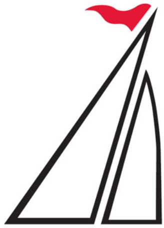
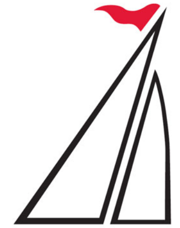


# WINDWARD CAPITAL

*Risk Averse Asset Management*

## 2022 Second Quarter Review



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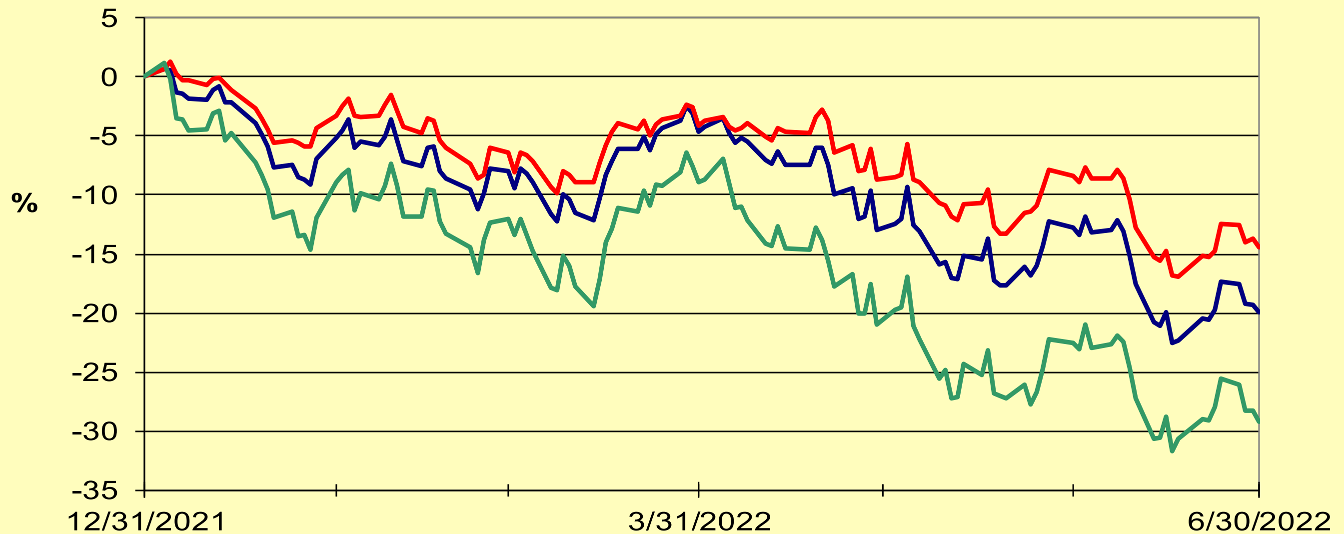


Source: Bloomberg

## *On Sale*

"If you spend more than 14 minutes a year worrying about the market, you've wasted 12 minutes."

— from *One Up On Wall Street* (1989)
Peter Lynch (b. 1944)
Legendary Investor and Philanthropist

After a modest pullback during the First Quarter of 2022, the major U.S. equity market indices extended their decline during the Second Quarter: the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) returned –16.11%, –10.78%, and –22.27%, respectively, for the period. As a result, for 2022 Year-to-Date, the S&P 500, DJIA, and NASDAQ have returned –19.97%, –14.44%, and –29.22%, respectively.

Among other things, the recent bout of financial market volatility appears to be related to significant uncertainties regarding the impacts of tighter monetary policy, inflation, and geopolitical conflict on the global macroeconomy and the resultant effect that these issues could have on the corporate revenue and earnings outlook. The extent and duration of these impacts remains unknowable. As a result, until there is greater clarity regarding the ultimate resolution of these uncertainties, we believe that the current inter-, and intra-, day financial market volatility may persist.

