

CONFIDENCE

“DON'T LET THE PERFECT BE THE ENEMY OF THE GOOD”

- VOLTAIRE

Several historically reliable recession indicators have been flashing warning signs for more than two years, yet economic growth has proven surprisingly resilient and the stock market

continues to reach new highs. Since the spring of 2022, any number of shocks could have caused a recession and derailed the markets—war, surging inflation, high energy prices, steep interest rate increases, bank failures, weakening manufacturing, and escalating trade tensions. Yet, aside from a few bouts of volatility, the bears have largely remained in hibernation.

A case can also be made that the investment backdrop is improving. GDP growth has picked up, corporate earnings are robust, energy prices have eased, productivity is rising, and monetary policy is easing. This isn't to suggest that every risk has been resolved or uncertainty has vanished. But markets don't require perfection—only confidence that conditions are good enough to sustain progress.

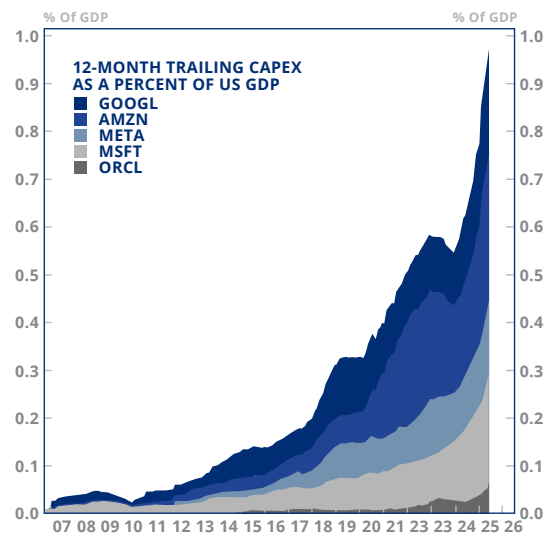
To this point, the US economy has been resilient, and the stock market continues to “climb the wall of worry.” Yet the possibility remains that those reliable recession signals are simply early, rather than “wrong.” As we enter the final quarter of the year, investor confidence will depend on the delicate balance between emerging tailwinds and longstanding challenges.

Job openings remain higher than unemployment, keeping the labor market supply constrained. Growth today is being driven less by demand for labor and more by gains in labor supply and productivity, which has helped keep recession risks at bay for now. Still, the gap between labor demand and labor supply has narrowed, and recession risks would rise meaningfully if job openings were to fall below the number of unemployed looking for work. At the same time, inflation has crept near 3%—about a full percentage point above the Fed's target—reflecting, in part, persistent wage growth.

Against this backdrop, the Fed's decision to cut rates in September has sparked debate about the wisdom of easing policy too soon. With real interest rates still modestly positive on the short end—around 0.6% on the

two-year Treasury—the Fed has some breathing room, but not much. Cutting too aggressively risks untethering inflation expectations and raising doubts about the Fed's commitment to its 2% target. Any loss of credibility could, in turn, push long-term yields higher and set the stage for a slippery slope in monetary policy.

