Quadrant
A Quarterly Update

WINDHAVEN
INVESTMENT MANAGEMENT

What a Difference a Year Makes

July 2018

Key Points:

1. Stock market volatility back to "normal"

2. Overall global growth persists, but increasingly driven by the United States

3. Windhaven Strategies adjusted as the environment changed

Participate and Protect

Last year, at about this time, it was pretty much smooth sailing in the market. Leaving aside some mid-summer geopolitical verbal skirmishes, market participants were enjoying double-digit returns in global equities amid a global synchronized economic recovery, low global interest rates, reduced European political risk (post-French elections) and the prospect of potential fiscal stimulus in the United States. A weakening U.S. dollar was supportive of U.S. company earnings and of international equities across the developed and emerging world.

A year later we are back to “normal.” Stock market volatility has picked up and is back in line with historical levels (figures 1 & 2). Global economic growth is still there, but far from synchronized, with the United States accelerating and the rest of the world slowing. Interest rates are rising in the United States and the Federal Reserve (Fed) has started to shrink its balance sheet, while the European Central Bank is planning for a potential unwind of its quantitative easing program by the end of the year. Political risk has returned in Europe with a vengeance (post-Italian elections). While some of the growth benefits from U.S. fiscal stimulus might still be ahead of us, the post-fiscal reform enthusiasm of this past January has been replaced by concerns around potential trade wars and a strengthening U.S. dollar.

As a result of this change in the macroeconomic and market landscape, we have tactically shifted the allocations of the strategies. After relatively high levels of equities in our strategies in 2017 and early 2018 to participate in the markets’ growth, we have steadily decreased our allocations to international equities, favoring more defensive asset classes such as fixed income and commodities as we sought more protection from market jitters.

Looking Ahead

As we look ahead into the second half of 2018, our research process continues to point to a weakening of global macroeconomic fundamentals and behavioral factors in the market. After the global growth momentum peak in early 2018, the United States is now the exception with fundamentals that have continued to surprise on the upside for most of the second quarter. Solid U.S. fundamentals might persist for longer in absolute terms and relative to the rest of the world (figure 3). In wake of falling unemployment and rising inflation, we believe that the Fed will continue on its interest rate hiking path, potentially accelerating the pace of hikes as indicated in the June policy meeting. The current macroeconomic and market conditions are also supportive of the recent strengthening of the U.S. dollar. As the business cycle becomes more mature, markets are likely to remain increasingly sensitive to negative headlines and data surprises, as well as to any change in the guidance coming out of central banks.

As always, we will maintain our discipline and continue to stay true to our research process. We seek opportunities across global asset classes which display solid behavioral conditions and economic fundamentals, while managing risk; seeking to participate when we can and protect when we must.

Fig 1: From smooth sailing in 2017 to rougher waters in 2018...
Source: Bloomberg as of 6/30/2018.

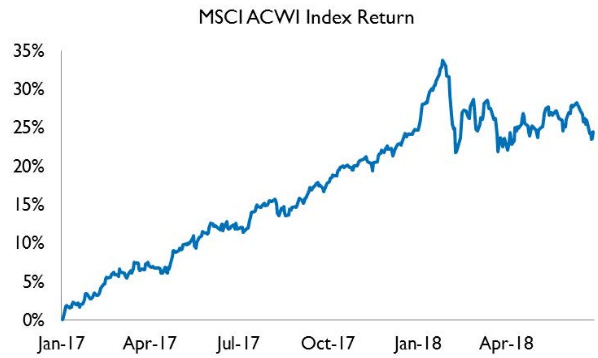


Fig 2: ...but volatility in line with historical levels
Source: Bloomberg as of 6/30/2018.

