



October 2018

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Summary

- The United States and China continued their tit-for-tat tariff war, which has adversely impacted major parts of both economies.
- According to some estimates, the Brexit decision has cost the U.K. nearly 500 million British pounds per week, putting an unnecessary drag on its economy.
- U.S. GDP is expected to rise 4.4% year over year, but slowing to 3% or less by the end of 2019.
- The Federal Reserve continues to raise interest rates in line with its quantitative tightening tactic. At least one more additional rate hike seems to be on the horizon.
- The European Union has reversed its earlier policy and has begun to tighten their monetary supply, joining the U.S. in pulling away from monetary expansionist policies.
- Money has been pouring into the poor performing liquid alternatives space, as investors look for non-traditional returns in an overheated economy.
- Unemployment in the U.S. has dropped to 3.7%, reaching its lowest level since 1969.



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Overview

Although 2018 has proved no match for the boisterous returns of 2017, economic conditions in the U.S. remain positive, while those abroad have taken a turn for the worse. Many of the returns produced by U.S. equities can be largely attributed to major technology stocks such as Apple, Amazon, Microsoft, Google, and Netflix, all of which have contributed to handsome gains for U.S. large cap stocks. The U.S. large cap Russell 1000 Index posted a 7.4% return for the 3rd quarter. This brings the index's year-to-date return up to 10.5%.

On the other hand, international stocks, and especially emerging market stocks, have seen declines. Developed country international stocks, as represented by the MSCI EAFE Index, posted only modest gains of 1.4% for the quarter and have declined 1% year-to-date. The emerging markets fared worse with the MSCI Emerging Markets Index reporting losses of 1% in the quarter and 7.4% year-to-date.

As interest rates and inflation rise, bonds struggle. Intermediate bonds have posted losses year-to-date, with short term bonds inching just north of zero with a gain of 0.4% year-to-date.

Overall, for American investors with diversified portfolios, this has been a frustrating period. The headlines announce a strong economy and rising markets, but total portfolio results are minimal, at best.

The U.S. Economy

GDP Forecast

The U.S. gross domestic product (GDP) is expected to continue its climb, with the Atlanta Federal Reserve projecting GDP to be 4.4% year over year for the third quarter of 2018. This will mark the third straight quarter that GDP has been above the 4% line.

The U.S. economy continues to thrive, despite trade wars with China, shaky trade agreements with our North American neighbors, and increasing interest rates that are no longer accommodative. Overall, consumer confidence remains high.

Interest Rates and the Federal Reserve

The Federal Reserve's September meeting produced another interest rate hike. The federal funds rate has now reached 2.25%. There was some fuss made over the Fed's decision to discontinue using the word "accommodative" as a descriptor for its monetary policy. In point of fact, in an effort to avoid an overheated economy, Federal Reserve Chairman Jerome Powell has indicated there is likely to be one more rate hike before year-end.

A concern amongst many economists and investors is the possibility that an "inverted yield curve" could develop. An "inverted" curve develops when short-term interest rates are higher than longer-term rates. This condition has often been a signal of impending economic slowdown. We believe this should not be a cause for current concern—one year rates today are well below 10 year treasury



yields. We expect the positive earnings environment and residual fiscal stimulus impacts to help maintain the economy’s strong trajectory.

Expectations for Inflation

Over the past few years, inflation has held relatively steady at a level of around 2% (the Federal Reserve’s target rate for inflation). Headline CPI, the Fed’s main inflation indicator clocked in at 2.2% for the third quarter. As labor markets continue to tighten and the economy continues to grow, we may see inflation begin to increase as we head into the final quarter of 2018. As reported by Ned Davis Economic Research, increases in wages, point to upward future pressure on the prices of goods and services.

nationalist movements emerged in a number of countries and the Italian economic picture continued to weaken. The ongoing uncertainties associated with Brexit have also continued to weigh heavily on the EU — particularly in Ireland. Complicating things further, the European Union is expected to end its period of quantitative easing in the coming months. While this will align the EU’s monetary policy with that of the United States, it could also result in some slowing of GDP growth in the Union. Unemployment in the European Union has remained stable at 8.5%, while GDP increased 0.6% year over year. As reported by the Financial Times, economic growth in Britain has significantly lagged its G7 counterparts. .

