THINNER AIR

ECONOMY | US DEBT | STOCK MARKET

EXECUTIVE SUMMARY

Economy

- Unemployment eased to 4.1%, though a sharp drop in labor force participation may overstate that strength.
- Nonfarm payrolls fell by 23,000 in July's revision, extending a year of inconsistent job creation.
- Manufacturing jumped to 55.6% and services held at 54.1%, both firmly in expansion territory.

US Debt

- Public debt has climbed back to roughly 120% of GDP, a level last seen at the end of World War II.
- Should inflation hold above 3%, Treasury yields may stay elevated, raising the government's borrowing costs.

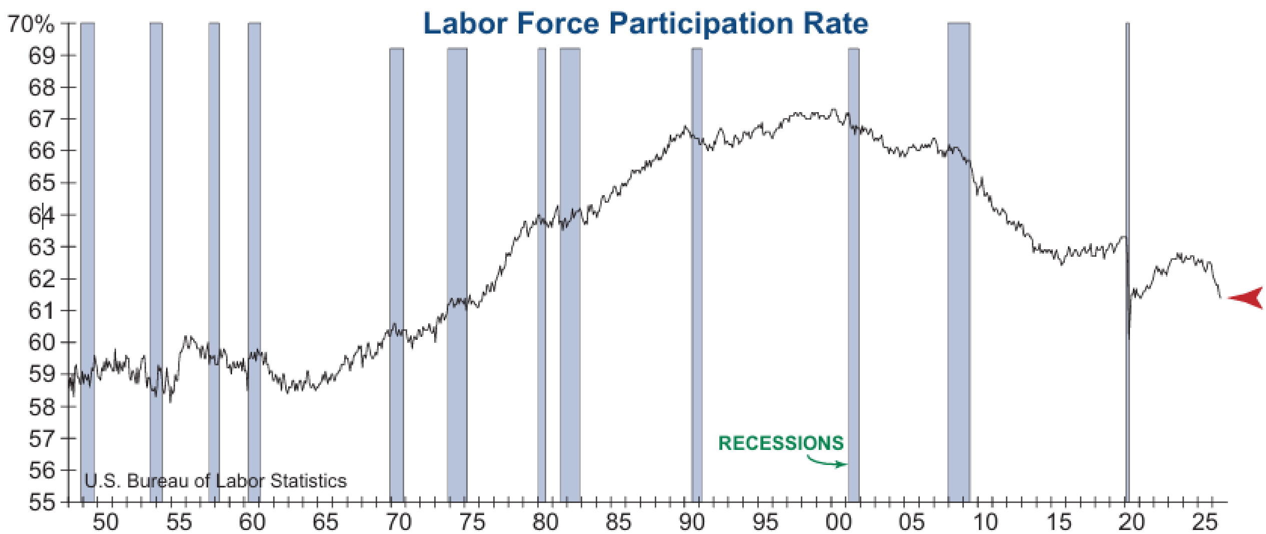
Stock Market

- The S&P 500 has absorbed COVID, inflation, banking stress, tariffs, and geopolitical conflict without lasting damage.
- Margin debt near 4.5% of GDP now exceeds the peak set in the 1999-2000 technology bubble.
- The ten largest holdings represent roughly 40% of the S&P 500 index, double their 2010 share.

The stock market is advancing the way a climber advances in altitude: the pack is no heavier, but the thinning air leaves less room for a misstep. Growth has held up, with manufacturing at its strongest level in more than four years, reinforcing the idea that the economy does not need to be perfect to keep moving forward.

