WINDWARD CAPITAL
Risk Averse Asset Management

2017 Third Quarter Review

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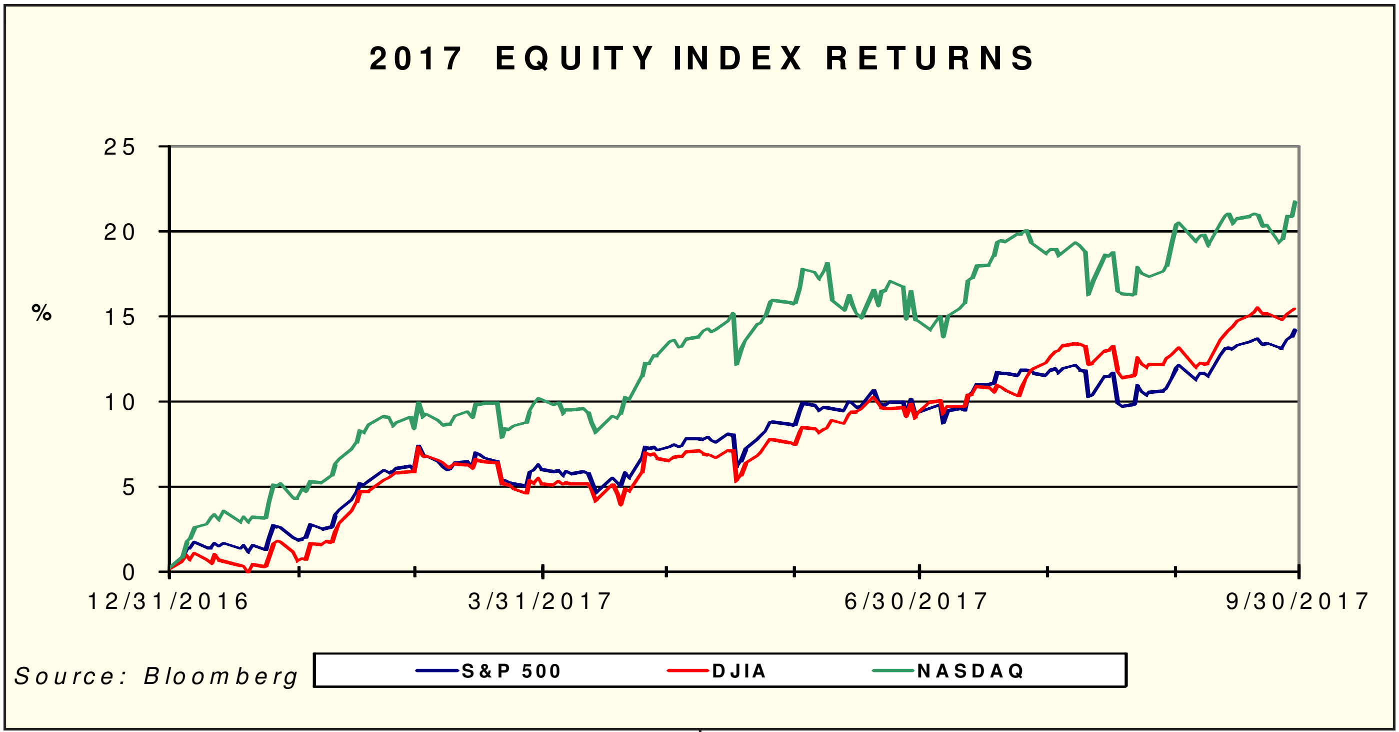

Source: Bloomberg

Unreality Show

"Follow the money."

—Hal Holbrook as "*Deep Throat*"
All The President's Men (1976)

The major U.S. equity market indices continued to advance during the Third Quarter of 2017, with the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) increasing +4.48%, +5.58%, and +6.07%, respectively, for the period. For 2017 through the end of the Third Quarter, the S&P 500, DJIA, and NASDAQ have returned +14.24%, +15.45%, and +21.73%, respectively.