Massive Capital Expenditures

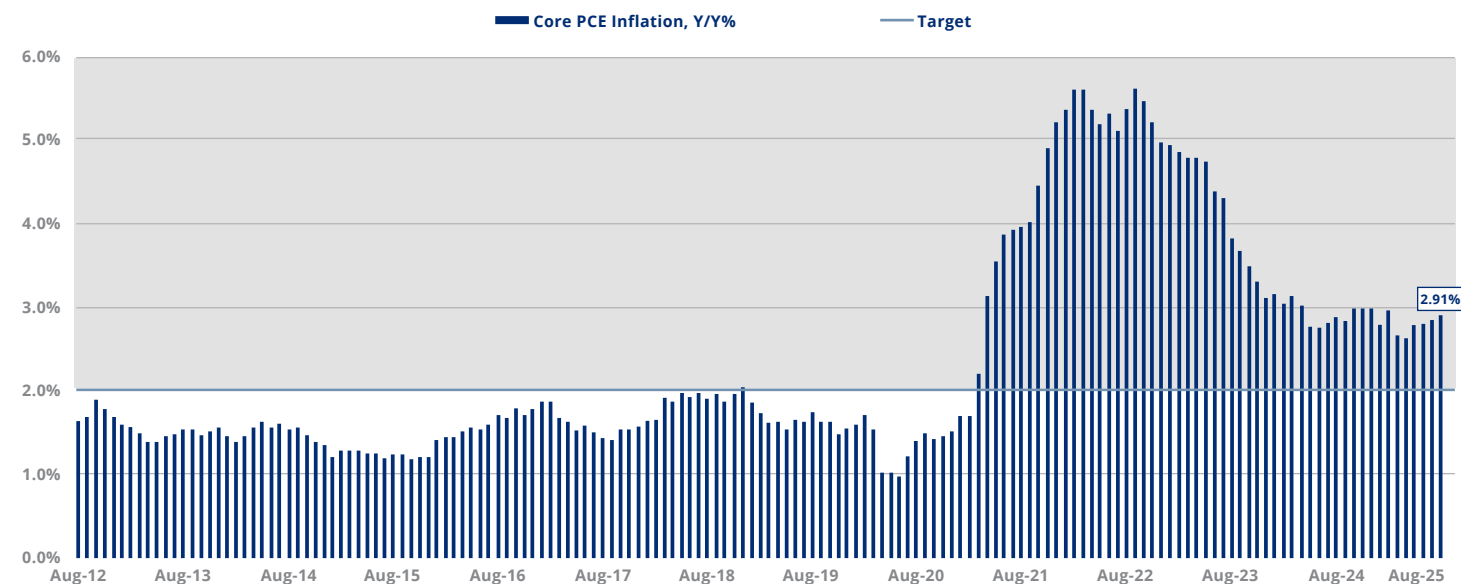


Source: BCA Research

Meanwhile, financial markets reflect their own tensions. The S&P 500 is trading at historically elevated valuations and has become increasingly concentrated in the technology sector, where a handful of large companies continue to dominate index performance. Similarly, US equities trade at a hefty 60–70% valuation premium to their European peers—among the widest in history. This gap has long been justified by the idea of US exceptionalism, but the durability of that argument is increasingly being tested. If inflation expectations rise, both US stocks and bonds could lose their relative appeal, and the dollar itself may come under additional pressure if global investors begin to fall out of love with US assets.

While persistently high valuations and increasing market concentrations have been hallmarks of the current bull market, the technology sector's contribution to overall economic growth has been undeniable. Until recently, much of the post-pandemic expansion stemmed from massive fiscal spending that propped up both labor numbers and GDP. Over the past year, however, the technology sector has emerged as a key driver of private investment by spending massive amounts on

Inflation Remains Above Target



Source: Hedgeye Risk Management LLC.

capital expenditures. Five of the largest tech companies alone are expected to collectively commit more than \$260 billion this year—nearly 1% of GDP. This not only fuels current growth but also represents a substantial investment in future productivity and innovation.

Layered on top of these dynamics is the role of artificial intelligence in shaping future growth. While AI is undoubtedly a transformative technology, its adoption appears to be following the familiar S-curve of past innovations. That path suggests a gradual lift to overall productivity rather than an abrupt paradigm shift. Much will depend on whether AI ultimately frees human capital for higher-value work or, conversely, encourages overreliance that erodes critical thinking and limits its broader benefits.

Taken together, these forces leave the economy walking a fine line—strong enough to avoid an immediate downturn, yet vulnerable to potential policy missteps, persistent inflation pressures, softening labor conditions, and untested technological promises. Market momentum could falter if these challenges grow more pronounced, but for now, the market continues to have confidence in a resilient yet imperfect outlook.

ECONOMIC VIEWPOINT

The Federal Reserve's next steps remain a divisive issue for markets. After holding the Fed funds rate steady in July—amid dissent from two committee members—the FOMC proceeded with a widely anticipated 0.25% rate cut in September. Capital markets largely welcomed the move and expect additional easing ahead, but recent inflation data complicate the case. Inflation has now exceeded the Fed's target for 54 consecutive months,

and Core Personal Consumption Expenditures (PCE) inflation rose to 2.91% in August—its highest reading since February. Meanwhile, third-quarter GDP growth is estimated to be a solid 3.8%, hardly the backdrop that typically calls for monetary easing.

Proponents of easing argue that lower rates would provide “insurance” against future labor market weakness and offer relief to consumers burdened by high credit card balances, auto loans, and the resumption of student loan payments. Yet history shows that monetary easing cycles typically begin in the aftermath of crises—credit crunches or recessions that demand stimulus. Today, there is no credit crisis, no economic contraction, and inflation remains nearly a full percentage point above target.