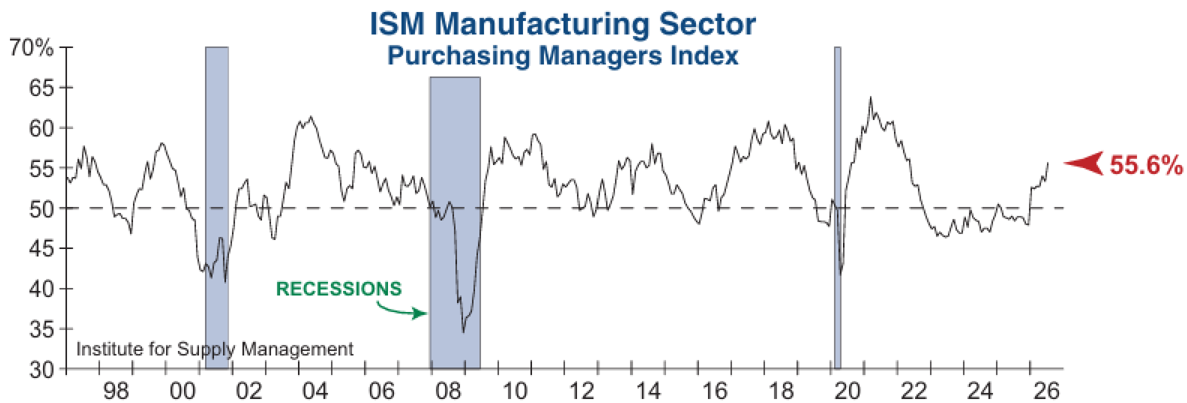
Inflation, though, remains firm enough to limit how much support the Fed can provide if labor weakens. This durable bull market has repeatedly recovered from major shocks. However, elevated valuations suggest investors expect a great deal of future growth. This environment remains constructive but less forgiving, and the margin for disappointment is narrowing even as the broader economic backdrop remains supportive.

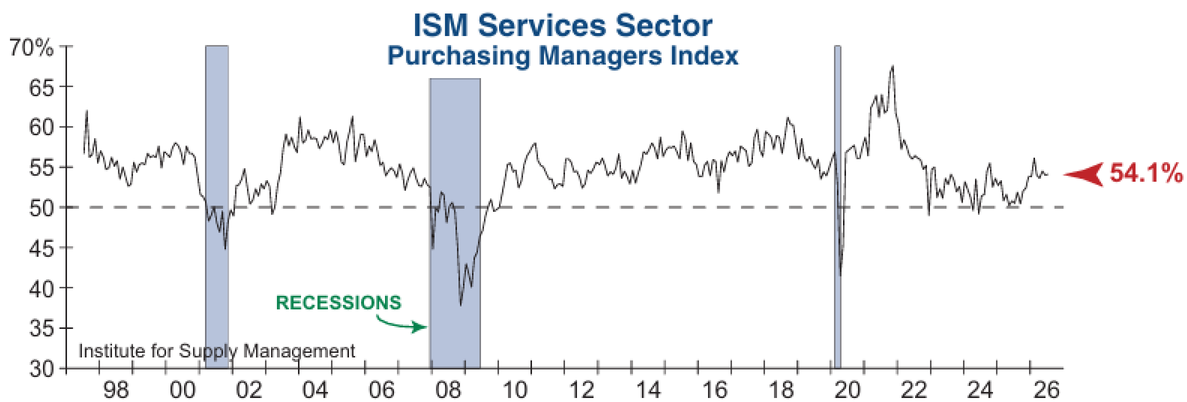
LABOR MARKET



- Despite continued economic resilience and a historically low unemployment rate, the labor market has shown signs of cooling. Job creation has been inconsistent over the past year, with nonfarm payrolls falling by 23,000 in July's latest revision.
- The drop in the unemployment rate to 4.1% over the last three months has been accompanied by a sharp decline in labor force participation. With fewer people working or actively looking for work, the lower unemployment rate may overstate the underlying strength of the job market.
- The result is a labor market that looks softer, but not broadly weak. That distinction matters because other economic indicators continue to point to expansion, suggesting labor conditions are cooling within a still-growing economy.

