

Good morning,

What's in this week's Report:

- Can the Rest of the Market Rally If Tech is Weak?
- Weekly Market Preview: Can AI Enthusiasm Rebound? (NVDA Earnings on Wednesday Are Key)
- Weekly Economic Cheat Sheet: The First Look at November Data (Flash PMIs on Friday)
- The Center of the Shutdown Fight (Why It Matters to Markets)

Futures are moderately lower after Friday's rebound.

On trade, there was positive news: the White House confirmed reduced tariffs on numerous food products, aiming to boost affordability.

Economically, the only notable Report was Italian CPI, which rose 1.3%, as expected.

Today we have the first economic Report for November, Empire Manufacturing (6.10), and numerous Fed speakers. Williams (9:00 a.m. ET) and Waller (3:35 p.m. ET) are the most important speakers today, but we will also hear from Jefferson (9:30 a.m. ET), Kashkari (1:00 p.m. ET), and Logan (7:55 p.m. ET). Bottom line, if Empire manufacturing is stable and the tone of Fed speak today is open to a December cut (especially from Williams and Waller), that should help extend Friday's rebound.

| Market            | Level    | Change | % Change |
|-------------------|----------|--------|----------|
| S&P 500 Futures   | 6,754.00 | -1.25  | -0.02%   |
| U.S. Dollar (DXY) | 99.44    | 0.14   | 0.14%    |
| Gold              | 4,078.21 | -15.99 | -0.39%   |
| WTI               | 60.25    | 0.30   | 0.50%    |
| 10 Year           | 4.138%   | -0.011 | -0.27%   |

## Stocks

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

U.S. equities surged into the middle of last week thanks to a deal to end the government shutdown. However, worries about lofty elevations and uncertainty surrounding what quarantined economic data may reveal about the labor market and consumer spending saw most of the gains given back by the week's end. The S&P 500 edged up 0.12% on the week.

Stocks began last week with a big gap higher, with beaten-down tech stocks leading the way amid broad risk-on money flows, as progress in Congress toward ending the government shutdown. Dovish money flows in the bond markets validated dovish commentary from Fed officials, which helped the S&P 500 end near the session highs Monday, up 1.54%.

There was an apparent loss of bullish momentum in the stock market on Tuesday, as news that SoftBank had fully exited its NVDA position, paired with negative guidance from AI-focused cloud storage company CRWV, weighed on tech stocks. A soft weekly ADP report didn't help sentiment; however, strong guidance from leadership at global logistics giant FDX helped keep a tentative bid in the market, and the S&P 500 added 0.21%.

The advance slowed further on Wednesday, despite early strength related to an upbeat AMD analyst day, during which the CEO noted "insatiable demand" for AI technology. Growing concerns about what delayed economic data may reveal once the government reopened capped gains, limiting the S&P 500's daily gain to just 0.06%.

Volatility returned to the equity markets in a big way on Thursday, as strong earnings from CSCO and a solid 6% pre-market rally in the stock failed to spark a broader rally in big-tech stocks amid growing AI skepticism among investors. A sell-the-news reaction to the reopening of the government amid growing worries about a recession or stagflation was amplified by cautious comments from the IMF, which noted there have been signs of "mounting strain" on the U.S. economy. The S&P 500 dropped 1.66%.

Stocks gapped lower again at the open on Friday, thanks to follow-through bearish momentum from Thursday and some evidence of a weakening Chinese economy, which saw the S&P 500 test key technical support at 6,650, coinciding with last week's lows. Dip buyers stepped in to defend that technical level, and stocks ripped back into positive territory, with historically active derivatives markets amplifying the move. The S&P 500 ran into resistance at 6,775 before the Trump administration's accusation that BABA helped the Chinese military target the U.S. weighed modestly on stocks. Some positive tariff news was offset by new economic angst after the BLS announced the September Employment Situation would be released on Nov. 20, which sent the S&P 500 rolling over to end the day effectively flat.

#### Can the Rest of the Market Rally If Tech is Weak?

The tech sector declined again last week, weighing on the S&P 500, as concerns grow about AI-related spending commitments and the potential negative implications for tech stocks and the economy if that cap-ex spending slows.

Nothing particularly bad happened in the tech space last week. Yes, CoreWeave (CRWV) declined post-earnings on a revenue miss, but that was due to timing, not a lack of overall demand. Meanwhile, other tech companies (AMAT and CSCO) posted strong numbers, and, in general, the outlook for AI spending remains as robust as it was three weeks ago (when stocks were surging on daily announcements).