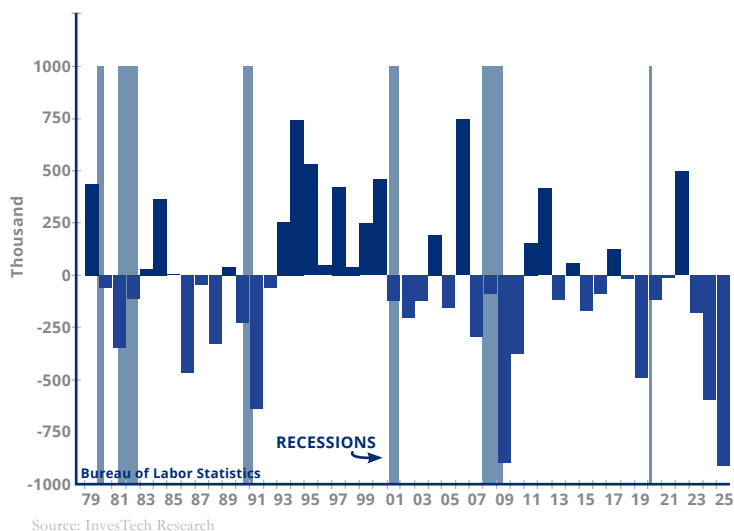
This backdrop raises the risk that additional rate cuts could do more harm than good. With real rates still modestly positive at the short end, excessive easing could entrench inflation above 2%, erode the Fed's credibility, and fuel renewed speculative excess in financial markets.

Labor market signals have been softening to mixed, but initial jobless claims indicate that activity is cooling only gradually, not collapsing. With the unemployment rate edging up to 4.3%, the labor market is losing altitude—but is not in free fall. Of concern is that August payrolls increased by a minuscule 22,000 jobs, far below expectations, and the revisions to prior months' data are even more troubling.

On September 9, the Bureau of Labor Statistics released its preliminary benchmark revisions for nonfarm payrolls covering the twelve months through March 2025. The revisions show that payroll growth was overstated by roughly 911,000 jobs—the largest downward adjustment since records began in 1979. In other words, the labor

market has been significantly weaker than previously believed. Historically, such large downward revisions have tended to coincide with recessions. While the final revisions won't be released until early next year, the preliminary data suggest the US economy may be on less stable footing than recent headline numbers imply.

Non-Farm Payrolls 12 Month Revisions



There has also been a meaningful shift in the balance of labor. For much of this cycle, job openings far outnumbered unemployed workers, leaving economic expansion to be constrained by the supply of labor. That dynamic may soon reverse. The latest JOLTS report showed about 7.2 million job openings in July—roughly matching the 7.4 million unemployed workers in August. If this gap continues to narrow or turns negative, it would signal a demand-driven slowdown rather than one limited by labor supply. As Chair Powell noted, “the labor market’s new “balance” reflects a cooling in both supply and demand—a mix that raises the risk of rising layoffs and unemployment.”

As labor market dynamics evolve, markets are increasingly betting that the Fed will lean further toward easing—signaling that, after the historic tightening cycle of 2022-2023, interest rates may now be poised to trend lower. Futures markets reflect that shift: investors assign roughly a 90% probability to a 0.25% cut at the October meeting and a 75% chance of another cut in December. The Fed’s updated signaling suggests an important change in its framework—placing less emphasis on the 2% inflation target and greater weight on supporting employment. The question is whether short-term relief from a softer job market is worth the longer-term risk to price stability.

In addition to Core PCE—the Fed’s preferred inflation measure—the latest Consumer Price Index (CPI) shows that prices are not moving sustainably toward the 2% target. Headline CPI rose to 2.9%, while core CPI—which excludes volatile food and energy components—climbed to 3.1%. Encouragingly, however, some recent data provide

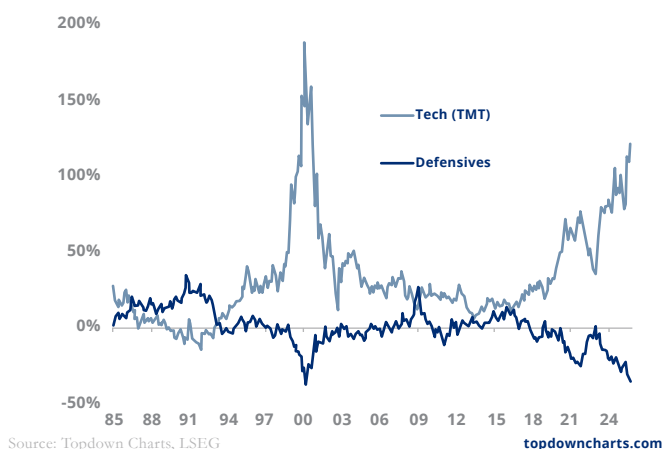
cover for the Fed and support the case for its anticipated path of gradual easing. The September Producer Price Index (PPI) increased 2.6%, below the 3.3% consensus estimate, and independent real-time gauges such as Truflation suggest that annual price growth has already slowed to below 2%. Together, these signals imply that disinflationary forces remain in play—even if the road back to target proves uneven.

