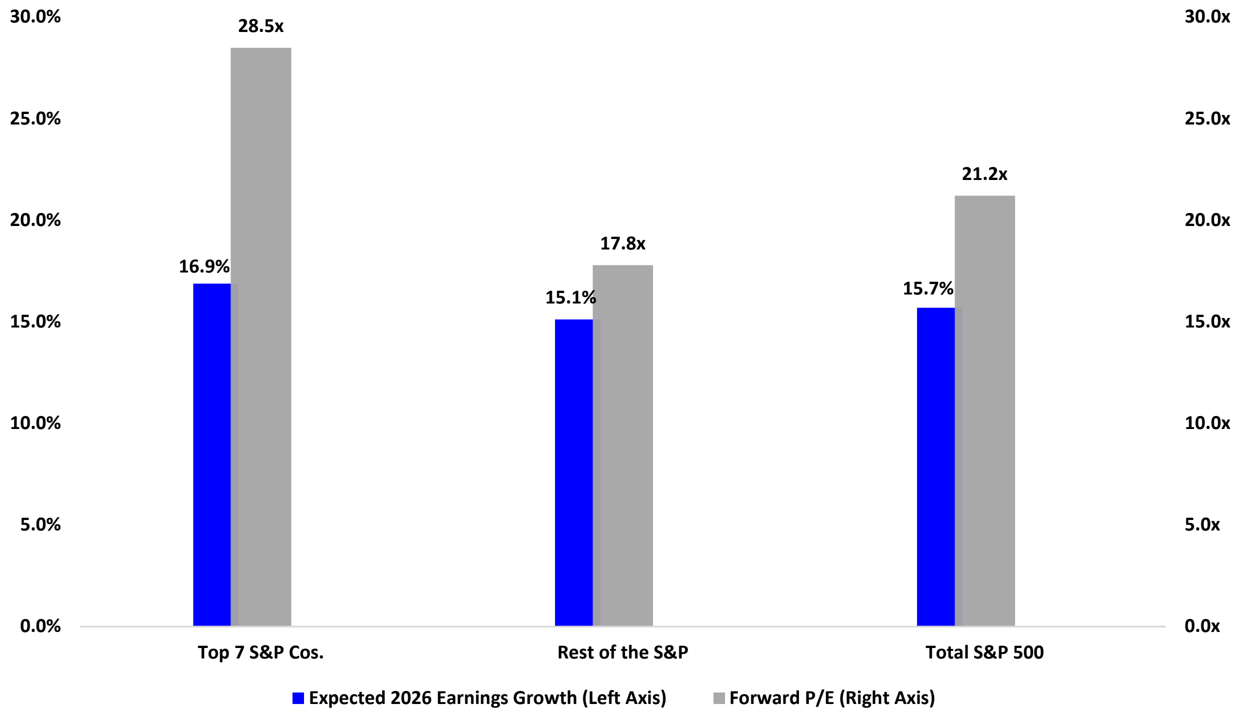
The rally took a slight breather this week; the S&P 500 finished roughly flat compared to last Friday's level. Investors continue to digest macro news regarding trade policy and economic data, with the upcoming earnings season set to kick into high gear over the coming weeks. The quarterly earnings announcements and, more importantly, updated forward guidance, will provide further insight regarding the financial health of key public companies and their outlook going into the latter half of the year and 2026.

As we've written about in recent letters, the market has come a long way in a very short period of time. Since the lows in early April, stocks have rallied roughly 30%. The period of time between February and July has included one of the fastest and steepest market declines in history followed by one of the sharpest and swiftest recoveries to reach fresh highs. It's hard to think of a more perfect case study illustrating a V-shaped recovery, 2020 reflecting the only comparable time period. A summer consolidation, if it continues, may be healthy as recent gains are digested.

Source: A Wealth of Common Sense

A key point of concern that's been at the forefront of the financial press since 2020 has been regarding valuations. The earnings multiple for the overall market (i.e. the S&P 500) has been elevated relative to history for the past several years, with the exception of the lows in late 2022. However, the composition of the index has significantly changed. Overall, businesses that currently command the greatest market weights have significantly higher margins, more revenue growth, and lower debt compared to the companies that dominated the stock market during prior periods. The top seven companies within the S&P 500, for example, which comprise just under a third of the index, are all technologyoriented businesses enjoying the benefits of massive scale, fat cash flow margins, and dominating share of their respective markets.

S&P 500 Earnings Growth And Forward Price/Earnings – Top 7 Versus Rest of the Index



Source: S&P Global, Capital Ideas Estimates

In my view, this suggests that elevated valuations as a whole may be justified given these dynamics. Excluding the top seven stocks (by market capitalization), the S&P 500's forward earnings multiple is approximately 18x, roughly in-line with the historical average. Furthermore, the emerging consensus view is that earnings growth for sectors outside of technology is expected to accelerate over the near to medium term. If this materializes, we could see a more broad-based expansion drive the next leg of this rally. That would be a welcome and healthy development for market dynamics and help extend the secular bull market that we are currently enjoying.

Importantly, multiples haven't become stretched to anything resembling what occurred in the late 90s, when many companies with questionable business models commanded nose-bleeding valuations. Generally speaking, the current market environment has instead rewarded the largest and most profitable companies, which seems justified. Investors appear more discerning compared to frothy markets of the past. A business with a long track record of success that's generating hundreds of billions in annual free cash flow growing in the mid-to-high teens, for example, should warrant a multi-trillion dollar market capitalization. Market laggards have been rightly priced at a discount; underperforming businesses, with a few exceptions, haven't risen with the tide.

The market's discernment throughout this run gives me optimism regarding its future prospects. While stocks aren't necessarily cheap, overall the winners and losers have been rightly bucketed, the free market correctly pricing investor capital accordingly. To coin a term from Adam Smith, the invisible hand of the market appears to be working. Many of the broad dynamics at play keep me in the bullish camp over the medium to longer term. The evolution of AI, massive and growing capital spending on new technology, the prospect of further productivity gains, and increasing capital efficiency are powerful long-term trends that I see persisting for many years to come.

To what extent these dynamics are currently priced in is anyone's guess, but if earnings growth persists for the foreseeable future, that's a powerful tailwind to bet against. We haven't seen an extended bear market without a subsequent earnings recession since 1987. And I'm not expecting that trend to change anytime soon.

Andrew P, Kerai, CFA®