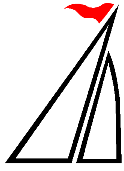
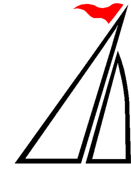


WINDWARD CAPITAL

Risk Averse Asset Management



2018 Fourth Quarter Review

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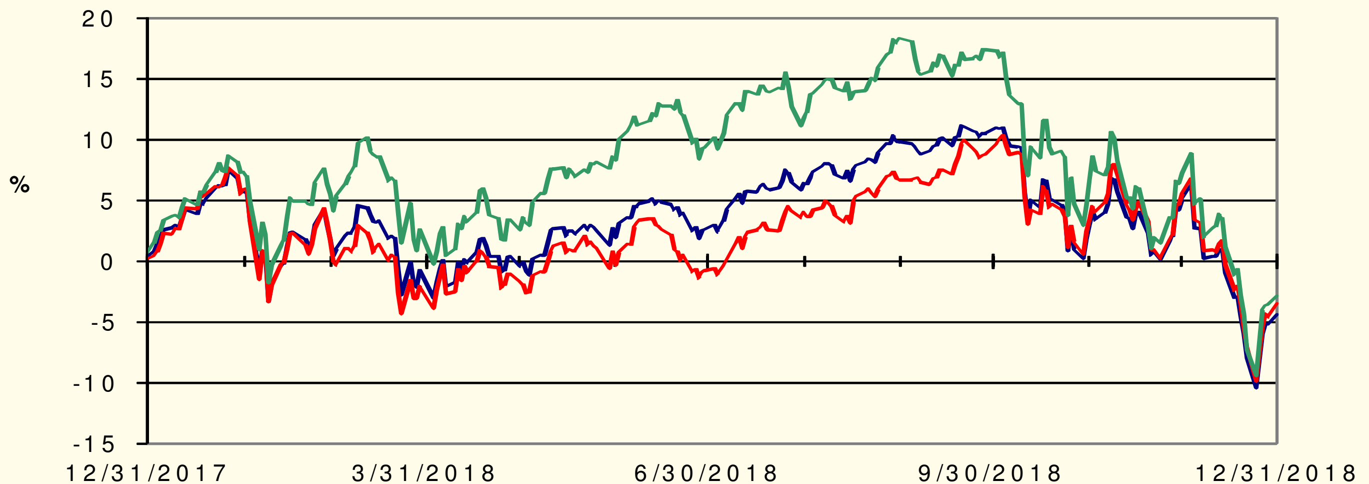

Make Volatility Great Again!

"The axis today is not liberal and conservative, the axis is constructive-destructive…"

—Steve Jobs (1955–2011)
quoted in *Steve Jobs* (2011) by Walter Isaacson

The major U.S. equity market indices declined during the Fourth Quarter of 2018, with the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) returning -13.52%, -11.31%, and -17.28%, respectively, for the period. During the Fourth Quarter, these equity market indices declined approximately -20% from their 2018 highs before rebounding somewhat into year-end. (The stock market's decline last month was the worst December since the depths of the Great Depression in 1931.) For 2018 Year-to-Date, the S&P 500, DJIA, and NASDAQ returned -4.39%, -3.48%, and -2.81%, respectively.

Despite the recent financial market volatility, the near-term corporate revenue and earnings outlook remains positive: for the Third Quarter of 2018, year-over-year S&P 500 Revenues and Earnings growth was +9.2% and +26.0%, respectively, with estimates of +6.1% and +11.4%, respectively, for the Fourth Quarter of 2018. For the Year, 2018 year-over-year S&P 500 Revenues and Earnings growth is estimated at +8.8% and +20.2%, respectively, with 2019 year-over-year growth rate projections of +5.3% and +7.9%, respectively. Additional factors providing underlying support to the markets include: consistent but moderate economic growth, optimism regarding the positive impact from

"tax reform," and liquidity effects. In light of the recent correction, we believe that the equity markets are currently "oversold" on a technical basis. In addition, we believe that the risk associated with further market declines 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 long-term 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 near-term investment environment will continue to exhibit greater uncertainty and increased volatility—a risk that may be poised to increase given the results of the November 2018 mid-term Congressional elections.

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?

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 effective 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 nearsighted 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.

