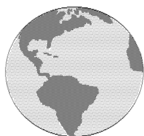
THE LUBITZ FINANCIAL GROUP

Market Watch
3rd Quarter 2017

October 2017 www.LubitzFinancial.com

Summary

- Despite the range of challenges that exist both domestically and internationally, the near-term outlook for the world's economies and markets continues to look positive.
- For the quarter, year-to-date and over the last twelve months, stocks delivered strong returns globally.
- Domestic stocks performed well over the past twelve months. The S&P 500 Index (U.S. large companies) and the Russell 2000 (small U.S. stocks) rose 14.2% and 10.9% respectively.
- Equities in the developed countries overseas enjoyed substantial gains with the MSCI EAFE Index (large companies) returning 20.5% while the EAFE Small Cap Index rose 25.8%.
- Emerging market stocks have risen 28.1% over the last twelve months (MSCI Emerging Markets Index).
- Domestic bond market returns faced a headwind of rising interest rates in 2017, yet still delivered modestly positive returns in most categories.
- Economists expect moderate inflation in 2018. The Fed can be expected to continue raising interest rates while it also seeks to reduce its balance sheet. We believe they'll do both gradually with care to limit economic impacts.
- We remain optimistic about global prospects in the year ahead.



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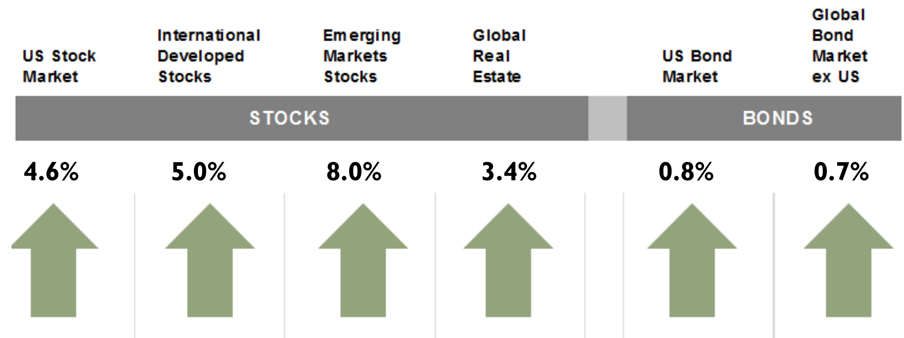
Overview

The third quarter of 2017 saw a series of devastating hurricanes wreak havoc in Texas, Florida and Puerto Rico. The quarter ended in further tragedy as the largest mass murder in U.S. history unfolded in Las Vegas. As we write, wildfires have engulfed portions of Northern and Southern California, leading to further loss of life and destruction of homes and businesses throughout the regions impacted. Comments on the financial markets and economy carry far less significance in comparison, given the magnitude of these events. Our hearts go out to those who have suffered these tragedies.

It remains our responsibility to offer our observations and comments on the economy and financial markets; these thoughts follow.

There was solid economic growth and rising values in markets around the globe in the third quarter. This trend held for all major asset classes—both equity and fixed income. In the U.S., both large and small company stocks generated solid returns for the quarter. This continued the trend seen so far this year and throughout 2016. Given the more recent decline in the value of the U.S. dollar, international equity returns have been even more robust than those in U.S. over this period.

Third Quarter Returns by Asset Class



Year-to-date, U.S. large company stocks, particularly technology stocks, have generated greater returns than their small company brethren (happily, both large and small U.S. stocks have seen strongly positive returns so far this year). In the international markets, both large and small stocks have seen significant increases this year, far outpacing returns in the U.S. Returns in developing markets have been even stronger, with year-to-date returns rising just over 28%.

In all of the primary U.S. bond categories, returns have been positive both for the quarter and on a year-to-date basis. While the Federal Reserve has begun to raise the short-term Fed funds rate, this shift has yet to negatively affect bond returns. Returns from international fixed income have also been positive for both the quarter and year-to-date. In many cases, for U.S. investors, international fixed income has benefited from a currency tailwind attributable to the weakening dollar.

Returns in the alternatives category have been a mixed bag of both

positive and negative. Timber has been the bright spot in our alternatives allocation while both managed futures and master limited partnerships (MLPs) have seen negative returns this year.

