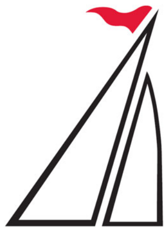

WINDWARD CAPITAL

Risk Averse Asset Management

2021 Fourth Quarter Review

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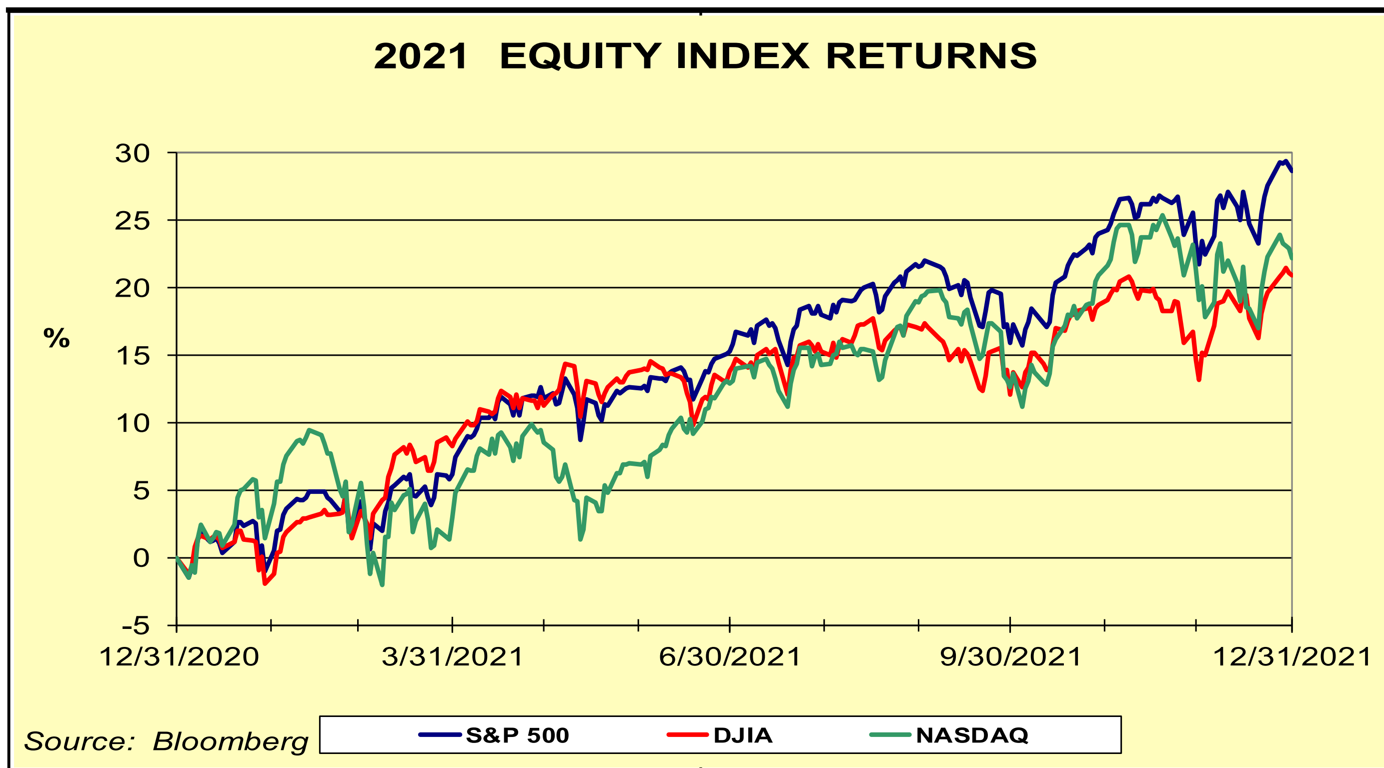

Source: Bloomberg

A Matter of Perspective

"...I guess I can put two and two together."

