WINDWARD CAPITAL

Risk Averse Asset Management

2019 Third Quarter Review

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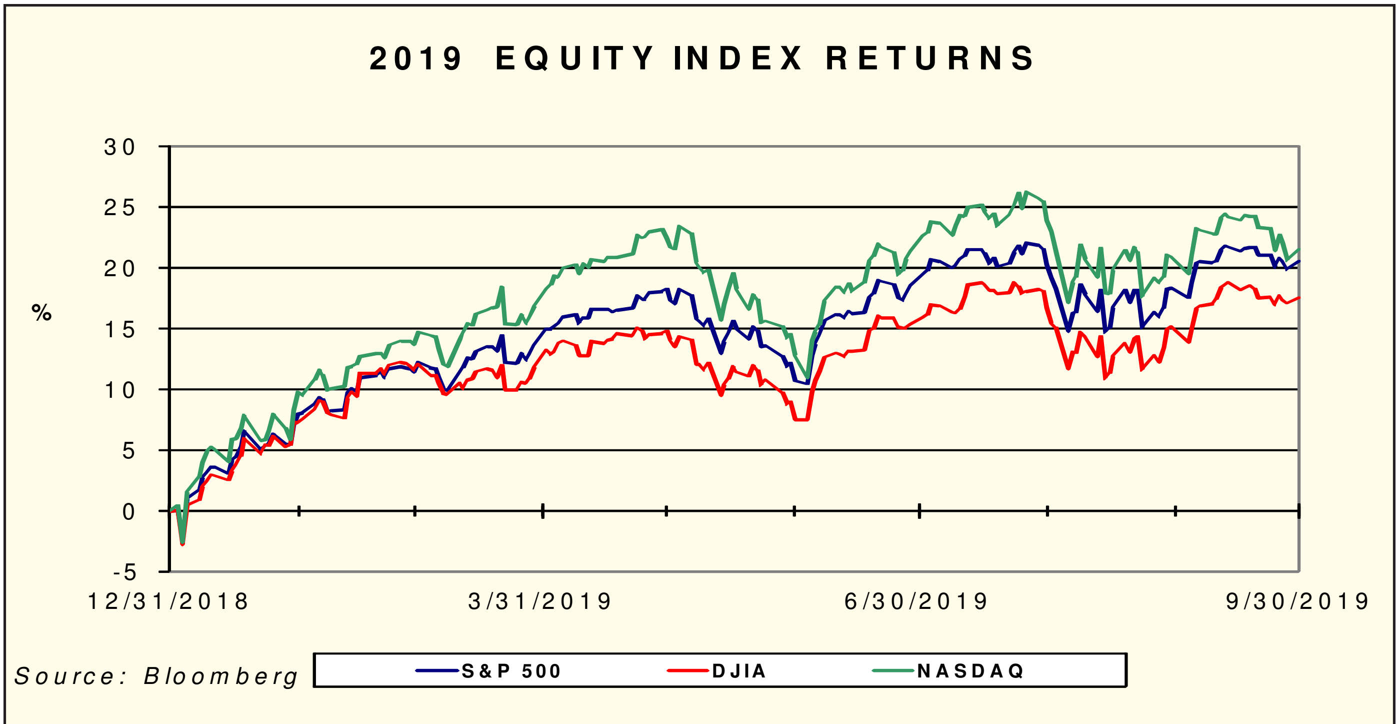

Nuts and Chews

"Is it just me, or is it getting crazier out there?"

—*Joaquin Phoenix* as *Arthur Fleck*
(aka "*the Joker*")
Joker (2019)

The major U.S. equity market indices increased during the Third Quarter of 2019, with the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) returning +1.70%, +1.83%, and +0.18%, respectively, for the period. For 2019 Year-to-Date, the S&P 500, DJIA, and NASDAQ have returned +20.55%, +17.51%, and +21.56%, respectively.

