

CURBSTONE FINANCIAL MANAGEMENT CORPORATION

From the Curb

Letter to Clients

Quarter Ending December 31, 2025

The S&P 500 rose to an all-time high in the fourth quarter as corporate earnings showed solid growth, the Fed met investor expectations by cutting interest rates and massive investment in AI infrastructure continued to support projections for further progress in 2026. The S&P 500 companies logged solid gains in both revenue and profit margin in 2025 providing the fuel to push stock prices higher. Earnings estimates continued to be revised higher through the fourth quarter with analyst consensus currently expecting 14.6% growth for 2026 with sales growth of 7.2%. Returns were strong across the board with all eleven sectors showing gains led by technology, communications and industrials.

AI related investment was a big factor as it exceeded \$400 billion in 2025 highlighting the scale of this transformative technology. Innovation waves of this significance have occurred over the course of history, and each one is responsible for changing the economic landscape. Railroads in the 19th century, automobiles in the early 1900s and more recently the internet boom during the 1990s all skewed markets as capital poured into the new technology in search of outsized returns. Innovation attracts capital because it improves productivity and drives labor costs down which results in earnings surprises to the upside. The influx of capital to the AI companies has driven strong returns for the S&P 500 during the last few years as these companies have come to be known as the “Magnificent Seven.” The influence of the Mag 7 cannot be understated as they contributed 46% of the index return during 2025 and their market capitalization has grown to represent more than 35% of the index. Their leadership is without question, but as increasing money flow has pushed valuations higher, some analysts have begun to wonder whether there is an AI bubble similar to the internet bubble that occurred in the late 1990s. The challenge for us in 2026 is to be disciplined and not become performance chasers into the late stages of a rally only to see prices subsequently collapse as the tech stocks did in the early 2000s.

Media commentators often refer to the market in broad terms that group all the stocks together for valuation and performance purposes. One of the challenges, and opportunities, in the market today is the disparity between the Mag 7 and “the other 493 companies.” Disciplined investors know that not all stocks are expensive at a given time. Here, at Curbstone, we are looking at “the other 493” to find companies that are attractively priced and offer the characteristics of having significant market share in their industry, being strong free cash flow generators, and maintaining healthy profit margins. These distinguishing qualities are the key for us to invest client assets wisely and generate consistent returns across a long-term horizon. This approach offers our clients a margin of safety as a function of better diversification that will be helpful in managing risk when the investment cycle ultimately shifts.

AI was not the only factor pushing stocks higher during the year as the Federal Reserve shifted course by reducing the Fed Funds rate three times in the final four months of the year. This move was not unanimous but indicated that a majority of the Fed’s voting members were concerned that action was needed to offset a slower pace of employment growth. These concerns were shared by central bankers across the globe as similar actions were taken by the Bank of England, European Central Bank, as well as policymakers in Canada, Australia, Switzerland and Mexico. Lower rates provide some assurance that central bankers are committed to maintaining a steady pace of economic and employment growth into 2026.

Trade policy, which had raised concerns earlier in the year due to escalating tensions over tariffs, settled down in the fourth quarter as President Trump and Chinese President Xi struck a deal in late October

that resulted in a tariff reduction for Chinese exports to the U.S. The gradual reduction of tariff rhetoric was an important driver for markets as inflation expectations eased over the course of the year and earnings were able to exceed expectations. The ongoing uncertainty about tariff policy impacted markets in other ways as hiring was more subdued and investors looked at ways to diversify outside the U.S. with foreign stocks outperforming their U.S. counterparts for the first time since 2017.

Enthusiasm for stocks is generally high right now but should be coupled with a healthy amount of skepticism. We are focused on factors that could derail this trend while closely following policy changes that could present risks to investors. Fed members appear divided over how aggressively to reduce rates since inflation is above the Fed's 2% target and employment growth is weak. Investors are closely watching who will be appointed as the new Fed Chair as it is important to preserve the Fed's independence. Trade policy and the federal deficit may have an impact on the inflation outlook and interest rates. Geopolitical issues will continue to add uncertainty to markets and may add to volatility with each new headline.

As we enter 2026, we are realistically optimistic about the market's prospects. Our investment process is oriented toward achieving long-term client objectives. We will continue to manage risks proactively and align portfolio construction in a manner that meets short-term cash flow needs and provides long-term capital appreciation. At Curbstone Financial Management, we thank you for your ongoing confidence and rest assured that our entire team will remain dedicated to helping you successfully navigate this market environment. Please do not hesitate to contact us with any questions, comments, or to schedule a portfolio review.