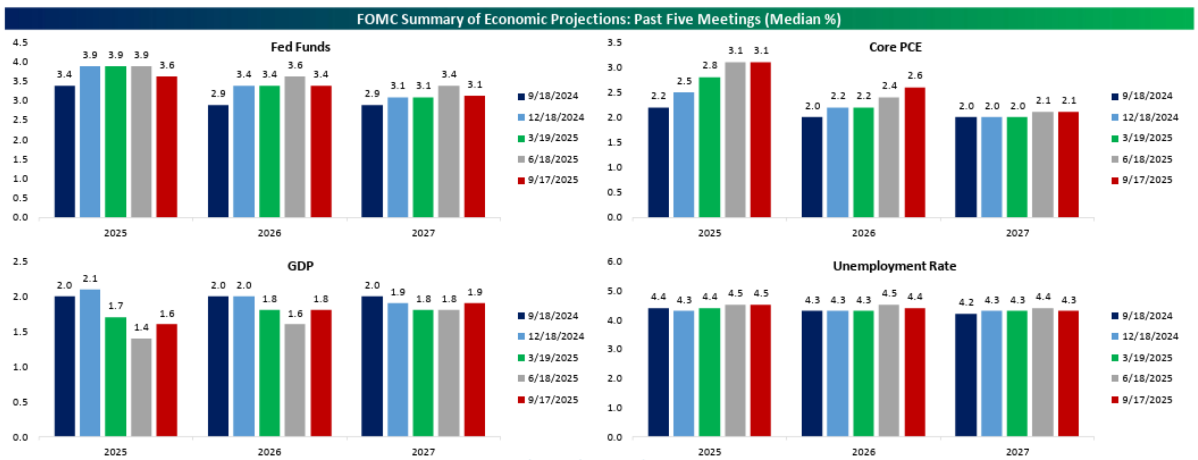
The Federal Reserve's widely anticipated quarter point rate cut on Wednesday was the most notable event last week. The Fed also released its updated Summary of Economic Projections, which suggests additional rate cuts are likely to occur during the last two meetings of the year. Investors resumed buying on Thursday with the announcement in the rear-view mirror, which lifted stocks to fresh all-time highs.



Source: Bespoke Investment Group

While the Fed's posture might still not be dovish enough for some market participants, I believe the resumption of the rate-cutting cycle is sufficient for bullish equity investors. Given robust earnings growth expectations, a more accommodative monetary policy tilt is an incremental positive. While Fed actions certainly produce headlines, I firmly believe the trajectory of corporate profits will drive the next leg of this secular bull market. The magnitude of Fed rate cuts by the end of next year is tangential to the long-term thesis for stocks in my view.

The good news is that the fundamentals for equity investors are extremely positive. Earnings are forecasted to grow by over 17% in 2026 with broad-based profit expansion across sectors. Given that capital investment is expected to further increase, the most likely base case is that profits follow a similar trajectory over the coming years. This is naturally contingent on the economy not falling into a recession; despite a soft labor market, most indicators (i.e. retail sales, consumer spending, etc.) suggest that broader economic growth is likely to remain positive.

