatens Multiple Pillars of the Rally

Futures are slightly lower as the Trump/Putin summit produced no substantial changes in the war amidst an otherwise quiet weekend (market focus is on Powell's speech Friday and whether he hints at a Sept rate cut, or not)

The Trump/Putin summit resulted in neither a ceasefire nor the threat of oil sanctions, and as such, the market is largely ignoring the event.

There were no notable economic reports overnight.

Focus today will be on geopolitics with President Trump meeting with Ukrainian President Zelensky and European leaders at the White House to discuss how to end the war in Ukraine. From a market standpoint, its focus remains on oil prices. If the cease-fire efforts fail and Trump again threatens oil sanctions on China and other countries buying Russian crude, that will push oil prices higher and put a headwind on stocks.

Outside of geopolitics, there is one economic report today, the NAHB Housing Market Index (E: 34), and an important earnings report after the close (Palo Alto Networks, PANW (\$0.50)). Given last week's underwhelming tech reports, markets will want to see a solid result.

<u>Market</u>	<u>Level</u>	<u>Change</u>	<u>% Change</u>
S&P 500 Futures	6,464.25	-7.25	-0.11%
U.S. Dollar (DXY)	98.04	0.19	0.19%
Gold	3,392.72	10.12	0.30%
WTI	62.29	0.31	0.50%
10 Year	4.307%	-0.020	-0.46%

Stocks

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

Stocks extended the 2025 rally to new highs as favorably low consumer inflation data offset a surge in wholesale inflation readings, while trade war extensions and prospects for easing geopolitical tensions served as positive market catalysts over the week. The S&P 500 rose 0.99%.

U.S. equities declined modestly to start the week last Monday on digestion, despite news that the U.S. extended its trade deal deadline. The S&P 500 fell 0.25%.

The rally was quick to resume on Tuesday, however, as an in-line CPI report was well received by investors, as was some market-friendly Fed commentary out of new Fed Board nominee Stephen Miran, who reiterated that Fed independence is of “paramount importance.” The S&P 500 accelerated higher by 1.13%, closing at a record high.

The bullish momentum spilled over into Wednesday as dovish optimism that “immaculate disinflation” was still occurring despite the global trade war and tariffs going into effect saw market-based odds of a 25-bps Fed rate cut in September firm to 100%. News that David Zervos, Rick Rieder, and Larry Lindsey were all on Trump’s short-list to be the next Fed Chair was also well received, as all are viewed as experienced and market-friendly industry veterans. Secretary Bessent’s mention of potentially expanding export taxes to other industries poured some cold water on the rally, but the S&P 500 still ended with a 0.32% gain.

The rally was disrupted by a materially “hot” July PPI report released ahead of the bell on Thursday, which was in stark contrast to the in-line CPI report and raised concerns about whether inflation was poised to rise considerably again in H2’25. The S&P 500 oscillated between early losses and midday gains before a late-day rally saw the index close with an increase of 0.03% at yet another record high.

Stocks gapped up to record highs Friday morning thanks to a solid Retail Sales report and better-than-anticipated Empire State Manufacturing Survey. The market was quick to turn lower, however, as the preliminary August Consumer Sentiment headline fell for the first time since April, while consumer inflation expectations were revised higher (another whiff of stagflation). Soft guidance from Applied Materials saw tech stocks underperform amid another record monthly options expiration that left the S&P 500 lower by 0.29% at the close.

Two Events That Could Cause a Pullback

The S&P 500 rallied last week despite news that was, on balance, slightly negative. Inflation metrics ran hot (CPI was on balance “ok,” but it’s not moving towards the Fed’s 2% target and PPI was very hot), corporate news was mixed (especially in the AI space as AMAT posted soft guidance, while C3.ai (AI) and CoreWeave (CRWV) both dropped sharply) and there wasn’t any substantial geopolitical improvement and expectations for Fed rate cuts softened (a September cut is still widely expected).

Despite the bad news, the S&P 500 rallied on the week and hit a new all-time high. The reason is apparent: None of the negative headlines were bad enough to make investors think that 1) Tariffs may cause stagflation or 2) Meaningfully reduce AI enthusiasm.

