THE LUBITZ FINANCIAL GROUP

Market Watch
2nd Quarter 2018

July 2018

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Summary

- Trade wars with China and elsewhere continued to escalate during the second quarter of the year, prompting worry and adding to broader volatility.
- The European Central Bank decided to end its program of quantitative easing, joining the U.S. Federal Reserve on its path to normalization and raising rates.
- The U.S. economy is expected to grow about 2.9% for all of 2018 with a projected 3.4% GDP growth for the second quarter.
- Chinese A Class shares (or A-shares) have been added to the MSCI International Indexes for the first time, introducing the second-largest equities market to foreign investors, and giving China a greater impact on foreign benchmark results.
- U.S. equities continue to blaze the trail, outperforming other market equities by a landslide.
- The general reversal of globalization trends in both the U.K. and U.S. may cause issues down the line.
- Economic fundamentals continue to look strong both at home and abroad, offering a positive backdrop for investors.

The Lubitz Financial Group
9350 S. Dixie Hwy., Suite 1500
Miami, FL 33156
www.LubitzFinancial.com
305.670.4440
LindaL@LubitzFinancial.com

Overview

The markets have been noticeably more volatile in recent months as the economic recovery approaches its limits. Between trade wars with China, continued uncertainty on the Korean Peninsula and with Russia, and a tightened monetary policy by the United States Federal Reserve—recently joined by the European Central Bank—we are seeing the beginning of a slowdown to one of the longest economic recoveries in history.

Market Returns

2016	2017	Q2 2018
BDCs 24.4	EM 37.7	REITs 6.4
Small US 21.3	Int'l Sm 33.5	Timber 5.2
Large US 12.1	Int'l Lrg 25.6	BDCs 4.9
EM 11.6	Timber 21.9	Large US 3.6
EM Bonds 9.6	Large US 21.8	Small US 7.8
Timber 8.3	Small US 14.6	Mrgr Arb 0.9
TIPS 4.7	Styl Prm 12.0	TIPS 0.8
REITs 4.6	REITs 8.6	ST Bonds 0.3
Int'l Sm 2.6	EM Bonds 8.2	Intrmed Bonds 0.0
Intrmed Bonds 2.1	Mrgr Arb 6.8	Int'l Lrg (1.0)
Int'l Lrg 1.5	TIPS 3.0	Int'l Sm (1.4)
ST Bonds 1.3	Intrmed Bonds 2.1	Mgd Futures (1.3)
Styl Prm (0.5)	Mgd Futures 2.2	EM Bonds (4.1)
Mrgr Arb (0.8)	ST Bonds 0.8	EM (7.9)
Mgd Futures (6.1)	BDCs 0.09	Styl Prm (8.0)

There are three main themes of 2018 thus far that we would like to highlight:

1) Inflation is rising as we experience the lowest levels of unemployment since 2000. This is beginning to contribute to upward price pressure, originally prompted from rising wage levels.
2) At current market price levels, there is inherently less economic reward available to investors to compensate for taking on stock market risk.
3) There is still room for the global economy to rise regardless of increasing volatility and gathering geopolitical tensions.

Regarding the global picture: while there is certainly some cause for concern, economic fundamentals still look strong both domestically and abroad. We continue to be cautiously optimistic as we head into the second half of the year despite an expected high level of market volatility.

In the second quarter, U.S. equities continued to outperform both emerging market and international equities, aided by the recent boost to tech stocks, such as Facebook, Amazon, Apple, Netflix, and Google.

Small cap stocks in particular continued their steady gains from the first quarter of 2018, providing investors with a 7.8% return, as measured by the Russell 2000 Index. Emerging markets, on the other hand, fell by a sizeable 7.8%. International large cap stocks (MSCI EAFE Index) fell nearly 1% and international small cap stocks (MSCI EAFE Small Cap Index) fell 1.3%.

Alternative investments remained a mixed bag, with global real estate and timber leading the pack with quarterly returns of 6.4% and 5.1%, respectively. Other alternatives also faired relatively well with business development companies producing a 4.9% return while merger arbitrage added 1% for the quarter.

