Conversations with Commerce Trust

A Look Inside the Equity Markets

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David Hagee: Hello, and welcome to Conversations with Commerce Trust, our show about the markets, investment themes, and economic insights that matter to you. I'm your host, David Hagee, Chief Investment Officer with Commerce Trust.

Today I'm joined by Kelly Jernigan, our Head of Investment Policy and Director of Family Wealth Strategy, and KC Mathews, our Chief Investment Strategist, to discuss the equity markets. Welcome back to the podcast, gentlemen.

KC Mathews: Hi, David.

Kelly Jernigan: Thanks for having me back, David.

David: Well, thanks for joining the podcast today. You know, today we're going to spend a little bit of time doing a little bit deeper dive inside the equity markets. We certainly spend a lot of time talking about asset allocation, which we view as the primary driver of return, getting that mix of stocks, bonds, alternatives, cash right inside the portfolios, really going to be the chief determinant of your overall returns.

As we look at things today inside the equity component of the allocation, I think spending a little bit of time dissecting the markets, where we've been, where we're going, would be extremely helpful. Looking over the past three years, we've had returns (as measured by the S&P 500 Index) bordering on 100% cumulative since the end of 2022, when we had a rough year in the markets as we were fighting inflation and interest rates went up fairly dramatically.

Post-then, it's been a market dominated by the tech sector. And really, the emergence of AI (artificial intelligence) with ChatGPT rolling out in 2023 and kind of off to the races since then. KC, looking back over the past three years, how are you thinking about the U.S. markets?

KC: Well, clearly the last three years has been driven by this technology/artificial intelligence trade, and those stocks, some of the largest stocks out there are the Mag Seven (Magnificent Seven) that we've all heard about, right?

The performance has been stellar, and it's been driven by those companies' earnings growth. It really is quite interesting. In our careers, we haven't seen companies like this grow on a sustainable basis like this. And the big question going forward is, will the leadership of the market continue to be in this technology/AI space?

David: Yeah, I think it is interesting to be able to evaluate these markets and say that this earnings growth that we've seen is real. It's not just people buying on the prospect of better earnings in the future. The tech companies have been able to deliver solid earnings growth.

You know, as we look at that, Kelly, I'm struck by, tech has been so dominant, and we haven't seen other areas of the market have that sort of performance. You know, in terms of the internal composition of the market, what stands out to you over the past couple of years?

Kelly: So, David, as you know, KC mentioned, we've seen, you know, really the mega-cap (capitalization) companies drive performance. There have been a few periods where they've pulled back a little bit, right?

So, you know, in April of last year, after the tariff announcements, you know, those mega names pulled back, but then they reasserted themselves, and they have been dominant, and returns have been concentrated in just seven or eight names for the most part. And those have really driven returns.

Now, what we saw the last couple of months of 2025 has been interesting as investors have searched for, you know, valuations that are cheaper. You've seen small-cap, micro-cap and mid-caps start to outperform. And then of course I think the significant story of 2025 was the performance of international, both developed and emerging market, outpacing the S&P (S&P 500 Index) for the first time in over about 15 years.

David: Yeah, you know, as we look at things, you know, certainly to characterize, you know, the equity performance over the past couple of years, a rising tide has lifted all boats. It's just lifted other boats significantly higher than, say, smaller-sized U.S. companies, as well as those mid-sized companies, which tend to be companies that are on their way up or on their way down in terms of their growth trajectory.

You know, as we think about things, you know, the other contrast here is growth companies, KC mentioned it earlier, have done extraordinarily well. This is the tech space as well as that communication services where Alphabet (Alphabet, Inc.) and Meta (Meta Platforms, Inc.) live.

But the value companies, you know, industrials, banking, healthcare, names like that, haven't performed as well. You know, KC, what are your thoughts about the value growth composition in here?

KC: Yeah, it's a significant question of rotation. What will we expect to see going forward? And over the last three years, growth has been the winner, but maybe in the last six months, or just call it short term, clearly we're seeing some things change. And one of that is earnings expectations, right?

So we just talked about these Mag Seven technology companies. Last year, 2025, their earnings growth was 23%, approximately, and the rest of the market, like industrials and finance, were at 6%. But today, going forward in 2026, that gap is narrowing, right? The Mag Seven earnings growth expectations are down to 22%, and the rest of the market is creeping up to 10[%].

