Claro Advisors, LLC.

Quarterly Newsletter
July 2018

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Summer Greetings To All

Please enjoy our latest market commentary as well as a recent article written by Paul Litchfield for the Worcester Business Journal on "5 Mistakes to Avoid in Retirement." We are also pleased to announce that Jim Abbott, Financial Advisor, was awarded the Accredited Investment Fiduciary designation on July 13th. You can read more on that here. Well done, Jim. We hope you and your families are enjoying your summer!

Ryan Belanger, CFP® - Managing Principal, Claro Advisors

Five Mistakes to Avoid in Retirement

By Paul Litchfield, CPA - Senior Vice President

From taking too much risk to increased spending, retirees have a lot to think about when beginning the next chapter. You've spent a lifetime working hard and saving so you can retire and enjoy the fruits of your labor. Hopefully you'll have created a comprehensive retirement plan long before that day comes. However, retirement planning doesn't stop once you retire.

(Continued on page 2)

(Continued from page 1)

Here are five common mistakes to avoid.

1. Failing to take a more conservative approach to investing.

Many folks who enter retirement fail to adjust their thinking on risk and how it relates to their investment portfolio. Understandable given the fact that people spend most of their lives in two stages of the financial life cycle: first, the asset accumulation phase (age 25-45); and second, and the pre-retirement phase (age 45-65). These first two phases typically coincide with a higher risk tolerance and therefore a more aggressive investment approach. However, once you enter the third and final phase of the financial life cycle, the retirement phase, it's important to set new parameters and ensure your portfolio is aligned with your overall objectives.

2. Spending like you used to and disregarding the budget.

During the pre-retirement years, people who work have a budget and cash-flow plan. However, because of family dynamics, increased cost of living, and other factors, these same folks usually exceed those plans by overspending. That may be okay because they can reimburse those expenses by bringing in more income. But the game changes in retirement. You're no longer deriving compensation, making it extremely important to stick to your budget. And this may be even more difficult for retirees as, with more time on your hands, it can be easier to overspend on travel, dining and spoiling the younger generations. But compounded with inflation, this can be a disastrous mix.

3. Taking social security benefits at the wrong time.

One of the most common questions for people in retirement is when to start taking social security. For years it was thought retirement began once you turned 65 years old, but that number has changed. For people born after 1954, the retirement age has been bumped up to age 66, and the earliest you can claim social security is at age 62 regardless of your full retirement age. The bottom line is the younger you are today, the greater the penalty for taking benefits early.

4. Not planning properly for the cost of health care.

People either have no idea what their healthcare costs will be or dramatically underestimate those costs in retirement. Those that understand this piece of the puzzle most likely had an experience with a parent or other elder person that they cared for – and it was probably expensive. From medications to nursing homes these costs continue to climb each year. A couple who retired in 2017 can expect to spend about $275,000 on healthcare costs in retirement.

5. Creating issues for the next generation.

One of the most procrastinated topics for retirees is generational planning and wealth-transfer strategies. Nobody likes talking about death. However, it's one of the most important topics to discuss. Families can be torn apart by conflict after a patriarch or matriarch passes on. Funeral costs, estate taxes and fighting over inheritances are among the burdens left for your loved ones if you don't leave them with a well-designed plan.

If you don't want to create issues for the next generation, establish a plan. Decide what you want to happen with your estate now so that your loved ones aren't burdened with trying to figure things out after it's too late. The earlier you start thinking about it, the better.

The Economy and Financial Markets - Q2 2018 Update

By Michael Mullin, CFA® - Chief Market Strategist

As we passed the midpoint of 2018, the financial markets have been searching for some sense of direction this year. Despite generally positive economic news and robust corporate earnings, there is noise both domestically and globally that has prevented stocks from achieving greater upside. The daily news of more tariffs has escalated the threat of trade wars with our global partners, while potentially increasing inflation. Rising interest rates have sparked fear of a flattening yield curve, which could dampen the economic "animal spirits" and potentially lead to a recessionary environment. Investors, subsequently, have become a little uncertain about which way the markets are headed, and the performance during both the second quarter and year-to-date (YTD) reflect this.

