THE LUBITZ FINANCIAL GROUP

Market Watch
1st Quarter 2016

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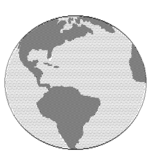
Summary

- US markets fell 13.3% in January and early February, raising concerns that a recession could be on the horizon. These concerns were further amplified by China's turmoil, the rising dollar, and worries over US corporate earnings.
- Alternative investments were generally positive for the quarter, led by emerging market bonds, global real estate and timber.
- Value stocks finally outperformed growth stocks at all levels. Large company value stocks were up 1.6% for the quarter versus 0.7% for growth. Smaller stocks were more dramatic, with value outperforming growth 1.7% to -4.7%.
- Bonds benefitted from a "flight to safety" arising from the recession worries. All bond categories rose for the quarter and all were positive for the year.
- Portfolio results for the twelve month period still look bad as they include the difficult middle quarters of 2015.
- Consumers are primed to help the US economy continue to grow: sentiment is positive, debt is low and housing values and net worth have been rising.



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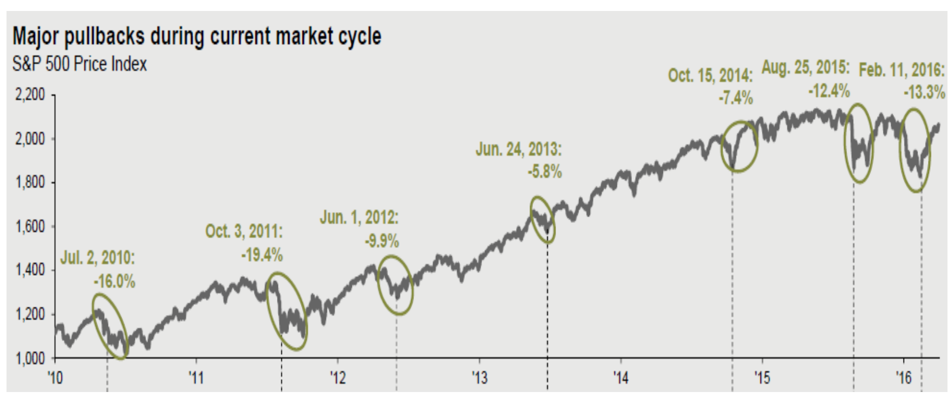
Overview

As you look through your report this time, you'll see a lot of negative numbers. We report performance on a twelve-month period, which this time is the period from April 1, 2015 to the end of March of this year. The second and third quarter of 2015 and Jan. 2016 were particularly difficult and overwhelm the 12-month numbers herein. But, the final quarter of 2015 was actually reasonably positive despite the negativity of the first several weeks of 2016. The turn-around at the end of the quarter may, in fact, represent a turn-around. At the end of the quarter, oil prices were strengthening, the dollar was weakening, consumer sentiment was strengthening, China's troubles were stabilizing and value was once again outperforming growth. Despite the negative numbers for the 12-month period, we think there is reason for an improved outlook.

Despite a tough start, the quarter ended moderately positive

The first quarter of 2016 had nearly everyone worried as it began, with stock markets around the world suffering sharp market declines throughout January and well into February (the biggest pullback since 2012). But by the end of March, most markets had nicely recovered.



Despite touching two-year lows in February, the S&P 500 and Dow Jones Industrial Average indexes finished the first quarter slightly higher than at its beginning—up 1.35% and 2.2% respectively. However, other closely watched U.S. market indexes ended the quarter in negative territory. The tech-heavy NASDAQ was still down 2.43% and the small U.S. company Russell 2000 fell 1.52% for the quarter.

As in the U.S., international equities experienced broad sell offs during the first half of the quarter and also recovered in the last few weeks of the quarter. Developed non-U.S. markets (the MSCI Europe Australia Far East Index—EAFE) fell more than 10% early on but came back to finish down 2.88%. Emerging Market economies experienced even greater declines during the quarter, but also enjoyed the strongest recovery, finishing the first quarter 2016 up 5.75%

With investors concerned about the equity markets, US bonds benefitted from a "flight to safety". Bond prices rose as the ten-year Treasury yield fell to its lowest end-of-quarter level since the fourth quarter of 2012 (as a reminder, when bond yields fall, bond values rise). Yields on ten-year Treasuries opened the quarter at around 2.27%, but ended it at 1.78% as continued demand drove prices higher.