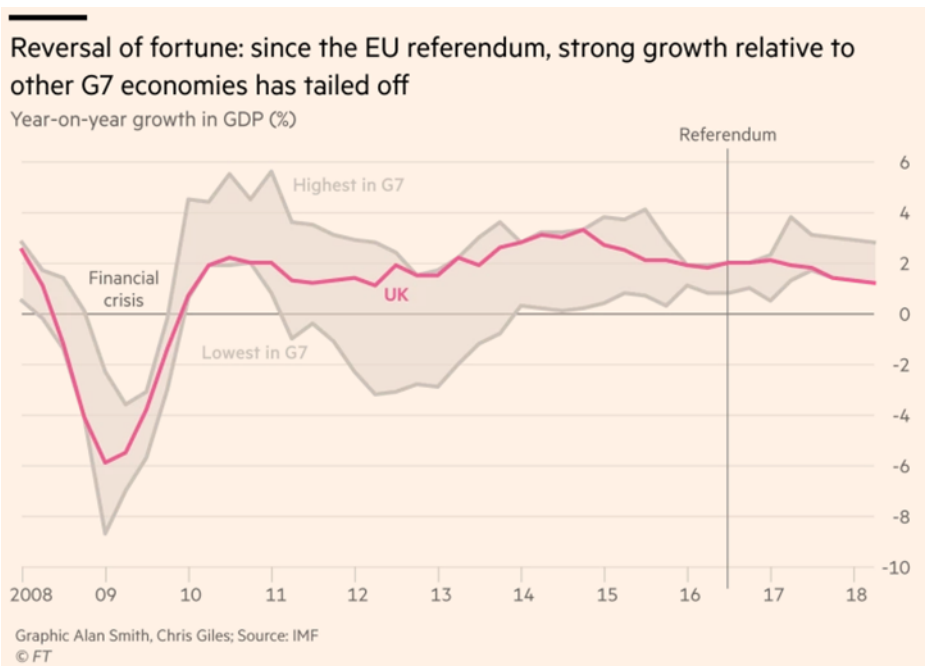
Employment

Labor markets have seen continuing declines in unemployment, wages beginning to rise, and increasing competition for new hires as the pool of skilled labor dries up. These trends can be expected to contribute to increasing inflation over time. According to the St. Louis Federal Reserve, the seasonally adjusted unemployment rate as of August is down to 3.7%. This is the lowest level of unemployment since late 1969 .

The World Economy

The Euro Zone

Turmoil in the European Union continued into the third quarter as



Japan

Japan has continued to employ easy monetary policy to spur economic growth. However, recent protectionist actions by the U.S. along with threats of additional measures have created uncertainty for Japanese producers and an additional headwind to economic growth.

Japan's significant national debt remains an issue for the foreseeable future as the Bank of Japan and the Japanese government work to find ways to encourage economic growth. Nonetheless, the Japanese economy is projected to grow 1.25% in the remaining months of 2018 and through 2019.

China

Unfortunately, China and the U.S. have continued their tit-for-tat tariff war. Ultimately, sectors in both economies are harmed. Despite this, China's economy grew at a 6.8% annual rate in the first half of 2018. Economists generally project that the full year 2018 growth rate to come in at 6.3-6.7%.

Record high consumer confidence has bolstered increases in Chinese domestic consumption across the board. Meanwhile, the Chinese government plans to loosen its fiscal and monetary policy further. This will begin with a planned moderation in the pace of their deleveraging campaign. Still, a trade war with the U.S. could change these economic growth projections. In this case, the Chinese government will have to figure out how to adjust fiscal and monetary policies in response to U.S. challenges.

Emerging Markets

Emerging market economies have been battered this year. One of the leading causes has been the continued strength of the U.S. dollar. Along with increasing energy costs for energy importers, (oil is priced and traded in dollars) the stronger dollar has negatively affected many emerging economies' ability to pay down dollar denominated debts. The stronger dollar also harms overall returns for U.S. investors as the prices of overseas stocks decline in dollar terms.

Natural disasters across a number of emerging market countries have played a role as they strained limited government resources, reduced productive capacity and ultimately reduced overall economic growth. Political problems have also played a role in contributing to economic weakness.

Despite the negative returns of 2018, it's important to recognize that, for those investors who maintained their investment discipline, this asset class has provided long term reward. Over the last fifteen years, the MSCI

Emerging Markets Index has generated a higher return than that of the S&P 500 (10.0% vs. 9.5%).

Investments

U.S. Equities

United States equities have been the star of the show for investors in 2018 (and really for the post-crisis recovery period). Large cap stocks led the way with quarterly returns of 7.4%. This brought the year-to-date tally up to 10.5% (Russell 1000 Index). Small cap stocks have also fared well, rising 3.6% in the quarter and 11.5% year-to-date (Russell 2000 Index). Much of this growth can be attributed to the still low interest rate environment along with the economic tailwind provided by the 2017 Tax Cuts and Jobs Act passed in December. Government steps to reduce industry regulation have also played some role. Still, growth can be expected to slow down as interest rates rise and inflation eats into earnings.

