Quadrant
A Quarterly Update

WINDHAVEN
INVESTMENT MANAGEMENT

Passing the Policy Baton: From Monetary to Fiscal

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Key Points:

1 An election shocker steals the fourth quarter show from the U.S. Federal Reserve.

2 Improving U.S. growth prospects and the promise of fiscal stimulus, accommodative central bank policies overseas, and attractive behavioral characteristics cause us to remain positive on equities.

3 While certain asset classes are becoming expensive and others face challenges from the prospect of higher interest rates, we believe there are several attractive opportunities globally.

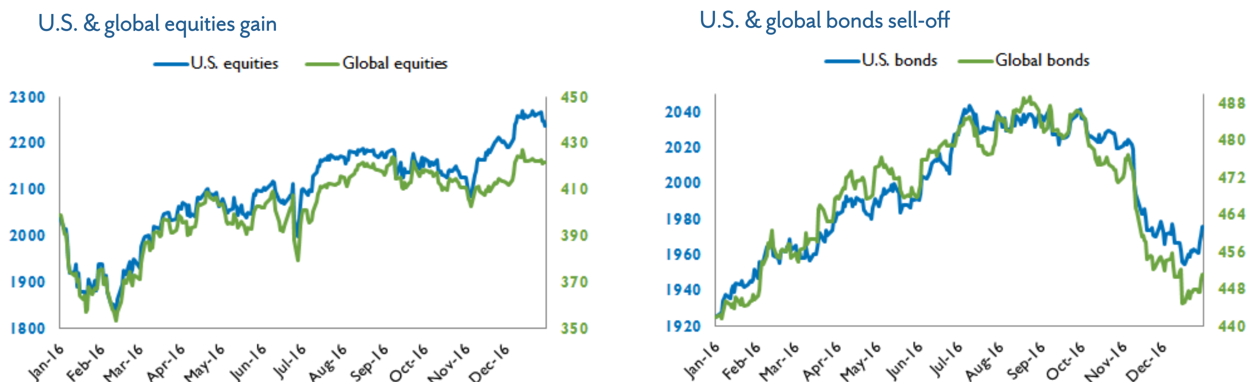
A November to Remember

Calling 2016 an eventful year would be an understatement. The year began with recession fears in the United States and globally, sending several markets into a tailspin. U.S. and global equities sold off over 10%[1] in the first six weeks of the year. As U.S. and global data improved, markets fully recovered only to take another dive around the Brexit vote at the end of June and then quickly bounced back for a rather flat summer.

During the fall, markets were focused on the U.S. Federal Reserve (Fed), with a December interest rate hike getting embedded into market pricing; and on the U.S. presidential campaign. Positive U.S. and global economic data released in the fourth quarter generally surprised to the upside, gradually removing any uncertainty around a Fed interest rate hike in December. However, the real market mover for the quarter was the outcome of the election. President-elect Donald Trump campaigned on relaxing overall regulation, cutting personal and corporate taxes including a comprehensive tax reform, and protectionist trade policies. While global markets had a dramatic sell-off in the first few hours after the election results became clear, the weeks after the election saw gains in the U.S. dollar and equity markets, in particular in the United States in wake of expectations of a large fiscal policy boost while emerging markets have struggled on protectionist fears. Global bond markets sold off heavily in anticipation of a U.S. led acceleration of global growth and inflation.

Fig 1: U.S. presidential election market impact

Source: Bloomberg 12/31/2015-12/31/2016 | U.S. equities are represented by the S&P 500 Index. Global equities are represented by MSCI ACWI Index. U.S. bonds are represented by Barclays U.S. Aggregate Bond Index. Global bonds are represented by Barclays Global Aggregate Index.



Looking ahead

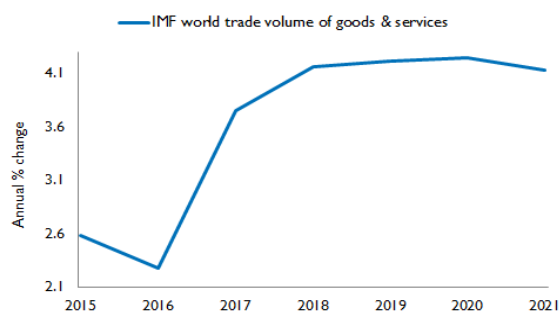
2016 was also the year in which the ongoing global monetary policy experiment switched from a zero interest rate policy to a negative interest rate policy – a switch that was received with mixed feelings by market participants given the potentially adverse side effects for bank and household balance sheets. 2017 may very well be the year when market movements ceased to be dominated by central banks, and fiscal policy could make a reappearance on the global stage.

