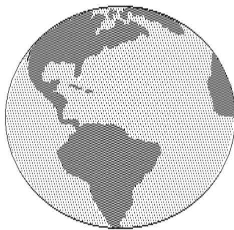
THE LUBITZ FINANCIAL GROUP

Market Watch
2nd Quarter 2015

July 2015 — LubitzFinancial.com

Summary

- **Weak performance all around**
- **The U.S. stock market returns were just positive for quarter, but still attractive for year**
- **The U.S. Gross Domestic Product contracted 0.2% in Q1, but economists expect improvement in Q2**
- **Q2 inflation remained low at 0.46%**
- **Rising interest rates caused most bonds to fall in Q2**
- **The Fed announced plans to raise interest rates by the end of 2015**
- **The US unemployment rate dropped to 5.3% in June**
- **Currency valuations steadied in Q2, but hurt 12 month results**
- **Greece risks exiting Euro-zone**
- **China's market rises, then falls precipitously**
- **Alts are in a uniquely poor period for performance**



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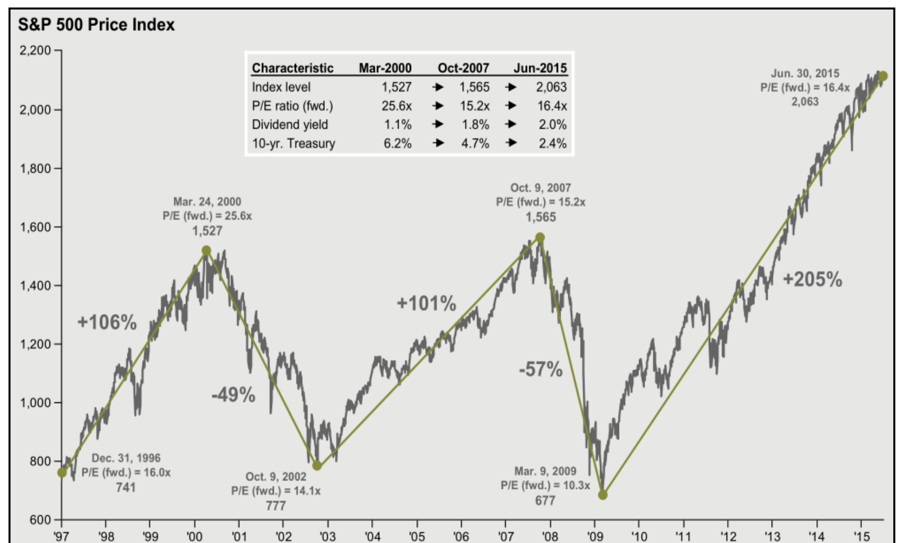
U.S. Markets reach another record high, but finish unchanged

Overall performance of investments has been disappointing for some time, and this quarter was no exception. There just wasn't a lot that was really interesting. For example, the difference between the high and low points during 2015 for the S&P 500 has been the smallest in at least 35 years.

U.S. stocks were perhaps the most "quiet." While most U.S. stock categories were positive, it wasn't by much. The S&P 500 finished the quarter essentially unchanged (+0.28%) and is up only 1.23% for the first six months of 2015. This quarter marked its 10th consecutive quarterly gain. Meanwhile, the Dow Jones Industrial Average finished the quarter down 0.29%. Q2 saw the technology-heavy Nasdaq composite index finally move past its last achieved high point, in the year 2000. Small stocks (Russell 2000) rose less than 0.5% for the quarter.