The U.S. Economy

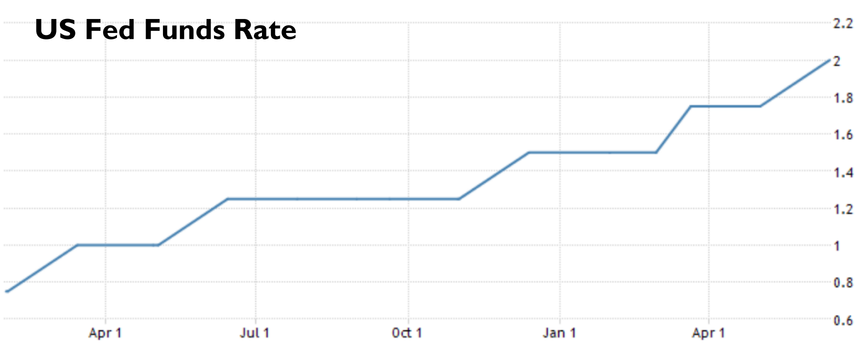
GDP Forecast

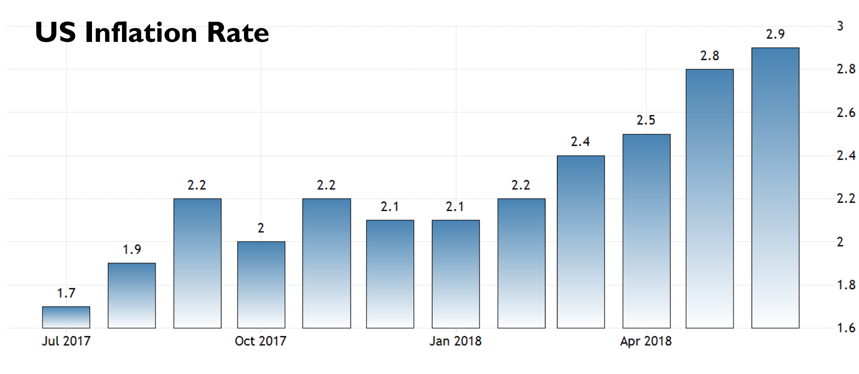
The global economic expansion is beginning to mature, although U.S. growth continues on a strong path. Overall market sentiment appears nervous as we head into the second half of 2018. There are heightened risks across the board, as U.S.-China trade war tensions escalate, emerging markets become increasingly vulnerable to volatile conditions, and global monetary policies continue to converge and tighten.

Forecasters typically have a wide spread of expectations; it is no different this time around. The Federal Reserve Banks of New York, Atlanta and St. Louis are showing U.S. GDP forecasts for the second half of 2018 ranging between 3.1% and 4.6%. Ned Davis Research has GDP clocking in at 2.9% for the year, while the overall consensus for Q2 shows U.S. GDP growing at 3.4%. The important thing to note about all of these numbers is that they all predict growth higher than the average of the last ten years.

Interest Rates and the Federal Reserve

The Fed increased interest rates yet again, to 2%, at their June 13th meeting. Most informed observers expect that there will be two more rate hikes before the year's end. This expectation will increase short term rates, and can have a slowing effect on economic activity. Higher interest rates inevitably create disincentives for consumers and businesses alike, as higher rates make it more expensive to borrow.





Expectations for Inflation

Core CPI inflation is currently at 2.2% and beginning to trend upward. Some are forecasting a level of 2.4% by year-end.

For the past several years, the Fed has struggled to increase inflation, but they have now reached their 2% target level. The next challenge will be keeping the level of inflation under control as labor market conditions tighten and unemployment remains at very low levels.

Employment

At the end of May, the unemployment rate dipped to a low of 3.8%. This is the lowest it has been since April 2000.

The low unemployment rate has created upward pressure on wages, which is a contributing factor in the Federal Reserve hitting its inflation target of 2%. According to minutes from the Fed's June 13th meeting, the unemployment rate is expected to decrease further, though it may moderate somewhat as more individuals return to the labor force.

The World Economy

The Euro Zone

Lately, there has been a higher than normal level of political uncertainty in Europe. Brexit negotiations are becoming more contentious, political turmoil exists in both Italy and Germany, and Spain continues to be uneasy over a potential Catalonia secession. With this backdrop, the euro zone's economic growth rate dropped to its lowest point since late 2016. As public sentiment weakens towards the global markets, it appears that the U.S. is not alone in contending with an aging economic recovery and domestic political turmoil. According to the European Central Bank (ECB), the current estimate for the euro zone's 2018 GDP is 2.1%. This is down from the 2.4% forecast previously.

We maintain a watchful eye on both the euro zone and the U.S. as we head into the second half of the year. On June 14th, the ECB announced plans to stop quantitative easing. While this signals a positive convergence of monetary policy between the U.S. Federal Reserve and the European Central Bank, it is also likely to put further pressure on the euro zone economy.