A solid U.S. economic outlook could spark an acceleration of the pace at which the Fed has been raising interest rates. The recent U.S. equities rally, we believe, is a clear indication that markets are positioned for forthcoming fiscal stimulus in the United States. The question is: *will markets expectations be met?* The proposals articulated throughout the President-elect's campaign would diverge substantially from the budget blueprint that the Republican House approved earlier this year. While the House's blueprint would amount to a ~$7 trillion[2] deficit *reduction* over the next decade, Trump's proposal could amount to a ~$5 trillion[3] deficit *expansion* over the same time period. This ~$12 trillion gap possibly means that agreeing on the shape and size of a potential fiscal stimulus package in Congress will be neither easy nor swift business, to the point that the impact of a potential fiscal stimulus package on the U.S. economy might not be seen until 2018.

That said fiscal stimulus will not just be a U.S. affair going forward. The European Commission has indicated the desire for fiscal expansion throughout 2017.[4] The fallout of Brexit might call for fiscal stimulus in the UK. Elections in Germany and France occurring in mid-2017 will likely fuel expectations around a fiscal push in those economies, while Italy may have to resort to a public solution (nationalization) of its fragile banks to give a much-needed boost to credit and economic growth.

Fig 2: IMF World Trade Volume of Goods and Services projected to continue to grow in 2017

Source: International Monetary Fund |12/31/2015-12/31/2021



While a fiscal push might largely come from the developed world, emerging markets could be well positioned to benefit from it as well; barring a sharp rise in U.S. led trade protectionism, a scenario that likely would not benefit anyone, the United States included. For now, global trade growth is projected to accelerate in 2017 (fig 2).

Windhaven Positioning

Windhaven's Diversified Strategies strive to provide diversification to help endure a variety of economic and market scenarios, while also dynamically 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 and our macroeconomic research, which seeks investments with the strongest risk-adjusted return characteristics based on economic, fundamental and investor behavioral criteria.

The fourth quarter of 2016 brought political surprises and volatility. In wake of a solid U.S. outlook and the potential for acceleration in U.S. growth and inflation, we increased our exposure to U.S. equities, global equities and U.S. high yield fixed income securities, while reducing exposure to interest rate sensitive assets like gold, intermediate U.S. treasuries and investment grade corporate fixed income securities, as well as U.S. and international real estate. In November, we added to our U.S. high yield fixed income position in all three strategies; by mid-December, the dramatic post-U.S. election rally caused high yield to exceed our projections for the coming year and so we trimmed a portion of that position in order to both capture the rally and maintain our risk discipline. U.S. equities were the largest contributor to our performance in the quarter, while international equities, both U.S. and international fixed income, hard assets, and real estate contributed negatively. It was a challenging quarter to be a diversified global manager as U.S. asset classes outperformed dramatically. Specifically, U.S. equities returned 3.8% while gold, emerging market equities and international developed equities returned -12.4%, -4.2% and -0.7% respectively.[5]

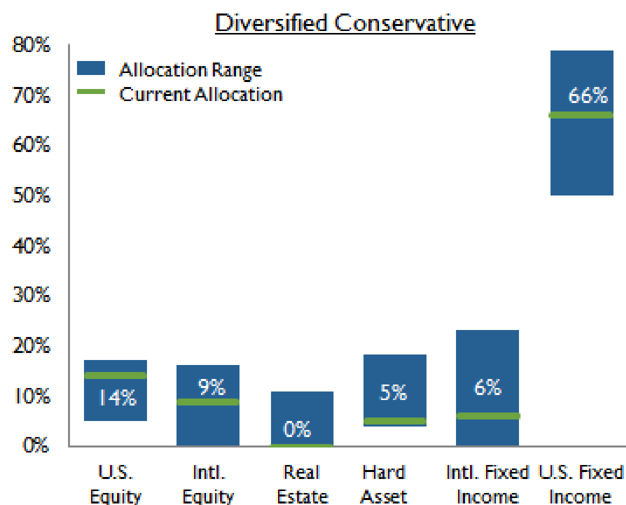
Our overall positioning is as follows:

