Q1 Review & Outlook

APRIL 2024

ELEMENT	TREND	COMMENTS
VALUATION	Neutral	Stock prices are high again, most especially the largest companies.
INTEREST RATES	Positive	Markets are now expecting three 25-basis-point rate cuts this year.
INFLATION	Positive	Inflation persists but is cooling.
VOLATILITY	Neutral	Market volatility remains fairly benign, which is somewhat bearish.
MONETARY POLICY	Neutral	Fed tightening to impede near-term economic growth, earnings.
DOMESTIC POLICY	Positive	Focus growing on U.S. election.
GEOPOLITICAL	Negative	Middle East ignites, China economy in trouble, Ukraine war drags on.

Eclipse

The time is 4:13 p.m. Eastern on April 8, 2024. I just tossed my brand-new solar eclipse glasses into the wastebasket by my desk. They showed up early this morning, even though we ordered them only yesterday.

When the Amazon driver departed my house at 7:28 a.m. (saw him on Amazon's Blink security camera), I was still on my iPhone scrolling through Instagram and messaging my friends about John Calipari's departure from the University of Kentucky basketball program. I had not yet Googled what the buyout clauses were of his rumored replacements because I had just received a curt email in Outlook from my chief compliance officer reminding me I was overdue to take an online cybersecurity quiz about deepfakes.

Amazon. Apple. Google. Meta. Microsoft. NVIDIA. I had been a customer of six out of the seven members of the Magnificent Seven before I left the house that morning. Along with Tesla, is it any wonder these companies are so gigantic and sport such massive valuations? Their sheer size blocks out the sun.

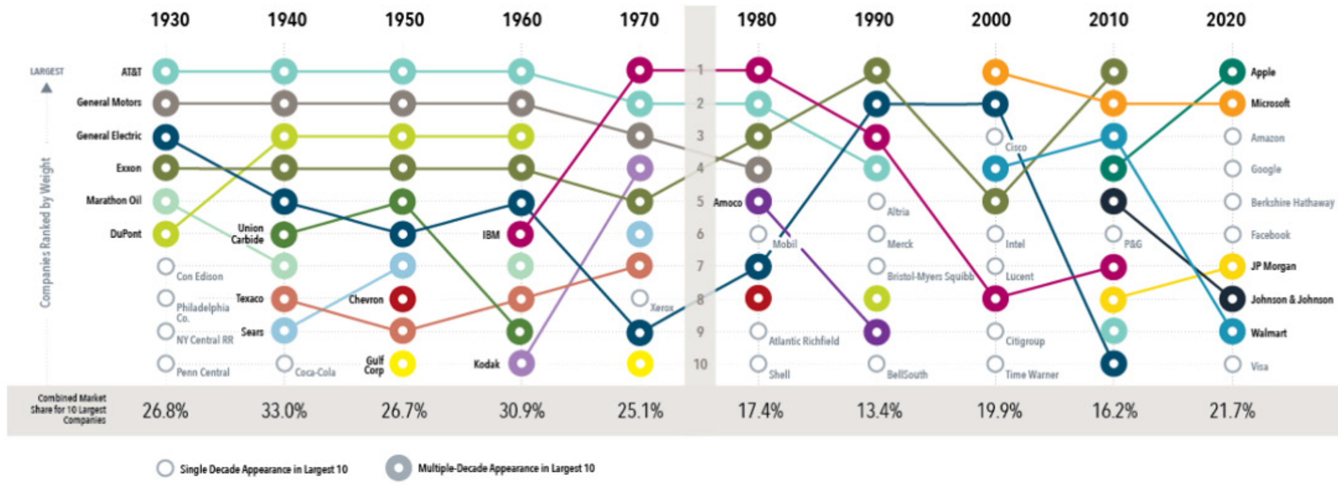
We have pointed out in these pages before how top-heavy the S&P 500 has become, owing to the massive weightings these tech giants now force upon the index. I would enjoy writing about something else, but it remains perhaps the biggest factor in near-term investment returns. The top ten stocks represent 34% of the entire index. That's the most concentration we have seen since the mid-1960s. What we haven't written about before is how big this shadow is even globally. According to the *Financial Times*, the ten largest stocks in the MSCI All Country World Index (Trust Company's benchmark for our model portfolios) now account for 19.5% of that index. This compares to less than 9% as recently as 2016 and is well above the dotcom era peak of 16.2%, using MSCI data going back to 1994.