"Sometimes the answer's four," I said, "and sometimes it's twenty-two..."

— from *The Thin Man* (1934)
Dashiell Hammett (1894 – 1961)

The major U.S. equity market indices continued to advance to new, historic highs during the Fourth Quarter of 2021. The Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) returned +11.02%, +7.87%, and +8.47%, respectively, for the period. As a result, for 2021 Year-to-Date, the S&P 500, DJIA, and NASDAQ have returned +28.68%, +20.95%, and +22.21%, respectively.

Despite recent market declines at the start of 2022, the overall positive financial market trends appear to be intact. The bullish sentiment among investors seems primarily related to optimism regarding the outlook for the U.S. economy and continues to be predicated upon strong monetary and fiscal policy support amid significant uncertainties regarding the extent and speed of the overall global macroeconomic recovery due to the lingering, and uneven, regional and international geographic impacts of the coronavirus pandemic.

As COVID-19 transitions from pandemic to endemic status, it is becoming increasingly clear regarding the path forward: vaccinated people will access boosters

whenever immunity wanes, and they (and businesses) will take other precautions necessary to protect themselves so as to resume normal activities. As a result, we believe that these set of circumstances will enable the global macroeconomy to continue to move forward, exceeding its pre-pandemic trend as the negative impact of the coronavirus, on the margin, continues to wane.

Predictably, some of the factors providing underlying support to the U.S. economy have also had the unintended consequence of creating speculative excesses in specific areas of the financial markets. Recent examples include trading activity in near-bankrupt companies, microcaps, penny stocks, cryptocurrencies, non-fungible tokens (NFTs), special purpose acquisition companies (SPACs), and thematic ETFs, among other financial instruments. Liquidity effects, excessive leverage, and momentum "investing" have combined with high-frequency trading, algorithms, the pervasive use of ETFs, and a variety of social media-driven commission-free retail trading platforms to exacerbate this trend. In addition, economic sectors with generally-suspect long-term business fundamentals (e.g., Energy, Materials, and Financials) have traded significantly higher based upon an unwinding (via higher yields) of the extraordinary bond market rally of mid-2020, projections of substantive and sustained inflation, and expectations regarding a renewed commodity supercycle.

The ultimate unwinding of these speculative excesses and rotational sector moves may result in increased volatility and, potentially, a near-term market correction. We do not believe, however, that these factors represent a systemic risk to the overall financial markets. In addition, we believe that the risk associated with any 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.

Historically, periods of excessive ex-ante savings, combined with demand that is too weak to justify investment, cause certain areas of the financial markets to become driven by the speculative rearranging of portfolios rather than by the underlying business fundamentals (like return on capital investment). We are not "traders;" we are investors. As such, it is irrelevant to us whether or not "the market" agrees with us over the short term. For speculators, on the other hand, daily market affirmation remains essential.

As discussed in detail in our *Windward Capital 2020 Fourth Quarter* and *2021 First Quarter Reviews*, we do not subscribe to the current assumptions being made by financial market participants regarding the outlook for inflation or a commodity supercycle. As a result, 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 speculative financial market trading. We believe, however, that we will continue to be successful in making profitable long-term investments for *Windward*'s portfolio strategies.

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.

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. 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.

An Object in Motion

Healthy household balance sheets, the need for businesses to rebuild inventory, and accommodative financial conditions are just some of the factors that should support continued robust U.S. economic growth. Business conditions appear to be improving broadly, including in sectors providing in-person services, such as the entertainment, travel, and leisure sectors. Although the emergence of the Omicron variant of the coronavirus makes the economic outlook more uncertain in the near term, we do not yet see the new variant as fundamentally altering the path of economic recovery in the United States (and, in fact, this variant may portend the beginning of the end of the coronavirus pandemic and the start of its endemic phase [see discussion below]).