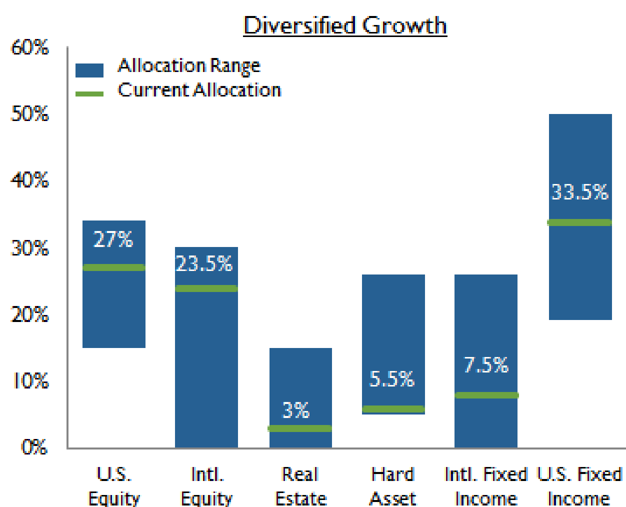
Equities: We increased our exposure to U.S. and international equities in the fourth quarter, given the positive global economic momentum and the continued support of foreign central banks. Europe remains the market in which we are most cautious, despite signs of improvement in the aftermath of the Brexit vote. While the Fed is cautiously raising interest rates, the European Central Bank remains accommodative and is likely to keep interest rates low for the foreseeable future. While emerging market equities were challenged both in the first three quarters as the dollar strengthened and in the post-election period; they remain one of the more attractive areas of the equity market, exhibiting positive economic fundamentals, attractive valuations, and good investor behavioral attributes. We expect the strong rise of the dollar to taper and be less of a headwind for emerging market equities in the future.

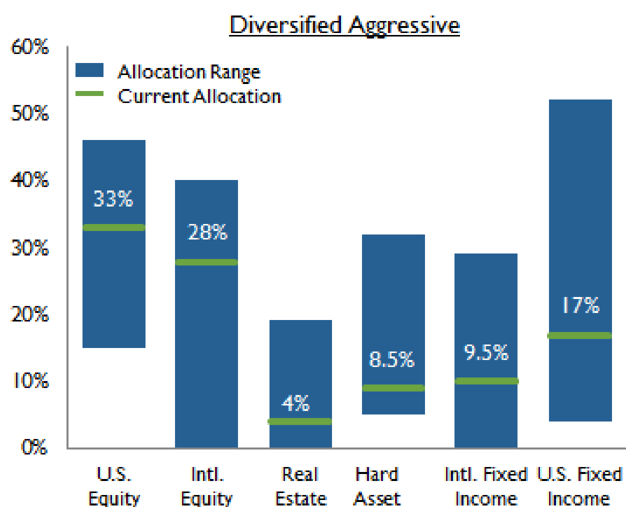
Hard assets: While we have reduced our overall exposure to hard assets, we continue to hold gold. Gold, similar to emerging market equities, experienced a sharp sell-off after the election, based on expectations that the Trump Administration's protectionist trade policies might lead to a higher U.S. dollar, and a stronger dollar typically leads to a lower gold price. Though interest rates have risen from the historic lows of July, the still low-interest rate environment is favorable for gold, as is the continued political and economic uncertainty. Moreover, gold is a diversifying asset that at times can provide protection to a portfolio. Because of this, gold remains ranked among our favored asset classes, though this could change if the dollar's rise proves to be persistent.

Fixed income: We have reduced our exposure to intermediate U.S. treasuries and investment grade corporate fixed income securities. We increased our exposure to U.S. high yield fixed income securities and short-term debt which has increased in yield. We believe high yield still offers an appealing yield given the positive U.S. economic outlook, the low-interest rate environment, and investors' appetite for risk.

Target allocations & ranges as of 12.31.2016







Allocation Range and Current Allocations are based on Model Allocations as of 12/31/2016 which do not necessarily reflect our current investment views and should not be used as the basis for investment decisions. Holdings of individual client portfolios may differ, sometimes significantly from those shown in the model allocations. Allocations are subject to change without notice.

Sources:

[1] Bloomberg 12/31/2015-2/11/2016 | U.S. equities are represented by the S&P 500 Index. Global equities are represented by MSCI ACWI Index

[2] http://budget.house.gov/uploadedfiles/fy17_summary_tables.pdf

[3] http://crfb.org/sites/default/files/Promises_and_Price_Tags_Preliminary_Update.pdf

[4] http://europa.eu/rapid/press-release_MEMO-16-3711_en.htm

[5] Bloomberg as of 12/31/2016 | Asset class performance is represented by annual total returns for the following indices and spot return: S&P 500® Index (U.S. equities), MSCI EAFE® Net of Taxes (international developed equities), MSCI Emerging Markets IndexSM (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.

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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