Following a first quarter that saw increased volatility and most asset classes experiencing flat to negative returns, the second quarter of 2018 saw little improvement. While the S&P 500 did share positive returns each month and finished the quarter up 2.88% (and is now up 1.67% at the midpoint of 2018), much of the return came from just a handful of stocks and sectors. Consider 36% of the return for the S&P 500 return YTD through June 30 was generated by Amazon, and 84% of the return for the S&P 500 return was generated by just Amazon, Microsoft, Apple, and Netflix combined. For the quarter, Energy, Consumer Discretionary, and Technology sectors were the strongest performers, generating gains of +13.5%, +8.2%, and +7.1%, respectively. While Industrials, Financials, and Consumer Staples were the weakest with returns of -3.2%, -3.2% and -1.5%.. Small company stocks have fared better as tax reform, strong consumer demand, and a focus on protecting domestic trade has buoyed investor sentiment. These stocks, as measured by the Russell 2000 index, returned +7.75% in the second quarter, following a flat first quarter.

The choppiness, however, spilled over to international markets. Developed non-U.S. equity markets represented by the MSCI EAFE were -2.34% for the quarter and for the year are now down 4.49%. Emerging markets fared even worse: -8.66% in the second quarter as trade disputes with China have accelerated, giving investors reason for pause.

Meanwhile, as telegraphed by many, fixed income investors have also encountered a difficult road. The Federal Reserve raised rates 0.25% for the second time this year and gave indication that there may be two more increases coming before year end as they seek to normalize rates to focus on an accelerating economy and the threat of increasing inflation. As we all know, as interest rates rise, the price of bonds typically fall, therefore it's not surprising that the Barclays Aggregate Index was off 0.16% for the quarter and is now down 1.62% YTD.

Is it the Right Time to Take the Training Wheels Off?

For those of us that have children, I'll relate it to teaching your kid how to ride a bike. I have experienced both the pleasure and pain that goes along with taking the training wheels off. Wobbly legs, maybe a small crash or two, but then off they go. One could say that is the approach that the United States has taken with China and many other trade partners through the years as the U.S. has helped them develop their economies. The United States has been a strong proponent of free trade through the years and its trade agreements reflect that. And as well it should, because with more open markets globally the country stands to benefit from

[1] ***On the Principles of Political Economy and Taxation*** by David Ricardo

overall cheaper labor, less expensive goods and services and more global consumers. This has helped other economies (as well as the United States' own) develop and grow. This is what economist David Ricardo once coined the law of "comparative advantage," which in its simplest terms argues that countries should focus on those goods and services where they have the greatest expertise and lowest costs and trade for those they do not. In theory this should improve the economic welfare of all countries and populations involved.[1]

However, in practice this becomes a lot more complicated. Countries tend to enact protectionist measures to give themselves advantages by either subsidizing particular industries in which they want to become an exporter (by reducing tax or offering other financial incentives) or by putting tariffs (essentially a foreign tax) on imports. Also, in the case of China, there is the valid argument that through the years they possibly have engaged in other protectionist actions by pirating intellectual property, and reverse-engineering and counterfeiting patented goods. Essentially, it appears to our trained eye that the president is declaring that it is time for other countries to "take the training wheels off", to trade fairly and to stop illegal trade practices. To do so, he has taken the trepidatious road of threatening protectionist measures of our own through tariffs, with the goal of renegotiated trade agreements and overall free trade. But the concern is that a trade war could harm the global flow of goods and services, which has caused investors to be nervous.

Biggest U.S. trade deficits, by country

2017 deficit in goods, in billions (services are excluded)

RANK	COUNTRY	2017	2016	CHANGE	BIGGEST IMPORT
1	China	$375.2	$347	**+28.2**	Consumer electronics
2	Mexico	$71.1	$64.4	**+6.7**	Autos, electronics
3	Japan	$68.8	$68.8	**0**	Autos, electronics
4	Germany	$64.3	$64.7	**-0.4**	Autos, transportation
5	Vietnam	$38.3	$32	**+6.3**	Rice, crops
6	Ireland	$38.1	$36	**+2.1**	Chemicals, drugs
7	Italy	$31.6	$28.6	**+3**	Machinery
8	Malaysia	$24.6	$24.8	**-0.2**	Consumer electronics
9	Netherlands	$24.5	$23.6	**+0.9**	Chemicals, machinery
10 (tie)	India	$22.9	$24.4	**-1.5**	Manufacturing, clothes
10 (tie)	South Korea	$22.9	$27.6	**-4.7**	Autos, electronics

