WINDWARD CAPITAL

Risk Averse Asset Management

2017 First Quarter Review

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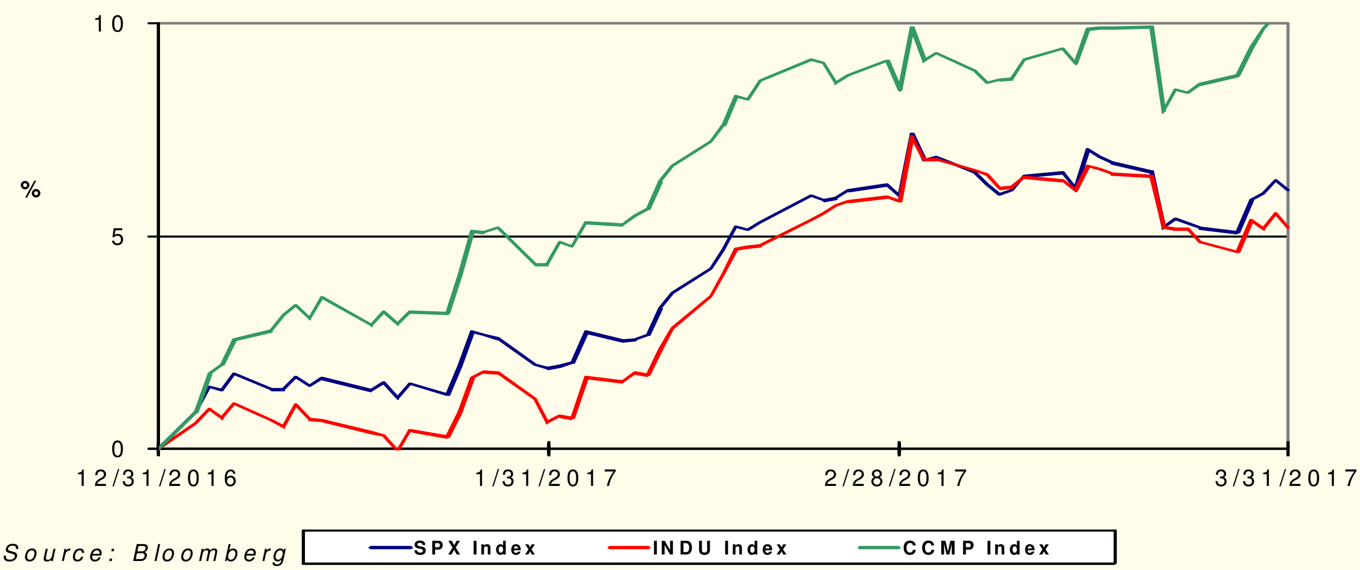
2017 EQUITY INDEX RETURNS



Source: Bloomberg

"Alternative Facts"

"I can't *prove* it, but I can *say* it."

—*Stephen Colbert*
American Comedian

The major U.S. equity market indices continued their post-2016 Presidential election advance during the First Quarter of 2017, with the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) increasing +6.07%, +5.19%, and +10.13%, respectively, for the period. Importantly, however, the complexion of the 2017 advance differed from that realized near the end of 2016.

As we discussed in our *Windward Capital 2016 Fourth Quarter Review*, most of the equity market rally since the Presidential election and through December 31, 2016, was a consequence of optimism regarding the potential for positive economic impacts from the Trump administration's new policy agenda (eg., tax reform, deregulation, and fiscal spending) combined with an investment asset reallocation out of fixed income securities and into stocks. The rally was primarily driven by economic sectors that we, in general, consider "low quality"—eg., Commodities, Industrials, and Financials. The long-term growth and stability of revenue and earnings in these economic sectors has historically been weak, making investments in these sectors prone to higher risk. In addition, these economic sectors generally are not comprised of dominant, financially strong, leading companies with best-in-class managements, high incremental returns on invested capital, or business models with sustainable competitive advantages. (As such, with the exception of specific and unique companies that have strong underlying financial dynamics/characteristics independent of their sectoral limitations, we typically de-emphasize these sectors in *Windward* portfolios.) Historically, however, our technical analysis of internal financial market divergences reveals that, among other conclusions, equity market rallies "bull markets" must, at some point, include "high quality" stocks—typically growth companies (usually NASDAQ stocks)—in order to be sustainable.

