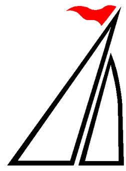
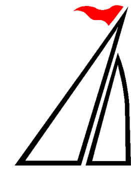


WINDWARD CAPITAL

Risk Averse Asset Management



2017 Second Quarter Review

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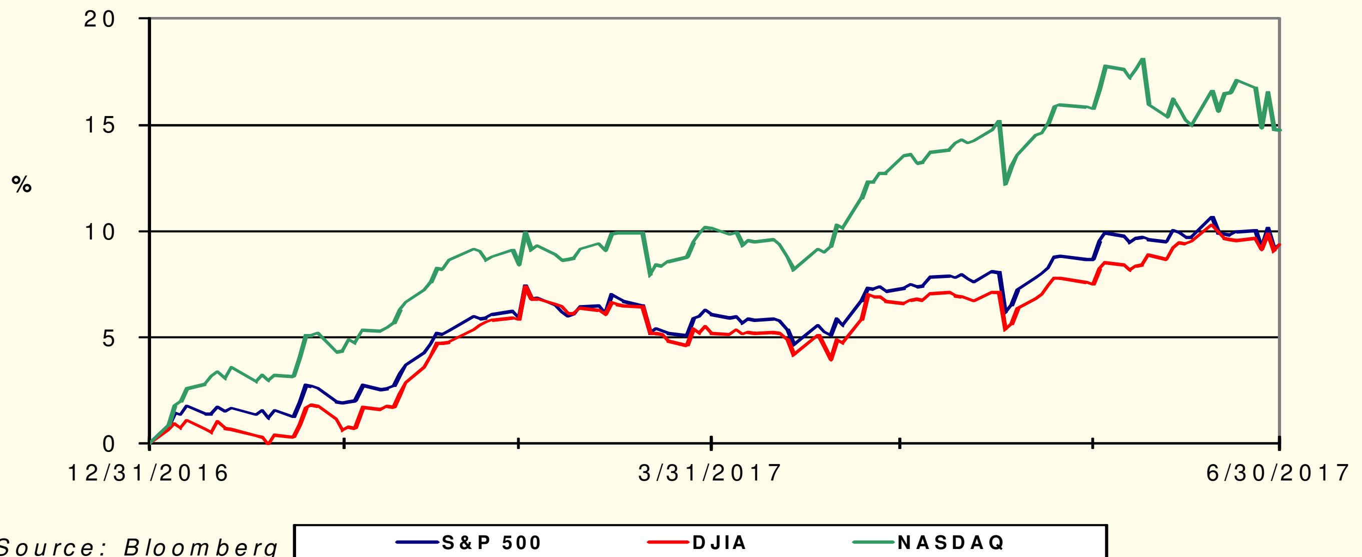

Shiny Objects

"Palm, Ditch, Steal, Load, Simulation, Misdirection, Switch"

—The Seven Basic Principles of Magic
Penn & Teller

The major U.S. equity market indices continued to advance during the Second Quarter of 2017, with the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) increasing +3.09%, +3.95%, and +4.21%, respectively, for the period. For 2017 through the end of the Second Quarter, the S&P 500, DJIA, and NASDAQ have returned +9.34%, +9.35%, and +14.76%, respectively.

As you know, Windward's portfolios are comprised of dominant, financially-strong, leading companies with best-in-class managements, high incremental returns on invested capital, and business models with sustainable competitive advantages. Typically, these "high quality" companies have characteristics that warrant their stocks' inclusion in a variety of growth indices (e.g., NASDAQ, Russell 1000 Growth Index, NASDAQ 100 Index). Despite the remarkable continued outperformance of the growth indices year-to-date, there was notable weakness in these indices during June, with the NASDAQ 100 Index, for example, declining nearly -5% from its June 08 intra-month peak. As long-term investors in a variety of companies which are components of these indices, this short-term stock volatility may affect *Windward* portfolios' near-term performance but has no impact whatsoever on our investment theses or ownership stakes in these businesses.

However, since equity market growth indices typically *lead* the broader financial markets (both up and down), this divergence bears watching.