Fortunately, despite expectations for a near-term tightening of financial conditions and concomitant slowdown in growth, the U.S. economy remains in a relatively strong position and continues to be supported by factors that we have discussed in the past, which include: employment-driven increases in household income, substantial net worth of the

household sector, and a high level of savings accumulated during the course of the pandemic.

Predictably, some of the factors providing underlying support to the U.S. economy over the last few years 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 in and out of favor 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.

As we have noted in the past, 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.

Although 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 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.

## ***Lowering the Temperature***

In the first half of 2022, U.S. inflation remained well

above the Federal Reserve's (Fed's) longer-run objective of +2%, with some inflation measures rising to their highest levels in more than 40 years. Consumer price inflation, as measured by the 12-month change in the price index for Personal Consumption Expenditures (PCE), rose from +5.8% in December 2021 to +6.3% in May 2022. The 12-month measure of inflation that excludes the volatile food and energy categories (so-called "Core PCE" inflation) rose initially and then fell back to +4.7% in May 2022—down from a peak of +5.3% in February 2022 and +4.9% last December.

Indeed, several recent economic and industry-specific indicators suggest that U.S. inflation may have peaked in the near term as a result of tighter financial conditions, ongoing progress in matching supply/demand imbalances, a moderation in economic growth, and demand destruction, among other factors:

- ✓ Declining global freight rates (as well as other measures, such as excess retail industry inventories) indicate that global supply chain disruptions, albeit ongoing, continue to resolve. The Federal Reserve Bank of New York's Global Supply Chain Pressure Index—which is based upon global transportation cost, delivery time, backlog, and purchased stocks data—has declined –45% from its December 2021 peak, pointing to an easing in global supply chain pressures (even though they remain at historically-high levels).

- ✓ Many commodities (e.g., crude oil, copper, aluminum, lumber, cotton, wheat, etc.) have declined approximately –30% from their previous Spring 2022 highs, and several are now trading at 2021 levels.

- ✓ Higher mortgage rates have slowed U.S. home price growth and eased housing industry supply chain shortages/imbalances.

- ✓ Despite ongoing strength in U.S. employment, Nominal Average Hourly Earnings growth has moderated on a year-over-year basis, and the rate of change in broad-based measures of overall wages that adjust for compositional changes in the labor force, such as the Employment Cost Index and the Atlanta Fed's Wage Growth Tracker, show no indication of a "wage-price spiral."

Importantly, besides current measures of inflation, longer-term inflation expectations continue to remain anchored. We carefully monitor a wide range of indicators of longer-term inflation expectations (including both the 5-year and 10-year breakeven inflation rates; i.e., the spread in interest rates between ordinary U.S. government bonds and inflation-protected bonds that are indexed to consumer prices). After spiking higher earlier this year, these measures have now returned to levels broadly consistent with the Fed's inflation objective. This suggests that households, businesses, and financial market participants believe that current high inflation readings are likely to prove temporary.

Why do inflation expectations matter? Not because either financial markets or consumer surveys are especially good at predicting inflation; rather, the significance is that most economists believe *expected* inflation is an important determinant of *actual* inflation. This means that inflation, once it has become entrenched in expectations, can become self-perpetuating. In that situation, the primary way for monetary policymakers to bring inflation down is to raise interest rates in order to engineer an extended period in which demand falls significantly short of supply. This normally causes a slowdown in economic growth and, if taken too far, could lead to a recession. Understandably, the Fed does not want to be in the position of directly causing a recession; therefore, it remains attuned to the level of inflation expectations.

With regard to the current state of the U.S. economy, Real GDP decreased at a –1.6% annualized rate in the First Quarter of 2022, compared to an increase of +6.9% in the Fourth Quarter of 2021. However, this decrease was primarily related to a decline in Net Exports, and all of the other components of GDP (with the exception of Government Expenditures) were positive contributors. We expect that Second Quarter Real GDP could also show a headline decline because of the significant accumulation in retail industry general merchandise inventories experienced during the Quarter.

