

NARROW PASSAGE

ENERGY | INFLATION | STOCK MARKET

EXECUTIVE SUMMARY

Energy & Inflation

- Hormuz disruption is curtailing roughly 20% of global oil flow. As the conflict persists, expectations for future oil prices have risen.
- Inflation consensus estimates are drifting north of 3.5%, reviving the “transitory versus permanent” debate from 2021.
- Unlike the 1970s, the US is now a net exporter of oil, which helps buffer the broader economic impact.

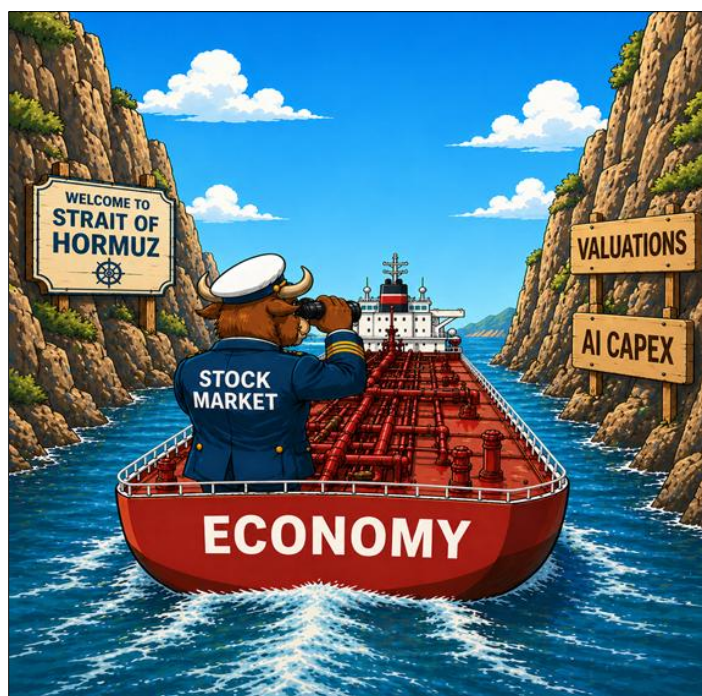
Economy

- ISM data shows both manufacturing and services sectors remain in expansion territory above the 50 threshold.
- Unemployment sits at 4.3%, low by historical standards, despite headline tech sector layoffs.

Stock Market

- The top 10 stocks now represent over 40% of the S&P 500, double their 19% share in 2010.
- Elevated capital spending in artificial intelligence reflects innovation potential but introduces late-cycle investment risks.
- The "S&P 493" net income growth is accelerating, suggesting market leadership is broadening and outlook more balanced.

Roughly twenty percent of the world’s oil flows through the Strait of Hormuz, a passage just twenty-one miles wide at its narrowest point. It is a reminder that a vast global economy can depend on a single, narrow geographic corridor where disruption can quickly ripple outward.