As we have discussed before, based upon the (by historical standards) unprecedented degree of uncertainty associated with the Trump 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 remains too much uncertainty and lack of details associated with the policies and directives of the Trump 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 early 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, 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. 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.

Phillips Curveball

In the *Windward Capital 2017 First Quarter Review*, we discussed, in detail, the process—and the risks—asso-

ciated with the U.S. Federal Reserve's (Fed's) imminent "normalization" of monetary policy, which entails a combination of Federal Funds (Fed Funds) interest rate increases and an unwinding of the Fed's balance sheet. As we predicted, at its June 14, 2017, policy meeting, the Federal Open Market Committee (FOMC) announced an explicit commitment to reduce its $4.5 trillion balance sheet by decreasing its reinvestment of the principal payments it receives from securities held by a certain dollar amount each month. Specifically: $10 billion per month initially, increasing in steps of $10 billion at three-month intervals over 12 months until reaching $50 billion per month. It is anticipated that the Fed will initiate this process in September, at the earliest, or by the end of the year, at the latest. At that same meeting, the FOMC increased the short-term Fed Funds interest rate by 25 basis points to 1.25%—a process that the Fed expects to continue into 2018.

As we have discussed in the past, the Fed appears committed to its normalization plan, despite historically-moderate U.S. economic growth and concerns regarding whether the Fed has actually achieved its dual mandate of price stability and maximum sustainable employment. Indeed, the dominant view at the central bank is that, with the U.S. operating at full employment, the slack in the jobs market is more or less gone, and it is only a matter of time before core inflation hits the Fed's 2% target. In fact, however, inflation (as measured by Core Personal Consumption Expenditures [PCE]) has undershot the Fed's target for nearly 60 straight months—even as the unemployment rate has nearly halved over that same time period to 4.4% (from 8.2% in June 2012). The conundrum is that low inflation argues for easier policy, while low unemployment argues for tighter policy. The Fed has prioritized the latter over the former on the theory that an economy operating beyond full employment will eventually place upward pressure on inflation (primarily via wage growth). However, is the U.S. economy truly at full employment? Or are labor participation rates and potential hysteresis effects from the 2008 Financial Crisis indicating otherwise? Is the non-accelerating inflation rate of unemployment (NAIRU)—the level of unemployment below which inflation rises—in fact lower than the Fed's 4.7% estimate of the long-run rate?

Given the uncertainty surrounding these issues, combined with the significant influence that the Fed's long-term monetary policy goals has on the U.S. (and global) economy, it is our opinion that the Fed should reassess—and, perhaps, relax—its 2% inflation rate target. Specifically, we believe that a *higher* U.S. inflation target would make conventional monetary policy much more effective in fighting recessions and spurring recoveries during periods when nominal short-term interest rates are at, or near, 0% (the "Zero Lower Bound," or ZLB)—periods which we anticipate will occur more frequently in the future, as we have discussed in previous missives. In our view, raising the inflation target above 2% greatly increases the probability that the next recession will be shorter and the recovery faster—not just because it will allow inflation-adjusted interest rates to be lowered further, but because it will be easier for households to mitigate their debt burdens.

The ZLB has been recognized as a potential problem for central bank policymakers for some time. Given the lack of effective fiscal policy stimulus, central bank reductions in short-term interest rates have become the primary policy tool used to fight recessions and spur recoveries in recent decades. Recessions and sluggish economic growth occur when spending by households, businesses, and governments (i.e., aggregate demand) is too low to spur the hiring of all available workers and maintain full employment. Cutting short-term rates boosts aggregate demand by putting downward pressure on long-term rates, which spurs households to consume more and businesses to invest more.

The problem occurs when aggregate demand remains too low to generate full employment even when short-term interest rates hit 0% (given that negative short-term interest rates are difficult to engineer on a sustainable basis). This problem has become more of an issue in recent decades: Japan has been stuck at the ZLB for most of the past two decades; in the Eurozone the short-term policy rate has been below 1% since the end of 2013; and in the U.S., the short-term policy rate controlled by the Fed hit zero late in 2008 and stayed there for seven years before increasing in December 2015.