In our view, however, the underlying trend in the U.S. economy remains positive and is stronger than the recent negative headline GDP numbers would suggest. Indeed, the economic data that we analyze do not currently indicate that a recession is imminent. For example, Personal Consumption Expenditures and Gross Private Domestic Investment—which, combined, represent 90% of U.S. Real GDP—both remain positive. Annualized growth in Real Gross Domestic Income (GDI)—another way of measuring U.S. economic activity—also remains positive. Most importantly, a U.S. economy in recession tends not to generate 460,000+ jobs per month, on average, for the first six months of the year and have a current unemployment rate of 3.6%.

These, and other, data indicate that the U.S. economy remains strong and that the Fed, despite what appears to be a near-term peak in inflation, will continue in its mission to restore additional price stability.

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 or a geopolitical shock (i.e., the Russia-Ukraine conflict). 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 these issues wane.

## *Do No Harm*

In response to sustained inflationary pressures and a strong labor market, the Federal Open Market Committee (FOMC) raised the target range for the short-term Federal Funds (Fed Funds) interest rate off of the zero lower bound to 0.25-0.50% at its March 2022 meeting. The Committee continued to raise the target range in May and June, bringing it to 1.50-1.75% following the June meeting, and indicated that ongoing increases are likely to be appropriate. The Fed currently projects a central tendency Fed Funds rate range of 2.9%-3.6% by 2024. (Note that this is somewhat higher than the level of Fed Funds rates seen during 2018-2019.) With regard to the Fed's balance sheet (and in line with our detailed discussion in the *Windward Capital 2022 First Quarter Review*), the FOMC ceased net asset purchases in early March and subsequently began reducing its securities holdings in June. All of these monetary policy actions portend tighter financial conditions going forward.

In recent speeches, FOMC members have indicated a desire to "front load" interest rate hikes and "move policy back to more neutral levels" of around 2.0-2.5%. That objective is consistent with the Fed's 75 basis point move on June 15 and supports expectations of another 75 basis points Fed Funds increase at the July 27 meeting.

The path thereafter is the next critical monetary policy decision. A "neutral" level is only a waypoint: by definition, it does not put *downward* pressure on inflation; it just ceases to put *upward* pressure on inflation. As a result, the Fed has signaled that it expects to take policy slightly *above* neutral in 2023 but remains wary of arguing for a much more aggressively restrictive policy. There is a limit to how much above neutral the Fed wants financial market participants to price in right now. The Fed does not want a disruptive movement in rates to create a sudden slowing in economic activity that elevates recession odds. Such an outcome might be counterproductive in that too much near-term slowing could put a halt to rate hikes. This would be a suboptimal outcome given the proximity of the Fed Funds rate to the zero lower bound. A better approach is to find the right mix of

policy signaling that "boils the frog" on the U.S. economy rather than "shocks" it into lower inflation.

Consequently, a primary consideration for monetary policymakers is judging how responsive economic activity is to the rising level of interest rates. This responsiveness is likely to change over time and with the state of the economy. For example, with consumption skewed towards durable goods (whose demand tends to be more interest-sensitive than other components of spending), it is possible that higher rates will have a more pronounced impact on those sectors of the economy than observed in the past. On the other hand, high levels of liquidity in the economy and healthy household balance sheets might make consumption more resilient to higher interest rates than expected, requiring a steeper path of rate increases to slow demand growth and bring inflation down. In addition to domestic matters, the interplay of global macroeconomic and geopolitical factors must also be noted (most of these are beyond the Fed's sphere of influence, however). Regardless of these uncertainties, we would not underestimate the Fed's commitment to restoring price stability.

Despite the recent run-up in short- and long-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 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 only now back to 2018 levels. (From an even longer-term perspective, U.S. government bond yields still remain within the secular downtrend that started in the early 1980s.) As U.S. Real GDP hits historic highs, this provides some economic headroom for an even higher move in interest rates, in our opinion.

Over the coming months, the Fed will be looking for compelling evidence that inflation is moving down. We anticipate that the Fed will continue to raise short-term interest rates, and that the pace of those increases will continue to depend on the incoming data and the evolving outlook for the U.S. economy. The Fed's overarching focus is using their monetary policy tools to bring inflation back down to their +2% goal and to keep longer-term inflation expectations well-anchored.

