WELLESLEY INVESTMENT PARTNERS
WEALTH MANAGEMENT
A SUBSIDIARY OF WELLESLEY BANK

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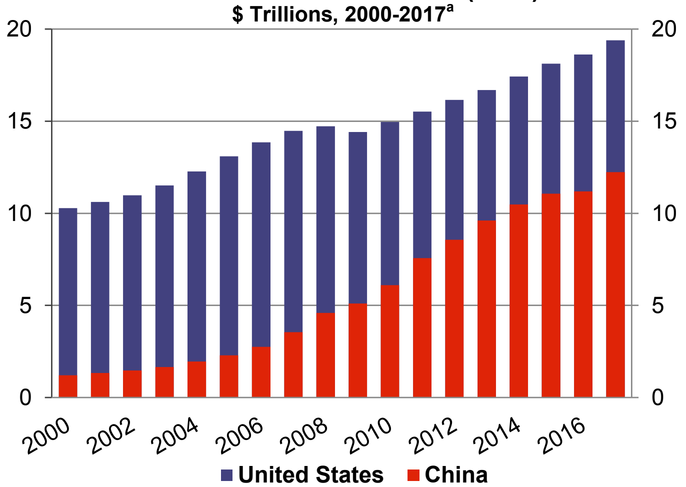
Clash of the Titans

China's foreign policy was long guided by a doctrine summed up in 1990 by Deng Xiaoping, its former leader, as "hide your strength and bide your time". Last fall, China's current leader, "President for Life" Xi Jinping, altered the narrative when he stated "It is time for us to take center stage in the world and to make a greater contribution to humankind."

So much for hiding and biding.

This pivot comes as China's $12 Trillion economy is nearing that of the European Union and is approaching the $19 Trillion U.S. economy[a]. Since its entry into the World Trade Organization in 2001, the Chinese economy has rapidly grown by becoming an exporting powerhouse.

Gross Domestic Product (GDP)
$ Trillions, 2000-2017[a]



Xi is playing the long game with his "China 2050" roadmap that promises to transform the country into a technology-driven economic power. It's why the recent trade dispute reflects a tension greater than just market access and trade deficits. On a deeper level, the standoff reflects an escalating economic and military rivalry between a status quo power (the U.S.) and an ascending one (China).

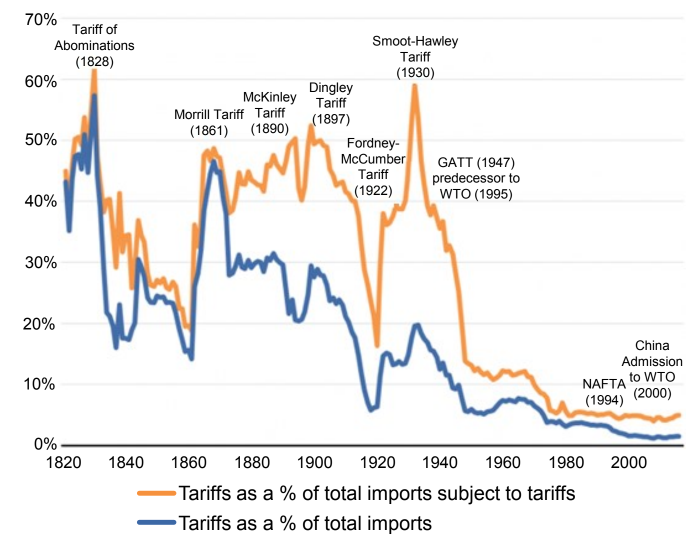
It's a clash between two very different systems – one state-directed and one primarily market-driven. A battle for global influence is in play as the U.S. has long sought to spread democracy and open markets while China's ruling Communist Party is pitching its centralized growth model as an alternative. This geopolitical tug-of-war will play out over years and companies will need to adapt as best they can to the shifting environment.

a. Data Source: World Trade Organization.
b. Forbes, "Trade Dispute No Match for a U.S. Fiscal Stimulus that 'Dwarfs Tariffs'", Kenneth Rapoza, 7/2/18, https://bit.ly/2KIK0CR
c. Bloomberg Businessweek, "After Years of Easing, Meet Quantitative Tightening", Alessandro Giovanni Borghese and Christopher Anstey, 7/9/18, https://bloom.bg/2m8pmNB

Putting tariffs into perspective

The U.S. stock market has seemingly brushed off these trade concerns as the impact is seen as modest in relation to recent fiscal stimulus. Between the Tax Cut and Jobs Act and increased federal spending, the U.S. is expecting nearly $275 billion in stimulus (1.4% of GDP) compared to the $80 - $100 billion impact of higher tariffs currently enacted[b]. In the short term, the markets are seemingly discounting the prospect of a protracted and deep confrontation over tariffs. However, a replay of the 1930's Smoot-Hawley tariff war would certainly be another matter. As the chart below shows, markets have become accustomed to a long period of de-escalating tariffs and an opening of global trade.

Tariffs: A Historical Perspective



Data Source: Charles Schwab & Co., U.S. Census Bureau and U.S. International Trade Commission, as of 6/18/2018.

Our own sense is that compromise of some sort will be found in coming months and that a replay of a trade war from a bygone era will not come to pass.

