First Quarter 2018

"*Don't just sit there, do something!*" "Doing something" to your investment portfolio – based on a hot stock, a sensational headline, or a bout of market volatility - can make you **feel** in control. But often, "doing something", like chasing the performance of a trendy stock or making a knee-jerk adjustment to your asset allocation, erodes long-term performance potential. Just because you **can** do something doesn't make it a worthwhile activity! Our version of "doing something" goes like this: We custom-design your portfolio, taking into consideration your unique circumstances, based on the proven fact that nobody knows which asset class or market is going to perform the best over any short-term period. We diversify asset classes and holdings to reduce risk. We research and analyze which investment choices will help us control what is actually controllable – taxes and expenses.

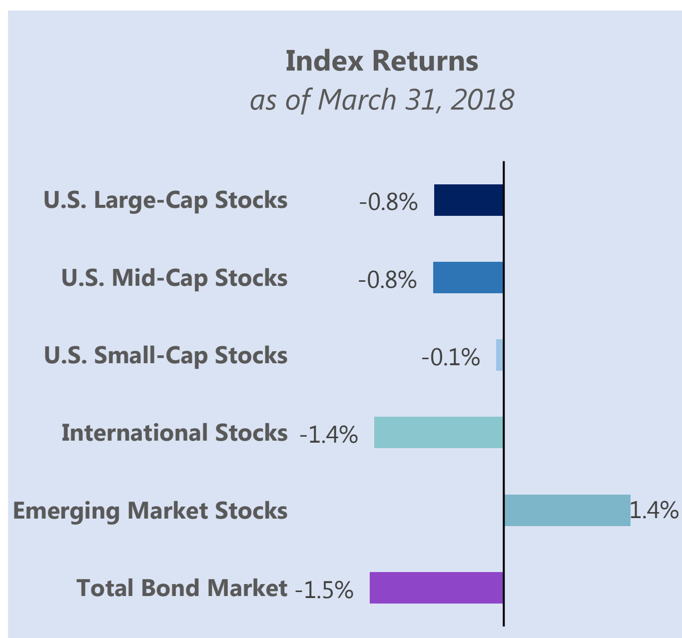
Our research led us, almost two decades ago, to become one of the first adopters of Exchange Traded Funds (ETFs), and one of a few advisors that has included U.S. Mid-Cap Stocks as a separate asset class in client portfolios. Despite recently volatility, we believe domestic small- and mid-cap companies, due to both a much higher percentage of domestic sales and, on average, a higher effective corporate tax rate than large U.S. multinational companies, can expect a more significant windfall from the newly-enacted reduced corporate tax rate. We have long had healthy small- and mid-cap exposures in client portfolios, meaning we weren't forced to make impulsive adjustments to portfolio asset allocations to capture the potential benefits, avoiding the pitfalls of both unnecessary capital gains and buying in at high valuations. When we "do something", it is based on sound research and a long-term perspective.

Market Recap

This quarter, we were reminded stocks can go down as well as up. U.S. Stocks stumbled this quarter, with the S&P 500 Index falling more than 10% from its high before recovering to end the quarter with just a slight loss. Despite these recent struggles, outlook remains positive as economic fundamentals continue to be supportive of equity growth.

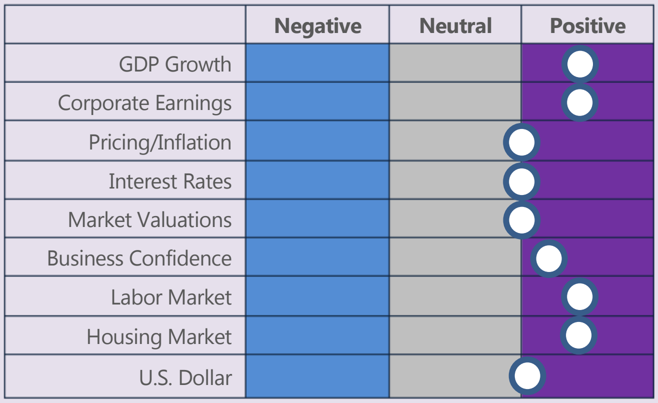
International markets experienced volatility, as the Eurozone surge in growth did not translate directly to stock returns. Emerging markets continued its outperformance from 2017, providing the only area of positive return for the quarter.