International Equities

International equities, meanwhile, have taken a beating this year. Emerging market equities have led the decline in the international space, as they lost 1% this quarter and nearly 7.4% for the year (MSCI). International small cap stocks, as measured by the MSCI EAFE Small Cap Index, lost 0.8% in the third quarter. This brings the year-to-date decline to 1.9%. International large cap stocks, as measured by the MSCI EAFE Index actually posted a small gain of 1.4% for the third quarter but still lost roughly 1% for the year-to-date. A strong dollar relative to global currencies, Brexit, continuing political upheavals and global trade and tariff concerns have all played a role.

We have decided to replace First Eagle Overseas Fund with Janus Henderson Global Equity Fund. First Eagle has been a longtime staple in the portfolio for downside protection, yet recent performance has raised concerns on whether it will continue to be a good option in the future. Janus & Henderson recently merged companies in 2017 and has given investors access well run and established investment strategies that Henderson managed from their UK office. This Global Equity Fund is one of them. This strategy focuses on capturing dividend income from global companies and has consistently delivered on their 5% plus dividend target for over 12 years now. The stability of their process and dividend income to investors makes this an attractive addition to the portfolio.

Fixed Income

Returns for fixed income have been challenged as the Federal Reserve continues to raise interest rates in its desire to bring the federal funds lending rate to a more normalized level. Short-term U.S. bonds, as measured by the Barclays US Government/Credit 1-3 Year Index, offered a small return of 0.3% in the third quarter bringing year-to-date gains only slightly higher at 0.4%. While Intermediate term bonds also experienced a slight gain in the quarter (+0.21%), on a year-to-date basis they have declined 0.76%. TIPS (Treasury Inflation-Protected Securities) are down 0.8% for both the 3rd quarter and year-to-date.

Given the relative strength of the U.S. dollar, foreign bonds issued in local currency have seen declines on a year-to-date basis. The FTSE Index reflects developed market declines of 3.3% year-to-date while emerging markets debt issued in local currency is down 8.2% over the same period (JP Morgan Emerging Market Bond Index). Emerging market debt issued in U.S. dollars have also decline but at a lesser rate—down 4.7% year-to-date (but up 1.5% in the 3rd quarter).

Real Estate

Global real estate has suffered on two fronts: rising interest rates and a strong U.S. dollar. Both have stunted U.S. investors' gains in 2018. Historically, real estate has been a good inflation hedge as real estate investments can adapt to rising inflation with increases to underlying rents and leases. While returns this year have been quite modest, they have been positive. Global real estate (S&P Global REIT Index) gained 0.2% in the third quarter and are up 0.8% year-to-date.

Alternatives

MLP's (Master Limited Partnerships): Because 'energy' is such a large market around the world, and it is normally not a march with the U.S. stock market sector, it's important to have exposure to this market. It is done in your portfolio through the Tortoise MLP & Pipeline Fund. This fund invests in securities that own and operate a network of energy infrastructure asset systems that produce crude oil, refined petroleum and natural gas. We are close to if, not already, energy "independent" here in the U.S. so this is a growing sector. Due to the volatility in the short term of energy, this fund has it's swings to be sure, but as energy returns to prominence as it has started to, the total return should continue to rise after a tough period. The past year to date return has been 3.6% which beat the category return of 1.9%. The trend is up.

Stone Ridge Reinsurance Fund: Since this fund was purchased in your portfolio, nature has seemed to be

against us with the recent U.S. hurricanes. Although not insignificant, the risk exposure to Southeastern U.S. hurricanes is about 27% of the total portfolio exposure to other perils such as airplane and marine disasters and earthquakes. In addition, we were advised that expected losses from Hurricane Michael were lower than originally though due to the low amount of insured property value in the area affected. On the flip side, whenever there are natural disasters, renewal premiums generally go up, and that is good for investors resulting in higher cash flow.

Managed Futures: Managed futures had a strong third quarter, as measured by the SG Trend Index, having offered a 2.1% return. However, managed futures still came out in the red for the nine months of 2018, showing year-to-date losses of 3.2%.

Conclusion

While the United States economy continues its positive ten-year run, this trend cannot continue forever. We see headwinds that are likely to lead to an inevitable slowing. Rising interest rates and inflation and a reversal of quantitative easing in many areas of the globe are likely to affect future economic growth and not in a positive way. Most of our clients likely experienced drops in their portfolios this quarter as most markets, including bond markets, performed poorly. The U.S. economy continues to grow given the stimulus provided by the Tax Cuts and Jobs Act, which provided a significant tax reduction windfall to many large corporations. Corporate profits and share prices rose in response. Still, as usual, we caution our clients to stay the course and focus on the long-term with respect to your financial goals. Now is not the time to be chasing past winners.

As always, we thank you and your families for allowing us to serve you.

Your team at



Sources: The Bureau of Labor Statistics, Focus Economics, Black Rock, Nuveen, Russell, Fiduciary Trust, Fidelity, The United States Federal Reserve, The European Central Bank, JP Morgan, Morningstar, Wall Street Journal, Ned Davis Research, Bloomberg, Schwab