While adverse economic impacts from the hurricanes and wildfires are certain to be experienced in the coming quarter, it is expected that these will be less far-reaching than many may fear. The U.S. has continued to see steady, if unspectacular, economic growth. The U.S. economy is completing its eighth year of expansion. While the expansion is perhaps getting a bit "long in the tooth," the severe damage caused by the natural disasters we've seen this year is not expected to derail this expansion.

The economic impact of these disasters may lead the Fed to be a bit more cautious in its plan to continue raising the federal funds rate. While the Fed has signaled its intention to gradually raise interest rates to more "normal" levels, they do not want to risk tipping the economy into recession—nor do they want to trigger an inflationary spiral.

The U.S. Economy

It is too soon to accurately forecast what affect the hurricanes and wildfires will have on the economy in the coming months. While the third quarter numbers were unaffected, it is certain that we will see economic impacts in the coming quarters. Prior to Hurricane Maria and the outbreak of California's fires, Moody's Analytics estimated that hurricanes Harvey and Irma could end up costing between $150 and $200 billion in damage and lost productivity. Clearly, these additional disasters will increase cost estimates substantially.

Economists are able to point to some positives that typically help offset the most significant economic consequences of disasters like those we've seen this year. Although natural disasters can temporarily devastate local communities and cause tremendous hardships for residents, the ensuing recovery efforts usually bring substantial re-investment that offsets the worst overall economic effects of these disasters. Typically, an influx of insurance and relief payments helps fuel massive new purchases of goods and materials needed to rebuild. Regional employment can be expected to fall in the short term as businesses are lost or shuttered in the immediate aftermath of a disaster. Post-disaster, employment often shows surprising gains as workers return to work and some areas of employment, most notably construction, spike as rebuilding gets underway.

Economists who study these phenomena generally believe that economic recovery from these types of catastrophic events can be relatively swift. Mark Zandi, the Chief Economist for Moody's, has said of Harvey and Irma that "80% of the economy will be back in six months, 90% in a year and 100% three years from now." A similar pace of recovery may well follow the devastation of hurricane Maria and the fires still raging in much of California.

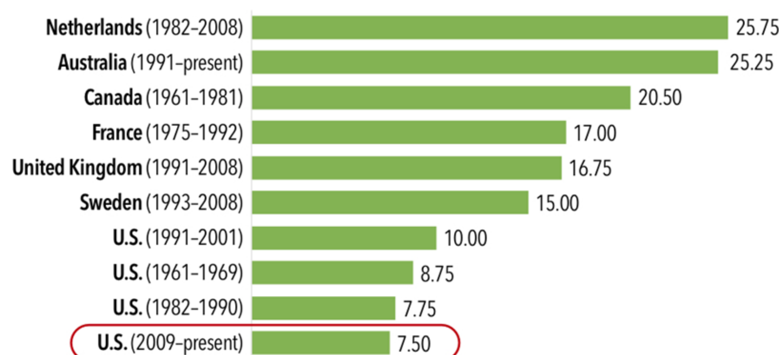
GDP Forecast

Looking at the U.S. economic picture through the third quarter, the economy has continued to see consistent, if comparatively modest, growth. As of the end of the second quarter, U.S. Gross Domestic Product (GDP) rose by 2.2% on a year-over-year basis. The U.S. economy is entering its ninth year of expansion. As many economists and market pundits have noted, the pace of economic growth in this recovery has been slower than that of past recoveries. Since the recovery began, GDP growth has averaged just 2.1% a year. This compares to a growth rate of 3% or more in past recoveries.

While some would argue that the sheer length of this recovery makes a recession imminent, there are many who counter with the view that the slow but steady pace of growth can enable the recovery to continue even longer. As noted in the chart below, this period is far from being the longest contemporary recovery either in the U.S .or globally.

Looking at the economic landscape, we continue to see low inflation, improving employment numbers, favorable manufacturing data, and continuing consumer confidence. All of these are positive indicators of continuing economic growth and a largely healthy economy.