INVESTMENT STRATEGY

The recovery in markets has been powerful. Earnings continue to outpace expectations, momentum has been strong, and sentiment has rebounded sharply. The equal-weighted S&P 500 even reached an all-time high in mid-August, reflecting a healthy broadening beyond the mega-cap leaders that have dominated performance. IPO activity has returned with strong demand, and volatility has compressed to a five-month low since the “tariff tantrum.” In many ways, this backdrop suggests continued momentum heading into year-end.

Yet vulnerabilities remain. Valuations are stretched, with nearly every metric hovering near historical highs. Relative valuations are also at extremes. For example, the technology sector now trades at a premium to the S&P 500 greater than at any time other than the dot.com era. Meanwhile, defensive sectors—utilities, consumer staples, and health care—are trading at a discount as deep as any seen in the past 40 years.

US Relative Valuations



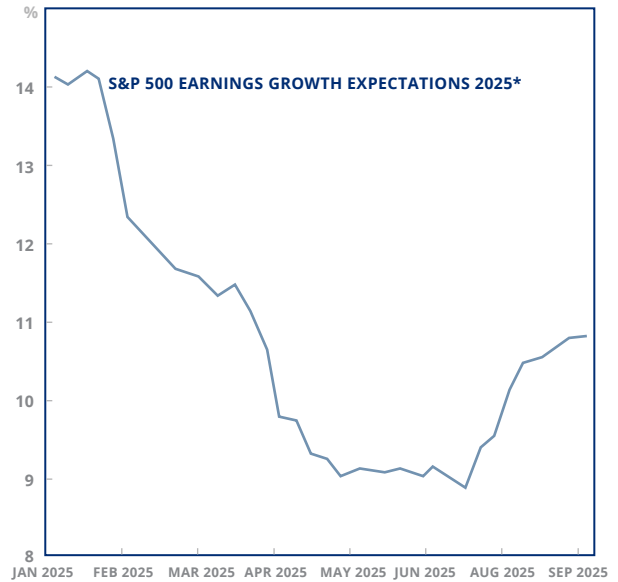
Market leadership remains another point of vulnerability. The cap-weighted S&P 500 has been driven higher by concentrated gains in mega-cap technology stocks, leaving the equal-weighted S&P 500 in an extended period of underperformance. During the quarter, however, participation has broadened, lifting the equal-weighted index and implying healthier market breadth. Still, the cap-weighted index’s dominant relative performance remains stretched versus long-term trends. A rotation toward cheaper stocks can be bullish if it signals that

laggards are catching up—but bearish if it reflects an unwinding of the extreme concentration that has powered recent returns.

Overlaying all this is the broader question of technology's true economic impact. Artificial intelligence remains at the center of both investor enthusiasm and the debate over productivity gains. While undeniably transformative, AI adoption will likely track the familiar S-curve of past technologies—delivering explosive early gains but slowing as adoption matures and as the productivity of earlier innovations diminishes through obsolescence. Productivity improvements will emerge across industries and are certain to have positive effects, but when measured against the enormous amount of capital that has flowed into the AI space and the stratospheric valuations of AI-related companies, it remains to be seen whether this period ultimately echoes the late-1990s tech bubble.

What remains undeniable is that earnings continue to grow. S&P 500 earnings are expected to rise about 8% in the third quarter, marking the ninth consecutive quarter of growth and an acceleration from expectations earlier in the year. In fact, 2025 full-year estimates have steadily climbed toward 11% since bottoming in July, underscoring the resilience of corporate profits despite a moderating economy, continued tariff uncertainty, and persistent inflation.

US Earnings Growth is Rising



Source: BCA Research

Taken together, markets and the economy are showing impressive resilience, but the balance between optimism and excess is becoming more delicate. Monetary easing, relatively stable inflation, and steady earnings growth have sustained confidence, yet elevated valuations and shifting policy leave little room for error.

The coming months will test whether the current expansion can evolve into an extended period of durable growth or merely extend current optimism into later innings. Resilience remains evident, but vulnerabilities are building beneath the surface. How policymakers manage this balance may determine whether the cycle bends or breaks—yet history reminds us that markets rarely demand perfection, only “good enough” to keep the bears asleep.



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