Second Quarter 2017

On the 50th anniversary of the social phenomenon that embraced environmental awareness, 'dropping out', and communal living, the financial markets seem to be experiencing their own rendition of "The Summer of Love". Casting aside our newly elected president's touted protectionist policies that would close borders and redirect trade, international and emerging market stocks all experienced strong returns, year-to-date. The promises of tax reform and less regulation helped keep U.S. stocks in positive territory, too. The rally wasn't limited to stocks, with global bonds also posting robust gains.

The trend of outflows from actively managed funds into indexed vehicles continues, as more investors refuse to accept underperformance accompanied by excessive fees. Regulators, too, are joining the anti-active manager chorus. The Financial Conduct Authority, the main regulator in the UK, issued a scathing report in June on the entire professional asset management community, chastising managers for high fees and poor performance, and investment consultants/advisors (not us!) for poor advice and no accountability. Add to that the recent Wall Street Journal article reporting that over the last twenty years, the number of publicly-traded stocks in the U.S. has been cut in half, a result of takeovers, privatizing, and other financial maneuverings. This constricted universe makes an even more difficult environment for active managers, who have a smaller number of stocks to select from when trying to deviate from the index. Tarbox Family Office is a pioneer in investing with a value-added indexing approach that ensures our clients the benchmark market return. Our successful efforts are largely focused on researching asset classes and constructing risk-adjusted portfolios that deliver to our clients the returns they expect in the most tax-efficient, cost-effective manner possible.

Market Recap

Global markets moved higher in unison during the second quarter as growth prospects around the world improved, both European and U.S. central banks became less accommodative, and domestic corporate earnings far exceeded expectations.

Internationally, political risks abated as the results of the highly anticipated European elections did not invoke any immediate concerns. Despite political concerns in the U.S., stocks pushed to new highs, led by technology and health-care companies.

The Federal Open Market Committee (FOMC) continues to reduce monetary policy accommodation, raising the Federal Funds Rate by 25 basis points (one-quarter of one percent), its fourth hike in the current cycle. Bond yields reacted by moving lower, a reflection that near-term inflation remains a domestic top concern.

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Tarbox Barometer

The U.S. labor market has continued to strengthen, leading to corporate confidence and a healthy overall market. The Federal Reserve Bank (Fed) once again increased the benchmark interest rate by 0.25%, to 1.25%. The Fed's hawkish attitude has surprised some, but nonetheless the tone parallels an overarching optimism in the U.S. economy.

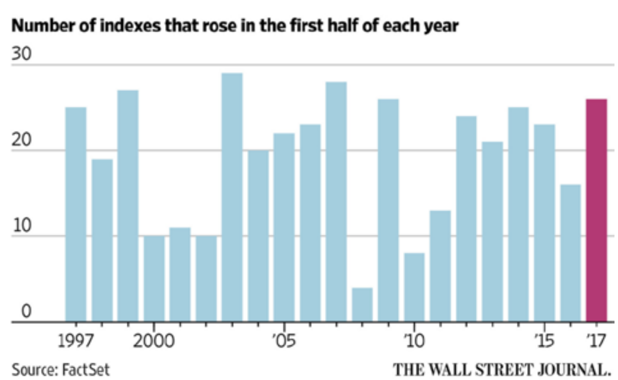
	Negative	Neutral	Positive
GDP Growth			○
Corporate Earnings			○
Pricing/Inflation		○	
Interest Rates			○
Market Valuations		○	
Business Confidence			○
Labor Market			○
Housing Market			○
U.S. Dollar			○

