

Good morning,

What's in this week's Report:

- An Important Week for Two Pillars of the Rally
- Weekly Market Preview: Does Fed Policy and AI News Fuel Push Markets to New Highs?
- Weekly Economic Cheat Sheet: More Labor Market Updates (Is It Stable?)
- Why Kevin Hassett as Fed Chair Is a Double-Edged Sword
- Why Google's Gemini Update Could Further Pressure AI Enthusiasm

Futures are little changed following a generally quiet weekend of news, and as investors look forward to important Fed and AI events later this week.

Investor focus, as we start the week, is on Wednesday's Fed decision.

Economically, foreign data was better than expected, with Chinese exports beating estimates (rising 5.9% vs. (E) 4.0%) and German Industrial Production (1.8% vs. (E) 0.1%).

This week will be a busy one, but today should be relatively quiet in the markets as there are no notable economic reports and just one earnings report after the close, TOL (\$4.87).

<u>Market</u>	<u>Level</u>	<u>Change</u>	<u>% Change</u>
S&P 500 Futures	6,889.50	11.25	0.16%
U.S. Dollar (DXY)	98.95	-0.04	-0.04%
Gold	4,235.05	-7.95	-0.19%
WTI	59.39	-0.69	-1.15%
10 Year	4.151%	0.011	0.27%

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

Stocks churned higher last week as traders digested the melt-up into November's close amid high conviction that the Fed will cut rates in December following mixed labor data. The S&P 500 edged up 0.35% on the week.

Equities opened December with a modest decline on Monday as the five-day Thanksgiving rally warranted some digestion, while overseas volatility tied to a potential hawkish BOJ pivot weighed early. A soft ISM Manufacturing print helped lift stocks from the lows before tariff concerns and heavy Bitcoin price action pressured markets again, leaving the S&P 500 down 0.53%.

Stocks steadied at the open on Tuesday. Mixed headlines about a Russia-Ukraine ceasefire and a rising Mag 7 AI chip competition briefly roiled markets, but the S&P 500 held support near Monday's lows and closed up 0.25% as traders welcomed news that Kevin Hassett was short-listed for Fed chair.

Equity futures were volatile on Wednesday as a weak ADP print fueled dovish flows, while solid MRVL earnings supported big tech. But a report that MSFT lowered AI software sales quotas sent indexes sharply lower at the open. A Goldilocks ISM Services print and MSFT's denial of the headlines helped the market reverse, and the S&P 500 closed up 0.30%.

Choppy trade continued Thursday with stocks firm at the open on strong CRM earnings, easing jobless claims, and lower Challenger job cuts. News that META planned sizeable Metaverse budget cuts added to the tech tailwind, while a solid T-bill auction reinforced dovish Fed expectations. A late-day "air pocket," potentially linked to Fitch observations on structured-finance risks, briefly hit sentiment, but markets quickly rebounded, and the S&P 500 eked out a 0.11% gain.

Stocks gapped higher Friday as the week's buoyant price action was seen as leaving the path of least resistance higher for stocks ahead of the final economic data points of the week. The slightly warm PCE print triggered profit-taking, but Consumer Sentiment was Goldilocks, showing a firm headline rise and easing inflation expectations, which limited follow-through selling and left the S&P 500 to close up 0.19%.

An Important Week for Two Pillars of the Rally

December in the markets, especially during years of substantial gains, can often be filled with holiday and family distractions, and the market can sometimes go on a type of "autopilot." But that's not the case this year, as the coming weeks contain important events for two of the four pillars of this rally: Expectations for Fed rate cuts and AI Enthusiasm.

Starting with the Fed, the decision on Wednesday is important not just because of an impending rate cut, but more so because the Fed will reveal just how committed it is to continuing rate cuts in 2026. To be clear, the idea of ongoing Fed rate cuts is key to the rally, and if that idea is invalidated (and investors have to think about rates staying at levels near these for the longer term), then it would be negative and cause year-end market volatility.

Regarding AI Enthusiasm, this is a potentially very important week, as there are three possible market-moving events: ORCL earnings, AVGO earnings, and the release of ChatGPT's model update.

ORCL has become the poster child for concerns about overspending and overcapacity in data centers. Put simply, ORCL is spending hundreds of billions and potentially running negative free cash flow, and investors have noticed, as ORCL's credit default swaps have risen sharply. To be clear, the risk of default is still very low, but the bottom line is investors will want to see ORCL earnings: 1) Produce strong financial results on revenue/earnings, 2) Provide aggressive guidance on future orders, and 3) Acknowledge the ramp in capex and stress positive ROI is expected.

The key to AVGO earnings is to confirm robust demand (which should continue). Chips remain the critical resource in the AI capex race, and reinforcement that demand remains solid, especially in the company forecasts, will boost AI Enthusiasm and support tech and the broader markets.

