WINDWARD CAPITAL

Risk Averse Asset Management

2022 Third Quarter Review

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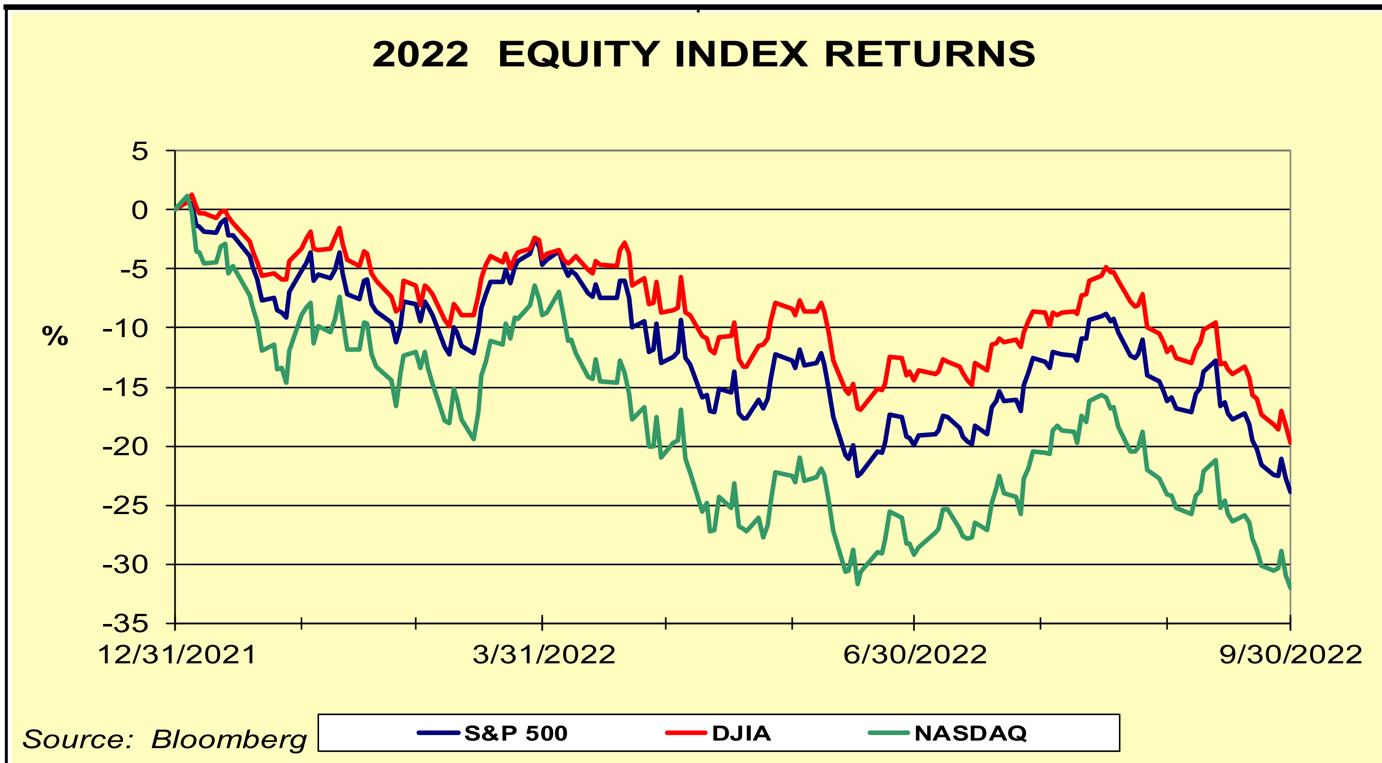

Fear vs. Greed

"An optimist is a person who sees a green light everywhere, while a pessimist sees only the red stoplight … the truly wise person is colorblind."

— Albert Schweitzer (1875—1965)
French Doctor, Philosopher, Theologist,
Nobel Peace Prize winner

After rebounding anywhere from +14% to +23% off of their mid-June 2022 lows, the major U.S. equity market indices subsequently re-tested those lows in September and ended the Third Quarter with the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) returning –4.89%, –6.17%, and –3.91%, respectively, for the period. As a result, for 2022 Year-to-Date, the S&P 500, DJIA, and NASDAQ have returned –23.88%, –19.72%, and –31.99%, 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.