Data Dependency

At its December 2018 meeting, U.S. Federal Reserve (Fed) officials acted as expected and raised the benchmark short-term Federal Funds lending rate by +25 basis points for the fourth time in 2018 to a range of 2.25-2.50%. However, in a shift from previous forecasts of a steeper path of three-to-four hikes in 2019 and 2020, a majority of Fed officials predicted at December's meeting that the central bank would raise rates no more than twice in 2019 and once in 2020

(given the estimates in their Summary of Economic Projections).

After growing at annualized rates of +2.2%, +4.2%, and +3.4% in the First, Second, and Third Quarters of 2018, respectively, U.S. Real Gross Domestic Product (GDP) appeared to be continuing to charge ahead at a growth rate of approximately +3% during the Fourth Quarter. In our view, there is nothing in the current underlying economic data that indicates an economic recession is imminent. The Fed's projections of annualized growth in U.S. Real GDP for 2019-2021 are +2.3%, +2.0%, and +1.8%, respectively, with a longer-run forecast of +1.9%.

The data drove the Fed's December interest rate decision: even with economic growth anticipated to slow, the pace of activity is expected to remain above the rate of potential growth, stoking inflationary pressures (in the Fed's view). In simple terms, the U.S. economy retains too much momentum heading into the New Year for the Fed to hold back from pushing closer to their estimate of neutral.

What makes the hike questionable was that it felt like purely a model-driven decision (much like the December 2015 hike: both occurred despite financial market turmoil, and both occurred in the context of low inflation). There was no pressing reason for a rate hike other than that the Fed insists on defining its policy on the basis of long-run forecasts and felt compelled to follow through with that approach.

That said, if the recent rate hike is an "error," it is a "recoverable error." We believe that the Fed may follow the 2016 script and pause for at least the first half of 2019 (if not longer). Now that the yield curve (a plot of interest rates as a function of maturity that is specifically focused on the difference between interest rates on short-term U.S. government bonds and long-term U.S. government bonds) has flattened further, continuing to aggressively raise short-term interest rates threatens to invite an outright yield curve inversion (an issue that we discussed in great detail in our *2018 Second Quarter Review*). Why tempt economic fate when it may be more prudent to wait for the lagged impact of rate hikes to make itself evident? The Fed can stop now, stand ready to ease if necessary, and still keep the economic expansion viable.

Indeed, after the stronger-than-expected December 2018 employment data were released in early January 2019, Fed Chairman Jerome Powell sought to allay financial market participants' interest rate concerns. Chairman Powell called 2018 "a good year for the United States economy" and said that economic data suggest "ongoing momentum heading into 2019." He welcomed the increased growth in wages reported in December's jobs report, and said that it "does not raise concerns about too-high inflation"—a signal to markets that the report is unlikely to accelerate plans for interest rate hikes. He said, "We're listening sensitively to the messages markets are sending," and that Fed officials would be "patient" as they watch economic developments play out this year, promising to adjust monetary policy quickly if global growth slows.

Equity markets have recently come under stress for a variety of reasons, including those that we have elucidated upon in the risk discussion noted in the introduction to this *Quarterly Review*. Additional near-term risks include: the expected fading of fiscal stimulus (including losing the impact on corporate profits from tax cuts after one year), expected slowing in global macroeconomic growth, tighter profit margins due to trade war tariffs and increased labor costs, external political factors (e.g., Brexit), the U.S. government shutdown, and general uncertainty about almost every aspect of U.S. policy—both domestic and foreign.

Of more intangible consequence, however, is President Trump's war with the Fed. In a previous *Quarterly Review*, we discussed the potential for how the Fed would react to a fiscal stimulus shock—namely, via a monetary policy offset. The Fed never fully embraced the story that tax cuts would induce a supply-side response (a story that looks increasingly at odds with the decline in 30-year bond yields back down below 3%)—something very clear in the Fed's forecasts. A monetary offset, therefore, was always on the table and destined to anger President Trump.

Trump's ire with Powell creates a precarious situation. President Trump has reportedly discussed firing Powell

as well as U.S. Treasury Secretary Steven Mnuchin, whom he blames for hiring Powell. Even aside from the obvious central bank independence issues, it is bad precedent for the President to fire his economic team at the first sign of financial market volatility. What would be the reaction of the President in the event of a recession or a real financial crisis? What would be the ability of the government to manage the economy in such an event? Unquestionably, this has now become an additional potential risk factor for market participants.