Longest Economic Expansions
Measured in years, as of September 30, 2016



Interest Rates and the Federal Reserve

The Federal Reserve Open Market Committee kept the effective federal funds rate (EFFR) steady at 1.25% following its September meeting. The Fed has indicated that it expects to increase the EFFR to 1.5% by the end of 2017. The Fed further expects to "normalize" their rate at 2% in 2018, and raise it to 3% in 2019. This stated timing suggests that the Fed holds an optimistic view of the state of the U.S. economy. Given the disasters that have occurred over the last two months, it remains to be seen whether the Fed stays with this stated plan.

The Fed also must address the huge accumulation of Treasury debt it added to its balance sheet when it initiated quantitative easing to help stimulate the then still weak U.S. economy. While the Fed will undoubtedly monitor broader economic conditions before acting, it has announced its plans to begin reducing its nearly $4.5 trillion in Treasury debt beginning in October.

When this process does begin, there will be an increase in the supply of Treasury debt (since the Fed will no longer be a buyer of Treasury issues). This is likely to lead to an increase in the yield on the 10-year Treasury note. An increase in the 10-year can be expected to drive up longer-term interest rates, such as mortgages and corporate bonds. This yield scenario could change, and rates may remain more stable if global demand for U.S. debt were to increase in response to broader economic or geopolitical shocks.

Expectations for Inflation

As noted, the Fed has established some clear targets for inflation in the months and year ahead. As of August, inflation, as measured by the Consumer Price Index (CPI), has come in at 1.9%. The Fed prefers to use the "core" inflation rate in setting monetary policy. The core inflation measure strips out more volatile gas and food prices. Core inflation through August was running 1.7%. Based on the Fed's 2% inflation target, they should still have room to continue raising their rate to a more normal level without driving inflation above target range.

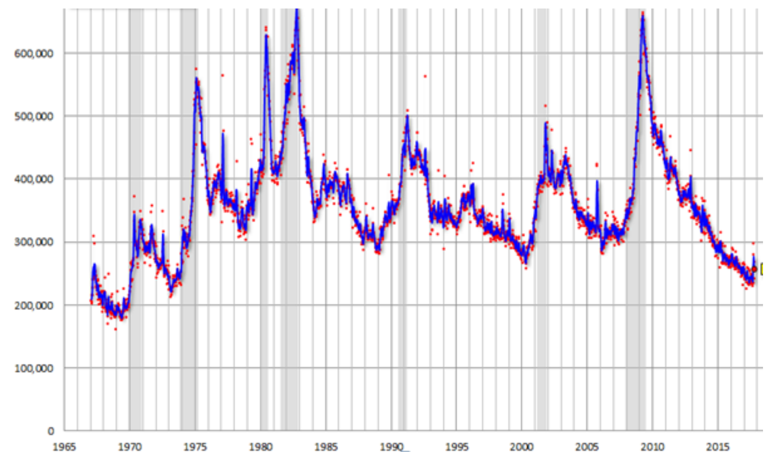
Employment

The U.S. employment picture continues to improve. The unemployment rate at the end of August was 4.2%. This is the lowest rate since February 2001. At the national level, while the disasters have contributed to a slowing of job growth numbers, there has been no uptick in overall unemployment rates. This will likely change in the fourth quarter, as repercussions from the regional natural disasters become more evident.

While new jobs and unemployment numbers reflect a positive economic trend, the overall labor force participation rate still remains below historic norms. The August rate stood at 62.9%. This is below its 2007 peak of 66%. More positively, the labor force participation rate has ticked up from its second quarter reading. As employment markets have tightened, average wages have begun to rise. Average hourly earnings rose by 2.9% year-over-year. This was an increase over the 2.4% year-over-year rise reported at the end of June—a hopeful sign for workers who have seen stagnant wage growth during this recovery.

