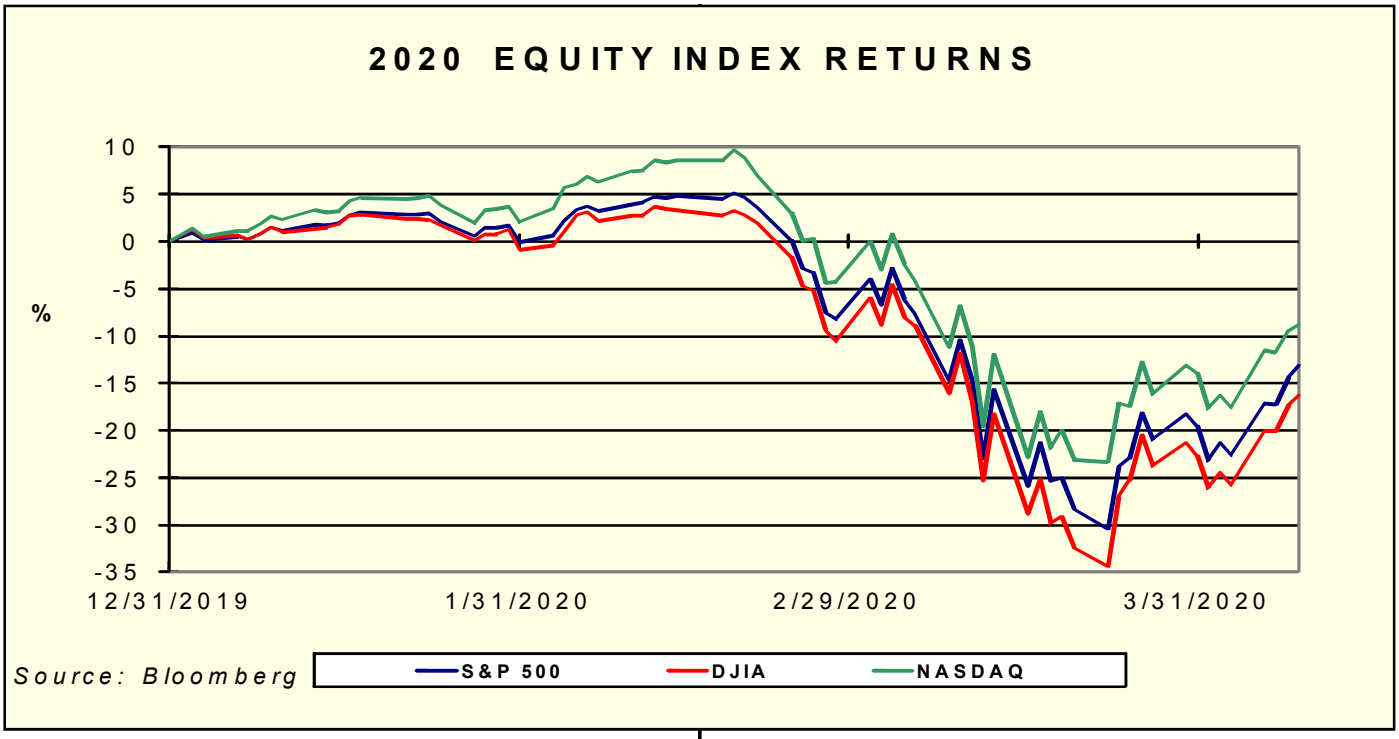
WINDWARD CAPITAL

Risk Averse Asset Management

2020 First Quarter Review

Volume 25, Issue 1 April 15, 2020



Unseen Enemy

"Bad companies are destroyed by crisis, good companies survive them, great companies are improved by them."

—Andy Grove (1936 - 2016)
Semiconductor Industry pioneer and former CEO of Intel

The major U.S. equity market indices experienced a significant correction during the First Quarter of 2020 as a result of the coronavirus pandemic and its concomitant disruption to the global macroeconomy. The Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) declined –19.60%, –22.73%, and –13.91%, respectively, for the period. After reaching historic highs during the Quarter, the indices then declined approximately –30-36% to the March 23 lows before subsequently rebounding +19-28% into mid-April (depending upon the particular index). The recent stock market downturn and its associated volatility have been exacerbated by the same "bad actors" that we have discussed with you in the past: asset allocators, high-frequency trading, quantitative/algorithmic "investment" strategies, and the pervasive use of ETFs.

The economic effect of the coronavirus pandemic is different from that of previous financial crises: this is, at its essence, a health crisis, not a credit crisis. The current economic downturn is not due to an endogenous event: this is an exogenous shock that has resulted in a conscious effort on the part of U.S. State and local governmental authorities to artificially freeze parts of the economy as a medical intervention in order to slow down the spread of the coronavirus. That

strategy should be viewed positively because responsive and appropriate monetary and fiscal policies can mitigate the negative economic side effects of this "treatment" until health authorities are successful in their coronavirus mitigation efforts.

Consequently, the coordinated monetary and fiscal policy goal is not to "stimulate" the economy (i.e., we *want* people to stay at home and not go outside and consume), but to help individuals and companies get through this self-imposed medical freeze with as little suffering as possible in order to avoid long-term/secular damage from this short-term treatment. As a result, when the economy is eventually restarted, it should then be in a better position to function more smoothly than if it had to be rebuilt from a lower base.

Although the depth and duration of the pandemic's impact on the world economy remains unknowable and may differ on a country-by-country basis, we remain confident that global health authorities will eventually succeed in controlling the spread of the coronavirus, and that the monetary and fiscal policy measures currently being implemented will mitigate a significant amount of the economic impact. Certainly, the tragic loss of life will continue for some time, and businesses—from small to large—will be disrupted to varying degrees over both the short and the long term: corporate bankruptcies, restructurings, and consolidation appear inevitable for some.