Don't Fight the Fed

On September 21, 2022, the U.S. Federal Reserve (Fed) raised the short-term Federal Funds (Fed Funds) interest rate by 75 basis points to a range of 3.00-3.25%. As you will recall, in response to sustained inflationary pressures and a strong labor market subsequent to the coronavirus pandemic, the Federal Open Market Committee (FOMC) initiated the current monetary policy tightening cycle by raising the target range for the Fed Funds rate off of the zero lower bound to 0.25-0.50% at its March 2022 meeting. The FOMC is currently projecting a Fed Funds rate of 4.25-4.50% at the end of 2022—the highest since the 2008 Financial Crisis—which suggests a combined additional +125 basis points of rate increases at the November and December FOMC meetings. In addition, with regard to the Fed's balance sheet, the FOMC ceased net asset purchases in early March 2022 and subsequently began reducing its holdings of U.S. Treasury securities and agency debt and agency mortgage-backed securities in June—currently at a rate of $95 billion per month.

These monetary policy actions portend tighter financial conditions going forward. Indeed, at the September press conference, Fed Chairman Jerome Powell indicated that the Fed remains far from the end of its monetary policy tightening, stating, "We will keep at it until we are confident the job is done."

This year's relatively rapid increase in monetary policy tightening is in response to the ongoing persistence of global inflation. By the time many global central bankers gathered at Jackson Hole in August for their premier annual conference, the mood had shifted decisively towards the greater action that is now being played out around the world. The Fed's plan to curtail consumer and business spending in a bid to reduce domestic inflation has been replicated elsewhere, even if the causes of high inflation are different. For example, in Europe, the extraordinary price of natural gas due to the Ukraine conflict have sent headline rates of inflation to similar levels as in the U.S., but core inflation is significantly lower. In emerging economies, declining currency values against the U.S. Dollar, which recently hit a 20-year high, have driven import prices higher.

It is important to remember that monetary policy works with long and variable lags. At some point, therefore, as the stance of monetary policy tightens further, it will become appropriate for central banks to slow the pace, while they assess how their cumulative policy adjustments are affecting their economies and inflation.

Unfortunately, central banks are moving so rapidly that, as they put these rate hikes in place, there really has not been enough time for them to judge what the feedback effects are on the global macroeconomy, and an increasing number of economists think that monetary policymakers are now being excessive in their actions to raise interest rates and that the effect of all of this tightening will be a global recession.

Indeed, based upon real-time forward, rather than lagging, indicators, some economists believe that the Fed has already over-tightened. For example, certain economists (e.g., monetarists) monitor current changes in the global money supply because they believe that such changes affect the price levels of securities, inflation, exchange rates, and the business cycle. Under the monetarist approach, the fact that several "narrow" and "broad" money supply indicators have been contracting for many months suggests that inflation risks are already fading fast and that further monetary policy tightening is unnecessary.

Certainly, 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 be dynamic, changing over time and with the state of the economy. In addition to domestic matters, the interplay of global macroeconomic and geopolitical factors must also be noted. Despite these uncertainties, we would not underestimate the Fed's commitment to restoring price stability.

As such, restoring price stability will likely require maintaining a restrictive policy stance for some time, because the historical record cautions strongly against prematurely loosening policy. Although reducing inflation is likely to require a sustained period of below-trend economic growth and softening of labor market conditions, restoring price stability is essential to set the stage for achieving maximum employment and stable prices over the longer run.

Help Wanted

Overall, the U.S. economy continues to slow from the historically high growth rates of 2021, which reflected the reopening of the economy following the pandemic recession. Recent indicators point to modest growth of spending and production. Growth in consumer spending has slowed from last year's rapid pace, in part reflecting lower real disposable income, tighter financial conditions, and the waning fiscal impact of the American Rescue Plan Act. Activity in the housing sector has weakened significantly, in large part reflecting higher mortgage rates. Higher interest rates and slower output growth also appear to be weighing on business fixed investment, while weaker economic growth abroad is restraining exports. Despite moderating, however, the U.S. economy continues to grow, and a recession does not appear imminent.

Despite the slowdown in growth, however, the U.S. labor market has remained extremely tight, with the unemployment rate near record lows, job vacancies near historical highs, and wage growth elevated. Although job gains have been strong—with employment rising by an average of 372,000 jobs per month over the last three months through September 2022—these gains have been moderating (537,000 jobs added in July, 315,000 in August, and 263,000 in September). While it is unclear when the pace of job growth will reach a longer-term sustainable rate, it appears likely to continue to slow in the months to come.

In our view, trends in upcoming monthly employment data will be critical to the Fed in determining its outlook for future monetary policy tightening actions. From that perspective, although still strong, some of the data contained within the September employment report are encouraging.

