Quadrant
A Quarterly Update

WINDHAVEN
INVESTMENT MANAGEMENT

The Bear is Still Sleeping
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Portfolio Management Team

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Key Points:

1 While central bank inflation targets remain elusive, positive economic news and strong equity returns continue

2 Europe is leading the way with positive economic surprises, while the U.S. and Japan slow

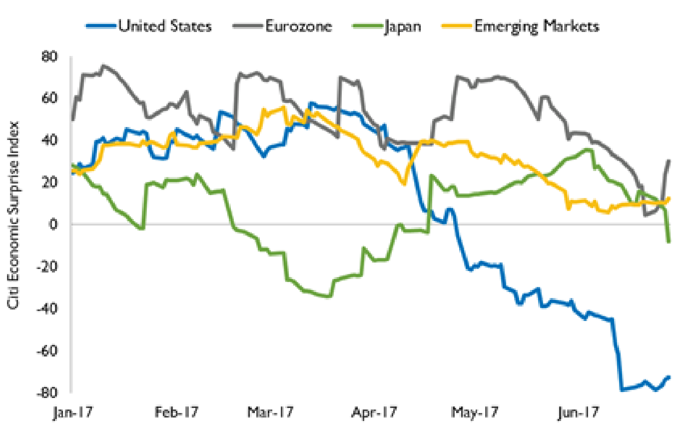
3 Windhaven's diversified strategies remain positioned for global growth, while cautious about assets sensitive to increasing interest rates

Hike while you can…

According to the International Monetary Fund (IMF), global growth is set to accelerate to the fastest pace since 2011, yet central banks continue to miss their inflation targets even after years of low and negative interest rates combined with quantitative easing policies.

The global growth and market environment has remained positive throughout the quarter, with positive economic surprises coming from Europe making up for less positive data in the United States and Japan (figure 1).

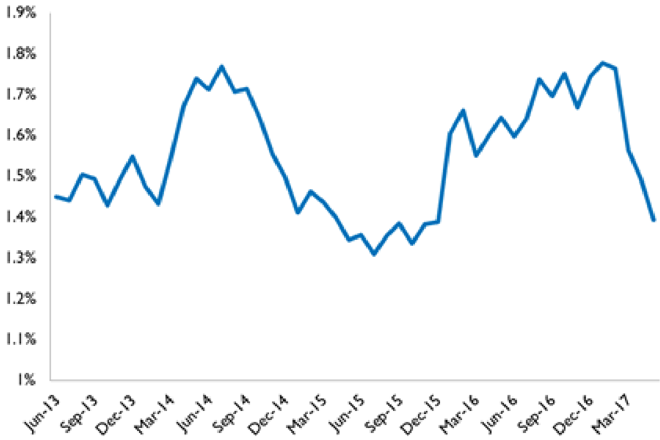
Fig 1: Economic surprises across the globe
Source: Bloomberg as of 6/30/2017



QUADRANT *N.* ONE PART OF A CIRCLE THAT IS EVENLY DIVIDED INTO FOUR PARTS.
AN INSTRUMENT USED FOR TAKING ANGULAR MEASUREMENTS OF ALTITUDE IN ASTRONOMY AND NAVIGATION.

Even with a tight labor market, the drop in inflation in the United States (figure 2) has cast doubt on the willingness of the U.S. Federal Reserve (Fed) to continue to raise interest rates in 2017 and has indicated some concerns about the persistence of the U.S. recovery. In addition, U.S. politics have produced a lot of background noise, but without any long-lasting impact to markets, which we believe are still expecting some form of stimulus in 2018.

Fig 2: U.S. personal consumption expenditure (PCE) core inflation soft patch | *Source: Bloomberg as of 5/31/2017*



Outside the United States, economic and political headlines have been largely positive with the exception of some policy-induced weakening of Chinese growth data. In particular, a market-friendly French election outcome has removed what was probably perceived as the biggest risk for Europe in an otherwise very positive period for European economic activity.