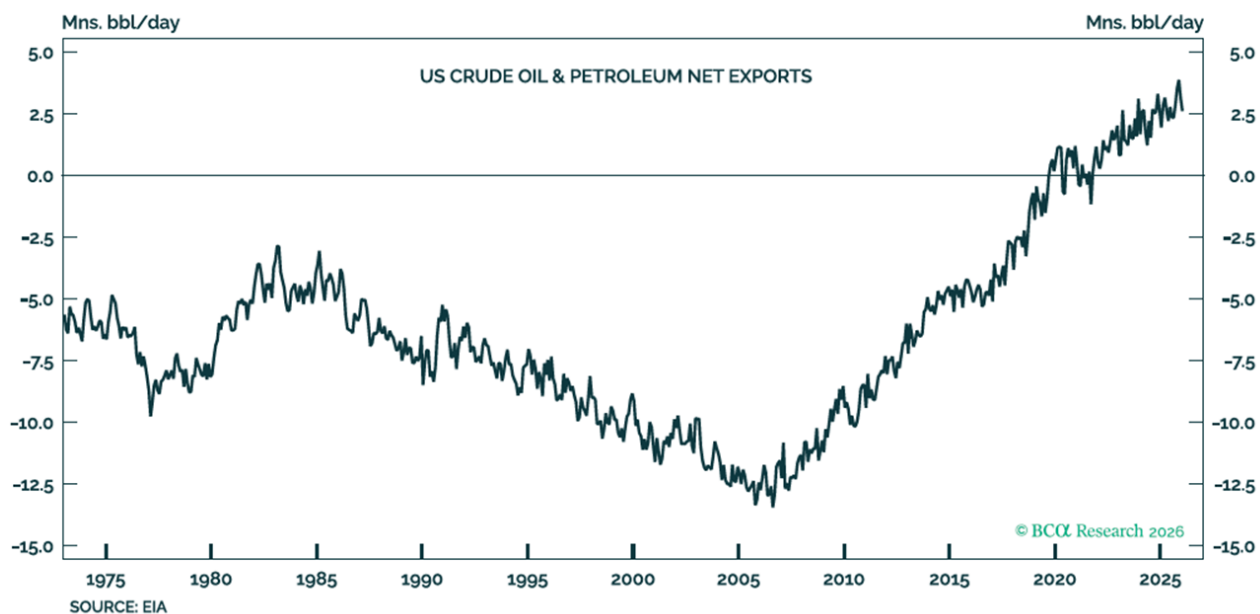


Today, rising energy prices and renewed supply concerns have begun to influence inflation expectations and market sentiment. Yet the broader backdrop remains resilient. Economic activity continues to expand, labor markets have been stable, and earnings are gradually broadening beyond a narrow group of leaders.

The challenge is not avoiding the narrow passage, but navigating it with discipline as pressures build and conditions evolve.

OIL SHOCK

Unlike In Previous Oil Shocks, The US Is Now A Net *Exporter* Of Oil



- Oil prices have moved back sharply to previous highs as "on-again, off-again" negotiations to end the Iran war and reopen the Strait of Hormuz have failed to meaningfully increase shipping traffic. With roughly 20 million barrels per day effectively removed from global markets, the ongoing conflict has pushed oil prices above \$115 per barrel and has reinforced upward pressure on prices across the global economy.
- Higher energy costs are beginning to work their way through the economy, contributing to inflation expectations well above 3% and impacting everyday activity, from transportation to consumer goods. Markets are once again debating whether inflation pressure is transitory, reminiscent of the late 2021 and 2022 time periods.
- While the shock is meaningful, the US is structurally better positioned than in prior cycles. As shown in the chart, the transition to a net exporter of oil due to the post-2017 US fracking revolution, combined with a less energy-intensive economy, provides a degree of resilience even as global energy volatility remains elevated.