Central Banks continue to unwind "extraordinary measures"

In the U.S., the Federal Reserve (Fed) hiked rates during the quarter as expected to a range of 1.75% to 2.0% and signaled they may raise rates twice more during 2018 depending on economic and inflationary developments.

Inflation has been relatively contained which allows the Fed to take a wait-and-see attitude. It is also reducing the size of its balance sheet by not reinvesting $40 billion of maturing bonds per month[c].

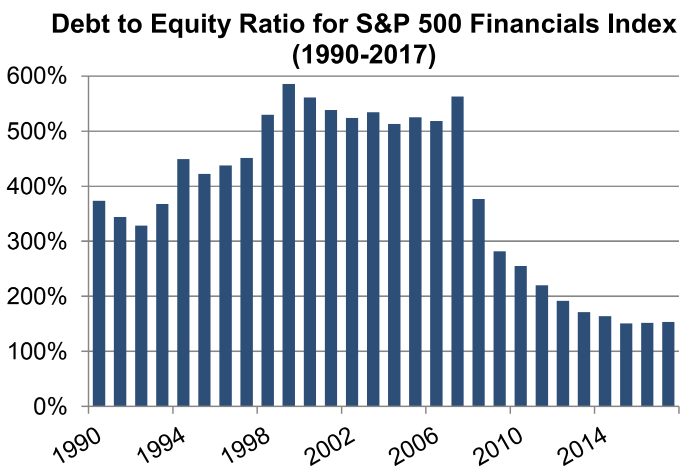
Meanwhile, in Europe, the European Central Bank (ECB) will slow its purchases of bonds to $15 billion per month in the fourth quarter but is not expected to lift rates. The ECB's long-time president, Mario Draghi of Italy, will end his eight-year term in October 2019. Expect to hear more about his successor in coming months as many see Jens Weidmann of Germany as the most likely successor. Weidmann has been a critic of the extended quantitative easing program. Coupled with the shifting political environment in Europe, a perceived upcoming shift in ECB policy could also impact the markets.

Market moves during the quarter

Rising U.S. interest rates and relatively good economic growth (compared to the rest of the world), has prompted a recent rise in the U.S. dollar. Emerging markets, including China, sold off during the quarter on concerns that export dependent economies may suffer from a pullback in trade. Finally, short-term interest rates rose modestly as the market expects a few more Fed hikes. Longer term rates were relatively unchanged as the outlook for inflation remains in check. On the year, bonds of nearly every maturity have registered slight price declines. The upside is that short-term bonds now carry higher yields than they have in nearly a decade.

Banks are in good shape

Since the Great Recession, the Federal Reserve has conducted annual stress tests of the major banks. This year the Fed determined that the 35 largest banks were “strongly capitalized”. With the additional oversight, banks have become less profitable as the collective profit margin of the S&P 500 Financials Index has averaged 9.3% from 2008 to 2017 as compared to an average of 13.8% from 2003 to 2007[d]. Profitability is lower in part because banks are carrying less leverage. You can see from the chart below that the debt-to-equity ratio for banks in the S&P 500 is far lower than in recent years.



Data Source: Bloomberg

It has been a long healing process for the U.S. banking system but the result is a return to a more solid foundation which should be resilient to future economic shocks.

Takeaway

The market is seemingly looking to find its legs as it balances strong corporate profitability with concerns over tightening monetary policy and the specter of disruptions to an entrenched and efficient global supply chain. We continue to be neutrally positioned in our Global Asset Allocation strategies. Recent pullbacks in overseas equity markets may offer an opportunity to add to those positions. We don’t foresee a rapid rise in interest rates but are cautious in our fixed income positioning with a preference for short-term and high-quality bonds.

In our Dividend Growth strategies, we continue to favor owning companies that are dynamic and flexible enough to adjust to changing business conditions. Companies that can pay a solid and growing dividend suggest they are operationally strong organizations that reward their owners with an ongoing cash flow stream.

Wellesley Investment Partners recently surpassed $400 million in assets under management[e]. We are grateful for the trust you place in us and will continue to work hard to earn that trust. We hope that you have a nice summer with friends and family. If there is anything we can do for you, please reach out.

Regards,

Richard Sipley, CFA
Chief Investment Officer

Performance of Notable Indices	Q2 2018	1-Year (7/1/17 – 6/30/18)
S&P 500 Index	3.4%	14.4%
U.S. Midcap Equities	4.3%	13.5%
U.S. Small Cap Equities	7.8%	17.6%
International Developed Market Equities	-1.2%	6.8%
Emerging Market Equities	-8.0%	8.2%
U.S. Core Bonds	-0.2%	-0.4%
Global Bonds	-2.5%	1.2%
Gold, $/troy oz	-5.4%	0.9%

Data Source: Bloomberg. Total return indices unless otherwise stated.

d. Bloomberg, “Forget Banks and Worry About High Stock Prices”, Nir Kaissar, 6/29/18, https://bloom.bg/2MOPzw9
e. As of January 31, 2018 Wellesley Investment Partners managed $406.4M in regulatory assets under management consisting of both discretionary and non-discretionary assets.

NOTES AND DISCLOSURES