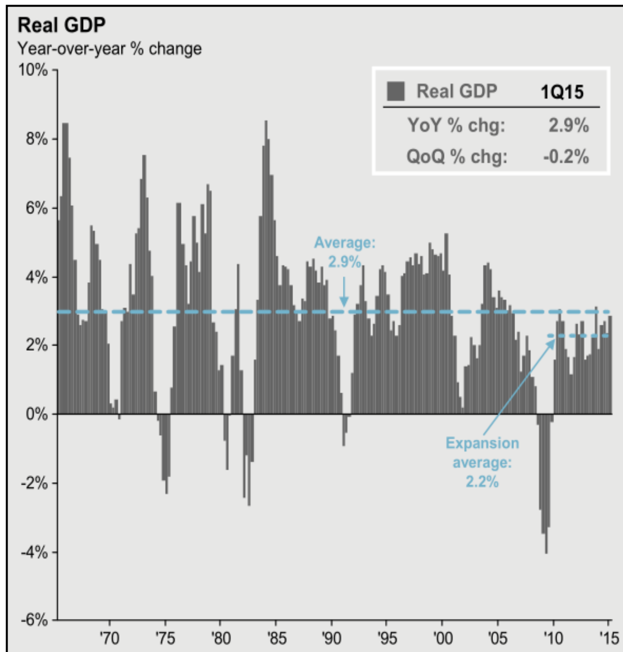


Despite the big news in both Greece and China, the broader international markets were modestly but surprisingly positive for the quarter. To help boost their economies, both the European Central Bank and Japan's Central Bank are in the early but aggressive stages of pumping money into their respective economies. These are their own "quantitative easing" programs, designed to make borrowing cheaper for consumers and business while also weakening their currencies to help boost trade. Global developed markets, as a whole (EAFE), were up 0.84% during the 2nd quarter of 2015. Japan finished up 3.12% (MSCI Japan) while Europe was up 0.36% (MSCI Europe). Emerging markets also posted modest returns, with MSCI Emerging Market Index finishing up 0.82% for the quarter, and up 3.12% year-to-date.

Currency values have been much more stable this year than in 2014. The dollar, which strengthened more than 20% against the Euro from June 2014 to March of this year, has settled back since then. The dollar is

also up more than 20% against the yen and 10% against the British Pound over the last year. While last year the change in rates hurt American investors, this year it has been a relatively minor issue and even a bit of a help this last quarter. The 12-month performance results of this report still reflect the run up in the dollar that happened late last year.

Greece represents 0.02% of the world stock market. Regardless of the outcome of its current crisis, once we've passed a few weeks of emotional reaction and concerns for contagion (i.e. what a resolution might mean for Spain, Italy and Portugal, among others), we doubt the end result will matter much to investors.



China, on the other hand, is the second largest economy in the world. In the 12 months prior to early June of this year, with government encouragement, the Chinese local markets had risen more than 150%. But, in the three weeks following June 12, those same markets fell by 32%. While the Chinese government has professed strong support for the idea of open markets, this downturn has proven contradictory as they imposed one aggressive regulatory limitation after another in trying to stem their markets' decline. While many aggressive investors have experienced significant losses since June 12th, a more important concern is that the government's dedication to free markets has come into question. The downturn itself is unlikely to have a big impact on the regional or world economy.

The U.S. bond sector showed signs of weakness during the second quarter, with increasing volatility attributable to the Federal Reserve's announced plan to raise interest rates later this year. The Barclays U.S. Aggregate Bond Index declined 1.68% this quarter while short-term bonds gained slightly.

Federal Reserve

The Fed has held its benchmark interest rate near zero since December 2008. It last raised interest rates in 2006. During its recent June meeting, the Fed announced they were finally prepared to begin increasing interest rates—and that this might happen as early as September. In their cautiousness, they also expressed concern about weak consumer spending and risks from China and Greece. They repeated that data on the U.S. economy will guide their decision on raising rates.

Keeping in mind that interest rate increases have been expected for much of the last five years, like most others, we expect to see rates finally start to rise before the end of this year. With the U.S. economy still weaker than desired and with the Greek and Chinese problems on their minds, we expect rate increases to happen gradually and perhaps with more delay than many have predicted.

The U.S. Economy

Forecast on GDP

As the chart to the left illustrates, the U.S. recovery continues, but at a disappointing pace. After a difficult first quarter in which the U.S. economy contracted 0.2%, the initial indications (still subject to revision) are that we rebounded at a 1.7% rate in the second quarter. Retailers reported stronger sales this quarter and employers stepped up hiring. Housing is also strengthening and manufacturing activity is beginning to stabilize.

The Fed's official projections now foresee growth in gross domestic product this year of just under 2%. This is down from earlier 2015 projections of 2.3% - 2.7%. With optimism fading, it's quite possible that the growth rate could finish even lower than the projected 2%.

