

MIXED-TO-GOOD

*"IN THE MIDST
OF CHAOS,
THERE IS ALSO
OPPORTUNITY."*

– SUN TZU, THE ART OF WAR

Investors overcame wide-ranging challenges in capital markets during the second quarter. The quarter began with "Liberation Day" trade volatility, witnessed a brief but unsettling "12-Day War" between Israel and Iran, and then closed with drama over the Big Beautiful Bill—"BBB" reigniting concerns about the country's fiscal outlook. Layered atop these events is a mixed bag of macroeconomic signals and an increasingly tense monetary policy standoff between President Trump and Fed Chair Powell—conditions that have collectively built up a familiar "wall of worry." Yet if history is any guide, markets often climb such walls.

In this environment, investors—like pilots flying through dense cloud cover—must rely on their instruments: data, fundamentals, forward-looking indicators, and historical precedent. Headlines and emotion may rattle investor confidence in the short term, but long-term outcomes are shaped by data and discipline.

The economy has softened but not stalled. Labor conditions continue to cool gradually and in an orderly fashion. Liquidity remains abundant, even with elevated real interest rates, and a measure of policy clarity has emerged with the passing of the "BBB". Financial markets have responded accordingly.

The "tariff turbulence" has been weathered better than feared. Initial threats to trade partners have given way to extended grace periods and softened rhetoric, allowing financial conditions to stabilize and equities to rebound from substantial early-quarter losses. The S&P 500 recovered to prior highs, while credit spreads across investment-grade and high-yield bond markets have compressed back to historically tight levels—clear signs of durable investor confidence.

Still, trade uncertainty has not fully cleared. The July 9 tariff deadline looms, and while the worst-case scenario appears to have been avoided, tariffs in some form are likely here to stay. Any forthcoming trade agreements will likely refine, not eliminate, tariff structures. Long-term US Treasury yields remain elevated, with the

30-year near 4.9% after briefly touching 5.15% in May—its highest level since 2007. The 10-year yield has climbed from 3.6% last fall to about 4.4% today, driven by persistent fiscal concerns, sticky inflation, and inconsistent Treasury auction demand. More notably, real interest rates—adjusted for inflation—have risen to approximately 2.2%, the highest in over a decade. While some of the move reflects growth resilience, elevated real yields tighten financial conditions and can weigh on asset valuations.

Recent fiscal developments—including the passage of the "BBB" and Moody's US debt downgrade to Aa1 in May—have intensified concerns over fiscal credibility. However, the term premium on long-term Treasuries remains well below prior levels of fiscal concern, such as during the 2011 US debt downgrade. The term premium is the extra yield investors demand to hold longer-term debt instead of rolling over short-term securities. It reflects compensation for uncertainty about the economy, inflation, and fiscal policy. A low term premium suggests confidence and means the US is borrowing long at relatively favorable terms. If sentiment shifts, the term premium could rise, lifting borrowing costs.



The Federal Reserve has held short-term interest rates steady at 4.5% since December, with markets now pricing in a probable rate cut at the September FOMC meeting. Monetary policy direction could become more complex next year. Jerome Powell's term as Fed Chair expires on May 15, 2026, but he could stay on as a Fed governor until January 31, 2028. President Trump is not constrained to current governors in naming a new Fed Chair, but any future chair—Trump loyalist or not—will still need consensus among the 11 voting members of the FOMC.

While headlines shaped much of the second quarter's narrative, the underlying data presents a more nuanced picture. Corporate balance sheets remain strong, consumer spending continues to be resilient, and near-term recession risks are muted. Labor markets have been cooling steadily—not collapsing—and long-term forces such as reshoring, shifting demographics, and government policy frictions will ultimately call for long-term solutions.

Markets have entered a phase where higher real yields, ongoing trade friction, and fiscal strain could test equity valuations. The S&P 500 trades around 22 times forward earnings—well above historical averages. Such high multiples leave little margin for disappointment should growth falter or policy missteps occur. In this unique environment, discipline matters, and it will be important to monitor earnings, labor, and real rates.

