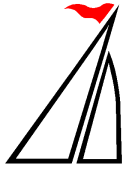
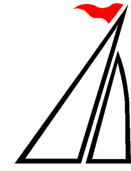


WINDWARD CAPITAL

Risk Averse Asset Management



2018 Second Quarter Review

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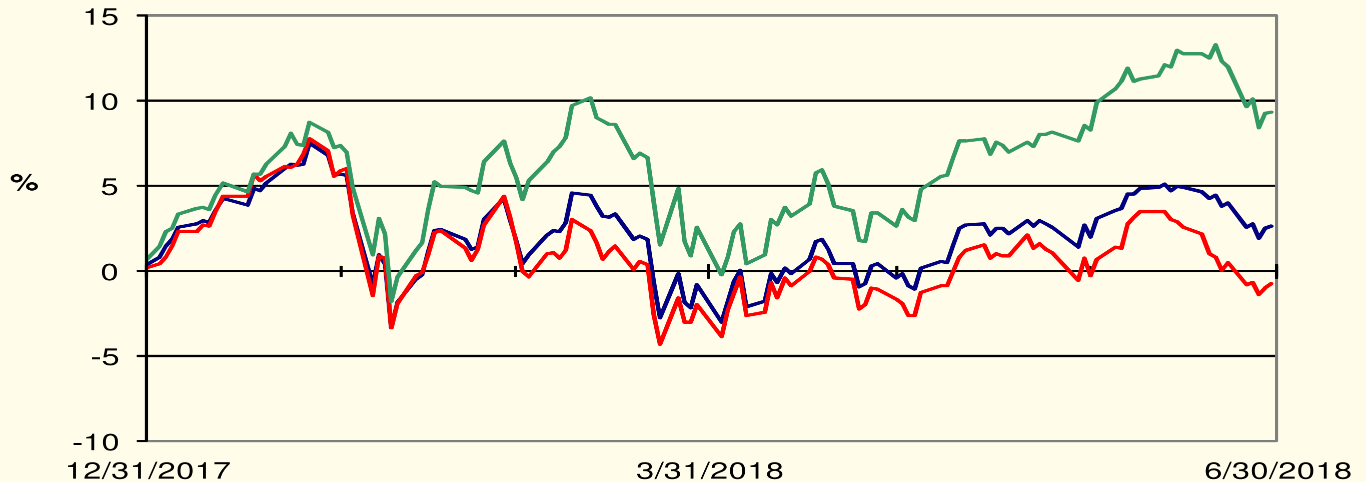

Chaos Theory

"You can either surf, or you can fight!"

—Robert Duvall as *Lieutenant Colonel Bill Kilgore*
Apocalypse Now (1979)

Despite some end-of-period volatility, the major U.S. equity market indices performed well during the Second Quarter of 2018, with the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) returning +3.43%, +1.26%, and +6.61%, respectively, for the period. For 2018 Year-to-Date, the S&P 500, DJIA, and NASDAQ have returned +2.65%, –0.73%, and +9.38%, respectively.

The near-term corporate revenue and earnings outlook remains positive: for the First Quarter of 2018, year-over-year S&P 500 Revenues and Earnings growth was +8.5% and +24.6%, respectively, with estimates of +8.7% and +20.0%, respectively, for the Second Quarter of 2018. Additional factors supporting the markets include: consistent but moderate economic growth, optimism regarding the positive impact from "tax reform," liquidity effects, reemergence of the "reflation trade," and momentum. As we noted during our *2017 Fourth Quarter Review*, some of these factors necessarily raise concerns regarding market valuation. Although we share this valuation concern and believe that the equity markets may still be "overbought" on a technical basis in the short term, we believe that this risk 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 regulatory and/or legislative clarity, we can only be confident that the investment environment will continue to exhibit greater uncertainty and increased volatility—a risk that may be poised to increase as the November mid-term Congressional elections approach.

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 year-and-a-half of the Trump Presidency appears inconclusive.

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 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.

Trading Down

In our *2018 First Quarter Review*, we discussed, at length, the broader, and more significant, strategic geopolitical factors at play beyond the narrow scope of the current U.S.-China trade discussions (see "The Chinese Dream"). Now that a trade conflict with China—along with other countries (like Canada, Mexico, and Germany)—appears imminent, it may be prudent to focus on some of the more tactical implications of a trade dispute as they relate specifically to the U.S..

