Quadrant
A Quarterly Update

WINDHAVEN
INVESTMENT MANAGEMENT

More Than Just Policy, Fortunately
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Portfolio Management Team

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Key Points:

1 Positive investor sentiment spread from U.S. to global equities in the first quarter of 2017.

2 After a difficult end to 2016, emerging market equities have rebounded nicely, and continue to look attractive.

3 Economic fundamentals are strong globally and are likely to drive markets with a possible interruption from European elections.

The Trump Reflation Trade

Much of the market action at the end of 2016 was attributed to the expectation that the new U.S. administration would introduce meaningful economic stimulus via fiscal spending and tax cuts. The so-called "Trump reflation trade" propelled the U.S. dollar and U.S. dollar based risky assets like U.S. equities while penalizing bonds, gold and non-dollar assets like emerging markets.

In the beginning of 2017, the enthusiasm generated by the prospect of U.S. fiscal stimulus has given way to global fundamental forces. The U.S. dollar has come down from the December highs while emerging market equities and gold have been among the top performing asset classes for the first quarter of this year. As the chart below indicates, U.S. equities have continued to perform well in the first quarter, while international equities, and emerging markets equities, in particular, have staged a dramatic turnaround after a poor fourth quarter. Our research and modeling process indicates that economic fundamentals and market sentiment have remained solid as they were already before the outcome of the U.S. presidential elections. This view is corroborated with the markets' resilience amid Federal Reserve (Fed) interest rate hikes and policy setbacks such as the inability to replace the 2010 Affordable Care Act, one of the pieces of the puzzle that might be necessary for attaining potentially stimulating fiscal reforms.

Fig 1: Recent global equity performance

Source: Bloomberg as of 3/31/2017 | U.S. equities are represented by S&P 500® Index, international developed equities are represented by MSCI EAFE® Index, and emerging market equities are represented MSCI Emerging Markets Index℠

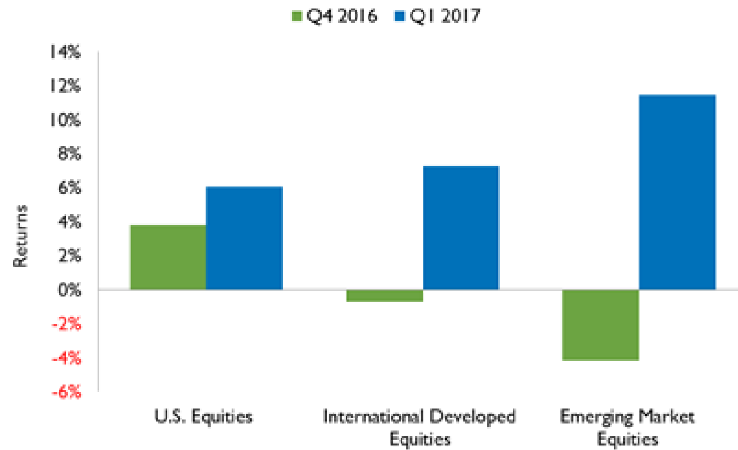
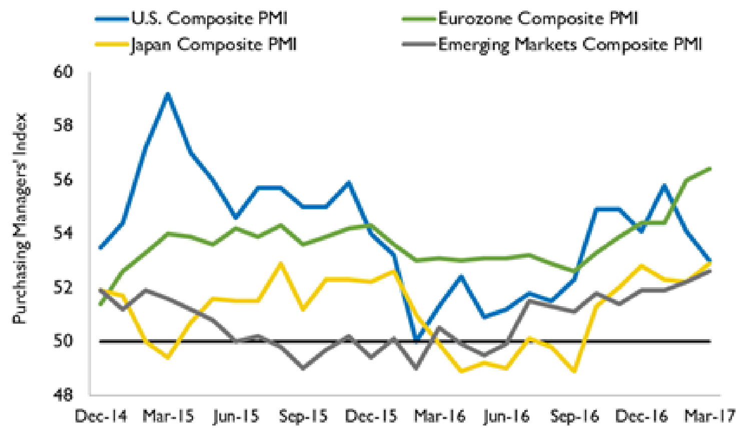


Fig 2: Solid global fundamentals

Source: Bloomberg, data based on Markit as of 3/31/2017



Looking ahead

The path ahead will likely be one of solid global economic fundamentals that will continue to constitute a tailwind for market sentiment.

Fundamentals across the global economy look quite strong. While the most recent data in the United States have surprised on the downside and growth in the first quarter of 2017 will likely turn out to be well below trend, we maintain that U.S. macro fundamentals point to an economy that will continue to expand and that will likely allow the Fed to continue to raise interest rates in 2017. The unemployment rate, at 4.5%, is at the lower bound of the Fed's long term projection.[1] A tight labor market should be conducive of some healthy wage inflation and continued growth in personal consumption. While leading indicators, such as PMIs, in the United States have cooled off recently, the economy appears to remain on a path of expansion and we believe, far from recession. A healthy U.S. economy remains a necessary but not sufficient condition for a healthy global economy.

