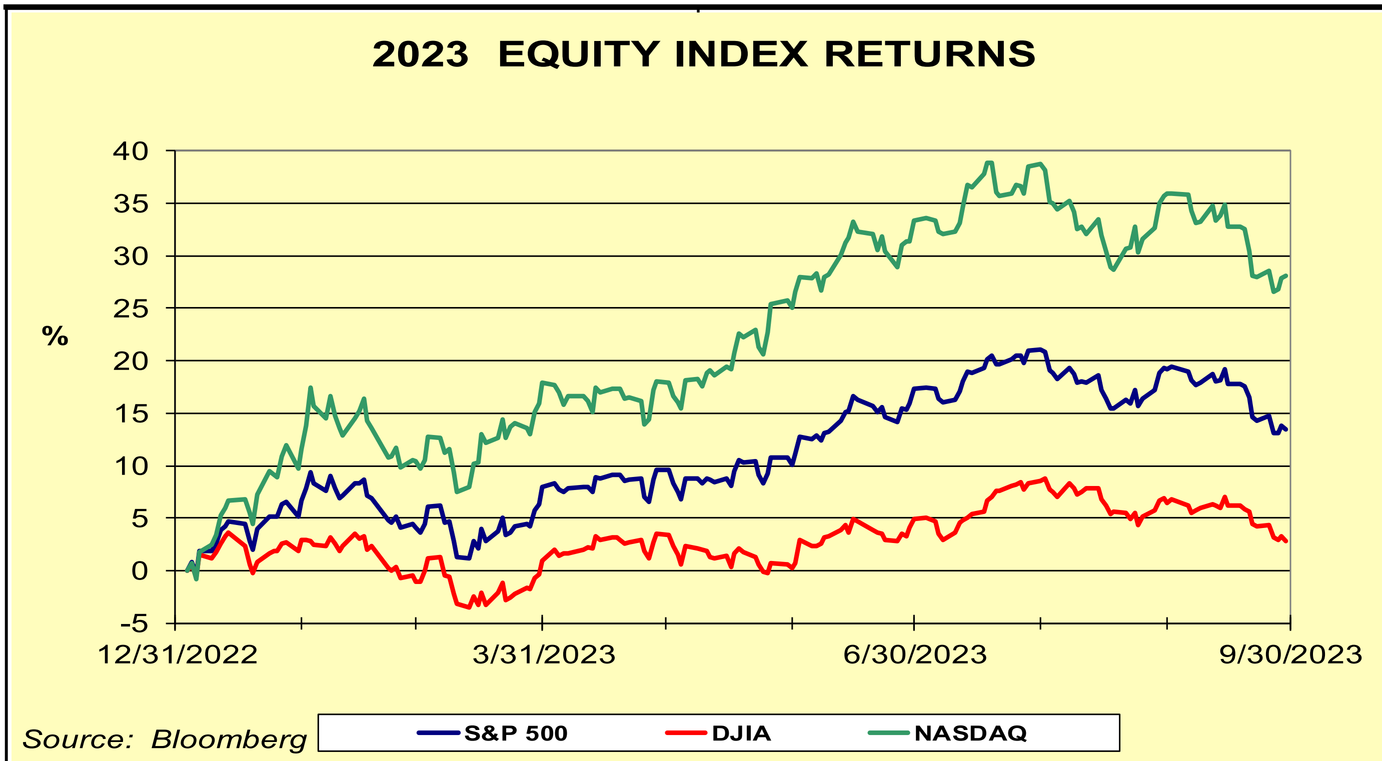
WINDWARD CAPITAL

Risk Averse Asset Management

2023 Third Quarter Review

Volume 28, Issue 3 October 13, 2023



Unbalanced

"I used to think that if there was reincarnation, I wanted to come back as the President or the Pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody."

— James Carville (b. October 25, 1944)
American Political Consultant

The major U.S. equity market indices' positive first half momentum stalled during the Third Quarter of 2023, with the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) declining –3.27%, –2.10%, and –3.94%, respectively, for the period. However, for 2023 Year-to-Date the S&P 500, DJIA, and NASDAQ still remain positive, with returns of +13.06%, +2.73%, and +27.11%, respectively.