As we have discussed with you in the past, a primary reason for the increased likelihood of hitting the ZLB is a measurable decline in the long-run "neutral" real rate of interest. This neutral rate is the inflation-adjusted short-term policy rate set by the Fed that would prevail when the economy is at full employment and inflation is stable. When forces in the American or global economy put consistent downward pressure on aggregate demand, this neutral rate is pushed down as lower rates become necessary to secure full employment. This chronic downward pressure on aggregate demand is sometimes referred to as "secular stagnation." What it means from a policy perspective is that macroeconomic policymakers (fiscal and monetary) will need to make policy *more expansionary* than in the past simply to keep the economy at full employment. Practically, this translates into a combination of lower interest rates or higher fiscal deficits or more progressive taxation or higher government spending.

Unfortunately, most of the recent decline in the neutral rate is attributable to factors that are unlikely to reverse any time soon. The key influences restraining growth in aggregate demand and pushing down the neutral rate are: rising income inequality, a persistent glut of global savings, and an aging demographic—risks that we have highlighted for several years.

Income Inequality

Income inequality is damaging to an economy because the redistribution of income to the top of the distribution, all else being equal, reduces aggregate demand. Higher-income households spend a smaller fraction of their income (both overall and of each marginal dollar) than do low- and middle-income households. This means that transferring income from low-saving to high-saving households will reduce national spending. Of course, the effect of this redistribution on aggregate demand can be neutralized through other means. The most obvious mechanism to neutralize it is a decline in the neutral rate of interest, as savings rise and push down the "cost" of savings to potential borrowers, and lower interest rates spur business investment. But this mechanism obviously has a limit: the ZLB.

Global Savings Glut

The global savings glut refers to the large excess of savings over investment in large regions of the world (mostly East Asia as well as oil-exporting countries). Much of this excess savings was used to buy U.S. Dollar-denominated assets. This in turn bid up the price of the Dollar in global markets. This expensive Dollar made U.S. exports expensive in global markets and made imports coming into the U.S. cheaper, resulting in a large rise in the U.S. trade deficit. All else being equal, this rise in the trade deficit reduces aggregate demand for U.S. production. In theory, this inflow of savings into the U.S. economy could have lowered interest rates and thereby boosted aggregate demand by spurring consumption and investment spending. But, again, this effect is greatly weakened in a world in which below-zero rates are needed to keep aggregate demand high enough to spur full employment. Further, the lower interest rates spurred by the inflow of foreign savings into the U.S. economy are precisely the source of the phenomenon—the falling neutral rate of interest—that makes future episodes of hitting the ZLB more likely.

Aging Demographic

While the rise of income inequality and the global savings glut both worked to increase the *supply* of available savings and thereby lower interest rates, the market for loanable funds also has a *demand* side. The demand for these funds is driven by the investment plans of businesses, firms, and households. A key driver of business investment (the largest component of national investment) is the need to equip workers with necessary capital to do their jobs efficiently. So, as the size of the nation's workforce grows, business investment must grow in tandem just to keep workers well-equipped—especially given the ongoing decline in worker productivity. A significant demographic issue facing several economies in recent and coming years is a pronounced slowdown in the rate of labor force growth, due to an aging population. This implies, all else being equal, a decline in the demand for loanable funds, which puts downward pressure on interest rates and leads to a reduction in the long-run neutral rate.

These secular issues pressuring the neutral rate of interest are exacerbated by cyclical issues during economic recessions—especially like those experienced during the 2008 Financial Crisis: some analysts estimated that the U.S. economy needed real short-term interest rates that were *negative 8 percent* to restore full employment—unattainable given the ZLB.