We believe, however, that the risk associated with the resultant financial market volatility is mitigated in *Windward* portfolios—especially over the long run—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 a result, we believe that, on the whole, the businesses in our portfolios will survive this crisis and ultimately prosper. Consequently, we have not raised cash or made any changes to the investments held in *Windward*'s portfolio strategies.

Despite current poor—and entirely expected—underlying economic data, it should be remembered that financial markets are "discounting mechanisms" and, as such, will eventually look ahead toward an economic recovery—the shape of which remains indeterminate at this time.

Relieving the disruptions in the credit markets and restoring the flow of credit to households and businesses are essential to the resumption of sustainable economic growth. In addition, it is important for the government to help fill the gap created by the drop in consumer spending and temporary business shutdowns. Finally, and most importantly, the health impacts of the coronavirus must be mitigated.

These policies—monetary, fiscal, and health—represent the three legs of a stool that is necessary for supporting the U.S. economy's return to prosperity reasonably quickly.

Whatever It Takes

(For details regarding the U.S. Federal Reserve's monetary policy actions related to the coronavirus pandemic, please see the Addendum to this *Quarterly Review*.)

The U.S. Federal Reserve (Fed) has taken unprecedented steps in recent weeks to cushion the U.S. economy from the effects of the expanding coronavirus pandemic. It has announced one liquidity program after another as central bankers around the world work to remove roadblocks interfering with the flow of credit to their economies. In addition to an alphabet soup of lending facilities, the Fed has revised regulatory guidance, encouraged the use of discount window lending to banks, and activated currency swap lines with global central banks to counter a global shortage of U.S. Dollars.

As a result of all of these actions, we estimate that the central bank's balance sheet could grow to more than $10 trillion in the coming year (from $4.2 trillion at the start of 2020) and may potentially exceed 50% of nominal U.S. Gross Domestic Product (GDP). Despite the scale and scope of these current actions, the Fed is

clearly not out of ammunition, nor is it done exhausting its potential liquidity commitments based upon the Congressional backstop provisions within the CARES Act (see attached Addendum).

It is unlikely that the Fed is going to stop with these kinds of actions until policymakers are confident that the flow of credit to the economy remains unimpeded. "We will continue to use these powers forcefully, proactively, and aggressively until we are confident that we are solidly on the road to recovery," said Fed Chairman Jerome Powell recently. Powell added that the "emergency tools" would be "put away" once recovery sets in and "private markets and institutions are once again able to perform their vital functions of channeling credit and supporting economic growth." Powell and his colleagues are determined not to repeat the mistakes of the Great Depression and allow a financial system collapse to spark a wave of bankruptcies. Moreover, they are not going to let another *Lehman Brothers* happen (the Fed learned that lesson the hard way during the 2008 Financial Crisis).

Access to credit will be critical for companies needing a financial lifeline to manage through the next few months. Loans, however, will not prevent companies from the risk of closing forever: they will eventually need customers. It is fiscal stimulus that helps bridge the gap until the economy reopens for business and those customers return. To that end, the U.S. government has reached agreement on a variety of fiscal stimulus measures aimed at limiting the economic impact of the outbreak. This does not mean, however, that monetary policy is exhausted. The Fed still has room to maneuver even after implementing the extraordinary measures that it has already taken.

First, and possibly foremost, the Fed has *enabled* the use of massive fiscal stimulus by instituting unlimited bond purchases. As a result, there is no threat of a monetary offset (i.e., the Fed raising short-term interest rates) during the coming boom in government borrowing. Although not explicit coordination of monetary and fiscal policy, this is about as close as is possible under current institutional arrangements.

And if fiscal spending and government borrowing ultimately put upward pressure on interest rates, the Fed can always employ something known as "yield curve control"—in effect buying as many U.S. Treasuries as needed to keep market rates from rising. In other words, there is no need for concern about the ability of financial markets to digest debt issuance with the Fed standing ready to buy as much as needed to hold rates low.

Also, the Fed can bolster its policy effectiveness with forward guidance. It can, for example, tie Quantitative Easing and yield curve control to explicit forward guidance using a revised "Evans Rule" to lock down expectations for policy rates. By way of background, the original 2012 Evans Rule (named after Charles L. Evans, the ninth President and Chief Executive Officer of the Federal Reserve Bank of Chicago) said that the Fed would hold interest rates at zero as long as unemployment is above 6.5% or inflation accelerates to 2.5%.

Given that inflation had not risen substantially despite unemployment falling to 3.5% during the recent economic expansion, we expect that, if a revised Evans Rule were to be implemented, the Fed would surely use much lower guidelines. Better yet, the Fed could drop the unemployment guideline in favor of just an inflation guideline. Given the recent experience of low rates of inflation, that measure alone would be a huge change in policy guidance: there would need to be some very rapid and inflationary economic growth in order to cross that threshold and initiate a rate increase (a good problem to have, given the current economic situation).

Beyond these steps, the Fed could implement an even more fundamental change, such as explicit "average inflation targeting" to offset any weak inflation numbers reported in the coming months. Or, they could make a change in the inflation target itself. The bottom line is that the Fed still has plenty of options to both support the economy now and accelerate the rebound when the lockdowns end.