In fact, this historical precedence reasserted itself with a vengeance during the First Quarter of 2017 as the U.S. equity market advance rotated away from the stocks of low-quality companies and toward the stocks of high-quality companies like those held in *Windward*'s portfolio strategies. For the S&P 500, the four *highest*-performing economic sectors from November 08, 2016 through December 31, 2016 (Energy, Financials, Industrials, Materials) were the *lowest*-performing sectors in the First Quarter of 2017. Conversely, the four *lowest*-performing economic sectors from November 08, 2016 through December 31, 2016 (Consumer Discretionary, Consumer Staples, Healthcare, Information Technology) were the *highest*-performing sectors in the First Quarter of 2017.

As we have discussed before, based upon the (by historical standards) unprecedented degree of uncertainty associated with the incoming administration's ultimate policy agenda/directives (and their domestic and international ramifications), we believe that near-term financial market movements may continue to be unpredictable. Donald Trump's campaign rhetoric was far-reaching, wide-ranging, vague, and, oftentimes, contradictory. From an economic perspective, he has (among other issues) advocated policies of trade protectionism and immigration reduction, individual and corporate income tax cuts, infrastructure investment, and the deregulation of financial services, healthcare, and energy policies. In our opinion, there is currently too much uncertainty and lack of details associated with the policies and directives of the incoming administration to be able to confidently make any definitive assertions regarding their impact on the geopolitical and global macroeconomic outlook, much less the financial markets. Until there is further clarity, we can only be confident that the investment environment will continue to exhibit greater uncertainty and increased volatility.

Indeed, what part of Trump's America-first political campaign policy rhetoric will translate into reality and what are the details as to how it will be implemented? Although no one knows, the first (nearly) 100 days of the Trump Presidency appear inconclusive. For example, despite complete Republican control of all branches of the U.S. government, Congressional Republicans have had difficulty in moving forward on their signature campaign promise to repeal and replace the Affordable Care Act (which has direct economic consequences for the Healthcare sector). This does not bode well for reaching quick agreement on other policies—like tax reform and/or infrastructure spending—thereby potentially delaying positive economic impacts from fiscal stimulus. In addition, while bipartisan political cooperation looked possible on some issues following the election, the political environment now appears to be more polarized than ever, suggesting that legislation requiring bipartisan support may be increasingly difficult to address. Indeed, "governing is hard."

As investors, we remain politically agnostic in evaluating the economic and corporate impacts of public policy. That is the reason why we would prefer to analyze the actual legislative mandates and policies that are enacted and determine their corporate beneficiaries before considering major changes to the current investments in *Windward*'s portfolio strategies. As a result, in the interim, our strategies may underperform to the upside relative to the market indices over the short-term given the degree to which other market participants make ungrounded assumptions, and/or high-frequency trading and algorithmic "investment" strategies engage in daily financial market trading based upon such things as Trump's "tweets" (as an example). Regardless of the policy initiatives ultimately enacted by the Trump administration (and despite ongoing financial market volatility), we believe that we will, however, continue to be successful in making profitable long-term investments for *Windward*'s portfolio strategies.

As always, we continue to monitor domestic and international political and economic developments as they unfold. As a result, from our long-term perspective (and consistent with the recent U.S. election results), ongoing equity market volatility continues to revolve around numerous global macroeconomic and geopolitical risks that we have elucidated upon in the past. As noted in our previous *Quarterly Review*s, some of these risks include:

- ✓ Central bankers' aggressive monetary policy antics since the 2008 Financial Crisis have only produced subpar global economic growth. Zero interest-rate monetary policy (ZIRP) has borrowed consumption from the future, underscoring the challenge of future economic growth and resulting in a global dearth of demand and surfeit of supply, with concomitant deflationary risks.

- ✓ No one knows the consequences of an extended period of ZIRP. (Indeed, if there were no consequences to ZIRP, interest rates could have been held at zero forever—in the past, as well as into the future.)

- ✓ Monetary policy overkill (in duration and in the level of interest rates) continues to produce adverse consequences of malinvestment and has resulted in the hoarding of cash and reduction in spending by the disadvantaged savings class.

- ✓ The "exclusive prosperity" of the "haves" (versus the "have nots") is politically unstable, leads to more uncertainty (and unexpected outcomes), and will likely have a negative and more volatile impact on social systems, the global macroeconomy, and the financial markets. As a result, global macroeconomic growth becomes uneven and less predictable.

- ✓ The world has never been more "flat" (i.e., more networked and more interconnected). As a result, country-specific actions have the potential to quickly lead to global consequences.

- ✓ The viability of the European Monetary Union (EMU) remains uncertain.