If the Fed's interest rate tools are insufficient to restore full employment, the economy may experience a prolonged period when aggregate demand is too low to restore full employment on its own. The resulting stretch of extended joblessness deprives workers of bargaining power (or forces them out of the workforce prematurely) and puts downward pressure on wages. Given that labor is the largest cost component of producing the vast majority of goods and services in the U.S. economy, a slowdown in wage growth will put downward pressure on production costs. In competitive economies, falling production costs put downward pressure on prices, thereby slowing inflation. If inflation decelerates during a period of economic weakness, this actually puts upward pressure on *real* interest rates, just when the economy needs it least. This dynamic is known as the "low-inflation trap" and is the reason why reassessment of the Fed's 2% inflation target has become more imperative.

The Fed has not achieved its 2% core inflation target because it (and other government policymakers) failed to quickly rectify the shortfall of aggregate demand following the negative shock of the Financial Crisis. This failure to maintain aggregate demand occurred because the Fed was unable to lower the real Fed Funds rate low enough to restore full employment. While the Fed also utilized unconventional monetary policies (i.e., Quantitative Easing), the fact remains that lowering interest rates (either conventionally, through short-term cuts in the Fed Funds rate, or unconventionally, through Fed purchases of long-term assets) is often a weak tool for boosting aggregate demand. Fiscal policy, on the other hand, is particularly effective in closing aggregate demand shortfalls. But a key lesson of the political economy in the past decade has been that the political system can fail terribly at delivering timely and effective discretionary spending policies aimed at fighting recessions. While U.S. fiscal stimulus packages were passed in 2008, 2009, and 2010, fiscal policy since the Budget Control Act of 2011 has been contractionary on the spending side. Congress did not pass sufficient fiscal stimulus measures to quickly restore full employment, and in fact put Federal spending on a historically slow growth path precisely when the economy needed a boost to aggregate demand. (The Fed acted more wisely, lowering short-term interest rates and keeping them down, but because the economy entered the recession at a low rate of inflation, Fed rate cuts could only go so far, particularly in the face of the fiscal drag.) This spending austerity helps explain why recovery from the 2008 Financial Crisis has been the slowest on record.

Some analysts have argued strongly for crafting "automatic stabilizers" to blunt negative aggregate demand shocks in the future. On the fiscal front, automatic stabilizers are programs that direct more income to struggling households when the economy is in distress without requiring Congress to pass new legislation. Progressive taxes and means-tested safety net programs (such as unemployment insurance, Medicaid, and food stamps) are the most-cited automatic stabilizers, providing a boost to purchasing power through fiscal policy as private incomes fall. On the monetary policy side, the Fed could consider adopting a higher inflation target as a potential automatic stabilizer. Unlike rate cuts, credit-easing programs, and large-scale asset purchases, each of which require Fed action at the time of need, setting a higher inflation target in advance could help the economy avoid "low-inflation traps" that will interact particularly badly with high levels of debt, thereby effectively—and, crucially, automatically—providing a backstop against negative aggregate demand shocks.

Will the U.S. economy face a positive productivity shock that further reduces inflationary pressures? Or will the U.S. Dollar continue its recent slide with the opposite impact on inflation? Will low unemployment finally start to kindle an inflationary fire? Or is the estimate of the natural rate of unemployment still too high? What will the Fed care about?

Barring a significant disruption to financial markets, the interplay between growth, unemployment, and inflation will be much more important than fiscal policy. On the growth front, the current pace of economic ac-

tivity will probably maintain the Fed's tightening bias (but signs of softness in consumer spending patterns as households struggle with rising debt loads remain a risk). The same goes for unemployment: it is already below Fed forecasts for this year. But inflation is telling the opposite story: if the U.S. economy were truly operating near capacity, the inflation data would not be this weak. Persistently low inflation suggests that the Fed's estimates of full employment are too pessimistic and, therefore, argues that the central bank is too far ahead of the inflation curve.

How the Fed balances these competing signals is the key to understanding monetary policy going forward. The chosen balance appears to yield a Fed that is on relative autopilot: as long as the current equilibrium holds, they plan to tighten policy gradually and predictably. For now, the Fed (as well as fiscal policymakers) remains biased toward *more* tightening, not *less*—a situation that does not seem tenable if low inflation persists. The bar to scaling back the Fed's plans appears fairly high, however, and requires either a more evident slowdown in growth that is likely to stabilize the unemployment rate or a substantial downward revision of full employment estimates.