Although the details of the current monetary programs may appear complex, know this: these recent moves are just the latest indication that the Fed is willing to do whatever it takes to support the economy and the proper functioning of the financial markets. The breadth

and diversity of these programs are an awesome display of creativity and decisiveness—well beyond the role that any monetary policymaker has played in modern history. The Fed remains committed to using its full range of tools to support the flow of credit to households and businesses to counter the economic impact of the coronavirus pandemic and promote a swift recovery once the disruptions abate.

Go Big, or Go Home

(For details regarding the U.S. Federal government's fiscal policy actions related to the coronavirus pandemic, please see the Addendum to this *Quarterly Review*.)

The current economic downturn is dissimilar to the typical economic cycle in which businesses and consumers are *unwilling* to spend. Rather, in this downturn, they are *unable* to spend. As such, its economic dynamics resemble that of a natural disaster—like a hurricane that closes an affected region. In those situations, businesses and employees typically treat a natural disaster as transitory and afterward resume their activities where they left off. The difference with the current "disaster" is that it is affecting the entire country—and may do so for months. The longer it drags on, the more businesses will fail, and the more temporary layoffs will become permanent—with reciprocal effects on spending and employment that may become difficult to reverse.

Research by the Organization for Economic Cooperation and Development found that in the 2008 Financial Crisis, unemployment rose less in countries where employers acted as if the downturn was transitory (i.e., like a natural disaster). That was especially notable in Germany, which encourages employers to reduce each worker's hours rather than cut workers altogether. The U.S. has traditionally resisted subsidizing employers to keep workers, preferring instead to subsidize the unemployed as they search for a new job.

U.S. fiscal policymakers have changed this traditional approach, and their current strategy is to treat the coronavirus pandemic as a natural disaster and basically freeze the economy in place, solve the public health crisis, and then restart the economy when feasible.

The difficulty is that the overall economy has no "pause button." Social distancing measures—such as telling people to stay home and businesses to close unless essential—can suspend the buying and selling of most goods and services. But many costs continue in the interim: households have rent or mortgages to pay, as well as bills for food and other necessities; businesses have payrolls, debts, and other fixed overhead; banks are owed money and so must collect it; etc..

Potential strategies to enable consumers and businesses to pay these types of costs during an economic shutdown include:

(1) Individuals and businesses could live off of their savings until the restrictions end. Many do not have enough reserves, however. As a result, the longer the health emergency lasts, the more likely that individuals and businesses will run out of funds.

(2) The private sector could cut its outlays to match the commerce that is still permitted. Unfortunately, this "step down" to a new level of GDP raises the specter of mass unemployment and bankruptcies, the destruction of countless normally-viable businesses, the scattering of workforces, and perhaps a more pernicious economic downturn.

(3) The government can step in and substitute for consumer spending, disbursing (or lending) enough money to cover wages, interest, and other fixed costs. In theory, the government could preserve the status of today's companies and jobs for months on end, provided it can borrow or print enough money and target the aid appropriately.

It is, in essence, this third strategy that U.S. fiscal policymakers are utilizing to support the economy's eventual return to prosperity.

To reach that positive outcome, the U.S. government has engaged in massive spending measures to ensure that those who lose their jobs do not experience personal catastrophe with long-lasting effects and that these individuals have jobs to return to—i.e., that businesses with sound long-term prospects do not collapse in the interim.

Congressional lawmakers have so far passed bills to address coronavirus relief in three "phases." The first phase was an $8.3 billion bill spurring coronavirus vaccine research and development (the Coronavirus Preparedness and Response Supplemental Appropriations Act, 2020), which was signed into law on March 6, 2020. The second phase was an approximately $104 billion package largely focused on paid sick leave and unemployment benefits for workers and families (the Families First Coronavirus Response Act), which was signed into law on March 18, 2020. The third phase was an approximately $2.2 trillion package meant to address the overall economic fallout of the pandemic (the Coronavirus Aid, Relief, and Economic Security Act—also known as the CARES Act), which was signed into law on March 27, 2020.

Due to the scale and scope of the demand associated with these programs, there have been logistical issues surrounding the implementation and disbursement of these aid packages. However, we anticipate that these issues will be resolved. We also anticipate that there will be further fiscal policy measures enacted—in addition to economic stimulus packages after the pandemic wanes.

On Ice

Just over a month ago, the U.S. economy looked poised for solid, albeit moderate, growth in 2020. Job growth was holding steady despite earlier fears that the labor supply would run dry as the unemployment rate sank below 4%. Housing markets were on an upswing, and both the manufacturing and larger services sectors were trending positively. Then the pandemic broadsided the economy.

The U.S. has experienced a sudden stop in economic activity due to the coronavirus. As a consequence, there will likely continue to be negative economic data reports in the weeks and months ahead given the severity and swiftness of the transition to the shutdown. This is to be expected. Indeed, current dour economic data are meaningless and backward-looking, in context. This drop in activity is by design as the impacts of social distancing and the various shelter-in-place policies are implemented around the country. Virtually all industries are affected by the drop in consumer demand, changes in staffing patterns and work-from-home policies, knock-on effects across supply chains, and the like.

Unlike the 2008 Financial Crisis (where the initial shock was in the housing industry) or the dotcom bust (where technology companies suffered the most), this downturn in the economy is different than previous declines. This initial shock is primarily concentrated in the consumer services, retailing, travel, leisure, and hospitality industries, in addition to impacts on the energy sector due to the decline in oil prices from the Saudi Arabia-Russia price war and the economically-driven demand collapse. Beyond those sectors, other factors impacting the severity of U.S. local or regional economics include demographic issues, in addition to reliance upon investment-related income and the wealth effects on spending given the recent asset market decline.