For example, employment grew by 263,000 jobs in September—the lowest in a year and a marked deceleration of the previous eight months' average of 464,750 (yet still above pre-pandemic growth rates). Wages rose just +0.3% for the month and are up +5% from a year earlier, the lowest since December 2021. Wages of non-management leisure and hospitality workers, a good barometer of wage pressure, rose just +0.3% for the month, and have grown at a +4.1% annual rate in the last three months, the lowest since early in the pandemic. Combine these data with a drop in job openings, and this currently looks like a labor market headed for a soft landing. With the impact of recent monetary tightening yet to be fully felt, a continuation of recent trends should lead to employment falling further.

Although encouraging, the September 2022 employment report, on its own, is still solid enough to keep the Fed on track for another large interest-rate increase at its November meeting as officials seek to lift borrowing costs high enough to soften the labor market further and ease inflation pressures.

"Peaky"

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 –75% from its December 2021 peak, pointing to an easing in global supply chain pressures (even though they remain at historically-high levels).

- ✓ Although crude oil prices have recently bounced after a –30% decline, many other commodities (e.g., natural gas, copper, aluminum, lumber, cotton, wheat, etc.) have declined approximately –30% to –60% off of their previous Spring/Summer 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. Over time, this should contribute to lower Owners' Equivalent Rent (OER), which is a significant component of certain inflation statistics.

- ✓ 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."

Although many components of inflation appear to have peaked, overall inflation remains well above the Fed's +2% longer-run goal—over the 12 months ending in August, total Personal Consumption Expenditures (PCE) prices rose +6.2%; excluding the volatile food and energy categories, core PCE prices rose +4.9% over the same period—and price pressures remain evident across a broad range of goods and services. Although its trend rate of growth is no longer *accelerating*, the elevated level of inflation remains persistent and is not moderating as quickly as anticipated.

Despite elevated levels of current inflation, longer-term inflation expectations appear to remain well anchored, as reflected in a broad range of surveys of households, businesses, and forecasters, as well as measures from financial markets. This indicates an expectation that the Fed will be successful in its efforts to ultimately control inflation.

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 and have whipsawed recently in an effort to digest both slower growth prospects globally, but also emerging financial stability concerns. While there have been some increased volatility and liquidity strains in financial markets lately (e.g., in the U.K.), we believe that, overall, markets are operating effectively. Actions by banks and financial regulators in recent years have greatly strengthened the financial system. Banks are well capitalized, and the functioning of the U.S. Treasury, equity, and commodity markets remains orderly.

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 restrictive stance of monetary policy is appropriate, in our opinion. At the same time, 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.

Ms. Truss'd

For the moment, Britain has narrowly avoided a self-inflicted financial crisis that threatened to dislocate the global financial markets.

On September 23, 2022, the U.K. government unveiled the biggest tax cuts since 1972 in a bid to boost economic growth but with little detail regarding how they will be financed—this at a time of full employment and high inflation. Subsequently, the British Pound (Sterling) crashed to its lowest-ever level against the U.S. Dollar, the cost of insuring British government debt (Gilts) against the risk of default soared to the highest since 2016, and the Bank of England (BoE) was forced to temporarily intervene amid concerns about the state of the nation's pension funds.

Incoming U.K. Prime Minister Liz Truss of the Conservative (Tory) Party, who took over from former Prime Minister Boris Johnson on September 06, 2022, has appointed Kwasi Kwarteng as her Chancellor of the Exchequer (Treasury). On September 23, Chancellor Kwarteng announced a set of economic policies (in what is informally known as a "mini-budget") that precipitated the crisis.

Among the more significant components of Kwarteng's mini-budget were the following:

- a cut in the basic income tax rate from 20% to 19%
- cancellation of the 45% higher income tax rate paid by people earning over £150,000 a year
- cuts to the stamp duty, which is charged on property purchases
- an emergency energy package, under which household bills will be frozen for two years
- reversal of the recent 1.25% increase in the National Insurance tax
- cancellation of the proposed Health and Social Care Levy
- scrapping of the limit on bankers' bonuses
- cancellation of the rise in the corporate tax rate, which was set to increase from 19% to 25%
- establishment of infrastructure and investment zones, with lower regulations for those who build businesses
- steps to reduce planning restrictions for land use

The Conservative government hopes that this program of lower taxes and deregulation will turbocharge the U.K. economy, stave off a recession (that the BoE says has already begun), and shake the U.K. out of a decade of weak growth. Per Chancellor Kwarteng, this mini-budget will cost £161 billion over five years (not including the energy package, which is estimated to cost £60 billion over the initial six months), will ultimately reduce debt as a percentage of Gross Domestic Product (GDP), should help curb inflation, and is intended to stimulate +2.5% trend growth in the medium term. While its goals may be laudable, in our opinion many of the economic assumptions contained within the mini-budget remain questionable, at best, and/or poorly designed, at worst.