In our view, these uncertainties reflect the broader deflationary consequence of a deformed world of overcapacity (China), underconsumption (Europe), excess savings (inequality), and lack of demand. Until these broader issues are resolved, global monetary and fiscal policymakers will continue to face a conundrum.

Mashed Potato Sandwich

Several events of interest occurred in Europe during the Second Quarter of 2017: a general election in the U.K., a presidential election in France, and indications of a monetary policy shift from the ECB.

U.K.

As you know, the U.K., surprising the consensus view, voted to leave the European Union (EU) (aka "Brexit") in June 2016 and subsequently elected Theresa May from the Conservative Party as its Prime Minister. On March 29, 2017, PM May triggered Article 50 of the Treaty on European Union—officially initiating the negotiation process whereby the U.K. would leave the EU no later than April 2019. The terms of exit will be negotiated between Britain's 27 European counterparts, and each will have a veto over the conditions. Unwinding Britain from the old membership should be relatively straightforward; however, it will be more difficult agreeing on a new trading relationship, establishing what tariffs and other barriers to entry are permitted, and agreeing on obligations such as free movement, among other issues (certain EU leaders claim that this could take an additional five years). We refer you to our *Windward Capital 2016 Second Quarter Review* for a detailed discussion of the potential alternative outcomes that could result from this evolving process.

In April 2017, PM May called for a U.K. general election (held on June 08), ostensibly in order to ensure a stronger mandate for her Brexit negotiating stance—but more likely a politically opportunistic maneuver designed to take advantage of poor polling numbers for the main opposition party (Labour) and thereby consolidate power and secure a larger majority in Parliament for the Conservatives. This gambit failed: the Labour Party actually *gained* seats, while the Conservative Party *lost* seats and majority rule. Losing the support of her party, May has refused to resign and has instead cobbled together a majority government by forming an alliance with Northern Ireland's Democratic Unionist Party (DUP).

Most pundits view the U.K. general election defeat of Theresa May as a rejection of Brexit, which itself was a relatively close result (52% For, 48% Against). Our view is different: approximately 84% of votes cast in the U.K. general election actually went to Brexit political parties. However, it was Mrs. May's particular version of Brexit that was rejected: May sees Brexit through the fatalistic prism of migration, borders, and criminal justice—an insular, pedantic, and illiberal view that

seems oblivious to the immense economic risks of pursuing such a narrow strategy. For more liberal, free-marketers, Brexit is, most importantly, an opportunity to restore the law-making prerogatives of Parliament (not the European Court of Justice), and to keep a safe distance from an EU that must evolve into a unitary political state if the Euro is to survive as a currency (such a destiny is self-evidently incompatible with British democracy and self rule).

In our view, whether it is the "Norwegian," "Swiss," or now "Finnish" (1980s) options, the vote for British independence can be consummated only if done safely, in manageable steps over many years, and with broad political consent. It should not be necessary to force through Brexit in a militant fashion. We believe that what "Leavers" seek can largely be achieved with statecraft, subtlety, and patience. It certainly cannot be done if the nation is frightened into a scorched-earth withdrawal from the EU.

France

On May 07, 2017, political centrist Emmanuel Macron, a former French Economics Minister, won 66.1% of the final round vote in the French presidential election over far-right Marine Le Pen of the anti-immigrant and anti-Europe Front National, who advocated for a managed break-up of the Eurozone and a return to national currencies. This represents the first time in the history of France's Fifth Republic that a president has been elected without the backing of a formal party machine. In mid-June, Mr. Macron's La Republique en Marche party subsequently secured an outright majority of seats in the National Assembly, the lower house of the French parliament.

French voters have picked an apostle of Europe and an arch-defender of the Franco-German axis. In our view, President Macron's strategy is to restore French credibility and then lever this to extract Eurozone concessions from Germany. He plans Nordic labor reforms, easier collective bargaining rules, and the sort of tax shake-up that German leaders have long demanded. The "quid pro quo" will be that Berlin must agree to a Eurozone fiscal union and cut its corrosive current account surplus—now 8.6% of Gross Domestic Product (GDP) and in breach of EU rules.