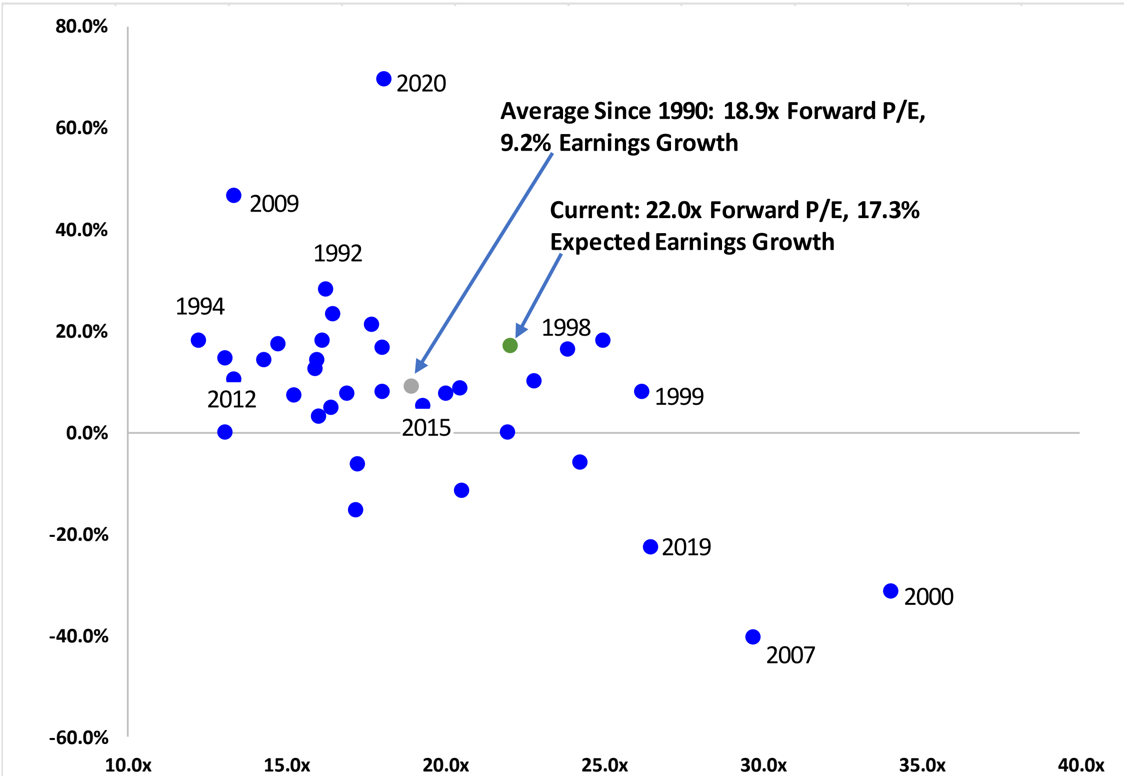
In short, we may be witnessing a "goldilocks" scenario for stocks. I believe earnings growth is likely to remain strong given secular tailwinds against a backdrop of relatively dovish monetary policy. The unprecedented level of technology spending is lifting earnings and likely fueling future productivity gains. However, an offset to this growth catalyst is a cooling labor market, which keeps the broader economy from "overheating." An economic backdrop which reflects an acceleration of capital spending combined with modestly increasing consumer spending levels is a potent cocktail for bullish investors.

Charlie Munger once said, “simplicity has a way of improving performance through enabling us to better understand what we are doing.” There are complex influences driving the underlying dynamics of any market, all of which could be written about or analyzed ad nauseum. This could include, for example, geopolitical developments, monetary and fiscal policy changes, or shifts across consumer and business spending behavior. It’s important, however, for investment managers to clearly identify the key factors impacting the broader market and individual companies. That includes distilling the most important key drivers and clearly understanding their consequences when managing portfolios. Investors best position themselves for success by maintaining disciplined focus on these core elements while ignoring much of the noise that captures the daily barrage of headlines.

In the current environment, screening for companies which benefit from elevated capital spending that are well positioned at scale is a good place to start. These include businesses both within and outside of the technology sector, many of which are direct beneficiaries of the AI spending boom. Investing across companies with promising growth prospects and defensible market positions with strong balance sheets is typically a successful recipe for long-term investors.

While valuation levels across the market are somewhat elevated, I believe there are still many attractive companies which fit these criteria that are trading at reasonable earnings multiples. Furthermore, while the current forward price / earnings multiple of 22x for the S&P 500 is higher compared to the average of roughly 19x since 1990, earnings growth is also expected to remain well above the historical average. In my view, this justifies a higher valuation for the market as a whole given robust profit expansion. I also believe that performance dispersion across stocks may increase over the medium term, which suggests that an active management approach may be the most prudent.

S&P 500 Valuation (Forward Price / Earnings, Vertical Axis) Vs. Forward 12M Earnings Growth (Horizontal Axis) : 1990 - 2025



Note: reflects 2025 and 2026 consensus estimates for S&P 500 earnings

Source: S&P Global

While September has historically been the weakest month for stocks, that seasonal phenomenon has not played out so far given that the S&P 500 is now up more than 3% month-to-date. There are a number of reasons for this, but the simplest explanation is that corporate fundamentals remain strong with the added benefit of a more dovish Fed. That's good enough for now, and if those trends continue, I believe the rally may persist as the calendar turns to the fourth quarter.

Andrew P, Kerai, CFA®, Chairman & Managing Partner

Capital Ideas, Inc.

Disclaimer