Japan

In contrast to the U.S. and Europe, the Japanese economy is still operating under an extremely accommodating monetary policy. Although Japan's economic growth rate has improved, it remains low relative to other developed economies; Japan's GDP is expected to increase by a mere 1.2% in 2018.

Improvement remains incremental as the country continues to face the demographic issue of a large, aging population which must be supported by a smaller, younger work force.

China

China is the second-largest economy in the world and what they do matters in the U.S. as well as around the globe. In May, Reuters reported that the International Monetary Fund (IMF) now expects China's growth to slow to 6.6% this year, although China itself predicted a slightly lower growth rate.

The slowdown in China's growth rate is influenced by a range of factors: the rapid expansion of the country's credit markets, the increase in borrowing costs, tougher limits on industrial pollution that have impacted Chinese manufacturing, a crackdown on local government spending, and growing trade frictions with the U.S.

Importantly for investors, MSCI Incorporated, a key producer of many investment benchmarks, has decided to add Chinese A-shares to their world indexes.

This will have an important, but difficult to predict, impact on how the results of international investments are reported.

The Chinese markets tend to be volatile; Chinese stock valuations are also comparatively high. Both of these circumstances could contribute to greater volatility for international benchmarks and their fund followers.

Emerging Markets

Recent spikes in oil prices due to a reduced global supply have helped lift oil exporting emerging market economies, such as Russia and Saudi Arabia. While rising oil prices have helped some, it has been a challenge for those countries that rely on imported oil. Moreover, as the U.S. dollar rises relative to other currencies, countries pay more for oil and other goods priced in dollars.

The relative value of emerging market currencies compared to the dollar has been an issue. Since the dollar is the world's reserve currency, this tends to cause ripples across other financial markets, especially emerging market economies.

According to the Wall Street Journal, a basket of emerging-market currencies tracked by MSCI has fallen 3% this year, pressured by a resurgent dollar, higher U.S. interest rates, and global trade tensions.

The currencies of Argentina, Turkey and China have been hit especially hard. Not surprisingly, smaller countries with smaller economies are subject to the economic swings caused by others—the ride can be rougher, but the growth rate over longer periods can be highly attractive.

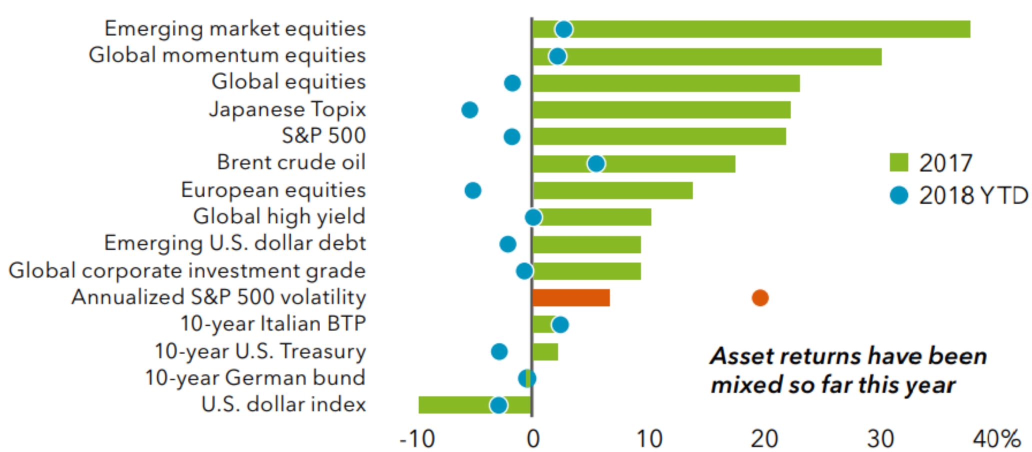
Investments

U.S. Equities

In line with our expectations, 2018 has been a much bumpier ride for the U.S. than in more recent years. Long-term growth ultimately comes from the risk associated with market volatility and the uncertainty of one's investment return. More recently, market volatility has come from the uncertainty surrounding our administration's economic policies and its direction regarding trade and our global leadership. This has been exacerbated by questions surrounding the future impact