- ✓ The economies of the BRICs (Brazil, Russia, India, and China), previous drivers of global macroeconomic growth, are slowing—in some cases, quite dramatically and uncontrollably.

- ✓ An increase in U.S. interest rates will have significant negative ramifications for those developing world economies that have dramatically increased their U.S. Dollar-denominated debt over the last decade.

- ✓ High-frequency trading, algorithms, and the pervasive use of ETFs, combined with overall financial market illiquidity, is a recipe for increased volatility.

- ✓ Demographically, the aging of the populations of the developed world will have important implications for future demand growth and entitlement costs.

- ✓ Terrorism (including cyber attacks), religious radicalism, and geopolitical instability are increasing and will be more of a threat in the future than in the past.

- ✓ Global political and economic coordination is at an all-time low, and isolationism/protectionism seem likely to be a mainstay in the time ahead.

- ✓ With monetary policy no longer providing extraordinary stimulus to domestic growth, the U.S. needs intelligent, innovative, and aggressive tax and fiscal policies to shoulder the responsibility of catalyzing economic activity. Although the outcome of the political election has been determined, it still remains uncertain what progress, if any, will be made on these fronts.

We closely monitor these, as well as other, risks when managing Windward's portfolios of investments. Since we take a long-term view, we typically do not react to short-term financial market fluctuations driven by near-sighted market participants. However, should there be a change in the global macroeconomic indicators and/or corporate fundamentals that we monitor, we are prepared to take whatever action is necessary to protect our clients' capital.

As you know, *Windward*'s goal is to protect our clients' capital and mitigate market-related risks by investing in specific, high-quality businesses that have long-term, secular growth opportunities. Indeed, we prefer to take a proactive approach to managing risk by investing in specific companies that are taking advantage of the changes in their operating environment to create long-run opportunities for their businesses. Our long-term performance results demonstrate the success of this disciplined investment approach.

Hard vs. Soft

There appears to be a growing disparity between the "hard" and the "soft" U.S. economic data.

The soft data—which comprises various poll-driven reports, like consumer confidence and business surveys—have been running strong for several months, primarily as a result of post-Presidential election optimism regarding confidence in the potential for a positive economic impact from the Trump administration's stated fiscal policy intentions. The hard data, on the other hand—which comprises reports of *actual* economic activity, like retail sales and durable-goods orders—have not, in general, confirmed this optimistic outlook and suggest that the U.S. economy is maintaining its moderate pace of post-Financial Crisis growth. For example, the Federal Reserve Bank of New York's Nowcast economic model, which gives more weight to the soft data, is currently projecting 2017 First Quarter U.S. Gross Domestic Product (GDP) growth of +2.8%; whereas the Federal Reserve Bank of Atlanta's latest GDPNow model, which gives more weight to the hard data, is projecting only +0.6% growth.

For 2016 as a whole, U.S. Real GDP expanded at an annualized rate of +1.6%, down from a +2.6% rate in 2015. For the Fourth Quarter of 2016, U.S. Real GDP increased +2.1%, compared to +3.5% in the Third Quarter of 2016. As a result, through 2016, the U.S. economy has averaged annualized Real GDP growth of +2.1% since the recession ended in mid-2009—the slowest expansion since World War II, although also one of the longest. As we have discussed with you in the past, we believe that this is primarily due to the typical aftereffects of a financial crisis, combined with other cyclical and secular issues, including demographics, divergences between advanced and emerging economies, and an overall surfeit of supply/dearth of demand.

These latest economic data underscore the obstacles to stronger growth facing Mr. Trump, who has pledged to raise the pace of expansion to +4% a year. He has argued that he can achieve stronger growth by overhauling the tax code, boosting infrastructure spending, rolling back Federal regulations, and cutting new trade deals that narrow the foreign-trade deficit. We remain skeptical of the potential for a significant shift in the U.S. economy's long-term growth outlook, however, based upon issues that we have discussed in previous *Windward Quarterly Review*s. In our view, there are a variety of forces depressing both supply and demand, including slow growth in the size of the U.S. labor force (due to retiring "baby boomers," low birth rates, and diminished immigration) and, more importantly, sluggish worker productivity.

With regard to productivity, Americans actually became *less* productive in 2016 for the first time since 2009, with multifactor productivity (which measures the overall efficiency with which labor and capital inputs are used in the production process) declining by -0.2% for the period. This means that the U.S. 2016 Real GDP growth rate of +1.6% was entirely due to corporations' increased spending on employees and equipment—not due to improvements in technology or organization that optimized or increased the efficiency of their existing resources. This is important because increasing multifactor productivity through innovation is a necessary component of sustainable long-term secular economic growth.