Although most of the measures in the mini-budget were largely in line with what had been previously telegraphed, the financial markets reacted extremely negatively to the actual announcement—not because the Chancellor did a lot more than what he had said the Treasury would do, but rather because he signaled an intent for potential *further* policy easing and a lack of deference to the U.K.'s fiscal police, the Office for Budget Responsibility (OBR).

This was never going to be an easy time to sell such a bold policy. The foreign exchange markets have been fragile over the Summer as the U.S. Dollar has strengthened in concert with the U.S. Federal Reserve's tighter monetary policy actions. Central banks, in general, have been *tightening* policy, and the price of government bonds has fallen as the financial markets have revised interest rate expectations upward. In the current macroeconomic environment, the speed, style, and scale of the mini-budget took market participants by surprise given their contrary approach and unfunded nature.

In terms of credibility, the Chancellor did not help himself by firing his respected Permanent Secretary, Tom Scholar, in his first week in office. In addition, refusing to commission a forecast from the independent OBR was an elementary error that could have been an opportunity for Kwarteng to validate his plan by demonstrating how his numbers reconciled. And for all the talk of regular meetings with the Governor of the BoE, U.K. fiscal policy is now explicitly at cross-purposes with its monetary policy: the Treasury seems to be aiming for a looser overall macroeconomic stance than the Bank. That is the opposite of policy coordination.

As markets tumbled, the BoE was forced into action to prevent a Gilt market crash by reversing course on its anticipated Quantitative Tightening measures (i.e., *selling* Gilts) and, instead, promising to *buy* whatever long-dated Gilts were needed so as to restore order to the market (i.e., Quantitative Easing). That set off a rally in long-dated Gilts, thereby decreasing interest rates. (The BoE also subsequently announced longer-lasting measures, such as a new facility designed to ease strains on U.K. pension funds that use liability-driven investing strategies.) But this increases the potential for two future risks: that the bank will have to raise interest rates even further than anticipated within weeks, and that investors could question whether the BoE has lost its independence.

In essence, in a single week, Britain has gone from being one among many nations facing significant economic headwinds to being a financial outlier: its currency plunging, bond yields and mortgage rates rising, and pension funds scrambling to stay afloat. It is possible that, between the BoE's interventions and the possibility of some moderation before the publication of Kwarteng's planned medium-term fiscal plan and new forecasts from the OBR, the economic crisis may abate. But the damage to the U.K.'s reputation—and that of the Conservative party's political future—may already be done.

The Truss government has savaged the credibility of public institutions and U.K. policymaking, they have assaulted the Treasury, repudiated fiscal transparency, caused mayhem in the Gilt and foreign exchange markets, and forced the BoE into an ill-timed return to Quantitative Easing.

Following criticism from several Conservative Members of Parliament, Chancellor Kwarteng partially reversed course on October 03, 2022, and said that the government would not pursue the plan to abolish the 45% higher rate of income tax paid by people earning over £150,000 a year. Kwarteng said the plan had become a "distraction from our overriding mission to tackle the challenges facing the country." He also indicated that he would bring forward the publication of his fiscal plan from November 23 to later this month instead, and its expected focus will be on spending and deregulation.

While this recent reversal may ease the immediate political pressure, the fundamental economic concerns about the unfunded tax cuts remain, however. In terms of the overall economic package, this retreat is relatively small. Indeed, the tax rate retreat signals less of a recognition of the economic realities than of the political ones: what became clear to Liz Truss and Kwasi Kwarteng was that they simply would not be able to prevent a parliamentary revolt on the issue, and that it would make other measures more difficult to achieve.

Politically, the underlying danger exposed by this about-face is clear: Truss and Kwarteng now look like they can be pushed around by their political foes within the Conservative party. The risk for Truss and Kwarteng is that those Conservatives hoping to destabilize the new government—some with a view to replacing it—might now try to force a reversal of other parts of the Prime Minister's economic strategy.