Those two ideas, 1) That tariffs may cause stagflation and/or 2) That AI enthusiasm wanes, are the two ideas that could cause meaningful declines in the markets right now because they push back on the underlying ideas that have sparked this rally (namely, that tariffs won't spike inflation or hit growth and that AI-driven earnings growth and momentum continue).

Importantly, the news last week did move in the direction of both, as CPI and PPI (combined) incrementally increased concerns that tariffs might boost inflation (and prevent Fed rate cuts), while AI corporate news was negative. However, neither of the news items was bad enough to make investors more concerned that tariffs may cause stagflation and that AI enthusiasm may be misplaced, and that's why markets generally ignored them.

Bottom line, there's a lot of noise in the markets right now with conflicting economic data, conflicting inflation data, concerns about data validity, geopolitics, AI outlook, etc. But to cut through that noise, we need to stay focused on these two questions: Did the news make it significantly more likely that tariffs may cause stagflation? And did the news make investors seriously question their AI enthusiasm? As long as the answer to both is "no," then while stocks may see some volatility, the trend in this market should remain higher.

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

Last Week

Last week's focus was on inflation, and the data caused a bit of a rollercoaster for investors, as CPI was viewed as tame and increased rate-cut expectations (and fueled a run to new all-time highs in stocks) until a very hot PPI report on Thursday reversed that sentiment and weighed modestly on markets.

Starting with CPI, it was a mixed bag. The headline reading was better than expected (2.7% y/y vs. (E) 2.8% y/y), but Core CPI rose 3.1% vs. (E) 3.0%. However, investors looked past the headlines, and the main upward pressure on prices came from services, which are not directly linked to tariffs. Much of the service price increase came from dental and airfare categories (hardly something that most view as tariff-related). So, the CPI, despite being mixed on the headline, actually served to ease inflation concerns, and that increased September rate-cut expectations (they hit 100% after the CPI) and fueled the rally in the S&P 500 above 6,400.

However, the Producer Price Index told a different story. PPI was much hotter than expected at 0.9% m/m vs (E) 0.2% and 3.3% vs. (E) 2.5% (and up from 2.4% last month). Like CPI, the majority of the upward pressure on prices came from services, including airfare (like in CPI), cable, and internet services. However, while investors gave CPI a "pass" because tariff categories were generally tame, the jump in PPI was too much, and it erased early gains in stocks, although notably, it didn't cause a sustained decline.

Bottom line, PPI is a volatile metric, and the major question on inflation isn't whether service inflation is rebounding (there aren't many analysts who are worried about that), but instead whether tariffs are causing goods inflation. There wasn't much evidence of that in either CPI or PPI. Markets exited the week still largely sure that the Fed will cut rates in September and again in December (and maybe once more in October). However, that will depend on the following three important inflation reports (Core PCE Price Index and next month's CPI and PPI), as last week's inflation data did not reduce concerns about stagflation.

Turning to growth data, the key report was Retail Sales on Friday, and like the inflation data, it was a mixed report but overall was solid. Headline retail sales slightly missed expectations (0.5% vs. (E) 0.6%), but there was a solid revision to the June data to 0.9% from 0.6%. More importantly, the “Control” group, which is retail sales less gas, autos, and building materials, beat estimates (0.5% vs. (E) 0.4%) and saw a positive revision (0.8% from 0.5%). Bottom line, through July, there was no sign of a significant slowdown in consumer spending (which does push back against the stagflation narrative).

Important Economic Data This Week

The most important event this week is also the one with the least amount of clarity: Fed Chair Powell’s speech at Jackson Hole on Friday. The reason this is an opaque event from the standpoint of markets is that it’s never precisely clear whether a Fed chair will discuss monetary policy in his speech. Two years ago, Powell used Jackson Hole to tell markets to brace for pain from rate hikes. Last year, the speech didn’t telegraph the 50-bps cut that came in September. Point being, Powell could pave the road for a 25-bps cut in September, he could push back on those expectations, or he could simply not discuss policy much at all. From a market standpoint, any hint of promise of a rate cut will be welcomed, and push back on rate-cut expectations will likely cause a market decline (as would no mention of policy, although less than if Powell pushes back against rate-cut hopes).

