WELLESLEY INVESTMENT PARTNERS
WEALTH MANAGEMENT
A SUBSIDIARY OF WELLESLEY BANK

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A time of transition and turning

There have been many cross currents this year; seemingly more than most years. The U.S. has had ongoing discussions with other countries over long standing trade practices. The Federal Reserve has been raising rates and removing accommodation while the recent Tax Cut and Jobs Act has served as a renewed stimulus to corporate bottom lines. Fresh anxieties have surfaced as a populist-led government in Italy pushes back against status-quo budget rules in the European Union. The list goes on.

These twists and turns have resulted in unusual investment results through the first nine months of 2018, including:

- Most fixed income returns have been negative. If this remains the case at year-end, it will mark just the fifth time since the early 1970's[a].
- U.S. equities, especially growth stocks, have far outperformed the rest of the world. Emerging Market stocks, in particular, have trailed. The S&P 500 has gained 10.6% while the MSCI Emerging Market index has dropped 7.7%[b].

The stock market weighs two things. First, what are earnings going to be in the intermediate to long term. In the U.S., last year's Tax Cut law has energized corporate earnings as far more earned cash flow drops to the bottom line. The market is now looking out to 2019 (and beyond) and is calibrating, among other items, the likelihood and impact of trade tensions.

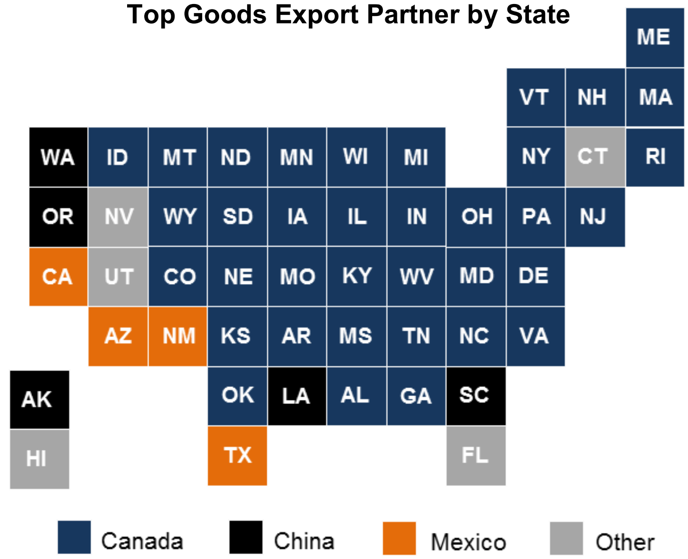
The other input the stock market considers is interest rates – higher interest rates are naturally seen as stronger competition for an investor's dollar. We'll return to rates in a bit, but first, it's helpful to put the trade concerns into context.

The New Nafta—did we hafta?

Much ink has been spilt on U.S.-China talks. Lost in those headlines has been the ongoing trade negotiation with Mexico and Canada. The original North American Free-Trade Act (Nafta), signed in 1993, was close to being completely abandoned. At the twelfth hour, a deal was brokered with a new acronym – USMCA (U.S.-Mexico-Canada Agreement).

a. "Bad years for US Treasuries don't mean bad years for markets", Jamie McGeever, Reuters, 10/9/18, https://reut.rs/2RIpFNX
b. Source: Bloomberg.
c. "USMCA Trade Pact: For Canada and Mexico, Throwing China Under the Bus was a No-Brainer, Alex Lo, 10/6/18, https://bit.ly/2y8n4Ey
d. Source: International Monetary Fund. GDP as of 12/31/17.

Top Goods Export Partner by State



Data Source: BMO Economics, U.S. Department of Commerce.
As of 6/18/2018.

The map above shows Canada as the largest export partner for 36 of the 50 U.S. states – Canada, in fact, bought $340.7 billion worth of goods and services from the U.S. last year which was twice that of China. The contiguous land mass of North America makes a natural trade zone that benefits all parties. From a political point of view, it's no surprise that the three countries reconciled their differences. Or, in our view, Nafta 2.0 with one important twist.

The New Cold War?