What is meant by a "trade war"? In the current context, it means a situation in which the world's economies, taking their lead from the U.S., abandon the rules

and agreements that currently constrain their tariffs and start setting tariffs unilaterally in their perceived self-interest. The problematic word, of course, is "perceived." In trade, as in other areas subject to political influence, perceptions are generally not tethered to reality.

There have been a number of attempts to model trade wars over the years, relying on one of two approaches. The first is to imagine that governments actually do maximize national income, or perhaps an objective function that gives extra weight to well-organized interest groups. The second appeals to the historical experience of the world before international trade agreements became the norm. Interestingly, these approaches suggest similar levels of tariff increases. There are many assumptions and imputations involved, with the results depending a lot on how easily goods from one country can be substituted for goods from another—a parameter that is hard to estimate. However, several fairly recent academic efforts estimate a rise in tariffs of between 30 and 60 percentage points from current levels would occur under a trade war. (Historically, the Smoot-Hawley tariff, the last great protectionist move by the U.S. before the global system of trade agreements were created, pushed tariffs up to around 45% on "dutiable" imports.)

How much would trade decline based upon this magnitude of tariff increases? For any given tariff rate, the amount of trade reduction depends on the elasticity of import demand—the percentage fall in imports for every 1% rise in their price. Such elasticities are difficult to estimate, however, because there have not been many real-world experiments (for obvious reasons). (Fluctuations in exchange rates *can* change import prices, but those only give an idea of short-run effects, and most economists believe that long-run elasticities are much larger.) Under optimal tariff warfare theory, however, the effects of the war on trade volumes are surprisingly insensitive to the precise value of the elasticity because the optimal tariff *also* depends on the elasticity. In other words, if foreign countries can easily substitute away from your goods, the optimal tariff is fairly low; if they cannot, it is high. So high elasticities mean low tariffs, low elasticities mean high tariffs, and the decline in trade is similar. Based upon these types of analyses, some economists currently estimates that there could be an approximate –70% reduction in global trade based upon a 40+% increase in tariffs. This could cause U.S. Gross Domestic Product (GDP) to decline by approximately 2-3%—not an insignificant amount. (By comparison, U.S. real GDP decreased at an average annual rate of –3.5% during the 2007-2009 recession, experiencing a cumulative decline over the six Quarters of contraction of –5.1%.)

More importantly, however, in our view, is that these estimates fail to account for the multiplier effects that this economic disruption could create due to the increased interconnectedness of today's global trade system, which comprises complex supply chains and the dispersion of raw, intermediate, and final goods production across a variety of countries. Along with the introduction of a variety of tariffs (and immigration restrictions), the Trump administration's recent vague threats to withdraw from the structures and administrative organizations that support and regulate international trade (like the World Trade Organization [WTO]) seem to be intended to destroy the "system" for the perceived benefit of a political base. Perversely, the actual societal ramifications of these actions could backfire severely. As occurred during the onset of global trade—particularly with the eventual admission of China into the WTO in 2001—retrenchment of the current system will lead to additional, and unexpected, "winners and losers" of uncertain magnitude.

The White House complaint against Germany and China (specifically) is that they have strategically gamed the global trade system, although in different ways. Peter Navarro, the ultra-hawkish White House trade adviser, argues, for good reason, that Germany has secured a semi-permanent trade advantage through the deformed structure of the Euro, allowing the country to amass and hold a current account surplus of over 8% of GDP. The "implicit" Deutsche Mark, therefore, is "grossly undervalued," he argues, so that the intra-EMU exchange rate is misaligned. (To the extent that there is a self-correcting mechanism, it is through "austerity" policies in the Southern Eurozone countries.) This means that the Eurozone has become a contractionary black hole, hollowing out world demand and distorting the global economy. Germany has not shown any will-

ingness to correct this because, among other reasons, Berlin deems the Eurozone surplus to be a virtue.

The U.S. conflict with China is different because the Chinese trade surplus has largely disappeared: it is, rather, a strategic contest for control over the technologies of the 21st Century (as discussed at length in our *2018 First Quarter Review*) and is more about geopolitics.

While we would agree that there are valid reasons to consider certain historical cross-country trading relationships/agreements as in need of renegotiation, we believe that, given the complexity of the current system, existing, generally-accepted methods of discussion (including arbitration/mediation) should be explored more fully before resorting to conflict because, in our view, "trade wars" are *not* "good" and are *not* "easy to win."

