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Rebuilding the Wall (of Worry)

President Trump and President Xi Jinping shown in less stressing times last November in Beijing.

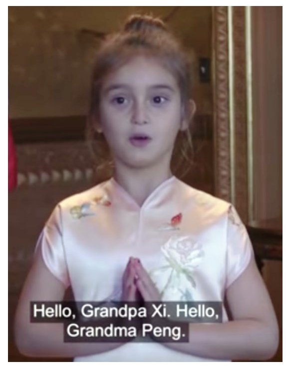
In a fairly dramatic quarter for the markets, China's National People's Congress quietly rubber stamped a proposal to remove the two-term limit on the presidency. The vote tally was 2,959 to 3[a]. Current President Xi Jinping, widely referred to as the "Chairman of Everything", consolidated his grip on power and is now the "President for Life". This change challenges the thinking that China may eventually pivot toward a Western style democracy.

Instead, China appears to be shifting toward a form of democratic dictatorship. Xi has presided over a tough crackdown, going so far as to jail for two years a man who referred to him as "Steamed Bun Xi" on a private group chat. For added measure, authorities disbarred the lawyer who defended the man[b]. Xi has called for a "Great Rejuvenation" for China on the world stage and appears equally determined to get his way.

The United States has frequently pressed China over the years on opening its markets to trade and equalizing access. Underlying tensions have risen as China's economy is now the second largest in the world (the U.S. is first)[c] and arguably its industries have grown to a size where they no longer require protection from outside competition. President Trump's mantle of "Make America Great Again" naturally collides with China's "Great Rejuvenation".

The stock market has reacted with volatile swings as the two countries exchange tariff threats. Short-term the concern is that a trade conflict may inflict damage to global economic growth. Longer-term the concern is that globalization may be on the wane and that protectionist measures could constrict cross-border business and profits. Economies and markets operate best on a bedrock of understanding and trust; the markets are calibrating just how deep these fissures will go.

Underneath the headlines and rhetoric are personal relationships that may play a moderating role. For instance, President Trump's granddaughter, Arabella, is learning Mandarin from her Chinese nanny. When Trump visited Beijing last November, he brought with him a video of Arabella singing a traditional Chinese folk song. Chinese state media agency Xinhua noted that President Xi said the "young girl deserved an A+"[d]. While Xi has never lived outside of China, breaking tradition with his predecessors, his only daughter did graduate from Harvard in 2015.



Trump's granddaughter, Arabella, in a video and Xi with his only daughter, Xi Mingze, when she was younger.

One hopes that these personal relationships and room for compromise – no one "wins" a trade war – will lead to a de-escalation of trade tensions. Until there is détente though, the market will likely react to each new development in this public negotiation between global powers.

As these geopolitical cross-currents play out, the markets also are digesting the following:

Interest Rates: The U.S. 10-year Treasury rate rose from 2.46% and nearly touched 3% in late February before settling back to 2.74% to end the quarter. The Federal Reserve, under new Fed Chair Jerome Powell, lifted the Federal Funds Rate as expected to 1.5 – 1.75% and signaled an expectation of at least two hikes by year-end. Unemployment is at 4.1%, a level last seen in late 2000. Wage growth has been fairly steady at about 2% and all eyes are on whether wage pressures build[e]. Historically, the Federal Reserve has hiked interest rates more aggressively when wage growth exceeds 4%.

Zuckerberg goes to Washington: Facebook is in the regulatory crosshairs as it was revealed that British firm Cambridge Analytica used identifiable information on up to 87 million Facebook users to influence voter opinions. Several technology stocks including Facebook and Google have been clipped on worries that this sector, which has faced light regulation, might have their business models disrupted by politicians.