Factors providing underlying support to the U.S. financial markets include: moderate domestic economic growth, positive (albeit waning) impacts from the *Tax Cuts and Jobs Act* of 2017, liquidity effects, and momentum. In addition, although slowing, the near-term corporate revenue and earnings outlook remains positive: for the Year, 2018 year-over-year S&P 500 Revenues and Earnings growth was +8.8% and +20.0%, respectively, with 2019 year-over-year growth rate projections of +4.1% and +1.3%, respectively. As we have noted in the past, however, some of these factors necessarily raise concerns regarding market valuation—especially in the face of a global economic slowdown and/or possible U.S. recession. As a result, we believe that the equity markets may be "overbought" on a technical basis in the short term, and that a near-term correction and/or re-test of previous lows remain a possibility.

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. From an economic perspective, this administration 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—either positive or negative—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 as the 2020 Presidential election approaches.

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.

We believe that the risk associated with financial market volatility 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 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 actions 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 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.

The Low Down

As we mentioned in our *2018 Fourth Quarter Review*, despite an apparent recent increase in geopolitical and global macroeconomic uncertainty, monetary policymakers still retain a significant degree of influence over the course of the financial markets. In that regard, it is notable that the U.S. Federal Reserve (Fed) has recently reversed course on tightening. In our view, this policy shift marks a critical moment in the interest rate cycle, with potentially positive implications for global asset markets and for the health of the international economy over the next year.

Confirming our previous predictions, the Fed lowered its short-term interest rate target by 50 basis points over the course of two meetings during the Third Quarter (on July 31 and on September 18) from a previous range of 2.25% to 2.5% to a current range of 1.75% to 2.0%. As U.S. economic growth continues to moderate, we believe that the odds favor the Fed cutting interest rates further. Indeed, certain recent U.S. economic data are not showing enough strength to justify holding short-term interest rates at their current level—especially relative to an interest rate environment where almost $17 trillion of global debt carries *negative* yields.

The Institute for Supply Management (ISM) reported that U.S. manufacturing activity *contracted* in September and fell to a 10-year low, indicating that factories are under substantial pressure from weakening global macroeconomic growth. (Notably, the component of the index measuring new export orders has fallen to levels previously associated with recessions.) In addition to the challenge of slowing global growth, companies are also struggling to cope with the impact of the trade war, a conflict with negative economic ramifications that we have discussed in detail in the past and whose final outcome remains indeterminate.

Manufacturing, of course, is a small part of the U.S. economy relative to services. However, recent data indicate that the service sector—although continuing to expand—is also growing at a slower rate. The ISM's non-manufacturing index dropped 3.8 points to 52.6 in September, the lowest since August 2016 and well below the most pessimistic consensus forecast. Growth in orders and business activity slowed abruptly, while the employment gauge registered its weakest reading in more than five years. New orders fell to a three-year low of 53.7 from 60.3—still in expansion territory, but closing in on the 50 demarcation point that is the dividing line between expansion and contraction.

The September employment report further substantiated concern that U.S. economic momentum slowed as the Third Quarter came to a close. While job growth remains solid at a monthly pace of 157,000 over the past three months, it has decelerated from a three-month pace of 245,000 at the beginning of the year. The Fed would likely be pleased with such a number absent the downside risks to the global macroeconomic outlook. Those risks, however, suggest that there is a possibility that job growth could decelerate further in the months ahead.

Encouragingly, the recent September employment report showed that the U.S. unemployment rate has dropped to a 50-year low of 3.5%, indicating that the labor market is still relatively strong and is adding more than enough jobs each month to absorb new entrants to the labor force. As a result, the more hawkish members of the Federal Open Market Committee (FOMC) may worry that there is a risk of overheating the economy if the Fed lowers rates further. But we believe that it is hard to justify that argument when wage gains remain modest, with average hourly earnings rising only +2.9% in September from a year earlier—the smallest increase since July 2018. In addition, inflation still remains below the Fed's 2% target, underscoring the challenge of future economic growth in an environment where there exists a global dearth of demand and surfeit of supply, with concomitant deflationary risks.

