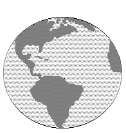
THE LUBITZ FINANCIAL GROUP

Market Watch
1st Quarter 2018

April 2018 www.LubitzFinancial.com

Summary

- After more than a year of relative calm in the markets, fears of trade wars with China along with concerns about higher inflation and interest rates caused U.S. stocks to hit new levels of volatility this quarter, but the U.S. economy continued to show positive momentum.
- All stock categories showed strong positive returns for the twelve-month period. For the quarter, it was a different story.
- Emerging markets were the only broad stock category that gained this quarter.
- The large technology stocks, for the first time in a long while, declined slightly this quarter.
- Most bonds fell this quarter, reflecting the Fed's efforts to raise interest rates.
- U.S. real estate (REITs) fell this quarter, dragging down global real estate, which remained in slightly positive territory for the year.
- As they typically are, alternatives were a mixed bag this period.



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Overview

This is a tale of two market environments. As you'll see in your quarterly report, the one-year numbers show strongly positive returns with very few exceptions. In contrast, the first quarter of 2018 was a different story. First quarter numbers were negative in a majority of investment asset classes. It remains to be seen whether this represents the beginning cracks in the long growth run we've enjoyed since the end of the great recession in early 2009. After experiencing relatively calm markets in 2017, volatility returned in the first quarter of 2018. Bond prices fell as interest rates rose, while U.S. and international stocks declined. The outcomes weren't terrible, but all of this is a change from the positive growth trends we've enjoyed recently.

Market Returns

2016	2017	Q1 2018
BDCs 24.4	EM 37.7	Timber 1.8
Small US 21.3	Int'l Sm 33.5	EM 1.4
MLP 18.7	Int'l Lrg 25.6	Small US (0.08)
Large US 12.1	Timber 21.9	ST Bonds (0.2)
EM 11.6	Large US 21.8	Int'l Sm (0.3)
EM Bonds 9.6	Small US 14.6	Large US (0.7)
Timber 8.3	REITs 8.6	TIPS (0.7)
TIPS 4.7	EM Bonds 8.2	Intrmed Bonds (0.9)
REITs 4.6	Mrgr Arb 6.8	Mrgr Arb (1.1)
Int'l Sm 2.6	TIPS 3.0	Int'l Lrg (1.4)
Intrmed Bonds 2.1	Intrmed Bonds 2.1	EM Bonds (2.0)
Int'l Lrg 1.5	Mgd Futures 2.2	BDCs (2.6)
ST Bonds 1.3	ST Bonds 0.8	Mgd Futures (3.9)
Mrgr Arb (0.8)	BDCs 0.09	REITs (5.5)
Mgd Futures (6.1)	MLP (8.8)	MLP (11.5)

With tensions heating up between the U.S. and leading communist countries (including potential trade wars with China, nuclear tension on the Korean Peninsula, and the expulsion of Russian diplomats), there is a great deal of uncertainty on the global stage, which all contributed to a weak first quarter.

The Federal Reserve Bank, under new Chairman Jerome Powell, pushed interest rates up another notch in the first quarter of 2018. The move is a part of the Fed's continued effort to normalize monetary policy while the economy's strength permits. Overall, the Fed maintained a generally positive outlook on a range of economic metrics including GDP growth, unemployment, and inflation.

The Tax Cuts and Jobs Act (TCJA) of December 2017 and recent budget legislation were both enacted with the intention of boosting the American economy. At the same time, the Fed's first quarter interest rate hike (and those expected later this year) could have a slowing effect on the economy. The market's direction in the coming year will, in part, be guided by whether fiscal or monetary policy plays the larger role.

Bond prices and interest rates move in opposite directions. As interest rates have risen recently, bond prices have declined, leaving bond returns in the red to begin the year.

U.S. equities were also weak. U.S. small company stocks, as measured by the Russell 2000

Index, were essentially flat (down 0.08% for the quarter). U.S. large company stocks, as measured by the S&P 500, lost 0.8%. Both remain strongly positive for the twelve-month period. The NASDAQ, with its significant concentration of large technology stocks, posted a positive first quarter return of 2.6%, despite the challenges the tech stocks face.