The stark differences in the first and second halves of the quarter arose primarily for two reasons:

- Oil prices began to recover. They hit a low in the mid-$20s before rising to around $40 by the end of the quarter. This helped lift stocks in the U.S. energy sector and provided a big boost to commodity-exporting Emerging Market economies such as Brazil and Russia.
- The Fed retreated on its intention to raise interest rates. They announced that overall economic conditions were not improved enough to justify a second interest rate hike at least until summer.

The U.S. Economy—Muddling Along

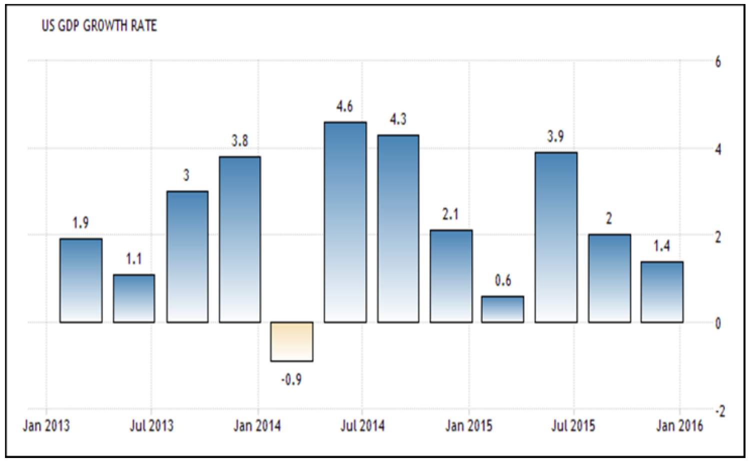
The U.S. economy grew in the fourth quarter at a faster pace than previously estimated, supported by stronger household spending that helped cushion lower than expected export results due to weakness overseas. While the economy is not running on all cylinders, it continues to grow at a modest pace. For the first few weeks of the year, fears about China, falling oil prices, and weak corporate earnings seemed to portend a stalling economy and concern about an upcoming recession were widely trumpeted.

More recently, U.S. manufacturing PMI data has steadied, construction spending has perked up and the latest inflation and unemployment indicators appear favorable.

Forecast on GDP

According to the Commerce Department, the U.S. Gross Domestic Product (GDP) increased at 1.4% annual rate in the fourth quarter and expanded at 2.4% for all of 2015.

Consumer spending continues to account for roughly two-thirds of our national GDP and consumer spending continues to rise (attributable to rising incomes, and improving circumstances in both employment and the housing market). With cutbacks in government spending having slowed, the economy currently has more positive than negative influences.



The strength of the dollar has been a headwind to our export markets as this has made American products more expensive for our trading partners. It was therefore something of a relief when the dollar weakened in the last half of the quarter.

Goldman Sachs currently forecasts US gross domestic product (GDP) growth will average 1.2%, low but still on the positive side. Longer term, growth in GDP will come from two sources: growth in our working population and improvements in productivity.

The last decade saw the slowest growth in the US civilian workforce in many decades. This was accompanied by low investment levels in the infrastructure and technology needed to create productivity improvements. These two factors lead some economists to predict continued lower economic growth rates going forward.

Note: If you are interested in the impact of demographics on economic growth rates, an excellent interactive source can be found at http://www.researchaffiliates.com/Our%20Ideas/Insights/DemographicsMarkets/Pages/Home.aspx

Consumer sentiment

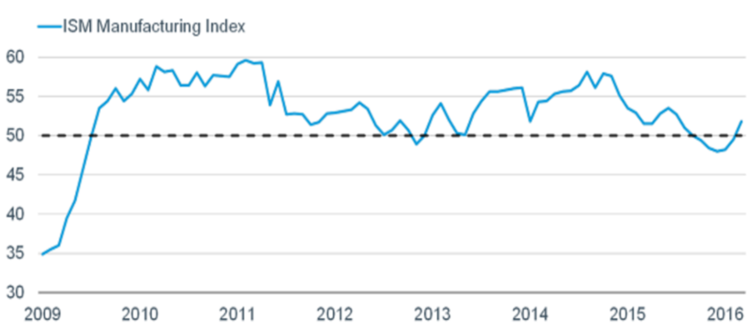
American consumers are in generally good shape. Household net worth is higher than it has ever been and debt payments as a percentage of disposable personal income is as low as it has been in at least 35 years (source: JP Morgan). Many analysts believed that falling oil prices would be a further boon to consumers –

acting like a tax cut for consumers and fueling spending and growth. There is often a lag in when this starts to happen, and on cue, consumer confidence seems to have picked up during the first quarter.