Economic growth is likely to be slow for a long period. Growth comes from two key elements: 1) Growth in num-

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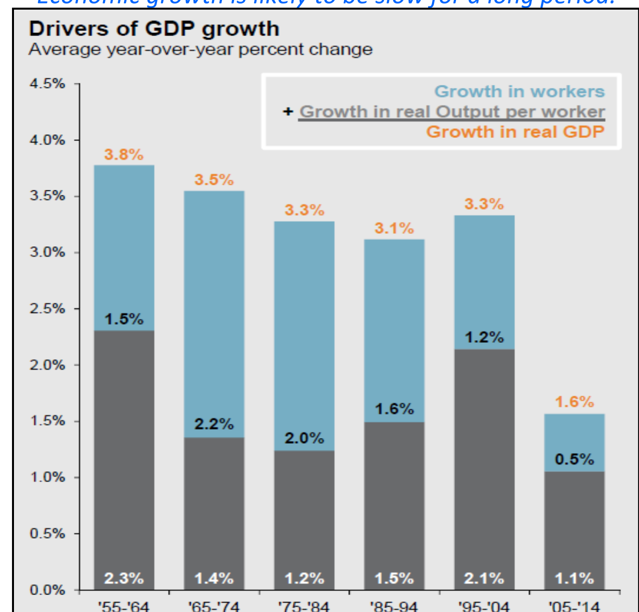
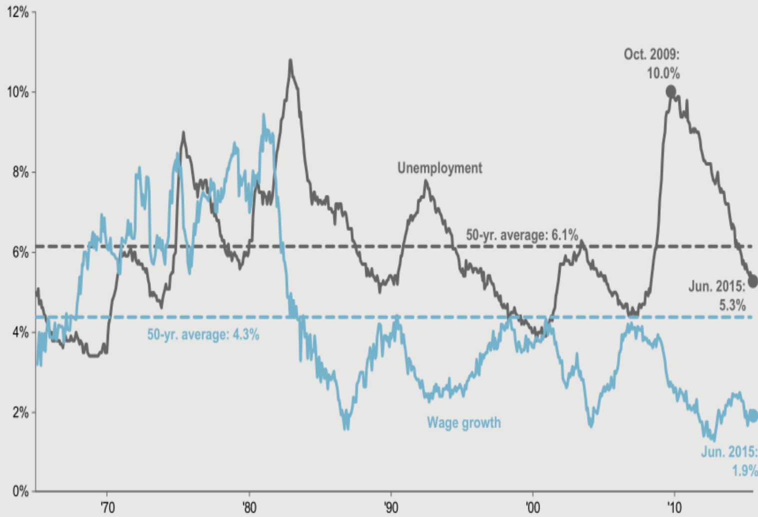




ber of workers, and 2) Growth in real output per worker. As the chart above indicates, economic growth has been weaker recently than has been true in the past. Without meaningful changes occurring in one of these two drivers, GDP growth is likely to continue below historical growth rates in the future. With fewer people entering the workforce than has been true over the last 60 years and with immigration policies tightening, population appears unlikely to add much to our economic growth rate. Productivity, the second factor, is also down from earlier periods. This is due, in part, to increased regulation but also to a slowing of investment in technology and other labor-saving tools. A rise in interest rates could create an additional hurdle for such investment, but we don't believe that a gradual rise in interest rates should have a significant impact—at least in the more immediate near term. Slower economic growth, of course, reduces opportunities for all of us for a better life.

The implication for investors is slower economic growth, inevitably resulting in weaker stock market returns.

Employment

Total employment in the U.S. continues to grow, bringing the unemployment rate down to a seven-year low of 5.3%. Unfortunately, as a percentage of the population, fewer people are working today than has been true over at least the last 38 years. Per the above chart, while the official rate of unemployment is approaching the point of "full employment," the rate of growth in wages remains well below the 50-year average rate. While this has helped keep inflation low, it has made it harder for people to achieve the American dream.

Housing

With the continued increases in the rate of family formation, there is a pent-up demand for more housing. As the chart to the right highlights, the housing market continues to improve – sales of existing and new homes have been rising. Home prices also continue to climb (the S&P/Case-Shiller index of national property values increased 4.9% from the prior year). Rising residential real-estate values have helped owners rebuild equity and have encouraged builders to take on more projects. Both could lead to increases in spending and investment that will boost the economy.