Since there has been no acceleration in corporate revenue or earnings growth, the equity market advance appears to be primarily related to a variety of other factors, including: consistent but moderate economic growth, a weak U.S. Dollar, corporate stock buybacks, merger and acquisition activity, optimism regarding the positive impact from potential "tax reform," liquidity effects, reemergence of the "reflation trade," and momentum. Some of these factors necessarily raise concerns regarding market valuation—a concern that we share, but which we believe is mitigated in *Windward* portfolios to a large degree by the fact that we are invested in "high quality," dominant, financially-strong, leading companies with best-in-class managements, high incremental returns on invested capital, and business models with sustainable competitive advantages.

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 first nine months 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.

Lessons Learned?

It was exactly ten years ago that two *Bear Stearns* subprime mortgage hedge funds collapsed, initiating the onset of the Financial Crisis. It was the first of many signals of the financial stress that would, a year later, send the global macroeconomy into a tailspin, with massive economic and financial dislocations that would come to a boil in late 2008 and continue through early 2009—bringing the world to the brink of a devastating multi-year depression.

Historically, financial crises can take a long time to develop, but, once they erupt, they tend to spread rapidly, widely, violently, and (seemingly) indiscriminately. In this process of cascading failures, overall financial conditions quickly contract: private credit facilities that previously seemed unconstrained are shut down, and central banks and governments are confronted with difficult, inherently uncertain policy choices. Policymakers have to account for the risk of a sudden stop to economic activity, which can devastate employment, trade, and investment in the near term and have detrimental sociopolitical and institutional effects over the long term.

In the most recent example, although it took some time for the monetary authorities to recognize the extent of the financial system's latent instability (which had accumulated over several years under their watch), global central bank policymakers, led by the U.S. Federal Reserve (Fed) under then-Chairman Ben Bernanke, ultimately moved to stabilize the system by providing unlimited liquidity through financial guarantees. Subsequent monetary policy actions (ZIRP and Quantitative Easing [QE]) provided additional support—albeit at a cost.

Politicians, on the other hand, ignored the limitations of their economies' structural constraints, falsely assuming that economic models that rely excessively on finance can create sustainable, productive, and inclusive economic growth. Instead, they often acted as if the Financial Crisis was merely a cyclical, albeit dramatic, shock and assumed that the global macroeconomy would bounce back in a "V-like" fashion typical of most economic recessions.

Because fiscal policymakers were initially captivated by cyclical thinking, they did not regard the Financial Crisis as a secular or epochal event. Consequently, their policy responses were purposely designed to be "timely, targeted, and temporary." Although it has become clear that the problem required a much broader, longer-term structural solution, the political window of opportunity for bold actions has now essentially closed (a "wasted crisis").

As a result, advanced economies have taken longer than expected to return to pre-Financial Crisis levels of Gross Domestic Product (GDP) and have been unable to unleash their considerable growth potential. Worse, the growth that has been achieved in the years since the crisis was not inclusive: the income, wealth, and opportunity gaps in many advanced economies have endured, if not widened. The longer that this pattern persists, the more that advanced economies' future growth prospects will be limited.

A decade after the onset of the Financial Crisis, advanced economies still have not decisively pivoted away from a growth model that is overly-reliant on liquidity and leverage—first from private financial institutions, and then from central banks. They have yet to make sufficient investments in infrastructure, education, and human capital. They have not addressed anti-growth distortions that undermine the efficacy of tax systems, financial intermediation, and trade. And they have failed to keep up with technology that takes advantage of the potential benefits of big data, machine learning, artificial intelligence, and new forms of mobility while effectively managing the related risks.

For the U.S., this is currently the third-longest economic expansion since 1850: job growth has been persistently strong, inflation remains subdued, the economy is effectively at full employment, and Real GDP is now +12% higher than its pre-recession peak. However, like many other advanced economies, the U.S. is confronting several secular shifts. These include technological change that is reshaping labor and product markets, low productivity growth, rising skills premia, and an aging population. Even with high per capita income and one of the most flexible, competitive, and innovative economies in the world, the U.S. model appears to be having difficulties adapting to these changes. Most critically, relative to historical performance, growth has been too low and too unequal, resulting in a decline in most measures of living standards compared to other Organisation for Economic Co-operation and Development (OECD) members.

