Windhaven® Strategies

Quadrant: A Quarterly Update

WINDHAVEN STRATEGIES

Dig deeper for opportunities

Second Quarter 2024

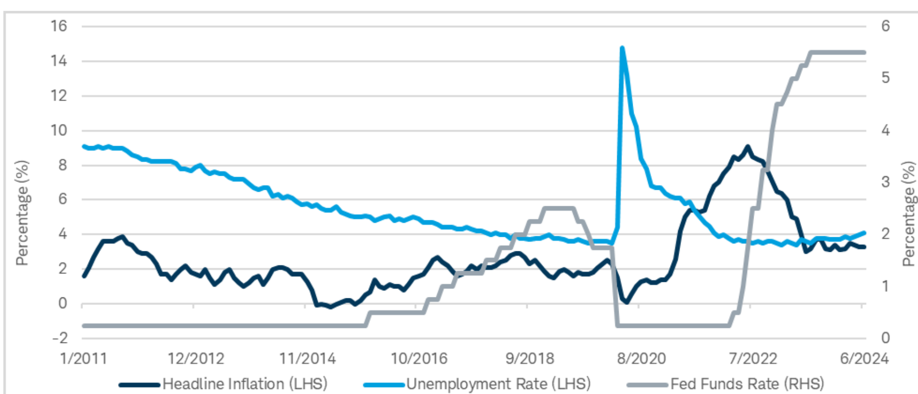
Key points:

1. Stubborn inflation has led to the U.S. Federal Reserve keeping rates higher for longer.
2. Asian equity markets have moved higher with strength across Japan and emerging markets in Asia.
3. Bond yields are attractive but watch out for tight spreads.

Higher for longer in the U.S.

The U.S. Federal Reserve continues to indicate that it does not expect to cut interest rates. What started as a market expectation of six rate cuts at the beginning of the year has rapidly re-adjusted to an expectation of just one to two rate cuts. Stubborn shelter prices continue to anchor inflation measures above the Fed's 2% target implying that rates are likely to stay higher for longer. The economic backdrop has shown resilience, particularly in the labor market where payrolls have posted steady gains month to month and real wage growth persists. However, the economy does appear to be slowing as indicated by other measures like Consumer Confidence and Capital Expenditures.

Chart 1: The Fed's dual mandate



Source: Bloomberg, 6/30/2024

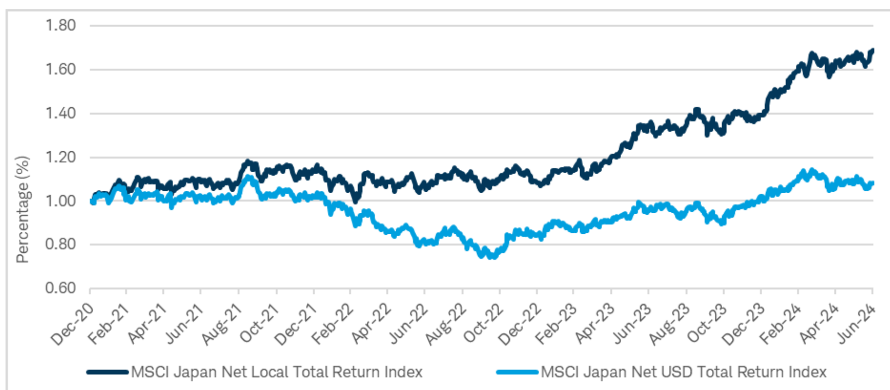
Japan: From deflation to inflation

The Japanese market has been one of the strongest performers year-to-date (in local currency terms) overtaking the 1989 peak after over three decades. The Japanese central bank has been accommodative even as the rest of the developed world combats inflation and rising interest rates. The central bank exited its negative interest rate policy, eliminated its yield curve control framework, and signaled a significant reduction in its asset purchase programs. Given the recent strength in equity markets, this strategy may have proven effective as equities and inflation have both continued to tick higher. Japan's transition from a deflationary economy to an inflationary one has come at a cost as the yen continues to decline against the dollar over time, making it tricky for U.S. based investors to fully participate in the Japanese market upside without adequate hedges (Chart 2).

Constructive reversal in emerging markets

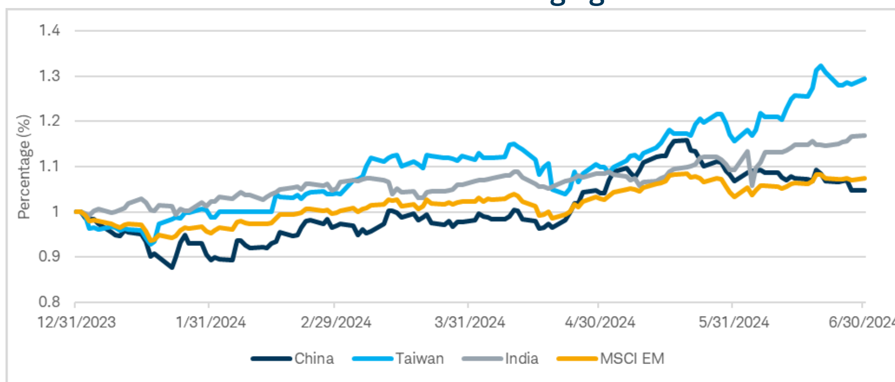
The emerging markets have also seen strength in the first half of the year, primarily in Asia (Chart 3). In India, economic strength, optimism around regulatory reform, and a rising middle class have attracted foreign flows which are propping up equity markets. Taiwan benefitted from a strong showing in semiconductors, which has affected names in the U.S. as well and driven the concentrated U.S. A.I. bull-run of the recent period.