It is clear that the economic fallout currently being experienced is a direct result of the response to the public health situation and global pandemic. Certainly, once the health situation improves, the economy will revive. In fact, the economy can come back earlier than the consensus expects due to the aggressive and extraordinary magnitude of the monetary and fiscal policy response as well as positive and/or successful health outcomes (via increased testing, incident curve flattening, contact tracing mitigation, and therapeutics and vaccines). These measures should restore confidence.

This raises important questions for financial market participants: What will be the ultimate depth and duration of this economic downturn, and will there be a deflationary impact?

The lights have literally been "turned off" in large parts of the U.S. economy. Over the short term, output may fall and unemployment may climb dramatically. While the exact numbers will only be revealed in hindsight, that there has been a collapse in economic activity is without doubt.

Depth, however, is only one part of the story. Duration is another. We do not categorize local level shutdowns resulting from natural disasters as depressions, or even recessions, because activity can rebound fairly quickly. We should not make these characterizations at the national level, either. The cornoavirus pandemic should be considered as a natural disaster (like a hurricane that has hit the entire U.S.). We cannot accurately forecast the duration of the downturn because it depends upon the course of the virus, of which a lot of uncertainties and unknowns remain. If we assume, optimistically, that we gain enough near-term control over the virus and its spread to begin lifting restrictions on activity, we can expect a rebound in activity beginning at some point during the Third Quarter of this year.

Still, any rebound would not be akin to simply flipping a light switch back to the "on" position. It may be more like turning the dial on a dimmer switch—maybe quickly at first, but more slowly thereafter (or vice versa). How much we can turn the dial at first, and how quickly thereafter, will determine the recovery's duration. Any economic "re-opening" must be dependent upon the scientific data and based upon what is in the best interest of the public's health. Certain parts of the economy may come back quickly. Inventory rebuilding might provide a boost to manufacturers, for instance. And pent-up demand might help clear the shelves at retailers. Regardless, we should expect a bounce when restrictions are lifted.

That bounce, however, will not be a full recovery. There are two broad obstacles to a V-shaped economic recovery, in our opinion.

First, expect some persistent damage to the economy as the result of some firms going bankrupt and the severing of some employer-employee relationships. The CARES Act, with its enhanced unemployment benefits and aid to business, helps minimize this damage, but it remains insufficient to stem all of the bleeding.

Second, until there are therapeutics or a vaccine for the virus, some segments of the economy may be impaired long into the future. Significant gatherings of people—conferences, sporting events, arts performances, etc.—could remain limited for an extended time. Leisure and hospitality industries may struggle in a world that suddenly grows smaller for everyone. That being said, subject to constraints, we believe that there is a deep underlying propensity for human habits to persist over time, and that, human nature being what it is, individuals will have a strong inclination to return to their former way of life as soon as reasonably practicable.

A final economic consideration is whether there is a risk of deflation generating a self-sustaining collapse in demand as existing debt becomes harder to support with falling nominal incomes. The ability of deflation to take hold will depend upon the success of monetary and fiscal support for the economy. To its credit, the Fed quickly adopted a "whatever it takes" strategy to keep the financial sector intact. Likewise, fiscal policy has swooped into action to support demand with enhanced unemployment benefits, which in some cases will provide more than 100% replacement income for workers. An unintended positive consequence of such high benefits is to prevent wage deflation and hopefully reinforce positive wage-setting expectations during the recovery phase.

In the long run, a significant short-lived downturn will not "break" the U.S. economy. Ultimately, however, the health of the economy depends upon controlling the virus. Whether or not this economic downturn becomes more severe is therefore contingent upon the actions of scientists and healthcare officials in the coming months.

Bend the Curve

Extraordinary monetary and fiscal policy measures are necessary, but not sufficient, to return the economy to "normalcy." Ultimately, the way out of this health crisis will depend upon successful mitigation and/or control of the coronavirus.

We are neither epidemiologists nor virologists—and we do not profess any expertise in those areas. We defer to and are reliant upon the research of scientists and healthcare professionals to guide this discussion. We are, however, optimistic that—given the unprecedented and extraordinary global scientific talent and financial resources being devoted to combating this coronavirus—their efforts will prove successful.

Within this context, then, it may be useful to compare the recent coronavirus pandemic to the SARS outbreak of nearly two decades ago.

In November 2002, the severe acute respiratory syndrome coronavirus (SARS-CoV) emerged in China and caused global anxiety as the outbreak rapidly spread, resulting in over 8000 cases in 26 countries by July 2003. In December 2019, a novel coronavirus, named SARS-CoV-2, emerged in Wuhan, China, and led to a rapidly spreading outbreak of coronavirus disease 2019 (COVID-19). By January 30, 2020, COVID-19 was declared a public health emergency of international concern.

The similarities between SARS-CoV and SARS-CoV-2 are striking, not only in name. The whole genome of SARS-CoV-2 has an 86% similarity with SARS-CoV. Both viruses share high degrees of shared ancestral genetic structures to SARS-like coronaviruses isolated in bats, suggesting that bats are the probable origin of both SARS-CoV and SARS-CoV-2. Live animal ("wet") markets selling multiple species of wild and domestic animals in proximity to large populations of densely-housed humans are thought to be the source of both outbreaks. Even in terms of disease dynamics there are apparent similarities: the main transmission route is thought to be respiratory droplets.