ECONOMIC VIEWPOINT

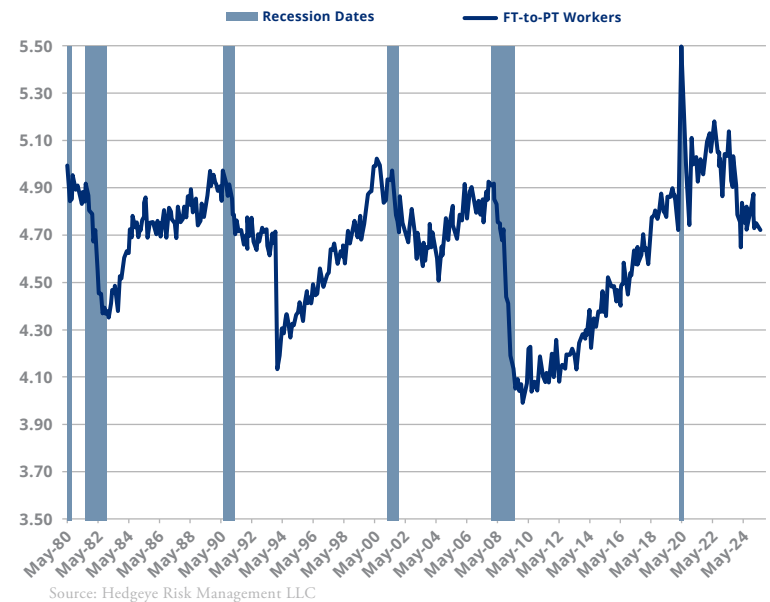
Despite persistent geopolitical tensions, tariff uncertainties, and monetary policy ambiguity, US economic data continues to reflect resilience. While signals are mixed, a near-term recession appears unlikely. However, this resilience doesn't negate the structural and cyclical challenges ahead.

The labor market is gradually softening, though it is not flashing acute warning signs. Initial jobless claims decreased by 10,000 to 236,000 toward the end of June, reflecting a healthy level of layoffs and turnover. However, continuing jobless claims rose to 1.974 million—the highest since November 2021. Immigration's impact on employment trends is also reversing, removing a key source of labor supply growth. These trends align with a moderating economy and should be watched.

The typical sequence—reduced overtime, fewer temp workers, trimmed hours, then hiring freezes—appears to be underway. Meanwhile, quit rates are falling, and the ratio of Full-time to Part-time workers is well off its recent peak. The US labor market's slow deceleration raises caution. While the plodding deterioration of the labor market has not yet signaled a recession, further

labor deterioration could quickly raise red flags and increase equity market volatility.

Ratio of Full-time to Part-time Workers



The most recent US GDP estimate for Q2 2025 is 2.5%. That said, this estimate has been revised downward from 2.9%, and forward momentum remains tentative. The economy's ability to sustain growth above 2% annualized will be tested by aging demographics, slowing immigration, and potential policy friction related to inflation.

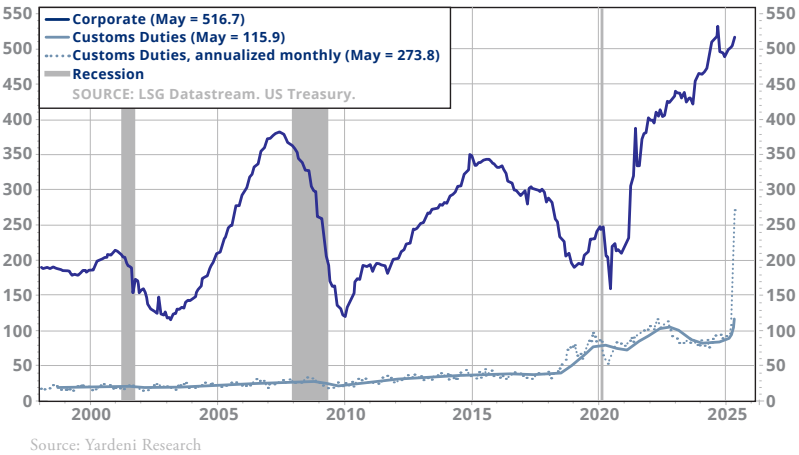
Inflation continues to be on the radar as estimates for June CPI increased to 2.5%, and for PCE to tick up from 2.1% to 2.3%. While these levels are not alarming, persistent inflation pressures—especially those tied to tariff-related supply chain shifts—are keeping the Fed hawkish. Compounding the near-term trends are elevated long-run inflation expectations. The University of Michigan's five-year expectations metric is projected at 4.1%—still high by historical standards.

Markets continue to recalibrate expectations and currently price the probability of a Fed Funds rate cut in July at just 20%. September is now seen as the more probable date for a rate cut, but not necessarily an inflection point in the Fed's thinking. Without a sharp change in labor market conditions or the inflation trajectory, the runway for monetary policy easing remains long.

Trade policy remains a wild card. Businesses and markets alike are still seeking clarity on whether the current tariff regime represents a negotiating tactic, a new revenue model, or a permanent shift. What's clear is that reversing decades of globalization will be a choppy process. Global competition helped drive disinflation over the past 25 years. A reversal—via reshoring or rerouting supply chains—will be net inflationary and capital-intensive.

Companies will need to invest heavily to reconfigure logistics and sourcing strategies. While the tariff hit to corporate profitability appears less severe than feared so far, these pressures are likely to persist for a long time.