Outside of the United States the cyclical recovery is in full swing across Europe, Japan and much of the emerging world. As shown in figure 2, leading indicators not only remain in expansionary territory (a PMI diffusion index value above 50 represents expansion), but they also show signs of acceleration denoted by the upward trend of lines which persist for Europe, Japan and emerging markets. In addition to solid macro-economic fundamentals the global economy is benefiting from the tailwind of accommodative global monetary policy. Even with the Fed engaged in a very gradual and data dependent tightening cycle, the three other major global central banks (European Central Bank, Bank of England and Bank of Japan) continue to flood the global economy with liquidity. These accommodative policies, coupled with solid fundamentals, remain an important tailwind for both developing and emerging economies, in particular for those regions with attractive valuations and behavioral characteristics.

With solid global fundamentals, we look at global policy and politics to remain a theme for markets to watch closely.

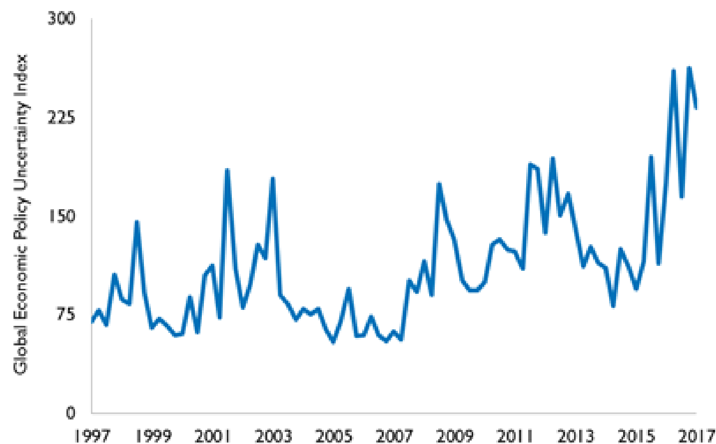
In the United States, uncertainty around potential tax reforms, debt ceiling issues and protectionist trade measures will likely accompany us throughout the remainder of the year. While it is likely that some form of tax reform and stimulus will eventually be implemented, the economic impact of policy implementation might not be felt until well into 2018, even though markets will likely be quick to price it in well before the impact materializes on corporations' bottom lines.

During the spring and summer, French and German general elections will unfold and while the risks of anti-European Union (EU) outcomes are certainly on the table, the common denominator among prospective administrations is an inclination towards some form of fiscal stimulus in a European economy that has shown signs of strength and potential growth acceleration. The fallout of Brexit will be ongoing as negotiations over the final separation arrangement of the UK (with or without Scotland) from the EU could spread over the next two years.

2017 is also a year of leadership transition for China. The new leadership will be faced with old issues: complicated relations with the United States and a managed unbalanced economy in need of reforms and gradual liberalization. China appears to be in a phase of cyclical expansion which the new leadership will likely continue to support through expansionary policy measures.

Fig 3: Policy uncertainty reaching new highs

Source: Bloomberg, data based on Baker, Bloom & Davis as of 3/31/2017



In conclusion, while global economic policy uncertainty has been marking new highs, our research and modeling process indicates that global fundamentals are quite strong. We believe that we are well-positioned to participate in up markets while managing risk during periods of uncertainty and down markets.

Windhaven Positioning

Windhaven's diversified global strategies are designed to provide diversification to endure a variety of economic and market scenarios, while also opportunistically allocating to asset classes that we believe are the most attractive in the short-term. We evaluate and identify attractive asset classes using our proprietary Global Strategies Model, which seeks investments with the strongest risk-adjusted return characteristics based on economic, fundamental, and investor behavioral criteria. We employ macroeconomic and market research as a compliment to the Model in order to independently assess the Model's forecasts.

In stark contrast to the first quarter of 2016, which saw the S&P 500 Index fall over 10% in the first six weeks of the year, and oil prices drop to $26 per barrel, 2017 is off with a bang.[2] Leading the way in the first quarter were global equities. This time, emerging market equities joined the rally, posting an 11.4% return as fears of protectionist policies from the Trump administration subsided.[3] Not to be outdone, the technology-led Nasdaq 100 Index climbed 12.1%, and gold recovered from a difficult fourth quarter with an 8.4% return.[3] All three were tactical holdings in each of our strategies and were important contributors to our solid first quarter performance. As the quarter unfolded, our research and modeling process became increasingly positive on global growth, and as a result, we increased both our U.S. and international equity exposure, while reducing our allocation to fixed income securities. Other notable individual trades included the removal of our exposure to REITs and a continuation of the trimming to our U.S. high yield fixed income position that began in late 2016.