However, the similarities end here. The epidemic trajectory of the two viruses appears different. The SARS epidemic in 2003 resulted in 8098 cases with 774 deaths, and was eventually brought under control by July 2003—a matter of 8 months. Although 26 countries reported cases, the vast majority of cases were concentrated in five countries or regions: China, Taiwan, Hong Kong, Singapore, and Toronto, Canada. SARS was eventually contained by means of syndromic surveillance, prompt isolation of patients, strict enforcement of quarantine of all contacts, and, in some areas, community-level quarantine. By interrupting all human-to-human transmission, SARS was effectively eradicated.

By contrast, as of mid-April 2020, approximately 1.8 million confirmed cases of COVID-19 have been reported worldwide with more than 110,000 deaths: of 1.3 million active cases, 96% have mild conditions; and of 0.5 million closed cases, 80% are recovered/discharged. Although there are striking similarities between SARS and COVID-19, the differences in the viruses' characteristics will ultimately determine whether the same measures for SARS will also be successful for COVID-19. COVID-19 differs from SARS in terms of infectious period, transmissibility, clinical severity, and extent of community spread. Even if traditional public health measures are not able to fully contain the outbreak of COVID-19, however, they should still be effective in reducing peak incidence and global deaths. Exporting COVID-19 to other countries need not result in rapid large-scale outbreaks if countries have the political will to rapidly implement countermeasures.

So why have the case numbers of COVID-19 already surpassed those of SARS over a shorter time interval?

There are several possible explanations provided by scientists. First, the situation is different. Logistically, Wuhan, the epicenter of COVID-19, combined multiple elements that made containment challenging. As the largest city in central China (population greater than 11 million), Wuhan is a major transport hub and center for industry and commerce, home to the largest train station, biggest airport, and largest deepwater port in central China. China's outward travel has more than doubled in the past decade, and its urban population densities tripled. The proximity of people in residen-

tial housing, during commuting, and in work environments in a megacity such as Wuhan amplifies person-to-person transmission (similar to what has been seen in New York City). Worse, in the days just before Wuhan was put under lockdown, more than 5 million people (many of whom might have been incubating the virus) had travelled out of the city because of the upcoming Spring Festival, thus spreading COVID-19 to other provinces in China. The high connectivity of Wuhan to international airports further facilitated rapid spread to cities and countries with high air passenger volumes from China, such as Singapore, Japan, and Thailand.

A second explanation might be that the infectious period is different. Isolation was effective for SARS because peak viral shedding occurred after patients were already quite ill with respiratory symptoms and could be easily identified. Although asymptomatic or mildly symptomatic patients have been reported for SARS, no known transmission occurred from these patients. By contrast, preliminary evidence from COVID-19 cases suggests that transmission during the early phase of illness also seems to contribute to overall transmission; therefore, isolation of more severely ill patients at the time of presentation to healthcare facilities is too late for control measures. The effectiveness of isolation and contact tracing methods depends on the proportion of transmission that occurs *before* symptom onset.

A third explanation could be that transmissibility and contagiousness might be higher for COVID-19 than for SARS. R_0 (the reproduction number) is a central concept in infectious disease epidemiology, indicating the risk and intensity of an infectious agent with respect to its epidemic potential. Recent analyses are finding that the average R_0 of COVID-19 to be higher than that of SARS, although more accurate estimates can only be ascertained when the epidemic stabilizes and further testing data are accumulated and analyzed.

A fourth explanation is that community spread may be more prominent. Whereas SARS was mainly an outbreak propagated within hospitals, widespread community transmission is already evident for COVID-19. Consequently, there will be more unknown contacts than known contacts in the community, which means that many contacts who will subsequently develop an infection are not quarantined and under proper medical observation, especially if they are asymptomatic.

Given these issues and in the current absence of vaccines and specific treatment, there are only certain public health tools available to control person-to-person transmittable diseases.

At the community level, epidemiologists tend to speak of two different paradigms to limit both the extent and the rate of infection. The first, known as containment, is used at the start of an outbreak. It involves tracking the dissemination of a disease within a community, and then using isolation and individual quarantines to keep people who have been infected by or exposed to the disease from spreading it.

Community mitigation is the other set of actions that persons and communities can take to help slow the spread of respiratory virus infections and is especially important before a vaccine or therapeutic drug becomes widely available. The primary goal for using mitigation strategies in communities with local COVID-19 transmission is to slow the transmission of disease; hence, "stay-at-home" and social distancing measures.

For a variety of reasons, the U.S. appears to have passed the possibility of containment and is now dealing with mitigation efforts. Although more difficult, mitigation can be effective in delaying the onset of widespread community transmission, reducing peak incidence and its impact on public services, and decreasing the overall attack rate. Other countries have shown that mitigation measures—although complex and logistically involved—can successfully control the virus. It is therefore important to monitor the data from these countries on an ongoing basis in order to learn from their experiences.

It remains unclear, however, to what degree the U.S. will be able to enact similar measures (e.g., widespread testing and contact tracing) given a variety of constraints. Clearly, minimizing the size of the outbreak or suppressing its peak at the local or regional level will reduce deaths by providing healthcare facilities with the opportunity to scale up and respond more effectively, thereby slowing down the spread until therapeu-

tics or vaccines become available. Only a coherent national response with a structured incident management system of disease surveillance that includes increased testing capacity combined with tracing and tracking data of those in contact with positive COVID-19 individuals will be able to achieve this goal.

This Too Shall Pass

If the U.S. economy reachs its nadir during the next couple of Quarters, then the primary issue for investors is not whether the stock market has "bottomed," but whether the recent equity market bounce/rally is sustainable. In other words, has the equity market correctly forecasted the timing of an economic recovery? If so, then the market could continue to rally. If not, then the market could re-test its previous lows.