The Conference Board Consumer Confidence Index for March rose to 96.2 following February's index reading of 94.0. Consumers expressed favorable views on the labor market and business conditions, but remained concerned with the overall economic outlook.

Manufacturing

One of the more hopeful signs recently has been manufacturing. As can be seen in the chart below, the March ISM Manufacturing Index rose to 51.8 in March from 49.5 in February (any number above 50 indicates growth). This was the highest level since last summer. The details within the report were strong, with new orders showing a particularly large increase. It appears to that the recent stabilization in oil prices and the very recent decline in the dollar are improving prospects for the U.S. manufacturing sector.



Employment

Continued improvement in the labor market suggests that the economic trends remain positive. Jobs continue to be added at a healthy pace, at 5%; unemployment is low; a higher percentage of Americans are working; and average hourly earnings have been rising faster than expected.

Inflation

According to the latest Labor Department data, the Consumer Price Index (CPI), excluding the volatile food and energy components, rose to the 2.3% annualized rate in February. For the first time since 2012, the U.S. economy experienced the core CPI number above the Fed's 2% target rate for three consecutive months.

Recession?

Lately, there has been talk about an "imminent recession" from Donald Trump and others. We are not in this camp. As Liz Ann Sonders, the Chief Investment Strategist at Schwab says, "even though this expansion is getting long in the tooth in terms of number of years, economic expansions don't die of old age. They die of excess—typically in growth, inflation, capital spending, monetary policy tightening, etc. If there is one benefit to such a sluggish expansion since mid 2009, it is that excess does not appear to abound."

The World Economy

The first quarter marked a reversal from 2015's best and worst performing world economies. While the developed world led performance in 2015, leadership in Q1 of 2016 was turned over to the commodity-oriented Emerging Markets. This change was driven by the turnaround in oil prices, which rebounded from a low in the mid-$20s to around $40 at the end of the quarter. That, in turn, strengthened EM currencies and lifted stock prices of commodity-exporting countries, such as Brazil and Russia.

In the Eurozone, economic expansion continued at a modest pace thanks in part to an additional €20 billion per month being injected into the economy by the European Central bank (ECB). Japan tried its own stimulus approach, lowering key interest rates below zero in January, in hopes it would encourage more bank lending. China continued to struggle with its many political and economic issues, but it also released its budget which projected growth continuing above 6%.

Europe

Eurostat data shows that in the last three months of 2015 the aggregate economy of the 19 countries sharing the euro zone, grew by 0.3% and by 1.6% for the year (compared to 0.9% growth in 2014). While Europe has had to contend with migrant, terrorism and governance issues, economic recovery seems to be strengthening after a deeper and longer recession than was experienced in the U.S.

While things are slowly improving, the average Eurozone unemployment rate has stayed above 10% for more than six years. Moreover, the difference between countries remains significant. The jobless rate is near or above 20% in Spain, Greece and Italy while Germany's unemployment rate is 4.3%. Europe is also being threatened by populist appeals including the possible departure of the U.K. from the European Union and Spain's struggle to form a new government.

Japan

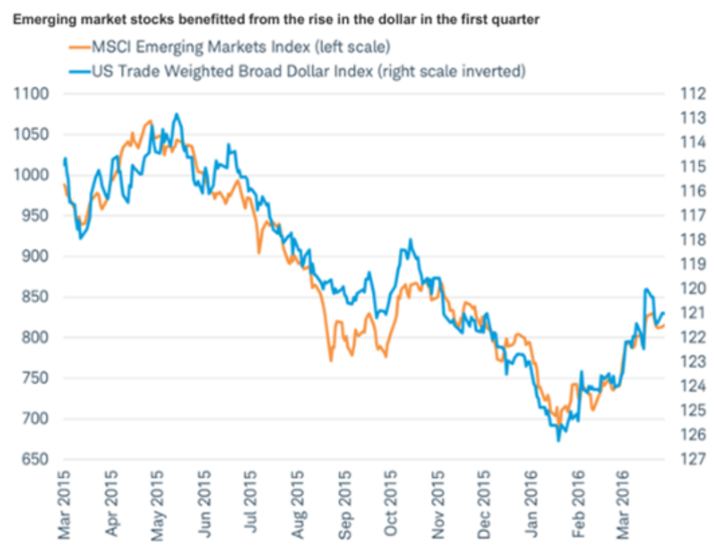
As in Europe, Japan is struggling to right its economy. The Bank of Japan joined other poor-performing economies in January when it lowered key interest rates below zero. This desperate approach to jump-starting the economy remains unproven in its effectiveness and both the Japanese stock market and the overall economy could suffer if the strategy doesn't work. [If the economy wasn't stimulated by near zero interest rates, will it really respond differently if the rates move a tiny bit lower?] Initial indications are that Japan's GDP contracted at a 1.1% annualized pace in the last quarter.