Shocks

U.S. Federal Reserve (Fed) officials raised the benchmark short-term Federal Funds lending rate by +25 basis points for the second time this year to a range of 1.75-2.00% at its June meeting and forecast a steeper path of hikes in 2019 and 2020, citing an improving economic outlook. During the Second Quarter, the U.S. economy appeared to be charging ahead at a growth rate faster than +3%. At the moment, the Fed looks on track for three—and perhaps four—rate hikes in 2018 of 25 basis points each, with an additional three to four hikes in 2019 as well. With economic growth sufficient to put downward pressure on an already low unemployment rate, central bankers will seek to push policy rates to their view of a neutral level; otherwise, the Fed believes, the U.S. economy faces a risk of overheating.

Escalating trade battles may impact this forecast by causing potential demand effects and/or supply shocks. Examples of negative demand include the impact of retaliatory tariffs on exports of U.S. manufactured goods and agricultural products. More complicated than demand contraction, which has straightforward implications for monetary policy, is the possibility that the Trump administration's protectionist trade approach yields an escalating negative supply shock that restricts the productive capacity of the U.S. economy. In the short run, an economy-wide negative supply shock will decrease output and increase prices, thereby both constraining economic activity while creating inflation. (The U.S.-imposed tariffs on steel are a perfect example of this; indeed, the possibility of a broad-based disruption from such tariffs is exactly why a nation should be wary of targeting intermediate goods in a trade war.) In severe instances, a negative supply shock can also lead to economic stagflation: persistent high inflation combined with high unemployment and stagnant demand in a country's economy.

Given its inflationary component, it is logical to assume that the Fed would react to a negative supply shock via *tighter* policy—especially when central bankers already face the prospect of an overheated economy. This may not be the case, however, as long as the Fed believes inflation expectations remain well-anchored. Rather than shift to a more hawkish stance, the Fed could look through any spike in prices as temporary and instead focus on the negative impacts on economic activity. If they conclude that those negative impacts will continue even after the price shock fades, central bankers might actually shift to a more *dovish* stance.

However, the Fed could be driven in a *more* hawkish direction if the economy faces a series of negative supply shocks, global trade conflicts escalate, and those shocks trigger a change in consumer behavior such that inflation expectations become ingrained to the upside. That kind of shift occurred in the late 1960s, leading to the "Great Inflation" period of 1965 to 1982. The Great Inflation was the defining macroeconomic event of the second half of the 20th century. Over the nearly two decades it lasted, the global monetary system established during World War II was abandoned, there were four economic recessions, two severe energy shortages, and the unprecedented peacetime implementation of wage and price controls. It was considered the greatest failure of American macroeconomic policy in the postwar period. With that episode still looming

large in the Fed's psyche, policymakers would respond to an unanchored rise in inflation expectations with *more* monetary tightening, resulting in a toxic combination of faster inflation, weaker growth, and tighter monetary policy.

Although this particular outcome is not in our baseline forecast, we continue, as always, to monitor the evolving global trade environment, a variety of macroeconomic data, and the Fed's statements and actions in order to assess their impact, if any, on the businesses owned in *Windward*'s portfolios.

Flat as a Pancake

Absent an exogenous shock, then, the Fed remains on track to gradually raise interest rates into 2019. However, the ongoing flattening (and potential for inversion) of the bond market yield curve may cause the Fed to rethink its tightening plans.

As you know, the bond yield curve plots interest rates as a function of maturity and is specifically focused on the difference between interest rates on short-term U.S. government bonds (e.g., two-year Treasury notes) and long-term U.S. government bonds (e.g., 10-year Treasury notes). Typically, when an economy seems in good health, the rate on the longer-term bonds will be higher than on the shorter-term bonds (i.e., a "normal," or "steep," yield curve). The extra interest is to compensate, in part, for the risk that strong economic growth could set off a broad rise in prices (i.e., inflation). During monetary tightening cycles, the yield curve "flattens" as rates on short-term bonds rise more quickly than rates on long-term bonds. The curve tends to flatten nearly completely as the economy reaches the mature stage of the business cycle and the Fed pushes policy rates toward their neutral level.