Although the market is often prescient, its forecasting ability will be challenged due to the unusual nature of this downturn and the characteristics of financial market participants. In our opinion, attention should not be focused on companies' earnings outlooks for the remainder of the year. It is obvious and well understood that there is tremendous uncertainty regarding the corporate earnings outlook, and that the variance in forecasts is much greater than normal. This is due, in part, to the extremely high degree of uncertainty about the economic recovery because of the unusual nature of the drivers of this downturn.

Offsetting this uncertainty is the positive impact of unprecedented and extraordinary fiscal and monetary policy measures.

We believe that, at the recent lows, the oversold nature of the markets served to highlight an extremely compelling risk-reward tradeoff, and helped to neutralize the overwhelming sense of negativity that prevailed with respect to the economic and earnings outlook. This sentiment shift should continue to drive the accumulation of stocks and help slow the magnitude, and speed, of future declines—and lend weight to rally efforts.

In our opinion, there are several factors relating to investor psychology that, qualitatively, should serve to support the market in the near-term:

- There seems to be less focus on trying to pick the absolute bottom for the market and more conviction in initiating, or adding to, core positions at lower cost bases.
- The violence of the recent rally reminded institutional investors how holding excessive cash can destroy performance when there is a shift in sentiment.
- There is a sense that it is less easy now to short stocks (particularly Financials) and be successful at it for an extended period of time.
- There appears to be a willingness to look past 2020 and into 2021, when the coronavirus mitigation efforts will produce more successes, the economy will be "re-opened," and corporate earnings growth will resume.

The direction of the stock market will not be straight up from here, however, and we expect a volatile backdrop over the balance of the year. Serious fundamental economic and structural financial issues need to be resolved—and this will take time. More importantly, headway must be made on coronavirus mitigation.

Although the long-term societal and economic implications of the pandemic, if any, remain unclear, specific companies are taking advantage of the changes in their operating environment to create long-run opportunities for their businesses. Those leading companies whose superior business models are best positioned to withstand the current shocks to the system will emerge stronger as the economy recovers.

Our goal, as always, is to identify those companies and invest in them for your *Windward* portfolio. Our risk averse approach to managing your investments causes us to take a more measured and unemotional view of extremes in bullish or bearish sentiment and find ways to outperform the market with less volatility by focusing on specific companies' fundamentals. Our results over the course of various market cycles demonstrate our success.

We appreciate your support as we continue to navigate through this challenging period and invite you to call us should you have any questions or concerns.

Sources:

Bloomberg
Centers for Disease Control and Prevention
Johns Hopkins University
National Institutes of Health
Organization for Economic Cooperation & Development
Reuters
The Lancet
U.S. Congress
U.S. Department of the Treasury
U.S. Federal Reserve
World Health Organization

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.

ADDENDUM

U.S. Monetary Policy Actions

Some of the steps taken by the Fed, so far, include:

Rate cuts
The Fed cut rates twice on an emergency basis in March, the first time it has done that since the 2008 Financial Crisis. The first cut of 50 basis points was on March 3, and the second of 100 basis points was on March 15—which brought the Fed's overnight borrowing rate for banks back to near zero. The reduction is meant to keep down the cost of loans for banks—and, by extension, their customers—to ensure that borrowers have ample access to credit during the crisis.

Repo market
The Fed has been intervening in money markets since last Fall, when a cash shortage led to a jump in short-term borrowing rates. Policymakers had planned this year to scale back operations in the market for repurchase agreements, or repo, through which dealers can borrow cash. But as the economic threat posed by the coronavirus increased, the central bank pivoted to offering almost unlimited support in the overnight lending markets for cash. On March 31, the Fed also announced that it broadened its repo agreements with foreign central banks, allowing them to exchange their holdings of U.S. Treasury securities for overnight Dollar loans.

Quantitative Easing (QE)
The Fed last employed QE during the 2008 Financial Crisis. The idea is that through large-scale purchases of various types of bonds—mostly Treasuries and mortgage-backed securities—it helps ensure that longer-term interest rates like those for mortgages and car loans remain low and helps keep major purchases affordable for consumers and businesses. When it cut rates back to near zero on March 15, the Fed restarted these large-scale purchases and is now doing so with an open-ended commitment.

Discount window
Banks in recent weeks have borrowed the most since 2009 from the Fed's lending tool of last resort at the urging of the central bank. The so-called "discount window" is rarely used because banks are worried that using it could make them appear weak. But policymakers have lowered the rate charged on the funding to 0.25% and extended the length of the loans offered from one day to 90 days in order to reduce this stigma.

Central bank foreign currency swap lines
The Fed has standing agreements with five other major foreign central banks—the Bank of Canada, European Central Bank, Bank of England, Bank of Japan, and Swiss National Bank—that allows them to provide U.S. Dollars to their financial institutions during times of stress. The Fed has increased the frequency of the operations to daily from weekly. It also offered temporary swap lines to nine additional countries to ease access to Dollars, which are in high demand because the liabilities of many foreign governments and companies are denominated in the U.S. currency.

Term Asset-Backed Securities Loan Facility (TALF)
Through a Special Purpose Vehicle (SPV), the TALF program will buy bundles of assets secured by auto loans, credit cards, student loans, loans backed by the Small Business Administration, and other types of credit. Its aim is to make sure banks and other lenders such as auto finance companies have ample cash to keep making loans to consumers and businesses during the crisis.

Commercial Paper Funding Facility (CPFF)
The Fed reintroduced the CPFF, a tool it used during the last financial crisis, to get money directly into the hands of large businesses, which are major employers. Like the TALF, it will use an SPV to make purchases of commercial paper, an essential source of short-term funding for many companies. The market had come under strain amid worries that companies hit by efforts to slow the spread of the coronavirus would not be

able to repay their IOUs.