Like the U.S., the developed world struggled (both the euro zone and Japan fell 1.9% during the first quarter). In contrast, emerging markets rose 1.5% in Q1. Latin America was a primary driver of emerging market returns, posting an impressive 8.1% gain in the quarter, as measured by the MSCI EM Latin America Index.

The U.S. Economy

GDP Forecast

According to the Fed, on an annualized basis, U.S. gross domestic product (GDP) for the fourth quarter of 2017 came in at 2.7%. This was lower than many forecasters predicted but does represent an increase over the prior quarter (it also exceeds the preliminary growth numbers reported earlier in 2017). The current Fed forecast is for annual GDP growth of 2.8% over the full year of 2018.

Based on recent surveys, consumer confidence is strongly positive and likely to contribute to continued consumer spending. This should be a positive support to economic growth. The Conference Board's Consumer Confidence Index rose over the quarter, reaching its highest level since 2000.

While interest rates and inflation are expected to rise, and U.S. labor markets remain tight, many economic indicators suggest that there is still room for growth both domestically and abroad. We expect the U.S. economy to continue to grow in 2018, albeit with a higher level of market volatility.

In our opinion, one of the greatest threats to continued American and world prosperity is the possibility of a trade war. Trade is based on the idea that if another country is able to deliver a service or produce a product better or more cheaply than we do, we sell them what we do produce well and we buy what we need from them that they do well. Both gain.

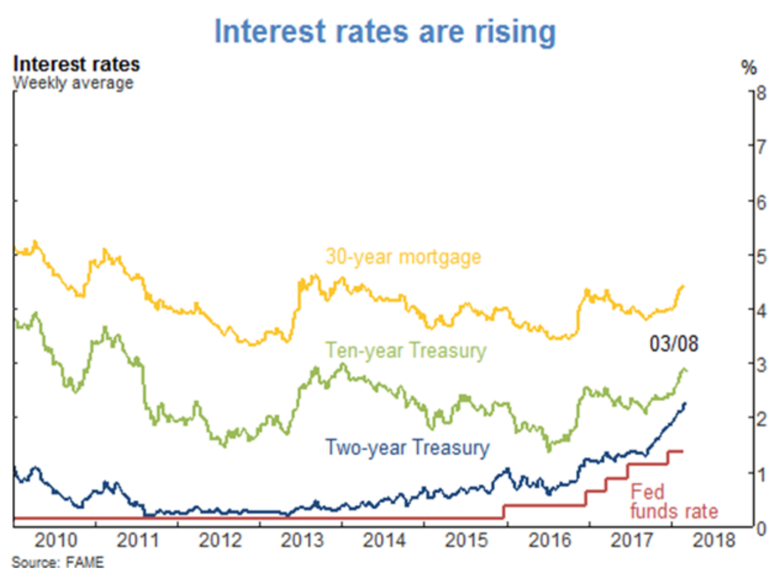
This model of trade can often lead to local hardships, as specialized foreign goods replace the demand for our more expensive or lower quality domestic products. As this occurs, domestic jobs are often lost by those involved in the production of these less competitive products or services. But ultimately, everyone else wins—with lower prices, better quality products, and access to previously unavailable goods. Trade encourages specialization and interdependency grows as a result (making military conflict less likely). Encouraging trade wars by imposing tariffs, border walls, and the like do exactly the opposite. A trade war with China or any other country will not bring better results.

Barring the risk of a trade war or some unforeseen event, our outlook for 2018 economic growth is generally positive. We believe global trade and investment growth can continue to foster overall growth in the global economy.