China

The health of China's financial system remains a concern, with large amounts of capital leaving the country monthly and freedoms being clamped ever tighter. While the economy posted 6.9% growth in 2015, this was its lowest reading since 1990. The preliminary first quarter GDP number of 6.6% suggests a continuing economic slowdown as China moves from an export-driven, low cost economy to one increasingly driven by internal consumption. While still an attractive growth rate, as it focuses increasingly on its own internal needs China is unlikely to remain, as much as it has recently been, a prime driver in the economies of its trading partners. And, given its current policy mix China's struggles are likely to continue.

Elsewhere

As can be seen in the chart below, strength of the dollar is tightly tied to the strength of Emerging Market equity returns. Fortunes of the BRIC economies (Brazil, Russia, India and China) turned in mid-Q1 of 2016 when the dollar began to weaken the U.S. deferred further interest rate increases and oil prices began to rise.



Characteristics of bull and bear markets

Market Corrections	Bear markets			Macro environment				Bull markets		
	Market peak	Bear return*	Duration (months)*	Recession	Commodity spike	Aggressive Fed	Extreme valuations	Bull begin date	Bull return	Duration (months)
1 Crash of 1929 - Excessive leverage, irrational exuberance	Sep 1929	-86%	33	◆			◆	Jul 1926	152%	38
2 1937 Fed Tightening - Premature policy tightening	Mar 1937	-60%	63	◆		◆		Mar 1935	129%	24
3 Post WWII Crash - Post-war demobilization, recession fears	May 1946	-30%	37	◆			◆	Apr 1942	158%	50
4 Flash Crash of 1962 - Flash crash, Cuban Missile Crisis	Dec 1961	-28%	7				◆	Oct 1960	39%	14
5 Tech Crash of 1970 - Economic overheating, civil unrest	Nov 1968	-36%	18	◆	◆	◆		Oct 1962	103%	74
6 Stagflation - OPEC oil embargo	Jan 1973	-48%	21	◆	◆			May 1970	74%	32
7 Volcker Tightening - Whip Inflation Now	Nov 1980	-27%	21	◆	◆	◆		Mar1978	62%	33
8 1987 Crash - Program trading, overheating markets	Aug 1987	-34%	3				◆	Aug 1982	229%	61
9 Tech Bubble - Extreme valuations, .com boom/bust	Mar 2000	-49%	31	◆			◆	Oct 1990	417%	115
10 Global Financial Crisis - Leverage/housing, Lehman collapse	Oct 2007	-57%	17	◆	◆	◆		Oct 2002	101%	61
Current Cycle								Mar 2009	204%	86
Averages	-	-45%	25					-	152%	54

Brazil is in the midst of a political crisis as its president Dilma Rousseff faces a potential impeachment process. Still, Brazil's long-term opportunities seem attractive should Brazil experience meaningful political change.

Russian financial stability remains a concern, particularly with uncertain oil and commodity price outlooks. While Putin remains popular, his staying power will increasingly rely on economic recovery.

India remains a relative bright spot within the BRICs economies and is well positioned with regard to external financing needs. India is faring well in terms of productivity gains and could continue to present infrastructure development opportunities.

Investments

U.S. Equities

All major U.S. stock market indices experienced a volatile 1st quarter. Both the Standard & Poor's 500 and Dow 30 Industrial indexes were down more than 10% at the mid-point in the quarter, but recovered to finish the quarter up 1.35% and 2.2%, with the defensive sectors Telecom and Utilities performing best. The S&P 500 is now 58.3% above its prior high point before the Great Recession (in other words, it has taken nine years to get total growth of 58.3%).

The U.S. market appears to be reasonably priced. Using the forward P/E (current stock price divided by estimated future earnings over the next twelve months), the S&P 500 is now priced at 16.6 times forecasted earnings versus the index's 25-year average of 15.8. The current dividend yield for the S&P 500 stands unchanged at 2.3%.

One of the issues that has caused our portfolios difficulty in recent years has been how Growth stocks have out-performed Value stocks. Our portfolios overweight value so this has been a drag in the recent past. In the first quarter of this year, as can be seen in the chart below left, Value finally produced the better results, as they have on average for the last century of investing.