The U.S. decline is part of a recent global macroeconomic trend of sluggish productivity growth among advanced economies, and its underlying causes remain subject to heated debate. Some analysts argue that the benefits from computerization ended in the 2000s, and since then the world has not developed innovative new technologies. Other analysts cite the aftereffects of the Financial Crisis, arguing that some of this malaise will eventually lift. Although we recognize the complexity in analyzing the sources of the slowdown in global productivity growth, we surmise that there are a combination of forces involved that will become more readily apparent over time.

We are, however, convinced that the benefits from machine learning, artificial intelligence, and robotics remain nascent, and that, as these technologies start to become more pervasive, productivity could resume its upward trend. This is suggested by historical precedence: in first few decades of the Industrial Revolution (the greatest economic change that has ever occurred in modern history), productivity growth was slow, and living standards temporarily fell. It took nearly a half-century until industrial breakthroughs had a significant economic impact. We may be witnessing a similar dynamic currently, whereby the world is on the cusp of a significant technological transformation that will have a dramatic impact on productivity.

Normalization

On March 15, 2017, the U.S. Federal Open Market Committee (FOMC) raised the Federal Funds (Fed Funds) rate +25 basis points to 1.00%—its third increase of +25 basis points in *10 years*—and has signaled its intention to continue its interest rate "normalization" process through a combination of Fed Funds interest rate increases and an unwinding of its balance sheet. In the FOMC's view, the U.S. economy is operating at, or near, "full employment;" inflation, albeit quiescent, has the potential to accelerate; and the reflationary impact of the Trump administration's fiscal policy remains an upside risk.

On its face, a 1.00% Fed Funds rate is incredibly low a full eight years into the current U.S. economic expansion. Indeed, it is deeply negative in *real* terms (especially compared to headline inflation). Former U.S. Treasury Secretary Larry Summers thinks the natural (equilibrium) rate of interest has dropped to -3% based upon his view of economic secular stagnation. U.S. Federal Reserve (Fed) Chairwoman Janet Yellen, on the other hand, has said that the long-term neutral rate has dropped to +1% in real terms but could be 0% at the moment as the economy continues to endure the aftereffects of the Financial Crisis and experiences a slowdown in the working-age population and in productivity growth.

These negative real interest rates continue to provide liquidity support for the financial markets, offsetting the potential for future near-term Fed Funds rate increases. For the markets, an uptick in inflation, combined with low (or negative) real yields, constitute a "sweet spot" and an easing of financial conditions. This has been reflected in falling credit spreads and a U.S. Dollar index whose post-Presidential election strength has moderated (for now, at least).

Yet no one really knows whether the global macroeconomy can handle a total of six rate increases over the course of 2017 and 2018 (as projected in the Fed's "dot plots" scenario). The Atlanta Fed's Wu-Xia "shadow rate" even suggests that the combined tightening so far this cycle is, in fact, equivalent to 13 rate rises, once the withdrawal of stimulus from Quantitative Easing (QE) and dovish forward guidance is included. The Wu-Xia model and others like it show a relentless fall in the natural rate of interest over the decades: each peak and each trough is lower. Based upon traditional metrics, such as the Taylor Rule, the Fed's overnight target rate appears too low relative to current price conditions by as much as 300 basis points. In our view, this reflects the deflationary consequence of a deformed world of overcapacity (China), underconsumption (Europe), excess savings (inequality), and lack of demand.

As we have discussed in the past, the post-War world has never been so leveraged to the U.S. Dollar or so sensitive to U.S. borrowing costs: offshore Dollar-denominated debt has risen fivefold to $10 trillion since 2002. This is the result of globalization and the Fed's own policies of ZIRP and QE, which unleashed a flood of cheap and irresistible Dollar liquidity into emerging markets. When the *Lehman Brothers* crisis unfolded, China and the emerging markets were able to buffer the global economy. Today, they face varying degrees of credit exhaustion. This leverage carries potential risks that could be triggered by a stronger U.S. Dollar, which would automatically cause a contraction of bank balance sheets through the structure of hedging contracts. As a result, the Fed must move with extreme care as it engages in the normalization process.

