THE LUBITZ FINANCIAL GROUP

Market Watch
3rd Quarter 2015

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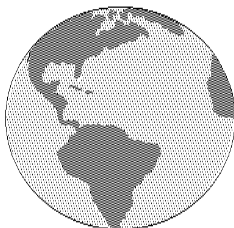
Summary

- Weak performance was evident throughout markets globally this quarter.
- The U.S. Gross Domestic Product increased at 3.9% annualized rate in Q2.
- As of September 30th, the annualized U.S. core inflation rate stood at 1.8% (core inflation excludes both food and energy). U.S. "headline inflation" was only 0.19% given the steep decline in energy prices. Europe's inflation rate declined reaching slightly negative territory.
- China's difficulty in transitioning its economy and opening up to freer markets hit some big snags this quarter. The impacts were felt throughout the global markets.
- China devalued its currency by 3% in an effort to boost its economic activity.
- The 10-year Treasury yield fell to 2.06% as many investors moved to the greater safety of U.S. government bonds.
- The U.S. employment rate dropped to 5.1%.



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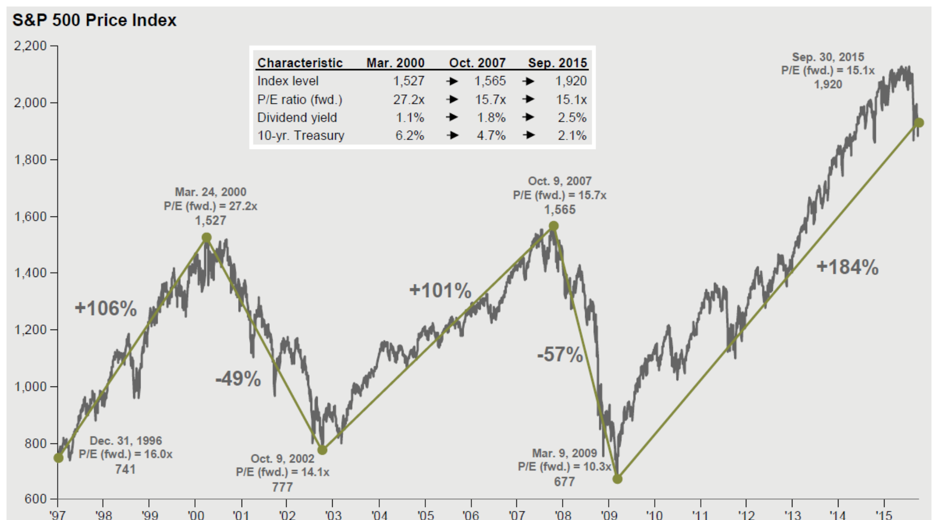
Overview: weak performance

U.S. stocks suffered through a disappointing 3rd quarter. After peaking in May, the S&P 500 dropped by as much as 12% before beginning to stabilize in September. The S&P finished the quarter down 6.44%. This was the first quarterly loss in eleven quarters and the worst quarterly decline since 2011.

No part of the market was immune from this pull-back. The Dow Jones Industrial Average finished the quarter down 6.98% while the technology-heavy Nasdaq composite showed even weaker results, falling 7.09%. International markets showed even larger losses. As measured by the MSCI Europe Australia Far East Index (EAFE), developed international markets declined by 10.19% in the third quarter. The Emerging Market economies experienced the greatest declines with the MSCI Emerging Market Index falling 17.78% for the quarter.



The U.S. bond sector was the winner this quarter as investors fled equities in favor of bonds. As the stock market fell, investors flocked to the safety of U.S. Treasuries. This pushed the yield on the 10-year Treasury down to 2.06% at quarter end. For the quarter, the Barclays's U.S. Aggregate Bond Index rose 1.23% and is up 2.94% over the last twelve months.