Weekly Unemployment Claims

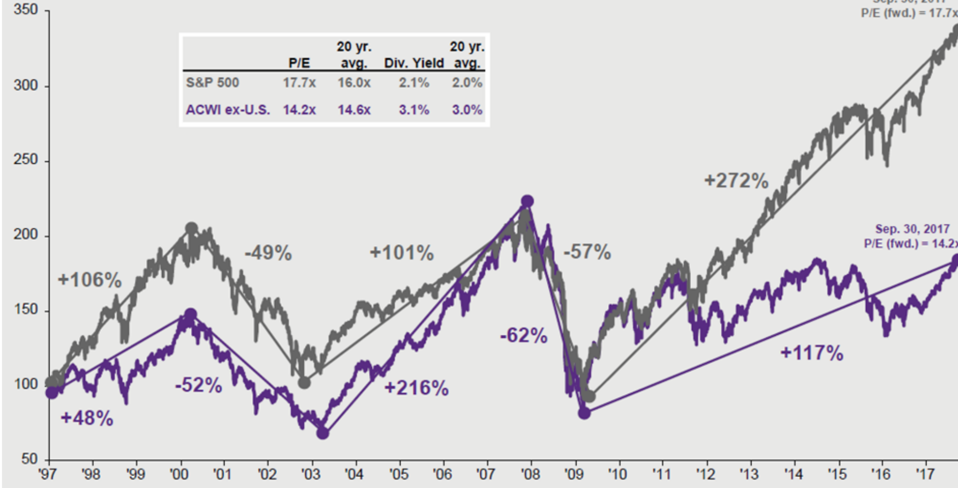
Seasonally adjusted four-week moving average



The World Economy

Following the "Great Recession," investment returns from the international markets have significantly lagged those achieved in the U.S. As can be seen in the chart on the following page, after tracking closely in the first two years of the recovery since late 2010, returns in the international markets (as measured by the MSCI All Country World ex-U.S. Index) have diverged significantly from those of the U.S. Since the 2009 market trough, the S&P 500 Index has increased by more than twice as much as the MSCI World ex-U.S. Index. Much of this divergence can be attributed to the relative strength of the dollar. Other factors, including foreign central bank policies, falling commodity prices and geopolitical pressures have all played a role.

Since the beginning of the year, the international markets have seen significantly better returns than those achieved in the U.S. A weaker U.S. dollar has been a major factor in this performance differential. This, along with improving global economic growth and attractive international equity market valuations have contributed to shifting the trend.



As of August, Europe's GDP growth continued its upward trend, coming in at 2.3%. On the labor front, unemployment continued to decline, reaching 9.1% in August. While this is still a very high rate of unemployment, it is down from the 12.1% peak reached in July 2013. Inflation remains muted with a September reading of 1.5% (still below the European Central Bank's 2% target rate).

Japan

In the Asia-Pacific region, Japan continues to struggle with its challenge to ignite its economy and generate greater growth. The Bank of Japan's (BOJ) four years of extraordinary monetary easing have no doubt had positive economic effects. Japan's job market is quite strong, with the unemployment rate falling to 2.8%. However, as of the end of August, GDP growth on a year-over-year basis was low at 1.4% and Japan's inflation rate of 0.6% remains well below the BOJ's 2% target rate. On a more positive note, the Nikkei 225 Index, the leading measure of the Japanese stock market, reached its highest point in twenty years surpassing the 20,000 level in September.

The Euro Area

The euro zone has seen accelerated growth this year due to an improving employment picture, strengthening manufacturing momentum, still modest inflation, and considerable pent-up consumer demand. For the present, both the European Union and the U.K. appear to be weathering the impact of the Brexit vote more successfully than many had feared.

The euro zone is now entering its fifth year of expansion. While positive trends are clearly evident, the EU still has a host of challenges to address. Since the global financial crisis, economic growth has been anemic at best. The current positive trends may portend a more favorable future, but this still remains to be seen. The recent pro-European elections in France and the Netherlands reflect a rejection of the more populist sentiments expressed by some of Europe's political parties. Nonetheless, tensions within the EU continue to exist as evidenced by the recent election protest in the Catalonia region of Spain, and potential leadership challenges in Germany.

Euro Zone Equities in US Dollar vs. Euro

Total return - Indexed to 100 as of December 2016

China

There are many positive economic and market trends present in China. Despite its high growth rate, inflation remains low at 1.9%. GDP growth continues to be robust at 6.9% and China's financial markets have generated significant gains so far in 2017.