Indeed, consumer demand and spending has remained strong and is supported by factors that we have discussed in the past: accommodative fiscal and monetary policies, employment-driven increases in household income, rising net worth of the household sector, and the high level of savings accumulated during the course of the pandemic. On an annualized basis through November 2021, total Personal Consumption Expenditures (PCE) are now trending above their pre-pandemic growth rate and exceed their historic February 2020 peak level by +11.1%. However, this growth continues to be disproportionately driven by spending on goods versus services: whereas spending on services represented 69% of total PCE in February 2020, it represented 65% of total PCE in November 2021. These ratios of spending should revert to their mean historical relationships over time as the pandemic phase of the coronavirus ends and consumers become more comfortable with in-person services.

Although U.S. Real Gross Domestic Product (GDP) increased at an annualized rate of only +2.3% in the Third Quarter of 2021—a slowdown from the +6.3% and +6.7% annualized paces realized during the First and Second Quarters of 2021, respectively—growth is expected to re-accelerate to +6.8% during the Fourth Quarter of 2021, according to the Federal Reserve Bank of Atlanta's *GDPNow* forecast, and should continue to exceed its long-term average annual growth rate of approximately +2% over the coming years.

Concomitantly, inflation readings have also been higher and are more persistent and widespread than previously anticipated.

Importantly, however, although several of the inflation indicators that we monitor (and which we discussed in detail in our *Windward Capital 2021 Third Quarter Review*) remain elevated or have recently moved upward, those that have risen still remain well below their pre-pandemic levels. As we have discussed in the past, because the dynamics of inflation are complex, we assess the inflation outlook by analyzing a variety of metrics. Looking forward, it will be important to specifically monitor the trajectory of rising housing costs and rents (i.e., owners' equivalent rent), the degree to which wage growth accelerates, and the duration and extent of global supply-side frictions—as well as the ability of businesses to pass through higher costs of labor and material to customers on a sustainable basis.

As we have stated in the past, the combination of extraordinary fiscal support and the prospect of households unleashing substantial post-pandemic pent-up demand highlighted the possibility of increased inflationary dynamics as a potential market risk. In the U.S., consumer demand is strong, vaccine coverage is expanding, and pandemic-affected sectors are reopening. As with the ebbs and flows of the onset of the pandemic shutdown, the scale of the economic reopening is similarly unprecedented—and it is generating near-term supply/demand mismatches in a variety of economic sectors. Separating signal from noise in the high-frequency economic data is therefore challenging: the supply/demand mismatches are making it difficult to precisely assess inflationary developments and the amount of resource slack from month-to-month.

Given year-over-year base effects, pent-up demand,

and short-term supply chain disruption, at this juncture it seems more likely that the U.S. economy could experience a transitory inflation "scare" rather than a sustained period of "real" inflation.

Indeed, the rapid post-pandemic reopening of the U.S. economy has brought a sharp run-up in price pressures. Over the 12 months through November 2021, measures of headline and core PCE inflation have run at annualized rates of +5.7% and +4.7%, respectively. Businesses and consumers widely report upward pressure on prices and wages. Although inflation at these levels—if sustained—would be a cause for concern, in our view a number of factors continue to suggest that these elevated readings are likely to prove temporary. This assessment is a critical and ongoing one, and we are carefully monitoring incoming data for any change to our forecast in this regard.

From a longer-term, historical perspective, as we have discussed numerous times in the past, it is important to remember that, since the 1990s, inflation in many advanced economies has run consistently below +2%—even during periods of sustained economic growth. This pattern of low inflation likely reflects sustained disinflationary forces, including technology, globalization, and demographic factors, as well as a stronger and more successful commitment by central banks to maintain price stability. With regard to global inflation dynamics, from a long-term investment perspective, the most important development is the secular deflationary trend that we have discussed in detail over the past several years. Namely, from a global macroeconomic perspective, there remains a surfeit of supply and dearth of demand which is serving as an overall constraint on any secular inflationary dynamic. While underlying global disinflationary factors are likely to evolve over time, there is little reason to believe that they have suddenly reversed or abated because of the pandemic. Indeed, we believe that the same structural forces that have driven this dynamic over recent decades (e.g., the global savings glut, demographic aging, etc.) should continue after the pandemic wanes.