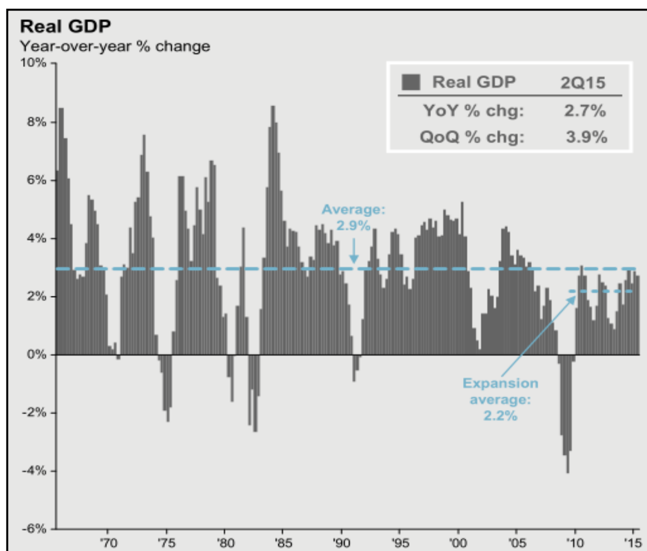
In August, China surprised the world's financial markets by devaluing its currency. This seemed to trigger investor fears that China's economy might be in worse shape than investors believed. Even the aggressive quantitative easing programs in Europe and Japan did not keep investors from selling stocks in response to their concerns about China's slowing economy.

U.S. Economy

As measured by Gross Domestic Product (GDP), the U.S. economy recovered in the 2nd quarter following a disappointing start to the year.

Year-over-year, GDP has risen 2.7% (based on Q2 data). Positive trends can be seen in an improving employment picture and rising consumer spending. Business spending (investment) has also been growing with stronger readings on construction, research and development, and business inventories. While still high, government spending has stabilized and deficits continue to decline. Although imports continue to exceed exports, this difference is shrinking. All of these trends bode well for the economy's future.

While there is a lot to applaud about the U.S. economy, some areas of concern have recently arisen. U.S.

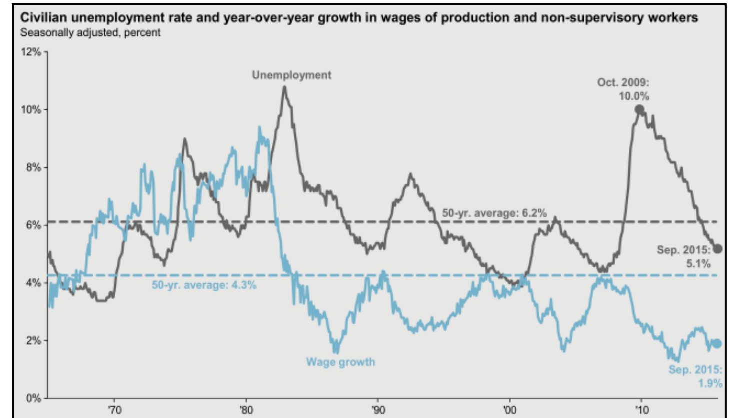


manufacturing activity has slowed and is now barely in expansion territory. What started out as oil-related weakness among energy companies may be spreading out to other industries as the stronger dollar combined with slower growth in international markets hurts foreign sales.

Employment

Although job growth slowed in September, the U.S. economy continues to add jobs. Our current unemployment rate held steady at 5.1%. The broader underemployment rate – which includes part-time workers who would prefer a full-time position and people who want to work but have given up looking – dropped to 10% from 10.3%. This gap between the unemployment rate and the underemployment rate continues to be a big concern for the Fed as it considers when to begin increasing interest rates.

As can be seen from the following chart, while the unemployment rate has fallen notably, wage growth has been quite stubborn and remains well below its historical rate of increase.



U.S. Housing

The housing market remains a bright spot. Steady job gains and historically low borrowing costs (the average 30-year, fixed-rate mortgage stood at 3.89% in September) are bolstering demand for new homes. Current housing stocks and new construction have not been sufficient to meet this demand. As a result, rising demand has pushed prices higher. The August S&P/Case-Shiller national Home Price Index rose 5% from the prior year.

It is not yet clear how the remaining inventory of foreclosed properties may affect housing prices as this inventory is added to the market. Should demand be able to absorb these additions, prices should remain stable or increase with time. This should help provide an underlying boost to keep the economy growing.

