Quadrant
A Quarterly Update

WINDHAVEN
INVESTMENT MANAGEMENT

The Rollercoaster of Policy & Politics

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Key Points:

1 Markets are likely to continue facing uncertainty stemming from monetary policy and politics

2 In the short-term, Federal Reserve policy and the U.S. presidential elections will take center stage

3 We are maintaining a rather defensive positioning while attempting to capture global opportunities

Central bank intervention & its unintended consequences

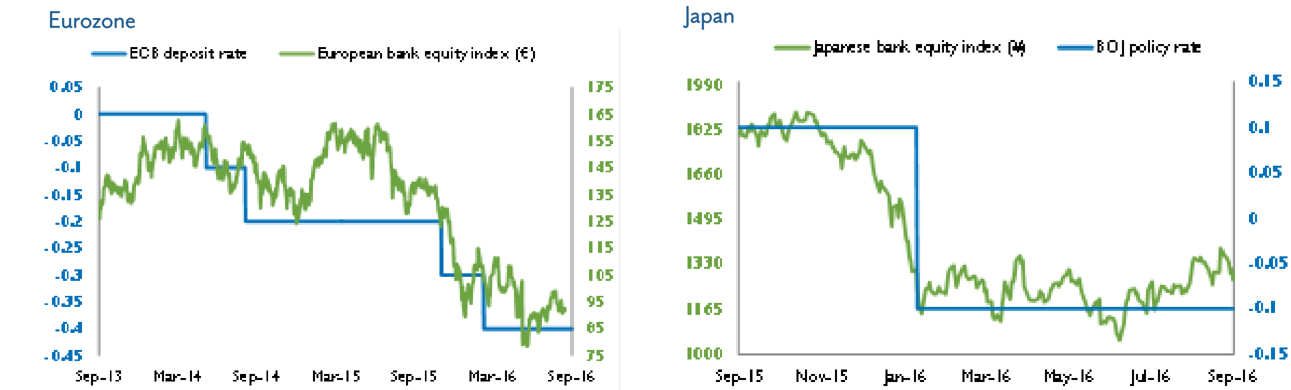
We entered the third quarter of 2016 with markets still recovering from the post-Brexit vote shock which took center stage for a few weeks before and after the actual vote. The potential global repercussions of that shock led markets to briefly price in a potential interest rate cut by the U.S. Federal Reserve (Fed). In the aftermath of the Brexit vote, the Bank of England (BoE) re-joined the club of those major developed central banks in the effort of propping up their economies. In absence of solid sustainable growth and inflation across Europe and developed Asia, monetary policy and politics have continued to drive market sentiment. The European Central Bank (ECB) and Bank of Japan (BOJ) remain committed to their inflation targets even though their creative attempts to make progress towards them have so far largely failed.

An important shortcoming of Negative Interest Rate Policies (NIRP) is that they fueled uncertainty around the profitability of bank intermediaries (fig 1), given their negative impact on net interest rate margins. More recently the BOJ announced new policy measures by setting a target for 10 year Japanese Government Bond (JGBs) yield at 0%; to put this in perspective, this amounts to committing to buying or selling any quantity of JGBs needed to achieve that yield target. Those measures are aimed at supporting bank margins by maintaining a certain spread between long-term and short-term interest rates; not like when the spread fell to zero in March (fig 2) after the NIRP adoption by the BOJ, or again in July following the Brexit vote.

While these new measures aim at offsetting some of the important shortcomings of NIRP, they open the door to the BOJ potentially having to sell JGBs, therefore tightening policy, in the event that 10-year yields fall below the 0% target, just like in July after the Brexit vote shock.

The above is just one example of central bank intervention which aims at supporting economic activity, in that specific case the Japanese banking sector. But there could also be serious unintended consequences: a potential tightening of policy following a negative shock, like Brexit, when some form of policy easing could be more appropriate.

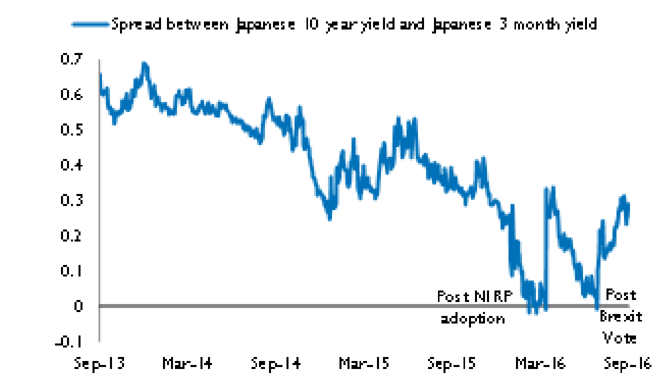
Fig 1: NIRP and bank equity prices in the Eurozone & Japan
Source: Bloomberg as of 9/30/16