In our view, Trump's war on Powell is already damaging the Fed. Although the Fed will deny vociferously that politics plays any role in its monetary policymaking decisions, central bankers *are* humans, and it seems unlikely that they can truly make decisions that are not impacted in some way, even if just subconsciously, by politics. We will never know if Trump's actions prodded the Fed to reassert its independence by hiking rates in December, for example. And if the Fed is forced to *cut* rates in the months ahead, they will be accused of caving to Trump even if the data or a Trump-induced market correction drives the decision. Trump is, therefore, placing the Fed in a "no-win" situation: effectively making the Fed do his bidding by creating a crisis that forces a response. Exerting Fed independence in such a situation puts the economy at risk because the Fed cannot stand idly by while that occurs; ultimately, they will need to cushion any administration-induced uncertainty.

Slow. Down.

As you know, within the overall context of the country's long-term secular rebalancing from an industrial- to a consumer-driven economy, the cyclical ups and downs of China's economy have become a crucial shorter-term factor impacting the global macroeconomy—from determining commodity prices and influencing emerging market growth rates, to affecting global multinational corporations' product supply and demand structures. Although these fundamental tenets are acknowledged by those who understand global macroeconomics, it appears that they are not realized by the broader public or by many governmental policymakers in the West who still rely upon old "pre-China" notions of how the world works (e.g., the Trump administration's trade wars).

The Chinese economy started slowing in September 2018 and is a key reason why the Eurozone economy has hit a wall—with both Italy and Germany flirting with possible recession—and why U.S. companies that have significant sales in China may increasingly fall short of revenue expectations. Consumption tax revenue was up +16.3% year-to-date as of that month. In the following two months, it collapsed, recording declines of -62% and -71% from a year earlier. Value-added tax revenue has also turned negative in the past three months. This is a sign that the economy's slowdown is more rapid and pronounced than the government has acknowledged.

China has also recently entered a manufacturing recession, signaling further risk to global macroeconomic growth. The data suggest that China's industrial sector declined abruptly in November (although services are holding up much better). Chinese automotive sales fell -14% from a year ago. Air cargo contracted. Industrial profit growth dropped to -1.8%. The official Purchasing Managers' Index (PMI) survey for December 2018 slumped below the expansion/contraction reading of 50 to a current 49.4. New export orders slid to 46.6—a level last seen in the depths of the Chinese currency scare of 2015.

The strains are mounting in China's corporate sector. Defaults tripled to a record 119 in 2018—although the scale of defaults is still relatively small at $17 billion, and the willingness of regulators to let companies fail is arguably a good sign. (The reflex until 2014 was to put together some sort of rescue to shore up confidence, disregarding endemic moral hazard.) However, the Communist authorities are walking a fine line as they seek to deflate a credit bubble that has pushed the ratio of corporate debt to GDP from 95% to 160% in a decade. The managed slowdown is proving hard to stabilize. The task is made more difficult by a U.S. trade war—one that is mostly a nuisance so far but could turn more serious in 2019.

The People's Bank of China has cut the Reserve Requirement Ratio five times over the last year to shore up the banking system and improve liquidity. This stimulus will take some time to gain traction in the real economy, however; the measure of "real M1" money growth appears to currently register zero on a six-month basis. Beijing is also pushing through tax cuts and infrastructure spending after a policy shift at the Central Economic Work Conference held before Christmas. Local governments have been told to speed up bond issuance for projects. Yet, as we have discussed in the past, China cannot keep relying on fresh credit. The economic potency of new debt has collapsed by -75% since the boom years of the early 2000s with the balance of risk and reward turning more negative since then.

In previous *Quarterly Review*s, we have discussed, at length and in great detail, the ongoing, long-term secular challenges facing China as it rebalances from an industrial- to a consumer-driven economy. Beijing has done an admirable job of starting the long-promised deleveraging process. The recent economic slowdown reflects a sharp tightening of credit that began in November 2017, the month after President Xi Jinping's reappointment for a second term as leader. It took a six- to nine-month pass-through period for that squeeze to be felt.

