

Q4 Review & Outlook

January 2026

ELEMENT	TREND	COMMENTS
VALUATION	Negative	Stock prices are stretched, particularly among the largest companies.
INTEREST RATES	Neutral	Short-term rates have fallen, but long-term rates have ticked up.
INFLATION	Neutral	Inflation remains under control, but tariff dangers lurk.
VOLATILITY	Positive	Price volatility has climbed slightly, but from quite low levels.
MONETARY POLICY	Positive	Fed to cut again this month, though the pace of future cuts is uncertain.
DOMESTIC POLICY	Neutral	Policy uncertainty is at least partly offsetting constructive deregulation.
GEOPOLITICAL	Negative	Tariffs and shuffling alliances are affecting global trade.

What Comes After a Three-Peat?

On a late October afternoon in the year 2000, I stood up from my cubicle on the 20th floor of Four World Financial Center, peeked around, and, seeing none of my immediate superiors, hopped on the elevator. I took the footbridge across West Side Highway, walked through the World Trade

Center, and within a few minutes, I was standing in a throng of hundreds of thousands of people watching the World Series victory parade of the New York Yankees. The Yankees—the Derek Jeter/Paul O’Neill/Bernie Williams-led juggernaut—had just won their third World Series in a row. They had completed the “three-peat” by vanquishing the Mets in five games. Amid the jubilant crowds that day on Broadway, it seemed the Yankees’ reign would last for many years to come.

Of course, one year later in 2001, the New York Yankees would not win the World Series. The Arizona Diamondbacks would win on a Luis Martinez single off of Mariano Rivera, and the storybook four-peat, which even the habitually cruel baseball gods had seemed to bless in the agonizing weeks after 9/11, vanished into the November night. What’s more, there could be no sneaking out of World Financial Center and scampering across the World Trade Center anyway because World Financial Center would be closed and World Trade Center would be gone.

Let’s be clear—we are not expecting anything remotely like the events of 2001 to happen in 2026. We are not predicting anything. Our position is that prognostications are generally worthless, especially when the crowds all prognosticate the same thing. But that does not mean one should not be prepared for what could happen, or even what might already be happening.

On that late October 2000 day in Lower Manhattan, the S&P 500 was within a few points of where it had started the year. Sure, the index had fallen about 10 percent from its March peak, but this was the dotcom era, baby. This time was different. Valuations didn’t matter as much as eyeballs and clicks. Come on, the geniuses in the equity research department where I was working said so!

Perhaps we should have known the party was over, but we did not. We did not know that the Yankees would not win another World Series until 2009, and we did not know that we were already in a three-year bear market.

“MOAR!”

Meanwhile, in January 2026, we find ourselves coming off an extraordinary run in the market. Stocks have just completed an extraordinary three-year run, with the ACWI returning 75.6 percent since the end of 2022. As humans, we are basically wired to extrapolate a future that sits on the same path as the recent past. We all have built-in “recency bias,” as Charlie Munger called it. One could be forgiven for not realizing that markets are more risky, not less risky, after a big run-up in prices.

Stocks are expensive today, and the largest, most beloved stocks are some of the most expensive. That’s because even though some of the AI-darlings and mega-cap technology stocks are indeed growing earnings at astonishing rates, their stock prices have risen even faster than their earnings growth. As a result, future outsized gains from these stocks, while still possible, are less probable.

Major Equity Index Returns

	2023	2024	1Q25	2Q25	3Q25	Oct	Nov	Dec	4Q25	2025
MSCI All Country World	22.2	17.5	-1.3	11.5	7.6	2.2	0.0	1.0	3.3	22.3
S&P 500	26.3	25.0	-4.3	10.9	8.1	2.3	0.2	0.1	2.7	17.9
DJIA	16.2	15.0	-0.9	5.5	5.7	2.6	0.5	0.9	4.0	14.9
NASDAQ	44.7	29.6	-10.3	18.0	11.4	4.7	-1.4	-0.5	2.7	21.2
Russell 2000	16.9	11.5	-9.5	8.5	12.4	1.8	1.0	-0.6	2.2	12.8
Russell 2000 Value	14.6	7.6	-7.7	5.0	12.6	0.2	2.9	0.0	3.1	12.4
Russell 2000 Growth	18.5	15.0	-11.1	12.0	12.1	3.3	-0.8	-1.3	1.2	12.9
Russell 3000	25.9	23.8	-4.7	11.0	8.2	2.1	0.3	0.0	2.4	17.1
Russell 3000 Value	11.6	14.0	1.6	3.8	5.6	0.4	2.7	0.7	3.8	15.7
Russell 3000 Growth	41.2	32.4	-10.0	17.6	10.4	3.5	-1.7	-0.6	1.1	18.1
International*	15.6	5.5	5.2	12.0	6.9	2.0	0.0	3.0	5.1	32.4