Macron wants a Eurozone finance minister and budget, with joint debt, and a banking union with shared deposit insurance—all legitimized by a new parliament for the currency bloc. This implies a unitary Eurozone Superstate and, effectively, calls Berlin's bluff. Germany often argues that they cannot accept such radical proposals as long as other Eurozone States ignore budget rules and fail to meet their Eurozone obligations. (Whether Germany's real motive is to protect its mercantilist interests as a creditor power and run monetary union to suit itself is conveniently never put to the test.)

As French Economics Minister, Mr. Macron was an acerbic critic of the austerity regime imposed on the Eurozone by Germany. He decried the current half-way house of an orphan currency with no EMU government to back it up, and argued that it was misguided policy to try to close the North-South gap in competitiveness by imposing all the burden of adjustment on the weakest high-debt States. In his view, such a policy misdiagnoses the cause of the EMU crisis—capital flows, rather than fiscal or moral failure—and leads to a deflationary vortex for the entire system.

The German Council of Economic Experts holds defiantly to the national view that trade surpluses are proof of "virtue." It sees EMU debt-pooling as a slippery slope towards a "Transferunion," which Germany's top court says would require a change to the country's constitution—a political impossibility. Mr. Macron's plans would require a new EU Treaty, opening a can of worms that several member States are determined to avoid. (In our view, the only thing that will force Germany to budge is if the French and Italians form a coalition and threaten to leave the Euro.)

Whether President Macron's reforms really go far enough to revive France itself is also an open question. He plans to keep the retirement age at 62, badly out of line with EU competitors. The 35-hour working week will be modified but not abolished. French government spending will be cut from 55% to 52% of GDP (which would happen to some degree anyway at this

phase of the economic cycle). In other words, this is *not* a free-market revolution.

Pushing through these plans is also no fait accompli as France remains Balkanized. The scale of Mr. Macron's 66:34 victory in the final-round vote is misleading: blank protest votes represented 11.5% of total registered voters, and the abstention rate was 25.4%. Populist undercurrents are better captured by the first round of voting, when 48% backed Euroskeptic parties from hard-Left to hard-Right. This is no validation of the EU Project. If this new generation of centrists fails to deliver, the populists will return—fed by even stronger anger and resentment.

ECB

The European Central Bank (ECB) has taken its first steps towards monetary tightening, signaling initial retreat from its radical experiment of negative interest rates and emergency stimulus. At his June 08, 2017, press conference, ECB President Mario Draghi noted that, in the ECB's opinion, the tail-risks of deflation have definitely disappeared, and that the labor market is tightening and the output gap is closing. He also said that the ECB considers that the risks to the growth outlook are now "balanced." Notably, this is the first time since 2011 that the ECB has opted for neutral language of this kind.

The bank dropped its pledge to cut interest rates even further below the current level of -0.4%. (These rates were already the most steeply negative in history and the cause of widespread protest from German savings banks and insurers.) Extreme stimulus is becoming untenable as the Eurozone economy stabilizes: the quadruple effects of loose money, a "cheap" Euro, the end of fiscal austerity, and lighter bank regulations have all combined to produce an increase in Eurozone GDP of +2.4% (on an annualized basis) during the First Quarter of 2017. This, after a decade of rolling bank crises and a more protracted economic slump than in the 1930s.

Despite his relative optimism, Mr. Draghi gave no indication of when the ECB will start to wind down its €60 billion program of bond purchases each month, and even left open the door for further doses of Quantitative Easing if needed to shore up the economy. However, the ECB is fast running out of bonds to buy under current rules, a task made even harder in Germany as Berlin runs a budget surplus and retires debt from the market. The bank has already bought €2.3 trillion of Eurozone debt and boosted its balance sheet to 38% of Eurozone GDP. This is far beyond peak levels reached by the Fed, prompting criticism from the German IFO Institute that it is seriously distorting the Eurozone financial system. The longer QE goes on, the more difficult and potentially dangerous it becomes to reverse.