2019 will be where the reality of economic pain meets calls for more credit. Beijing is trying to negotiate an end to the U.S.-China trade war as internal opposition to the conflict gains momentum. Although it is clear to us that Beijing holds greater leverage than Washington, the dispute has nevertheless sapped confidence within China and is pushing the government to consider painful market-opening concessions. The trade negotiations have probably delayed Beijing's response to the economic downturn, as officials wait to see what concessions they may have to make (the U.S. and other countries are pushing for verifiable changes to Chinese protectionism, overseas investment, and intellectual property enforcement, among other issues). With reports of a weak job market and falling asset prices, their indecision becomes more problematic.

Unfortunately, authorities have few tools at their disposal. The government wants to avoid being seen as flooding the market with credit to prop up growth as it did in 2009-2011 and 2016-2017. However, monetary easing also raises issues as yields are already near parity with those in the U.S., creating outflow pressures on the Chinese Yuan. In addition, there is evidence that potential tax and interest rate cuts will be less stimulative than in the past as more of the increased income is saved. Finally, Chinese banks are under enormous pressure. Bank of China Ltd. has announced plans to sell as much as 40 billion Yuan ($5.8 billion) of perpetual bonds; other banks are considering raising 100 billion Yuan each. (It was only in November that the central bank's financial stability report declared Chinese bank capital "abundant.") With new loans outpacing new deposits by 13% in 2018, how the government recapitalizes a strained banking sector will be a major theme in 2019. This issue is significant because authorities will struggle to carry out fiscal stimulus as long as banks are capital-constrained.

Every year the challenges for Beijing seem to increase, but, due to a variety of reasons that we have discussed with you in the past, the central authorities' policymaking responses only delay the inevitable reckoning rather than fully address the problem. Never underestimate China's ability to sustain growth, however. Despite temporarily setting back a deleveraging process that is essential to the Chinese economy's long-term health, additional stimulus would provide some short-term relief. As a result, it appears increasingly likely that expensive palliatives will, once again, be China's policy route of choice in 2019.

A Dog's Breakfast

As you will recall, a referendum was held on June 23, 2016, to decide whether the U.K. should leave or remain in the European Union (EU). "Leave" won by 51.9% to 48.1%. For the U.K. to leave the EU it had to invoke Article 50 of the Lisbon Treaty which gave the two sides two years to agree to the terms of the

split. U.K. Prime Minister Theresa May triggered this process on March 29, 2017, meaning the U.K. is scheduled to leave the EU on March 29, 2019. A European court has ruled that the U.K. can decide to stop the process. Alternatively it can be extended if all 28 EU members agree; but, at the moment, all sides are focusing on that date as being the key one, and Theresa May has put it into British law.

Assuming that Brexit occurs this March as scheduled, there will be a subsequent "transition period." This is a period of time from March 2019 to December 2020 (or possibly later), to get everything in place and allow businesses and others to prepare for the moment when the new post-Brexit rules between the U.K. and the EU begin. It also allows more time for the details of the new relationship to be fully agreed. This transition period is currently only due to happen if the U.K. and the EU agree to a Brexit deal.

Since the U.K. is legally scheduled to leave the EU on March 29, 2019, stopping Brexit would require a change in the law in the U.K.. The European Court of Justice (ECJ) ruled in December 2018 that the U.K. could cancel the Article 50 Brexit process without the permission of the other 27 EU members and remain a member of the EU on its existing terms, provided the decision followed a "democratic process." The EU might agree to extend Article 50 if its leaders thought there was a chance the U.K. could end up staying in, possibly through another referendum, but it would only be by a few months. The U.K.'s main opposition party, Labour, wants to force a general election and, after winning it, go back to Brussels to negotiate its own version of Brexit. That would also require Brexit day being pushed past March 29, something the EU might agree to, to give a new U.K. government the chance to make its case. If Labour cannot force a general election it has said it will push for another referendum, but it has yet to say what it thinks the question on the ballot should be.

In terms of the Brexit deal itself, it comes in two parts:

(1) A 585-page Withdrawal Agreement (WA). This is a legally-binding text that sets the terms of the U.K.'s divorce from the EU. Among a variety of details, it covers how much money the U.K. owes the EU—an estimated £39 billion—and what happens to U.K. citizens living elsewhere in the EU and EU citizens living in the U.K.. It also proposes a method of avoiding the return of a physical Northern Ireland border (the "backstop arrangement").