Nonetheless, challenges continue. Excessive debt remains a primary problem. While the rate of credit growth has slowed, overall debt as a percentage of GDP exceeds 200% (economists are concerned at debt to GDP levels above 100%). China's level of debt is mitigated in part by the country's high growth rate, but China's level of debt remains a concern. According to an International Monetary Fund estimate, China's 7.3% growth rate over the last five years would have been twenty percent lower (at 5.3%) if its debt were increasing at a more sustainable rate.

Emerging Markets

The emerging markets have faced challenges and struggles over the past few years. These include falling commodity prices for EM producers, reduced trade from decreases global demand, currency declines relative to the dollar and other developed market currencies, and domestic political tensions. These challenges have moderated. Commodity prices, while still low, have

stabilized. Local currencies have strengthened in relation to the dollar, and while political tensions persist in a number of EM countries (most notably Russia, Brazil, and Turkey), in many instances, these tensions have lessened over the last year.

Investments

An eight-year equity bull market has lifted stock valuations across the globe. Equity market returns in virtually every major country market have been strongly positive thus far in 2017. Globally, inflation remains modest and the world's major economies are experiencing positive growth. While risks and concerns are always present, we believe the year will end much as it has begun with globally strong equity market returns.

United States Equities

Major U.S. market indexes continued to achieve record highs in the third quarter. The S&P 500 Index increased by 4.5% in the quarter and is up 14.2% year-to-date. All major sectors of the U.S. economy posted positive returns for the quarter. Year-to -date returns were also positive across the board with the exception of energy and telecom—both of which have experienced mid-single digit declines year-to-date. The strongest returns thus far in 2017 have been in healthcare (up 20.3%) and technology (up 27.4%). The S&P 500 has now risen 272% from its March 2009 lows (excluding dividends).

Small company stocks, as measured by the Russell 2000 Index, have generated positive returns this year. The index rose 5.7% in the third quarter and 10.9% for 2017 year-to-date. In looking at investment "style," growth stocks have generated higher returns in 2017—both on a quarterly and a year-to-date basis.

Market Returns

As of September 30, 2017

2015	2016	YTD
Int'l Sm 9.9	BDCs 24.4	EM 28.1
EM Bonds 1.8	Small US 21.3	Int'l Sm 25.8
Mrgr Arb 1.7	MLP 18.7	Int'l Lrg 20.5
Intermed Bonds 1.1	Large US 12.1	Timber 16.3
Large US 1.0	EM 11.6	Large US 14.2
ST Bonds 0.7	EM Bonds 9.6	Small US 10.9
Mgd Futures 0.04	Timber 8.3	REITs 10.8
Int'l Lrg (0.4)	TIPS 4.7	EM Bonds 8.6
REITs (0.4)	REITs 4.6	Mrgr Arb 5.5
TIPS (1.5)	Int'l Sm 2.6	BDCs 3.4
BDCs (4.1)	Intrmed Bonds 2.1	Intrmed Bonds 2.3
Small US (4.4)	Int'l Lrg 1.5	TIPS 1.7
Timber (7.0)	ST Bonds 1.3	ST Bonds 1.1
EM (14.6)	Mrgr Arb (0.8)	Mgd Futures (5.1)
MLP (31.7)	Mgd Futures (6.1)	MLP (7.2)

International Equities

After the last few years of relatively lackluster performance, the international markets posted strong gains in 2017—in both the developed and developing regions of the world. Continuing U.S. dollar weakness during the quarter added to U.S. investors' overseas gains. The MSCI EAFE Index, the most widely used international index, rose 5.5% during the third quarter and has risen 20.5% year-to-date (measured in dollar terms, as opposed to local currency). European markets posted gains of 6.5% for the quarter and are up 23.5% year-to-date. Japan has risen 14.6% YTD in dollar terms.

The developing world has experienced even stronger returns—both in the quarter and year-to-date. As with the returns of the developed markets, an improving economic climate and the dollar's relative weakness contributed to these positive returns. The MSCI Emerging Markets Index rose 8.0% last quarter and has risen 28.1% year-to-date (all returns reported in dollar terms). With exception of Russia, returns for the BRIC countries (Brazil, Russia, India, and China) were very strong ranging from 24.1% for India to an eye-popping 43.4% for China. Russian returns year-to-date sit at 1.6%. These returns reflect the continuing weakness of the oil markets and the ongoing political tensions with the U.S. and our NATO allies.

