

## August Private Client Letter | Multiple Expansion Argues for Caution

*by John E. Chapman*

U.S. equities have been in a strong rally mode for much of the past four months. Following the April lows triggered by President Trump's announcement of sweeping tariff policies, stocks have rallied higher by about 25%. The predicate for much of the gains has been a growing belief that the new tariffs would not be nearly as disruptive to the economy as was originally feared.

As July ended, the markets reached new record highs and investors appeared to be relatively unconcerned that the rally had largely been driven by multiple expansion, rather than broad-based earnings growth. In other words, stocks have become increasingly more expensive as the economy shows signs of slowing. Without a commensurate rise in corporate profitability, it can be argued that market behavior is becoming detached from fundamentals. Some strategists see this as a red flag pointing to the possibility that equity valuations are starting to overheat.

Favorable liquidity conditions, exciting innovations like AI, and expectations that the Fed will soon be cutting interest rates have combined to create what some believe is a bubble for equities. Accordingly, the risk-reward outlook may be shifting. Expensive markets increase the risks for higher volatility and sharp pullbacks should expectations run too far ahead of reality.

Investors are well advised to remember that a company's intrinsic value is ultimately tied to its ability to generate earnings and profits for its shareholders. If prices move beyond this fundamental value, then the risk of setbacks rises, and record prices could become unsustainable.

Rising signals of speculative activity are also a concern for near-term market performance. Increased use of leveraged ETFs, zero-day options, and cryptocurrencies points to risk levels rising. There have been at least 77 Special Purpose Acquisition Companies (SPACs) IPOs on U.S. exchanges so far in 2025, substantially higher than the 57 deals in all of 2024, and the highest activity since 2022 (ARC Group). Lastly, margin debt (the money investors borrow to fund stock purchases) surged past \$1 trillion in June. All of these developments reflect a renewed investor appetite for speculation.

As for the real economy, there are some signs that activity is slowing, but not declining. U.S. nonfarm payrolls rose a disappointing 73,000, and revisions to the May and June numbers were downward by 258,000. The first estimate for Q2 GDP showed a headline number of 3.0% growth; however, some of the internal measures were less impressive, with real (inflation-adjusted) final sales growing at only 1.2% (U.S. Bureau of Labor Statistics).

Overall, this important measure of economic activity has become temporarily distorted by how various businesses are responding to new tariffs. Looking at GDP growth for the first half of the year (as opposed to the individual quarters), we see that the economy is at a modest 1.2% annual rate, well below the 2.0% average rate of the past 20 years (First Trust).

Our conclusion to all of this is that the economy remains relatively resilient, and it would be a mistake to dismiss this year's bull rally entirely. This said, we do believe that a great many investors may have become too complacent about valuations in the near term. Valuations for the market are elevated; however, certain sectors are still reasonably priced relative to earnings expectations. Fittingly, we currently favor areas of the market where value can be found, such as dividend-paying stocks.

One thing is certain: markets have a tendency for excess in both directions. Markets characterized by record-high and elevated valuations are vulnerable to setbacks. While we do not expect a significant selloff this year, we do believe that risk assets have fully priced in a wide range of positive expectations that may, or may not, materialize. In other words, we see stocks as fully valued at mid-year, with any meaningful disappointments in the second half leading to an uptick in volatility.

Longer term, we like many things about this economy. Most notable is the clarity over tax policy and the pro-growth initiatives encouraging business investment. This administration's regulatory reform plans are in the early stages of development, and productivity gains from innovations such as artificial intelligence are almost entirely in front of us.

Our outlook remains constructive for the economy over the next several years, even as we expect a choppy market along the way.



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