Finally, ChatGPT's upcoming model update is significant because performance metrics need to match (or, better yet, exceed) Google's Gemini 3 model to keep the excitement of the AI derby intact.

As previously discussed, Google's Gemini 3 model represents a mortal threat to OpenAI. And since literally trillions will be spent by OpenAI in the coming years, it's important for the tech sector and the economy in general that expectations for that spending don't change. If ChatGPT's release underwhelms, it'll further increase AI skepticism, which will likely result in volatility.

Bottom line, this week is important for the Fed and AI enthusiasm, the two factors most responsible for the 2H 2025 rally. For the rally to continue into year-end, we'll need to see 1) The Fed signal more cuts coming, 2) ORCL and AVGO reinforce strong guidance and acknowledge some fiscal discipline, and 3) OpenAI release an improvement to ChatGPT that keeps major tech firms spending to try and catch up.

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

Last Week

Investor opinion heading into a mini-data deluge last week was that growth was generally stable. After several reports over the past week, investors ended the week with the same general opinion. That was an important support for markets.

The two key reports last week were the ISM Manufacturing and Service PMIs. The key for these reports is that neither fell below 50, and despite some deterioration in the manufacturing PMI, the services PMI improved, preventing the two important readings from flashing an economic warning signal.

Starting with manufacturing PMI, it declined to 48.2 vs. (E) 49.0. That's the lowest reading in a few months, and while we'd obviously prefer the number to be higher than 50, the 48.2 reading isn't that bad. It doesn't imply sudden deterioration in manufacturing activity. New Orders, the leading indicator in the report, slipped to 47.4 from 49.4, a low reading that warrants note, but as long as the manufacturing PMI doesn't move towards 45 in the coming months, then manufacturing activity should be viewed as mostly stable.

The service PMI showed improvement and rose to 52.6 vs. (E) 52.1, and that's important because 1) It stayed above 50 and 2) The service sector of the economy is much larger than the manufacturing portion of the economy, so solid activity here is a better signal for broader growth. Details of the report were also solid, as New Orders, again the leading indicator in the report, slipped to 52.9 from 56.2, a deterioration, but still comfortably above the 50 level. The November ISM PMIs (the most important up-to-date economic report we can get until the Dec. 16 jobs report) showed an economy that remains largely as it's been: sluggish manufacturing activity but not a disaster, and generally resilient and solid service-sector activity (which is positive for the broader economy). In sum, stable but unspectacular growth.

Turning to labor market data, we did not get the November jobs report last week, but we did get several notable labor market readings, and the net message is that the labor market may be deteriorating but not collapsing, which means it remains a risk to monitor, not fear. The monthly ADP jobs report was the biggest disappointment, showing a -32k job loss vs. (E) 20k job gains, which will increase anxiety that the government report out next week could be negative. However, other labor market metrics were solid. Jobless claims fell to the lowest level of the year at 191k vs. (E) 225k (although that's likely an anomaly and we should expect claims to rise back above 200k in the coming weeks), while the Challenger layoff survey showed 71k job losses, well below the 153k job losses from last month.

Bottom line: economic data wasn't perfect, and we shouldn't be dismissive of risks to the economy (continued stability is not a foregone conclusion given still-present macro headwinds), but for now the data is showing still-solid growth, which is important support into year-end (and should help stocks hold gains).

Important Economic Data This Week

The key economic event this week is Wednesday's FOMC decision. The focus here won't be just on whether the Fed cuts by 25 bps. To be clear, the Fed is fully expected to cut rates, and if it does not, that would be a substantial hawkish surprise and likely cause a solid decline in stocks in the short term. However, beyond the December cut, the bigger question for investors is what the Fed signals for 2026 via the updated dot plot. If the dots show fewer-than-expected rate cuts, that will be negative for markets.

Looking at other data this week, we do get two notable labor market reports (remember the labor market is the area of focus for the economy because if it weakens further, it'll be a negative signal). JOLTS on Tuesday and the weekly jobless claims report on Thursday are the key readings, and the stronger the readings, the better. JOLTS are well off the pandemic high but remain comfortably above levels we'd associate with an economic slowdown (JOLTS are above 7 million, and to throw an economic warning sign, they'd need to drop below 6 million).

Jobless claims are likely to be even "noisier" than usual, given the shutdown and now that it's the holidays (temporary hiring skews claims data this time of year), but the bottom line is we're not seeing any major deterioration that would signal trouble in the labor market.

Special Reports and Editorial

Why Kevin Hassett as Fed Chair Is a Double-Edged Sword

Stocks have rebounded over the past two weeks mainly due to market expectations for a more dovish Fed. Initially, that was driven by dovish comments from New York Fed President Williams and by some soft labor market and inflation data, as the expectation for a December rate cut rose from sub-50 % just over two weeks ago to nearly 100% now.