Instead, the rising number of articles and opinions doubting the sustainability of the AI cap-ex boom is leading to a rise in skepticism that fed on itself last week, as selling created more selling in the tech sector. Now, investors are looking for NVDA earnings, out Wednesday after the close, to "stop the bleeding" and remind investors of the earnings growth and extreme cap-ex spend that is powering the entire AI boom. Essentially, investors expect strong NVDA earnings to quell the recent uptick in AI skepticism that is behind this decline in tech and the S&P 500.

But what if that doesn't happen? What if NVDA results aren't good enough to stop this modest increase in AI skepticism? In that case, can the rest of the market hold up while tech/AI decline?

History suggests it's unlikely, but it is possible. Over the past three years, the Nasdaq has declined by more than 10% on three occasions for extended periods (which I define as a few weeks). Essentially, these have been the three pullbacks/corrections in the robust tech bull market.

In two of those instances, July 2023-October 2023, and February of this year until April, the rest of the market did not hold up when tech fell. In both instances, the QQQs fell 10.5% and 23%, respectively, while the equal-weight S&P 500 ETF (RSP) declined 13.2% and 16.4%. Point being, diversifying away to the rest of the market didn't really matter.

However, there is one instance, from early July 2024 to early August 2024, when the rest of the market held up. During that period, QQQ fell 12.5%, while RSP was essentially flat. In that instance, the declines in tech were driven by underwhelming Q2 earnings and broader concerns about economic growth (labor market data softened, and inflation rose). That stagflation environment hit the most expensive/highest flyers the hardest, while more value-oriented sectors held up and offered significant outperformance.

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

### **Last Week**

The dearth of economic data continued last week, despite the end of the government shutdown, and the Fed reports we received implied softening in the labor market and sentiment. At the same time, Fed speak suggested the December rate cut was far from a done deal.

Starting with economic data, there were only two notable reports last week: the NFIB Small Business Optimism Survey and the ADP weekly jobs report, both of which were soft. The NFIB Small Business Optimism Survey declined slightly to 98.2 vs. (E) 98.3 as small business optimism continued to chop somewhat sideways.

The more impactful Report was the new ADP weekly jobs report, which showed an average of -11,250 jobs lost per week for the four weeks ending Oct. 25. Again, this is a new data point, and it offers a rolling look at what the well-known ADP monthly jobs report would be if it were taken each week. So, for last week's Report, if the ADP jobs report were released then (instead of the week before on the regular schedule), it would have shown a loss of 45k jobs (11,250\*4 weeks). That number did impact markets, as the dollar and the 10-year Treasury yield dropped modestly. The primary source of concern about the economy is the labor market, and amid the dearth of data, this figure suggests it may be weakening more than expected.

Bottom line, the lack of economic data makes each private report punch above its weight, and that was the case last week, as the new ADP data reminded investors that the outlook for the labor market remains uncertain and could be weaker than expected. For now, the totality of the data still points to a stable labor market and overall solid growth, although that obviously could change once the backlogged data deluge begins in the next week or two.

### **Important Economic Data This Week**

The release schedule for government data is in flux, but even without government data, investors do get several potentially important economic reports this week.

On Friday, we get the first major economic Report for November via the flash composite PMIs. This is the first national data point for November, and investors will be looking for stability in the data, especially in the flash services PMI, as that accounts for the majority of the economy. Bottom line, as long as the data stays stable and doesn't imply a sudden, dramatic loss of momentum in November, it should help support this market.

Friday's flash PMI (which, again, is a national report) will steal the thunder from the first two looks at November activity, which will be released earlier in the week via Empire Manufacturing (today) and Philly Fed (Thursday). But even with the more important flash PMI looming on Friday, these reports still matter. And, as with Friday's flash PMI, the key is that we don't see activity suddenly nosedive, suggesting that economic growth may have hit a wall in November.

Finally, on the data front, the weekly ADP jobs report will be released on Tuesday and, as we saw last week, it has the potential to move markets. After a modestly negative number last week, markets will ideally want to see a bounce back towards or into positive territory. At the same time, a further decline (say, towards or past 15k) would only raise concerns that the labor market has weakened, while the government was shut down (increasing the chances of an economic slowdown).