In fact, the drop in the unemployment rate gives increased weight to the very low estimates of the natural rate of unemployment and the neutral rate of interest (R*) that we have discussed with you extensively in the past, indicating that the Fed can maintain lower interest rates at lower-than-historical levels of unemployment without triggering inflationary pressures. Fed Vice Chairman Richard Clarida recently said that he believes estimates of *sustainable* unemployment below 4% are plausible. In such a world, a 3.5% unemployment rate does not preclude additional interest rate cuts given fading economic momentum. Moreover, the unemployment rate is a lagging indicator; the fact that it is falling does not necessarily imply that economic growth will re-accelerate and push inflation higher.

The U.S. economy continues to grow, and, although moderating, we do not foresee an economic recession in the near term. After growing at annualized rates of +2.5%, +3.5%, +2.9%, and +1.1% in the First, Second, Third, and Fourth Quarters of 2018, respectively, U.S. Real Gross Domestic Product (GDP) grew at a strong +3.1% annualized rate during the First Quarter of 2019 before moderating to a +2.0% annualized rate during the Second Quarter of 2019, in line with our previous expectations. Most importantly, consumer spending, the primary driver of the U.S. economy, remains strong, growing at an annualized rate of +4.6% during the Second Quarter and matching the growth rate of the Fourth Quarter of 2017, which was the strongest growth since the Fourth Quarter of 2014.

We continue to believe that the U.S. economy is both stronger and more resilient than the consensus expects. So far, none of the downside risks of recent years have been sufficient to derail the recovery from the 2008 Financial Crisis. These risks are mostly external, while the primary engine of U.S. growth is internal and flexible. As long as there is some amount of demographic growth, capital depreciation, technological evolution, and a change in tastes and preferences, there will be a powerful underlying (and under-appreciated) impetus for growth that is almost certain to reveal itself in any reasonably well-managed economy. This ultimately is the reason that, despite the seemingly persistent belief that the recessionary bogeyman is just around the corner, economic recessions are remarkably rare events.

Although it may seem odd that the Fed would cut rates when the economy is, as Fed Chairman Jerome Powell and others describe it, "in a good place," the core voting members on the FOMC seem predisposed to reduce rates until they are confident that they have offset the negative forces weighing on the economy. Although 50 basis points of rate reductions that have already been implemented this year could be enough to sustain the U.S. economic expansion, the proximity to the zero lower bound, persistently low inflation, and a desire to continue reaping the benefits of low unemployment should cause the Fed to err on the side of additional rate cuts—dependent upon incoming economic data, of course.

The degree to which monetary policy easing can counteract global economic headwinds at this stage of the business cycle, however, remains to be seen, as the cost of money and access to capital are not the primary constraints to economic growth, in our opinion.

Growing Pains

As we discussed in great detail in our *2019 Second Quarter Review*, in general, an economy's "speed limit" (that is, how fast it can grow without triggering rising price pressures [i.e., inflation]) is primarily determined by growth in the labor force (via demographics, skill levels, immigration, etc.) and productivity improvement. Absent any exogenous events, it appears that the future estimated pace of U.S. GDP growth will remain between +1.5% and +2%, noticeably slower than the typical pace since World War II. The slowdown stems mainly from demographic trends that have retarded labor force growth, as well as a decline in productivity growth.

This continues to be the longest U.S. economic expansion since 1850: job growth has been persistently strong, inflation remains subdued, the economy is effectively operating at full employment, and Real GDP is now more than +20% higher than its pre-recession peak. Despite the recent slowdown in business investment spending due to uncertainty regarding the global macroeconomic environment, U.S. GDP and corporate earnings continue to reach new highs, unemployment is at a 50-year low, wages are growing (albeit modestly), and consumer spending remains steady.

Although the business cycle is not 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 continue to be a record breaker. Consequently, the anticipated economic slowdown in the months ahead will make for some interesting analysis as it will be easy for pundits to see a recession in every soft indicator. Although we expect to see an increase in soft data as the economy slows, it is important to remember that, historically, "growth" remains the norm, "recession" is the rarity, and "deep recessions"—like that experienced coincident with the 2008 Financial Crisis—are generational in nature.