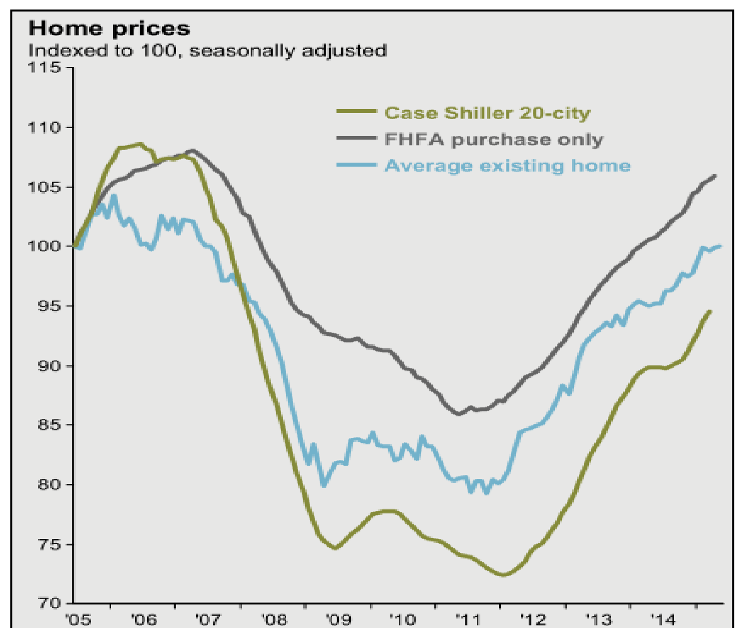
Mortgage rates play a key role in the demand for housing. With interest rates expected to rise at the same time home prices are increasing, buyers could find it ever more difficult to get into a new home. How much of a dampening effect this will have on economic growth remains to be seen. Overall, mortgage costs still remain near historically low levels. According to data from Freddie Mac, the average 30-year, fixed-rate mortgage stood at 3.98% at the end of the year, down from 4.16% a year ago.

If your mortgage rate is above these levels, we encourage you to consider refinancing soon.

Consumer confidence

Consumer spending currently makes up 68.5% of the economy (government spending is 17.9%, business spending is 13.4%, while housing represents 3.3% and net exports deduct 3.2%).

As a whole, consumers today are in better financial shape than they have been for years. More people are working and their debt burdens are lower. As a result, consumer attitudes are positive. According to the University of Michigan's Consumer Sentiment Survey, in the first half of 2015 consumers voiced the largest and most sustained increase in economic optimism since 2004. Just as important, that same degree of optimism was expressed not only by those in the top third of the income distribution, but also by those in the middle and lower thirds. The recent surveys highlighted similar across the board positive sentiment when consumers were asked to evaluate prospects for the national economy, their personal finances, and buying condi-



2014	YTD
REITs 28.0%	DM Equity 5.9%
Large Cap 13.7%	Small Cap 4.8%
Fixed Income 6.0%	EM Equity 3.1%
Asset Alloc. 5.2%	High Yield 1.9%
Small Cap 4.9%	Asset Alloc. 1.5%
Cash 0.0%	Large Cap 1.2%
High Yield 0.0%	Cash 0.0%
EM Equity -1.8%	Fixed Income -0.1%
DM Equity -4.5%	Comdty. -1.6%
Comdty. -17.0%	REITs -5.4%

tions.

Consumers are feeling richer and have more money to spend. Aggregate household net worth continues to climb. This contributes to consumers feeling better-off. Moreover, consumer debt payments as a percent of disposable personal income are now at 9.9%. This is the lowest level in more than 35 years.

With an optimistic outlook, fewer debts to pay and more money in their pocket, consumers are expected to continue to be the leading force for U.S. economic growth.