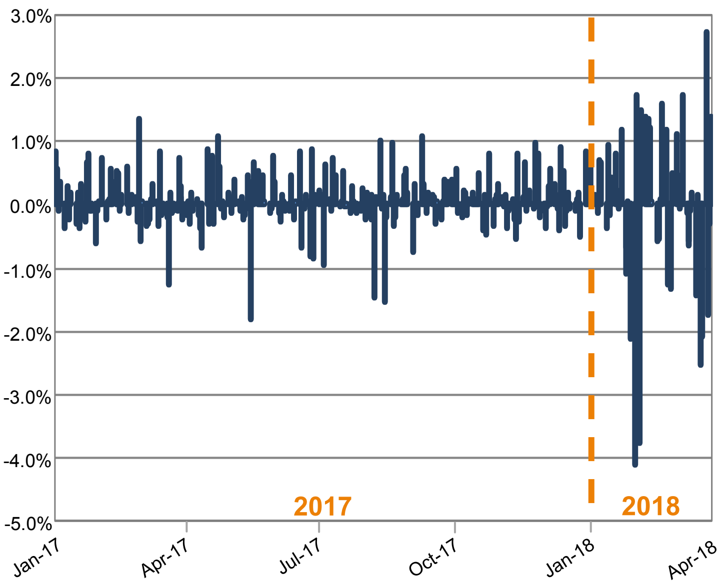
a.Bloomberg, "Nobody Wants to Vote Against Xi Jinping", 3/20/2018, bloomberg.com/news/articles/2018-03-20/nobody-wants-to-vote-against-xi-jinping
b.Financial Times, "Under Xi Jinping, China is turning back to dictatorship", 10/10/2017, Jamil Anderlini, ft.com/content/cb2c8578-adb4-11e7-aab9-abaa44b1e130
c.World Bank, as of 2016
d.DailyMail UK, "Chinese 'love' Trump's Mandarin Speaking Granddaughter", 11/9/2017, dailymail.co.uk/wires/afp/article-5065749/Chinese-love-Trumps-Mandarin-speaking-granddaughter.html
e. St. Louis Federal Reserve, FRED

Earnings Expectations: Profits are predicted to rise 27% from the second quarter this year through mid-2019[f]. Much of this good news is based on the Tax Cut law passed in late 2017 which substantially reduced the corporate tax rate. Warren Buffett said this on the topic in late January.

> *"The tax cut is a huge factor in valuation. You had this major change in the silent stock holder in American business (the U.S. Government) who has been content with 35 percent … and now instead of getting 35% interest in the earnings they get 21 percent and that makes the remaining stock more valuable[g]."*

The result of all this is a return, with a vengeance, of volatile times in the market. The chart below shows the daily volatility of the S&P 500 – note that there were no 2% moves during 2017 and yet we had six in the first quarter of 2018.

S&P 500 Daily Returns (1/2017-3/2018)[h]



f. Bloomberg, "Stock Market Scavenger Hunters Should Think Again", Stephen Gandel, 4/11/2018, bloomberg.com/gadfly/articles/2018-04-11/stock-market-scavenger-hunters-should-think-again
g. CNBC, "Warren Buffett says 'huge' corporate tax cut is 'not baked in' stock market", Tae Kim, 1/10/2018, cnbc.com/2018/01/10/warren-buffett-says-huge-corporate-tax-cut-is-not-baked-in-stock-market.html
h. Bloomberg.

Bottom Line

The current volatility reflects a tug-of-war between positive and negative forces. There are tax cuts (positive), rising interest rates (negative), strong domestic earnings growth (positive), tariffs and threats of a trade war (negative), potential regulatory action against technology companies (negative) and solid global economic growth (positive).

From our perch, these competing forces and resulting volatility is "normal" and doesn't necessarily mark the beginning of a sustained market decline. We continue to be neutrally positioned in our Global Asset Allocation strategies. Whether or not we change this view, we will use the market volatility to rebalance portfolios when they drift far enough away from our target. We believe this discipline adds to returns and dampens volatility over the long-term.

In our Dividend Growth strategy, we are content to get paid (via dividends) while we endure the market volatility. Over time, we expect/anticipate that our patience will be rewarded through our ownership of companies that can compound wealth over time by adjusting to market realities.

We, along with all of New England, await the arrival of Spring and the end to this long stretch of Winter. As always, please feel free to reach out with any questions or thoughts.

Regards,

Richard Sipley, CFA
Chief Investment Officer

Performance of Notable Indices	Q1 2018	1-Year (4/1/17 – 3/31/18)
S&P 500 Index	-0.8%	14.0%
U.S. Midcap Equities	-0.8%	11.0%
U.S. Small Cap Equities	-0.1%	11.8%
International Developed Market Equities	-1.5%	14.8%
Emerging Market Equities	1.4%	24.9%
U.S. Core Bonds	-1.5%	1.2%
Global Bonds	1.0%	6.5%
Gold, $/troy oz	1.7%	6.1%

Total return indices unless otherwise stated.

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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). You cannot invest directly in an index. Data source: Bloomberg.
9. This report is for the quarter ending March 31, 2018.