Turning to the Fed, next week brings the release of the Fed minutes from the October meeting, and the key here is clear: Markets will want to see how divided the Fed was regarding the October cut and search for clues about the level of support for another cut in December. The stakes here for markets are pretty straightforward: If the minutes imply that a majority of Fed members are still open to a December rate cut, markets will welcome it. Conversely, if the minutes show the Fed is even more divided on a December cut, that will be a negative. The Fed's rate cuts are an important support for this market. The Fed's commentary implies a December rate cut is far from certain and that the Fed could end the rate-cutting cycle altogether. The market is largely ignoring this possibility, but if it becomes more likely, it will be negative for stocks.

## **Special Reports and Editorial**

### **The Center of the Shutdown Fight (Why It Matters to Markets)**

The government shutdown ended last week, but it did so without resolving the core issue that caused it, and resolving this issue matters a lot to an important sector of the market and to the U.S. fiscal debate more broadly. As such, I wanted to cover the main reason for the shutdown, explain why it's a problem, how it's impacting the healthcare sector and a specific healthcare industry, and how it could affect markets more broadly.

The core issue that caused the government shutdown was government subsidies for private marketplace health insurance. People in the U.S. generally fall into three "buckets" of healthcare plans: employer plans (the largest cohort), government plans (Medicare and Medicaid), or private plans. It's those people on a private plan that we are focused on. People buy private health insurance, usually through the Affordable Care Act marketplace, when they 1) don't have an employer option because they are self-employed or a small business, and 2) aren't old enough for Medicare or poor enough for Medicaid.

When the ACA was created, it included subsidies for these private market insurance plans to help people with low incomes afford them and to encourage them to purchase health insurance. The seeds of the fight that led to the government shutdown were sown in 2021, when the American Rescue Plan Act (ARPA) dramatically increased the subsidies the government provides to people who buy private insurance on the marketplace. Without boring you with specifics, before the ARPA, only people whose incomes were below 400% of the federal poverty level (which, in 2021, was \$26,500 for a family of four) could get health insurance subsidies. In 2021, the ARPA scrapped that limit, instead allowing anyone to qualify for government subsidies if their premiums were above 8.5% of their taxable income.

The net result was a dramatic increase in the number of people using the subsidies and a corresponding increase in the gross cost to the federal government. The Kaiser Family Foundation (an excellent resource for healthcare-related research) estimated that the number of people eligible for subsidies rose from 18.1 million before the ARPA to just under 22 million. The increase in costs due to these changes is substantial: the federal cost of ACA subsidies rose from about \$50 billion in 2018 to \$92 billion in 2023 and is projected to reach around \$138 billion in 2025!

These increased subsidies are set to expire at the end of 2025, and that was at the core of the fight that led to the government shutdown. As you might imagine, Democrats are for extending these subsidies for the longer term or making them permanent, arguing that if they go away, healthcare premiums will spike and enrollment will plunge. Republicans, on the other hand, want to limit their extension (perhaps just another year) and reintroduce income caps and other means testing to ensure they are directed at the people who genuinely need them most.

The shutdown ended without resolution of this issue, and the subsidies are still scheduled to expire at the end of the year (although negotiations on an extension will begin once the government reopens).

### Why Does This Matter to Markets?

This matters from a macroeconomic sense generally through the deficit and fiscal state of the U.S. While not a huge line-item issue, entitlement spending is a significant cost of the U.S. government, and if entitlements continue to be extended and increased without spending offsets, it will contribute to the deteriorating fiscal situation, and that could push Treasury yields higher and hurt the U.S. dollar.

From a microeconomic angle, it's massively important for the healthcare sector. The healthcare sector is comprised of the pharma companies (JNJ, PFE, MRK, LLY, etc.), the hospital stocks (HCA), and the insurers. The insurers with the highest ACA marketplace exposure are most at risk if the subsidies are not extended: Centene (CNC), Molina (MOH), Oscar (OSCR), and, to a lesser extent, UnitedHealth (UNH).

These stocks have, for the most part, been hit on concerns about the lack of extension of those subsidies, as they are important for earnings (without the subsidies, fewer people will buy insurance on the marketplace). To that point, four of the five insurers are down solidly over the past month, while just one (CNC) is close to flat (-1%).

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Richard Rose AIF®  
917-597-7432  
rrose@nationwideplanning.com