1Q 2016

	Value	Blend	Growth
Large	1.6%	1.3%	0.7%
Mid	3.9%	2.2%	0.6%
Small	1.7%	-1.5%	-4.7%

2015

	Value	Blend	Growth
Large	-3.8%	1.4%	5.7%
Mid	-4.8%	-2.4%	-0.2%
Small	-7.5%	-4.4%	-1.4%

2015	YTD
REITs 2.8%	REITs 5.8%
Large Cap 1.4%	EM Equity 5.8%
Fixed Income 0.5%	High Yield 4.1%
Cash 0.0%	Fixed Income 3.0%
DM Equity -0.4%	Large Cap 1.3%
Asset Alloc. -2.0%	Asset Alloc. 1.3%
High Yield -2.7%	Comdty. 0.4%
Small Cap -4.4%	Cash 0.1%
EM Equity -14.6%	Small Cap -1.5%
Comdty. -24.7%	DM Equity -2.9%

International Equities

For American investors, the relative valuation of the dollar versus other currencies is an important investment consideration. When the dollar strengthens, it makes travelling abroad cheaper, but it also causes overseas earnings and stock prices to be worth less in dollar terms. For example, if the dollar's value increased by 4% versus the euro, a 10% return in France would only be a 6% return to a US investor. Conversely, if the dollar's value were to fall by 4% instead, the French stock would provide a 14% return to that same investor.

With currency differences in mind, one can understand the impact of a strong dollar to US investors holding international investments. Since mid 2014, the dollar has increased by roughly 20% against other global currencies (in some cases, the increase has been much more substantial). As the dollar has strengthened, returns from our international holdings have suffered. We know that this will not always be so. Toward the end of the first quarter, the dollar did indeed begin to weaken relative to other global currencies.

Despite some dollar weakness at quarter's end (favorable for US investors), international markets still posted mixed results. Most developed economies posted negative results in both local currency and in dollar terms. In the first quarter of 2016, developed international markets (represented by the MSCI EAFE index) fell 2.9% for American investors (down 6.4% in euro terms). Japan experienced the weakest performance among developed economies. Year to date, Japan was down 6.4% in dollar terms and 12.5% for Japanese investors. Over the last 15 years, the MSCI EAFE index has risen by 4.8% annually (compared to the S&P 500's rise of 5.99% per year).

The MSCI Emerging Markets' returns (traditionally more volatile than the developed markets) benefitted from both a weaker dollar and a rebound in oil and commodity prices. During the 1st quarter, the Index grew 2.8% in local currency and was up 5.8% for U.S. investors making it our second best performing stock category. The rebounds in commodity and oil prices have boosted the growth prospects of exporters such as Brazil (up 28.6% in dollar terms) and Russia (up 15.8% in dollar terms), whose economies are highly dependent on commodity exports.

That said, China and India were struggling with their own economic headwinds. China's market was down 4.8% while India's fell 2.5% in dollar terms (both counties showed negative returns in 2015). Over the last 15 years, the Emerging Markets asset class has been one of the strongest equity sectors, offering investors who could stomach the volatility a compound annual return of 9.69%.

Fixed Income

The bond market continued its strong performance into 2016. In theory, the expected increase in interest rates this summer should have pushed bond yields higher, making bond values fall. However, during the volatile first quarter of 2016, Treasuries (usually perceived a "safe heaven") were in very high demand among investors who were seeking extra protection from the turbulent stock market. This pushed bond values higher, and thus yields fell. Since bond returns are a combination of the interest received (the yield) and the price change, bond returns this quarter were strong.

	1st Qtr	1 Year	3 Years
Ultra ST Bonds	0.46%	0.57%	0.46%
Short Term Bonds	0.98%	1.04%	0.95%
Short Term TIPS	2.14%	1.53%	-0.48%
Interm US Bonds	2.45%	2.06%	4.91%
Foreign Bonds Hedged	3.78%	2.86%	4.92%
Intermediate TIPS	4.84%	2.18%	-0.89%

As can be seen from the chart below left, during the 1st quarter, returns for all major U.S. bond sectors were positive.

On a side note, we have been doing extensive research in the global fixed income marketplace and have decided to delegate the asset allocation decision in the more volatile bonds, such as emerging market debt, high yield bonds, TIPS (Treasury Inflation Protected Securities) and others to a group of multi-sector bond managers in our client's portfolios. We believe that with the specter of rising interest rates and the resulting increased volatility, we are presented with both rising risk and rising opportunity. We believe that specialist bond managers are better equipped to make the sector rotation decisions than we are.