In order to address these challenges, current and future U.S. administrations need to realign policies to raise productivity and labor force participation, reduce poverty and income polarization, and help restore the economy's adaptability and dynamism. In our opinion, these policies should consider including the following measures:

- ✓ ***Fiscal policy*** should be calibrated to achieve a sustained but gradual reduction in the general government deficit, starting with the upcoming Fiscal 2018 budget. This would ensure that the public debt-to-GDP ratio declines through the medium-term.
- ✓ ***Monetary policy***. The pace of future increases in the Federal Funds (Fed Funds) rate can be gradual, especially when compared with previous tightening cycles, and should certainly be "data dependent" given the concern regarding underlying inflation dynamics. Concomitantly, the Fed's recent addendum to its balance sheet normalization principles and plans provides financial market participants with a clear path for changes in reinvestment policy that should help avoid undue volatility in fixed income markets.
- ✓ ***Tax reform***. The U.S. personal and corporate tax system needs to be simpler and less distorted, with lower tax rates and fewer exemptions. The redesign of the tax system should aim to raise labor force participation, mitigate income polarization, and support low- and middle-income households. Given the unfavorable debt dynamics and the resources needed to strengthen the supply side, tax reform ought to be designed to be revenue-enhancing over the medium term.
- ✓ ***Infrastructure***. There is a need for a significant increase in public spending on maintenance, repair, and new infrastructure projects.
- ✓ ***Trade***. Greater trade integration—particularly in growth areas such as services—offers important gains to the U.S. with positive spillovers for the global macroeconomy.
- ✓ ***Financial regulation***. Important gains have been made in strengthening the financial oversight structure since the global Financial Crisis. There is scope to fine-tune some aspects of the system while preserving the current risk-based approach to regulation, supervision, and resolution.
- ✓ ***Deregulation***. A simplification and streamlining of Federal regulations, as well as harmonizing rules across States, would likely boost efficiency and could stimulate job creation and growth. Care is needed to avoid negative consequences for the environment, ensure workplace safety, and provide protections for lower-income workers, however.
- ✓ ***Maintaining a productive and flexible workforce***. Measures should include improving educational opportunities and outcomes, offering childcare support for low- and middle-income families, introducing paid family leave, expanding the earned income tax credit, designing better social assistance programs for the poor, addressing healthcare coverage, and containing healthcare cost inflation. A skills-based immigration system would enhance labor participation and productivity as well as ameliorate medium-term fiscal imbalances.

The U.S. economy faces constraints on its medium- and long-term growth prospects. These include weak productivity, falling labor force participation, an increasingly polarized income distribution, an aging population, and high levels of poverty. These secular trends have led to a labor share of income that is around -5% lower today than it was 15 years ago, a middle class that is smaller today than at any point in the last 30 years, and—aside from the immediate aftermath of the Financial Crisis—the lowest potential economic growth rate since the 1940s. Finding solutions to alleviate these issues and mitigate the associated unfavorable trends in income distribution will be key to the long-term health of both the U.S. and the global economies. It will require intelligent, innovative, and aggressive action in multiple areas—tax, infrastructure, trade, regulation, education, healthcare, immigration, and support for low-and middle income households. It remains uncertain whether current or future U.S. administrations will be able to successfully meet these challenges.

On the QT

As was widely expected, on September 20 the Federal Open Market Committee (FOMC) held its short-term interest rate steady and announced that starting this month the Fed will gradually shrink its $4.5 trillion balance sheet, which it built up in response to the Financial Crisis to support the economy. An unexpected development at the meeting was a further reduction in the median view of FOMC participants about where the short-term interest rate will settle in the long run. The Fed apparently endorses the view, promoted by research of some of its own staff, that the slowdowns in the growth rates of productivity and the working-age population have persistently lowered both the U.S. economy's potential growth rate and the rate of return on investment. For the time being, it also appears that the Fed has placed any monetary offset policy response on hold given the lack of fiscal stimulus from the Trump administration.