We're not in 2017 anymore

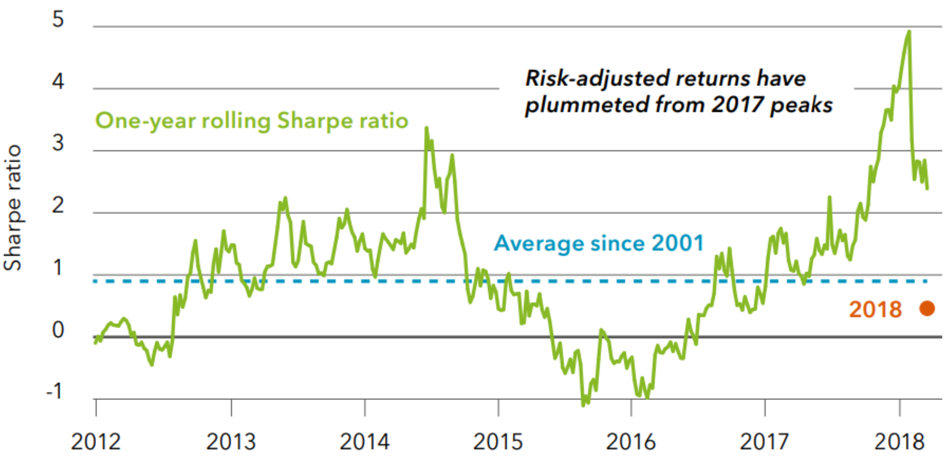
Asset performance: full-year 2017 vs. 2018 year-to-date



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.
Sources: BlackRock Investment Institute, with data from Thomson Reuters, March 2018. Notes: 2018 data are through March

Back to earth

Rolling one-year Sharpe ratio of a hypothetical global 60/40 portfolio, 2012-2018



Past performance is not a reliable indicator of current or future results. It is not possible to invest directly in an index.
Sources: BlackRock Investment Institute, with data from Bloomberg Barclays, MSCI and Thomson Reuters, March 2018.

of recent fiscal and monetary policies.

U.S. equities (stocks) have been outperforming their international counterparts, due to both the currency considerations noted above, and in response to the fiscal stimulus associated with the Tax Cuts and Jobs Act (TCJA). Legislation associated with the TCJA has led to the repatriation of some $500 billion in U.S. dollars previously held abroad. Small cap stocks, as measured by the Russell 2000 Index, returned 7.8% in the second quarter, bringing the year to date total up to 7.7%. In contrast, U.S. large cap stocks, as measured by the Russell 1000 Index, rose 3.6% in the second quarter bringing year-to-date gains to 2.8% following a negative first quarter.

International Equities

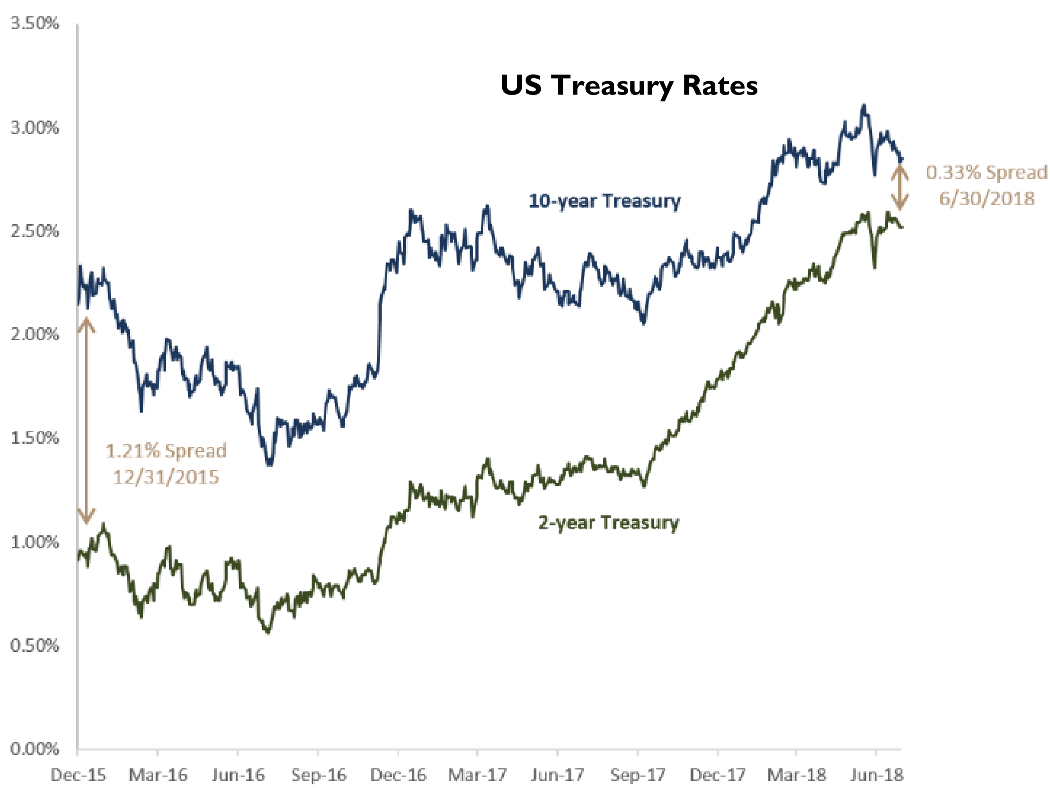
International and emerging market equities saw substantial returns in 2017, but have suffered in recent months thanks to geopolitical shifts, a rising dollar, and weakening economic fundamentals. International small caps, as measured by the MSCI EAFE Small Cap Index, dipped 1.4% in the second quarter and are down 1% year -to-date through June. International large cap stocks (MSCI EAFE Index) lost 0.9% for the quarter and have declined 2.3% year-to-date. Meanwhile, emerging markets, as measured by the MSCI Emerging Markets Index, have fared much worse, falling 7.8% during the quarter and 6.5% year-to-date.

