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Breaking Up is Hard to Do

Source: Council of the European Union

"We already miss you. There is no reason to pretend this is a happy day."

- European Union (EU) President Donald Tusk as Sir Tim Barrow, Britain's EU representative, delivers a letter invoking Article 50 which formally begins negotiations of Britain's exit from the EU.

"In these negotiations the Union will act as one and preserve its interests."

- The EU's other 27 member states

In our last quarterly letter, we noted how stagnant wages and income disparity have contributed to a world-wide rise in populist sentiment and pushback against globalization. While global business conditions are generally healthy, one lingering concern for investors is the prospect of a dismantling of the interconnected economy. Britain's decision last summer to exit the European Union was seen as a shot across the bow against the established order.

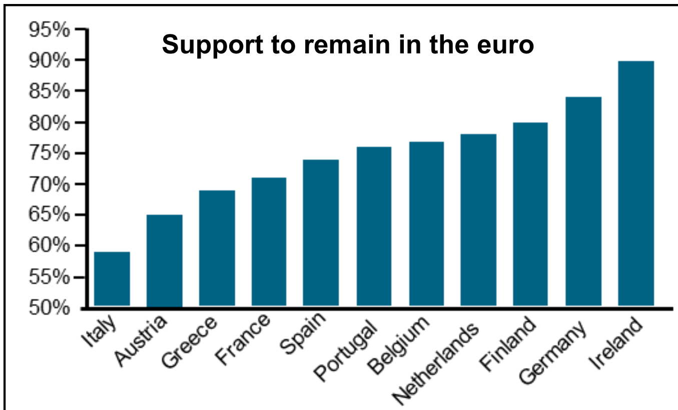
However, recent developments have softened worries over a chaotic unwinding. In Europe, the Netherlands vote in early March was seen as a continental referendum on the EU. Amid record turnout, voters re-elected Prime Minister Mark Rutte, a seasoned, pro-EU politician who pivoted his views to acknowledge voter grievances. Upon an unexpectedly large margin of victory he said "The Netherlands, after Brexit, after the American elections, said 'Whoa' to the wrong kind of populism". The suspicion is that a similar result will play out in France and Germany later this year.

a. Bloomberg

Performance of Notable Indices[a]	Q1 2017	1-Yr (4/1/16 – 3/31/17)
S&P 500 Index	6.1%	17.2%
U.S. Midcap Equities	3.9%	20.9%
U.S. Small Cap Equities	2.5%	26.2%
International Developed Market Equities	7.4%	12.3%
Emerging Market Equities	11.5%	17.6%
U.S. Core Bonds	0.8%	0.4%
Global Bonds	1.5%	-1.9%
Gold, $/troy oz	8.9%	1.3%

Total return indices unless otherwise stated

Lost in the headlines is a steady undercurrent of support for the euro. While many voters chafe at EU bureaucracy, on balance most prefer the single currency and the free movement of labor and capital. We expect continued headlines proclaiming EU disintegration but suspect the pain of leaving is greater than the pain of making needed adjustments.



Source: TNS, Capital Economics, March 2017.

Loud Twitter posts and newspaper headlines also drown out a fuller appreciation of important nuances in the Chinese-U.S. relationship. President Trump's public stance against China's trade practices stand in contrast to his quiet appointment of Iowa Governor Terry Branstad as Ambassador to China. Branstad has known Chinese President Xi Jinping since 1985 when Branstad was serving his first term as Governor and Xi was a lower level agricultural official. While there are concerns with the sustainability of China's economic momentum, there is less unease over a trade war when long-standing personal relationships are maintained.

Campaigning vs. Governing

Since the election, equity markets have rallied (S&P 500 up 10% through 3/31/2017[a]) and bond yields have risen (10-year Treasury from 1.88% to 2.39% through 3/31/2017[a]) on the prospect of significant regulatory and tax changes. The founding fathers of the United States designed government to resist rapid and wrenching change. There is an embedded preference for the status-quo and this means the recently defeated Health Care Bill inevitably had a high hurdle to pass. The same may hold true for tax reform and infrastructure spending. Updates to the tax code will need to be revenue-neutral in order to pass on a party-line vote. We suspect the market may be disappointed in the next few months as market-friendly reform will likely be delayed or watered down.

With that being said, there is currently a positive momentum for economies around the world. In the U.S., initial unemployment claims are the lowest in over 40 years and housing data is positive[a]. Data from Europe shows growth approaching 2% and Japan, China and India all show economic improvement[a]. As long as these favorable trends remain in place we are inclined to add to our equity holdings on a pull back.

"I view diversification not only as a survival strategy but as an aggressive strategy, because the next windfall might come from a surprising place. I want to make sure I'm exposed to it. Somebody once said that if you're comfortable with everything you own, you're not diversified."

- Peter Bernstein, noted financial historian

As the following chart shows, international equity markets have trailed U.S. stocks during the past decade. We would not be surprised if the next decade stays true to form with lagging asset classes outperforming recent winners. Due to valuation concerns, we are underweight U.S. small-cap stocks relative to large and mid-cap stocks. And if the aforementioned pull-back materializes we will be inclined to add to our non-U.S. equity holdings. These are long-term trends but are important as we position your holdings for the future.

10 Year Performance Returns as of 12/31/2016[a]:

2008	2013	2016
Emerging Mkt Stocks 9.2%	Emerging Mkt Stocks 11.5%	U.S. Mid Cap 9.1%
Commodities 7.6%	U.S. Mid Cap 10.3%	U.S. Small Cap 7.0%
U.S. REITs 7.4%	U.S. Small Cap 9.0%	U.S. Large Cap 6.9%
TIPS 6.8%	U.S. REITs 8.6%	U.S. REITs 5.1%
U.S. Agg Bonds 5.6%	Int'l Dev. Stocks 7.5%	TIPS 4.4%
U.S. Mid Cap 4.5%	U.S. Large Cap 7.4%	U.S. Agg Bonds 4.3%
Cash 3.4%	TIPS 4.8%	Emerging Mkt Stocks 2.1%
U.S. Small Cap 3.0%	U.S. Agg Bonds 4.5%	Int'l Dev. Stocks 1.3%
Int'l Dev. Stocks 1.3%	Cash 1.7%	Cash 0.8%
U.S. Large Cap -1.4%	Commodities 0.9%	Commodities -5.6%

While there are certainly areas of concern this year, we think the upcoming decade will see progress coming from "surprising places". We're reminded of this as Jeff Bezos, founder of Amazon, recently surpassed Warren Buffett to become the nation's second richest man behind Bill Gates. Among emerging technologies, Artificial Intelligence (AI) will likely lead to self-driving cars, health care advances and smarter industrial robots - each will present its own sets of opportunities and challenges. As we've mentioned before, equities are the asset class that benefits most from human ingenuity. We are biased, therefore, to tilt portfolios over the long run towards stocks as we navigate the future together.

All the best,

Richard Sipley, CFA
Wellesley Investment Partners

a. Bloomberg

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8. Notable indices shown for illustrative purposes include the S&P 500 Total Return Index, the S&P Midcap 400 Total Return Index (U.S. Midcap Equities), the Russell 2000 Total Return Index (U.S. Smallcap Equities), the MSCI EAFE Total Return Index (International Developed Market Equities), the MSCI Emerging Markets Total Return Index (Emerging Market Equities), the Barclays U.S. Aggregate Total Return Bond Index (U.S. Core Bonds), Gold spot price/troy ounce in U.S. dollars, and the JP Morgan Global Aggregate Total Return Bond Index (International Core Bonds). Data source: Bloomberg.
9. This report is for the quarter ending March 31, 2017.