So that's what you're seeing. The stock market's a leading indicator. So, as we expect earnings growth to move around, all of a sudden, the performance of growth might take a breather, and the performance of value is now picking up. So, we remain well diversified because trying to do those trades and trade the market is very, very difficult.

But we also believe in that technology trade that, right now, you're seeing a bit of a pause in those stocks, but we think we're at the tip of the iceberg with this technology and artificial intelligence. And later in the year, if we see the growth rate that I just stated, you'll see growth perform well and value, I think, perform better than what we've seen in the past.

David: You know, as we talk about diversifiers, international stocks have fallen into that category of being a solid diversifier. You know, last year, I think the biggest surprise for me in 2025 was the performance of international securities.

Kelly, you know, what were some of the catalysts that drove some of that international outperformance, and what's in place for 2026 there?

Kelly: So, a very significant catalyst was, of course, you know the valuation of the (U.S.) dollar and the fact that you saw the dollar pull back in, you know, the first half of 2025. The interesting thing is, if you take a look at June 30th of 2025 and go 12 months back, the dollar looks flat. But at the beginning of 2025, if you look at it compared to a basket of currencies, it was valued at 110.

Then it pulls back about, you know, 10-12%, you know, to a valuation of about 95. So, not unreasonable, but that 10%, 12% pullback is going to add to those international returns for U.S. investors. So that was a big driver.

You also had European stimulus that happened in, you know, the first half of the year as well. So, there were some other reasons for international outperformance, you know, other than just dollar valuation, it is something that we continue to look at. If there is continued dollar weakness, then you would expect international returns to perform well. If the dollar is neutral to, you know, strengthen, then again, domestic markets would outperform international.

David: Yeah, I think that's a good point. You know, the one area that we've spent a little bit of time on, but really haven't gone deep on is this valuation question. Certainly, as we talked about, the end of the 90s (1990's), that was a market that you saw price-to-earnings ratios well above 100 on some of the darlings of the market. People were coming up with different valuation metrics, like how many eyeballs are looking on the Pets.com website, things like that. You know, as we look at valuations today, you mentioned we're a little above historical averages in terms of 23-, 24-times forward earnings on the S&P 500. But are there lingering concerns around valuations?

KC: Absolutely, but the one thing I would add to this is, look at the S&P 500 sector breakdown. You know, 34%, approximately 34% is in technology, and there's another 11% in communication services like Meta and Alphabet.

So those stocks with the earnings growth demand a higher multiple. When you have valuations at 22 times forward earnings, is that reasonable? Absolutely. And just adding on to our international trade, guess what? The eurozone index (MSCI Europe Index) has about 10% technology. That's more in financials, so you expect a lower multiple because a lower growth rate.

So sure, you know, there's a lot of things we have to look at. We have to be mindful of where valuations are, but when you think about what the sector weightings and the high sector weighting into technology, the index itself should have a higher multiple, and we think that's reasonable going forward.

David: Yeah, you're right, that really valuation alone doesn't tell the story. You have to throw growth behind that, and this growth does appear to be sustainable, right? You know, we have definitely transitioned as an economy away from more cyclical areas like industrials towards this more consistent earnings model that you get off of some of these tech names. Whether it's NVIDIA (Nvidia Corporation) selling a ton of chips or whether it's TV being replaced by YouTube at this point, they seem to have consistent drivers of earnings.

Looking forward in terms of where we're at return-wise, our research would say that after three years of double-digit returns, which we have just crossed over, that inside the fourth year, 3/4 of the time you're up inside that fourth year. And that the average amount that you're up is about 7.5%. Kelly, as we're looking forward and thinking about stocks in portfolios, what sort of returns are we contemplating?

Kelly: So, I think that 7.5% is, you know, that would kind of revert back to that historical mean, right? We've had great double-digit returns driven by a narrow sector of the market. And as we talked about earlier, you've seen, because of valuations, people searching for other opportunities, like in small-cap, mid-cap. There are some structural reasons why mid-cap and small-cap have not done as well, and those may be changing.

One of those reasons is that you haven't seen as many companies go from private to public. So that's what we call, you know, IPOs or initial public offerings. In the 2000s before the Dot-com bubble, you had a lot of companies that IPO'd, and it was a scramble to get into IPOs.

Now you have companies staying private longer, like SpaceX (Space Exploration Technologies Corp.), for example. And so, there's a couple reasons for that. One, of course, is that companies that stay private can focus on longer-term returns than doing quarterly analyst calls.