Interest Rates and the Federal Reserve

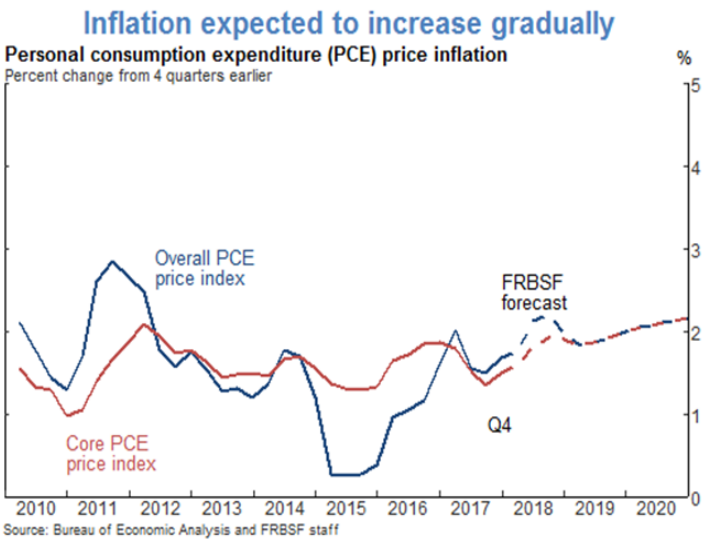
Following the most recent interest rate increase, the Federal Reserve indicated that they expect there to be three additional rate hikes this year. Current Fed expectations call for a funds rate of 2.1% at the end of this year and a 2.7% rate at the end of 2019. Assuming these projections hold, borrowing costs for business and consumers will increase. This may well reduce demand and slow the economy down.

The Fed has made clear that they desire to return the federal funds rate to a more normal (higher) level; they will do so while seeking to avoid a push into recession. This must be done with care, as in parallel, they try to hit their long-run 2% inflation target.



Expectations for Inflation

Inflation, as measured by the Consumer Price Index (CPI), has been largely stable over the past decade. The Federal Reserve's target for inflation is set at 2%; currently, core CPI, the measure of inflation used by the Fed, which excludes food and energy prices, is running at 1.9% while the personal consumption expenditures (PCE) measure is estimated at 1.8%, as you can see in the chart titled, "Inflation expected to increase gradually," as shown on the following chart.



Inflation is commonly driven by increases in underlying commodity prices (as an example, think energy) or labor costs. Given reduced commodity demand globally, commodity prices have seen little inflationary pressure over the last few years. On the labor front, average wages for American workers have grown slowly or been largely stagnant for a number of years. Both of these trends are likely to change.

As the unemployment rate has declined following the great recession, job openings have become harder to fill. This trend began a few quarters ago, but has accelerated more recently as companies have found it harder to source and hire qualified workers. This has begun to put upward pressure on wages.

Similarly, commodity prices have begun to stabilize and in some cases rise. According to the World Bank, energy prices rose by more than 28% in 2017 and many commodities are forecast to see some level of increase in 2018. As a result, core CPI is expected to rise.

The World Economy

Led by gains in developing countries, global economic growth continues to gain strength. In the developed world, with Germany leading the way, Europe appears to have its economy on a more stable footing. Japan meanwhile has been able to sustain a slow but steady rate of growth. In the U.K., fears of Brexit derailing the economy appear to have subsided. It is now expected that the U.K. economy will grow at a positive rate along with its European neighbors.

As can be seen in next table, over the past few years, economic growth in the developing world has been significant. In considering the BRIC countries (Brazil, Russia, India and China), growth rates have been strongest in China and India. Both countries continue to dedicate significant resources toward the development of their infrastructure. Both have also seen an increasing percentage of their populations rise from poverty into a growing middle class. While Russia and Brazil suffered economic slowdowns in 2015 and 2016, those two appear to be back in growth mode.

The overriding economic issue in the world today is the U.S. imposition of tariffs on imports. Barring some resolution, the nations targeted by these tariffs—notably China—will inevitably respond in kind with tariffs of their own on U.S. goods. This creates negative economic impacts in both directions. Tariffs raise the price of goods and ultimately reduce trade (both import and export activity). While some U.S. producers may benefit, consumers and many other industries are negatively affected.