The FOMC's estimate of the so-called "neutral" Fed Funds rate had declined from 4¼% a few years ago to 3% earlier this year and is now only 2¾%. With the Fed Funds rate currently near 1¼%, the Fed is (theoretically) almost halfway through its tightening cycle. In fact, it is possible that the projected neutral rate will decline further, as the FOMC analyzes research that suggests the long-run neutral rate might be as low as 2%.

As we have discussed before, the mechanics of balance sheet reduction (Quantitative Tightening, or "QT") were described in the June FOMC announcement. As its Treasury securities mature and its mortgage-backed securities are paid off, the Fed has been reinvesting all of the proceeds to keep its total assets at $4.5 trillion. Starting this month, as much as $10 billion per month will not be reinvested. Over time, the amount of maturing and prepaid assets that will be reinvested will decline, and the balance sheet will shrink at a faster pace. Under current plans, the balance sheet could shrink by as much as $50 billion per month by late next year. Although the FOMC has not indicated a long-run target for its balance sheet, we believe that somewhere in the range of $2 trillion to $3 trillion seems most likely. (The pre-recession operating procedure would imply a balance sheet of around $1.5 trillion, but we expect the Fed to maintain a significantly higher volume of bank reserves than under the previous regime in order to enhance the safety and liquidity of the financial system.)

Shrinking the balance sheet will tighten financial conditions because it will increase the quantity of long-term bonds in the market—thereby lowering their prices and pushing up their yields. Although not entirely clear, it appears to us that most of any increase is probably already priced into long-term bond yields, given that this decision was telegraphed so clearly in advance. The 10-year Treasury Bond yield rose only +2 basis points on September 20, but it has risen +58 basis points over the past 12 months—in part reflecting expectations of the September 20 decision. In addition, as we have discussed in the past, the current global macroeconomic growth outlook does not support significantly higher long-term interest rates, in our opinion.

The FOMC continues to project another Fed Funds rate hike in December. However, Chairwoman Janet Yellen made it clear in her recent press conference that many participants on the Committee are troubled by the decline of measures of core inflation. If data over the coming months do not show some evidence of inflation returning toward the Fed's target of 2%, rate hikes could be postponed. Although the odds still favor a December rate hike, concerns regarding falling inflation expectations could cause policymakers to start downgrading rate-increase projections for 2018.

The Fed is in a bind. With the U.S. economy ostensibly operating at full employment, policymakers remain committed to favoring their bias for a preemptive increased interest-rate policy based upon their faith in the Phillips Curve unemployment rate/inflation rate framework that we discussed in our *Windward Capital 2017 Second Quarter Review*. As a result, they do not believe that they can wait until inflation actually reaches their 2% target before acting again to tighten policy. At a minimum, this conviction looks sufficient to warrant another interest rate hike this year.

Nonetheless, it appears that the Fed's commitment to further tightening may be weakening and will not last beyond the December meeting if inflation remains mired below target. Their decision will ultimately depend upon which factors the Fed decides are responsible for low inflation. Chairwoman Yellen summarized the potential non-transitory factors: underestimating the amount of slack in the economy, misstated inflation dynamics, and falling inflation dynamics. If any of these hold, the Fed can still meet its inflation target—it just needs to raise rates more slowly. The problem is that gradualism will not be sufficient to halt and reverse a fall in inflation *expectations*. If inflation *expectations* decline, it will almost certainly be driven by the assumption that the Fed views 2% inflation not as a symmetric *target*, but as a *ceiling*. Policymakers might need to actually target inflation *in excess of 2%* to prove their determination to meet the target and manage expectations higher. Previous Fed commentary, however, may make it more difficult for the Fed to fully convince financial market participants of these intentions.