The World Economy

Euro-zone

The Euro-zone economy expanded in the first quarter of 2015. Still growth remains weak while the inflation rate remains low. Economists continue to foresee a broad recovery in the Euro-zone. Gross domestic product (GDP) was up 0.4% in the first quarter of 2015, better than either the UK or the U.S. Although Q2 data is not yet available, it appears that despite the drama of Greece, the liquidity being poured into the Euro-zone economy, along with the weaker Euro and lower gas prices is helping the area in its recovery process.

Outside of Greece, employment is improving , albeit slowly. Euro-zone unemployment in June was still at an unfortunate 11.1% (but, that's the lowest it's been in three years). This improvement masks wildly differing situations across the region. While Italy and Germany saw unemployment rates remain steady for June at 12.4% and 6.4% respectively, unemployment in Spain and Greece remains over 20% (and youth unemployment in both countries hovers near the 50% mark). What lessons are young people learning for the future?

The big issue in Europe is, of course, Greece. Despite representing only 0.02% of the world capital markets, its import is larger as the European Union tries to find clarity about its reason for being and its internal processes. If Greece were to exit the Euro, as now seems unlikely, what would that mean for other countries that have struggled to right themselves? With the agreements reached July 13, it's clear that European demands for Greek sacrifices have held sway. Greece's only other choice appears to be to exit the Euro. One can, of course, argue that the Greeks have brought this upon themselves. The government chose to fund social programs rather than reduce spending to better match their revenues. But like our own housing crisis of 2007, it's not just the borrowers, but also the lenders who share the blame, and therefore Germans and other Europeans carry some responsibility to help fix the Greek mess.

Japan

The Japanese economy has now rebounded from the contraction caused by its 2014 tax hike. The most recent data shows Japan grew 3.9% in the first three months of 2015. Supported by the fall in oil prices and showing real wage gains, output growth is projected to grow nicely this year and more so in 2016. Export growth is projected to remain buoyant, reflecting the weaker yen and a gradual pick-up in world trade. Inflation, which has fallen close to zero, is projected to begin rising in the second half of 2015 (this is actually a positive thing for he Japanese economy). Japan's unemployment rate (currently 3.3%) continues to fall.

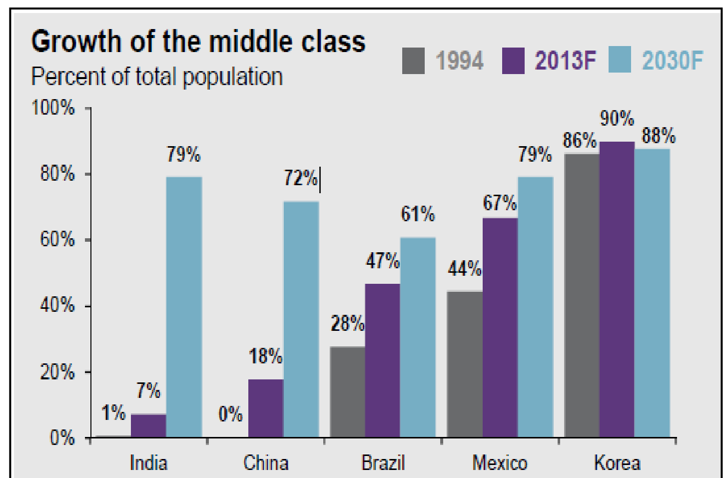
China

China is, of course, the world's second largest economy, so what happens there matters. Its economy expanded last quarter at its weakest pace since 2009. Economic output, investment and retail data all point to a deepening slowdown. That said, China's gross domestic product still rose at a 7% rate in the first quarter of 2015. The International Monetary Fund retained its projection for a 6.8 percent expansion for the full year.

China's recent stock market turmoil has some worrying about what impact this will have on the broader Chinese economy. While the government's actions have raised some important concerns, the recent drop followed a run-up of more than 150% over the prior 12-month period and so is still up 82% for the 12-month period, the most among the world's major markets. We doubt there will be much lingering economic effect, particularly since as of this writing Chinese markets seem to have stabilized.

Emerging Markets

Developing countries (the "emerging markets") represent enormous potential. Since 1990, the share of global consumption generated in the emerging markets, as a whole, has grown from roughly 22% to 35%. This increased demand



for goods and services has risen in part, due to population growth, but more importantly, because these countries are rapidly moving toward developed country status. As the chart below shows, for the major countries of the developing world, the size and importance of the middle class in each of these countries is growing rapidly. By 2030, the middle class is projected to be a significant majority of the population in each of the countries noted. Their share of the world's economic activity will inevitably grow as a result. Despite recent weak returns, the longer term prospects for these developing countries is a key reason we continue to be enthusiastic about the emerging market equities in your portfolio.