And yet the Fed has set the stage to be deep into the policy normalization process by the end of 2017 despite an inflation forecast that not only never breached the +2% target but has repeatedly fallen short of its mark for years. It appears, then, that the *threat* of inflation, rather than the *current* inflation reading, is what is motivating the Fed, which decided long ago to favor preemptive policy action in order to stay ahead of the curve. Monetary policymakers therefore see themselves as straddling a fine line: too much tightening, and they leave the economy weakened and vulnerable to negative shocks; too little tightening, and they set the stage for inflation that they would be unable to control without a more aggressive policy stance that could cause a recession.

Maintaining the appropriate balance would extend the life of the U.S. economic expansion and maximize employment over the medium- to long-run. Preemptive monetary policy action reflects recognition on the part of the Fed that they do not have the ability to fine-tune the U.S. economy. The crux of the Fed's challenge—whether it is the employment mandate, the inflation mandate, or issues of "financial stability"—is that what might seem best for the short run might not be best over the long run. In practical terms, the Fed needs to weigh the risks of favoring the former over the latter within the context of imperfect policy tools. Lacking precise policy tools, then, requires the Fed to lurch between hikes, halts, and now, balance sheet adjustments.

"Shrinkage"

As you may recall, the genesis of the Fed's large balance sheet began in late 2008, when it could no longer lower its short-term interest rate target to support the economy. The target rate reached the zero lower bound (0%), so the Fed began purchasing long-term Treasury and mortgage-backed securities in order to lower long-term interest rates, hoping to stimulate the economy. These transactions required large-scale asset purchases by the Fed. By the time the Fed was done in late 2014, it had expanded the size of its balance sheet from roughly $900 billion to $4.5 trillion. Since then, the Fed has kept the size of its balance sheet constant through reinvestment of principal maturities.

The large increase in the Fed's holdings of Treasury and mortgage-related assets was matched by a large increase in its liabilities (i.e., the money "created" by the Fed) in the form of bank reserves. To effectively manage this large increase in bank reserves, the Fed began paying banks to deposit their excess reserves at the Fed. This interest payment on excess reserves (IOER) was higher than what banks could earn on other short-term safe investments like Treasury Bills. As a result, banks began parking their funds at the Fed. These excess reserves, along with the Fed's assets, kept growing through late 2014 and have remained elevated ever since.

Since the large-scale asset purchases began, the Fed has been clear that it intends to shrink its balance sheet once interest rates resume an upward trajectory. Fed Chairwoman Yellen reiterated this point last month before Congress, and recently St. Louis Fed President James Bullard began talking up the need to reduce the size of the Fed's balance sheet. The minutes of the March 2017 FOMC meeting confirmed that the Fed remains poised to tighten policy further—first via raising the Fed Funds rate, then followed by action to reduce the balance sheet later in the year. In our opinion, it appears likely that the Fed will view the latter as a substitute for the former. If true, this means that rate hikes would perhaps be on hold during the start of 2018 as the Fed assesses the efficacy of its balance sheet actions.

Shrinkage, however, may not be easy.

The path to monetary policy normalization is fraught with risk. Not only must the Fed avoid getting ahead of the recovery with its interest rate hikes, but it must delicately navigate the shrinking of a balance sheet that has grown five-fold since 2008. This latter task may prove to be especially daunting since it puts the Fed in uncharted territory: never before has the Fed had to shrink its balance sheet. We view the unwinding of the Fed's balance sheet, then, as the Fed's next big challenge.

The Fed's normalization plans could potentially cause financial market disruption. The Fed's desire to raise its short-term interest rate target before shrinking its balance sheet could cause short-term interest rates to rise faster than long-term interest rates, thereby "flattening" the yield curve. This could cause difficulty for financial firms that depend on the spread between these interest rates for their profitability. (Banks, for example, generally earn more on their long-term home and auto loans than on the interest payments they make to their short-term depositors. If, however, short-term interest rates were to rise above long-term interest rates they could start losing money, and lending might be reduced.) If, instead, the Fed began shrinking its balance sheet at the same time it was raising its interest rate target, both short-term and long-term interest rates would rise more closely together. This would occur because shrinking the Fed's balance sheet would be releasing the Fed's long-term securities to the public and that, in turn, would push down their prices and drive up their yields. This would be better for financial firms and the economy.