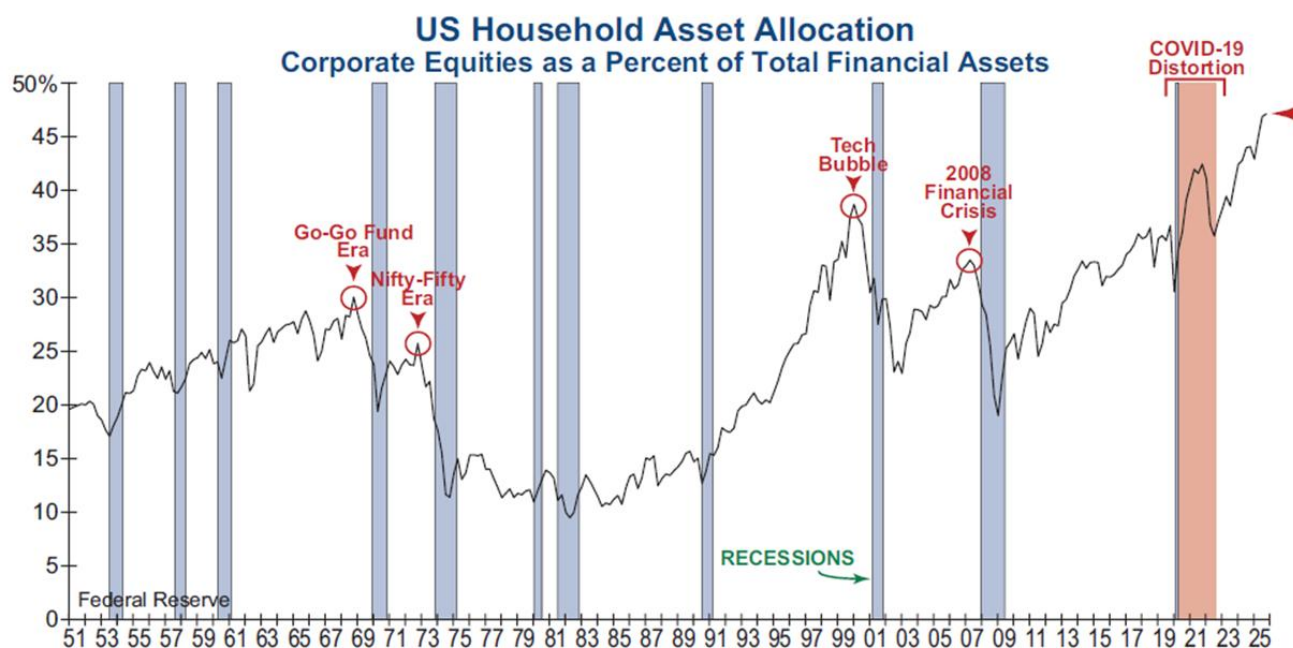
ECONOMY EXPANDING



Source: InvesTech Research

- Economic activity remains firmly in expansion, with ISM Manufacturing at 52.4% and Services at 56.1%. Both indices are trending above the 50 level that separates growth from contraction. These readings indicate that while momentum has been buffered by the crisis, the broader economy continues to move forward at a steady pace.
- Unemployment is holding near 4.3%, a historically low level. Overall job availability remains, supported by longstanding labor shortages that followed the post-pandemic retirement wave. Together, these dynamics suggest that while growth is no longer accelerating, the economy remains resilient even in the face of evolving pressures.

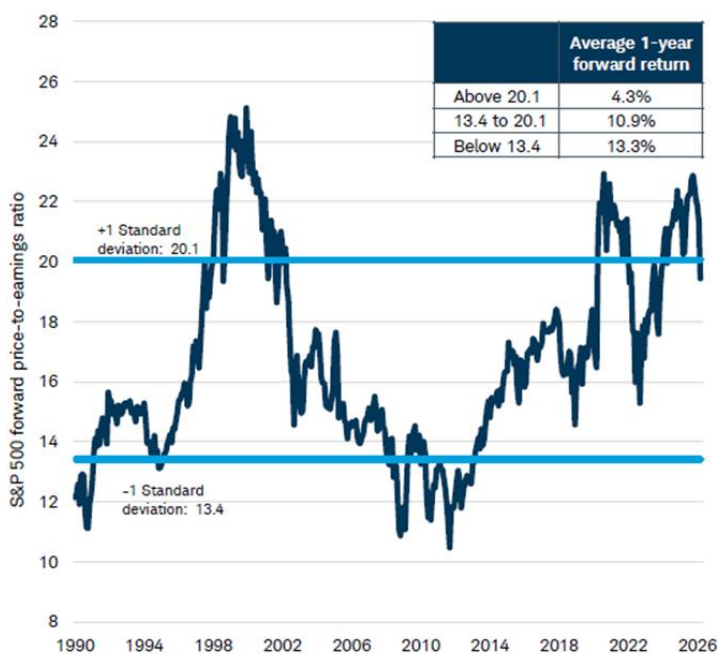
WEALTH & THE CONSUMER



Source: InvesTech Research

- Household wealth has expanded significantly, with total US paper wealth across equities and real estate rising from approximately \$65 trillion in 2019 to nearly \$120 trillion today. This surge has supported consumption and broader economic growth, as higher asset values continue to reinforce confidence, spending, and overall economic activity.
- US households now hold a near-record share of financial assets in equities, approaching levels last seen during prior market peaks. This reflects both strong returns and increased access to markets, but also raises sensitivity to volatility as a larger portion of household balance sheets becomes tied to equity performance.
- The benefits of rising asset prices have not been evenly distributed, contributing to a more pronounced divide between asset owners and those more exposed to rising costs. While asset holders have seen meaningful gains, many households without market exposure continue to face pressure from inflation, reinforcing the uneven nature of the current economic cycle.