Federal Reserve

The Fed needs to increase interest rates—both to lower the financial imbalances created by artificially low rates and to give the Fed some flexibility to respond to any future economic downturn. But, raising rates today would further strengthen the dollar, (which, since June 2014, has already increased by roughly 20% relative to a basket of world currencies).

Higher interest rates would obviously increase government borrowing costs and add to our deficit. As importantly, a stronger dollar would restrict America's ability to sell products overseas and make it harder for dollar -based loans and purchases to occur. Both would place stress on the American economic recovery.

With the world's second largest economy (China) having joined both Europe and Japan as they all struggle to right their respective economies, the Fed therefore finds itself in a dilemma with no easy solution. As a result, at its last meeting in September, the Federal Reserve

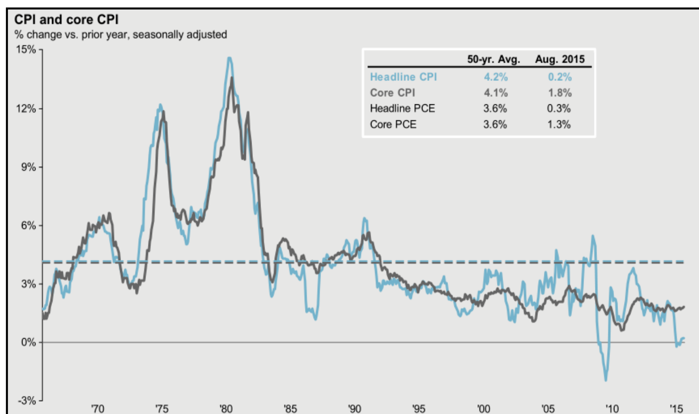
punted and kept interest rates unchanged. Experts are now split in their opinions on whether the Fed will finally begin to gradually rise rates beginning in December or sometime in the first part of 2016.

Consumer Confidence

Happy, confident consumers spend more. While attitudes among lower-income and middle-income households appeared to be more mixed in September, consumer sentiment remains positive. Despite volatility in the global stock markets and turmoil in the Middle East, improving U.S. economic conditions continue to bolster positive sentiment. Both the Conference Board and the University of Michigan's Consumer Sentiment surveys were strongly in positive territory, though the latter's results suggested some level of consumer concern.

Inflation

Inflation, which has persistently run below the Fed's 2% target rate, remained muted this quarter. August results showed core inflation to be up only 1.8% over the prior year while "headline" inflation, which excludes food and energy, was only up 0.19%..



Europe

Good news and bad news. The Eurozone economy expanded in the second quarter primarily due to the faster growth in Italy and Greece. Still, overall growth remained weak and the possibility of deflation continues to worry the European Central Bank. European GDP was up 0.4% in the second quarter and rose 1.2% year-over-year. While a Greek debt crisis was avoided, the unfolding migrant crisis from the war-torn countries of the Middle East has created another difficult political and economic test for the region.

The Eurozone's high 11% unemployment rate and nearly non-existent inflation add challenges to the area's economic growth prospects. Consumer prices in the 19-country bloc fell 0.1% from one year earlier (largely a consequence of cheaper energy). In response, the European Central Bank (ECB) has already signaled that it stands ready to expand quantitative easing if needed to avert future deflation. The ECB's current "quantitative easing" program, is injecting 1.1 trillion Euros ($1.2 trillion) into the Eurozone economy in an effort to stimulate growth. So far, the program has produced mixed results (as some would argue is the case in the U.S.).

Politically, extremist parties have been gaining more traction across Europe. Greece saw its leftist leadership reelected, signaling more resistance to Euro-centric solutions. Spain's unity was threatened with a vote to split Catalonia from the rest of Spain. France's right-wing seems to be gaining broad support from those tired of subordinating local interests to interests of the Euro bloc. None of this is encouraging for longer-term greater European unity.

Japan

Japan's economy shrank 1.2% on an annualized basis in the second quarter. Japan has been fighting a 25-year long recession. With its low birth rate, restrictive immigration policies and a worldwide slowdown in productivity growth, normal economic growth seems a distant goal. Deflation fears have added to Japanese worries over slow growth,. This has led the Japanese government to initiate its own "quantitative easing" program. Like Europe, Japan's QE program has yet to realize its intended objectives.

