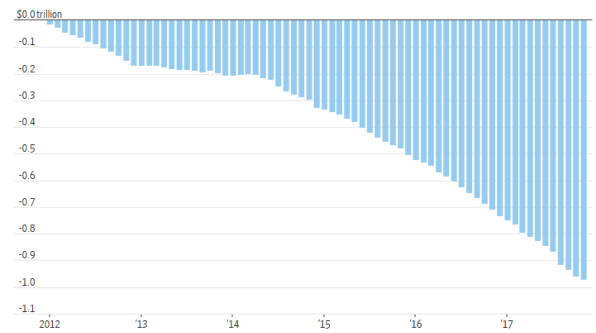
Fourth Quarter 2017

2017 was a fantastic year for the stock market…

… but many investors were on the sidelines. We have experienced a nearly nine-year surge in stock prices. Over the past five years, investors continuously pulled money out of funds that own U.S. stocks. Despite the fact that some of the money made its way back into the market, U.S. stock funds in aggregate have experienced net outflows in each of the past three years. Nobody has ever timed the market successfully and consistently over multiple business or stock market cycles. Acting on the temptation to do so almost always results in lost investment opportunity.

Stock market forecasts have about as much value as George Carlin's Hippy Dippy Weatherman's forecast: "Tonight's weather is dark, followed by widely scattered light in the morning." But it's so tempting to try to predict the future! After all, who doesn't want to buy low, right at the end of a bear market, and sell high, just before the next bear market begins?

Retail (out)flows from U.S. stock mutual funds



Growth of the S&P 500 Index

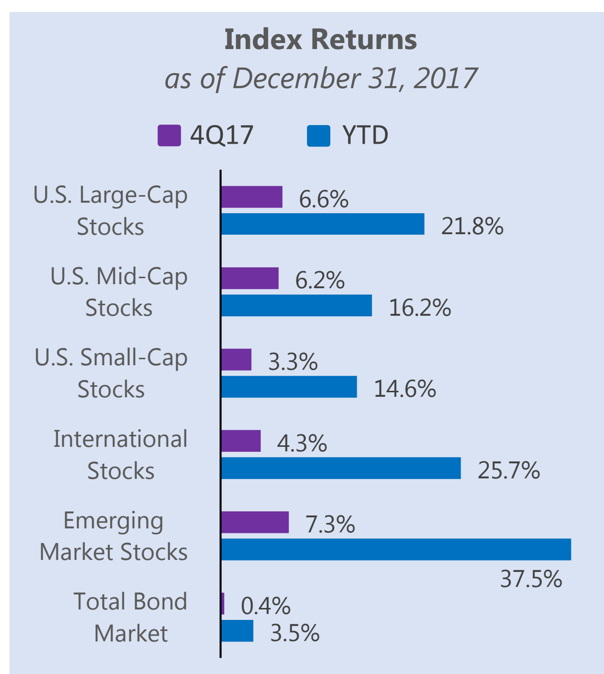
Source: Wall Street Journal, EPFR Global Flows, Tarbox Family Office

Market Recap

U.S. stocks continued their ascent, with the S&P 500 Index posting its ninth straight quarter of gains. Economic indicators such as strong consumer spending, a favorable business outlook, and continued Federal Reserve interest rate hikes maintain an outlook for healthy U.S. market growth for 2018.

International developed and emerging markets also continued their climb. Most of the growth in emerging markets was attributed to Asia, particularly China and South Korea. The euro area has regained a spring in its step, with a feeling of normality returning.

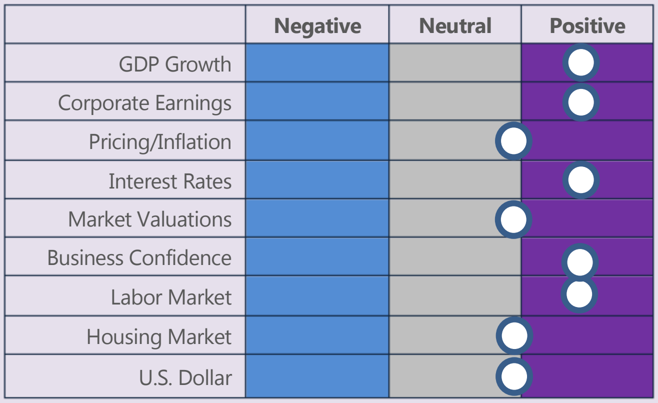
Bond performance was significantly affected by a flattening yield curve with lower returns for short duration bonds and outperformance in the long-duration indices. Our diversified approach is appropriate given Fed tightening.



Source: Standard and Poor's, MSCI, Russell

Tarbox Barometer

The market continued an upward trend, and analysts expect further growth due to the new tax plan's favorability toward business. The Fed's increase in interest rates, low unemployment, and healthy corporate earnings all lead to business confidence.