Most Alternatives weathered the tough start to 2016 and ended with positive quarterly results

Alternatives

In building an investment portfolio, it is desirable to have a variety of investments which each can add positively to returns but which are driven by different factors, causing them to rise or fall at different times and for different reasons. This "non-correlation" of investments hopes that most of the time there will be a few strategies that "zig" while others are "zagging." It is for this reason that Alternatives are expected to both improve overall returns and lower portfolio volatility. But it's worth remembering that since these different investments are largely independent of one another, it is still very possible that at times they will move in similar directions. When they all struggle, as it has seemed to do the last couple of years, or when they all rise in unison, it does not disprove the concept. Just as many things seemed to reverse trends in February, we think there are important indications that the tough period Alternatives have experienced recently may also have turned.

Like the economy in general, most Alternative holdings fell in the first part of the quarter and came back up to produce largely positive returns during the first quarter of 2016. MLPs had a similar ride, but the early drop was more severe, thus they were unique in ending the quarter down.

- **REITs**—Publicly listed real estate companies around the world, represented by the NAREIT Global Real Estate Index, rose 5.08% over the quarter, bucking the negative trends that made up the recent twelve-month period. Global real estate was up 0.59% over the full year.
- **MLPs**—The Alerian Master Limited Partnership Infrastructure Index, which tracks energy transportation and storage facilities, lost 5.65% for the quarter and is down 32.11% for the last 12 months' period. MLPs have tracked the price of oil, and thus showed a nice recovery at the end of the recent quarter, but not enough to overcome the big drop at the start of the quarter. Despite the severe tumble of the last couple of years, as we have expressed in recent emails, we continue to believe in the fundamentals of this business strategy and in its investment future.
- **Managed Futures**—As measured by the S&P Diversified Trends Indicator Index, which represents this category, fell minimally for the quarter but declined 4.92% for the 12-month period.
- **Merger/Arbitrage**—While the returns the last few years have not been exciting, this sector's stability is what attracts us. In 2008, when the S&P fell nearly 40%, the fund lost only 2.3%. Returns for this category were up 2.18% for the quarter and 4.23% for the full year. Returns are expected to increase as interest rates rise.
- **Timber**—As measured by the FTSE NAREIT Timber REIT, posted positive results for the quarter – up 5.33%, and is up 1.91% for the last 12 months. The big news in this sector was that the second largest Timber REIT (Plum Creek Timber) was acquired by the largest one (Weyerhaeuser) with that transaction being finalized in Q1.
- **Emerging Market Debt—**Fundamentals for Emerging Market bonds generally remain under pressure due to slow growth, exposure to the commodity downturn, and uncertainty about China's financial and structural reform efforts. Despite weak longer-term fundamentals, dollar-denominated Emerging Market bonds had a positive quarter. Emerging Markets Bonds (issued in dollars) were up 5.94 % during the quarter and up 5.88% for the last year.

Summary

Looking ahead to the second quarter, more volatility is the most likely outcome. While the reversal during the second half of the first quarter may continue to lift stocks, the value of the dollar and oil prices will likely weigh on stock market performance. A bright spot could be an increasing inflation expectation, which was above Fed's 2% target rate for the three consecutive months. Higher inflation is likely to help lift longer-term interest rates, therefore widening banks' profit margins on lending, which could support a stronger growth outlook.

A key message from the first quarter is a reminder that double-digit stock market pullbacks are common and don't necessarily mean stocks are headed for a prolonged and deep bear market. In fact, the world's stock market went through a decline of more than 10% during more than two-thirds of the past 35 years and yet more than half of the time those calendar years ended with a gain. Not overreacting to short-term pullbacks is critical to long-term investing success. Having a well-designed portfolio is important, but the ability to stay disciplined through the market's inevitable ups and downs is paramount. That includes avoiding the temptation to chase the markets for fear of missing out, as well as resisting the urge to sell when markets correct. Here at The Lubitz Financial Group it is our job and duty to be with our clients during the times of uncertainty and remind you to stay the course.

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

Your Team at
The Lubitz Financial Group

The Lubitz Financial Group
PERSONAL FINANCIAL PLANNING & INVESTMENT MANAGEMENT

Sources: *Morningstar, JP Morgan Asset Management, Reuters, Bloomberg, Charles Schwab, NY Times, U.S. Bureau of Labor Statistics, Thebricspost.com*