Looking ahead

Looking ahead, markets will continue to deal with distortionary central bank policies and their intended and unintended consequences for the foreseeable future. However, in the short-term, Federal Reserve policy and the U.S. presidential elections will take center stage. The U.S. economic data was soft during the summer leading the Fed to remain on hold and not raise interest rates. For now, Fed Fund Futures market pricing would currently suggest that markets expect the Fed to hike interest rates in December (fig 3). As it was the case in December 2015, Fed Fund rate hikes tend to be fully priced in about a month before the actual hike, (fig 4). The forthcoming U.S. presidential election, one of the most contested in history, which takes place about a month ahead of the December Fed meeting, could play into market uncertainty and potentially influence the Fed's decision in December.

Fig 2: Steepness of the Japanese sovereign yield curve
Source: Bloomberg as of 9/30/16



While U.S. domestic policy and politics will remain center stage through year end, global markets will certainly keep an eye on global events. On Sunday, December 4th, prior to the December 14 Fed meeting, Italians will hold a referendum to amend the Italian Constitution in the direction of streamlining the current legislative framework. This is no Brexit referendum kind of event; nevertheless, a negative outcome could have implications for Italy's near-term political and financial stability which in turn could create the prospect of contagion across other financial sectors in the Eurozone. At the same time, the negotiations on the Brexit terms will likely heat up as we get closer to the official triggering of Article 50 of the Lisbon Treaty.

Fig 3: Chances of an interest rate hike in December 2016 at 50% (green line) – markets are not convinced that the Fed will hike in December

Source: Bloomberg as of 10/6/16 | Market estimate based on Bloomberg World Interest Rate Probability (WIRP).

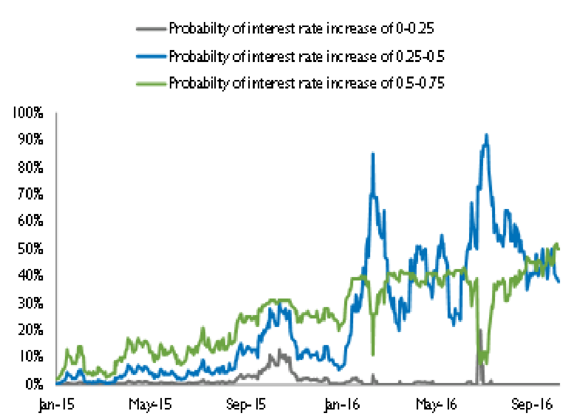
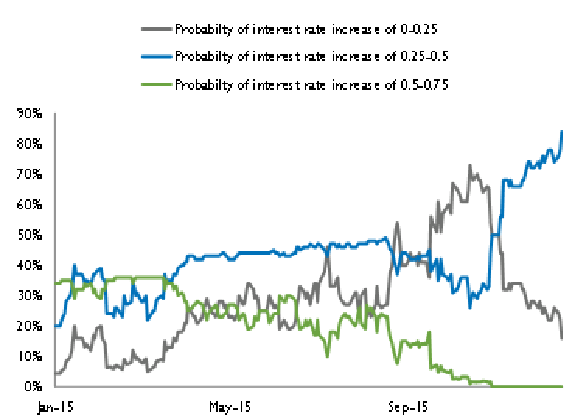


Fig 4: Evolution of the probability of a December 2015 Fed interest rate hike (Blue line) – the December 2015 interest rate hike was fully priced into the market a month earlier

Source: Bloomberg as of 12/16/15 | Market estimate based on Bloomberg World Interest Rate Probability (WIRP).



Windhaven Positioning

Amid distortionary intervention and political uncertainty, our research and modeling process leads us to maintain a rather defensive positioning, while still attempting to capture global opportunities. In this low-interest rate environment, we have maintained our exposure to interest rate sensitive assets like gold and real estate, as well as to high yielding dollar denominated emerging market debt. We added to our U.S. equity allocation through U.S. dividend payers and increased international equity exposure via the Hong Kong market – a market that has displayed strong positive momentum and fundamentals over the summer. We also increased our exposure to U.S. high yield bonds, an asset that offers an appealing spread considering the relatively good fundamentals of the U.S. economy.

Our overall positioning is as follows:

Equities: We have recently increased our exposure to international equities given positive global momentum and the continued support of central banks. Europe remains our most significant underweight.

Real estate: Remains one of our largest tactical exposures in light of the recent global low-interest rate environment.

Hard assets: All strategies increased their exposure to gold earlier this year in wake of the global uncertainty created by the Brexit vote and global central bank negative interest rate policies.

Fixed income: The strategies are relatively neutral in our overall fixed income positioning, with the Diversified Growth and Diversified Conservative strategies slightly underweight and Diversified Aggressive slightly overweight.

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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.

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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.

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.

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

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