Although continued vigilance is warranted, in our view the inflation data thus far appear to reflect a temporary misalignment of supply and demand that should fade over time as the demand surge normalizes, reopening is completed, and supply adapts to the post-pandemic environment. It remains uncertain, however, how long it will take for this realignment to occur.

The Powell Pivot

As you may know, since 1977 the U.S. Federal Reserve (Fed) has operated under a mandate from Congress to promote price stability and maximum sustainable employment—what is now commonly referred to as the Fed's "dual mandate." The idea that the Fed should pursue these goals can be traced back to at least the 1940s, however—with shifting emphasis on which objective should be paramount at any one time since then. That such a mandate may, at times, create tensions for monetary policy, given the increasing ebbs and flows of the global macroeconomy and the widening influence of the international financial markets, has long been recognized.

As we have discussed with you over the years, the last decade has challenged the Fed's operating framework with issues such as: a falling natural rate of inflation, policy rates near the zero lower bound, a weakened relationship between unemployment and inflation, questionable estimates of the natural rate of unemployment, and a heightened awareness of the cost of unemployment. Remember, excess savings relative to intended investment has driven the global equilibrium rate of interest (the real rate of return required to keep the economy's output equal to potential output) well below zero. In response, global monetary policymakers responded appropriately by maintaining nominal short-term interest rates near the zero lower bound for an extended period.

On August 27, 2020, after a more than yearlong review of its monetary policy strategy, the Fed announced changes to the framework used for its policy actions and instituted "flexible average inflation targeting." (For details regarding this policy framework change, please see our discussion in the *Windward Capital 2020 Third Quarter Review*.) As a result, for all

intents and purposes, the Fed essentially decided that, going forward, it would throw away the rule book and let inflation run higher and unemployment run lower before seeking to tighten financial conditions. To be clear, this change left the central bank pursuing an almost completely discretionary monetary policy.

Monetary policymakers have long been moving in the direction of more discretion. The old rules-based approach governing when to tighten and loosen monetary policy has fallen into disfavor as those rules were proven to be unreliable in times when economic conditions swiftly changed. In retrospect, a reliance on guides such as the Taylor rule (which relates policy rates to output and inflation gaps) and the Phillips Curve (which relates inflation to unemployment rates) caused the Fed to over-predict inflation and set interest rates too high in 2018.

Even if the Fed could not rely on the old economic rules to guide policy, that guidance was still directed at sparking inflation toward its 2% target. First implemented in 2012, the target gave a sense of where the Fed wanted to go even if changing economic fundamentals made it less certain of how to get there. That has now changed, with Fed Chairman Jerome Powell signaling that the central bank will tolerate an inflation rate above its 2% target by an unspecified magnitude for an unspecified period of time before tightening monetary policy.

While the Fed has moved monetary policy in a dovish direction with these changes, it has also brought more uncertainty about the ultimate goal. Without a formula to define the "average," the Fed's interpretation of average is subject to change. Consequently, we do not really know the Fed's goal for the inflation rate in either the near or medium term—and, as you know, with greater uncertainty comes increased financial market volatility.

Given that the U.S. is now operating near "maximum employment" and economic growth remains strong, persistent near-term inflationary data has caused the Fed to reevaluate its recent monetary policy stance and err on the side of caution by initiating a reduction in monetary policy accommodation.

As a result, at the December 2021 Federal Open Market Committee (FOMC) meeting, the Fed announced a doubling of the pace at which it tapers its bond purchases to $30 billion per month—$20 billion for U.S. Treasuries and $10 billion for agency mortgage-backed securities. At this rate, the Fed should conclude its asset purchase program by March 2022 and be poised to actually start unwinding its balance sheet some time thereafter.