Despite a low headline U.S. unemployment rate, inflation has slowed this year, confounding central bankers who set in motion a tightening cycle on the expectation of firming prices. This leaves the Fed stuck in a quandary: either transitory factors are restraining inflation only temporarily, or inflation expectations have sunk below the Fed's 2% target. If the former is true, the FOMC can continue along the current path of gradual rate hikes. But if the latter is correct, maintaining the current plan risks causing excessive economic slowing and a possible recession. Global economic expansions do not die of "old age:" outside of geopolitical conflict or violent energy shocks, they are invariably murdered by central banks fearing inflation.

Extreme Fed Makeover

Upcoming changes in the composition of the membership of the Fed is certain to further exacerbate the uncertainty associated with future U.S. monetary policymaking.

The Fed is split into 12 Regional branches that unevenly divide the country. Each Region is organized like a private corporation: there are 12 Fed Presidents, chosen for five-year terms by their Regional Boards. On a rotating basis, five of the Presidents vote in any given year (the New York Fed is one—and while others rotate, it has a permanent vote). Overseeing them from Washington is a Board of seven Governors. Unlike the bank Presidents, Governors vote on all FOMC matters. The seven Governors are appointed by the U.S. President and confirmed by the Senate for staggered 14-year terms.

Five Regional Presidents plus seven Board Governors comprise the 12 members of the FOMC. There are currently three vacancies on the Fed's seven-member Board of Governors. Indeed, the Fed has not had its full complement of Governors since 2013; there has been at least one vacancy for 85% of the past decade. The culprit is political gridlock: the U.S. President nominates the Governors, but they cannot take office until confirmed by the U.S. Senate—a duty it often shirks.

Because of the retirement of Daniel Tarullo, the Governor informally tasked with heading financial regulation, the Fed Board has been down to four voters since May. With Vice Chairman Stanley Fischer leaving, the number would have been reduced to three; however, Randal Quarles, Trump's first nominee, was just confirmed by the Senate, holding the Governors steady at four. The Regional contingent, meanwhile, remains near full force, with only the Richmond Fed currently looking for a new President.

Current Chairwoman Yellen, Lael Brainard, and Jerome Powell are the holdovers on the Board in Washington, and President Trump is not expected to reappoint Yellen as Chairman when her term ends in February 2018. The remaining three Board spots are open, and it is uncertain whom Trump will nominate and the Senate confirm.

Fortunately for the Fed, which the world counts on for stability and predictability, its structure means institutional knowledge and independent voters should smooth over any Fed-related tumult in Washington. The current decentralized system, created with an eye on representing a diverse set of national interests, was explicitly crafted to reduce the danger of control by Washington or capture by Wall Street.

At a time when the current occupant of the Oval Office could choose at least four new Governors (including Quarles), the power of the Regional Presidents amounts to a stabilizing backbone and bastion of independence in an era of transition at the Fed. At a time when populism pervades politics and Washington is so out of favor, the Regional branch banks serve a secondary purpose: they give at least the impression that the Fed, seen by many as aloof and esoteric, is in touch with the American people. Regional Presidents make regular appearances at Chambers of Commerce, Rotary Clubs, and other community organizations across the country. Therefore, it could fall to the Fed's arcane system, born of populist angst, to protect monetary policy from massive upheaval. The current state of affairs underscores how this uniquely American setup, erected in stages beginning in the years before World War I, remains relevant a century later, even though many of the functional duties of the world's most powerful central bank have changed.

If there is one place where the Regional Banks cannot provide much of a moderating influence, it is regulation. As quasi-private bodies, Regional Feds do not vote on rules governing banking; that is the exclusive purview of the Fed Board. But the Branches supervise banks in their districts, and until the Financial Crisis they had discretion in implementing regulations and enforcing them. The stock market crash and the rise of Tarullo as the Fed's post-crisis finance czar changed that. Tarullo pulled regulatory authority back to Washington and away from Regional examiners, especially those at the New York Fed who had been tasked with overseeing the largest financial institutions. Now much of the power Tarullo wielded will shift to his likely successor. Quarles, who got the Senate Banking Committee's nod in September and was just confirmed by the full Senate, is expected to be more bank-friendly than his predecessor.