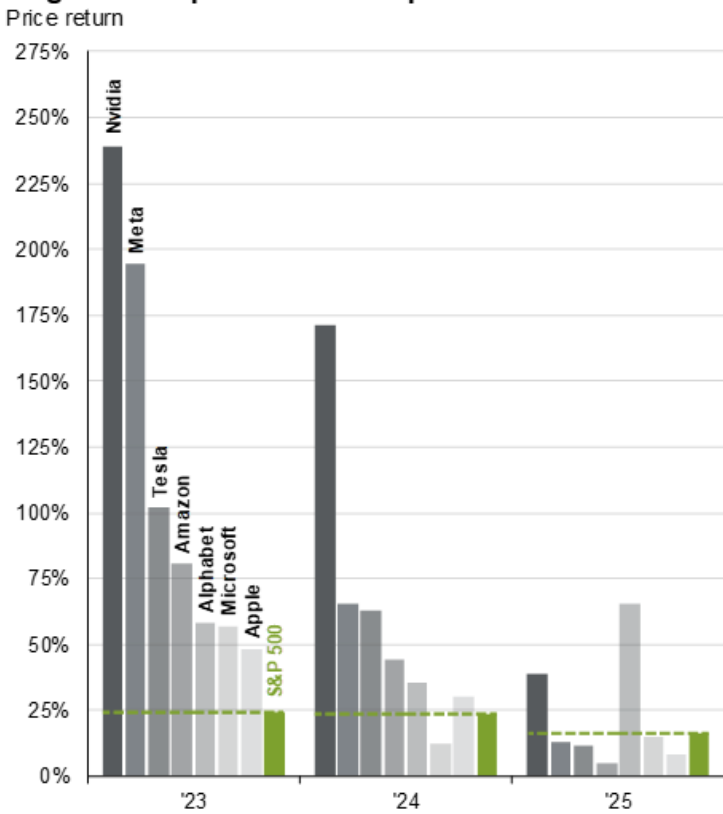
Source: Bloomberg

*MSCI ACWI ex USA Net Total Return USD Index

Last year was another banger year for the markets, with global stocks returning 22.3 percent. While U.S. stocks had another great year, international shares led the way, returning 32.4 percent. Valuations overseas were far more compelling than in the U.S. and remain so. Weakness in the U.S. dollar also played a significant role in international outperformance, as investors re-evaluate their exposure to the U.S. Large-cap growth stocks had another excellent year, outperforming their value and small-cap counterparts, but not by a wide margin. In fact, during the fourth quarter, value stocks and small-cap stocks outpaced the reigning asset-class champions. However, all of these were outpaced by continued international outperformance. These trends have continued into the New Year.

The relative weakness in tech, which began in November, could well reverse itself at any moment. On the other hand, this is a well-worn script; history would suggest that this is merely what always happens to market leadership over time. In fact, the leadership of the Magnificent Seven has been faltering for a while now. In 2023, each one of the Magnificent Seven stocks—Amazon, Apple, Google, Meta, Microsoft, Nvidia and Tesla—outperformed the S&P 500. In 2024, six outperformed. Last year, only two outperformed.

Magnificent 7 performance dispersion



Source: Guide to the Markets – U.S. Data are as of December 31, 2025.

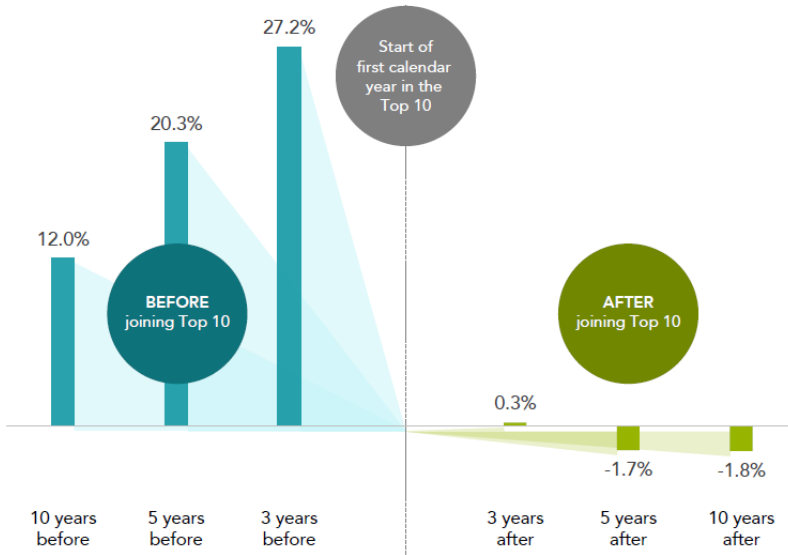
best outperformance of these stocks happens before they become top-ten stocks, not after. In fact, stocks of the ten largest stocks in the S&P 500 have underperformed once achieving that milestone.