In addition, based upon the Committee members' December 2021 Summary of Economic Projections, it appears that the Fed is now planning to pull forward its increases in the short-term Federal Funds (Fed Funds) interest rate from 2023 with at least three hikes in 2022—with the possibility of additional increases should inflation readings prove more intransigent than the central bank is currently forecasting.

As always, these anticipated monetary policy actions remain data dependent, allowing the Fed to maintain its flexibility to adjust the details of its approach to "normalization" in response to changing economic and financial developments.

As we noted several times over the last two years, the inflation question is not about inflation alone, but inflation combined with how quickly the economy recovers. The risk for the interest rate outlook (i.e., the risk of higher rates) was that the economy would recover to full capacity operating levels faster than policymakers or financial market participants expected. As discussed earlier, we currently expect inflation pressure to moderate, over time. However, given the rapidity with which the U.S. economic output and employment gaps have subsequently closed, we cannot entirely discount the possibility that a variety of factors could cause inflation to remain elevated for longer than anticipated and that the Fed could be "behind the curve" in its efforts to control it. If true, the Fed will need to face the challenge of letting inflation remain persistently high in the intermediate term or risk causing a recession through more aggressive monetary policy actions.

In our view, the financial markets may have already discounted substantial future interest rate increases and less accommodative monetary policy actions. Despite the recent run-up in long-term nominal interest rates (and the anticipated increase in short-term

nominal interest rates), it is critical to realize that *real* interest rates remain negative, are still broadly accommodative for economic growth, and are significantly below their pre-pandemic levels. To maintain some perspective regarding the recent rise in nominal interest rates: only now have the increases in long-term (10- and 30-year) U.S. government bond yields approached the lower end of what has been a narrow range in rates that has remained in place for the last 10 years, pre-pandemic. Intermediate (2- and 5-year) U.S. government bond yields, on the other hand, are still at the lowest levels seen since 2016. This provides some economic headroom for an even higher move in interest rates, in our opinion.

We continue to monitor this situation closely.

The Beginning of the End?

Coronavirus cases continue to skyrocket around the world. However, although legitimate concerns exist, it appears that the latest coronavirus variant, Omicron—despite its high degree of transmissibility—is less virulent than the Delta variant, causing a more significant spread of cases than previously experienced, yet fewer severe symptoms that would typically require hospitalization and that could potentially be life threatening.

Based upon what is known so far, from an investment perspective the effect of the Omicron variant could represent a significant initial shift in the coronavirus from a pandemic to an endemic phase—namely, a variant that spreads like wildfire but with mostly mild symptoms, delivering a short, sharp shock that clears the way for a rapid return to life as normal. This would be a positive development.

Should this benign scenario prevail, it will further support continued global economic growth. In addition, a relatively benign Omicron outcome also reshuffles the political debate and splits the world into different camps. Those countries, such as the U.K., the U.S., Mexico, Brazil, and India, which are inclined to "live with the virus," will return to normal very fast. At the other extreme, China—trapped by a zero-Covid ideology, semi-defective vaccines, and two years of State propaganda extolling the country's superiority over the West for having successfully bottled up the virus—has scant natural immunity and remains more at risk for disruption.

The current lack of definitive data mean that, for now at least, the immediate epidemiological future of the coronavirus is uncertain: we could be in for a few months of relatively mild inconvenience before Omicron exits with a whimper, or we could be about to experience yet another exponential rise in hospitalizations and deaths. Whatever course Omicron—or future strains of the disease—might take, we believe that we are near the end of the pandemic as a *social* phenomenon.

From the first days of the coronavirus pandemic, both experts and laypeople have disagreed about the extent to which we should engage in social distancing, government-imposed shutdowns, or other mitigation measures. At every stage, some people wanted to take radical steps while others were more worried about the costs and drawbacks of such interventions. That debate still holds true today.