As always, financial markets remain vulnerable to economic and monetary policy uncertainty. Given the current state of the U.S. economy—with inflation at a 40-year high and the unemployment rate near record lows—moving expeditiously to a neutral stance of monetary policy is appropriate, in our opinion. At the same time, the factors we noted earlier—including monitoring risks and the responsiveness of economic activity to interest rate changes—will be important guides in adjusting the pace of that transition.

The resolution of pandemic-induced supply/demand disruptions and the lagging impact of tighter monetary policy should contribute to an easing of inflationary pressures via the resultant moderation in economic growth. In the meantime, a monetary tightening cycle is always fraught with challenges. However, the rationale for removing accommodation is obvious when inflation is high, demand is strong, and the labor market is tight. Under those conditions, an economic "soft landing" is probable but not guaranteed—and the risk of recession still exists. While an outlook of easing supply constraints and moderating demand growth is consistent with inflation stepping down even as the labor market remains strong, less favorable outcomes are certainly possible. In the event high inflation persists while demand turns down and the labor market falters, monetary policymaker resolve may be tested—but should never be doubted.

## *Whatever It Takes II*

Overall Eurozone inflation was +8.6% in June 2022—ranging from +6.1% in Malta to +22% in Estonia—and is at its highest annual rate since the creation of the Euro currency in 1999. Like many other monetary policymakers, European authorities are try-

ing to address the region's inflation issues by raising short-term interest rates and curtailing Quantitative Easing.

As a result, the European Central Bank (ECB) plans to raise short-term interest rates for the first time in more than a decade by 25 basis points in July (from a current –0.50%). Rates are expected to continue rising thereafter under a self-proclaimed principle of "gradualism" that "should not necessarily be interpreted as slow action in small steps."

The ECB is only just starting to raise interest rates, months behind its counterpart in the U.S. Although high inflation is a global phenomenon, differences in the sources of price increases has allowed the ECB to take a slower approach. In addition, the Fed is trying to cool down an overheating economy, whereas European consumption has still not recovered to its pre-pandemic levels.

While the ECB fights inflation, it also has to ward off another potential crisis—the risk that raising interest rates and ending its massive bond-buying programs cause the borrowing costs of the financially-weaker Eurozone economies to spiral higher.

Recently, there have been growing concerns regarding the negative impact that financial tightening will have on countries that have significant debt burdens. In mid-June, Italy, for example, which has the Eurozone's second-highest ratio of government debt-to-GDP, saw yields on its 10-year government bonds climb above 4% for the first time since 2014. The gap, or spread, between its yield and Germany's, considered the region's benchmark, grew to the widest since early 2020, when the pandemic roiled bond markets.

These widening spreads evoke memories of some of the Eurozone's most turbulent years, particularly 2012. As you may recall, subsequent to the Financial Crisis of 2008, investors shunned Greece's debt, deeming it unsustainable, and worried about the economies of Portugal and Ireland. The fear spread to other southern, "Club Med," European countries with high debt and less-stringent fiscal management. Yield spreads on bonds in Italy and Spain subsequently "blew out" relative to the benchmark (Germany), and there were concerns about the ongoing viability and integrity of the Eurozone as a whole.

That Summer, Mario Draghi, who was then President of the ECB and is now the Prime Minister of Italy, famously vowed to do "whatever it takes" to preserve the Euro. Later, a tool was unveiled that would have allowed the bank to make unlimited purchases of a country's debt. Although it was never used, the creation of that tool alone was enough to help stabilize financial markets.

While the risks to the Euro are much smaller now compared to then, countries in the bloc face a variety of risks individually and have different fiscal abilities to manage them. The pandemic has undone some of the progress that highly-indebted countries made in lowering their debt burdens as they have needed to spend heavily on their crisis responses. As a result, the pandemic has left lasting vulnerabilities in the Euro area economy which are contributing to the uneven transmission of the normalization of the ECB's monetary policy across jurisdictions.