Annual Corporate Taxes & Customs Duties



Nonetheless, there are reasons for optimism. As seen during the pandemic, resilient companies adapt. Strategic mitigation efforts are already underway. And while announced tariff levels are headline-grabbing, the final negotiated trade deals could exceed expectations and win concessions from large trading partners if diplomatic progress is made.

At the same time, because the importer must send a check to the US Treasury to pay the Customs Duty on the imported goods, even a 10% across-the-board tariff on all goods imports could potentially raise \$400 billion over a 12-month period. As seen in the chart above, this is not an inconsequential sum of income for the government. For comparison, federal corporate tax receipts totaled \$516.7 billion over the past 12 months.

The bottom line is the US economy is in “mixed-to-good” shape. Near-term clarity may prove elusive, but resilient systems adapt over time. The real challenge isn’t forecasting a dramatic shift—it’s managing through the slow, uneven grind of incremental change.

INVESTMENT STRATEGY

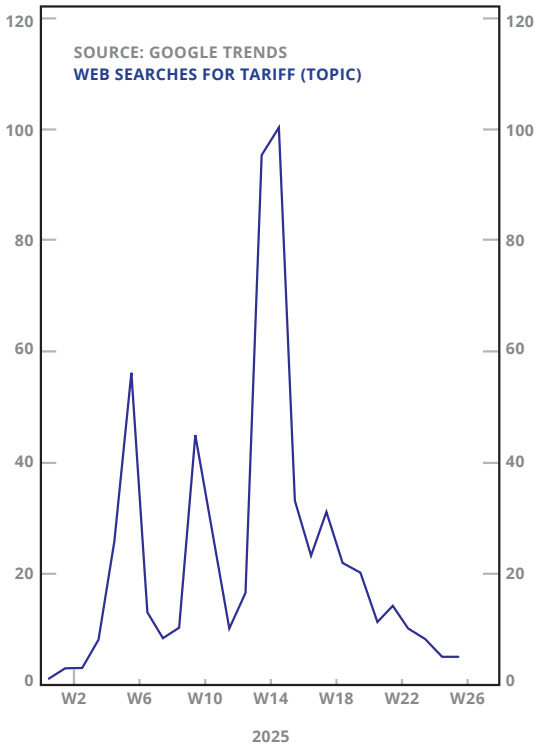
Any market-moving news story begins with its emergence, when it first breaks and attracts initial attention. This is followed by intensification, as coverage expands and public interest peaks, before entering a saturation phase where the story dominates headlines. Finally, the story moves into decline, with coverage and public focus fading as attention shifts to new topics.

The tariff fears news cycle was no different, as the internet searches peaked in April and then steadily declined. The S&P 500 rebounded from “Liberation Day” turmoil to close the quarter at all-time highs.

Market pullbacks are often initially mistaken for something worse. While volatility can be uncomfortable, corrections are common and even healthy—especially following extended bull runs. Historically speaking, the stock market rises roughly 73% of the time. The other 27% is often spent digesting prior gains. Importantly, corrections of 10% or greater occur just 13% of the time, highlighting that while corrections may feel urgent, they are statistically infrequent and typically self-correcting.

Differentiating between structural and event-driven bear markets also provides helpful context. Structural bear markets, which coincide with recessions, tend to be deep and long-lasting—averaging 55% drawdowns over nearly four years. In contrast, event-driven downturns tend to be shorter and shallower, often reversing in less than a year.

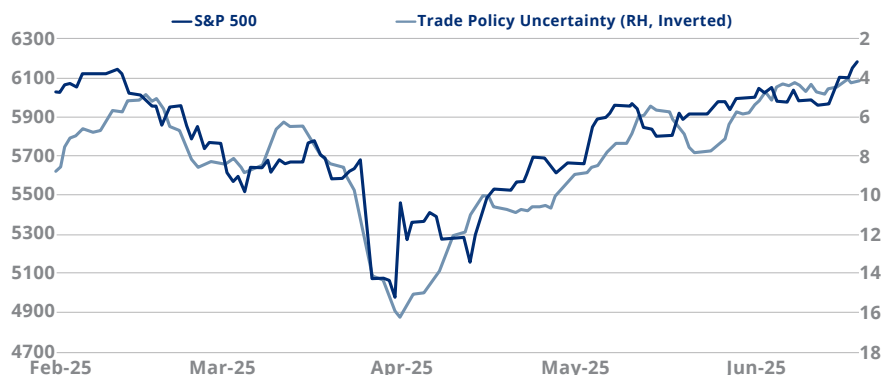
Tariff Fears Have Peaked



It is clear that the extreme volatility of early April more closely resembles the latter, where the changes in the Trade Policy Uncertainty Index were highly correlated with the movement of stocks (chart on next page).