Source: Bureau of Economic Analysis, U.S. Census

Trouble with the Curve

Another concern is the ongoing flattening and potential inverting of the yield curve. This is something that we've alluded to in the past that is historically a reliable indicator of an impending recession. Currently the difference in yield between a two-year Treasury and a ten-year Treasury bond is just 0.30%. This shows that there is not much incentive between borrowers and lenders that like to borrow short and lend long, which can curb overall investment and slow economic activity. If we are to take stock in the Federal Reserve's intent to continue further "gradual increases in the target range for the federal funds rate will be consistent with sustained expansion of economic activity, strong labor market conditions, and

[2] www.federalreserve.gov – Press Release June 13, 2018, Federal Reserve issues FOMC statement

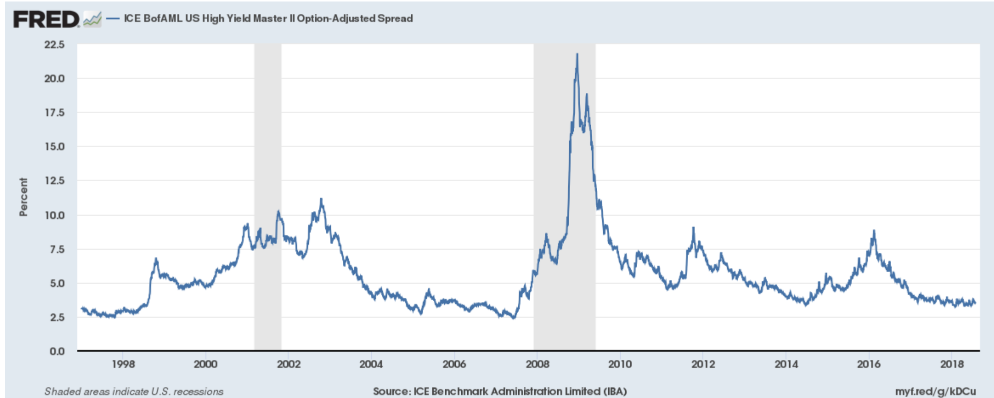
inflation near the Committee's symmetric 2 percent objective over the medium term"[2] then this translates to a neutral Fed Funds rate closer to 3% (currently 2%). Yet, unless there are significant changes, investors expect long-term rates to remain at or below 3%, which would lead to a flat or inverted curve. If the curve does in fact invert for a lengthy period it could stall economic activity and lead to a recession.

Portfolio positioning as the economic cycle matures

Not all is doom and gloom, however. We feel the market is pausing to digest a lot of this information and has a good chance to continue its expansion. There is more good economic data than negative; corporate profits continue to expand, tax reform has helped smaller companies and consumers, the labor market is stronger than it has been in years, construction is booming and the real estate market is healthy. However, as this particular cycle has matured, we have been cautioning investors with their approach to asset allocation.

While we still favor equities, we have been lowering our target to a more neutral position. As economic activity accelerates there comes a point where demand starts to outstrip supply, therefore sectors such as Energy, Materials, Industrials, and Consumer Discretionary companies are able to generate superior profits. Much of this is being reflected in the prices for companies in these sectors currently. The elephant in the room, however, will be inflation, whether it can be held in check and the Fed's response to any increase. Eventually as economic activity peaks and we are faced with the possibility of a recession, more defensive sectors such as Healthcare, Consumer Staples, Telecom, and Utilities will outperform. Again, that may be further down the road, but it would be wise to at least start thinking about it.

Next, we are becoming more conservative with our allocation to fixed income, with a focus on credit quality. We think credit spreads are too narrow, meaning there isn't incentive to take on credit risk. For example, the current high yield credit spread is 3.5%, which measures the difference between below investment grade "junk" bonds and a treasury benchmark yield. That spread historically averages closer to 5.5% and in times of crisis can typically widen to 8% or higher. We would rather be more selective and focus on higher quality bank loans, corporates, treasuries, and municipal bonds.



Cash is also becoming a more attractive asset class as rates increase. The Fed has raised rates six times in the last 18 months and is projected to continue that path. A year ago, more than 65% of

[3]https://fred.stlouisfed.org: **ICE BofAML US High Yield Master II Option-Adjusted Spread**

stocks had a dividend yield higher than the three-month Treasury, today that number is less than 30%. Cash is not a terrible place to be sometimes.

Finally, we have been increasing our allocation to alternative assets for diversification and their lower correlation benefits including some market neutral and hedging strategies. In a market showing signs of increasing volatility and lack of direction, it is a good idea to think about adding or increasing an allocation to alternative assets. If there is a storm on the horizon, it is better to be early than late. As always, we are more than happy to review your portfolio with you, and encourage you to refer any friends or colleagues that you feel would benefit from our guidance.

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