A trade war results in higher prices for consumers and for those producers who rely on the imported goods for parts of their own manufacturing. Importantly, tariffs applied to U.S. products ultimately impair the ability of U.S. producers to compete on equal terms with other producing nations (tariffs on U.S. agricultural goods being a prime example). While the imposition of tariffs may save a few jobs in the short-run, it will inevitably cause slower economic growth and hold back quality of life around the world.

The Euro Zone

In over a decade, 2017 was the best year in European stock markets. This reflected overall positive trends in euro zone economic growth. GDP for all of 2017 rose 2.7% (fourth quarter growth rose 0.6%). Unemployment in the euro zone continues to decline while corporate earnings continue to rise.

Like the U.S., first quarter market performance in the euro zone was weak. Nonetheless, current forecasts call for the European economy to continue to show positive growth throughout the rest of the year. While euro zone unemployment is roughly twice that of the U.S., they too are beginning to see tighter labor markets and rising wages. Monetary policy is expected to continue to tighten as the European Central Bank reduces its stimulus programs.

Japan

After years of slow or even negative growth, Japan saw GDP growth of 1.6% in 2017 (fourth quarter growth was up 0.4%). The Japanese economy has now seen eight consecutive quarters of economic growth—a very positive trend following many years of weakness. The government's actions in injecting substantial capital into

Economic Growth Rates

	2015	2016	2017	2018	2019
United States	2.9%	1.5%	2.2%	2.4%	2.1%
Developed World	2.3%	1.7%	2.2%	2.1%	1.9%
Emerging Markets	4.6%	4.7%	4.5%	4.9%	5.0%
World	3.5%	3.2%	3.5%	3.6%	3.4%

Bloomberg Consensus Forecasts as of November, 2017

the economy has seemed to reignite economic growth: GDP growth is forecast to stabilize at around 1.3% in 2018.

One of the risks to Japan's economic picture involves trade with China. As China is Japan's largest trading partner, a slowdown in the Chinese economy would have repercussions in Japan. In this instance, trade tensions between the U.S. and China could have a spill over effect on Japan as well as on developing economies in the surrounding region.

A secondary risk to Japan's economic picture could arise should Japan's currency strengthen relative to other regional currencies. A rising currency makes Japan's goods more expensive to its trading partners. This would hurt the competitiveness of Japanese products, which could, in turn, hinder Japan's growth.

China

Virtually all economic indicators suggest China's economy is still firing on all cylinders. GDP growth was 6.9% in 2017. Strong growth has been accompanied by an expansion of corporate debt which is now estimated to exceed 160% of China's GDP. This understandably represents an area of concern. This, along with tariff tensions between China and the U.S., seems to be the primary risk to the Chinese economy.

Emerging Markets

As with China, the other emerging market economies expect strengthening economic growth in the coming year. India, which saw a 7.4% increase in GDP in 2017, has rolled out several policies which should further strengthen its underlying economic foundation over the long term. Its telecommunications, technology, and agriculture sectors are all thriving in this large global recovery.

According to the International Monetary Fund (IMF), Latin American economies excluding Venezuela saw a 1.9% increase in their GDP in 2017. Domestic consumption and exports were the main drivers of growth in 2017. Aided in part by improvement in commodity prices, current IMF forecasts project even stronger growth in 2018 with a current estimate of 2.5%.

Investments

U.S. Equities

After enjoying strong returns in 2017, returns for U.S. equities posted mixed first quarter results. After beginning the year with a strongly positive January and early February, returns turned sharply negative to close February and throughout March. U.S. small cap stocks, as measured by the Russell 2000 Index, ended essentially flat with a decline of 0.08% for the quarter. The large cap S&P 500 Index fell by 0.8%. Contributors to the market's slide included the expectation of rising interest rates, uncertainties relating to global trade and tariffs, and concerns about the potential for higher inflation on the horizon.

By and large, growth stocks rose while value-oriented stocks fell.

International Equities

Like U.S. equities, developed country international stock market returns began the quarter positively but saw reversals in the latter half of February and March. As measured by the MSCI EAFE Index, international small cap equities eked out a modest gain of 0.3% while international large caps posted a 1.4% loss. Returns for the euro zone declined by 1.9% while Japan rose 1% over the quarter.