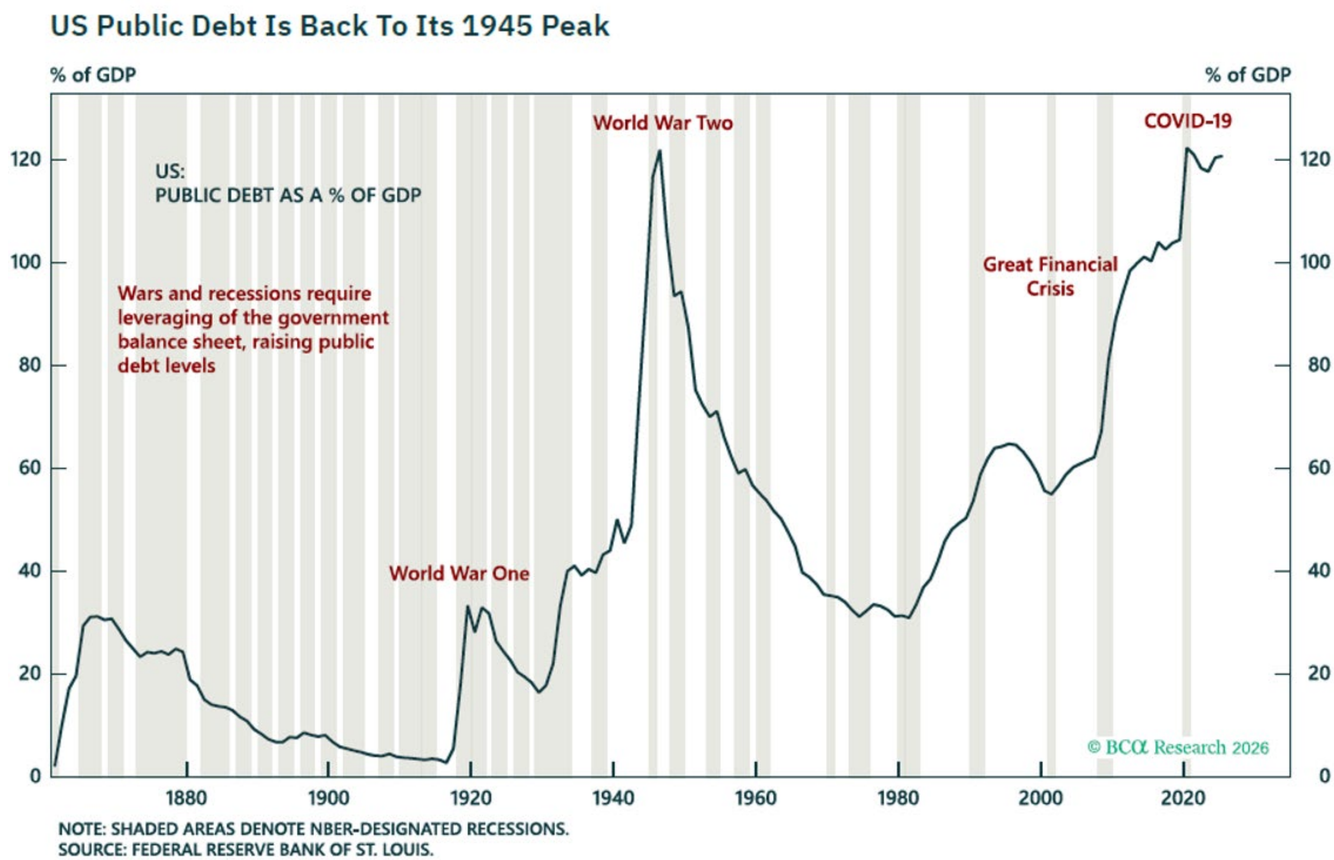
ECONOMY EXPANDING





- Despite softer labor conditions, broader economic activity remains firmly in expansion. The ISM Manufacturing PMI jumped to 55.6%, its highest level in more than four years, while the Services PMI remains solidly expansionary at 54.1%.
- Continued growth complicates the Fed's balancing act. Cooling employment argues for greater policy flexibility, but an expanding economy and inflation still running above target may limit the urgency for meaningful rate cuts.
- For now, the Purchasing Managers Indexes reinforce the message that the economy remains on steady footing. If growth holds while inflation stays elevated, interest rates may remain higher for longer, making these trends important to watch for signs of either renewed strength or deterioration.