Fixed Income

The fixed income markets have been surprisingly positive given the Fed's signaling of its intentions to continue raising short-term interest rates. The Fed held rates steady at its September meeting but will continue to monitor economic conditions and can be expected to raise rates in the months ahead. The yield on 10-year Treasuries remained flat at 2.3% (technically, it was up 0.02% from Q2). The return on the

10-year has been 2.4% year-to-date. The Barclays Capital U.S. Aggregate Bond Index rose 0.8% in the quarter and is up 3.1% year-to-date.

Treasury Inflation-Protected Securities (TIPS) reflect investor expectations about future inflation trends. Given modest inflation numbers, U.S. TIPS rose 0.9% in the third quarter and are up 1.7% so far in 2017.

Emerging market debt posted strongly positive results both in dollars and in local currency (many clients hold both types of EM bonds in the "alternatives" allocation in their portfolios). The JP Morgan Emerging Markets Bond Index, which tracks bonds issued in dollars, was up 2.2% in the third quarter and 8.6% year-to-date. For EM bonds issued in local currency, the gains were 2.0% for the quarter and 9.4% year-to-date.

Alternatives

Although the individual components of our alternative strategy have experienced mixed results, as a group, our alternative allocation has generated a slightly positive return year-to-date.

- **Global real estate**—as represented by the FTSE NAREIT Global Index, was up 3.4% for the quarter, and is up 10.8% year-to-date. The index was down in the latter half of 2016. Accordingly, one-year returns are up a more modest 4.4%. Overseas real estate returns have benefitted from the weaker dollar.
- **MLPs**—as measured by the Alerian Master Limited Partnership Infrastructure Index, energy infrastructure MLP prices fell as oil prices were falling in 2014 and 2015. The index rebounded strongly in 2016 as oil prices began to recover. With oil prices again declining in 2017, the index declined 4.2% for the quarter and is down 7.21% year-to-date. The one-year return on the index is negative at -4.9%.
- **MultiAlternatives**—as measured by the Credit Suisse Hedge Fund Index, was positive for the quarter with an increase of 1.3%. Year-to-date the category is up 4.7%. The access to many trading strategies continues to help dampen portfolio volatility.
- **Managed Futures**—represented by the SG Trend Index, rose 0.7% in the third quarter but declined 5.1% on a year-to-date basis. Returns from this investment category have been weak for the past few years. Nonetheless, we believe managed futures is a valuable diversifier in our portfolios. Historically, they have virtually no correlation with stocks or bonds. This category has been able to provide helpful ballast to the portfolio in past periods of market turmoil. Declines in the energy sector combined with volatility in many of the underlying asset types have both contributed to this weak performance over the past few years.
- **Reinsurance**—It has been an increasingly tough year for reinsurers as the number of disasters and perils has been historically high. This year-to-date the index has been down 3.2%. We expect returns to sharply incline once insurers raise rates after the policy renewals come due.

Conclusion

Despite the range of challenges that exist both domestically and internationally, the near-term outlook for the world's economies and markets continues to look positive. There is little question that recent natural disasters that have wreaked destruction will affect the U.S. economy. Still, we believe that the wider impact of these effects will be relatively short-lived and are unlikely to derail the economy as a whole. Local recovery is another matter.

While there remains a host of economic and geopolitical challenges facing the European Union, Asia and the developing world, there are enough positive developments to be cautiously optimistic about prospects for the future. And although the state of U.S. and world politics may be concerning, we will hold to an optimistic view that reason and good judgment will ultimately prevail.

Thank you for allowing us at The Lubitz Financial Group to be of service to you. We feel honored and privileged that you have chosen us and we will do our best to continue to earn that trust.

Your team at

Sources: *National Bureau of Economic Research, MSCI, Standard & Poor's, US Department of Labor, Frank Russell Company, Dimensional Funds, FactSet, JP Morgan Asset Management, Morningstar, Advisor Perspectives, Business Insider.*