Another challenge with the Fed's normalization plans is that it calls for a "passive unwinding" of the balance sheet. In other words, the Fed would refrain from reinvesting payments it earns on its securities as they matured. This would automatically shrink the Fed's balance sheet. While this approach appears simple and predictable, it would also create "discontinuities." The reduction would not be a smooth process, but one with irregular and sometimes large declines in the Fed's balance sheet as various securities matured. In 2017, for example, $164 billion of securities mature on the Fed's balance sheet. That amount increases to $425 billion in 2018 and then declines to $352 billion in 2019. In our opinion, it would be better to actively manage the shrinking of the Fed's balance sheet.

Another challenge in scaling back the Fed's balance sheet may be associated with the post-2008 regulation that requires banks to hold more liquid assets. Specifically, banks now have to hold enough high-quality liquid assets to withstand 30 days of cash outflow. This liquidity coverage ratio has increased the demand for such assets—of which bank reserves and Treasury securities are considered the safest. So, in theory, as the Fed shrinks its balance sheet, the banks could simply swap their excess reserves (that the Fed was pulling out of circulation) for Treasury bills (that the Fed was putting into circulation). The problem is that the Fed's IOER has been higher than the interest rate on Treasury bills. This creates relatively higher demand for bank reserves. Banks would not want to give up the higher-earning bank reserves at the very moment the Fed was trying to pull them out of circulation. This tension could create an effective shortage of bank reserves and be disruptive to financial markets. In our view, a possible solution would be for the Fed to lower the IOER to the level of Treasury bill interest rates.

In our view, simultaneously shrinking the Fed's balance sheet while raising interest rates, actively managing the reduction of assets, and lowering the IOER to the level of Treasury bill yields would go a long way toward making the unwinding of the Fed's balance sheet less disruptive to the financial markets. More generally, the Fed needs to tie its balance sheet policies to the state of the economy. We believe that it should consider explicitly committing to reducing its balance sheet a certain dollar amount each month as long as the economy continues to improve. These plans should be communicated clearly and regularly to the public. One way to do this is to have the Fed start providing forecasts of its balance sheet in the Quarterly Summary of Economic Projections.

Together, these steps should improve the Fed's ability to handle its next big challenge, the unwinding of its balance sheet.

Exits

On the other side of the pond, "Brexit" and, potentially, "Frexit" and "Italexit" pose ongoing risks:

- ✓ On March 29, 2017, UK Prime Minister Theresa May triggered the European Union (EU) Article 50 exit mechanism, initiating the two-year negotiating process whereby Britain will ultimately emerge as an independent nation—free from the legal jurisdiction of the European Court of Justice, but a continued economic power and a strategic military partner in the region.

- ✓ On April 23, 2017, France will hold the first round of its Presidential election process, with a run-off election between the top two candidates to be held on May 07. The current leading candidates include: Far-right Marine Le Pen of the anti-immigrant and anti-Europe Front National, who advocates for a managed break-up of the Eurozone and a return to national currencies; Centrist Emmanuel Macron, a former French Economics Minister; Conservative former French Prime Minister Francois Fillon, who is embroiled in a scandal over payments of public funds to his family; and Far-left candidate Jean-Luc Melenchon, who advocates for a 100% tax on the rich and an exit from NATO.

- ✓ In Italy, the ruling Democratic Party is tearing itself apart. Party leader Matteo Renzi calls the mutiny a "gift to Beppe Grillo," whose Euro-skeptic Five Star movement leads Italy's polls at 31%. As matters now stand, four Italian parties with half the seats in Parliament are flirting with a return to the Lira, and they are edging toward a loose alliance.

In December 2016, the ECB decided to reduce its monthly bond purchases of €80 billion to €60 billion starting in April 2017, and to extend the program for a further nine months until December 2017 while maintaining its Deposit Facility interest rate at -0.40%. Overall Eurozone economic growth, albeit stable, remains anemic (less than +2% on an annualized basis), and despite the cyclical benefits of cheap oil, a weak Euro, QE, and the end of fiscal austerity leading to an increase in headline inflation (HICP) over the last year, Eurozone core inflation is declining and remains *lower* year-over-year. Although the ECB is talking up the economic recoveries and HICP, we believe that this is a "false dawn": the ECB cannot generate higher *core* inflation without help from fiscal policy. Unfortunately, due to the dysfunctional nature of its construction, the EMU lacks a fiscal union, Eurobonds, and counter-cyclical transfers needed to make it viable over time.

The Eurozone remains horribly split into creditor and debtor blocs, each with divergent macroeconomic interests. QE by the ECB and a cyclical economic upturn have masked the tension over the past two years, but the underlying North-South divide remains. If global macroeconomic reflation builds, German authorities will force the ECB to end its bond purchases and increase interest rates. Once the ECB tapers its stimulus, Italy, Portugal, and Spain will lose a "buyer of last resort" for their debt, further exposing their financial vulnerabilities and creating a whole new set of risks to Eurozone sustainability.