Looking ahead

The end of the quarter saw a minor market tantrum induced by a hawkish toned Fed, hiking interest rates in expectation of a bright outlook ahead for U.S. growth and inflation. In line with the Fed's view, our research and modeling process continues to indicate solid fundamentals across the globe, even with the negative surprises in the quarter which constitute a soft patch for the U.S. economy. This should be a good environment for equities, and a challenging one for interest rate sensitive asset classes. Additionally, this should continue to translate into opportunities for international equity markets where there are solid economic fundamentals, supportive investor sentiment, and attractive valuations.

Finally, we always pay close attention to potential risks. As stated earlier, U.S. politics has largely been background noise; however, debates around the forthcoming need to raise the debt ceiling might grab the market's attention near the end of the summer. Outside the United States, the Brexit negotiation and the politics around it might be more of an upset for the UK rather than the rest of Europe and therefore any fallout should remain localized. Geopolitics remains a wild card, full of known unknowns, in particular when it comes to the potential for a confrontation between the United States and North Korea. While we remain positioned to capture the market upside that comes with positive sentiment and fundamentals, we continue to remain diversified and manage risk.

Windhaven's Philosophy & Perspective

Windhaven's diversified global strategies are designed to provide diversification to perform in a variety of economic and market scenarios, while also opportunistically allocating to asset classes that we believe are the most attractive. 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.

Despite a spike in equity volatility late in the quarter, U.S. equity indices remain near all-time highs, and many international markets have double-digit returns year to date.[1] But it is clear the post-election momentum slowed in the quarter, despite improvements in the unemployment rate, gross domestic product (GDP) forecasts, and a Fed interest rate increase that ordinarily would indicate increasing economic confidence.

Our overall positioning is as follows:

Equities: Consistent with our strategy adjustments over the past several quarters, our research and modeling process continues to show confidence in global economic growth and a benign interest rate environment. While the U.S. economy is doing well, equity valuations after an eight-year bull market are above historical averages.[2] In contrast, international equities are considerably less expensive. Also, international developed and emerging market economies are enjoying greater GDP growth than the United States. This relative strength in economic fundamentals and behavioral characteristics for non-U.S. asset classes led us to reduce U.S. equities in favor of international developed equities, including a new position in German equities that we implemented using an exchange-traded fund (ETF) that also hedges euro currency risk. In our Diversified Aggressive strategy, we initiated a new position in the U.S. financial sector; which we believe has positive attributes including strong behavioral factors, attractive valuation, and a history of responding well when interest rates rise since banks and other financials tend to benefit from higher interest rate environments. Overall, we modestly increased the total exposure to equities in each of our strategies.

Hard assets & real estate: Gold's strong performance and behavioral characteristics in the first quarter moderated in the second, causing us to reduce our exposure in early May. At the end of this quarter, all three strategies held allocations near our minimum guidelines to gold and commodities, and no allocation to real estate.

Fixed income: U.S. Treasury yields currently are lower than at the beginning of the year[3] despite positive economic news, two interest rate hikes and strong equity markets. Our research and modeling process still indicates a persistently good outlook for growth and inflation, an environment which might induce the Fed to raise interest rates one or two more times this year. With this backdrop, throughout the quarter we slightly reduced our fixed income allocation, trimming our exposure to U.S. high yield and aggregate bonds. We initiated a variable rate preferred portfolio position within the Diversified Conservative and Diversified Growth strategies which offers an attractive yield and tends to perform well in a rising interest rate environment as more than three-quarters of the holdings are financial companies.

From all of us at Windhaven, thank you for your continued support. Please contact your 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

Sources:

1 Bloomberg as of 6/30/2017
2 Shiller CAPE Ratio http://www.econ.yale.edu/~shiller/data.htm
3 Bloomberg as of 6/30/2017

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.

Some specialized exchange-traded funds can be subject to additional market risks.

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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