US DEBT

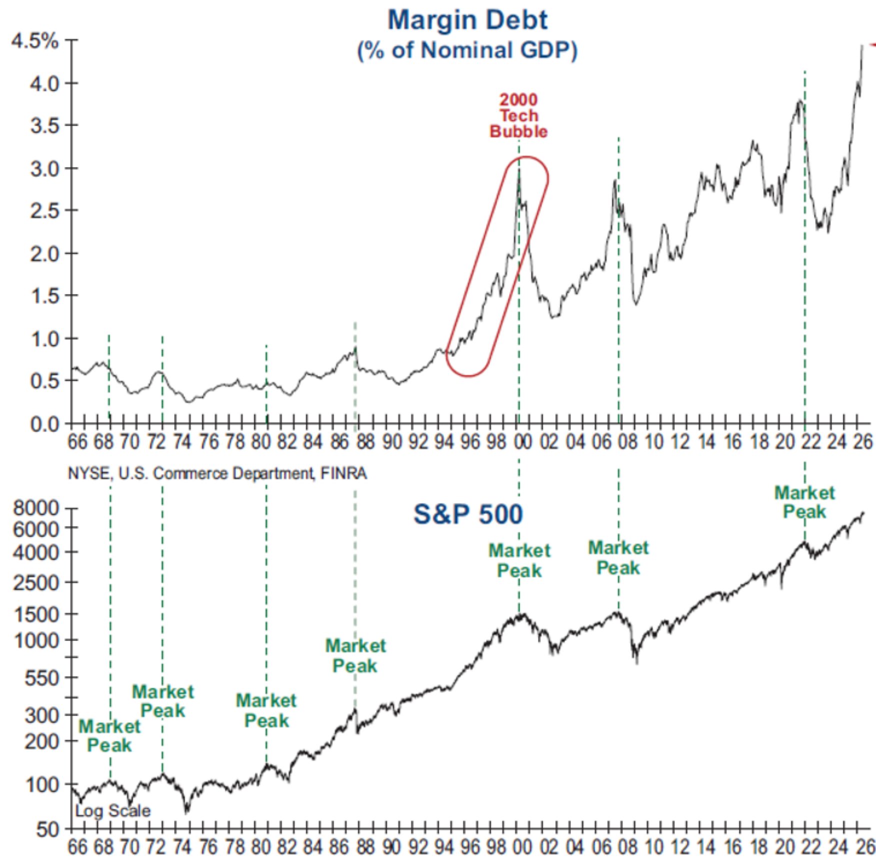


- US public debt has climbed back to roughly 120% of GDP, a level last seen at the end of World War II. Unlike past peaks tied to wars or recessions, today's debt burden remains elevated during an economic expansion.
- While households and corporations reduced leverage after the Great Financial Crisis, federal debt continued to rise. The question now is whether economic growth can outpace further debt accumulation enough to stabilize the ratio.
- This makes the inflation outlook even more important. If inflation remains above 3%, Treasury yields may stay elevated, increasing the government's sensitivity to borrowing costs and limiting the benefit of lower rates.

THE BULL MARKET

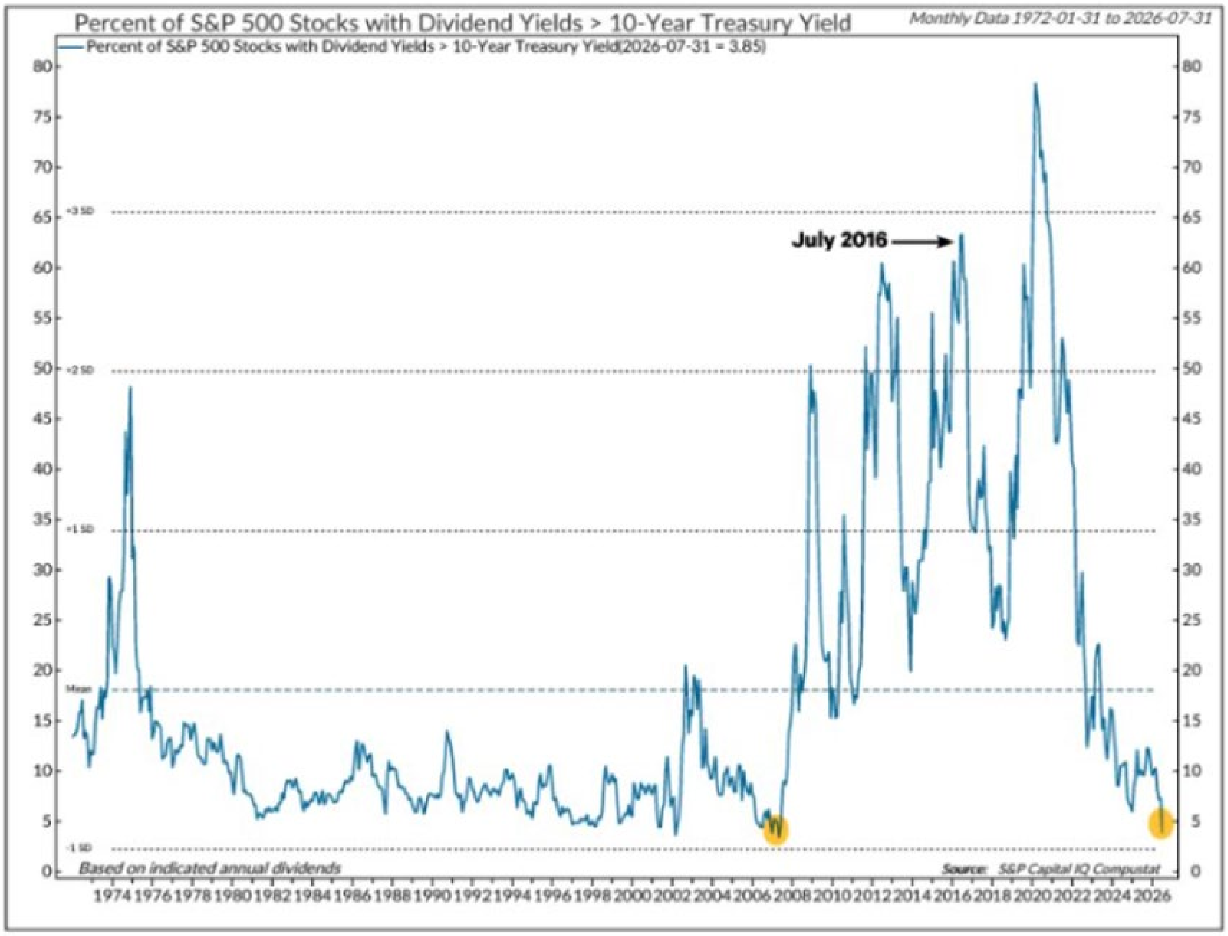
- The S&P 500 has repeatedly recovered from major shocks, including COVID, surging inflation, banking stress, tariffs, and geopolitical conflicts. Each setback has been meaningful, but none has produced a sustained break in the market's longer-term advance.
- Persistent economic growth and robust corporate earnings have bolstered stock market resilience, raising the bar for any lasting bearish case. The market has repeatedly required more than troubling headlines to derail the bullish trend.
- However, that strength does not eliminate risk. "Trees do not grow to the sky." As markets have overcome repeated disruptions, leverage and valuation have also become more elevated, making the durability of those underlying supports increasingly important.