Emerging market economies maintained their momentum coming out of 2017. As measured by the MSCI Emerging Markets Index, returns for these countries were up 1.5% in the first quarter. Latin America, as tracked by the MSCI EM Latin America Index, were a true bright spot with gains of 8.1%.

As the global economy continues to strengthen, the emerging market economies should see meaningful growth.

Fixed Income

As interest rates rise and concerns about increasing inflation heighten, fixed income assets tend to underperform. The Fed's plans for raising rates combined with a tighter U.S. labor market have increased fears that higher inflation is ahead. Inflation lowers the real returns offered by bonds. Both concerns create downward pressure on bond prices. For these reasons, bond returns across the credit and term spectrum saw negative returns in the first quarter.

Alternatives

Global Real Estate: Global Real Estate, which gained 8.6% last year, fell in Q1 to -5.5%. The category remained in positive territory for the twelve-month period.

MultiAlternatives: This category contains many types of funds. In aggregate, these posted a positve 1 year reaching 5.4% as measured by the Credit Suisse Hedge Fund Index. In the first quarter at 0.5%, most strategies began to feel the pressure of the equity & bond markets.

MLPs: A recent change enacted by the Federal Energy Regulatory Commission (FERC) on how Master Limited Partnerships (MLPs) are taxed may have a profound impact on their fundamental business model. This, in conjunction with the recent corporate tax cuts—from 35% to 21%—have pushed some of these MLPs to move to C corporation status. As more MLPs merge or convert to C corps, there are fewer companies in the underlying Alerian MLP Index. The Alerian MLP Infrastructure Index fell by 11.1% in the quarter—even as oil prices stabilized and rose by 5.1%, as measured by Brent crude oil prices.

Managed Futures: Managed futures have been an integral part of our alternatives strategy to reduce the portfolio's collective correlation to the equity markets, and to give us greater diversification. With this said, like many investments, managed futures experienced volatility during 2018's first quarter and declined roughly 3.8%, making them our second lowest performer, behind MLPs. Managed Futures were down 0.8% over the last twelve months.

Reinsurance: As a refresher, Reinsurance is made up of both Catasthrophe Bonds and Quota Shares. As the investor, you are earning the premiums on the insurance policies of natural disasters or perils. As measured by the SwissRe Global Cat Bond index, the first quarter posted positive returns of 1.4%. In the reinsurance world, the beginning of the year tends to be rather slow because the majority of the policies are taken out during the summer months when there is a greater chance for certain risks. The category exhibited poise while the U.S. Equity markets, S&P 500, where down over 3%. We believe this investment will add substantial diversificiation to the portfolio over the long-run.

Conclusion

The first quarter of 2018 saw continued domestic political strife, rising geopolitical tensions, a continuation of interest rate increases and, as a result: renewed market volatility. Nonetheless, we believe that the underlying fundamentals of our economy are still solid and we expect the economy to maintain a positive momentum. Keep in mind the economy and the stock markets don't always move in tandem—though markets are ultimately driven by corporate earnings and the strength of the economy.

Overall, while returns over the last twelve months remain quite positive, the quarter broke ranks and ended modestly down amid concerns for trade wars and general market volatility. As with any long-term oriented investment, it is important to maintain your discipline, stay true to a sound underlying investment strategy, and keep your focus on your goals.

As investment managers and financial planners, it is our hope that we can help you stay consistent and achieve those goals.

Thank you for allowing us to be of service to you and your family.

Your team at

THE LUBITZ FINANCIAL GROUP

Personal Financial Planning & Investment Management

Sources: The Conference Board, Ned Davis Research, The Wall Street Journal, Federal Open Market Committee (FOMC), the Federal Reserve Bank of San Francisco, The Economist, FocusEconomics, the Organization for Economic Co-operation and Development (OECD), the trade advocacy letter to Trump, Goldman Sachs, Bloomberg Consensus Forecast, the SunGard FAME database, Forbes, and the Bureau of Economic Analysis.