The consensus view is that the ECB is likely to start talking about bond tapering in September or October. According to that view, it may wind down bond purchases in the first half of 2018, and then begin to raise rates around the middle of the year. But the process is fraught with risk. The ECB is currently absorbing Italy's entire budget deficit as well as financing the rollover of existing debt. By acting as a buyer-of-last-resort, it has masked chronic capital outflows from Italy, evident in the exploding level of Italy's Target2 liabilities to the ECB system. It has, in effect, disguised the underlying solvency risk for the Italian State. The worry is that financial market participants might start to abandon the Italian debt markets once the ECB shield is removed.

Mr. Draghi has another stubborn problem, similar to that facing the Fed: lack of inflation. The ECB's inflation target is near, but below, 2%. This target appears unreachable: June 2017 headline inflation (HICP) is expected to be 1.3% (on an annualized basis) and has been trending downward during 2017. The ECB has had to reverse itself yet again and cut its HICP forecast to 1.3% in 2018 and 1.6% in 2019. As a result, it will not achieve its 2% target this decade. Core inflation has been stuck near 1% for some time. In addition, job creation remains painfully slow and has primarily comprised low-quality and/or part-time or temporary jobs. As of May 2017, the headline Eurozone unemployment rate has dropped to an 8-year low of 9.3% (22.5% in Greece, 17.7% in Spain, 11.3% in Italy, 9.6% in France,

and 9.4% in Portugal), with youth unemployment at 18.9% (46.6% in Greece, 38.6% in Spain, 37.0% in Italy, 24.6% in Portugal, and 21.6% in France).

The ECB and the Fed (along with the Bank of Japan) have discovered that it is much harder to pull out of the low-inflation trap than they had anticipated.

The Year of the Chicken?

Anyone reading news reports about the Chinese economy a year ago might have thought that the country was on the verge of financial collapse. At the time, there seemed plenty of evidence supporting those who expected an economic breakdown: debt was surging at unprecedented rates, regulators were in disarray following a stock market collapse the previous Summer, and liquidity panics periodically swept through the banking system. In addition, so much capital was fleeing the country that even a huge current account surplus could not prevent central bank reserves from eventually declining by nearly -25% from their June 2014 peak.

However, as we have discussed for years, China is not on the verge of a financial collapse and will likely never collapse as long as regulators remain credible and are able to restructure liabilities in the banking system with relative ease. We have discussed, at length, that financial crises are caused not by insolvency or economic downturns, but rather by highly inverted asset-liability mismatches severe enough to cause a breakdown when evaporating liquidity prevents the rolling over of liabilities. On paper, the Chinese financial system seems plagued by such mismatches, but liabilities in a closed banking system with all-powerful regulators are much more stable than they seem because the regulators have many ways to restructure liabilities throughout the banking system.

Currently, consensus sentiment has changed dramatically from one year ago. Central bank reserve levels have stabilized, and economic growth is on track to meet Beijing's 2011 promise to double China's GDP between 2010 and 2020. There is now a growing consensus that the worst of China's adjustment is behind it, and that once Beijing gets debt under control—something banking regulators have clearly set their sights on—China can enjoy another decade or more of +5-6% annualized GDP growth. In fact, China's real 2017 First Quarter GDP rose by a higher-than-expected +6.9%, above the +6.8% achieved in the previous Quarter and last matched in the Third Quarter of 2015. This was comfortably above the 2017 GDP growth target of +6.5%. Nominal GDP growth was even more impressive, at +11.8%, which is the highest level since the First Quarter of 2012. (2017 Second Quarter GDP data, along with other economic statistics, are to be released in mid-July.)

On the surface, these data seem broadly consistent with the new optimistic consensus: after five years of decline, GDP growth seems poised to reaccelerate, and, while debt continues to grow too quickly, regulators have successfully targeted credit growth in certain troublesome sectors. With the right policies and, more importantly, the necessary resolve, the newly optimistic consensus assumes that Beijing can get debt under control. If it does, when growth has bottomed out, it follows that China will finally put its difficult economic adjustment behind it.