Primary Dealer Credit Facility (PDCF)
Through this facility, the Fed offers short-term loans to the two dozen Wall Street firms authorized to transact directly with the central bank. The program offers funding of up to 90 days to primary dealers. A similar program run from 2008 to 2010 only offered overnight loans.

Primary Market Corporate Credit Facility (PMCCF)
With this program, the Fed will act as a backstop for corporate debt issued by highly-rated companies. Through an SPV, the PMCCF will buy bonds and issue loans to companies that can help them cover business expenses and stay in operation. The debt must be repaid to the PMCCF within four years.

Secondary Market Corporate Credit Facility (SMCCF)
Closely related to the PMCCF, under this program an SPV will purchase corporate bonds and exchange-traded funds in the secondary market, or the public market where these securities are traded after they are first issued. The market liquidity added by the Fed is meant to stabilize conditions in the corporate bond market and make it easier for companies to raise funds there. Only so-called investment grade securities are eligible for purchase.

Money Market Mutual Fund Liquidity Facility (MMFLF)
This new facility is meant to keep the $3.8 trillion money market mutual fund industry functioning even when investors are withdrawing money at a fast clip. The tool offers loans of up to one year to financial institutions that pledge as collateral high-quality assets like U.S. Treasury bonds that they have purchased from money market mutual funds. The Fed indirectly encourages banks to buy assets from money market funds, reducing the odds that the funds will need to sell those assets at a loss to meet redemptions.

On April 9, the Fed took additional actions to provide up to $2.3 trillion in loans to support the economy: it will wade into the $3.9 trillion U.S. municipal bond market to an unprecedented degree, can now purchase "fallen angel" bonds from companies that have recently lost their investment grade ratings, and has expanded its TALF to include top-rated commercial mortgage-backed securities and collateralized loan obligations. This funding will assist households and employers of all sizes and bolster the ability of State and local governments to deliver critical services during the coronavirus pandemic.

The most recent actions that the Fed is taking to support employers of all sizes and communities across the country will:

- ✓ Bolster the effectiveness of the Small Business Administration's Paycheck Protection Program (PPP) by supplying liquidity to participating financial institutions through term financing backed by PPP loans to small businesses. The PPP provides loans to small businesses so that they can keep their workers on the payroll. The Paycheck Protection Program Liquidity Facility (PPPLF) will extend credit to eligible financial institutions that originate PPP loans, taking the loans as collateral at face value;

- ✓ Ensure credit flows to small and mid-sized businesses with the purchase of up to $600 billion in loans through the Main Street Lending Program. The Department of the Treasury, using funding from the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) will provide $75 billion in equity to the facility;

- ✓ Increase the flow of credit to households and businesses through capital markets, by expanding the size and scope of the Primary and Secondary Market Corporate Credit Facilities (PMCCF and SMCCF) as well as the Term Asset-Backed Securities Loan Facility (TALF). These three programs will now support up to $850 billion in credit backed by $85 billion in credit protection provided by the Treasury; and

- ✓ Help State and local governments manage cash flow stresses caused by the coronavirus pandemic by establishing a Municipal Liquidity Facility that will offer up to $500 billion in lend-

ing to States and municipalities. The Treasury will provide $35 billion of credit protection to the Fed for the Municipal Liquidity Facility using funds appropriated by the CARES Act.

The Main Street Lending Program will enhance support for small and mid-sized businesses that were in good financial standing before the crisis by offering 4-year loans to companies employing up to 10,000 workers or with revenues of less than $2.5 billion. Principal and interest payments will be deferred for one year. Eligible banks may originate new Main Street loans or use Main Street loans to increase the size of existing loans to businesses. Banks will retain a 5% share, selling the remaining 95% to the Main Street facility, which will purchase up to $600 billion of loans. Firms seeking Main Street loans must commit to make reasonable efforts to maintain payroll and retain workers. Borrowers must also follow compensation, stock repurchase, and dividend restrictions that apply to direct loan programs under the CARES Act. Firms that have taken advantage of the PPP may also take out Main Street loans.

To support further credit flow to households and businesses, the Fed will broaden the range of assets that are eligible collateral for TALF. TALF-eligible collateral will now include the triple-A rated tranches of both outstanding commercial mortgage-backed securities and newly issued collateralized loan obligations. The size of the facility will remain $100 billion, and TALF will continue to support the issuance of asset-backed securities that fund a wide range of lending, including student loans, auto loans, and credit card loans.

The Municipal Liquidity Facility will help State and local governments better manage cash flow pressures in order to continue to serve households and businesses in their communities. The facility will purchase up to $500 billion of short term notes directly from U.S. States (including the District of Columbia), U.S. counties with a population of at least two million residents, and U.S. cities with a population of at least one million residents. Eligible State-level issuers may use the proceeds to support additional counties and cities. In addition to the actions described above, the Fed will continue to closely monitor conditions in the primary and secondary markets for municipal securities and will evaluate whether additional measures are needed to support the flow of credit and liquidity to state and local governments.

All of the facilities mentioned above are established by the Fed under the authority of Section 13(3) of the Federal Reserve Act, with approval of the Treasury Secretary.