Accordingly, this, and the very nature of capitalism, is why the lists of companies among the top ten stocks are always changing. Consider the top ten stocks in the S&P 500 at the end of 2025. Only one in the top ten stocks (Microsoft) was in the top ten 20 years ago, and six of the ten were not in the group a decade ago. Moreover, the aggregate value of the top ten stocks in the index has mushroomed from \$3.2 trillion in 2015 to \$19.4 trillion at the end of 2025. Of course, the value of the index has grown dramatically over the last decade, but the percentage of the index represented by these giants has grown from high teens to almost 40%.

There's nothing wrong with these companies. In fact, a market-cap-weighted basket of the Magnificent Seven stocks outperformed the S&P 500 last year (23.0% vs. 17.9%), but it was because of just the two stocks that outperformed (Google and Nvidia). On the contrary, as a group, their prospects may never have been brighter. It's just that they became awfully expensive, and investors are seeing better opportunities elsewhere. It's also a fact of life that, historically, the largest stocks in the market tend to underperform after they become the largest stocks in the market. This makes total sense; the earnings growth rate required to become a mega-cap stock cannot be sustained into perpetuity. The

Resist Chasing Past Performance

Average annualized outperformance vs. S&P 500 of 10 largest US stocks, 1927–2024

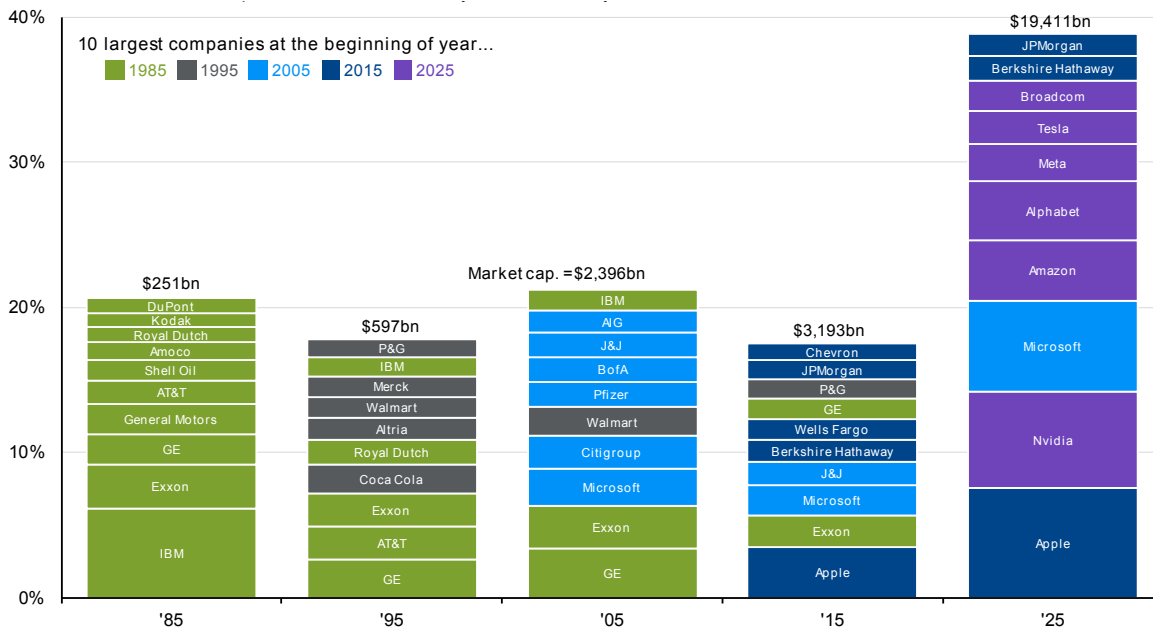


Source: Dimensional Fund Advisors

The Financial Times reports that since the launch of ChatGPT in October 2022, the market capitalization of the S&P 500 as a share of US GDP has soared from 142 percent to a record high of 214 percent, with tech stocks more than doubling from 44 percent to 101 percent.

What does this mean? Well, frankly, it means that the bets have never been higher that the Yankees are going to win the World Series, and the odds have never been worse that they will.