(2) A 26-page Statement on Future Relations. This is not legally binding and sketches out the kind of long-term relationship the U.K. and EU want to have in a range of areas, including trade, defense, and security.

The U.K. cabinet agreed on the WA text on November 14, 2018, but there were two resignations as a result, including Brexit Secretary Dominic Raab. Members of the U.K. Parliament (MPs) have been debating the deal, but the PM postponed a Commons vote scheduled for December 11 to seek "further assurances" from the EU for MPs about the post-Brexit plan for the Irish border. Downing Street says the vote will be rescheduled for January 21, 2019 at the latest, but we expect that a vote is more imminent.

Can Theresa May get her Brexit deal through the Commons? As things stand, it appears unlikely.

Theresa May has been operating without a Common majority since the 2017 general election, relying on the support of Northern Ireland's Democratic Unionist Party (DUP) MPs to back her in key votes. She has faced criticism from Brexiteer MPs in her party since she published her Brexit deal, culminating in them forcing a confidence vote in her as Conservative leader. Mrs. May recently won the vote by 200 to 117, which was enough to keep her as party leader, although the general view has been that she was weakened because it showed a third of the party did not back her. Tory MPs cannot challenge her for another year. However, Labour and other opposition parties could call a vote of no confidence in her as prime minister—this would be a vote of all MPs and to succeed would require the DUP MPs and some Tory MPs to abstain or vote to bring their own government down.

The deal itself offers something for everyone to hate. Brexiteers who promoted this debacle are angry because the deal means that Britain is indefinitely obliged to follow the rules of the European single market, yet will be unable to shape them. It might make it hard for the U.K. to pursue trade deals with anyone else. Trade flexibility, supposedly the great advantage of Brexit, now becomes a distant dream.

Anti-Brexit campaigners are furious because the deal leaves Britain weaker and less influential than before. The Northern Irish hate it because it implies that they still might end up in a separate trading arrangement from the rest of Britain. The Scottish hate it because they would like a guarantee similar to the one that the Northern Irish have obtained.

Labour and all the other opposition parties in the House of Commons have said they will vote against May's Brexit deal. Dozens of Conservative MPs—some reports say as many as 100—are also opposed to it. And Northern Ireland's DUP, whom Mrs. May relies on to keep her in power, have also said they will vote against it. Theresa May is hoping to persuade MPs that the deal not only delivers on the result of the EU referendum by allowing the U.K. to take back control of its "money, laws, and borders" but is also the best the U.K. can get from the EU and that there is no alternative on offer. She also argues that if her deal is voted down, Britain risks leaving without a deal—a prospect feared by many MPs, who think it will cause economic chaos. Alternatively, she says, there will be "no Brexit at all." However, Mrs. May postponed the scheduled December 11 vote, admitting the deal would have been rejected "by a significant margin" because of "widespread and deep concern" over the backstop arrangement.

What happens if PM May cannot get the deal through the Commons? Although it is difficult to know, there are a number of possible scenarios, including:

- ✓ Leaving the EU without a deal
- ✓ Having another vote in Parliament (Mrs. May would get three weeks after losing a vote to make a second attempt)
- ✓ Another EU referendum (this can only happen if the government brings forward legislation to hold a referendum and a majority in the Commons supports it)
- ✓ A general election (Labour's preferred option but it would need a no-confidence vote in the PM)
- ✓ Theresa May is removed by her own MPs and a new leader tries to renegotiate a deal with the EU (Tory MPs say they are close to having enough signatures to trigger a confidence vote in her)

(Some of these options would involve delaying the official Brexit date of March 29 by a few months to allow time to renegotiate a deal—if the EU agrees.)

In thinking about the political disarray associated with the Brexit situation, it is important to recall some of its fundamental premises: The U.K. is legally and morally entitled to withdraw from a European project that keeps evolving in a direction where British voters do not wish to go. The EU and its States are equally obliged by membership in the United Nations, the World Trade Organization, the Vienna Convention, and a nexus of accords, to respect that decision in good faith and a spirit of cooperation. There is nothing dishonorable in seeking the restoration of sovereign self-government. Nor is it unreasonable to reject a system with a long-decried "democratic deficit" like the EU (the EU establishes an upper level government that is not elected and cannot be removed by voters, even when it persists in error).