Looking at the MCSI World Index, which excludes developing markets, the top ten companies are all American companies, and they constitute 21.7% of the index's total market capitalization. The total share of U.S. companies in the World Index is now almost 71%. That may not be a total eclipse, but it's a long, long shadow. What's more, the degree of concentration is even higher when one considers that the top ten includes two separate share classes of Alphabet, the parent of Google. (*Alabama coach Nate Oats' buyout is $18m, by the way.*)

Nothing New Under The Sun

So, is this the most concentration equity markets have ever seen? No. According to data from the London Business School, the ten largest stocks in the U.S. accounted for more than 38% of the U.S. stock market in 1900, in the age of the robber barons. I think that is a fascinating data point. Some of these companies today are essentially monopolies, and of course, Standard Oil was taken apart by the U.S. government in 1922. Technology changes engulfed other great companies in industries such as railroads.

Looking back over the largest companies at the start of each decade, a couple of factors



Source: Dimensional Fund Advisers

become apparent. First, the constituents of the top ten stocks each decade change a lot. Of the top ten companies in the S&P 500 in 2010, only five remained in 2020—Apple, Microsoft, J.P. Morgan, Johnson & Johnson and Walmart (and today, JNJ and WMT are out). Of the top ten in 2000, only two stayed in the group (MSFT and WMT), and only one remains today. So the first factor we notice is that the names change.

The second factor we notice is that the rate of change accelerated during the 1960s, which is the last time the market was this concentrated. Up to 1960, there was actually quite a lot of stability in the group. AT&T and General Motors were number one and number two, respectively, for more than 40 years. After the 1960s and all the excitement surrounding the Nifty Fifty (fifty stocks that were widely considered must-haves at any price) membership in the top ten began to change more rapidly.

So, are we embarking on four decades of powerful growth from today's top ten stocks that will continue to justify their massive valuations, or will the top ten turn over? We suspect the trend toward turnover will prevail. And lest this all sound like 'sour grapes,' it is worth pointing out that we own material amounts of the Magnificent Seven in client portfolios; it's just that we do not own as much as the major equity market indices do.

Global Equity Index Performance

	2022	2023	January	February	March	YTD
S&P 500	-18.1	26.3	1.7	5.3	3.2	10.6
DJIA	-6.9	16.2	1.3	2.5	2.2	6.1
NASDAQ	-32.5	44.7	1.0	6.2	1.8	9.3
Russell 2000	-20.5	16.9	-3.9	5.7	3.6	5.2
Russell 2000 Value	-14.8	14.6	-4.6	3.3	4.2	2.6
Russell 2000 Growth	10.0	18.5	-3.1	8.0	2.7	7.5
Russell 3000	-19.2	25.9	1.1	5.4	3.2	10.0
Russell 3000 Value	-8.0	11.6	-0.2	3.7	5.0	8.6
Russell 3000 Growth	-29.0	41.2	2.2	6.9	1.8	11.2
International	21.0	17.9	0.4	1.7	3.4	5.6

Source: Bloomberg, Trust Company of the South

Speaking of markets, they're off to a great start so far this year. The S&P 500 returned 10.6% for the quarter, pacing the group. Tech firms and other companies promising outsized growth outperformed for the quarter, although, notably, not uniformly. During March, the market's charge higher was led not by big tech but by other companies with less expensive stock prices. Large caps still outperformed shares of small firms, continuing the recent trend. We think shares of smaller cap companies will likely do better as interest rates fall, in large part because smaller firms tend to be more indebted than larger ones. As inflation has proven more nettlesome than the market believed, bets that the Fed would cut rates as much as six times this year have vaporized. The market is now pricing in just a handful of 25-basis-point rate cuts.