China

China, the world's second largest economy, has seen its growth rate slowing. China officially announced that GDP expanded by 7% in Q2,. While there have always been doubts about the validity of China's official reports, it is clear that the Chinese economy has continued to expand. Still, few questions that its rate of growth has slowed significantly. Given China's size and the amount of world trade in which China is involved, any slowdown will have an impact on global markets.

A recovering U.S. and an expanding China have kept the rest of the world afloat over the last few years. Accordingly, there is reason to be concerned if one of these engines falters. Meanwhile, the World Bank has cut its growth forecast for China by 0.3 percentage points to 6.7 per cent next year. While this level of growth would be enviable for any other economy, it does represent a slowdown for China. It remains to be seen whether this forecast may still be too optimistic.

In early 2014, China created new opportunities for its people (and some outsiders) to invest in the nation's economy. Over the next year or so, the local Chinese stock markets rose by more than 150%. This staggering rise

came to a halt in June of this year when these local markets began to fall—declining almost 40% in just a few months. Despite government attempts at intervention, investor confidence continued to erode and the Chinese markets continued to tumble. Ultimately, in August, China surprised the world by devaluating its tightly controlled currency by 3%. Done in hopes that a weaker currency could help flagging exports when other efforts to boost the economy hadn't proved effective, the devaluation seemingly signaled the government's growing worry about the slow growth of its economy. This sent world markets tumbling.

The faster-than-expected slowdown in China has been rippling around the globe. It has contributed to a fall in commodity prices and exacerbated economic slowing in a number of other developing countries. For example, commodity-driven economies such as Brazil and Russia, are now forecasted to face a much deeper recession as these counties are hit by lower revenues, rising borrowing costs, and capital outflows.

Investments

U.S. Equities

All major U.S. market indices experienced high volatility during the quarter and finished in negative territory. The S&P 500 was down 6.44% for the quarter and is now down 5.29% year to date. All major sectors of the economy posted negative quarterly returns. The Energy and Material sectors were among the weakest, losing 17.4% and 16.9% during the quarter.

Still, one chapter does not a story make. Including this most recent quarter, the S&P 500 index has now risen 226% from its March 2009 lows (including dividends) and it ended the quarter 45.9% above its October 2007 peak.

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 15.1 times forecasted earnings. This is below the 25-year average of 15.7 and an argument for saying that the U.S. stock market is currently fairly priced. The S&P's dividend yield at quarter end was 2.5%.

Historically, small company stocks outperform their larger brethren—as was the case for the first half of this year. However, small company stocks have more uncertainties associated with their businesses and are thus more volatile by their nature. As economic and geopolitical worries rose in the third quarter, small stocks fell more than large and now trail large company performance year-to-date and as was the case in 2014.

As fundamental optimists, our expectation is that this recent downturn will be short-lived (early October performance has been encouraging in this regard). This said, with dividend yields and price-earnings multiples already near historical averages, the only thing likely to push stock prices higher will be earnings. Recent earnings levels are already at or near record highs. With the headwind of a stronger dollar and a slow-growth economy, it would not be unreasonable to expect positive but below average returns from stocks over the next few years.

International Equities

International markets have continued to struggle to find positive news. They were nicely ahead of U.S. markets in the first half of this year, but the MSCI EAFE index, the most widely-used international index, declined 10.19% for the third quarter. Year to date, European markets have declined 4.91% in dollar terms (0.6% in local currencies). Japan posted a loss of 11.7% during the quarter but is up 0.48% year to date for U.S. investors.

The MSCI Emerging Markets Index (traditionally more volatile than the developed market indices), showed exceptionally weak results and was down 17.78% during the third quarter. All of the major Emerging Market economies (Brazil, Russia, India and China) were negative for the quarter. Year-to-date, the MSCI Emerging Markets Index is down 15.22%.