Based upon our analysis of the current economic data, we believe that a period of sluggish growth looks more likely for the U.S. than an outright recession. It might be painful in industries directly affected by the trade wars and the global manufacturing slowdown; however, those sectors are a relatively small share of the economy. In effect, the shift of the U.S. economy toward service industries over the last two generations may have left it better able to endure a global trade and manufacturing slowdown, particularly compared with export-reliant countries like China and Germany. Even as the risk of recession has clearly increased, there are also sources of resilience that have every chance of proving powerful enough to keep the decade-long expansion intact.

In a benign scenario, strong consumer spending—driven by ongoing employment gains—continues to power the economy forward, the economic damage from the trade wars remains mostly confined to the manufacturing and agriculture sectors, and the Fed's shift toward easier monetary policy since the start of 2019 kicks in with its usual delayed effects.

Consumer spending represents approximately 70% of the U.S. economy. American consumers have been the drivers of the expansion this year, increasing their spending even as businesses display more caution. Because consumer spending accounts for a much larger share of the economy than business investment, this has propelled overall growth. If business investment does drop severely, it could translate into layoffs and a weaker labor market and, therefore, weaker consumer spending. But, historically, there have been periods in which business investment shrank but consumer spending kept growing.

For example, from mid-2015 to mid-2016, there was a huge pullback in business investment, caused by falling commodity prices and a slowing global economy. Yet Personal Consumption Expenditures (PCE) rose +2.7% in that 12-month period, keeping the American economy out of recession. Similarly, consumer spending kept rising despite a steep pullback in business spending after the "dot-com" crash in 2000 and 2001. That helped make the 2001 recession mild by historical standards—and it probably would not have been classified as a recession at all if the September 11, 2001, terrorist attacks had not taken place.

Consequently, there is historical precedence for optimism that American consumers will maintain their resilience even amidst business pessimism. However, we believe that will remain true only if the trade wars do not escalate further.

Enter the Dragon

The U.S. trade war with China reached a new phase on August 5 after the U.S. labeled China a "currency manipulator." That followed a surprise move by the Chinese government to let the Yuan break through the longstanding 7-to-1 exchange rate for the first time in 11 years. Tensions eased slightly when China's central bank fixed the exchange rate a bit higher than the lowest point the Yuan hit, but global financial markets remained volatile in the aftermath of these moves, with U.S. equity markets and government bond yields recording their biggest one-day drops of the year.

Recent events in the trade dispute have been fast-moving. On August 1, President Trump announced new tariffs on China—10% on an additional $300 billion in goods—saying that China had not bought large amounts of U.S. farm products as promised. Four days later, China devalued the Yuan, and the U.S. currency manipulation charge followed. Then on August 6, China said it may increase tariffs on U.S. farm products. As a result, there are concerns that the U.S.-China trade dispute may metastasize into a full-on currency war.

The logic is straightforward: China's economy depends significantly on its exported goods. By devaluing its currency, the Asian giant lowered the price of its exports and gained a competitive advantage in the international markets. A weaker currency also made China's imports costlier, thus spurring the production of substitute products at home to aid domestic producers. A weaker Chinese currency cushions the blow of American tariffs on Chinese exports. But greater Chinese exports to the U.S. increases America's trade deficit with China, creating incentives for the Trump administration to retaliate with a tit-for-tat weakening of the U.S. Dollar.

President Trump is right to worry about a weaker Yuan. Even though it shields American consumers from higher prices, it makes American goods more expensive in China, hurting U.S. exporters. For China, a weak Yuan can be a strong weapon. Trump might have been happier if China, rather than letting its currency fall, had simply cut prices, thereby destroying profitability. But that was obviously never a realistic scenario.