It is important to recognize, however, that these overall equity market gains have been primarily driven by the stocks of a select few companies. Specifically, the top seven companies (by market capitalization) in the S&P 500 currently represent 27.52% of the total Index (and are, notably, all in the Information Technology sector). As a result, although the market-weighted S&P 500 is up +13.06% Year-to-Date, the S&P 500 on an equal-weighted basis is up only +1.79% during the same period. Historically, this type of narrowness and divergence in returns is not usually sustainable—and is typically resolved either by a correction of the leading stocks and/or by gains of the lagging stocks (a "broadening out"). We expect that any potential convergence, or "mean reversion," may lead to additional market volatility in the coming months.

In addition to issues related to the narrowness of the markets, the current ongoing financial market volatility appears to continue to be related to significant uncertainty 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. Although the extent and duration of these impacts remain unknowable, based upon recent economic data it seems that at least some of these issues may either be in the process of moderating or have peaked. Until there is greater clarity regarding the ultimate resolution of these uncertainties, however, we believe that the current inter-, and intra-, day financial market volatility may persist. It is important to remember, though, that financial markets usually discount any positive (or, conversely, negative) outcomes before they actually occur.

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 and unjustified economic sector rotation in specific areas of the financial markets. 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. In our view, one of the best ways to accumulate wealth over the long term continues to be by investing in high quality businesses—especially during periods of financial market volatility when investors can take advantage of valuation discounts to purchase such businesses "on sale."

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.

Bondage

The U.S. Federal Reserve's (Fed's) restrictive monetary policy stance (initiated in March 2022) has served to tighten financial conditions but has had little immediate and direct impact on U.S. economic growth. A factor that could change this dynamic is the persistent increase in long-term interest rates.

Despite the Fed's recent pause in raising short-term interest rates, yields on long-term U.S. Government Bonds have continued to rise. Specifically, from the April 2023 lows, yields on U.S. Government Bonds with longer-dated maturities (i.e., 10-, 20-, and 30-years) have risen approximately 150 basis points to a 16-year high of nearly 5.00% recently, while the Federal Open Market Committee (FOMC) of the Fed has increased the Federal Funds (Fed Funds) short-term interest rate by only 50 basis points during that period to a current 5.25-5.50%. As a result, the bond market has tightened financial conditions further. This could have a significant economic impact over the coming months.

This year's spike in long-term rates in the face of the Fed's more moderate increase in short-term rates may, or may not, be sustainable and could be attributable to a variety of factors: long rates could be signaling a "higher for longer" monetary policy, higher economic growth expectations, and/or a higher term premium, for example.

Higher for Longer?

As we have discussed for some time now, several economic and industry-specific indicators suggest that U.S. inflation has peaked 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.

Although many components of inflation appear to have peaked, certain inflation statistics (core inflation levels, in particular) appear to be persistent and remain well above the Fed's +2% longer-run goal: over the 12 months ending in August 2023, total Personal Consumption Expenditures (PCE) prices rose +3.5% (down from the June 2022 peak of +6.8%); excluding the volatile food and energy categories, core PCE prices rose +3.9% over the same period (down from the February 2022 peak of +5.4%). Although price pressures remain evident across a broad range of goods and services, it is important to note that the trend rate of price growth is no longer *accelerating* but is, in fact, *moderating*.

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.

In November 2022, Fed Chairman Jerome Powell discussed how the Fed monitors inflation by breaking core inflation into three component categories: (1) core Goods inflation, (2) Housing Services inflation (which measures the rise in the price of all rents and the rise in the rental-equivalent cost of owner-occupied housing, or OER), and (3) inflation in core Services other than Housing (the so-called "supercore" inflation).

Of these three component categories, Services ex Housing is the largest (constituting more than half of the core PCE index) and may be the most important category for understanding the future evolution of core inflation: after peaking at +6.46% year-over-year in September 2022, "supercore" inflation has gradually declined nearly every month since then to a current rate of +3.91% year-over-year as of September 2023. This is a large spending category that covers a wide range of services—from health care and education to activities as varied as travel and recreation, legal services, and hospitality. Because wages make up the largest cost in delivering these services, it is the labor market that holds the key to understanding the direction of inflation in this category and, by extension, the direction of the Fed's interest rate policy.

Although we believe that we are near the end of the current monetary tightening cycle, it remains uncertain how long these current higher interest rates will remain in effect given the persistence of certain components of inflation. As a result, restoring price stability could require maintaining a restrictive monetary policy stance for some time because the historical record cautions strongly against prematurely loosening policy. This could increase the risk of an economic recession. 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. At the same time, monitoring risks and the responsiveness of economic activity to interest rate changes will be important guides in adjusting the pace—and duration—of that transition.