Staying with the Fed, the minutes from the July meeting will be released on Wednesday, and it’s safe to say that these will be the most watched minutes in some time, because the July meeting saw two Fed officials vote for a rate cut, the most dissents since the early 1990s. Investors will look through the minutes for signs that more Fed officials wanted to cut, but didn’t want to vote for it. If the tone of the minutes is dovish (saying “many” people were open to a cut but wanted to wait a bit longer or something like that), it will be a dovish positive for markets.

Turning to actual economic data, there are some notable reports this week that will give us anecdotal insight into the current state of growth (and remember, growth was disappointing in June). Thursday’s flash composite PMI is the first significant national economic number for August, and the point here is clear: The stronger, the better. June’s underwhelming data and last week’s PPI are helping to keep stagflation fears alive, and if the flash PMI is weak, those fears will grow (and pressure markets).

Bottom line, this week will provide essential updates to 1) Fed rate-cut expectations and 2) Opinions on economic growth. Anything that makes markets further expect a September rate cut and implies steady growth should further boost stocks, while pushback on expectations for a September cut and data that adds to stagflation anxiety will be a negative for markets (likely stocks and bonds).

Special Reports and Editorial

What Happens if AI Starts to Lose Momentum?

While most of the focus in markets last week has been on the CPI report and looming interest rate cuts, two of the higher-profile AI bellwethers posted some disappointing results, as C3.ai (AI) fell 25% on Monday following soft guidance, and CoreWeave (CRWV) dropped 21% after posting disappointing results. Those moves put a question in my head that is the subject of last week’s Sevens Report Alpha webinar: What happens to this market if AI loses momentum?

Many analysts (including this one) are very focused on economic data and the impacts of tariffs, and specifically whether tariffs will cause an economic slowdown, and/or stagflation. But when I think back to the tech bubble (and I'm not saying AI is the same, but there are similarities), the reality was the tech bubble killed the markets, not the actual economy.

For those of us who were in the business then, the tech bubble bursting was a market phenomenon. The S&P 500 fell more than 20% from the highs in March 2000 through August 2001, but the economy was broadly stable. To that point, the unemployment rate only increased from 4.0% to 4.6% (it topped out at 5.9%).

Now, it's true that ultimately the economy eventually buckled, but that was due to a combination of the tech bubble and September 11th and the resulting economic slowdown. Here's the point: We're all laser focused on the economy and rightly so given the dramatic policy changes that have been implemented (tariffs), legislation (Big Beautiful Bill) and Fed drama, but I think it's important also to acknowledge that the economy could stay resilient (maybe in a stagflation-light scenario where growth slows materially and inflation bumps higher, but not too much), but AI begins to disappoint and the market drops despite macroeconomic stability.

The reality is that this market is vulnerable to a loss of enthusiasm for AI-linked tech stocks. The simple fact is that five stocks (NVDA/MSFT/META/AVGO/PLTR) have accounted for about 6% of the 9.7% YTD return of the S&P 500, or some 60%! Slightly more broadly, the Information Technology sector and Communication Services sector, combined, have accounted for approximately two-thirds of the entire YTD rally.

Bottom line, C3.ai and CoreWeave's declines are a reminder that the AI revolution is continuing to mature and that execution will be important going forward, not just for tech-focused AI stocks but also for the broader market in general—because if AI enthusiasm begins to fade, this market will face a headwind regardless of whether the economy is stable.

The Hot PPI Threatens Multiple Pillars of the Rally

The July Producer Price Index was the latest in a string of economic data points to materially surprise markets vs. expectations, as the headline surged by the most since March 2022 with a month-over-month rise more than 4X the consensus estimate. That is a problem for markets for several reasons in the current macroeconomic environment because a resurgence in inflation pressures poses a threat to several "pillars" currently supporting the 2025 stock market rally.

