Quadrant
A Quarterly Update

WINDHAVEN
INVESTMENT MANAGEMENT

Normalization: A Balancing Act

October 2017

Key Points:

1 All eyes remain on the U.S. Federal Reserve (Fed) and central banks across the globe

2 Steady as she goes: global growth continues apace

3 Equities remain attractive albeit sensitive to geopolitics in the short-term

Central banks back in the driver's seat

The period of economic expansion that began at the end of the recession in 2009 is already one of the longest in post-war history,[1] and the third quarter of 2017 helped to keep that streak intact. Notwithstanding bouts of market skittishness primarily driven by geopolitics, global economic expansion and the equity bull market continue to power forward in the wake of good global economic fundamentals, solid earnings growth, and supportive central banks.

The global economy as a whole remains in expansion mode, as we are witnessing a global synchronized expansion across most regions of the developed and emerging world. This is accompanied by earnings growth, which has been stronger outside the United States, contributing to this year's outperformance of international equity markets relative to the United States.[2] While the global economy exhibits healthy growth, inflation continues to be constrained. This has led central banks to remain accommodative, maintaining real benchmark interest rates[3] in negative territory while economies are displaying positive real economic growth, as displayed in figure 4 for the case of the United States.

Almost a decade into this cycle of economic expansion, questions around the timing of the next recession are becoming more and more frequent with clients. As an old market adage goes, "expansions don't die of old age"; rather, they tend to be brought to an end by central bank moves.

Fig 1: U.S. recessions since 1945 – currently among one of the longest periods of expansion | *Source: Bloomberg as of 9/30/2017*

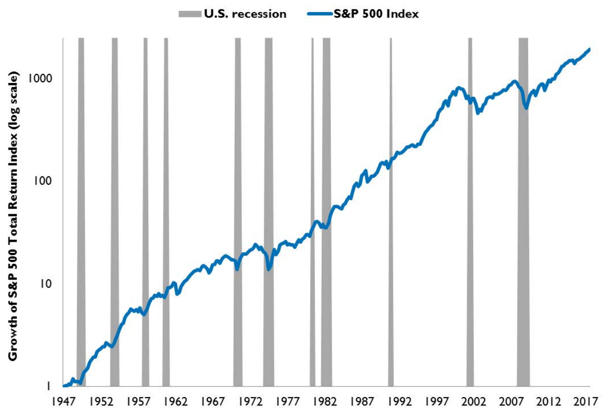


Fig 2: Economic fundamentals point to a continued synchronized global expansion | *Source: Bloomberg, data based on Markit as of 9/30/2017*

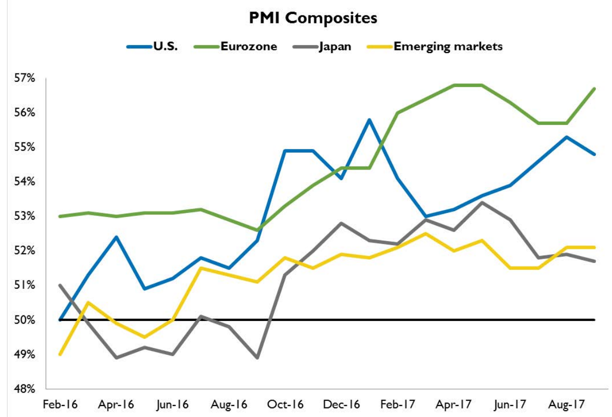


Fig 3: Earnings growth across regions | *Source: Bloomberg as of 9/30/2017 | Trailing 12-month EPS for MSCI ACWI (global), MSCI USA, MSCI Emerging Markets, MSCI EAFE (developed markets ex U.S.). Growth in EPS based to 1/31/2016 = 100%.*

