FIRST FINANCIAL TRUST

Equity Market Update

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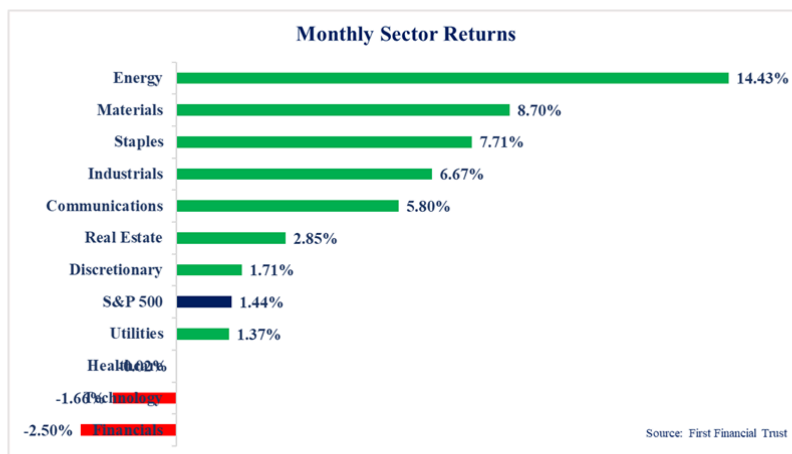
Stocks started their new year in rally mode with their ninth straight month of gains. However, the composition of winners and losers was vastly different than last year. Investors spent the month rotating away from growth pockets in the market into value areas that had been left behind. Earnings reports have been strong. Economic data appears to be accelerating, although labor remains weak. President Trump nominated Kevin Warsh to replace Jerome Powell as Federal Reserve Chairman in May. Mr. Warsh is a solid choice and was well-received by the markets.

Performance

January was characterized by broad-based gains, with a notable leadership shift toward smaller-cap equities. While the S&P 500 and the Dow Jones Industrial Average posted solid total returns of 1.44% and 1.80%, respectively, they were significantly outperformed by the mid- and small-cap segments. The S&P MidCap Index rose 4.05%, while the S&P SmallCap Index led the major benchmarks with a robust 5.69% total return, indicating a strong appetite for risk and a broadening of market participation.



Sector performance during this period revealed a sharp divergence between cyclical value and growth-oriented industries. The Energy sector was the clear standout, delivering a staggering 14.43% return, followed by substantial gains in Materials (+8.70%) and Consumer Staples (+7.71%). In contrast, the heavyweight Information Technology and Financials sectors struggled to find momentum, ending the month as the primary laggards with negative returns of -1.66% and -2.50%, respectively. This rotation suggests a tactical barbell pivot by investors toward tangible assets and defensive positioning.

Individual stock contributors heavily influenced the headline index movements, particularly within the Dow and S&P 500. Alphabet (GOOGL) and Micron (MU) acted as the primary growth engines for the S&P 500, while Caterpillar (CAT) provided a massive boost to the Dow Jones with a net price change of over $81.00. However, these gains were partially offset by significant weakness in traditional mega-cap leaders. Microsoft (MSFT) and Apple (AAPL) emerged as the top drags on overall performance during the month.

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Economic Data Summary

As we enter the new year, economic data is mixed, but there are signs that the US economy is attempting to reaccelerate from the soft patch witnessed during the summer and fall months. Consumer spending is firm, but it continues to come primarily from higher-income households that have record amounts of their net worth tied up in the stock market. Lower-income households are polling weak in consumer sentiment surveys, and they have become very sensitive to the affordability of basic goods and services, which has started to shape political messaging for government officials as mid-term election campaigns kick off. Labor, which has been the bright spot for the past two years, has visibly slowed. The January jobs data is being delayed by one week, given the brief government shutdown. Private jobs data from ADP and other sources indicate a mere 25,000 jobs were created during the month. Initial jobless claims are very mild, while continuing claims have stabilized. This tells us the labor market's appetite to hire new employees has waned. Lack of immigration is also weighing on employment growth. Collectively, getting a new job is becoming harder for people on unemployment, as the JOLTs report showed a plunge in open positions, and the previous month's U6 report indicated more people are working part-time.

Consumer inflation remains stubborn, with prices increasing 2.7% from one year ago. Core inflation that removes food and energy is 2.6%. PCE data, the Fed's preferred measure of inflation, showed total prices climbing 2.8%, while prices ex-food and energy also rose 2.8%. The stickiness of inflation has created a large debate among investors about how much room the Fed has to lower interest rates, especially if tariffs push prices higher in future months as pre-tariff inventories are worked out of the system. Investors are also awaiting a ruling from the Supreme Court on whether President Trump overstepped his authority on applying widespread tariffs without authorization or ratification of new trade deals from Congress. The President has already lost the case in both the lower and appellate courts.