Unfortunately, based upon our analysis, Theresa May's Brexit plan, in our opinion, does not support these fundamental premises. The U.K. goes from being legally sovereign as an EU member, entitled to exit unilaterally under Article 50, to non-sovereign status as a legally-captured adjunct to the EU. Brussels has a veto on whether Britain can leave the Irish backstop and therefore whether the U.K. can leave the "customs territory." Level playing field clauses lock the U.K. into EU law on labor, the environment, taxation, competition, and State aid, with varying levels of "dynamic alignment" on future law. The European Court of Justice will have the final say on disputes.

In essence, the objective of the U.K.'s 2016 EU referendum remains unfulfilled. As such, this cannot result in a stable equilibrium or the basis for a sound agreement/accord with Europe. Rather, this "unequal treaty" will compound the grievances that led to Brexit in the first place. It is a recipe for another decade of ruinous cross-Channel relations.

How the fractious politics of Brexit eventually are resolved remains to be seen.

Bear Trap

Despite an apparent recent increase in geopolitical and global macroeconomic uncertainty (including issues like Brexit), monetary policymakers still retain significant influence over the course of the financial markets. In that regard, it is notable that the Fed has called off the hounds, and China has abandoned efforts to purge financial excess, reverting to stimulus on multiple fronts. In our view, these policy pirouettes by the world's twin superpowers mark a critical moment in the tightening cycle, with potentially sweeping implications for global asset markets and for the health of the international economy over the next year.

The "Powell shift" at the Fed—assuming it is more than just a rhetorical exercise—is the more potent of the two. It has echoes of the Fed retreat in early 2016 when China's currency scare threatened to spin out of control. On that occasion the Janet Yellen Fed came to the rescue and shelved plans for higher interest rates, launching a +25% surge in an index of world equities over the following twelve months. A turbo-charged variant of this happened in late 1998 following the East Asia crisis and Russia's default: the Alan Greenspan Fed rushed through emergency rate cuts, igniting the final leg of the explosive dotcom boom.

It is too early to judge whether this is a comparable turning point, but there is no doubt that current Fed Chairman Jerome Powell went out of his way to soothe markets recently, pointedly invoking the 2016 episode. To us, the message could hardly have been clearer: he vowed to shift gears "quickly" if need be. The Fed "wouldn't hesitate" to suspend Quantitative Tightening if circumstances deteriorate. (This was a far cry from his comment before Christmas that the Fed's preset plan to shrink the balance sheet by $50 billion per month was on "autopilot.")

In a supporting chorus, the Chinese have cut the Reserve Requirement Ratio for banks a fifth time in a year. Local governments have been ordered to pull forward new bond issuance. Beijing's Central Economic Work Conference has committed to stimulus, temporarily suspending deleveraging.

It is the Fed that matters the most, however. For the last year it has been draining Dollar liquidity mercilessly, both by shrinking its balance sheet and by raising rates. The Broad Dollar Index has soared to an 18-year high. The squeeze has been slow torture for a world financial system that has never been more Dollarized or more sensitive to U.S. borrowing costs, especially in those emerging markets that were flooded with cheap Dollar debt during the Quantitative Easing/ZIRP years. The extra twist this time is that the Fed has had to cope with the Trump administration's late-economic cycle fiscal stimulus and the associated risks of overheating.

The central question now facing financial markets is whether the Fed is merely tweaking its message or is preparing to halt the tightening cycle altogether, a move that would send the U.S. Dollar tumbling and act as a powerful global stimulus. If that happens, the "tourniquet effect" of the last year will go into reverse and emerging markets can breathe again. The great Dollar rally would be over. If so, a U.S.-China trade deal agreement, if reached, would be the perfect catalyst to set off a roaring equity market rally.

Although this is not a prediction, it is a possible scenario worth considering. Let the bearish beware.

Pay Less, Get More

Despite the recent correction, the U.S. equity markets have exhibited significant strength since 2009. To us, the greatest risk of further equity market declines 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. In addition, recent dovish comments by the Fed, additional Chinese economic stimulus, as well as the potential for a U.S.-China trade resolution, could spark significant buying interest. 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 in-

cremental 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
FactSet
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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