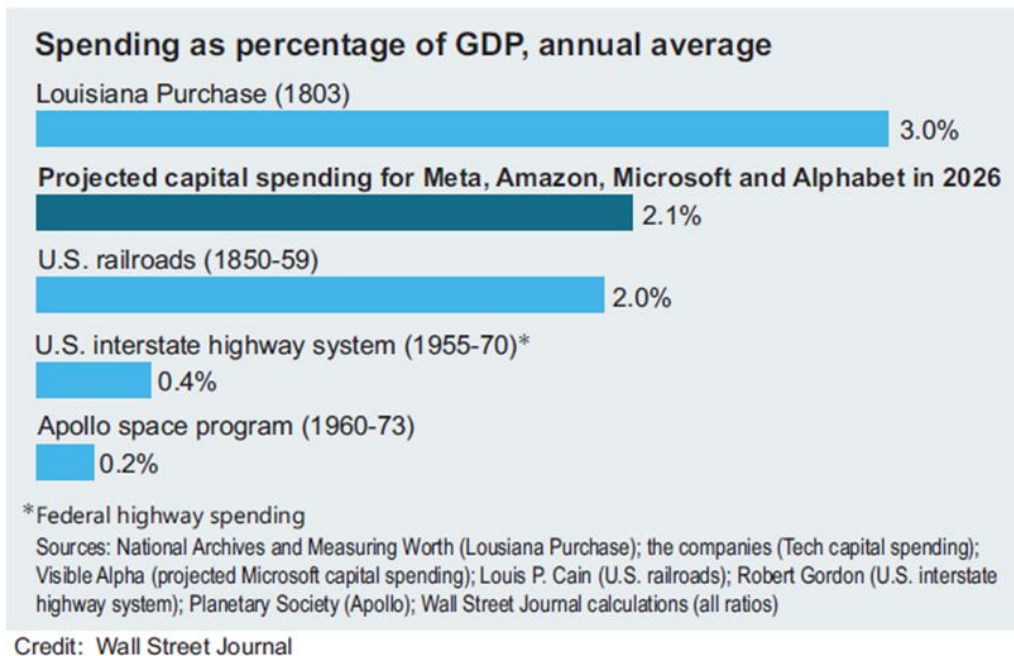
STOCKS ARE EXPENSIVE



Valuation	
Metric	Current percentile ranking (relative to history)
S&P 500 forward P/E	Expensive
S&P 500 trailing P/E	Very expensive
S&P 500 5-year normalized P/E	Very expensive
S&P 500 price/book value ratio	Very expensive
S&P 500 price/cash flow	Very expensive
S&P 500 dividend yield	Very expensive
Shiller's CAPE (cyclically adjusted P/E)	Very expensive
Rule of 20	Expensive
Equity risk premium (10-year Treasury yield)	Expensive
Equity risk premium (Baa corporate bond yield)	Expensive
Fed Model	Expensive
Tobin's Q	Very expensive
Market cap/GDP	Very expensive

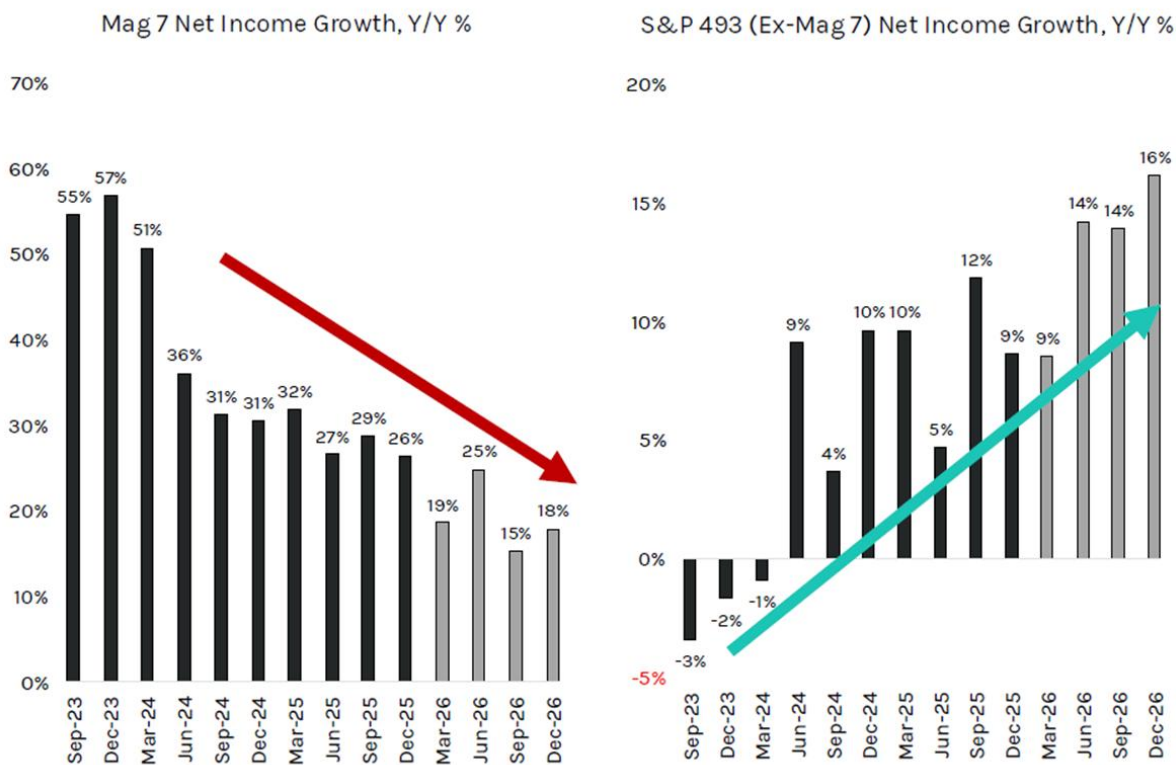
- Equity markets remain highly concentrated, with the largest companies representing a historically elevated share of the overall index. This level of concentration has driven a significant portion of recent returns, but it also increases vulnerability if leadership begins to narrow or reverse.
- Virtually all valuation measures across the S&P 500 continue to signal expensive conditions, with the forward price-to-earnings ratio sitting well above its long-term average and in the upper range of historical standard deviations. This indicates that the S&P 500's current pricing reflects elevated earnings expectations, leaving less room for error if growth does not keep pace.
- Higher asset prices have supported confidence and spending, reinforcing the broader wealth effect across the economy. However, increased household exposure to equities also means that any shift in market performance could more quickly impact both sentiment and financial conditions.