Pillar 1: Inflation Is Widely Expected to Return to the Fed's 2% Mandated Target

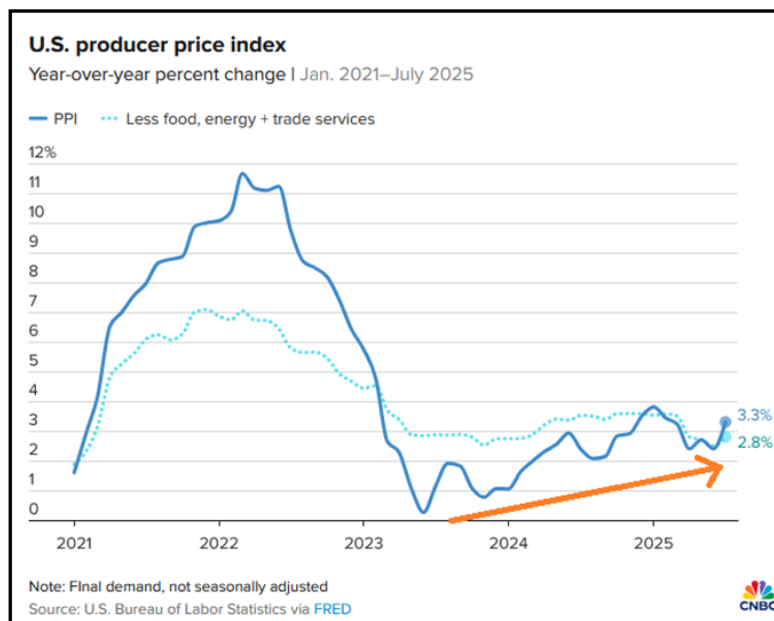
A continued decline in core measures of consumer inflation is widely expected to continue in the months and quarters ahead. Historically speaking, headline PPI has a strong tendency to lead CPI. So, if the July spike in PPI turns out to be the start of a resurgence in wholesale price pressures, history would suggest that CPI is poised to reaccelerate higher in the next two-to-six months, a development that is not priced in with stocks at record highs.

Pillar 2: The Fed Is Expected to Resume Rate Cuts in September

This second pillar is directly related to the first in that low and falling inflation metrics would open the door to the Fed continuing with rate cuts after “pausing” the cutting cycle in December 2024, after a rapid 100-bps cutting campaign was seen as an effective response to signs the labor market was suddenly weakening. A rise in PPI that ultimately turns out to precede a rise in CPI would present the Fed with a “mandate dilemma,” as the July jobs report revealed a much less encouraging picture of the labor market in the first half of the summer. Expected economic accommodation by the Fed via rate cuts has eased concerns about the labor market in recent weeks. Higher inflation challenges the case for rate cuts this fall.

Pillar 3: Corporate Earnings Are Seen Growing Solidly into 2026

A third pillar supporting the equity market rally into H2'25 is a consensus view that earnings growth will remain robust this year and through next year based on corporate guidance delivered throughout this latest Q2 reporting period. So, with a sudden “price shock” potentially emerging in July, the first month of the Q3 corporate reporting season, evidence of suddenly higher input costs challenges the thesis that earnings will be as high as broadly expected, as margins are compressed. Coming full circle back to the first pillar, if corporate management teams choose to pass along the price increases to the end user to preserve healthy margins and meet their forward guidance, the higher prices will result in upside pressure on consumer inflation measures.



Bottom line, the hot PPI report presents a multifaceted threat to the prospects that the equity market rally will continue to new highs between now and the end of the year, as upside inflation risks were not on the radar before the July PPI. Critically, the fundamental “pillars” discussed here are all intertwined and related to one another, with rising producer prices posing a threat to corporate earnings estimates, while simultaneously suggesting the Fed is more likely to face a mandate dilemma if labor market data continues to deteriorate. At the same time, inflation begins to rise again, the textbook definition of stagflation. If a stagflation economic environment emerges in H2'25, equity markets are well over their skis with the S&P 500 trading at a 22X multiple of what could prove to be overly optimistic 2026 earnings expectations.

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