While structural issues haven’t yet emerged, a look inside the S&P 500 reveals a more nuanced market. Despite the index’s record performance, market breadth remains

Trade Policy Drove the Market



Source: Hedgeye Risk Management LLC

concerningly narrow. While the overall index is hovering near new highs, only about 5% of S&P 500 constituents recently hit all-time highs – meaning 95% of stocks have not. Such concentrated leadership—primarily among large-cap tech—has been a feature of this cycle but also remains a potential risk.

The S&P 500 is expected to report overall earnings growth of 5.0% year-over-year, a slowdown from prior quarters and the weakest since Q4 2023. The current estimate also reflects a steep drop from the 9.4% growth expected at the start of the quarter. Notably, all 11 sectors have seen downward earnings revisions since late March, and only six of the eleven S&P 500 sectors are expected to post earnings growth in the second quarter—the lowest count since Q1 2023.

Yet revenue growth paints a more encouraging picture. Ten of 11 sectors are projected to grow revenues year-over-year in Q2, the broadest participation since Q3 2022. This divergence—broadening revenue strength paired with narrowing earnings growth—suggests that while demand is holding up, margin pressures may have crept in, possibly due to higher input costs, wage pressures, and newly implemented tariffs.

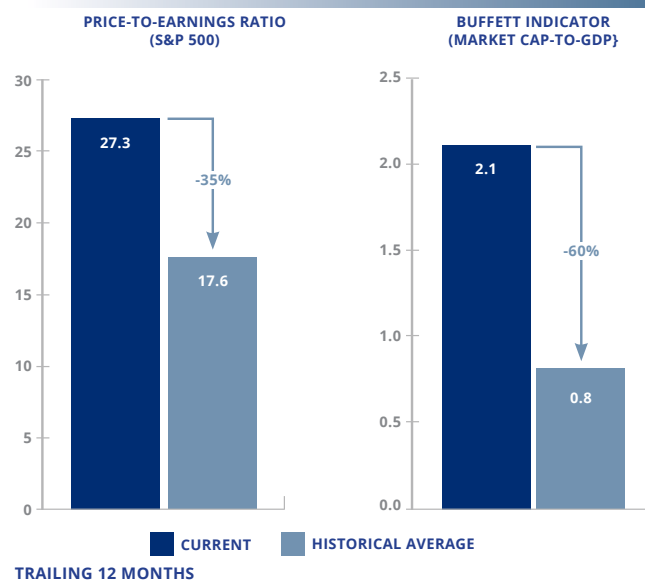
Profit margin protection strategies are being put into effect, and early evidence suggests tariff turmoil over the last three months has had relatively little impact on the forward profit margin of the S&P 500 so far. It remains essentially flat for the year—hovering near a record high of

13.7%. That's striking, given that tariffs function as a tax on companies that import goods.

At 21.9x forward earnings, the S&P 500 trades well above its long-term average. Even more stark are current valuations based on trailing earnings and the Buffett Indicator, which imply prices would need to decline 35-60% in order to revert to historical averages. These elevated ratios leave little room for disappointment, especially with fragile earnings growth and narrowing market leadership. Investor sentiment has improved, but complacency may be setting in, just as underlying fundamentals begin to show signs of strain.

Looking ahead, the macro outlook is mixed but with more yellow and green flags than red. With growth moderating, both fiscal and monetary policy appear poised to turn more supportive. If inflationary pressures remain stable, the Fed could begin cutting rates by September. With policy alignment and modest economic traction, the second half could see a continuation of the recent bullish recovery.

S&P 500 Valuations Are High



Source: InvesTech Research

PREPARED BY: SPECTRUM ASSET MANAGEMENT RESEARCH TEAM

WWW.MYSPECTRUM.COM

1301 DOVE STREET, SUITE 720 NEWPORT BEACH, CA

TEL: 949.717.3400

Say It Again S.A.M. is authored by Spectrum Asset Management, Inc. (S.A.M.); and expressed opinions originate with S.A.M. and are subject to change. Due to various factors, including changing market conditions, the contents of this newsletter may no longer reflect our current opinions or positions. Different investments have varying degrees of risks; and there is no assurance that future performance of any investment strategy including those undertaken by S.A.M. will be profitable, equal any performance index, or be suitable for the reader's portfolio. Past performance may not be indicative of future results. Statistics and information have been obtained from professional sources that we believe are reliable and complete, but that may become inaccurate or outdated. The reader should not assume that any discussion or information in this newsletter is a substitute for personalized investment advice from S.A.M. Any questions regarding the applicability of any specific issues discussed in the newsletter should be reviewed with the professional advisor of the reader's choosing. Copies of S.A.M.'s disclosure statements discussing our advisory services and fees are available upon request.