Our overall positioning is as follows:

Equities: U.S. and international equities continue to be attractive from both fundamental and behavioral perspectives, as most measures of economic growth around the globe remain positive. Though promises of tax cuts and deregulation from the new U.S. administration might be bolstering U.S. equity returns, hard measures of economic health, such as gross domestic product (GDP) growth and unemployment, are still quite favorable and supportive of equities. With that in mind, we modestly increased exposure to U.S. equities across our three strategies in the first quarter. While the Fed has already begun the process of normalizing interest rates, European Central Banks are continuing their pro-growth monetary policies, which we believe could provide a very hospitable environment for international equity returns. The economic malaise plaguing the Eurozone since the Financial Crisis has prevented most European stock markets from recovering fully, leaving many significantly undervalued as compared to the United States. A similar valuation advantage exists in emerging markets, and with low interest rates, a benign currency environment, and a soft landing in China, they make for a very compelling opportunity. We added to our developed international equities exposure and maintained an elevated allocation to emerging market equities, which was initiated in the fourth quarter.

Hard assets: Commodities are showing some improvement from a fundamental standpoint, and are certainly more intriguing after falling in value by more than 50% over the past five years[4], but they remain challenging. Gold remains one of our largest tactical positions and is supported by low interest rates, a slightly weaker U.S. dollar, and myriad geopolitical uncertainties around the globe.

Fixed income: Despite a minor yield spike in mid-March, interest rates ended the first quarter about where they began. We continue to be cautious about interest rate sensitive asset classes and reduced our overall fixed income exposure in the quarter. We continue to hold tactical allocations to high yield, investment grade, and emerging market fixed income, as investors' thirst for yield continues to support our positive view, as well as short duration bonds which are less sensitive to rising interest rates.

From all of us at Windhaven, thank you for your continued support. Please contact your Charles Schwab Investment Professional if your investment objectives or circumstances have changed such that a review of your Windhaven investments 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.

-Portfolio Management Team

Asset Class Allocations as of 3/31/2017*	Diversified Conservative Strategy	Allowable Asset Class Range	Diversified Growth Strategy	Allowable Asset Class Range	Diversified Aggressive Strategy	Allowable Asset Class Range
U.S. equities	14.3%	2-24%	30.%	12-45%	37.1%	20-60%
International equities	12.4%	0-28%	25.9%	2-48%	31.6%	4-62%
Real estate	0%	0-14%	0%	0-19%	0%	0-24%
Hard assets	4%	3-17%	5.5%	4-24%	8.5%	4-30%
U.S. fixed income	64.3%	59-93%	30.8%	24-71%	13.3%	2-60%
International fixed income	5%	0-28%	7.5%	0-43%	9.5%	0-56%

*Model Allocations as of 3/31/2017. Asset classes and the proportional weightings in the strategies may change at any time without notice subject to the discretion of Windhaven. Cash positions whether in US dollars or other currency are included in the relevant fixed income section. Hard Assets are physical assets and include exposure to gold, commodities and energy.

Sources:

1 U.S. Bureau of Labor Statistics as of 3/31/2017
2 Bloomberg | 12/31/2015-2/11/2016
3 Bloomberg as of 3/31/2017 | Asset class performance is represented by annual total returns for the following indices and spot return: NASDAQ 100 Index, MSCI Emerging Markets Index[SM] (emerging market equities), GOLDS Comdty Gold Spot price (Gold). Returns assume reinvestment of dividends, interest and capital gains. Indexes are unmanaged, do not incur fees or expenses, and cannot be invested in directly.
4 Bloomberg | 03/30/2012-03/31/2017

Important Disclosures:

The information provided herein is for general informational purposes only and should not be considered an individualized recommendation or personalized investment advice. The investment strategies mentioned here may not be suitable for everyone. Each investor needs to review an investment strategy for his or her own particular situation before making any investment decision.

All expressions of opinion are subject to change without notice in reaction to shifting market conditions. Data contained herein from third party providers is obtained from what are considered reliable sources. However, its accuracy, completeness or reliability cannot be guaranteed.

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.

Past performance is no guarantee of future results.

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.

Portfolio management for Windhaven Strategies is provided by Windhaven Investment Management, Inc. ("Windhaven"), a registered investment advisor. Windhaven and Charles Schwab & Co., Inc. are separate but affiliated companies and subsidiaries of The Charles Schwab Corporation.

Please refer to Windhaven's ADV Part 2 for additional information.

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