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Volatility has returned to the financial markets. In this newsletter Bryce discusses the current market and what seems to be driving the current round of market volatility—tariffs and fears of trade wars. Casey reviews the difference between traditional and Roth IRAs. Jon takes another look at budgeting in this newsletter and discusses budgeting in the real world. We wrap up this newsletter with some updates on some of the things we are involved with around the office.

Bryce's Point of View

-By Bryce Pease, CFP®, Chief Investment Officer

As much as we don't like it, volatility is normal. On average, the market has about a 15% correction during each year.(1)

It's just that over the past two years the market has only seen about a 3% correction on average. The market goes up like an escalator and down like an elevator. We believe its important to stay diversified, stick to a sound investment processs and not try to chase the markets.

This is just back to normal for our markets and we expect 2018 and beyond to continue down this path of getting back to regular market volatility. But even with all this volatility, we feel it's worth noting that the economy is very strong right now. We have low unemployment, strong corporate dividends, and strong corporate earnings.(2) We will see how things play out for the financial markets this year.

Whichever direction the markets go from here, this is probably a good time for investors to do a "gut-check" and review their risk tolerance. It also might not be a bad idea to review your strategy and action plan for a potentially volatile market. Let us know if you'd like a second opinion on your investments or strategy. We offer a complimentary, no obligation meeting to discuss your situation.

Last month's stock market volatility was sparked by inflation and interest rate fears. This month's volatility is being driven by tarrifs and fears over trade wars.

On Thursday, March 1, President Trump announced a new plan to institute a 25% tariff on steel imports and a 10% tariff on aluminum.(3) Like so many things these days, the response was radically different depending on who you talk to. More on that in a moment.

Traditionally, tariffs are something most of us don't have to think about, especially as tariff levels in the United States have been low for decades. But for investors, President Trump's announcement has the potential to be very significant. Why? Because of the possibility that it could spark a trade war.

Should a trade war actually happen, it could have a major impact on investors. To understand why, let's have a short Q&A session.

What are tariffs and why do they matter?

Since it's probably been a while since your Economics 101 class, let's quickly cover a few basics. To put it simply, a tariff is essentially a tax on imported goods and services. Tariffs can be levied on almost anything: metals, foodstuffs, products, etc. Historically, tariffs are most commonly used when a country wants to protect certain industries within its own borders. For example, the Tariff Act of 1930 was designed to protect farmers by increasing the cost of importing agricultural products. By making it more expensive to import crops from other countries, people would be forced to buy mainly from American farmers. This is known as protectionism.

Once upon a time, tariffs in the United States were both high and common. But after World War II, average tariff rates dropped significantly, and have stayed low ever since. In fact, since the 1970s, the average tariff rate on imports has been well under 10%.(4)

So are tariffs good or bad?

Remember how I said the response to President Trump's announcement was radically different depending on who you talk to? That's because a tariff's effects can vary wildly, too.

Tariffs can bring two major benefits:

1. Because tariffs are a kind of tax, they can bring more revenue to the government.

2. Tariffs, and protectionism in general, can be a major boon to certain industries – including the workers *within* those industries. In this case, the U.S. steel industry would benefit from a 20% tariff on steel, because it means more people are buying from them instead of their competitors overseas.

You can see why the idea of tariffs can be attractive for many people.

Unfortunately, tariffs can also cause some very negative side effects. Specifically:

1. Tariffs can make life more difficult for consumers, whether they be individuals, families, or businesses. That's because higher tariffs often lead to higher prices, which in turn lead to higher expenses. For example, if companies must pay more for the steel they need, that could significantly eat into their own profits.

2. Higher tariffs can lead to trade wars.

Okay, so what is a trade war, anyway?

We live in a global, interconnected world. Toss a stone into the water off one shore and the ripples can be seen near another. In this case, higher tariffs can cause some very large ripples.

When one country raises tariffs on a certain kind of product, other countries that depend on *exporting* that product won't take to it kindly. As a result, those countries might retaliate by increasing tariffs on *their* imports, thereby harming the first country. Before you know it, tariffs become weaponized and a trade war breaks out.

Trade wars are risky things, because they can quickly jump from industry to industry. Let's take the current situation as an example.

After President Trump announced his plan to raise tariffs on steel and aluminum, the European Union threatened to do the same to U.S. imports – everything from motorcycles to bourbon to blue jeans.(5) Other countries like Japan and Canada, which are both major steel producers *and* important trading

partners, have threatened similar measures. Should all this happen, the currents of international trade will quickly become choked. That would lead to higher prices on *many* goods and services, which in turn would lead to lower profits, higher costs of living, and even – potentially – higher unemployment.