MARKET LEVERAGE



- Margin debt has climbed to roughly 4.5% of nominal GDP, exceeding prior peaks and suggesting that borrowed money has become an increasingly important part of today's market strength.
- Elevated leverage has often appeared near major market peaks, including the 1999-2000 technology bubble. However, the relationship is not a timing signal, and previous peaks in margin debt have not always been followed by an immediate or severe market decline.
- For now, leverage is best viewed as a flashing yellow light rather than a reason to turn bearish. Combined with elevated valuations and relatively narrow market breadth, it suggests that the bull market's resilience is increasingly dependent on the continued earnings strength of a handful of companies.

MARKET VALUATION



- Fewer than 4% of S&P 500 stocks now offer a dividend yield above the 10-year Treasury, near the low end of the historical range. With bonds offering more competitive income, investors are accepting less yield from stocks while also taking on greater market risk, raising the hurdle for equities to justify current prices.
- Valuation concerns extend beyond dividend yields. Stock P/E and price-to-sales ratios remain lofty, while the 10 largest S&P 500 stocks now represent roughly 40% of the index, double their share in 2010. High valuations and concentration leave the market increasingly dependent on a small group of companies continuing to deliver exceptional growth.
- Strong revenues, earnings, and AI-related capital spending help explain why elevated valuations have persisted. Even so, parts of the market increasingly look priced for perfection, leaving the stock market vulnerable to disappointments if growth or earnings fall short of expectations.

CONCLUSION

The charts do not describe an economy or market in trouble. They describe an expansion that has climbed a long way and is still gaining ground. Labor conditions are cooling, but broader business activity continues to grow. Inflation has improved considerably from its peak, yet remains firm enough to limit the Fed's flexibility, while rising federal debt adds another constraint on any policy support.

Throughout this bull run, the stock market has shown a remarkable ability to absorb shocks. Robust earnings and continued growth are providing real support, but elevated valuations and historically high leverage suggest some of the momentum reflects increasingly optimistic expectations. The ground gained is real, and so is the thinner air that comes with holding it.

Conditions do not need to be perfect for the expansion to persist. But they do need to remain good enough. As the advance continues, the cost of a misstep rises, which is why discipline in separating fundamentals from momentum matters more now than it did earlier in the climb.

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 to provide clarity and confidence along the way.

Sincerely,

Spectrum Asset Management, Inc.
Newport Beach, CA