Lately, though, long-term bond yields have been stubbornly slow to rise—which, by some accounts, suggests bond traders are concerned about long-term growth—even as the U.S. economy shows plenty of vitality. At the same time, the Fed has been consistently raising short-term interest rates. As a result, the yield curve has been flattening. In other words, the gap between short-term interest rates and long-term interest rates is shrinking. At about 30 basis points, the current difference between two- and 10-year Treasury note yields is down from about 125 basis points when the Fed began its current rate hiking cycle in December 2015 and from about 265 basis points in December 2013. In fact, it was last at these levels in 2007 when the U.S. economy was heading into what was arguably the worst recession in almost 80 years.

An "inverted" yield curve is one in which the term structure of interest rates is such that short-term interest rates are *above* long-term interest rates. Although the yield curve is *not currently* inverted, the rate of decline in the long-term/short-term yield spread is quickly moving in that direction. This is important because an inverted yield curve has historically been a very prescient recession indicator: every U.S. recession of the past 60 years has been preceded by an inverted yield curve. Curve inversions have correctly signaled all nine recessions since 1955 and had only one false positive, in the mid-1960s, when an inversion was followed by an economic slowdown but not an official recession. An important caveat to the predictive power of the yield curve is that it cannot predict precisely *when* a recession will begin. In the past, the recession has come in as little as six months, or as long as two years, after the inversion.

The question of whether an inverted yield curve, which is traditionally a very prescient recession indicator, will cause the Fed to rethink its tightening plans is shaping up to be the next big debate among monetary policymakers, with potentially significant consequences for the financial markets. The answer may lie in recent comments by key Fed officials who suggest an inversion may not mean what it has in the past.

In a recent speech, Fed Governor Lael Brainard argued that the current yield curve may be a misleading indicator due to lower yields on longer-dated assets compared with past tightening cycles. The lower yields are attributable to a lower neutral interest rate and a low term premium (the additional return required by inves-

tors to compensate for the added risk of holding longer-dated bonds). Low term premiums arise from a number of potential sources, including the Fed's large-scale asset purchases via their Quantitative Easing strategy that was designed to suppress yields.

As you will recall, during the Financial Crisis, the Fed bought trillions of Dollars of bonds as they tried to push long-term interest rates lower in order to combat the recession triggered by the 2007-2009 global credit crisis. Since October 2017, the Fed began to scale back the reinvestment of maturing Treasuries and agency mortgage-backed securities it amassed during three rounds of Quantitative Easing, and the central bank's balance sheet has, consequently, shrunk to $4.3 trillion from $4.5 trillion in September 2017, just before the start of its normalization program. A projected total of $395 billion in bonds are expected to exit the Fed's balance sheet in 2018 and another $470 billion in 2019. On this current path, the Fed's bond holdings and other assets would fall to $3 trillion by early 2021, according to the New York Fed's latest forecast.

Even though they are reversing course now, central banks still own massive amounts of those bonds, and that may be keeping long-term interest rates lower than they would otherwise be. As the Fed reduces its more than $4 trillion of balance-sheet assets, Brainard anticipates the term premium will rise. (Another explanation for low term premiums is lower and more stable inflation expectations than in past cycles, a factor likely to continue to hold given the Fed's commitment to its inflation target but at risk given the current global trade imbroglio.)

The low long-term rates attributable to a low term premium imply the yield curve will invert at lower levels of policy rates than in the past. This opens up the possibility that the yield curve will invert at a policy rate that is not high enough to induce a recession. Brainard acknowledges that if the term premium remains low, the path of rates described in the Fed's Summary of Economic Projections (SEP) would likely invert the yield curve though "there would probably be less adverse signal from any given yield curve spread."

The implication for policy according to Brainard:

> It is important to emphasize that the flattening yield curve suggested by the SEP median is associated with a policy path calibrated to sustain full employment and inflation around target. So while I will keep a close watch on the yield curve as an important signal on how tight financial conditions are becoming, I consider it as just one among several important indicators. Yield curve movements will need to be interpreted within the broader context of financial conditions and the outlook and will be one of many considerations informing my assessment of appropriate policy.

The implications for investors are two-fold. First, the Fed may be very aggressive when boosting rates over the next year—not aggressive in the *pace* of rate hikes, but aggressive in the willingness to keep increasing them *despite* an inverted yield curve. Investors should therefore not discount the Fed's intentions to continue hiking rates, especially if the economic data remain strong. Second, the Fed is playing with a spark that might kindle the next recession sooner rather than later. Perhaps the yield curve is not the signal it once was, but history is not on the Fed's side in that regard.

