# CURBSTONE FINANCIAL MANAGEMENT CORPORATION

## From the Curb
### Letter to Clients
Quarter Ending March 31, 2017

Fueled by the optimism of a new administration, the first quarter of 2017 was a strong one for stocks. The S&P500 posted a gain of 6.07% with the Dow Jones Industrial Average lagging by about 1% providing a return of 5.19% for the three months ending March 31, 2017. The rally, however, was mixed and returns varied depending on how your investments were positioned. Large caps outperformed both mid and small caps while domestic large cap growth holdings trumped just about all else.

Investors wanted exposure to stocks reflecting strong confidence in the U.S. economy, best demonstrated by the heavy inflows into Exchange Traded Funds (ETFs). Just under $135 billion moved into ETFs making it the best quarter on record. Approximately 45% invested flowed into U.S. equities (dominated by S&P500 funds) with about 38% flowing into international equities. But is this rush into stocks warranted?

We think the answer is "yes" and "no". As we discussed in our year-end letter, there are some fundamentals that support higher equity prices. Corporate earnings bottomed in the first quarter of 2016 and turned positive in the third quarter and that trend has held. We are just entering earnings' season for the first quarter of 2017 and estimates have earnings growing at an average of 8% to 10% - a rate of growth that hasn't been seen for about six years. Total Non-Farm payrolls which measures the number of jobs being added or lost and accounts for 80% of the workers who contribute to GDP continues to move higher. This positive momentum is confirmed by the National Unemployment Rate, which fell to 4.5% as of the March report.

There is more good news on the consumer front, as Real Disposable Personal Income and wage are both ticking up while debt as a percentage of disposable income is trending downward. The global economy seems to be picking up steam, boding well for investors and consumers alike. This strength in many of the fundamentals is accompanied by some pockets of weakness or cross-currents. Inflation, as measured by the CPI (Consumer Price Index), is trending up and as of February 2017 was running at 2.8%. GDP seems stuck around the 2% rate while interest rates appear to be moving higher with at least two Fed interest rate hikes expected later this year. So, is this enough to support an earnings ratio of approximately 21 times?

Perhaps not, and this is where animal spirits emerge. Since President Trump's election, equity markets are up low double digits, on average, moving valuations, in our opinion,

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from fairly to over-valued levels. Investors betting on benefits from tax reform, infrastructure investment and regulatory overhaul have pushed equity prices up in anticipation of stronger fundamentals in the future. Think about the individual you know who spends their bonus before it's rewarded. It works provided the bonus is actually paid out. A similar principle applies here; if we get additional growth from these fiscal stimulus plans, earnings may grow at a higher rate and price earnings ratios would fall, bringing valuations back to more reasonable levels.

As long-term investors, we focus on the underlying fundamentals and maintain a disciplined approach to investing while acknowledging that there are periods where arkets are driven by momentum. Momentum can take different forms. There's a recency bias where investors assume that recent past performance implies a continuation into the future. Confirmation bias focuses solely on information that validates one's own opinion. And, finally, there is herd mentality where investors, giving up all independent thinking, blindly follow the behavior of others. We believe that our "bonus" analogy has created an environment where bits of all of these factors are at play. Our disciplined approach helps us to look beyond simple investor biases and allows us to assess the "why" of certain market movements, bypassing emotions and fleeting trends.

As we move further into 2017, we are mindful that headlines, tweets and week to week data will all play a part in the direction of markets. We also don't want to lose sight of the potential for an impactful event, given the current geo-political instability that exists around the world. Closer to home, all eyes rest on Washington as ideas must move into the policy stage or risk disappointing investor expectations for higher growth. For these reasons, we expect to see higher market volatility in the coming months.

We remain committed to managing well-diversified portfolios that are intended to perform well during uptrends supported by fundamentals and to better withstand market declines when compared to a passive index. We are at a point in the valuation spectrum where we are willing to give up some short-term upside by moderating our exposure to stocks in favor of preserving value for the long-term. As investors, we believe that competitive returns are generated over long periods of time and that you will be well-served by our disciplined approach.

We appreciate the opportunity to partner with you as your wealth advisor. Please feel free to share any thoughts or comments you have regarding our service and we welcome all inquiries.