Quarterly Commentary

First Quarter 2017

Spring is in the air, and its (super-bloom!) arrival brings renewed optimism about one of our key investment principles, to trust in the enduring power of financial markets. Sources of risk – commodity price volatility, geopolitical strife, media noise, to name a few – can cause calamitous market events and will always be with us. So why the optimism? Think back to the first weeks of last year, which is in the books as the worst start to the U.S. stock market of any year to date. Other shocks later in the year, like the Brexit vote and the surprising outcome of the U.S. presidential election, caused wild market swings, yet U.S. stocks ended with a healthy positive return. The year 2016 is a textbook case of the merits of maintaining investment discipline. Through all market environments, we continue to focus on the "big picture decisions" – a global approach that diversifies asset classes, styles and holdings – that harness the returns of the markets. We consistently implement our strategy to deliver the optimal risk/reward scenario to help each client reach his or her wealth management goals.

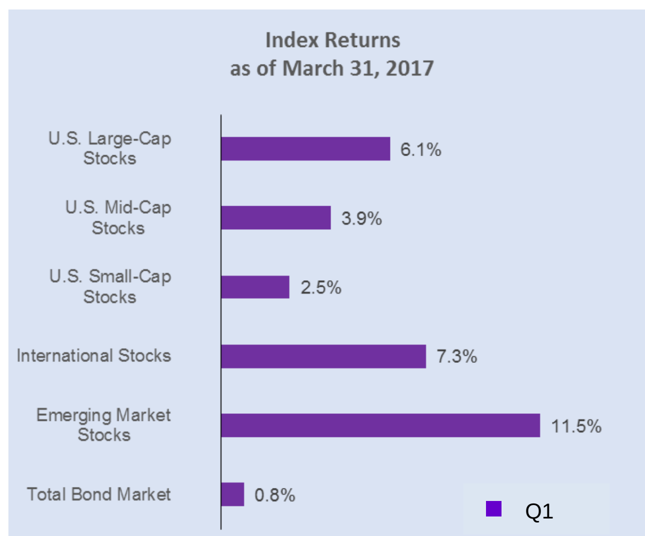
Spring is the season for optimism, but for many, it also is time to pay income taxes. For most, this disagreeable thought only comes to mind right around April 15 each year. At Tarbox, we think about taxes *all the time* – in the thick of winter, the balminess of summer, the chill of autumn – and continuously work to make portfolios as tax-efficient as possible. From individual holding selections to asset location choices to rebalancing options, we pride ourselves on how we approach each client situation and the care that goes into each trade determination. Instead of trying to select an active manager or an individual stock likely to underperform over time, we concentrate our efforts where we have an upper hand. Our advantage lies in how we construct each client portfolio to achieve the asset class returns of the markets in a risk-managed, tax-efficient manner, employing strategies that have proven historically successful and sustainable.

Market Recap

U.S. stocks continued their ascent in the first quarter, helped by tailwinds of the "reflation trade" - shorthand for the continued climb in stock prices with the view that growth and inflation will rise.

Internationally, markets are enjoying a synchronized recovery in corporate earnings that is also supporting stocks. Hopes for regulatory easing, stronger consumer demand, and corporate cost cutting are all contributing to strong 2017 earnings expectations. Earnings momentum is particularly strong in Japan and emerging markets, and certainly solid in Europe.

In a departure from the glacial pace of the past two years, the Federal Reserve (Fed) is indicating a quicker pace of interest rate hikes. Bonds are likely to face challenges amid broadly rising interest rates, with high valuations and tight credit spreads, meaning active selection is key.



Source: Standard & Poors, MSCI, Russell

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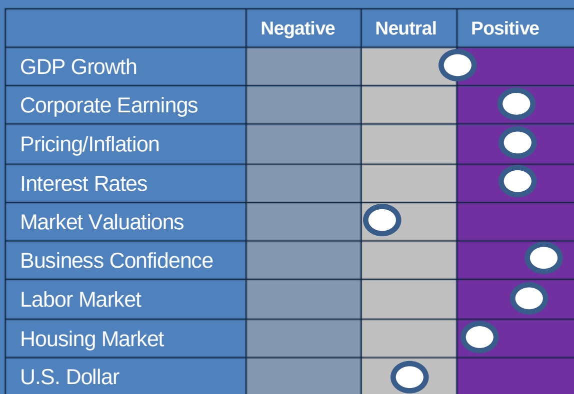
Tarbox Barometer

The U.S. labor market has tightened and inflation is gaining traction. The Federal Reserve Bank (Fed) increased the benchmark interest rate by 0.25%, further reducing monetary policy accommodation. Oil prices saw a late-quarter decline on supply buildup, while the U.S. dollar retreated versus its global counterparts.



