

Company earnings and guidance continued to impress this week, while Friday's monthly core inflation reading of 0.2% was relatively tame and below expectations. Both of these factors drove the market to fresh all-time highs at Friday's close. While the labor market remains soft, many other key data points (i.e PMI data, capital investment, consumer spending patterns, etc.) suggest that the U.S. economy is expanding at a robust pace. The Atlanta Fed's GDP forecast model (GDPNow) is predicting 3.9% economic growth during the third quarter following 3.8% growth in Q2.

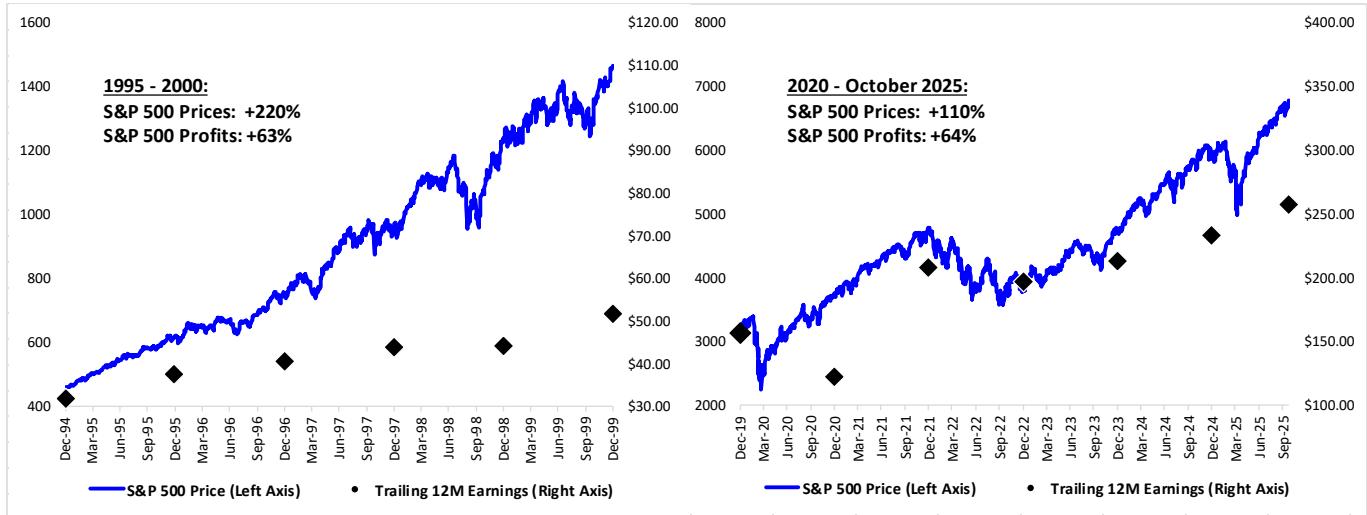
For this week's letter, I thought it would be helpful to take a step back and look at the bigger picture given the market's behavior so far this year. From the peak in February through the early April lows, stocks fell 21%, and have now risen 40% off the bottom. Stock prices are a function of two inputs – earnings produced by the underlying companies as well as the valuation of those earnings. For example, if a company's stock is trading at \$100/share while its earnings are \$5/share, it would trade at a valuation multiple of 20x. In other words, based on the \$100/share price, in this scenario investors are willing to pay \$20 for every dollar of annual earnings generated by the business. There are a number of factors that influence valuations, including future growth expectations, balance sheet strength, investor sentiment, and interest rates. A higher growth outlook, lower corporate debt levels, bullish investor sentiment, and lower rates typically drive valuation multiples higher, all else equal, and vice versa. At the April bottom, investors feared that elevated tariffs would drive the U.S. into a recession while corporate margins would get squeezed due to higher input costs. This depressed the growth outlook and investor sentiment which greatly reduced valuations.

In the current environment, however, investors expect profit growth to remain robust going forward, fueled by the capital investment boom largely driven by AI-related spending. Furthermore, while government debt has become increasingly elevated, corporate debt levels remain very modest overall. The combination of high profit growth and strong balance sheets has driven valuation multiples above the historical average. In addition, a more dovish interest rate backdrop has further supported company valuations. Investor sentiment is still relatively muted, unlike the euphoria that typically occurs at bull market peaks. This lack of unbridled optimism has for the most part kept price levels within a rational range in my view.

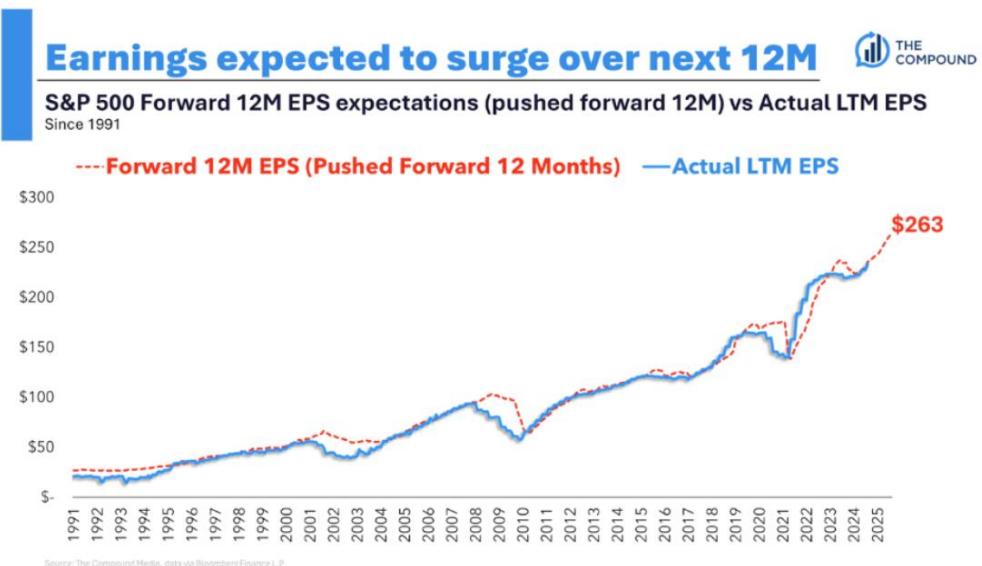
Therefore, unlike the "irrational exuberance" which fueled the tech bubble of the late 1990s, I believe the current bull market could be more accurately described as a rational ascent. Since 2019, stock prices have increased at an annualized rate of 13% while corporate profits have risen by 9% per year. From 1995-2000, by comparison, stock prices and earnings increased by an annualized 21% and 9%, respectively. This secular bull

market has been predominately fueled by strong fundamentals (profit expansion) versus speculative excesses.

Then (1995 – 2000) Versus Now (2020 – 2025): Stock Prices Vs. Profit Growth



Source: S&P Global



Source: A Wealth of Common Sense, S&P Global

Should sentiment increase meaningfully from here, that would likely be reflected in significantly higher prices that may eventually become disconnected from underlying fundamentals. I am simply not seeing that today; the valuations for the largest growth companies pale in comparison to the levels reached at the peak during the late 1990s. Furthermore, the current market leaders generate significantly higher levels of free cash flow with less debt and greater margins compared to past cycles.

In short, while the recent rally has been impressive, I believe it's justified given the growth outlook and earnings power produced by the largest and most consequential American businesses. Elevated headline risk and somewhat skeptical investors have prevented markets from becoming too frothy so far. In my view, the strong fundamental support backing this bull market bodes well for its go-forward prospects and sustainability. If that's the case, we may be closer to the early innings than the late innings of the current expansionary cycle, with the potential for significant further upside over the medium term.

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