It is important to note, however, that the flattening of the yield curve in and of itself does not necessarily indicate trouble ahead. A flat yield curve can coexist with an extended period of economic growth, such as during the late 1990s. It is inversion (a negative spread) or nothing when it comes to using the curve as a recession signal. More importantly, our analyses of the economic data do not currently foresee a U.S. economic recession in the near term. Despite the recent pause in business investment spending due to uncertainty regarding trade wars, U.S. GDP and corporate earnings continue to reach new highs, unemployment is at an 18-year low, wages are growing (albeit modestly), and consumer spending remains steady.

Although the business cycle has not been pronounced dead—so, by definition, the future is guaranteed to include another economic recession—many things have to start going wrong fairly quickly in order to bring about an economic downturn in the near term. Although the risk of a monetary policy error and/or geopolitical mistake should not be ignored, we believe that a much better bet is to expect that this economic expansion could be a record breaker.

Gobsmacked

Several events that could have financial market implications occurred in Europe during the Second Quarter of 2018: (1) an anti-Euro government was formed in Italy, (2) Germany's staunch defender of the Euro was politically weakened, and (3) the U.K.'s Brexit negotiators descended into internal political chaos.

Italy

Leaders of the radical *Five Star Movement* and the anti-Euro *Lega* party have taken power in Italy, forming the first "anti-system" government in a major Western European country since the Second World War. At a time when Italy is supposed to be *tightening* fiscal policy by 1% of GDP to comply with the "cyclically-adjusted" target under the EMU Fiscal Compact and Stability Pact, the unlikely allies vow a blizzard of contentious measures costing 6-7% of GDP, including: threatening to cancel VAT rises, overturning key market reforms, introducing a universal "basic income" for the poor, and launching a fiscal blitz in open defiance of EU spending rules. As stated, the broad thrust of the parties' fiscal policies appears to be incompatible with long-term Euro membership. These actions will stiffen German resistance to any form of EMU fiscal union or debt pooling. It effectively dooms French President Macron's plan for a Eurozone budget, leaving monetary union almost unworkable in the next global downturn.

Italy remains a paradox. The country accounts for 15% of Eurozone GDP and has 23% of the region's debt (more than €2 trillion). While public liabilities are high at 132% of GDP, private liabilities are low. The Bank of International Settlements (BIS) estimates that total (core) debt is 263% of GDP—compared to 290% in the Netherlands, 303% in France, 321% in Portugal, and 338% in Belgium. Italians have greater financial wealth per capita than the Germans (with €1 trillion in bank accounts and €3 trillion in liquid assets). The country has a current account *surplus* of 2.6% of GDP. It has a primary budget *surplus* of 1.7% of GDP, and a better fiscal record lately than France or Spain. Unfortunately, it has become trapped in a "bad equilibrium" with an overvalued intra-EMU exchange rate. The Eurozone's contractionary policies fatally destabilized Italy's debt dynamics. As a result, forced investment cuts and hysteresis from mass unemployment lowered Italy's economic speed limit, resulting in a "lost decade" that will negatively impact the country's future productivity: Italy's 2017 GDP remains nearly –20% below its peak and has not yet reached 2006 levels.

Unfortunately, Italy no longer has a lender of last resort standing behind its sovereign debt, and therefore has no backstop defense for its commercial banking system in the event of a significant economic downturn. The European Central Bank (ECB) is progressively removing its shield as Quantitative Easing is wound down and purchases of Italian bonds fall to zero. There will be no protection by the end of the year. ECB President Draghi's pledge to do "whatever it takes" no longer holds. No future rescue by the ECB is possible unless the Italian government formally invokes the bailout mechanisms (OMT-ESM) and accepts austerity imposed by Brussels, amounting to a "Troika" regime similar to that imposed on Greece during its bailout. In essence, Italy would come under foreign economic occupation. In our view, it is inconceivable that *Lega* nationalists and *Five Star* insurgents would ever accept such a package.