As we head into the second half of the year, we anticipate continued volatility in the global equity markets.

Fixed Income

As the Federal Reserve has increased short-term interest rates, the spread in Treasury yields between short and intermediate bond issues has narrowed. To many, this suggests that we are in the late stages of our economic expansion.

The combination of rising rates and an increase in the rate of inflation has contributed to weak fixed income returns so far this year. As measured by the Barclays U.S. Intermediate Bond Index, bond returns were essentially flat in the second quarter and declined by 1% year-to-date. Longer maturities fared worse though shorter maturity bonds fared modestly better: the Barclays 1-3 Year Index rose 0.3% in Q2 and is flat for the year. Municipal bonds, as measured by the Barclays Municipal Bond Index, generated a positive 0.8% for the quarter but



Source: Bloomberg, Fiduciary Trust. Note: Data through June 30, 2018 still posted a negative return on a year-to-date basis.

Alternatives

Global Real Estate: Global real estate has been a positive contributor to investment growth in client portfolios throughout the economic recovery. The S&P Global REIT Index rose 6.4% in the second quarter following a very weak first quarter, when the index declined by nearly the same amount (YTD returns are up 0.5%). The sector's long-term growth provides a valuable hedge against rising inflation.

MultiAlternatives: In aggregate, these posted a positve 1 year reaching 4.7% as measured by the Credit Suisse Hedge Fund Index. Returns should expect to remain low as the purpose of these funds is to provide downside protection and returns unlike other traditional investments.

Managed Futures: Despite poor returns achieved over the past few years, managed futures continue to be an important alternative. With a low correlation to both bonds and equities, managed futures enables our portfolios to capture some of the otherwise underutilized premium inherent in broad diversification. Managed futures, as measured by the SG Trend Index, continued to exhibit weakness, declining by 1.3% over the quarter and by 5.2% so far in 2018. As a general rule, managed futures do well when trends are clear, and struggles when markets are volatile.

MLPs: *This asset class posted a great quarter up 11.8% as represented by the Alerian MLP Index.* 1 Year returns remain negative at 4.5%, but we expect future growth among the partnerships that provide storage and transporttation for energy.

Reinsurance: As measured by the SwissRe Global Cat Bond index, the first quarter posted positive returns of 1.4% and the trailing year was positive 1.8%. This asset class see the majority of its return stream from June to Novemeber during the seasonal weather trends that may occur.

Conclusion

Though inflation, volatility, and geopolitical tensions seem to be ever present in the market (and the news for that matter), the underlying economic fundamentals remain strong and attractive, particularly in the U.S.. While it is easy to get bogged down by headlines and uncertainty, it is important to maintain a prudent approach to asset allocation decisions and exposure to the expanding market.

Looking forward for the second half of 2018, we believe that inflation will continue to increase, propped up by low unemployment numbers and pressure from the Federal Reserve. The global economy still has room to run, though the risk-reward trade-offs continue to tighten for investors across the board.

Our goal is to provide our clients with level-headed advice, to deter myopic views of the market, and to maintain a positive long-term outlook. Smart rebalancing decisions, recent tax-loss harvesting opportunities, and asset allocation decision-making have enabled us to take advantage of market conditions. As we head into the second half of 2018, we will keep a watchful eye on global issues and growth opportunities.

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

Your team at

THE LUBITZ FINANCIAL GROUP

Personal Financial Planning & Investment Management

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