Should all those things happen, the markets will surely suffer. As an investor, you don't need me to tell you what that means.

So why did President Trump decide to raise tariffs?

For decades, the United States has seen a worsening trade deficit with many countries. In other words, we pay more for importing their goods than they do for ours. According to the *Wall Street Journal,* the U.S. "ran a global goods deficit of $810 billion" in 2017.(6) One of the president's most long-standing campaign promises was to address that deficit. It appears that tariffs, along with renegotiating certain trade agreements, like NAFTA, are his tool of choice.

Geopolitical economics is a loaded topic, and there's a *lot* of disagreement out there about causes and effects. Again, tariffs can unquestionably bring lots of advantages, and there's no question the United States is on the lower end of a trade imbalance with many countries.

At the same time, there's also no question that Trump's announcement has spooked both the markets and the global economy. The Dow fell more than 400 points on the day of the announcement, and continued to fall the next day.(7) Many world leaders have already warned about a trade war being a very real possibility. Even many Congressmen in President Trump's own party have spoken out against the prospect of higher tariffs. This isn't surprising, because the Republican party – or at least a large percentage of it – has traditionally been very much in favor of free trade.

As I'm not an economist, it's not really my place to decide whether protectionism is good or bad. It's worth noting, however, that a trade war did break out the last time the U.S. raised tariff rates this high.

The Tariff Act of 1930, or Smoot-Hawley Tariff Act, raised tariff rates to their second highest level in U.S. history. These days, economists *generally* agree that the resulting trade war worsened the Great Depression. (What no one seems to agree on, though, is by how much.) On the other hand, the United States is in a very different position in 2018 than it was in 1930. Back then, the Great Depression had long-since started. These days, our economy is *much* stronger. That makes it hard to predict how hard a trade war will hit.

What happens now?

There are still so many things we don't know. What we *do* know is that the possibility of a trade war can have a substantial impact on the economy and the markets.

Back in February, the markets took a hit due to the threat of inflation and rising interest rates – and then recovered. The markets dipped slightly in response to President Trump's announcement. Just a few short weeks later, The Dow Jones fell over 1,100 points in two days as China responded with threats of their own.(8) We should have more clarity in the coming weeks and months.

This is why my team and I keep such a close eye on what's going on in the world. Part of my job is to keep you informed of any ripples in the water so that you always stay afloat. It's impossible for me to say what's going to happen next, but I'll tell you this: We'll always be here keeping our hands on the tiller. In the meantime, please contact me if you have questions, or if there's anything I can do for you!

Casey's Corner

-By Casey Morris, CFP®

Over the years, one of the most popular ways to save for retirement is to contribute to an Individual Retirement Account, or IRA. That's because IRAs enable you to invest (and hopefully grow) your money for retirement in a way that also brings significant tax advantages. As you can imagine, much of my time as a financial advisor is spent answering questions on how people can get the most out of their IRAs. But the most common question I get is this: What's best for me: a Traditional IRA, or a Roth IRA? It's a smart question to ask, because while both types of IRAs help you save for retirement, they each come with different advantages and disadvantages. For that reason, you should weigh the pros and cons of each in order to decide which is more suitable for you.

But before we do that, let's quickly list what both Traditional and Roth IRAs have in common; both are designed to help you save for retirement, both usually come with a wide range of investment options, both have the same annual contribution limits (the maximum amount you can contribute to your IRA each year) and both come with substantial tax advantages. It's when these tax advantages apply that Traditional and Roth IRAs differ.

Here's how it works. With a Traditional IRA, all of the contributions you make are usually tax deductible. For example, imagine you contributed $5,500 to an IRA in 2017. Typically, you would not have to pay taxes on that contribution. However, you will likely have to start paying taxes on your distributions, meaning the withdrawals you take out of your IRA once you're retired. These distributions are considered ordinary income and may be subject to income taxes. With a Roth IRA, your contributions are not tax-deductible, but your distributions are not taxed as income. So in other words, the tax advantages of a Traditional IRA come before retirement, while the tax advantages of a Roth IRA come after retirement.

So how do you choose between the two? By following this simple rule of thumb: If you expect your tax rate in retirement to be lower than it is now, go with a Traditional IRA. That way, you can skip paying taxes on your IRA while your tax rate is higher, and then pay less in taxes once your tax rate is lower. On the other hand, if you expect your tax rate to be the same or higher during retirement, a Roth IRA is likely a better choice. For obvious reasons, you should consult with a tax professional to determine what your tax rate might be in retirement. Of course, there are a few other differences between Traditional and Roth IRAs.