Fed Funds Futures - January 5

Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Change	Implied Rate
01/31/2024	-0.065	-6.5	-0.016	5.313
03/20/2024	-0.733	-66.8	-0.183	5.145
05/01/2024	-1.593	-86	-0.398	4.931
06/12/2024	-2.519	-92.6	-0.63	4.699
07/31/2024	-3.345	-82.6	-0.836	4.493
09/18/2024	-4.218	-87.3	-1.054	4.274
11/07/2024	-4.893	-67.6	-1.223	4.105
12/18/2024	-5.527	-63.3	-1.382	3.947
01/29/2025	-6.145	-61.8	-1.536	3.793

Source: Bloomberg, Trust Company of the South

Fed Funds Futures – April 5

Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Change	Implied Rate
05/01/2024	-0.057	-5.7	-0.014	5.312
06/12/2024	-0.581	-52.4	-0.145	5.181
07/31/2024	-0.975	-39.4	-0.244	5.082
09/18/2024	-1.643	-66.8	-0.411	4.916
11/07/2024	-2.013	-37.1	-0.503	4.823
12/18/2024	-2.677	-66.3	-0.669	4.657
01/29/2025	-3.085	-40.8	-0.771	4.555

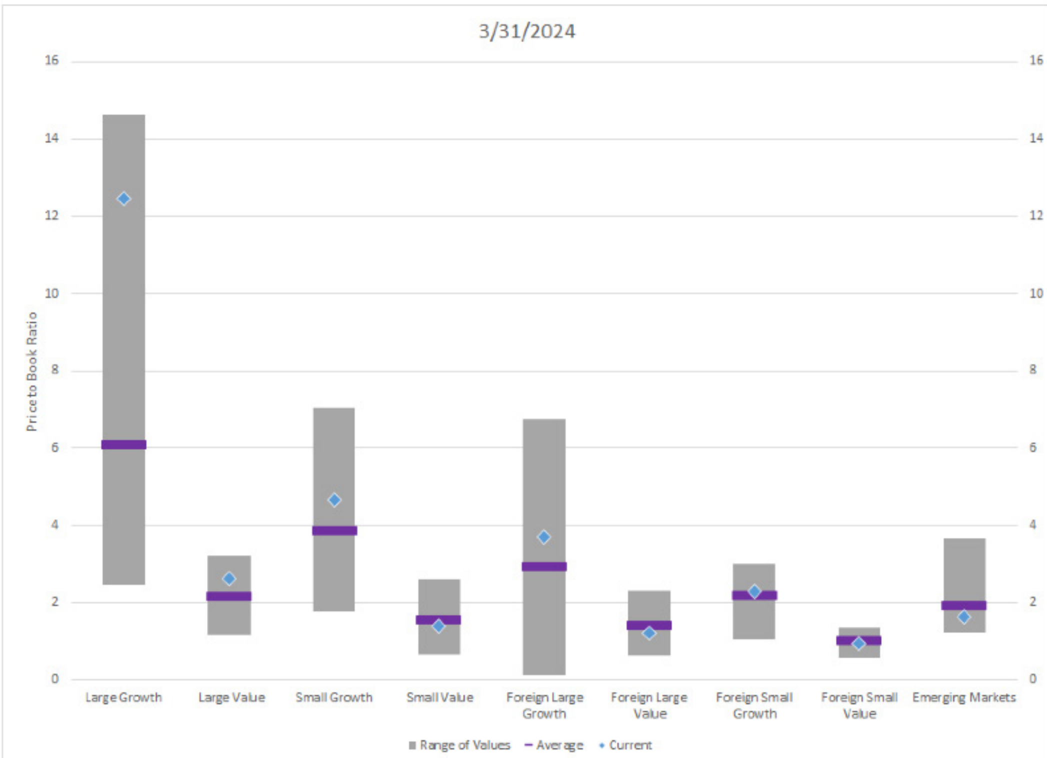
Source: Bloomberg, Trust Company of the South

Higher rates have a way of taking the wind out of the sails of the most expensive stocks, so we would not be surprised to see further pullbacks among the most pricey parts of the market. They also impede the growth of smaller firms, so we think the odds of an imminent major rally among small caps have diminished somewhat.