But beyond the December action, another event also emboldened the expectation for lower rates: The looming nomination of Kevin Hassett as Fed chair. President Trump all but admitted he'll nominate Hassett in early 2026, and of the finalist candidates, Hassett is viewed as the most dovish. As such, markets expect a more dovish Fed once Hassett takes over from Powell in mid-2026.

However, nothing in markets is free. While stocks cheered a more dovish Fed chair, bond markets did not. The 10-year Treasury yield rose 10 basis points over the last 7-10 days, in part because of hawkish BOJ rhetoric. Still, also because bond markets are wary that if Hassett is too dovish for any reason (poor decision-making, political influence, misreading data, whatever), then inflation will return. U.S. markets could be looking at a replay of the 1970s Arthur Burns-led Fed's inflation-on-again/off-again policy, which led to the decade's economic malaise. And while Hassett's apparent selection isn't the only reason the 10-year yield is above levels from last week, it's one of the reasons.

Bottom line, lower rates are, broadly speaking, supportive of risk assets, but if the Fed's independence is viewed as compromised, even a little bit, then the Treasury markets will drop, and yields will rise, something that could more than offset any Fed funds rate cuts. Positively, despite concerns from political opponents, Hassett has not demonstrated throughout his lengthy career that he would sacrifice Fed independence. As we start 2026, it is much more important to support stocks than to worry about whether the Fed funds rate ends 2026 at 3.625% or 2.875%.

Why Google's Gemini Update Could Further Pressure AI Enthusiasm

Over the past several weeks, the AI landscape has seen a potentially tectonic shift, but it's received little coverage outside the tech/financial markets. I want to make sure that we 1) understand what's happened and 2) can explain why it matters, because it's not an exaggeration to say it's a material threat to the entire AI cap-ex-driven rally of 2H 2025.

The event I'm referring to happened earlier in November to little fanfare. Google released its Gemini AI Model 3, and the reason this became a big deal was that many believe Gemini performs as well as, or better than, ChatGPT. On the surface, that might not seem like a potential revelation, but it is, and here's why...

ChatGPT burst on the scene just over three years ago and showed the entire tech industry that they were way ahead of the mega-cap tech firms on AI development. Google, Apple, Microsoft, Meta, and others were caught with their proverbial pants down, and since then, they have been spending billions on chips and infrastructure to catch up, with limited success.

Much of the explosion in demand for NVDA, AVGO, and TSMC chips has been driven by this mad dash among well-financed companies to build their own AI models that can compete with ChatGPT. But until Gemini 3, they were largely failing, and ChatGPT remained the "Google" of AI search. This wasn't just based on usage but also on performance. Put simply, the mega-cap tech companies' domestic AIs couldn't compete with ChatGPT.

However, given Google's dominant position in search, the Gemini update poses a massive risk to ChatGPT: people will stop using ChatGPT and switch to Google and Gemini. For those of us on the older spectrum, this brings back memories of other early-stage companies in substantial technology evolutions.

In the early 1990s, a service called Prodigy was actually the first widely used email and web software. It was the first mover in the adoption of the internet by the general public. But it was later surpassed by AOL and websites such as Yahoo and Google. Ultimately, despite being the first mover, Prodigy closed. In the mid-2000s, Myspace was the first widely used social media platform. However, it was passed by Facebook and has since slid into relative obscurity.

You can see the analogy. Google's Gemini could create the same story for ChatGPT. Yes, ChatGPT was the first mover and burst onto the scene, but a superior, better-capitalized company later surpassed it. This is especially important because, unlike Prodigy in the 1990s or Myspace in the mid-2000s, ChatGPT has committed to spending more than \$1.4 trillion over the coming years to build out its AI infrastructure. The entire tech industry, the broader market, and the U.S. economy have all benefited from the ongoing and future cap-ex boom. And ChatGPT has spawned sub-industries chasing AI, as well as multiple other smaller companies that have made cap-ex commitments.

If Google's Gemini takes a dominant position in AI like Google took a dominant position in search, then funding not just for ChatGPT but also for all these other smaller AI companies could dry up, as investors will view Google's position and resources (Google doesn't need money, is working to retrofit chips and has an enormous and powerful balance sheet) as insurmountable. That could result in the cancellation of many of these AI infrastructure projects, weighing on the tech sector and the economy more broadly in 2026.

Bottom line: AI infrastructure spending has been driven by the mega-cap tech companies, mainly in a race to catch up with ChatGPT. Suppose Google has accomplished that goal (and it's too early to say whether it has, but it's worth considering). In that case, it risks jeopardizing the trillions in spending commitments that have fueled this tech-driven rally and boosted economic growth. Looking ahead, ChatGPT is releasing an updated model this week, which could be a big deal for markets. If the new model doesn't "leapfrog" Gemini 3, then these fears will continue to grow, and that could hit markets. We'll be watching.

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