U.S. Fiscal Policy Actions

Coronavirus Preparedness and Response Supplemental Appropriations Act, 2020

Broken down by category, this bill provides funding for the following purposes:

- More than $3 billion for research and development of vaccines, as well as therapeutics and diagnostics
- $2.2 billion in public health funding to aid in prevention, preparedness and response efforts—including $950 million to support State and local agencies
- Almost $1 billion for medical supplies, healthcare preparedness, Community Health Centers, and medical surge capacity
- $500 million for Medicare telehealth
- $1.25 billion to fight COVID-19 internationally

Families First Coronavirus Response Act

- Free testing

  The legislation seeks to make testing for the coronavirus free to the public (without having to use deductibles or copayments). It includes a variety of waivers in order for testing costs to be covered by either insurance or government programs.

  Additionally, it includes a temporary 6.2% increase in Federal payments to Medicaid for States.

  An additional $60 million will go to the Department of Veterans Affairs for testing veterans, $64 million to the Indian Health Service for testing members of Native American tribes, and $1 billion to the National Disaster Medical System for reimbursing testing costs for those without health insurance.

- Paid sick leave

  The bill establishes a Federal emergency paid-leave benefits program to provide payments to some employees.

  It requires employers with fewer than 500 employees to provide two weeks' worth of paid sick leave if employees are unable to work because they are subject to quarantine or isolation, are experiencing symptoms of COVID–19, are caring for someone who is in quarantine or isolation, and/or have children in schools that have closed.

  Employers themselves will receive tax credits to offset the costs of providing this paid leave.

  Under the legislation, an employer cannot require employees to find a replacement worker for themselves or require them to use other paid time off.

  For those who are self-employed, there will be a tax credit equivalent to the sick leave amount.

  The legislation also gives up to three months of paid family and medical leave, equivalent to no less than two-thirds of the person's pay.

- Unemployment aid

  The legislation boosts unemployment benefits, with nearly $1 billion in State grants to cover processing and paying unemployment insurance.

  It also raises the amount of assistance to States with high unemployment for those who have exhausted benefits already.

- Nutrition assistance

  Nearly $1 billion is being given to provide access to meals for those without food security. Half of that amount will go toward funding for

the Special Supplemental Nutrition Program for Women, Infants, and Children, also known as WIC.

Another $400 million is allocated for an emergency food assistance program that will be available through September 30, 2021.

Certain households will be eligible for help if a child's school has been closed for at least five consecutive days because of the health crisis.

The legislation allows certain waivers in order to expand who qualifies for benefits through the Supplemental Nutrition Assistance Program and suspends the program's work requirements.

An additional $100 million will be set aside for nutrition assistance grants for U.S. territories (Northern Mariana Islands, Puerto Rico and American Samoa).

Coronavirus Aid, Relief, and Economic Security (CARES) Act

The CARES Act contains the following provisions:

- Allocates up to $500 billion for assistance to eligible businesses, States, and municipalities, with not more than $25 billion designated for passenger air carriers, not more than $4 billion for air cargo carriers, and not more than $17 billion for businesses critical to maintaining national security
- Creates a $349 billion loan program, called the Paycheck Protection Program (PPP), for small businesses with funds available for loans originated from February 15 through June 30, 2020
- Allocates $130 billion in relief to the medical and hospital industries
- Provides rebates for eligible individuals who are neither nonresident aliens nor claimed as dependents by another taxpayer: $1,200 to each individual or $2,400 to each married couple filing jointly, and $500 for each dependent who is a qualifying child under age 17 as of December 31, 2020. The credits are reduced, but not below zero, by each five percent of so much of the taxpayers' adjusted gross income as exceeds $150,000 for a joint return; $112,500 for a head of household; or $75,000 for other taxpayers.
- Expands eligibility for unemployment insurance and provides people with an additional $600 per week on top of the unemployment amount determined by each State
- Gig workers and freelancers are covered by unemployment insurance for the first time
- Further expands telehealth services in Medicare
- Provides the Secretary of the Treasury with the authority to make loans or loan guarantees to States, municipalities, and eligible businesses
- Provides a refundable employee retention tax credit for employers whose operations were suspended due to COVID-19 or whose revenue has significantly decreased due to COVID-19
- Allows employers to defer payment of the employers' share of FICA tax for up to two years (payment of half of self-employment tax may also be deferred for up to two years)
- Allows individuals who take the standard deduction to take a tax credit for up to $300 of charitable contributions per year, effective January 1, 2020
- Increases the limit for most tax-deductible charitable contributions from 50% to 100% of adjusted gross income for individuals and from 10% to 25% for corporations; increases the limit for tax-deductions for charitable contributions of food inventory
- Payments of student loan principal and interest by an employer to either an employee or a lender is not taxable to the employee if paid on or before December 31, 2020
- Suspends required minimum distributions for 2020
- Increases the maximum amount of a loan from an employer-sponsored retirement plan from $50,000 to $100,000 and from 50% of vested assets to 100% of vested assets
- Delays the 80% limitation on net operating losses from 2018 to 2021; allows net operating

losses from 2018, 2019, and 2020 to be carried back to up to five years; delays the $500,000 limitation on deductible net operating losses until 2021

- When a consumer affected by COVID-19 requests and receives flexibility with their payment obligations from a creditor, the creditor is required to report to credit bureaus that the consumer is in compliance with their payment obligations

NOTES

NOTES

NOTES

WINDWARD CAPITAL MANAGEMENT CO.

Risk Averse Asset Management

www.WindwardCapital.com

11111 Santa Monica Boulevard, Suite 1200
Los Angeles, California 90025

(310) 893-3000
(800) WINDWARD
(800) 946-3927
(310) 893-3001 Facsimile
mail@WindwardCapital.com

Robert Nichols, PhD
CEO / Portfolio Manager

Donald R. Bessler, CPA
Chief Investment Officer / Portfolio Manager