Top 10 Companies By Decade



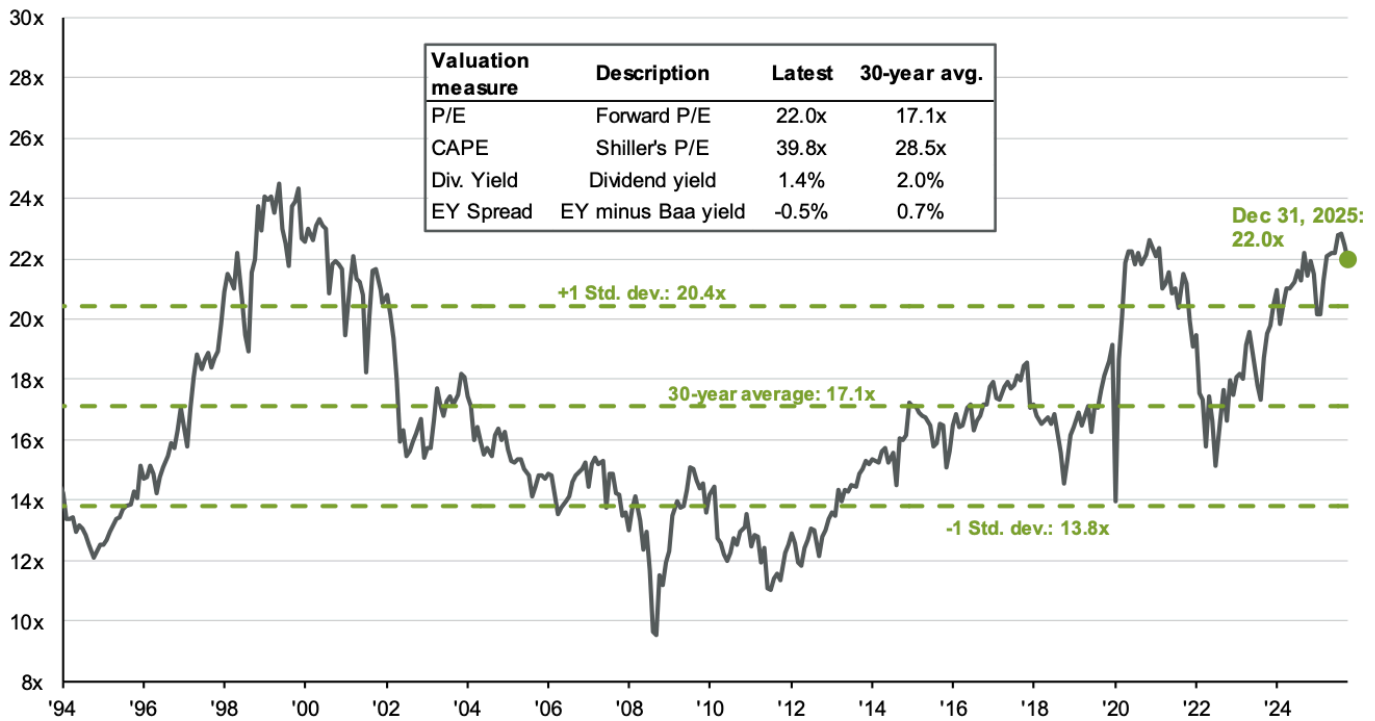
Source: Bloomberg, Standard & Poor's, J.P. Morgan Asset Management. Companies are organized from highest weight at the bottom to lowest weight at the top. Past performance is no guarantee of future results.

Guide to the Markets – U.S. Data are as of December 31, 2025.

This does not mean that investors should shun stocks, but I think a compelling case can be made that investors would be well served by being diversified beyond the tried-and-true S&P 500. No one is arguing that investing in the S&P 500 is not a perfectly sensible strategy over the long term. However, after the gains we have witnessed over the last three years and with the level of concentration in the index, it takes a stout-hearted investor indeed (and one unfamiliar with history) to expect that the near-term future will resemble the recent past.

Put another way, while it has been difficult to be a value investor for the last several years, experiencing good returns while growth investors zoomed ahead, that is tiddlywinks compared to sitting on a pile of indiscriminately purchased expensive stocks that are either getting cheaper by the day as multiples fall, or worse, that are not getting cheaper by the day because earnings fall.

S&P 500 Index: Forward P/E Ratio



Source: Bloomberg, FactSet, Moody's, Refinitiv Datastream, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management.