Unfortunately, there is an implicit assumption in this optimistic outlook which, in our opinion, is completely wrong. The assumption is that the underlying drivers of economic activity are somehow independent of the process of credit expansion, so that it is possible to talk about reining in credit growth and maintaining GDP growth as if these were two separate things. The new consensus misreads the Chinese economy just as badly as the old consensus did last year, when many analysts expected a crisis; in both cases, the misreading is the result of treating individual pieces of data as separate and discrete instead of as interlocking parts of a system. What looked like extremely fragile balance sheets last year were a lot less fragile than they seemed when we consider the relatively closed nature of the Chinese financial system and the ability of the regulators to shift liabilities among the banks. Similarly, what might look like a bottoming out of economic growth this year—and, separately, an increasingly successful attack on fi-

nancial irresponsibility—is, in fact, a single system in which stable GDP growth requires accelerating credit expansion.

It is important to recognize that Beijing has not been able to control credit growth. China's reported GDP growth does not represent fundamental growth in the country's productive capacity, but rather growth in certain accepted measures of economic activity, productive or not. At least part of this growth is driven by increases in debt. Without this credit expansion, growth must automatically fall to the sustainable growth rate that can be organically generated from rising household income and needed investment. We would argue that this sustainable growth today is at least 50% lower than the current growth levels, and that over the next ten to fifteen years China is unlikely to manage growth rates above +3%, on average—and probably much lower.

The increase in China's debt during the First Quarter of 2017 was 7.0 trillion renminbi —an amount equal to an astonishing 39% of the country's 2017 First Quarter GDP. Part of this increased lending was used simply to roll over bad debt that is not being recognized. But most of it went to fund a +13.6% increase in public sector investment, much of it unproductive (adding to the future amount of bad debt that must be rolled over). It was this debt that drove economic activity in the First Quarter above China's sustainable growth rate.

Whatever the current sustainable growth rate, it is dangerous to assume that it is stable. In finance theory, it is widely understood how a rising debt burden can automatically force down the growth rate of the borrowing entity through a process referred to as "financial distress." We have discussed how this process works in previous *Windward Quarterly Review*s and why the supporting evidence is overwhelming: as China's debt burden rises, the accumulated effects of financial distress caused by the debt automatically forces down China's sustainable growth rate. This process has locked China into a vicious circle: rising debt automatically forces down China's sustainable growth rate, and as it declines, the gap between China's sustainable growth rate and its GDP growth target rises. This requires even greater credit expansion to meet the growth target, which, of course, forces the sustainable growth rate even lower. Long-term prospects for the Chinese economy, in other words, will deteriorate as long as the Chinese economy is forced into relying on debt to grow faster than it can manage organically. For now, China's GDP growth is largely driven by the political calendar: President Xi Jinping must consolidate economic decision-making in the run-up to this year's Party Congress if he is to implement the difficult reforms that will break China out of its debt cycle, and higher growth early in the year will make this politically easier to do. If he is successful in overcoming the vested interest opposition that has for nearly a decade prevented necessary adjustments in the Chinese economy, GDP growth will begin to drop, probably declining to barely above +6% by year end, and will continue to decline sharply over the rest of this decade. If he is not successful, he may be forced to maintain overly-high GDP growth targets for as long as necessary—or as long as the country has the debt capacity.

As we have discussed in detail in the past, the rebalancing of China's economy from investment- to consumer-driven will, by definition, result in lower overall GDP growth by curtailing China's current unproductive growth dynamic and redirecting it toward household wealth creation—a net positive for the long-term sustainability of the country's economy. This process also has significant global macroeconomic ramifications. Consequently, high growth today does not imply that the growth deceleration of the past five years has ended. It only means that, for political reasons, Beijing cannot yet abandon its GDP growth target, and so it is willing to let credit expand however quickly it must. In our view, the more rapidly that GDP growth decelerates, the better for China in the medium- and long-term because it indicates that the rebalancing process has begun.

Sui Generis

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
Congressional Budget Office
European Central Bank
Eurostat
International Monetary Fund
The People's Bank of China
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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