The public debt ratios of Italy, Spain, Portugal, Cyprus, and Greece are all higher than they were at the onset of the debt crisis in 2012. Their central banks also owe more to the ECB through the internal Target2 payments system than they did at the worst moments of that episode. These fiscal debts are rapidly approaching €1 trillion and are the unintended side-effect of the ECB's QE program, which has degenerated into a conduit for capital flight from the Club Med bloc to Germany, Luxembourg, and The Netherlands.

This "socialisation of risk" is a mechanical effect of the ECB's Target2 payments system. The Target2 system is designed to adjust accounts automatically between the branches of the ECB's family of central banks, self-correcting with each ebb and flow. In reality, it has become a cloak for chronic one-way capital outflows. Private investors sell their holdings of Italian or Portuguese sovereign debt, for example, to the ECB at a profit, and rotate the proceeds into mutual funds in Germany or Luxembourg. Banca d'Italia alone now owes a record €364 billion to the ECB (20+% of Italy's GDP), and the amount keeps rising. The implicit shift in private risk to the public sector exposes the Italian central bank to insolvency if the Euro breaks up or if Italy is forced out of monetary union.

The ECB argued for years that these Target2 imbalances were an accounting fiction that did not matter in a monetary union. Not any longer. President Draghi wrote a letter to Italian Euro-MPs in January 2017 warning them that the debts would have to be "settled in full" if Italy left the Euro and restored the Lira. This is significant in that it confirms that Target2 liabilities are actual debts. Spain's Target2 liabilities are €328 billion (almost 25% of GDP), whereas Portugal and Greece are both at €72 billion. All are either insolvent or dangerously close if these debts become payable. On the other side of the ledger, the German Bundesbank has built up Target2 credits of €796 billion, and Luxembourg has credits of €187 billion (300+% of GDP, reflecting its role as a financial hub).

Although the ECB is navigating calm waters at the moment, the upcoming French Presidential election and increasing political discord in Italy certainly have the capacity to cause upheavals. It is France and Italy that threaten to subject the Euro experiment to its ordeal by fire. If the system breaks, the Target2 liabilities will become all too real.

So what happens if the Euro fractures? We assume that there would be a tidal wave of capital flows long before that moment arrived, pushing the Target2 imbalances beyond €1 trillion. The ECB would then have to cut off funding lines to "irreparably insolvent" central banks in order to protect itself. The chain reaction would begin with a Southern default to the ECB, which in turn would struggle to meet its Target2 obligations to the Northern bloc. The central banks of Germany, The Netherlands, and Luxembourg would lose some of their Target2 credits, yet they would have offsetting liabilities under enforceable legal contracts to banks operating in their financial centers. (These liabilities occur because that is how the creditor central banks sterilize Target2 inflows.)

The ECB would then face an agonizing dilemma. A promise by Mr. Draghi to do "whatever it takes" to keep the Euro intact would not be credible if France or Italy was threatening to withdraw and Germany was refusing to allow Target2 imbalances to rise further. The market disruption would quickly become systemic. The only option at that point would be to follow the Greek example of the Summer of 2015, imposing capital controls in many Eurozone countries and freezing convertibility of internal banking accounts until a new political settlement was reached. As occurred in Greece, the subsequent economic turmoil in France or Italy may eventually be sufficient to change the political mood and therefore end the possibility of exit.

Although this series of events remains highly improbable, it is not impossible, and therefore is a risk that should be monitored. Overall, the core problem remains: the conflicting needs of Germany and the South cannot be reconciled within EMU. The gap in competitiveness and debt burdens is too great. They should not be sharing a currency union at all. As we have stated in the past, monetary union must evolve into a full-fledged Federal State—with a single EMU Treasury, fiscal system, and government—if it is to survive.

Fake News

The equity markets have recently exhibited substantial volatility, and the potential for a more significant correction always remains possible given the risks we have noted above. However, the U.S. economy continues to grow, and we do not foresee a recession in the near term. To us, that means that the long-term upward bias in stock prices should continue. We believe, therefore, that the recent market volatility has created an exceptional opportunity to take advantage of the misunderstandings of myopic market participants and purchase high-quality businesses that meet our investment criteria.