- **GDP Growth**. GDP readings for the first quarter are at 0.6%, with projections for 2017 at 2.1%, near its five-year average.
- **Corporate Earnings**: Earnings registered a 5% increase during Q4 2016. Expectations for Q1 2017 are on the uptick, for an increase of 9%.
- **Pricing/Inflation:** Inflation is pushing higher, reaching 2.7% in the first quarter, and hovers at the Fed target, ex-energy and food prices. Although tempering recently, average hourly earnings remain elevated from post-crisis lows.
- **Federal Reserve**: The Fed raised the fed funds rate by 0.25%, citing the minimal slack in the labor market and robust inflation data. At this point, inflation remains under control and is not signaling any “overheating” in the U.S. economy. The markets anticipate two more increases in 2017.
- **Market Valuations**: After another quarter of robust stock returns, market valuations have increased. As measured by the S&P 500 Index, stocks are trading around 21x earnings, above their 10-year median of 17x earnings.
- **Business Confidence**: The promises from the new administration of tax cuts, business and infrastructure spending, in addition to growth prospects from deregulation, propelled small business optimism to spike at the end of 2016 and held strong through the first quarter of 2017.
- **Labor Market**: Fed Chair Yellen recently remarked that the U.S. labor market is “the strongest in more than a decade.” Unemployment has continued to decline, ending the first quarter of 2017 at 4.5%. Labor force participation remains a headwind, below pre-crisis and historical levels.
- **Housing Market**: After a strong finish to 2016, existing home sales paused in the first quarter, registering a month-over-month decline of over -3.5%. On a year-over-year basis, existing home sales are higher by 5.5%. Affordability continues to pressure buyers across the U.S., as inventory remains lower than last year.
- **U.S. Dollar**: The U.S. Dollar hit a 14-year high in Q4, gaining 4.5% post-election. As U.S. consumers benefit from an increase in purchasing power of imported goods, U.S. companies experience dampening in exports. A higher dollar value makes the trillions in U.S. dollar-based debt around the world more expensive to pay back.

DARE… to Be Optimistic

The mission of the Dictionary of American Regional English (DARE) is to catalogue and preserve words of local dialects. The dictionary contains such treasures as “to pungle up”, meaning for someone to produce money or something else owed, and “the mulligrubs”, indicating a foul mood. Consumer sentiment, as measured by the Conference Board, is at the highest level since 2000, the antithesis of “the mulligrubs”. A lot of people (and businesses run by people) are as optimistic as they have been in a long while. Certainly, there has been a gradual improvement in the U.S. economy, albeit a much more gradual pace relative to the jump in confidence.

The current hard data shows that the U.S. economy is doing well. Labor and housing data have been especially strong, with manufacturing and construction on the lighter side, although bad weather may account for some of the weakness. The broadest measure of economic output, gross domestic product (GDP), has been remarkably stable over the past five years, at around 2% per annum. So, what’s beneath the high level of optimism? Much of it has been attributed to the recent election promises to sweep away the old ways of Washington, to be replaced by swift and decisive actions: cutting taxes, reducing regulations and, especially, creating jobs - all extremely beneficial to the U.S. consumer and corporations.

We view this economic enthusiasm in context: While growth prospects have improved, they remain restrained by stagnant productivity growth and slow-growing (or shrinking) workforces in the U.S., (and much of rest of the world), all against a backdrop of more richly valued asset prices.

Until recently, the U.S. markets have been the growth engine of the global economy. We’re now seeing signs of a rebound outside the U.S. Long-dormant inflation rates have started to creep higher in the Eurozone and the UK. Energy prices have driven much of the trend, but a rising percentage of consumer price index components are showing

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increases, bolstering our view that the current upswing has legs. With growth broadening out to more countries and inflationary pressures building in the U.S., we think economies will feel increasingly "normal" in 2017. We expect to see a slow but cyclical recovery, where interest rates should rise over time, rather than "secular stagnation," where rates could stay at extremely low levels on a more structural basis.

Despite possible policy shocks from the U.S. administration, conditions supporting emerging markets are solid. Emerging markets, as we have pointed out in the past, shouldn't be viewed as one-dimensional. The category offers diversification as it contains both importers and exporters, consumption-driven and investment-driven economies, and state-owned and private companies. China's focus for 2017 is on keeping the economy stable and managing risks, rather than unleashing radical reforms. A more measured approach to monetary policy will be taken (the official line is "prudent and neutral") in contrast to the expansionary attitude in 2016. A squeeze on the real estate sector to slow demand and lessen the inventory overhang, combined with a focus on fiscal policy, including rebates and tax cuts to boost private sector investment, leads us to view the actions as a commitment to meaningful change.

If 2016 was known as "the year of tough decisions" in the energy industry, 2017 is being coined "the slow road back." OPEC's decision to cut production should accelerate the drawdown of global oil inventories, helping to support an increase in crude oil prices in 2017. It remains to be seen how quickly and to what extent U.S. shale oil drillers might respond by resuming more active drilling programs. Overall, there are reasons to be positive about the year ahead, including the tightening of supply and demand imbalances and moderate growth in both global and U.S. oil demand.

We're witnessing a transition in the current economic environment from a dominant trend of globalism, which brought increased cross-border flows of goods and people, to a support for parties with more populist messages. The assessment of the impact from protectionist policies, and the response of China and other countries are a critical component of our research. We have a long history of maintaining investment discipline through structural shifts and a variety of markets. The market will always have its "frog stranglers" (downpours), but we are "on our beanwater" (optimistic) that the financial markets will continue to "pungle up" good long-term returns over time.

Investment Spotlight – Asset Location

The saying that the three most important things in buying real estate are *location*, *location*, *location* can translate into how we manage client portfolios. Where we "locate" your investments – in a taxable vs. a tax-deferred and/or non-taxable account – can make a substantial difference in how much you keep after tax, over time. We rate our investments on a tax-efficiency scale, and then, when possible, invest the assets where they may help enhance after-tax returns. This "householding" technique allows us to position, for example, some of our alternative assets that are less tax efficient in a tax-deferred account, and core stock ETFs, which are ultra tax-efficient, in a taxable account. We cannot control market returns or tax law, but we can control how we manage assets and utilize accounts that offer tax advantages.