However, despite recent skyrocketing caseloads due to Omicron, fewer pundits or politicians are proposing strict measures to slow the virus' spread. The appetite for shutdowns or other large-scale social interventions is simply not there. Most current measures are predominantly in the realm of adaptation: the goal is to help cope with a potential surge of hospitalizations.

Reality may force some adjustments to this strategy over the coming weeks and months. If Omicron (or some more virulent strain of the coronavirus) starts to send patients to ICUs in the tens of thousands and brings hospitals to the brink of collapse, both politicians and citizens are going to respond. But if the goal had once been to stop an emergency from arising, serious restrictions like shutdowns are now relatively unthinkable.

Of course, epidemiologists have their own way of deciding that a pandemic is over. But one useful *social-scientific* marker is when people have gotten used to

living with the ongoing presence of a particular pathogen. By that definition, the massive surge of Omicron infections that is currently coursing through scores of developed countries without eliciting a more aggressive response could mark the end of the pandemic, in our view.

Viruses are most dangerous when they are introduced into a population that has never had contact with them before. The more "immunologically naive" people are, the more of them are likely to suffer from bad outcomes. This suggests that the next few weeks or months could provide us with significant protection against future strains of the virus: once a large portion of the population is exposed to Omicron (or has been vaccinated), humanity will be a lot less immunologically naive, which might help us better handle future strains of the coronavirus without a significant increase in mortality.

This is not a foregone conclusion, however. Omicron could turn out to afford those it infects with very brief or very weak immunity against other strains. Some future variant could turn out to be (at least) as infectious as Omicron and (at least) as deadly as Delta.

Regardless, the determination to "get on with life" remains a deeply held, and perhaps unchangeable, human desire. In that sense, the Spring of 2020 will be remembered as one of the most extraordinary periods in history—a time when people completely withdrew from social life to slow the spread of a dangerous pathogen. But what was possible for a few months has turned out to be unsustainable for years, let alone decades. In our opinion, whatever damage Omicron might wreak in the immediate future, we will, most likely, soon lead lives that look a lot more like they did in the Spring of 2019 than in the Spring of 2020.

The Long Game

As detailed in our *2020 First Quarter Review*, on an overall basis, our investment strategy during the pandemic crisis remained consistent with the investment strategy that we have followed in the past—essentially: to invest in high-quality businesses at the right valuations and hold them for as long as they remain high-quality businesses. In fact, the competitive strengths of these businesses, in many cases, *increased* as a result of the pandemic as lower-quality businesses failed to survive. As a result, this dynamic drove the valuations of companies held in *Windward*'s portfolios dramatically higher than previously seen.

Similarly, crises usually accelerate real, pre-existing trends in society and technology—they do not create or destroy them. Subject to constraints, therefore, 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. As a result, we did not make changes in *Windward*'s strategies to invest in those companies that were deriving benefits from near-term coronavirus trends (e.g., telecommuting, media streaming, etc.) because we believed that those trends would not persist. In addition, we did not invest in any speculative Healthcare companies involved in the discovery of a therapeutic or vaccine because we believed that the benefit to be derived from this discovery would primarily accrue to the existing businesses held in *Windward*'s portfolios. In other words, we continue to believe that the long-term secular investment themes that we have previously identified remain intact.

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

Information Technology regulation, Healthcare reform, Infrastructure investment, 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

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.

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, speculators, 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 mar-

ket 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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Harvard Global Health Institute
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National Institutes of Health
Organisation for Economic Co-operation and Development
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The Lancet
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U.S. Bureau of Labor Statistics
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U.S. Department of the Treasury
U.S. Federal Reserve
U.S. White House
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 website.

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 at 8:00 pm 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 or Form CRS free of charge, please email Steve Pene at : spene@windwardcapital.com, or call Mr. Pene at our main number: (310) 893-3000.

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