Our investment process utilizes a combined top-down/bottom-up approach whereby, based upon our analysis of the components of global macroeconomic GDP, we identify a variety of investment themes, both secular and cyclical, that drive further fundamental analyses of individual businesses that meet our investment criteria. Currently, some of our investment themes include:

- ✓ *Rise of The Rest*
  Globalization and the development of the middle class in emerging markets is a long-term secular trend.

- ✓ *Disruptive Innovation*
  Companies that are disruptive innovators are well positioned to outperform their peers in the current economic environment.

- ✓ *Regulation*
  Financial Services regulation, Healthcare reform, and Climate Change policy are all currently areas of government focus, and the economic sectors within these areas may, therefore, be subject to challenges or opportunities based upon how successful the government is in implementing its programs.

- ✓ *Continued De-leveraging*
  De-leveraging and the shrinking of private and public balance sheets will be a multi-year process that will restrain global macroeconomic growth.

- ✓ *The Great Unwind*
  The eventual "normalization" of monetary policy may result in unforeseen and unintended consequences.

- ✓ *China Rebalancing*
  The rebalancing of China's economy from investment- to consumer-driven has significant global macroeconomic ramifications.

- ✓ *Supply and Demand*
  Global macroeconomic growth remains anemic due to a surfeit of supply and a dearth of demand.

- ✓ *Demographics*
  Demographically, the aging of the populations of the developed, and some developing, economies will have important implications for future demand growth and entitlement costs.

As you know, we do not predict, nor does your *Windward* portfolio own, "the market." Instead, we seek to mitigate market risk and generate excess returns by making long-term investments in individual businesses with the following underlying fundamental characteristics:

- ✓ *Quality*
  Dominant, financially strong, leading companies with best-in-class managements, high incremental returns on invested capital, and business models with sustainable competitive advantages

- ✓ *Growth*
  Companies with predictable and sustainable above-average growth in revenue, earnings, and free cash flow

- ✓ *Value*
  Companies that are undervalued on either an absolute or relative basis, based upon our projections of future cash flow and earnings

Windward's portfolios of individual businesses, with their own company-specific fundamental dynamics, are continuing to thrive and prosper. In the short term, this fact may be obscured by "market action"—which results in highly-correlated security price movements during periods of increased volatility—and/or the negative influences of ETFs, asset allocators, and algorithmic traders—whose focus is on baskets of securities or on stock symbols, not on underlying business model fundamentals. However, financial history has proven, time and again, that, over the long term, investors are ultimately rewarded by being owners of these type of companies.

We have been investing this way for decades, and have successfully navigated a variety of historic market environments.

We believe that the "indices" will become less relevant as time goes on and that successful wealth creation and capital preservation in the years to come will become increasingly dependent upon the identification and ownership of those businesses that, although possibly impacted by exogenous events in the short run, remain relatively immune to these global macroeconomic issues over the long run due to their own underlying growth dynamics.

Despite recent market volatility, we remain exceedingly optimistic on the prospects for the individual companies that we own in *Windward* portfolios and encourage you to contact us should you have any questions or concerns.

Sources:
- Bloomberg
- European Central Bank
- Eurostat
- International Monetary Fund
- U.S. Bureau of Economic Analysis
- U.S. Bureau of Labor Statistics
- U.S. Federal Reserve

HAS YOUR FINANCIAL CONDITION CHANGED?

Portfolio decisions are based on an individual's income requirements, tax bracket, time to retirement, risk tolerance, and other characteristics. If your financial condition has changed, or is about to change, please call us. We strive to prepare a portfolio that meets each investor's objectives, and the more information we have, the better the job we can do. If you have any questions regarding your portfolio, your asset allocation, or any investment within your portfolio, please let us know.

THE FUTURE IS NOW

As you may know, we post a weekly commentary on our website every Friday afternoon. We only mail some of these comments out when markets are particularly unsettled. Please be aware that these notes will continue to be available on-line, and we want to encourage you to sign up to receive a password for access to our secure web-site.

Our website provides the capability for clients to review their portfolios, their year-to-date realized capital gains, and income and expenses. Clients also have access to our weekend market comments. These reports are updated after 8:00pm each Friday, and are available to clients who have requested access. Clients may also request that their accountants and/or attorneys have access to the same information. We hope you will visit us at www.windwardcapital.com.

If you have interest in these capabilities, or if you would like to receive a copy of our Form ADV Part II free of charge, please email Steve Pene at: spene@windwardcapital.com, or call Mr. Pene at our main number: (310) 893-3000.

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