The borrowing costs of Eurozone countries have diverged sharply in recent weeks, particularly between Germany, Europe's largest economy, and Italy, in anticipation of the bank's raising interest rates. This widening gap, an example of market "fragmentation" (a sudden break in the relationship between government borrowing costs and economic fundamentals), illustrates the delicate task facing Europe's central bankers as they tackle inflation, and could impair the ability of the bank to manage monetary policy across the 19 countries that use the Euro. (Remember, the ECB is tasked with having to supply one interest rate policy for 19 disparate economies that have different growth and debt dynamics and are not bound by either a political or a fiscal union.)

In order to address this issue, the ECB stated on June 15, 2022, that it would take new steps to protect against spiraling borrowing costs for some of the highly-indebted members of the Eurozone. The announcement followed an unexpected meeting of bank policymakers looking to soothe growing concerns in the bond market.

The ECB said it would consider using the reinvest-

ment of proceeds from maturing bonds in its €1.85 trillion ($1.9 trillion) pandemic-era bond-buying program to avoid this fragmentation, by buying bonds that would help bring down governments' borrowing costs. The bank confirmed that it would make these bond purchases with "flexibility," a term used to describe the bank's ability to steer purchases to different bond maturities and between countries to best support its monetary policy goals (such as buying a large portion of Italian debt). The bank also said it would accelerate the design of a new tool to combat market fragmentation. The tool—to be considered at the ECB's July 20-21 meeting—is currently referred to as the Transmission Protection Mechanism. Many details of the instrument remain unknown, including how the ECB plans to ensure asset purchases do not upset efforts to remove monetary stimulus, what kind of conditions countries must fulfill, and how to make the program legally watertight.

The announcement of both the flexible reinvestments and the new tool served to bring bond yields down across the Eurozone: Italy's 10-year government bond yield fell to 3.26% as of June 30 from a high of 4.17% on June 14, and its gap with Germany's yield has also narrowed.

The ECB faces a particular challenge as it determines Eurozone monetary policy across a range of disparate economies. On the one hand, it is tightening monetary policy in the face of undesirably-high inflation, but on the other hand it is trying to ease financing conditions for some of its more highly-indebted member countries via bond purchases. We will continue to monitor this balancing act and its implications for the global macroeconomy as it unfolds.

## *Made-Up in China*

Since the Omicron variant of the coronavirus arrived in China, the government has maintained harsh lockdowns, mass testing, strict isolation, and border restrictions, arguing that such measures are needed to protect the population. While the rest of the world is trying to live with COVID, China is the only major economy still prioritizing the fight against the virus above almost everything else.

As a result, China's zero-COVID policies have triggered an economic slowdown that is in some ways worse than the one in early 2020 during the initial outbreak of the coronavirus in Wuhan. A two-month lockdown in Shanghai, China's commercial capital, and sporadic lockdowns elsewhere have hampered assembly lines, trapped workers, snarled logistics, and confined millions of consumers to their homes. In the First Quarter of 2022, China's GDP grew at +4.8%, up from +4% during the Fourth Quarter of 2021 but below the official annual target of +5.5%. Since many of the harshest COVID containment measures have been imposed in the Second Quarter, it is doubtful that the country can achieve its annual growth target. Although most of these lockdowns were eased in June, a recent increase in COVID cases has once again put several regions under the restrictions.

The country's Premier, Li Keqiang, recently announced efforts to bolster growth and urged local leaders do more to keep the economy running. Mr. Li said China needed to find a balance between its zero-COVID policy and promoting economic growth, seemingly putting him at direct odds with President Xi Jinping, who has repeatedly warned that no other path is acceptable and who is up for re-election for a third term at the Communist Party Congress in November 2022. In the meantime, authorities are pinning hopes of economic growth on infrastructure construction, which rose by +8.5% in the First Quarter. They are also pulling levers to encourage home sales, a conventional tool to ramp up the economy that has been depressed since the onset of the pandemic and the fallout from the default of the world's most-indebted property developer, *China Evergrande Group*.