Germany

Germany's two biggest political parties—the conservative Christian Democratic Union (CDU) (together with its Bavarian sister party the Christian Social Union [CSU]) and the Social Democratic Party (SPD)—finalized an agreement in March 2018 to form a government six months after the September 2017 elections, representing an important victory for German Chancellor Angela Merkel, who is expected to serve her fourth and final term at the helm of another "grand coalition."

In June, however, this coalition was threatened because of challenges among the coalition partners regarding Germany's open-door migrant policy. Bavaria has been the point of entry for most of the refugees who arrived in the country in recent years. The CSU, which has ruled Bavaria almost without interruption since the end of World War II, faces a difficult State election in October 2018, with polls predicting the CSU will lose its absolute majority to the anti-immigrant/anti-Euro Alternative for Germany (AfD) party. In response, the CSU recently took a harder line on immigration. By openly challenging Merkel's authority on a key policy, the CSU tacitly signaled a willingness to sacrifice both its longstanding alliance with the CDU and the grand coalition itself for its own survival.

Despite recurring tensions and threats of divorce, the two conservative parties, collectively known as the "Union" in Germany, have collaborated without interruption throughout the post-war period. (In the Bundestag, they form a single parliamentary group.) Though the CSU is a regional party, its partnership with the CDU gives it influence over national politics that a party of its size would not normally enjoy: it accounted for less than one-fifth of the conservative bloc's total vote in last year's election; however, together, the parties won 33% of the electorate. More importantly, this coalition—and Chancellor Merkel, in particular—remain staunch defenders of the Euro project and the Eurozone.

Ultimately, a compromise was reached, and the grand coalition remains intact. However, Merkel and, indirectly, the Eurozone were weakened in the process.

U.K.

As you may recall, 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.

Although unwinding Britain from the old membership should have been relatively straightforward, it has become much more difficult than expected due to disagreements on a new trading relationship, establishing what tariffs and other barriers to entry are permitted, and on obligations such as free movement, among other issues.

Complicating matters has been Mrs. May's overly-conciliatory approach to the negotiations, whereby her particular version of Brexit has been rejected domestically—most recently by MP David Davis (Brexit Secretary) and MP Boris Johnson (Secretary of State for Foreign and Commonwealth Affairs), whose just-announced resignations from Parliament have called Mrs. May's authority and leadership into question—potentially triggering a vote of no confidence and a subsequent general election.

PM 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. As such, the Prime Minister overplayed her hand disastrously by trying to force support for a settlement that violates the electoral manifesto, the verdict of the referendum, and the minimum conditions of sovereign self-government. Specifically, May's proposals led directly to a worst-of-all-worlds Brexit whereby the U.K. is stuck permanently as a vassal state in the EU's legal and regulatory morass, still has to obey EU laws and European Court of Justice (ECJ) rulings across vast areas, cannot develop an effective international trade policy, and has lost its vote and treaty veto rights.

Her plan effectively binds Britain into EU law on the environment, social policy, employment, and consumer protection, and leaves British judges subordinate to rulings by the ECJ—all behind a cloak of formal sovereignty. May's "Facilitated Customs Arrangement" would make it all but impossible for the U.K. to carry out free trade deals with the U.S., Australia, Japan, and China, or to join the Trans-Pacific Trade Partnership. The U.K. would not be able to offer "mutual recognition" on goods and farm produce; it would therefore leave the U.K. trapped in perpetuity in the EU's legal orbit.

For more liberal, free-marketers, Brexit represents, most importantly, an opportunity to restore the law-making prerogatives of Parliament (not the ECJ), to forge a comprehensive free trade deal, 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).

As matters currently stand, the U.K.'s politicians and Brexit negotiators are in disarray.

Ministry of Truth

The U.S. equity markets have exhibited significant strength since 2009. To us, rather than an asset bubble, the greatest risk of an equity market correction continues to revolve around the numerous global macroeconomic and geopolitical risks that we have elucidated upon in our introduction and that we have discussed over the years since the onset of the 2008 Financial Crisis. Of these, the most imminent risk lies with the potential for an international trade conflict in an environment of global central bank monetary policy tightening.

However, despite these current challenges, 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 types 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:
American Economic Association
Bank for International Settlements
Bloomberg
Congressional Budget Office
Federal Reserve Banks of New York, San Francisco, and St. Louis
International Monetary Fund
Office of the U.S. Trade Representative
Organisation for Economic Co-Operation and Development
Reuters
State Administration of Foreign Exchange, China
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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