Two of the key geographic areas for emerging markets are Asia and Latin America. While their economies have traveled in roughly parallel fashion, as the above chart displays, the latter has consistently grown at slower rates (growth has been near zero for the past year and a half). The recent slower growth rates in Latin America shows up in their weaker stock market performance over the same period.

Investments

U.S. Equities

Although the U.S. stock market finished the second quarter of 2015 mostly unchanged, both the Standard & Poor's 500 and Dow 30 Industrial indexes reached new all-time highs in May. The S&P 500 index has now risen 248% from its March 2009 lows, and is 56% above its October 2007 peak.

Given current interest rate levels and where we are in the recovery from the Great Recession, we believe today's markets are fairly and fully valued. They do not seem to us to be overpriced, but they are also not cheap. Using the forward P/E (current stock price divided by estimated future earnings over the next 12 months), the S&P 500 index is now priced at 16.4 times forecasted earnings. This is only barely above the 25-year average of 15.7. The current dividend yield for S&P 500 index was 2% at the end of the quarter.

In 2014, small U.S. stocks trailed larger stocks. This year they are outperforming them. Results seen in this report are for the full 12-month period and thus include the big differential that occurred in the last half of 2014. For the 12-months ending June 30th, the Russell 2000 small stock index was up 6.49% versus 7.42% for the S&P 500. Year-to-date, the Russell 2000 is up 4.75% versus 1.23% for the large stocks. Both were only slightly positive for the second quarter.

International Equities

Last year, international results were broadly negative. This was due almost entirely to the change in the value of the dollar relative to non-U.S. currencies. This year has largely been modified. For example, for the MSCI EAFE index, the most widely-used international index, was up 0.84% for the quarter in dollar terms. But for local investors, it fell 2.79%. In local terms international markets rose 9.03% for the last 12-months, but because of the currency issues last year the index fell 4.22% for the same period.

The developing world was a somewhat different story. The MSCI Emerging Markets Index rose 0.82% in Q2. The returns of the emerging market economies were affected by the strong dollar and declining oil and commodity prices. Year-to-date the MSCI Emerging Markets index was up 5.8% in local currency, while gaining 3.12% for U.S. investors.

Fixed Income

During the 2nd quarter, prices in nearly all major bond sectors declined, reflecting the rise in interest rates as the market prepared for the Fed to begin to push rates higher. As rates rise, the price of currently issued bonds falls. The longer the term of the bond, the more exaggerated this effect. By way of example, 10-year Treasury yields rose over the quarter from a low of 1.94% in March to 2.35%. During this time, the price of existing 10-year treasuries declined by 3.04%. In the same fashion, the overall U.S. bond market (the BarCap Aggregate Bond Index) declined 1.68% for the quarter and is down 0.1% year-to-date.

Over the quarter, with interest rates rising a bit, short-term bonds posted modest growth of 0.13% while intermediate and long-term bonds lost 0.62% and 7.57%, respectively. As a reminder, Lubitz Financial portfolios do not hold long-term bonds so as to avoid the volatility associated with these longer maturities.

Given the current low inflationary environment, U.S. Treasury Inflation Protection Securities (TIPS) underperformed nominal treasuries declining 1.06% in the quarter.

Emerging market debt posted slightly negative results in the last quarter as dollar-denominated Emerging Market Bonds lost 0.87%, but is still up 0.98% year-to-date.

Alternatives

Alternatives have been a frustrating place to be for a while now. The chart on the next page shows how unusual this period has been compared to prior periods. Most alternative holdings declined during the second quarter of 2015 and there has been little positive news in this area of the portfolio.