Forward P/E ratio is the most recent S&P 500 index price divided by consensus analyst estimates for earnings in the next 12 months, provided by IBES since March 1994 and FactSet since January 2022. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as consensus estimates of dividends in the next 12 months, provided by FactSet, divided by the most recent S&P 500 index price. EY minus Baa yield is the forward earnings yield (the inverse of the forward P/E ratio) minus the Bloomberg U.S. corporate Baa yield since December 2008 and interpolated using the Moody's Baa seasoned corporate bond yield for values beforehand.

Guide to the Markets – U.S. Data are as of December 31, 2025.

Valuation alone is not a reason to act rashly or to call for a downturn ahead, but it does amplify the effect of future volatility; it does raise the stakes. With the S&P 500 trading at 22x forward earnings at the end of 2025, it is priced more than one standard deviation higher than the average over the last 30 years. Is it a coincidence that 22x is where the index was trading right around the time I was standing on Broadway looking for Derek Jeter? With valuations near where they were in the dotcom era, S&P 500 investors should be aware of the risks.

In our letter last month, we talked about “the wall of worry” in markets and how risk is normal. There are always risks to owning stocks; this is generally a good thing because accepting certain risks is how we, as equity investors, get paid. The point I am trying to make, though, is that when valuations are high, as they are now, the near-term effects of risks manifesting into reality are greater.

“Rummy” Wisdom?

So what are some of the risks?

Well, let’s start with the “known unknowns” as Donald Rumsfeld used to say, beginning with price stability. Maintaining price stability has traditionally been the most important mandate of the Federal Reserve. The Fed influences financial conditions (and thereby prices) via setting short-term interest rates and buying and selling Treasury bonds. During the last year, the Fed lowered short-term interest rates as the economy showed some signs of softening and might have eased more were it not for fears about the impact of the tariffs that were introduced throughout the year.

Count us among those who were pleasantly surprised that tariffs have not had a larger impact on the economy to date, as importers have found ways to either pay them without passing them along in full to consumers, or to avoid them by reshuffling supply chains. Furthermore, some of the most destructive tariffs have been postponed, shelved or exempted. Even so, the risk persists that there is more price pressure coming down the pike, and so price stability has some risk to the upside, which would warrant the Fed raising short-term interest rates.

This feeds directly into another “known unknown,” which is how I would describe what happens when a U.S. president attempts to coerce the Fed into lowering interest rates. In other words, we know we do not know what happens next. Does Fed Chairman Powell give in and allow the administration to set short-term interest rates? Does he resign, perhaps hoping to minimize long-term damage to the Fed as an institution? Or does he stay on, rebuking the administration and setting off a monetary policy stand-off? Or does Powell get fired?

There are other standard known unknowns, such as the rate at which AI will begin to dampen job growth. What will the regulatory response be, if any? Our economy is getting a massive boost from spending on AI and from enhanced productivity. What will the tradeoffs be? When do they arrive? The unemployment rate among recent college graduates is more than double the national rate. Is this a harbinger of things to come?

Then, there are the unknown unknowns. These are the systemic risks that can't really be avoided (wars, pandemics, 9/11s), though they can be managed via diversification.

We cannot help but note that while the list of unknown unknowns is by definition infinite, there are a growing number of risks that were formerly unknown unknowns which are now known unknowns, such as the risk that the federal government might take a stake in your company or a competitor's company, or the risk of conflict spreading in Europe or the risk that lending money to consumers at market rates could potentially be deemed illegal. These risks, which a year ago seemed ridiculous, are now a reality, as shareholders in European defense companies would happily report, and which shareholders in companies such as American Express and Capital One would like to forget.

Perhaps counterintuitively, is the emergence of this new subcategory of newly known unknowns actually bullish if it means that the potential for economic zanyness is now more fully reflected in market prices? This surely tests the limits of the efficient market hypothesis, but maybe?

Looking Ahead

None of these risks should keep investors on the sidelines. We do not advocate timing the market, but we do advocate maintaining discipline. We believe that investors are well-served by maintaining globally diversified portfolios, by maintaining price discipline and by maintaining the discipline not to chase areas of the market where margins of safety are not readily found.

As we enter the New Year, we believe we are in an excellent position. Of course, this is what we normally believe, but this year we perhaps feel even more confident than normal, given the recent momentum building in areas of the market where we have long been allocating. We believe our significant allocations to international markets and to areas of the international and domestic markets that have historically produced long-term outperformance, such as value, small caps and quality, are poised to produce favorable investment results for our clients. We are grateful for your confidence in us, and we look forward to working for you again this year, whoever wins the World Series.

And for the record, I hope it is the New York Yankees, not in the metaphorical sense, but the actual New York Yankees.

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