Barely three weeks into her job, Ms. Truss has suffered a dizzying loss of public support. According to certain polls, her Conservative Party now trails the opposition Labour Party by 33 percentage points. That is the largest Labour Party lead since Tony Blair's early days as Prime Minister in 1998, and the kind of gap that usually results in a landslide election defeat. Although the recent 45% tax cut reversal may placate the markets (and probably some voters), it is a heavy psychological blow for a leader who ran her campaign, and has built her government, on the conviction that tax cuts and supply-side policies will reignite growth. Abandoning that conviction would undermine the ideological rationale of her government and potentially turn her into a lame-duck leader until the next election, which she has to call before January 2025.

It remains to be seen whether these events will temper Truss' ambitious supply-side reforms aimed at boosting growth, however: at the moment, her rhetoric appears to indicate that she will double down instead. In the early 1970s, Anthony Barber, the then Chancellor, similarly sought to unleash Britain's growth potential through unfunded tax cuts and easy credit. Output briefly soared (known as the "Barber Boom") before hitting a wall of high inflation, industrial unrest, and an oil crisis. His boom was seen as triggering the series of policy errors that led inexorably to Britain's emergency loan from the IMF in 1976 (at the time, the largest amount ever requested of the Fund) in response to the collapse of the Sterling.

Despite the historical rhyme, we do not anticipate that the U.K. will repeat its 1970s experience. First, the U.K. remains fundamentally solvent. The nation's debt stock has risen in recent years, but it still compares well with other G7 countries. Second, floating exchange rates are much more firmly embedded than in the 1970s. Exchange controls are a distant memory, and the Sterling foreign exchange market is deep and liquid. Third, unlike in the 1970s, the BoE is independent. Its remit is to stop inflationary booms. The financial markets are now predicting steep rises in interest rates, and the Bank has a reputation to maintain: if fiscal policy is looser, it has to tighten monetary policy regardless of the political environment and directives of the Treasury.

In the longer term, the U.K.'s economic performance will need to advance if the country wants to improve its overall standard of living. Tactically, there is a veritable "laundry list" of measures that any country can take to help achieve this goal: Systematic tax reform is necessary. There must also be difficult deregulation, notably of land use. The government must supply first-class public goods, in the understanding that these are a social benefit, not a cost. There must be fiscal and monetary stability. There must be far higher investment in physical and human capital, innovation, research, and skills, both public and private. There must be higher savings. There must be a pro-growth regional policy. There must be an internationally-open economy. There must be stable and credible trade policies.

Despite the near-term financial market dislocations, the long-term economic context is clear: this will be a marathon, not a sprint, and the public and private sectors must both be committed to putting in the necessary work to achieve these goals. Obviously, this is a daunting task—and it will be a heavy lift. However, it is imperative that the U.K. demonstrates concerted progress on these issues if it is to successfully improve its standard of living while competing in a more dynamic global macroeconomic environment.

Party Lines

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. In our view, 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 non-productive investment in property and infrastructure to balance out its structurally-high savings rate and to bridge the gap between genuine growth and the central leadership's GDP growth target.

While Chinese economic policymakers and advisers increasingly recognize that China's existing growth model is reaching its limits, the political importance for the country's leadership of this year's upcoming 20th National Congress of the Chinese Communist Party 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.

Resolving China's debt burden and rebalancing the sources of demand in the Chinese economy may have an important impact on the distribution of power within the Chinese government. More specifically, this process may exacerbate and intensify a conflict that is brewing between Beijing and provincial and municipal government officials and has important implications for the rebalancing of China's economy that we have discussed in the past.

China's property market slowdown and strains from the country's zero-COVID campaign are putting new pressure on local governments' finances, forcing some to rein in spending.

Local governments, which shoulder much of the expense for education, healthcare, and other services in China, were already struggling with high debt loads and unsustainable expenses as 2022 began. Now the strains are getting worse. Cities must fund costly mass COVID testing programs imposed by Beijing to try to keep caseloads near zero. They are also being asked by Beijing to support stimulus meant to revive growth, including tens of billions of Yuan worth of railways and other infrastructure projects. On top of all that, cities are being tasked with delivering unfinished housing projects across China, after numerous developers defaulted on debts amid a year-long slide in home sales.

Yet as demands on cities escalate, their revenues are shrinking. Land sales, which currently comprise about 40% of local governments' revenues, have dried up as property development grinds to a halt. Local governments are also collecting less in taxes, as Beijing offers more tax relief for private companies to promote growth.