Of course, we must give credit where credit is due. Stocks follow earnings growth in the short term, and the place to find earnings growth in 2023 was in the Magnificent Seven. According to J.P. Morgan, the Mag Seven grew earnings 31% last year vs. the market's overall 4% decline. Mag Seven earnings will outpace the index this year, as to be expected, but a) not by as much and b) not after the third quarter. By the fourth quarter, the consensus earnings growth estimates for the S&P 500 exceed Mag Seven. Perhaps that's one reason we're seeing the rally broaden and leadership change.

It's also why we are especially reluctant to underwrite large-cap growth at these levels. While the markets have grown expensive again, it's still mainly valuations at the top that are the most egregious.

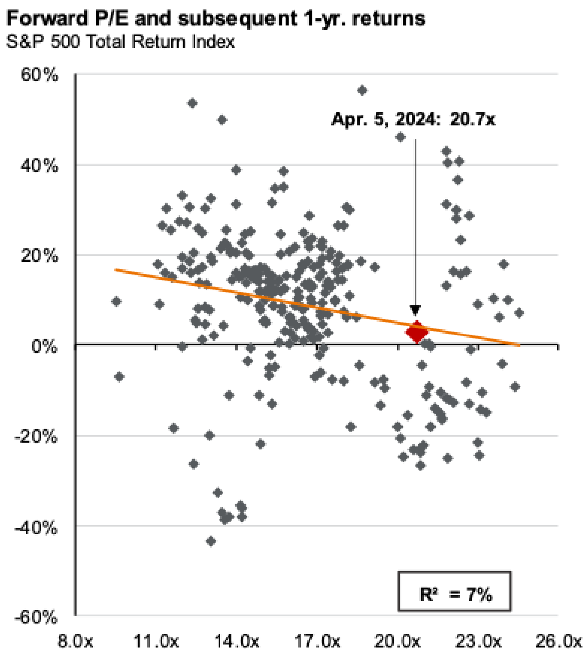
Price/Book Ratios and Expected Returns

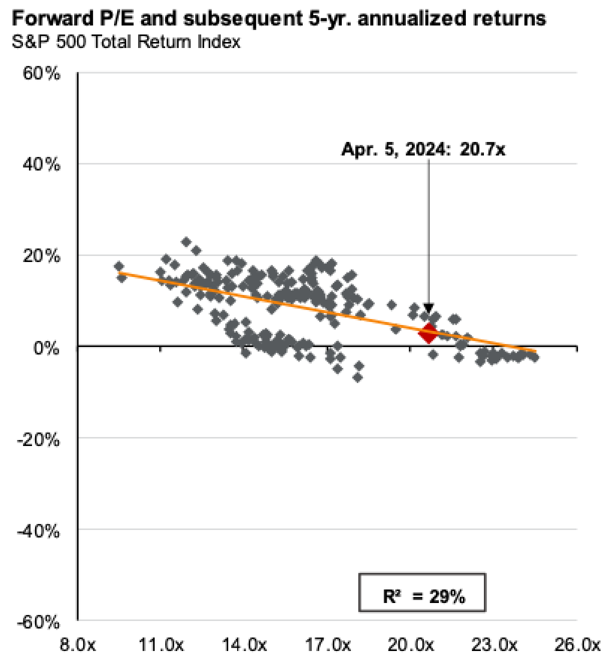


Source: Bloomberg, Trust Company of the South. Range of values calculated monthly beginning in January, 1995.

This is because, as the above chart shows, most equity asset classes are trading quite close to their historical averages. Examining price-to-book ratios going back to the mid-1990s, only one asset class is an outlier—large-cap growth, which is trading north of 12x book value.

Valuation is not a particularly strong determinant of future investment returns in the short term, but it grows more powerful over time. Many factors can affect near-term performance: momentum, index inclusion or exclusion or macro events, but over time, earnings have to materialize. Sure, stocks follow earnings growth, but the real value determinant is earnings in general. There is a clear relationship between price paid and future returns, and the relationship only strengthens over time. It's not exactly rocket science, but it is basically the underpinning of our entire investment philosophy.