Given how badly trade talks with the U.S. have gone, the Chinese have little to lose by letting the Yuan slide. It is reasonable to assume that China's decision makers place a low probability on the chances of a win-win trade deal with the U.S. With no signs of any significant momentum in the talks, the world's two largest economies could be braced for an open-ended trade dispute. That means the political cost of a weaker Yuan is reduced. The tightrope that Chinese President Xi Jinping walks, however, is that allowing too little depreciation would hurt China's competitiveness, while market expectations of a too-big depreciation could trigger an all-out currency crisis, with Chinese and foreign investors desperately evading controls to get money out of the country before it lost even more value. (China had to spend almost $1 trillion buying Yuan to defend it against a serious bout of capital flight in 2015.) As a result, the Chinese government cannot afford the risk of a Yuan in free fall.

Despite all of the charges by America over the years that China is a currency manipulator, the fact is that, for more than a decade after 2005, the Chinese currency actually *appreciated* considerably against the U.S. Dollar. This no doubt reduced China's exports to America, but to China it was worth the price for stability. The specter of mass capital flight has been an existential fear of the Chinese government since the Asian financial crisis of the late 1990s. China then saw the devastating effects of capital flight due to those countries' currency devaluations and vowed that it would never happen in China. With the recent slowdown of the Chinese economy causing concern to holders of the Yuan, the last thing that China's government wants is to turn currency market nervousness into a full-on rush for the exits.

Almost two years into the trade war, China is flexing its muscles to show that it can respond to U.S. tariff pressure with additional forms of retaliation—like a currency devaluation. If Trump imposes increased tariffs, Beijing just needs to open the lid on its capital controls a little wider (the Yuan has a natural tendency to weaken). Although, as we have discussed in the past, China's state-driven economic model has many problems, it also has competitive and strategic strengths—chief of which is policy coordination. Unlike the U.S., Beijing's bureaucrats and state-owned enterprises can piece together fiscal, monetary, industrial, and foreign-policy measures into a focused and coordinated action.

As we have stated in the past, we believe that the current trade dispute is, instead, a strategic contest for geopolitical hegemony. Although financial market participants do not appear to currently appreciate this important distinction—perhaps because the economic impact so far has not been that large (and the earnings and revenue effects even less)—we believe that this strategic conflict could have significant long-term ramifications for both the global macroeconomy and the financial markets.

"That Way Madness Lies"

The economic stakes are rising very fast for the European Union (EU) as the U.K.'s Brexit "D-Day" nears on October 31.

European leaders must judge the risks of a showdown with Britain against a deepening global trade slump and an industrial recession that threatens to spread and overrun the monetary defenses of the European Central Bank (ECB).

The recent escalation of the U.S.-China trade war has changed the calculus, threatening to engulf the Eurozone economy through multiple channels of contagion. If China's exports to the U.S. decline, its shipments are displaced into Europe and the rest of the world—and on a scale large enough to significantly impact the international trade system. When China devalues the Yuan to defend itself against the Trump administration's tariffs, it devalues against everyone and in the process transmits a powerful deflationary impulse around the world.

Europe is the primary recipient of the collateral damage from these actions. It has a vulnerable economic model that is highly geared to the global trade cycle and dependent upon world consumption to make up for its structural inability to generate internal demand.

On September 12, in order to address the current economic weakness and make another attempt at reflating the Eurozone economy, ECB President Mario Draghi overcame critics of his stimulus policies and directed the ECB to implement a fresh monetary stimulus package, reducing interest rates further below zero percent and reviving bond purchases.

Specifically, the ECB reduced the deposit rate to -0.5% from -0.4%, and said that it would buy debt from November 1 at a pace of €20 billion per month for as long as is necessary to hit its inflation goal. The ECB also eased the terms of its long-term loans to banks, and lenders will get an exemption from negative rates for some of their deposits after an outcry from the industry about the resultant squeeze on profitability. The ECB changed its guidance on interest rates to say that they will stay at present or lower levels until the outlook for inflation "robustly" converges to its goal of just below 2%. (It previously expected borrowing costs to stay unchanged until mid-2020.) It also scrapped a 10-basis point rate premium previously attached to its long-term loan program.