Overall, there is the potential for significant personnel changes at the Fed over the next several months. Whether this results in any meaningful change in monetary policy remains to be seen.

Dollar Daze

After the result of the November 2016 U.S. Presidential election, the U.S. Dollar Index appreciated by +8% in anticipation of extensive fiscal stimulus and the potential for a monetary policy offset. Since peaking in January at a 7-year high, however, the U.S. Dollar declined -12.5% to a 3-year low in September because global currency investors have lost faith in the Trump administration's ability to deliver on a variety of fiscal stimulus measures and have, therefore, marked down their expectations regarding the pace of Fed interest rate increases (it is typically the differential in interest rates across countries that drive exchange rate moves). However, a confluence of factors could start draining liquidity from the financial system, threatening a bout of Dollar scarcity and potential volatility in currency markets over coming months.

Besides QT by the Fed, the U.S. Treasury is also poised to tighten. The U.S. Treasury has run down its cash balance sheet to almost zero this year as it nears the Federal debt ceiling fixed by law. This has increased the U.S. monetary base. The Treasury has stated that it wishes to maintain a cash buffer of $500 billion in normal times as a reserve to cover terrorist strikes, natural disasters, market shocks, or other emergencies. But as it builds the cash balance—by making a permanent deposit at the Fed—it automatically tightens monetary policy. Assuming that the limit is raised, the U.S. Treasury is expected to replenish the buffer rapidly, setting off a Dollar rebound.

Tightening by the Treasury is a time-honored pattern following debt-ceiling episodes. After the last big showdown in September 2015, there was an abrupt monetary squeeze as the cash buffer rose, causing the Dollar to rocket with a slight delay. That Dollar appreciation had many secondary effects: it set off a capital flight problem in China at a vulnerable moment; it aggravated the oil price crash; and it led to the sharp selloff on global stock markets in early 2016 (the S&P 500 fell -12%). Those impacts should be interpreted with care, however; correlation is not causality, and the circumstances are different today. Yet lack of Dollar liquidity clearly played a central role in those events. This time, the twin-shift in policy is likely to tighten the availability of credit and send a strong impulse through financial markets—though whether it will be powerful enough to dampen asset prices in the current exuberant mood is an open question.

The implication of synchronized tightening by both the U.S. Treasury and the Fed is that the Dollar could begin to rally after sliding all year, contrary to the consensus view. If there is a liquidity squeeze, the great unknown is what will happen to those emerging markets that have borrowed heavily in U.S. Dollars. As we have discussed in the past, some $10 trillion of debt has been raised in U.S. currency beyond America's borders (with an additional $14 trillion in Dollar-denominated derivatives and swap contracts), leaving the global economy more sensitive to the U.S. exchange rate and to U.S. borrowing costs than at any time in post-World War II history. The Dollar has become the barometer and the driving force of global risk appetite. It is the key to global asset prices. When the Dollar strengthens, banks in Asia and Europe are forced to curtail overseas lending through the complex effect of hedging contracts on the derivatives markets.

For now, the global economy continues to grow. However, financial markets move to a different rhythm, and typically anticipate shifts in the economic cycle several months in advance. Correlations, divergences, and reversions to the mean occur consistently over time with enough degree of regularity to remain notable indicators of market inflection points. A U.S. Dollar surge could be a wild card that confounds many consensus assumptions.

Sellers' Strike

Although the equity markets have recently exhibited significant strength, the potential for a 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 potential market volatility can create 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.

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:

Bank for International Settlements
Bloomberg
Congressional Budget Office
International Monetary Fund
Organisation for Economic Co-Operation and Development
U.S. Bureau of Economic Analysis
U.S. Bureau of Labor Statistics
U.S. Department of the Treasury
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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