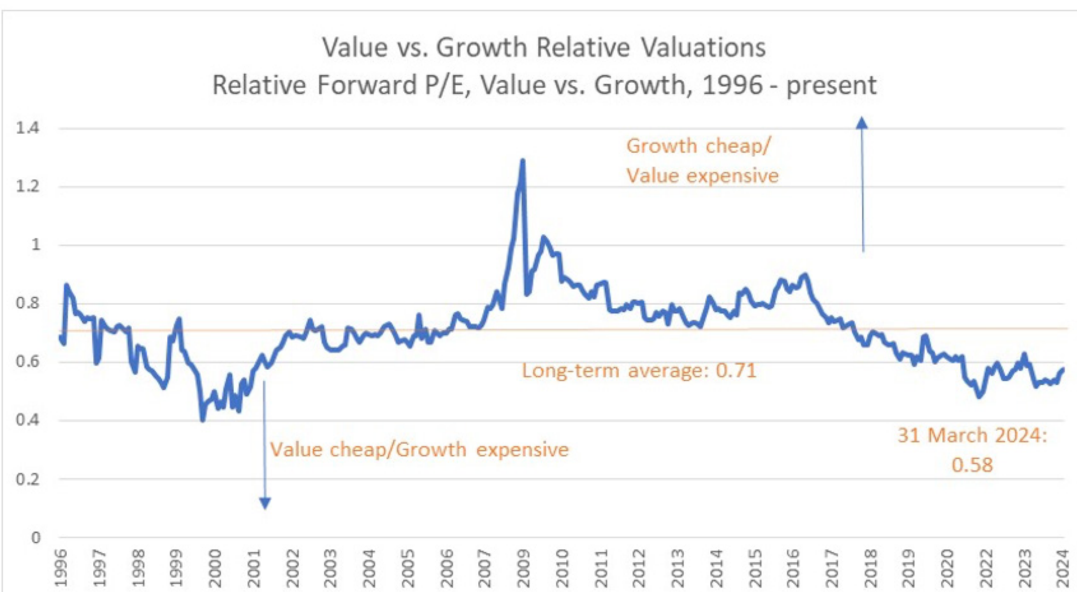




Source: FactSet, Refinitiv Datastream, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

Returns are 12-month and 60-month annualized total returns, measured monthly, beginning 11/30/1998. R^2 represents the percent of total variation in total returns that can be explained by forward price-to-earnings ratios. Price-to-earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since February 1998 and by FactSet since January 2022. *Guide to the Markets – U.S.* Data are as of April 5, 2024.

The opportunity set for value-leaning investors looks especially compelling right now. The U.S. economy appears to be powering ahead, and fears of an imminent recession have largely disappeared. Accordingly, there's ample earnings growth to be found in lots of places, so why pay the exorbitant premiums demanded by the Magnificent Seven and other crowded names? On a relative basis, value is much more attractive, and if March is any indication, the market might be starting to sniff this out.



Source: Bloomberg, Trust Company of the South. Value represented by the Russell 1000 Value Index; Growth represented by the Russell 1000 Growth Index.

Broadly speaking, value stocks have not been this inexpensive vs. growth stocks since the tech bubble of the late 1990s. Meaningful outperformance from value would not require a return to the washout of the Great Financial Crisis; just a natural course toward the long-term average price relationship would suffice.

We are not making the case that this market is identical to the market of the late 1990s; the leaders today are giant, successful companies with real earnings as opposed to sock puppets and marketing budgets. What we are saying, though, is that it is human nature to extrapolate trends where they do not necessarily exist.

As the late behavioral economist Danny Kahneman used to point out, humans make terrible economic decisions all the time because of flaws in our thinking that stem from evolution. We exhibit recency bias, for example, thinking that prices that move up keep moving up forever. As it turns out, we are very bad at changing our minds and learning from our mistakes.

In other words, there's nothing new under the sun.

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