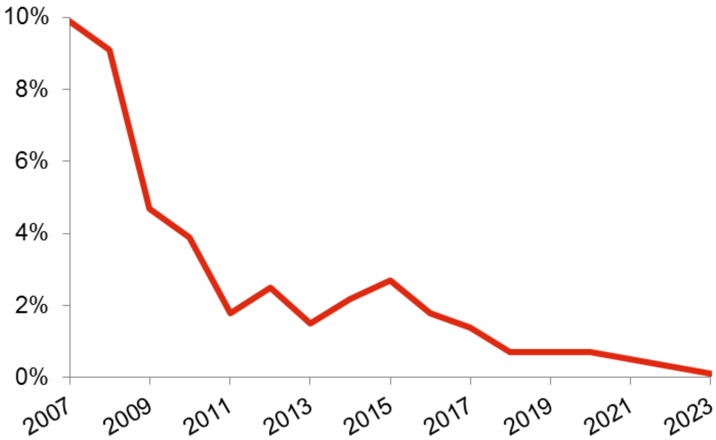
One wrinkle introduced into USMCA is a provision, Article 32.10, which allows the U.S. to end USMCA if any of the countries strike a bilateral deal with 'a non-market economy'. It sounds innocuous, but the South China Morning Post wasn't alone in recognizing the impact[c]:

> **USMCA TRADE PACT: FOR CANADA AND MEXICO, THROWING CHINA UNDER BUS WAS A NO-BRAINER**

This appears to be the template as U.S. trade negotiators seemingly look to isolate and temper China's trade practices and global ambitions. But, one can argue the calculus has changed – perhaps China is being more assertive on the world stage for a reason. One can see in the chart below that China's export surplus has steadily shrunk as its domestic economy has grown. This surplus is now only 0.7% of its $12 Trillion economy and expected to shrink further[d].

At the risk of understating the investment impact, perhaps the economic fallout for both countries from trade tensions may be less than initially thought. Also, trade tariffs can be circumvented so the actual reduction in trade may be materially less than predicted. Finally, there may be a mutual recognition of damage being done and some form of détente could be reached.

China's Account Surplus Relative to it's Economy (% of GDP)



Data Source: International Monetary Fund (IMF), World Economic Outlook, October 2018. Figures after 2018 are IMF projections.

The Fed Flexes

In the aftermath of the great recession, then Fed Chairman Ben Bernanke regularly implored Congress to support the economy by expanding government (i.e., fiscal) spending. The Fed's accommodative monetary stance was seen by many as 'the only game in town'. With the stimulus from lower taxes and expanded government spending, the Fed is understandably willing to return rates to a 'normal' level. After three hikes in 2018, the Fed Funds rate is finally roughly on par with the inflation rate. The debate now revolves around what 'normal' interest rate underpins healthy economic activity without igniting inflationary pressures.

Which returns us to the stock market. For much of the past decade, interest rates were more easily predicted as the Fed assured anyone that would listen that interest rates would stay low. This recent uncertainty over the path of rates introduces a level of tension and volatility into the markets. Our view is that long-term deflationary trends will serve to limit this recent increase in rates. Longer term we have concerns with the expanding fiscal deficit; it's the single biggest item that would alter our view on rates.

The Bottom Line

As we've discussed before, the economic and political issues with China are real and reflect an ideological clash over very different economic and political systems. It's helpful to place this in context in terms of bottom line profits – Canada, somewhat surprisingly, is far more important and that relationship remains intact.

We suspect equity returns may be muted going forward as many investors take a fresh look towards allocating funds to fixed income due to the higher rates now offered.

In our Global Asset Allocation strategies, we continue to maintain a Neutral stance between bonds and stocks. This summer we further reduced the interest rate sensitivity and are glad we did so; if rates continue to rise we may reconsider and pivot to lock in those higher rates by lengthening the average maturity of our holdings. The outperformance of U.S. equities may give us another opportunity to rebalance accounts back to our target allocations by trimming the outperformers (i.e., U.S. stocks) and adding to the laggards (i.e., non-U.S. stocks).

In our Dividend Growth strategy, we continue to monitor long-term trends and position into owning those companies that have the operational heft and managerial deftness to roll with the punches.

We hope everyone enjoys the Fall season, the time of turning for the trees. We will watch the leaves change color from our offices and are here to answer any questions you may have.

Regards,

Richard Sipley, CFA
Chief Investment Officer

Performance of Notable Indices	Q3 2018	1-Year (10/1/17 –9/30/18)
S&P 500 Index	7.7%	17.9%
U.S. Midcap Equities	3.9%	14.2%
U.S. Small Cap Equities	3.6%	15.2%
International Developed Market Equities	1.4%	2.7%
Emerging Market Equities	1.1%	-0.8%
U.S. Core Bonds	0.0%	-1.2%
Global Bonds	-0.8%	-1.4%
Gold, $/troy oz	-4.8%	-6.9%

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

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9. This report is for the quarter ending September 30, 2018.