Another reason why is that private markets are now actually trading among themselves or doing, you know, a succession fund to keep those companies private longer. So, if you start to have more IPOs, then that will certainly benefit small-caps and mid-caps. So that's something that we're looking at, and that could drive or change the outlook for those sub asset classes.

David: Yeah, that's a great point, you know, as we're looking at things, it definitely has structurally maybe a little bit different market than we looked at certainly in the late 90s. And you know, there is a significant amount of private company activity as opposed to that was really an emerging asset class inside the 90s and early 2000s.

KC, one tenet of the markets has been interest rates are used for valuation right to discount that valuation. We've seen the Fed (Federal Reserve) go through three rate cuts in 2025. Just made it through the Federal Reserve meeting where they held rates steady at the end of January here. And then this morning, it was announced that Kevin Warsh will be the nominee for the next Fed chair.

As I look at interest rate futures, they're pricing in two rate cuts over the course of 2026. KC, what are our thoughts about how sensitive these stocks are going to be to interest rates, as well as directionally where we're going?

KC: Yeah, it definitely plays a role in valuation and even performance in different sectors of the S&P 500. So, it looks like short-term interest rates will be on the decline through 2026, and that means that valuations could actually go up for the market. As we mentioned, the market currently trades at 22-times forward earnings. With lower interest rates, could you see 24-times forward earnings?

The answer is yes. At least historically, with low interest rates, you can have a higher price/earnings multiple, and that would increase performance for equities. And then maybe a second point would be looking at the sectors themselves in the markets. You know, in the last 12 months, real estate has been the poorest performer in the S&P 500.

But if we see the entire yield curve go down, so not just short rates but also longer rates, so mortgages and commercial mortgages come down, that could benefit the real estate sector. So those are things that every day the Commerce team is watching.

David: You know, broadly here as we're evaluating markets, I'm struck by a couple of different things, and you mentioned this with real estate. Healthcare has really had struggles, traditionally viewed as a very defensive sector. Where gold, also a store of value and a safe haven asset, has exploded up.

And I think part of this is sort of conflicting views here is related around that AI question. And the question I get most frequently: Is this an AI bubble or is it an AI boom? You know, as we're evaluating the AI space and certainly a driver of the market over the past three years. How are we thinking about that?

Kelly: So David, when taking a look at whether it's a bubble or boom, I think the short answer is yes. It's a bubble and a boom. And bubbles aren't necessarily a bad thing, in that there are bubbles that can drive technological innovation. Now, when investors heard the hear the term bubble, the thought immediately goes to either 2008 or 2000.

Now I would say that, are we in a bubble environment? You know, when we take a look, as KC said, at earnings, at productivity, it doesn't certainly feel like a bubble environment for equities. There are areas that can seem like a bubble environment. We saw crypto (cryptocurrency), for example, have a run-up and then fall back.

You mentioned gold. Gold is interesting because it's had, gold and silver, have had significant gains. And you would think if you just looked at a gold chart that the world is falling apart economically, which it's not. But you do have additional buyers in the gold market that are helping drive returns.

There's a lot of Chinese investors and ETFs (exchange-traded funds) that are causing gold to rise, and as we speak, gold is down about 5% today. Of course, it could be flat to up by the close of the markets. You know we'll certainly see, but certainly a lot of talk about whether or not we're in a bubble because we have had double-digit returns for several years in a row among equities.

David: As we evaluate that space and that AI space, it is hard not to feel like this is the start of a revolution in terms of how we're using this for productivity, how it'll affect the jobs market, labor market out there. So yeah, it's an open question as to whether have we priced in all that growth? I'm struck by a company named Global Crossing (Global Crossing Limited) that laid a lot of fiber optic cable across the oceans in the late 90s, early 2000s, and we're still only using a portion of that capacity today.

Where we are building massive data centers out there. That being said, the amount of user uptake on AI is remarkable. It's the fastest pace we've ever seen in terms of new technology uptake. So, you're right, it's a bit of a mixed message here.

Well, gentlemen, thank you for the interesting discussion today. For more on this topic, please visit www.commercetrustcompany.com, and you can look for our Outlook there, which is “Markets Defy Economic Tension.”

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Thank you for joining us on Conversations with Commerce Trust. I'm David Hagee. We'll talk again soon.

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