

ELEMENT	TREND	COMMENTS
VALUATION	Neutral	Stock prices are generally fair except for the largest tech companies.
INTEREST RATES	Positive	Long-term rates, which had drifted higher, have fallen sharply.
INFLATION	Positive	Inflation persists but is cooling.
VOLATILITY	Negative	Market volatility is low, which is somewhat bearish.
MONETARY POLICY	Neutral	Fed tightening to impede near-term economic growth, earnings.
DOMESTIC POLICY	Neutral	Focus growing on US debt levels, election.
GEOPOLITICAL	Negative	Middle East on edge, China's economy in peril, Ukraine war drags on.

Pascal's Market?

Markets behaved in January like they did through much of last year, with large mega-cap tech stocks continuing to outperform the rest of the market. The amazing performance of the Magnificent Seven and other large-cap growth names helped propel the S&P 500 to its all-time highs last month, finally climbing past its previous peak reached in January 2022. The strong rally that ensued late last year, when the Fed began to signal that there would be no more rate increases, continued. The S&P 500 climbed 1.7%, the Dow Jones advanced 1.3% and an equal-weighted basket of the Magnificent

Seven (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla) returned 1.8%. After a blistering finish to 2023, smaller and less pricey stocks underperformed vs. their larger and pricier brethren. In general, it was the continuation of one of the primary themes that dominated the financial markets last year. Like the Led Zeppelin documentary, “The Song Remains The Same.”

	2022	1Q23	2Q23	3Q23	4Q23	2023	January
S&P 500	-18.1	7.5	8.7	-3.3	11.7	26.3	1.7
DJIA	-6.9	0.9	4.0	-2.1	13.1	16.2	1.3
NASDAQ	-32.5	17.0	13.1	-3.9	13.8	44.7	1.0
Russell 2000	-20.5	2.7	5.2	-5.1	14.0	16.9	-3.9
Russell 2000 Value	-14.8	-0.7	3.2	-3.1	15.3	14.6	-4.6
Russell 2000 Growth	10.0	6.0	7.1	-7.4	12.8	18.5	-3.1
Russell 3000	-19.2	7.2	8.4	-3.3	12.1	25.9	1.1
Russell 3000 Value	-8.0	0.9	4.0	-3.2	9.8	11.6	-0.2
Russell 3000 Growth	-29.0	13.8	12.5	-3.3	14.1	41.2	2.2
International*	21.0	8.0	3.0	-4.1	10.5	17.9	0.4

Source: Bloomberg

*MSCI Daily TR Net World Ex USA USD

The topheaviness of this market is impossible to ignore. According to our friends at J.P. Morgan, a basket of the top ten stocks in the S&P 500 returned 67% between the beginning of 2023 and the end of January. The other 490 stocks returned 9%. Eighty-six percent of the index’s return since January 1, 2023, has been in ten stocks.

One of the more well-known arguments in popular philosophy is Pascal’s wager, proffered by the 17th-century French mathematician, philosopher and physicist Blaise Pascal. The *Cliff’s Notes* version is essentially that God’s existence might be impossible to prove, but believing in God was the smart bet. The reasoning here was that if God exists, then believers reap eternal rewards, and if God does not exist, then believers have lost nothing of lasting importance by believing. On the other hand, while non-believers lose nothing of lasting importance if God doesn’t exist, they lose a great deal if God does.

Now, my old Sunday School teacher might not appreciate this analogy, but let's substitute the concept of valuation in the place of a Creator in Pascal's wager. Either value exists and matters, or it does not exist. Let's define value as the book value of a company, the actual accounting-based value of a firm—assets minus liabilities. We could also use a DCF, a discounted cash flow model, to approximate the present value of all the cash flows associated with a company. If one were unfamiliar with the concept of valuation and were tasked with allocating dollars, how would one do it? Well, probably by buying stocks that are going up, right? Wouldn't that be the point? As I once heard someone say in my dentist's office, "When I see a stampede, I jump on a cow!" In a world where intrinsic value does not matter, and prices are all that count, there's no reason not to just buy whatever is going up.

"Unless that crop report..." — Mortimer Duke, *Trading Places*, 1983

If the *Trading Places* co-villain Mortimer Duke hadn't been so despicable, it would have been easy to feel sorry for the old man when his illegal attempt to corner the frozen concentrated orange juice market was foiled, impoverishing the Duke brothers. They had been so sure of their success. "Just keep buying," they instructed their trader as prices skyrocketed. Of course, when their sure thing (a stolen crop report) turned out to be wrong, it was, as one of the smartest traders I know likes to say, "Turtles all the way down."

A stock with a high price vs. its current book value will almost always get cheaper, either by growing book value by leaps and bounds over many years by growing earnings, or by failing to meet investor expectations and causing the stock price to plummet as earnings fail to materialize. It's usually the second one, and you won't hear about it at the dentist's office.

We firmly believe that value does exist and does matter. Sometimes, adhering to a strategy that emphasizes discipline isn't that easy, but as Pascal advised and as the Dukes discovered the hard way, that's the way to bet!

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