- **GDP Growth:** GDP numbers are following the same broad trends: a softening consumer, weak government spending, and an uptick in corporate investment. Analysts expect between 2.0 and 2.5% continued growth in 2017.
- **Corporate Earnings:** Corporate earnings remain relatively strong in the energy, materials, technology, and financial sectors with 20% year-over-year earnings per share growth. The retail sector has seen decreased consumer spending and industry changes with the growing e-commerce market.
- **Pricing/Inflation:** While inflation has yet to reach the 2% target, the Fed believes that the strong labor market will eventually get it there.
- **Federal Reserve**: The Fed raised the federal funds rate for a second time in 2017 from 1% to 1.25%, showing increasing optimism. "The economy is doing very well [and] is showing resilience," Fed Chairwoman Yellen said.
- **Market Valuations**: The technology sector, once again, has received criticism for high valuations, leading to a late-quarter correction despite a strong YTD performance.
- **Business Confidence**: The initial heightened optimism over favorable business legislation has subsided, but the outlook remains positive. Concerns remain over the retail sector's competition with growing e-commerce.
- **Labor Market**: Unemployment has fallen to a 16-year low of 4.3%. The Fed predicts the unemployment rate will continually decrease to 4.2% by 2019. Job growth is, however, the slowest it has been in five years, most likely due to a drop in the participation rate.
- **Housing Market**: The housing market has continued to strengthen as home prices increase. Over the next year, analyst forecast home prices to rise by 5%. Analysts suggest that a lack of available homes is causing the shortage.
- **U.S. Dollar**: The U.S. dollar reversed its climb in the second quarter, experiencing its worst two-quarter decline since 2011. A weaker U.S. currency helps corporate profits, making U.S. multinationals' exports more competitive abroad. A weaker dollar also would relieve pressure on emerging-market nations by making their dollar-denominated debts easier to service and relieving downward pressure on their currencies.

The Shifting Status Quo

What's FANMAG? Back in the days of classic Hollywood, fan magazines had a monopoly on star publicity, performing the same function as a much-lauded appearance on a late-night show, or paparazzi-shots on one of the many gossip-centric blogs. Today, FANMAG is the acronym for the companies that give us our media fix - and so much more - by browsing our **F**acebook newsfeed, watching movies on **A**pple TV and **N**etflix, gaming on **M**icrosoft Xbox, shopping on **A**mazon, or searching for latest star gossip on **G**oogle News.

Current conditions have provided some of the most pronounced market returns of all time, in an environment which has also been historically calm. As stock prices marched higher in the second quarter (all-time records were set in the U.S.), many grew increasingly leery of high valuations. In a somewhat unexpected move, bond prices also rose. Second quarter was good to just about everyone (well, besides oil – sorry!)



The VIX (a widely followed index which measures expectations of volatility) set a multi-decade record low for being, well, boring. This may be poised to change. FANMAG, part of the information technology sector in the S&P 500 Index, was primarily responsible for propelling the U.S. large-cap stock market in the first half of the year…until it wasn't. The second quarter ended with a fierce rotation away from previously high-flying technology stocks, raising volatility in the markets. Globally, stocks and currencies gyrated on the news of less central-bank accommodation.

Many smart people are now saying "The bubble needs to burst!" or "We are due for a correction!" But market rallies do not die of old age; they need a catalyst to shift. The good news is that many fundamental factors across the globe show no signs of a slowdown in the near-term. Global growth is healthy. Core international markets are beginning to see signs of a reduction in monetary policy accommodation, as inflation and growth in these regions pick up. In emerging economies, geopolitical risks have abated, commodity prices are no longer in free-fall, and currencies are gaining versus the U.S. dollar for the first time in years, an additional tailwind for markets abroad. Here in the U.S., corporate earnings proved resilient as we entered the eighth year of the recovery since the market meltdown, supporting momentum in both stocks and corporate bonds. The employment data reflects continued hiring as the unemployment rate hit a 16-year low.

The old fan magazines served the purpose of reassuring the public that stars are who they think they are but also exposed some of the seamier sides of Hollywood. While global fundamentals do point to prolonged growth, we remain vigilant on the search for potential risks that bring on volatility. The markets have always had their ups and downs - and we believe they always will. Even if recent market volatility has been low, history has shown that volatility spikes can and do happen unexpectedly. That's why it is key to develop and maintain an appropriate diversified asset allocation that provides stability along with growth.

Investment Spotlight – Emerging Markets

Tarbox Family Office recently made a small shift to increase exposure to emerging markets stocks, taking advantage of a favorable landscape benefiting emerging economies. The term "emerging markets" was created by economists in early 1980s and is defined as economies with low to middle per capita income that are characterized by relatively high growth and positive demographics. These economies often lack Western standards of income and administrative depth in their political and financial institutions.

A recent favorable development for emerging markets capital investment is the decision by the most widely-used index provider, MSCI, to widen its scope for China securities. China is currently the largest country by market value in the emerging market index, at 25%. The index will now include China's less liquid and until recently, unavailable, A-Shares (stocks denominated in yuan and listed in either Shanghai or Shenzhen). This signals confidence in the country's transparency and liquidity.

Given the current supportive backdrop for emerging market capital investment, including a weakening U.S. dollar, higher yields, attractive valuations, and forecasts of improving growth, in addition to reduced volatility in commodity prices, we felt it was the right time to increase our exposure.