Top officials in Beijing have said they are aware of cities' struggles. The central government has earmarked a record 9.8 trillion Yuan ($1.37 trillion) in transfer payments to local governments this year in part to help offset reduced tax revenue. Authorities have also rolled out new lending quotas for Chinese banks to help cities pay for infrastructure, and they are pulling forward 1.8 trillion Yuan ($250 billion) in transfer payments to local governments from 2023 to this year.

However, this central government support may fall short of what is needed. Local governments in China have limited power to tax and raise funds directly. About 60% of most tax revenue goes to the central government, while local governments keep the rest. Borrowing by local governments is restricted under an annual quota allocated by Beijing. Over the past two decades, local governments have skirted official limits and amassed a huge volume of debt by borrowing through opaque channels, including special-purpose entities known as local government financing vehicles (LGFVs).

The costs of resolving China's bad debt are large enough, but there is also the cost of rebalancing demand within the economy. China invests roughly 20 to 30 percentage points of GDP annually in the property and infrastructure sectors of the economy. This is far too high a share of GDP to be sustainable and must (and, eventually, will) come down sharply.

If the domestic share of Chinese consumption is to become an important enough driver of growth to accommodate a sharp reduction in the investment share, Chinese households will directly or indirectly have to retain a share of GDP that is at least 10 to 15 percentage points greater than their current share, and, conversely, some other sector or sectors must suffer a 10 to 15 percentage point reduction.

There are various ways in which this could happen, many of them very painful and value-destroying, but the way that would be least damaging to the economy involves implicit or explicit transfers from one of the non-household sectors of the economy to the household sector.

For a variety of reasons, we believe that the government is the only non-household sector that can ultimately bear these costs. But which level of government: local governments or the central government? Given its centralizing tendencies, our assumption is that Beijing will try to force local governments to absorb the bulk of the adjustment costs, which means ultimately stripping them of a substantial share of their revenue sources and, perhaps more importantly, their assets.

The required transfer is large enough that it will almost certainly result in a major redistribution of political power, making this decision among the most important and contentious political decisions China is likely to face for many years. While this process has not yet started in earnest, it seems to be the logical culmination of the way Beijing has handled the limited adjustments China has already made toward a new growth model. National policymakers have already come down hard on the property sector, which was a major source of revenue for local governments, and while it now seems that it underestimated the economic impact of its attempts to slow down the out-of-control property sector, it is pretty clear that it had long wanted to do this anyway.

Beijing's next step is to control the ability of local governments to raise large and risky amounts of debt—especially via LGFVs.

Ultimately, we believe that local governments will be forced to liquidate or otherwise deploy their extensive ownership of real estate and state-owned enterprises to fund what in effect must be a major transfer of income and wealth, both to resolve bad debt and to increase the household sector's share of GDP. This will inevitably be a difficult process and might prove politically disruptive, but one way or another we expect it to be at the heart of China's adjustment process over the next several years.

This represents a notable shift from the past. Since Deng Xiaoping launched his "reform and opening-up" agenda in 1978, China has usually managed to strike a dynamic balance between local government accountability and local policy innovation, thereby maximizing the benefits and minimizing the costs of both. Local governments have long served as a major source of policy innovation in China. While the central government drew up the main policy road map, local governments were encouraged and inspired to pursue policy innovation, experimentation, and adaptation.

Because local governments were empowered to adapt policies and programs to their context, policy shocks became less likely. This counteracted the shortcomings of China's formal institutions and allayed private-sector concerns about protection of property rights, access to markets, and infrastructure, thereby helping to spur dynamism at all levels of the economy. Local-level policy innovation thus played an integral role in driving China's "economic miracle."

In recent years, however, such local innovation has become increasingly rare. This is partly because local officials fear the political consequences, and the central government's strengthened anti-corruption drive has exacerbated their anxiety. But the changed behavior of local governments may also reflect changes to their core incentives caused by China's apparent efforts to move away from the decentralized system of the past.

This change will have far-reaching implications for the nation's economic development. Unless China commits to pursuing comprehensive structural reforms and building a more complete market system, a move away from the regionally decentralized system of the past will expose the flaws in its economic system. Those flaws—which local-government competition under a regionally decentralized system at least partly mitigated—will become obstacles to economic dynamism and sustained growth, in our opinion.

Fundamental Matters

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:
Bank of England
Bloomberg
Congressional Budget Office
Council of Economic Advisers
Eurostat
Federal Reserve Banks of Atlanta, New York, and St. Louis
International Monetary Fund
Organisation for Economic Co-operation and Development
Reuters
U.K. Treasury
U.S. Bureau of Economic Analysis
U.S. Bureau of Labor Statistics
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.

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