	Average-- '87 to 6/15	Average— 15 Years	The Last 3 Years	2014	2015 YTD
Commodities	6.39	1.56	(8.36)	(17.01)	(1.56)
EM Bonds USD	10.37	9.12	2.76	6.15	0.98
EM Currency	7.00	5.31	(2.10)	(7.03)	(1.21)
Energy MLPs	17.72	18.69	9.31	7.61	(11.02)
Managed Futures	9.15	4.58	2.49	7.03	(0.91)
Merger Arbitrage	8.59	4.65	0.68	(5.84)	1.21
Real Estate Global	9.71	10.28	9.07	14.73	(1.91)
Timber	15.35	10.30	9.06	8.57	(8.47)

- Alerian Master Limited Partnership Infrastructure Index, which tracks energy transportation and storage facilities, was down 6.20% during the quarter and has declined 11.02% year-to-date. Investors appear to be concerned about 1) the coming interest rate increases which will reduce the attractiveness of MLP yields, and 2) with oil prices down so low, much of the production is being shut down, so investors worry there may not be as much product to move.
- Global real estate, represented by the NAREIT Real Global Index, declined 5.72% over the quarter and is down 1.91% year-to-date. This was one of the brightest spots in 2014, so is likely to be a temporary event.
- Timber, as measured by the FTSE NAREIT Timber REIT Index, declined 4.81% during the quarter and is negative 8.47% year-to-date. While housing starts and sales in general are rising, the price of timber has fallen dramatically, causing concern for the profitability of timber companies.
- Commodities (the basket of energy, precious metals, agriculture and livestock products) showed solid returns and are up 4.66% for the quarter. But they are still negative 1.56% year-to-date and for the 12-month period they are down a huge 23.71%, reflecting in large part the 50% drop in oil prices in the last half of 2014. With 27 different kinds of goods comprising a "basket of commodities," each has a different story. The primary ones center around 1) the price of oil, and 2) the slowdown in demand in emerging markets, particularly China.
- Managed Futures, represented by the S&P Diversified Trends Indicator Index, was down 2.85% for the year and 0.91% year-to-date. Uncertainty is the enemy of Managed Futures, which follow trends in in the prices of natural resources, currencies, precious metals, livestock and agricultural products. Last year saw a return to positive results but that has been interrupted this year by events in Greece, China and elsewhere. Statistically, this strategy is least correlated with other parts of your portfolio and was the only category that rose in 2008.
- Emerging Market Currencies invest with the goal of capturing the growth potential of emerging countries as their economies strengthen and they make fiscal reforms. The stronger position of the dollar has made this a difficult strategy recently, dropping 7.03% in 2014 and 1.21% year-to-date.

Summary

Since the end of the Great Recession in March 2009, the U.S. stock market has been rising for more than 75 months. The current rally is now the third longest in the U.S. history. Despite the successes, there is still much fear left over from the near-disaster of 2007-2009. On top of that, it is natural for investors to grow increasingly jittery as bull markets last longer and longer. The danger for investors now is that they allow their emotional nervousness overwhelm the discipline that comes from knowing that all investments go in cycles. Successful investors keep their sights on their long-term goals and steadily adhere to the strategies designed to get them there.

This last year has been a particularly difficult period for diversified investors. Low yields and rising interest rates have made bonds unattractive. While large U.S. stocks led all categories last year and created the expectation that "everything was doing well," small company stocks lagged far behind and overseas positions fell in value. U.S. large stock leadership has been reversed in 2015, but the 12-month numbers don't yet reflect that.

On the "Alternative" front, global real estate, one of this century's outstanding performers, has recently hit a speed bump. And as was reflected in our above comments, over the last three years and particularly the last year, this and every other alternative strategy has been well below its historical performance average.

For many, portfolio results of the last 12 months or even the last few years have been frustrating and disappointing. It can be easy to lose sight of the natural cyclicality of investment markets. We want to emphasize that it is our continued deeply-held conviction that a well-diversified portfolio and a solid financial roadmap are the tools that will help increase your chances of the financial success you aim for when it comes to your retirement and achieving your goals in life.

It is our hope and expectation that we can continue to help you progress towards your long term financial goals. We thank you again for your confidence in us.

Sources:

Morningstar, JP Morgan Asset Management, Reuters, Bloomberg.com, NYtimes.com, WSJ.com, US Bureau of Labor Statistics, HSBC Markit, x-rates.com