Despite wage growth and relatively low unemployment, clouds are forming over select segments of the consumer population. Personal income and spending data showed strong growth on an inflation-adjusted basis; however, an increasing number of retail and restaurant CEOs are describing a "k-shape" economy in which wealthy households continue to prosper while lower- and middle-income families are cutting back. Consumers have increasingly funded their expenditures with the use of debt. Credit card balances are elevated, and debt delinquency has stabilized at levels higher than one year ago in both credit cards and auto loans, especially among people with lower credit scores.

Meanwhile, the ISM Manufacturing PMI Index was 52.6, a rare bright spot. This index has contracted for 35 of the last 39 months. Employment data (48.1) contracted once again, although the rate of job loss was much slower than in recent months. Manufacturing jobs have fallen in 32 of the last 36 months, something that historically happens only during deep recessions. New orders (57.1) expanded for the first time in four months. Unfortunately, prices paid (59.0) remained very hot, adding to fears that inflation from tariffs could be lurking under the surface of more widely followed economic metrics. Service has been the engine powering the economy. The ISM Service PMI Index (53.8) was very healthy. Service employment (50.3) barely expanded, providing evidence that labor conditions have tightened. Meanwhile, new orders (53.1) continued to grow, a very encouraging look at future activity. However, just like its manufacturing cousin, prices paid for services (66.6) remained very hot, although this was a significant improvement from the 70.0 reading we got in October.

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Collectively, the data shows the Fed is winning the battle with inflation, although as stated above, President Trump's tariff agenda has inserted a high degree of uncertainty for future prices. The President has begun to exempt several food-related items from tariffs to help with affordability. He also delayed by one year the implementation of tariffs against furniture-related products. Many are wondering how many products the President will try to reclassify under other sections of the trade code should he lose the Supreme Court case.

The FOMC held interest rates steady at a range of 3.50% to 3.75% at their January meeting, but post-meeting details showed two dissenters that wanted to cut rates by a quarter-point. Finally, President Trump nominated Kevin Warsh as Jerome Powell's successor as Fed chair come May. Mr. Warsh was well received by market participants given his extensive experience, and he was viewed by many as less of an insider to the administration that helped dispel worries about the President threatening the Fed's independence.

Valuation & Earnings

The valuation of the S&P 500 currently stands at 22.2x forward earnings estimates. This is slightly more than one year ago (21.9x), and it is also above the 5-year (20.0x) and 10-year (18.8x) averages despite the higher interest rate environment. Therefore, the equity risk premium that compensates investors for the excess risks associated with stocks compared to bonds remains thin.

We are in the thick of earnings season, and results have been better than expected. With 53% of the companies already reported, profits are up 11.9% from one year ago, better than analysts' 8.3% estimate. If this holds up, it would mark the fifth consecutive quarter of double-digit earnings growth. Results are being powered by strong growth in Information Technology and Industrials, which are the only two sectors with profits growing faster than the total index. Despite the strong data, analysts have lowered their full-year 2026 earnings growth rate to 14.3% from 15%. Technology is still expected to be the best grower of earnings, but the spread between tech and other sectors is thought to narrow. That view has been the primary driver of the rotation away from the more expensive big tech names towards other areas of the market where growth rates are improving at much lower valuations, like financials, industrials, and materials. We would caution that above-average profit growth in these other sectors is coming from select industries or individual names that are skewing overall results.

With the market currently trading above the valuations of the past decade, stocks are vulnerable to headline risk from major economic reports, the Fed, and geopolitical events. The S&P 500 has experienced three straight years in which returns exceeded profit growth, resulting in significant PE multiple expansion. However, analysts are quick to remind investors that the S&P 500's forward PE ratio expands ~90% of the time when EPS growth is above the long-term average and monetary policy is accommodative. This makes quarterly earnings reports and forecasts, along with Fed meetings, must-watch events.

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Conclusion

For months, we have written about the large difference in valuation between the big tech companies at the top of the index and everybody else. Currently, if you equal-weight the names inside the S&P 500, the forward PE ratio drops from 22.2x to 17.1x. Since December, we have seen a major rotation away from higher valuation tech names at the top of the index to reinvest in areas with improving profit growth at lower valuations, primarily industrials, healthcare, and smaller-sized financials. Today, the median stock inside the S&P 500 trades at less than a 3-turn discount to the cap-weighted PE ratio; therefore, the incentive to buy non-tech positions remains high. Most analysts are recommending cyclical areas of the market in anticipation of an economic re-acceleration fueled by lower taxes, looser regulations, and accelerated depreciation from the One Big Beautiful Bill, along with softer monetary policy from the Fed and lower capital ratios for big banks. While these trades are attractive, the sharp rally over the last two months has made future positioning in these areas more difficult as their valuation has risen. Currently, the sell-off in technology has been across-the-board, although the sharpest declines have been in software-related names due to disruption fears from advances in AI-related coding. We believe a pocket of opportunity is starting to open inside select software names that are deemed mission-critical given their "systems of record" business models. Also, in a market where all participants appear to be playing offense, some nibbling on defensive positions within the portfolio serves as cheap insurance for what is likely to be a volatile year.

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