Chart 2: A weak Yen affecting Japanese markets



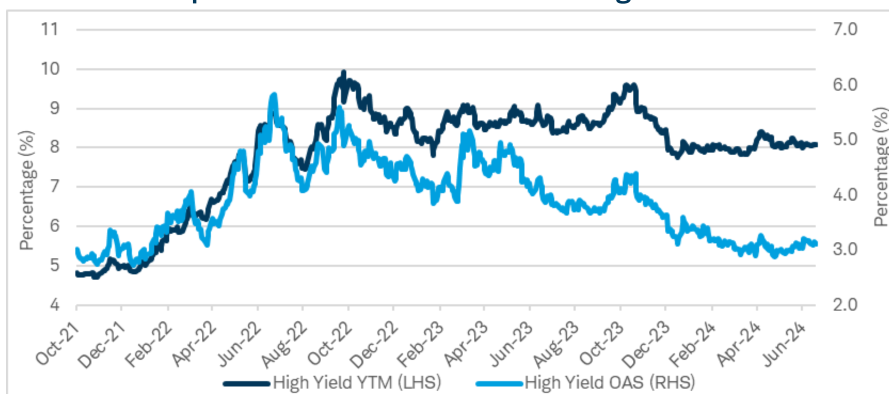
Source: Bloomberg, 6/30/2024. Indices rebased to December 31, 2020.

Chart 3: First half 2024 success for emerging markets



Source: Bloomberg, as of 6/30/2024. Indices rebased to December 31, 2023. China represents the MSCI China Index; Taiwan represents the MSCI Taiwan Index; India represents the MSCI India Index.

Chart 4: Compensation for credit risk declining



Source: Bloomberg, as of 6/30/2024

China has also seen strength this year as global investors have returned to their markets and geopolitical risks have started to ease. Additionally, China appears to be making a concerted effort to improve its capital markets with further governance and participation, and Chinese consumer confidence has continued to improve with expectations that high historical savings rates may translate into further consumption.

Bond yields remain attractive but spreads are tight!

On the fixed income side, bond yields have become more attractive as rates have risen and stabilized. Despite the inverted yield curve, Treasuries, Investment Grade Corporates, and High Yield bonds are offering higher yields than we have seen recently. As these spreads tighten, the level of compensation provided by taking credit risk has diminished (Chart 4). As underlying fundamentals continue to steadily deteriorate, moving up in quality can still produce an attractive yield and potentially reduce the risk that continues to build in the lower quality portions of the market.

Looking ahead: Waiting for a catalyst

The story is little changed so far this year. The dominance of a handful of mega cap companies continues to force equity market indices to trend higher and risks to remain contained on a macro level. On a micro level, opportunities are plentiful. Strong momentum in the U.S., regional rebounds across Asia, and attractive bond yields support a globally diversified portfolio.

All things considered, the strength of the global economy is prevailing and supports earnings generation and asset price inflation. At the same time, the Fed's commitment to the current policy rates could mean that expectations of future rate cuts continue to decline, barring a marked slowdown in economic activity. Under the hood, credit markets continue to see deterioration as spreads tighten further, potentially setting up a catalyst in those markets.

Overall, we remain positive and are positioned to participate in rising markets. However, we continue to monitor the economic backdrop to gauge the resilience of consumers and businesses globally.

Positioning

	What our research shows	How we are positioned
Equity	U.S. large cap continues to exhibit favorable fundamental and behavioral factors, though the concentration of returns in a handful of growth-oriented technology companies bears watching. Central banks across the globe are mostly poised to lower rates this year, which should be supportive of equities.	U.S large cap equities are overweight in all three strategies, with an emphasis on sectors that are profitable, have reasonable valuations, and favorable behavioral factors. These include consumer discretionary and staples, energy, industrials, and healthcare. Pacific equities remain our favored international region.
Fixed Income	Though higher yields are attractive, interest rates have marched higher so far in 2024, creating a headwind that has stifled hopes of recovering from 2022.	The strategies remain underweight fixed income, favoring U.S. Treasurys and higher-quality investment grade corporate bonds.
Hard Assets and REITs	Geopolitics and supply constraints continue to cause oil and other commodity prices to rise, despite moderating inflation. Higher interest rates and turmoil in the office and retail real estate sectors make real estate unattractive.	Broad commodities are a modest overweight in all three strategies, and this favorable view is also expressed by equity holdings in energy and global natural resources. There are currently no REIT holdings.

Quarterly Trade Updates

Equities	Equities were slightly trimmed during two reallocation trading periods in the second quarter. Developed international and European equities were trimmed in favor of emerging markets and U.S. industrials.
Fixed Income	Bonds were slightly reduced in all three strategies.
Hard Assets and REITs	Broad commodities were added to in the second quarter and the strategies have not held REITs since June 2022.

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Diversification strategies do not ensure a profit and do not protect against losses in declining markets. Investments in managed accounts should be considered in view of a larger, more diversified investment portfolio.

Allocations 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.

Asset classes and the proportional weightings in the strategies may change at any time without notice subject to the discretion of the Windhaven Strategies portfolio management team. Cash positions whether in US dollars or other currency are included in the relevant fixed income section. Hard assets are physical assets and may include exposure to gold, commodities, and energy.

Past performance is no guarantee of future results.

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.

Investing in REITs may pose additional risks such as real estate industry risk, interest rate risk and liquidity risk.

Schwab Asset Management'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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