- **GDP Growth:** Analysts anticipate, on average, 3% GDP growth. Despite mixed expectations (NY Fed expecting growth closer to 4% and surveys of economists conducted by the WSJ expecting more around 2.7%), consensus expects healthy growth.
- **Corporate Earnings:** Corporate earnings are a primary factor for the rally in the U.S. stock market in 2017. All eleven primary S&P 500 sectors saw growth. Of note are the massive stock buyback programs which increased 15% in the third quarter. (Companies with extra cash or undervalued shares use buybacks to reduce the number of outstanding shares, thus boosting earnings per share.)
- **Pricing/Inflation:** While inflation has yet to reach the 2% target, Fed Chairwoman Janet Yellen says that this inflation rate should not affect an economy growing at a steady pace and operating a full employment. Yellen expects 1.9% inflation for 2018 and the 2% target for 2019.
- **Federal Reserve**: As expected, the Fed raised interest rates for the third time in 2017 to a range of 1.25 to 1.5%. The Fed expects three more rate hikes in 2018.
- **Market Valuations**: Yellen speaks to appropriate valuation, citing that a highly valued stock market does not necessarily mean it is overvalued.
- **Business Confidence**: The new tax plan, the most comprehensive overhaul of the system in three decades, most notably cuts the corporate tax rate from 35% to 21%. The plan will most particularly benefit retail, health insurers, telecommunications, automakers, refiners, pharmaceuticals, manufacturing, and renewables. The biggest beneficiaries will be U.S.-based companies, deriving most of their profits in the U.S.
- **Labor Market**: The unemployment rate continues to decline, currently resting at 4.1% with expectations of a 3.9% rate in 2018 and 2019.
- **Housing Market**: The tax plan reduces the mortgage interest rate deduction; anticipation of this deduction may be a factor in homebuying decisions. As a result, home prices are expected to decrease by 4% by mid-2019 and up to 10% in the most expensive markets.
- **U.S. Dollar**: Investors are flocking to the yen, euro and other currencies with the promise of quickening growth overseas, thereby weakening the U.S. dollar.

A Balancing Act

2017 saw the world economy accelerating to its strongest pace since 2010. Stock markets hit record highs as measures of financial risk were unusually low. After eight years of expansion in the U.S., some may have concerns that the domestic economy is nearing the end of the cycle. But the evidence points elsewhere. The tax overhaul that was signed into law in December capped a year in which many initiatives on taxes and regulation were broadly welcomed by business. Concerns about trade policy persist, but corporate profit growth in the U.S. remains healthy.

U.S. inflation has been subdued for the past several years, a condition that has perplexed Federal Reserve officials, given a tightening labor market and scarcity of other economic resources. We now see inflation poised to strengthen at a modest and steady gait, a positive sign for the economy. Wages are finally rising and we are seeing an uptick in core prices, although at a rate still below the Fed's target.

For most of the rest of the world, we see mounting evidence that many countries are still fairly early in the economic cycle. Europe has enjoyed a remarkable recovery in recent months, driven by a combination of central bank stimulus, ultra-low interest rates and improving growth. A stabilizing political picture and healthy manufacturing activity (previously a weak point in the region's path to recovery) combine to make the region a particularly attractive investment opportunity.

The rally in emerging markets stocks is nearing the two-year mark, with underlying fundamentals supporting its continuance. An expanding global economy, strengthening currencies and robust demand for technology-related components all bode well for emerging markets. A shift from a predominance of cyclical, commodity-oriented companies in the energy and materials sectors (which are susceptible to infrastructure-driven booms and busts) to technology-related firms that are catering to a growing middle class seems to have decreased the volatility of the region.

Last year was another volatile one for oil markets, with prices finally appearing on track to a sustainable recovery after several false starts. Recent price strength stems from Organization of the Petroleum Exporting Countries (OPEC) and non-OPEC countries cutting production for better supply/demand balance in the market. The cuts are expected to remain in place through 2018.

Since the financial crisis, central banks have expanded their balance sheets to unprecedented levels. Now, as the global economy improves, some central banks are beginning to move in the other direction. The Fed began shrinking its balance sheet in October. The European Central Bank signaled it will begin to trim its purchases of securities starting this month.

Financial markets surprised many investors in 2017, but then again, they have a long history of surprising investors. During the year, a great deal of media coverage was focused on markets at all-time highs, and some investors bailed, expecting a sharp drop in stock prices. Not only did the much anticipated "correction" never occur, financial markets remained remarkably calm. Daily market news and commentary can challenge your investment discipline. Some messages stir anxiety about the future, while others tempt you to chase the latest investment fad. When headlines unsettle you, consider the source and maintain a long-term perspective. We anticipate and are prepared for higher volatility as the Fed continues hiking rates. It's good to keep in mind that the Fed is only considering rate hikes because the economy is healthier than it was in the aftermath of the crisis. Overall, this is a good thing for global stocks.

Investment Spotlight – Investment vs. Speculation

When even your Lyft driver asks for your opinion on bitcoin, it's safe to say there's a bit of hype surrounding the cryptocurrency. In the early 17th century, hype and speculation helped drive the value of tulip bulbs in the Netherlands to previously unheard of prices. Newly imported from Turkey, tulips were a big novelty at the time! Like many bubbles, prices were driven by greed or the fear of missing out. Speculators were buying tulip bulbs in the hope that they could sell them at an even higher price. It didn't last. A flurry of sales caused a domino effect, and prices collapsed.

Tulip-mania seems a lot like the current cryptocurrency-mania. A cryptocurrency serves as an electronic means of making payments without an intermediary, most commonly a bank, brokering the transaction. It makes sense that such a means of direct peer-to-peer exchange has historically been linked to illegal activity—there's no centralized governing authority. As currencies, bitcoin and others like it are becoming more widely recognized for their potential use as a seamless, efficient, and cheap way to conduct a transaction. As an investment, however, cryptocurrencies do not get past our first "gut check" – a sensible explanation for and persistency of return patterns.

A significant concern about bitcoin is its extreme volatility. A recent Wall Street Journal study highlighted that, since 2012, bitcoin moved an average of 3% a day and on 5% of those days, it moved more than 10%. In the same period, the dollar varied just 0.3% against a basket of currencies.

We base our investment choices on research. Sifting through emerging investment ideas is one thing, but identifying sound investments and knowing how to apply them in practice is entirely different.