In our view, whether China grows above +3%, +4%, or even +5% this year is irrelevant. What really matters to the underlying economy is the intense degradation in the quality of Chinese growth. As in 2020, growth in 2022 will be driven mainly by non-productive investment and government spending and very little by consumption and business investment. This will be accompanied by a surge in the country's

debt burden.

As we have discussed in detail over the years in previous *Windward Capital Quarterly Reviews*, China's current economic growth model is unsustainable, in our opinion. China's GDP growth is not a measure of the country's economic output and performance in the same way that the statistic is used for other major economies. China's GDP growth target is an input decided by Beijing at the beginning of the year. Its fulfillment depends on the extent to which the economic authorities are able and willing to use the country's resources and debt capacity to achieve the required amount of economic activity. Higher GDP growth for China, in other words, does not mean a better economic outcome than lower GDP growth, as it does for most other economies. It just means that the authorities were more willing to employ resources for creating economic activity, whether or not that activity is productive, sustainable, or value-enhancing.

That being the case, what matters is not the level of GDP growth China manages to reach in 2022 but rather the way in which that growth, whatever its level, is achieved. Beijing has already long distinguished between "high quality" growth and "other" growth, a distinction that was reflected in an important essay last year by President Xi in which he called for more "genuine," not "inflated," growth.

Broadly speaking, "genuine" growth can be thought of as sustainable growth generated largely by consumption, exports, and business investment (with the last of these elements aimed mostly at serving the first two), whereas "inflated" growth consists mainly of nonproductive, or insufficiently productive, investment in infrastructure and real estate. The purpose of inflated growth is to bridge the gap between genuine growth and the GDP growth target deemed necessary to achieve the Chinese leadership's political objectives.

This reinforces our view that the surge in China's debt burden in the past decade, among the fastest in history, is a result of the economy's overdependence on nonproductive investment in property and infrastructure to balance out its structurally-high savings rate and to bridge the gap between genuine growth and the GDP growth target.

Even with a substantial and rising amount of wasted investment, which showed up in the staggering amount of nonperforming loans in China's banks that were cleaned up between 2000 and 2010, China's high investment levels during that period were nonetheless productive in the aggregate and resulted in rapid, sustainable growth. By 2006 to 2008, however, like every other country that has followed a similar high savings, high investment growth model—most notoriously the Soviet Union in the 1950s and 1960s, Brazil during those same decades, Japan in the 1970s and 1980s, and perhaps a dozen other countries—China seemed to have closed the gap between its level of capital stock and the level that its workers and businesses could productively absorb, after which China's debt burden began to rise rapidly.

The problem with this stage of the development model—and it is worth repeating that this also happened to every other country that followed a similar approach—is that the continued high levels of growth generated by systemic investment misallocation are not sustainable. Once it reaches that stage, such a country must shift to a new growth model, perhaps a much more bottom-up one in which the authorities abandon their previous supply-side orientation in favor of income redistribution and demand-side support.

Until the country begins this difficult adjustment, it can continue to grow rapidly only with the piling on of more nonproductive investment, creating more inflated growth. Because this fictitious growth is not sustainable, it must eventually be amortized, and in every previous case the period of adjustment reversed much of the previous growth. Unfortunately, the more fictitious growth that is created, the more politically difficult and economically costly the amortization of this growth tends to be.

While Chinese economic policymakers and advisers increasingly recognize that China's existing growth model is reaching its limits, the political importance of the year 2022 for the country's leadership is likely to mean at least one more year of rapid growth driven by investment excesses, even though the economy has been badly hurt by the recent pandemic-related

lockdowns of significant parts of the economy. Historical precedents, however, suggest that the longer it takes for Beijing to make the decision to rebalance its growth model, the more economically difficult and politically disruptive the ultimate adjustment is likely to be.

## *Back to Basics*

Our strategy during the current investment environment remains 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 addition, 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 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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International Monetary Fund
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U.S. Congress
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 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.

# NOTES

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