Bonds had a difficult start to the year, as rising rates and inflation worries dragged on prices.



Tarbox Barometer

After a historically quiet year in 2017, volatility returned to the markets this quarter in dramatic fashion. Despite some investor jitters, however, economic fundamentals remain strong, as steady GDP growth, strong corporate earnings, and still-low interest rates leaves room for continued price appreciation in 2018.



- **GDP Growth:** The Atlanta FED GDPNow model estimates Real GDP growth of 2.3% for Q1 2018. While still above the post-2009 average of 2.2%, should this figure hold it will be the third consecutive quarter of decelerating growth. While this cycle's peak growth rates have likely passed, fiscal stimulus should help GDP growth remain positive through 2018.
- **Corporate Earnings:** Corporate earnings are estimated to have grown by 17.1% year-over-year during the quarter, which would represent the highest quarterly earnings growth rate since Q1 2011.
- **Pricing/Inflation:** Inflation remains surprisingly low given the length of the current expansion, with the most recent Core CPI reading at 1.9%.
- **Federal Reserve**: Shortly after Jerome Powell succeeded Janet Yellen as Chair of the Federal Reserve, the Fed implemented its first rate hike of 2018, raising the target Federal Funds target range to 1.50% - 1.75%, with the dot plot forecast projecting an additional two hikes this year. While rates remain low by historical standards, it is yet to be seen how the economy will react to further tightening after almost a decade of near-zero interest rate policy.
- **Market Valuations**: Between the recent market correction and analyst projections for EPS growth, market valuations now sit at fairly reasonable levels compared to recent years. The S&P 500 P/E Ratio is currently 16.4x forward earnings (vs a 16.1x 25-year average).
- **Business Confidence**: Despite a minor pullback amidst equity market volatility and trade war fears, the OECD Business Confidence Index remains at its highest quarterly reading in since June 2004.
- **Labor Market**: Unemployment continues to fall, finishing the quarter at 4.1%, the lowest rate since 2000. Wage growth, however, remains at a subdued 2.4%, compared to its 50-year average of 4.2%.
- **Housing Market**: Although U.S. housing starts dipped 7% in February, momentum has been building over the past year, and the pace of new construction is expected to continue to trend higher through 2018.
- **U.S. Dollar**: After posting its first annual decline in seven years in 2017, the Dollar opened the year with its fifth consecutive down quarter. Further weakness is possible should the Trump administration continue to push the protectionist trade policies recently discussed; however, a strong economic backdrop and hawkish Fed limits downside risk.

Humming Along

The U.S. economy is humming, with the U.S. tax overhaul and public spending plans supercharging growth and earnings estimates. The potential for greater business spending and productivity is a positive, but on the flipside, there is the risk of overheating. Inflation in the U.S. has picked up, keeping the Fed on track to raise rates, but on a global level is not high enough to reverse monetary easing policy in the Eurozone or Japan.

The central aim of U.S. quantitative easing experienced over the past ten years was to normalize inflation. Now that it's happened, investors are concerned that the central bank is behind the curve, and will need to become overly aggressive in rate hikes which could potentially negatively impact the market. We feel confident in both the growth and inflation outlook, expecting strong corporate profits overall and positive effects of a weaker dollar.

The risk of trade wars has moved to the forefront of the headlines, but despite their dire nature, it seems more like negotiations are aimed at getting better and fairer trade deals in place. All of the back and forth between the U.S. and China has increased volatility in the markets, and while a trade war would not be inconsequential, it is useful to keep in mind that total U.S. exports to China represent only 0.7% of U.S. GDP.