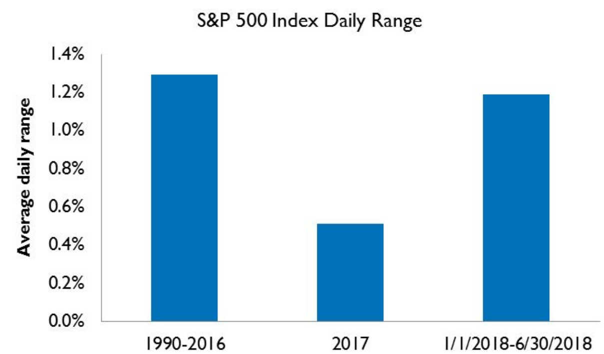
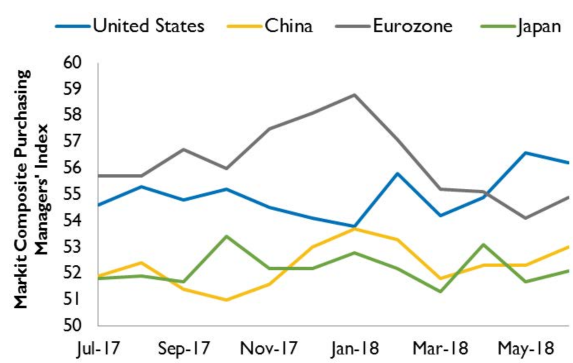


Fig 3: U.S. fundamentals look better in relative terms
Source: Bloomberg as of 6/30/2018.



Positioning

As alluded to above, our trading in the second quarter featured a somewhat modest reduction in the overall allocation to equities; for example, in our Diversified Growth strategy, the allocation to equities was reduced by 2.7% to 56.4%[1] over the quarter. However, the composition of all of the strategies' equity allocation changed quite dramatically. As of April 1st, nearly two-thirds of all three strategies' allocation to equities was international, including both developed and emerging markets countries. At the end of the quarter, the international and emerging market equity exposure was less than half of the equity allocation. This positioning reflected both the growth outlook and attractive valuations that existed in many regions of the globe in 2017 and early 2018. As it became clear that politics, central bank policy, and growth were taking a turn for the worse; we tactically adjusted our exposure away from what we believe are increasingly problematic areas and redeployed capital in more attractive assets, including both U.S. large and small-cap stocks, commodities, and U.S. bonds. As we enter the third quarter, all three Windhaven Strategies retain a healthy allocation to equities that slightly exceeds the amount in their respective, passive benchmarks. Our approach to fixed income is unchanged, focused on protecting against the effect of rising interest rates, while not reaching for yield at this late stage of the economic cycle. Real estate is not currently held in the strategies. The outlook for commodities, led by oil, has improved, which resulted in us increasing our exposure this quarter.

We appreciate your investment in the Windhaven Strategies. Please contact your Investment Professional if your investment objectives or circumstances have changed such that a review of your Windhaven Strategy account(s) might be necessary, or if you have any specific questions about how your account is managed. We value the trust our clients have placed in us, and we are passionate about the Windhaven Strategies and the role they play in helping each of you reach your investment goals.

-The Windhaven Portfolio Management Team

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[1]Model allocations as of 6/5/2018. Since clients invested in the Windhaven Diversified Growth Strategy maintain their assets in separately managed accounts, there may be exceptions to the allocations and changes discussed. For a variety of reasons, some client accounts may not hold certain asset classes or securities mentioned.

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Asset classes and the proportional weightings in the strategies may change at any time without notice subject to the discretion of the Windhaven Portfolio Management Team.

Indexes shown in the charts throughout are unmanaged, do not incur fees or expenses, and cannot be invested in directly.

Past performance is no guarantee of future results.

International investments may involve additional risks, which could include differences in financial accounting standards, currency fluctuations, political instability, foreign taxes and regulations, and the potential for illiquid markets. Investing in emerging markets may accentuate these risks.

Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed income investments are subject to various other risks including changes in credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors.

Hard assets can be significantly affected by commodity prices, world events, import controls, worldwide competition, government regulations, and economic conditions.

Windhaven's risk management process includes an effort to monitor and manage risk, but should not be confused with and does not imply low risk or the ability to control risk.

Please refer to the Windhaven Strategies Disclosure Brochure for additional information.
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