The ECB's announcement of a new stimulus package is a remarkable turn of events, just nine months after it signaled it was done with ever-looser policy. Currently, inflation is running at barely half of its goal, and the manufacturing sector is in a contraction. Hours before the decision, industrial production figures showed that the Third Quarter was off to a weak start: year-over-year, output declined -2.0% and -1.2% in July for the Eurozone and the EU, respectively. The corresponding decline in Germany was -5.3%, and the country is on the verge of a recession as a global slowdown in trade caused by the U.S.-China standoff and the uncertainties surrounding Brexit hurts its exporters: Germany's exports equate to nearly 50% of its GDP, compared to 12% for the U.S. and 20% for China.

Monetary policy would normally be a significant tool for fighting this weakness, but it has lost its efficacy in a world constrained by interest rates near the zero lower bound. The ECB's latest stimulus package may, perversely, have the opposite effect of its intended purpose. Funding markets have tightened and inflation expectations have fallen further. The household savings rate in the Eurozone jumped from 12.3% last year to 13.3% in the Second Quarter, a nine-year high. (It has reached 18.1% in Germany.) Negative interest rates are causing savers to put aside *more* money, and the policy is leading to a *contraction* in demand.

Although more QE might fend off a cascade of debt defaults, it cannot lift the real economy by incentivizing demand. The only meaningful channel of stimulus is through either a weaker exchange rate (which will not be tolerated by the Trump administration) or via fiscal stimulus. This puts the Eurozone in a difficult position. The *EU Stability and Growth Pact* and the *European Fiscal Compact* are apparatuses of fiscal contraction written into EU treaty structures that, by definition, render it chronically incapable of generating internal domestic demand. This arrangement was originally established at German insistence as an alternative to a Eurozone fiscal union. Unfortunately, it renders fiscal policy almost unworkable in pre-crisis conditions because only Germany and other low-debt "fiscally-responsible" countries are allowed to undertake such measures—and Berlin is currently showing little willingness to oblige. As a result, we do not anticipate that a significant fiscal package will be implemented any time soon.

Compounding this economic uncertainty, the political chaos related to the U.K.'s withdrawal from the EU continues unabated. With a critical summit in Brussels aimed at renegotiating a Brexit deal scheduled to begin on October 17, British and EU officials have recently clashed over the terms of the divorce and look to shift the responsibility for any eventual breakdown in negotiation onto the other side. British Prime Minister Boris Johnson—appointed in July after the resignation of Theresa May—has repeatedly pledged, "do or die," to leave the EU on October 31—"deal" or "no-deal"—but Parliament has passed a law stipulating that the U.K. must request a three-month extension to talks if a deal is not secured. All of this as the U.K. gears up for a general election challenge to Johnson's leadership likely to be held later this year.

Ever since the 2008 Financial Crisis, the EU authorities in Brussels have been slow to grasp the magnitude and long-term ramifications of the global economic downturn. As we have stated numerous times in the past, monetary union (like the Euro) without political and fiscal union is dysfunctional and pernicious. Unfortunately, Germany has yet to agree to a joint EU treasury, or joint taxes, or debt pooling, or a full banking union with shared deposit insurance. Nor can it do so without changing the German Constitution because fiscal union eviscerates the budgetary powers of the Bundestag and empties German democracy of meaning.

As a result, the Eurozone has reached an impasse. Monetary policy is exhausted and fiscal stimulus is constrained by a tangle of rules and laws. Now the currency bloc faces a barrage of potential recessionary shocks from Brexit and China. EU leaders must decide soon whether to engage seriously with PM Johnson on his Brexit plan or whether to gamble on the Benn Act (an Article 50 extension). If they get it wrong and instead precipitate a "no-deal," the economic chain reaction could have negative ramifications for them as well as for Britain.

It remains unclear how this situation will be resolved.

Get Woke!

Despite ongoing uncertainty (and resultant volatility), the U.S. equity markets have exhibited significant strength since 2009. To us, the greatest risk of future 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.

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 an interim 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 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:
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Bloomberg
Eurostat
FactSet
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International Monetary Fund
Office of the U.S. Trade Representative
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Reuters
State Administration of Foreign Exchange, China
The World Bank
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.

NOTES

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