TECHNOLOGY IS DRIVING THE ECONOMY



- Capital spending on artificial intelligence has reached historic levels, with projected 2026 investment by Meta, Amazon, Microsoft, and Alphabet approaching 2.1% of GDP. This rivals some of the largest infrastructure buildouts in US history and highlights the scale and importance of AI as the next major investment cycle.
- Of some concern is that investment flows across the AI ecosystem are becoming increasingly interconnected, with major firms both committing to spend and relying on funding from one another across the value chain. While this reflects strong conviction and coordination, it also introduces a more circular flow of capital that can amplify both gains and risks within the system.

EARNINGS GROWTH IS BROADENING



Source: Hedgeye Risk Management LLC

- Earnings growth among the largest technology companies remains strong, but is clearly moderating from prior peaks, with growth rates stepping down from elevated levels seen over the past year. This reflects a transition from extreme outperformance toward a more normalized pace of contribution.
- At the same time, the broader S&P 493 is showing improving earnings momentum, with growth rates moving higher and beginning to close the gap with mega-cap leaders. This visible convergence in the chart signals that participation is expanding beyond a narrow group of companies.
- Historically, this type of earnings rotation has supported more balanced and durable market performance. While mega-cap firms remain important drivers, and may be vulnerable due to lofty valuations, the strengthening contribution from the broader index provides a more durable and sustainable foundation for equities.

CONCLUSION

As the quarter progresses, markets have been heavily influenced by headlines surrounding the Strait of Hormuz and rising oil prices, yet the underlying picture remains more complex, shaped by a broader set of competing forces. Energy disruptions, geopolitical uncertainty, and elevated valuations are applying pressure, while steady economic expansion, resilient labor markets, and a still powerful wealth effect continue to provide support. Beneath the surface, important transitions are underway. Earnings leadership is beginning to broaden, even as capital flows into artificial intelligence reach historic scale and introduce both opportunity and complexity.

History suggests that environments like this tend to evolve rather than resolve. Periods of concentration and elevated expectations often give way to shifts in leadership, valuation, and participation over time. The current backdrop reflects that process, with resilience and friction moving in parallel as markets adjust to changing conditions.

Rather than a single defining outcome, the more likely path is one shaped by gradual change. In that kind of environment, consistency, perspective, and attention to underlying trends matter more than any single headline.

If you would like to review your risk exposure and how it aligns with your long-term financial plan, we are happy to discuss your situation, the markets, or anything else you would like to talk about.

We are here to guide you and provide clarity along the way.

Sincerely,

Spectrum Asset Management, Inc.

Newport Beach, CA

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