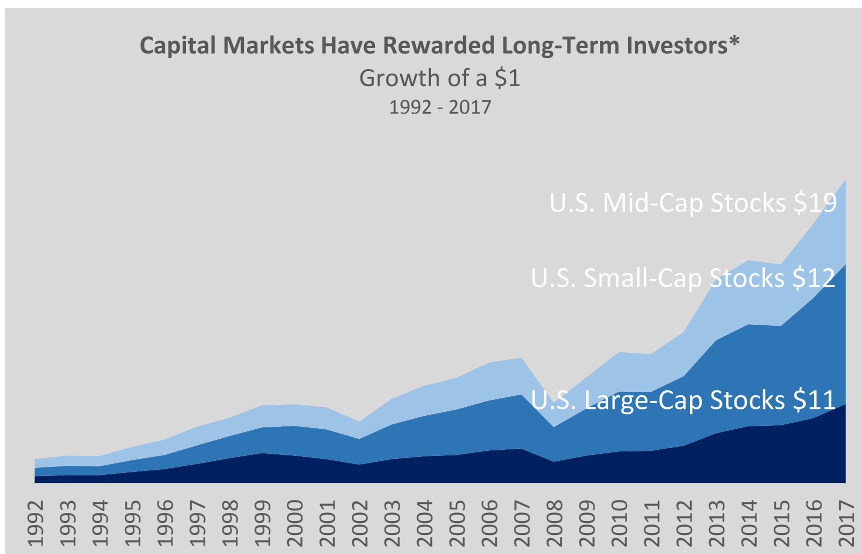
The Eurozone is stuck between two competing forces. Forward-looking indicators are consistent with healthy growth, but financial markets continue to struggle with Euro strength. An additional headwind to international stocks comes in the form of the fiscal boost to corporate earnings expectations in the U.S. Japan is experiencing more shareholder-friendly corporate behavior and solid earnings, but, as with the Euro, further yen-strengthening is a risk.

An expanding global economy, strengthening currencies and the shift from "smokestacks to smartphones", due to high demand for technology-related components, all point to continuing strength for emerging markets. There seems to be no shortage of worries about China, ranging from debt levels at state-owned enterprises to an overheated real estate market. China, however, seems to be ably managing its economic transition to a services-led economy, so far avoiding a much feared hard landing, mainly through curbs to capital flight and targeted stimulus measures.

After various setbacks and spurts of mediocre growth over the last decade, the global economy seems to be holding its own. We believe that market conditions may become more complicated in the months ahead, as U.S. tax cuts, synchronized global growth, and strong corporate profits battle monetary tightening and inflation pressures. However, we are strongly encouraged with current global economic momentum and reasonable global stock valuations, and are continuously monitoring potential market disruption from all sources.

Investment Spotlight – "The Sweet Spot"

Most investors are familiar with larger, well-known companies. At the other end of the spectrum, small companies are of interest due to their long-standing reputation for growth and superior returns. This dual focus can result in many investors concentrating only on U.S. Large- and Small-Cap Stocks, neglecting Mid-Cap Stocks altogether. Tarbox is an exception, as clients' portfolios have benefited from a dedicated allocation to U.S. Mid-Caps since the early 2000s.



Mid-size companies are generally small enough in size to offer higher long-term growth potential in the same realm as smaller companies, and theoretically higher than the potential of larger companies. Larger companies tend to operate in more mature industries and have less opportunity to grow by gaining market share. In contrast to smaller companies, mid-cap businesses often enjoy greater access to capital and more established dominant market position, and often have more experienced management teams. Because of these factors, mid-cap companies exhibit more earnings stability which typically translates into less volatile stock prices.

In a world of efficient markets, as the risk of a particular investment increases, so must the expected return to compensate the investor for taking on the additional risk. Since U.S. Small-Cap Stocks are riskier than U.S. Large-Cap Stocks, in terms of volatility, the extra return makes sense. U.S. Mid-Caps not only have outperformed their small-cap partners, but have done so with less risk over the long term.

These asset classes complement each other through various business cycles. While each is dependent primarily on the health of the U.S. economy, each can also have unique characteristics during economic downturns and recoveries. Our long-term commitment and the specific mix of the U.S. Large-, Mid- and Small-Cap Stocks allocation in client portfolios is designed to provide the highest return with the lowest risk.

*S&P 500 Index® represents U.S. Large-Cap Stocks, S&P MidCap400 Index® represents U.S. Mid-Cap Stocks, Russell 2000 Index® represents U.S. Small-Cap Stocks. Market capitalizations: U.S. Large-Cap is $10 billion and above, U.S. Mid-Cap is between $2 and $10 billion, and U.S. Small-Cap is less than $2 billion. Time period shown is from the first full year (1992) after the inception date (6/19/1991) of the S&P MidCap 400 Index®.