With a Traditional IRA you can no longer make contributions on the year you reach age 70½, a Roth doesn't have an age limit to making contributions. Both require earned income, either from yourself or a spouse. Income Limitations: Anyone can contribute to a Traditional IRA no matter how much income they make (unless you are covered by an employer plan at work, then there are certain limitations). With a Roth, if your income exceeds a certain limit you may not contribute. Required Minimum Distributions: with a Traditional IRA, you must withdraw a minimum amount from your IRA every year following the year you reach age 70½. (Remember, these withdrawals may be subject to income tax.) Roth IRA owners do not have to withdraw money from their accounts if they don't want to, even after retirement.

The IRS website states that if you are under 50 years of age at the end of 2017, the maximum contribution that can be made to a traditional or Roth IRA is the smaller of $5,500 or the amount of your taxable compensation for 2017. If you are 50 years of age or older the limit is the smaller of $6,500 or the amount

of your taxable compensation for 2017. These limits can be split between these two types of IRAs as long as the combined amount doesn't exceed the limits.

There are many other factors, details, and options to consider with both Traditional and Roth IRAs—far too many to cover in a single column. But at least now you understand some of the basics. Contributing to Individual Retirement Accounts, whether Traditional or Roth, is an excellent way to save for retirement. As such, it's important that you take the time to determine which type of IRA is right for you. Hopefully this will give you a good place to start. As always, let me know if you have any questions.

The Planning Perspective

-By Jon Teran, CFP®

Personal Budgeting in the Real World

One of the most important things we think a person or family needs to get their arms around when it comes to financial planning is their cash flow. Knowing exactly how much is coming in the door and going out the door each month is one of the most important steps in navigating your financial future.

Identifying how much money you have coming in the door each month through your income, pensions or Social Security etc., can be easy for most. In fact, most people can probably easily rattle this number pretty closely off the top of their head.

Identifying how much money is going out the door is not quite so easy. This part takes discipline. There are all sorts of ways a person might track their expenses and spending. Some like to do it the old fashioned way, by hand. Others might choose to track it on their computer. These days certain websites, or your bank or credit card company, offer automated ways to help track your spending. Whether it's by pen and paper, or with the help of technology, tracking and documenting your spending can make a big impact on your personal financial well being. Here's why.

To make a financial plan, whether it's for retirement, saving for a first home, or trying to save for college, you need to know exactly what you have to work with and what areas of your spending and expenses you might be able to change to focus on your priorities.

But everyone's situation is different. We think one of the best ways to set a budget is to find out what you spend. Track your spending over 3-6 months. Cut yourself some slack and just see how you and your family operate and what you spend your money on. In our opinion, this is the best starting point for budgeting—you. Rather than trying to fit your spending into predetermined categories and trying to force yourself to stay within those parameters, start by seeing what you naturally tend to spend money on and go from there. After seeing what you spend over a period of time, there may be some things you want to change and there might be some things you might not want to change. Create the budget that suits your situation. It's your life.

Here's another thing about budgeting in the real world you may want to consider—this is America. Simply focusing on where you can cut back or make changes in your spending is only part of budgeting in the real world. If you don't want to make certain changes or there are other areas of your life you want to continue to enjoy, why not think about making changes to the first aspect I discusssed in this article? The money coming in the door? Whether you are retired, have a full time job or work in a non-profit field, there are all sorts of ways to work part-time and generate a little extra income. Maybe there is a small

business you've always wanted to start on the side. Maybe a friend could use some help with their business. Or maybe your professional skills could be put to work in consulting, teaching, or in some other aspect outside your main job. Be open minded about this part, you might be surprised about what ideas you come up with.

So, to sum up. Identify your income, track your spending, create a budget around your priorites, and if need be, find new ways to generate a little extra income to fund and live the life you want.

Finally…

We continue to provide employee financial education. In May, Casey Morris will be traveling to Chattanooga Tennessee and Sacramento CA (in the same week!) to provide financial education classes for the US Forest Service.

Jon Teran has been volunteering again this year helping plan and coordinate the Covina Rotary Fun Run. This year's run is expected to be bigger and better than ever. Go to www.covinafunrun.com if you'd like to participate in this year's run.

Sincerely,

The Team at Capstone Pacific

P.S. If you ever run across anyone who could use our services, we always appreciate it when you pass on our name.

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