	YTD		2014	
Country / Region	Local	USD	Local	USD
Regions / Broad Indexes				
All Country World	-3.8	-6.6	9.9	4.7
U.S. (S&P 500)	-	-5.3	-	13.7
EAFE	-0.6	-4.9	6.4	-4.5
Europe ex-U.K.	2.9	-3.1	7.4	-5.8
Pacific ex-Japan	-6.4	-15.4	5.8	-0.3
Emerging Markets	-6.9	-15.2	5.6	-1.8

Fixed Income

During the 3rd quarter, prices in nearly all major bond sectors rose. This reflected investors' flight to safety as equity markets became more volatile. When more money looks to buy bonds (or anything), prices rise. Since the interest rate is fixed once a bond is issued, when prices rise the yield (interest rate divided by current market price) falls. For example, the 10-year Treasury yield declined over the quarter from 2.35% in June to 2.06% in September. During this period, the price of existing 10-

year treasuries rose by 2.9%. For the quarter, the overall U.S. bond market (the BarCap Aggregate Bond Index) went up by 1.23% and is now up 1.13% year-to-date.

Treasury Inflation-Protected Securities (TIPS) reflect investor concerns about the future inflation trends. Along with that, they are often less sensitive to interest rate movements. TIPS declined by 1.15% during the 3rd quarter period and are down 0.8% during the last nine months.

Emerging market debt posted slightly negative results in the last quarter as dollar-denominated Emerging Market bonds lost 0.92%. The category is essentially flat year-to-date at 0.05%.

2014	YTD
REITs 28.0%	Fixed Income 1.1%
Large Cap 13.7%	Cash 0.0%
Fixed Income 6.0%	High Yield -1.9%
Asset Alloc. 5.2%	Asset Alloc. -4.4%
Small Cap 4.9%	REITs -4.5%
Cash 0.0%	DM Equity -4.9%
High Yield 0.0%	Large Cap -5.3%
EM Equity -1.8%	Small Cap -7.7%
DM Equity -4.5%	EM Equity -15.2%
Comdty. -17.0%	Comdty. -15.8%

Alternatives

Most alternative holdings declined during the third quarter on 2015:

- The Alerian Master Limited Partnership Infrastructure Index, which tracks energy transportation and storage facilities, lost 22% during the quarter (down 30.60% year-to-date). We think investor psychology has overwhelmed fundamentals in the decline of this sector. While risks are present, we believe the fundamentals of the sector will ultimately be reflected in the returns.
- Global real estate, represented by the NAREIT Real Estate Global Index, was down 3.18% for the quarter and is down 5.03% year-to-date. Real estate has been a long-term solid performer and we're confident it will continue be so.
- Timber, as measured by the FTSE NAREIT Timber REIT, posted a 9.81% loss for the quarter and is down 17.45% year-to-date. Lower export levels and timber prices have weighed on this sector. Still much of the success of this sector remains tied to domestic construction activity. While construction activity is up from earlier years, it is still well behind historical averages. While timber is a volatile investment category, we continue to believe in its ability to contribute to longer term portfolio performance.
- Commodities (the basket of energy, precious metals, agriculture and livestock) was down 14.47% for the quarter and is negative 15.8% year-to-date. There continues to be headwinds arising from a strengthening dollar and weakened demand due to a slowing in emerging economies.
- Managed Futures, as measured by S&P Diversified Trends Indicator, were down 3.37% for the quarter and are negative 4.25% for the year. Managed futures have historically been the "ideal" alternative strategy due to its positive returns and complete lack of correlation with stocks.

Summary

Overall, this was a very difficult quarter, with the exception of most bond categories. It's never fun to see your hard-earned money fall in value. We take very seriously the responsibility you have handed to us to protect and grow your assets. Part of our responsibility is help you establish a long-term vision of what you want to accomplish and to impose an important level of discipline to help you realize that vision. This discipline requires both a sensitivity to what is going on currently and a perspective on asset class behavior and market performance. We want to employ sound strategy while ensuring we do not over-react to temporary events.

All investments go through cycles. Virtually all of the research suggests that a) being diversified serves investors well over time; and that b) trying to move in and out of holdings does not work well over time. We base all our decisions and recommendations on well-researched concepts and the data that is necessary to be well-informed. Over time, we believe that this approach has and will again serve you very well.

We thank you for your confidence and allowing us to be of service to you.

The Team at
The Lubitz Financial Group

Sources: Morningstar, JP Morgan Asset Management, Reuters, Blooomberg.com, NYtimes.com, U.S. Bureau of Labor Statistics, www.ft.com, www.seekingalpha.com