

Stocks

We've received several questions about the level of the market, its progress, and how the good performance can be reconciled with the US political landscape. I know it's not second nature for investors to remember what matters to stock valuation, so it's worth repeating here: earnings growth and interest rate movements are the most important factors for stock price performance; this short list does not include politicians. We'll delve into each of these this month to explain why these factors take top billing and why the current environment might be good – not bad – for stock returns. But before we launch into this topic, it's worth mentioning that stocks posted another solid month, reaching all-time highs in many indices, not just here but around the world. Both the Dow and the S&P rose about 2.5%; the Nasdaq continued its winning ways with a 4.7% move. Overseas, markets were mixed, with Europe posting a strong 3.7%, but both Canadian and Mexican listings flat to down.

So why do earnings and interest rates matter so much, and how should we evaluate each of these factors in today's environment? Mostly, the impact of these two items comes down to math. I think we can all agree that the more a company earns, the more valuable it becomes. But the effects of interest rates are more subtle: declining interest rates impact companies several ways: their cost of borrowing may fall, feeding the earnings machine, but also, lower yields diminish the competition for investor dollars. If you could earn 8% on a Treasury note, you'd jump at it; but at around 4%, it's not so compelling.

What about the health of these factors now? Earnings have been strong, contrary to expectations at the beginning of the year. The average increase in earnings across all companies that have reported thus far in Q3 is over 8% versus a roughly 6% expectation; at a granular level, more than 60% of companies have beat expectations. Tariffs, thoroughly discounted by now, are impacting companies unevenly; it's worth noting that even the stocks of some companies paying very large tariff bills – such as General Motors, John Deere, and Apple - have risen this year by quite a lot. That's not true across the board, but overall, stock sectors are behaving in a way that's more responsive to how well their particular product or service is selling in the market and how well they're managing costs, versus the character of the political milieu. As we've mentioned before, we're not willing to ignore the ability of company managements to pivot as needed to adjust to most environments – whether the country is run by a Democrat or a Republican. Regarding interest rates, discussed below, the all-important ten-year yield has declined from about 4.8% in January to just 4.10% now. That decline has helped support stock prices.

We've also pointed out in the past that there's a ton of money that needs to make a return: pension money, 401k money, retirement savings, college savings, you name it, those are funds that can't sit around at 4% - all cramming into a limited set of stocks, even if you include overseas markets. Steady demand against limited supply equals higher prices.

Despite our emphasis on earnings and interest rates in stock valuation, bear markets happen. Why? It's rarely a matter of a political misstep; bear markets are nearly always attributable to the Federal Reserve keeping interest rates too high for too long, slowing borrowing from banks who are the real money creators. Which brings us to....

Bonds:

The Fed dished up a 25 bps (0.25%) rate cut, with two dissensions on the panel. One member wanted no cut, and the other wanted 50 bps. Powell's hawkish comments about inflation after the meeting suppressed the probability that another cut will follow in December. Still, the labor market is weaker, and the Fed must support the labor market, so it's a toss-up whether he'll remain so hawkish as the month grinds along.

As noted, the ten-year note is hovering around 4.1%. That's not low enough to do housing much good, but it's not a disaster; furthermore, credit card rates, the prime rate, auto loans, and other rates have eased. Looking forward, we don't see much reason for rates to burst out of the recent subdued trading range. That lack of volatility alone is helpful both to the economy and stock valuations.

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