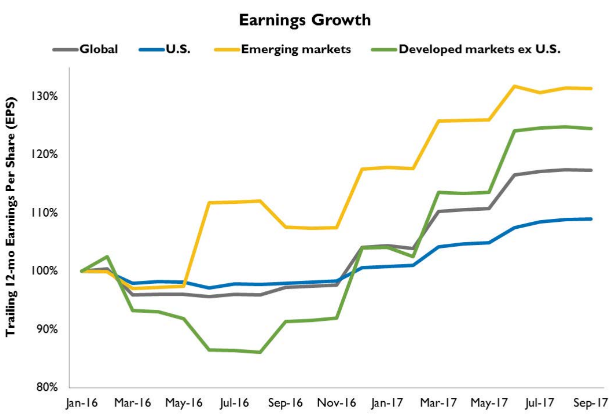
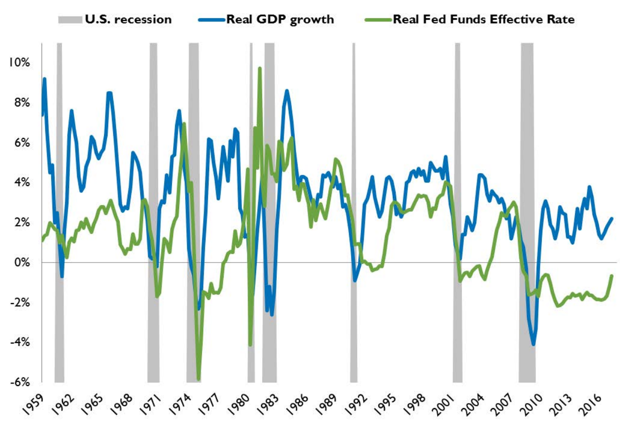


Fig 4: Supportive U.S. monetary policy – Real Fed Fund rates are still below real GDP growth | *Source: Bloomberg as of 6/30/2017 | Real Fed Funds Effective Rate is measured by Fed Funds Effective Rate minus Consumer Price Index (inflation)*



Looking ahead

After much of this year was spent speculating about U.S. infrastructure stimulus and tax cuts/reforms, investors' attention is shifting back to central banks across the globe – with the occasional diversion of geopolitical tensions, which are likely bound to continue.

The current stance of global central banks remains supportive, fueling an economic expansion and setting the stage for central banks to gradually remove policy accommodation through higher interest rates, balance sheet contraction for the Fed, and a slower balance sheet expansion for the European Central Bank (ECB). Looking ahead, central banks' difficult balancing act between monetary policy normalization and economic growth will remain in the spotlight. While central banks will likely continue to proceed cautiously by tightening gradually and telegraphing their intentions well ahead of time, the response to the 2008 financial crisis has resulted in large buildups of debt. This debt, taken on at very low interest rates, will overtime reset at higher interest rates, bringing to bear the full tightening effect (even if gradual) of the past few years and of the months to come. Financial markets remain the place to look for signs of stress that could lead to the next economic downturn. For now, we believe that a recession does not appear to be at our doorstep; however, excessive monetary policy tightening could change that picture rather swiftly, especially if inflation remains low. While we remain positioned to capture the upside of this economic expansion, we continue to pay close attention to potential downside risk.

Positioning

Our process continues to favor equities while limiting our exposure to interest rate sensitive assets and hard assets. Within equities, we continue to have a preference for international equities, particularly emerging markets. These positions are a result of our research which shows:

- Behavioral conditions are strong in equities with continued gains and limited sell-offs, classic signs that we continue to be in a bull-market.
- Our economic indicators suggest economic growth is strong and likely to continue making interest rate sensitive allocations less favorable.
- Valuations in international equities appear reasonable while economic conditions are strong, signaling attractive conditions for future returns.
- Behavioral conditions in fixed income and hard assets are not as strong as equities currently.

Our allocations to broad asset categories such as equities, fixed income, and hard assets changed minimally during the course of the third quarter, perhaps a testament to low volatility and the consistency of global growth. The adjustments we did make within each asset class were principally to adjust our exposure to certain risks, such as interest rates, currencies, or specific countries or regions. Both our macroeconomic and quantitative research continues to favor equities across most of the developed and emerging markets. As has been true for much of 2017, our emphasis on international developed and emerging market equities was a tailwind aiding our returns in the third quarter. All in all the year continues to be a good one for investors with global exposure across asset classes as the global economy steadily powers along. Windhaven continues to participate with those asset classes we find attractive, while mindful of ever present risks and balancing our participation with risk management.

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 strategy 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 National Bureau of Economic Research
2 Bloomberg as of 9/30/2017 | International equity markets is measured by MSCI ACWI excluding U.S. Index and United States measured by S&P 500 Index
3 Benchmark interest rates are intended as the policy interest rate set by central banks: for example the Fed Funds rate in the case of the Fed or the Main Refinancing Rate in the case of the ECB

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