Still Growing

While most countries are struggling to achieve their pre-Pandemic levels of economic growth, the U.S. economy, although moderating, has surpassed this level and continues to grow near its long-term historical rate. In our opinion, based upon our analysis of the economic data, a recession does not appear imminent:

U.S. Real Gross Domestic Product (GDP) increased at an annualized rate of +2.1% and +2.2% in the Second and First Quarters of 2023, respectively, after increasing +2.6% and +3.2% in the Fourth and Third Quarters of 2022, respectively. The employment situation remains strong. The remarkable run of monthly post-pandemic job gains continued in September 2023 as the U.S. economy generated 336,000 new jobs, while the unemployment rate remained steady at 3.8% (still near a historic low). For 2023, 2.5 million new jobs have been created, with demand for services continuing to be the foundation of the post-pandemic economic expansion. Behind the labor market's enduring strength are a variety of structural and demographic forces that—combined with approximately $200 billion remaining of the nearly $2 trillion in excess savings that households accumulated during the course of the pandemic—have resulted in a U.S. economy that appears to be more resilient and less sensitive to interest rate hikes than in the past.

Recent employment data, while still strong, indicate a moderation in growth, however. Over the last 12 months, the three-month moving average of monthly job gains has declined from 305,000 to 240,000 and is down significantly from its mid-2020 peak. In addition, although September 2023 Nominal Average Hourly Earnings growth on a year-over-year basis remained strong at +4.2%, it has decelerated from a peak of +5.6% in March 2022. This slowdown should relieve upward pressure on "supercore" inflation.

However, persistent wage growth—the largest and most reliable source of financing for consumer spending—means that interest rates may stay "higher for longer" unless consumers start spending a much lower share of their incremental earnings, real output per worker rises sharply, or both. Fed Chairman Jerome Powell seems to agree. At a recent press conference, he said, "We want wages to be going up at a level that's consistent with two per cent inflation over time" and that "wages are probably an important issue going forward." This explains Fed officials' continued focus on "softening" the job market via higher interest rates. This represents a risk that interest rates may not come down as quickly as implied by current market prices.

Despite the slowdown in these monthly jobs data (and an easing in total PCE), however, sustained U.S. employment and wage gains at current levels suggest that monetary policy tightening will continue because the projected rate of "supercore" inflation will otherwise remain too high for the Fed to achieve its +2% inflation policy objective in the near term.

In No Uncertain Terms

Bond term premium is the compensation that investors require for the risk that interest rates may change over the life of the bond. It is one of several contributors to a bond's yield and is affected by numerous factors. In effect, it is a measure of how confident or uncertain investors are about predicting the key factors that affect bond yields: inflation, economic growth, and fiscal and monetary policy.

Although the term premium is not directly observable, it is estimated based upon financial and macroeconomic variables. Per the Federal Reserve Bank of New York, the term premium has been reliably negative since 2017, reaching a generational low of –1.65% in March 2020. This was partly because of declining inflation that made investors willing to accept lower long-term yields. For much of the period since 2016, the term premium was also constrained by Fed purchases of U.S. Government Bonds (i.e., Treasuries) as a component of its Quantitative Easing monetary policy.

Notably, the term premium has just recently turned positive.

Unfortunately, the resulting lower U.S. Government Bond values associated with a higher term premium (when a bond's interest rate goes up, its price goes down) have negative carryover effects for risk asset liquidity and prices because these bonds are a crucial form of financial trading collateral: AAA-rated bonds (like U.S. Treasuries) used for collateral are critical for the plumbing of the global credit system and are a mainstay for a $170 trillion pool of global liquidity. This pool has been shrinking for several months as the collateral itself is degraded (in July, the Bank for International Settlements issued a report entitled "Collateral Damage" warning of exactly the situation that is now developing).

Besides the key factors affecting bond yields noted above, a confluence of additional issues could be causing the term premium to have turned positive, including supply/demand imbalances, political dysfunction, and/or structural deficits, among other reasons.

The supply/demand balance for long-dated U.S. Government Bonds has changed for the worse. Forced by a rapidly-deteriorating budget deficit and rising interest rates, the U.S. Treasury is ramping up issuance of longer-dated bonds. This increase in bond issuance is projected to stretch into 2024. Public borrowing needs are on the rise due to a combination of lower tax revenues, increased entitlement spending, and higher debt service costs. At the same time, the Fed continues to reduce its holdings of U.S. Treasury securities and agency debt and agency mortgage backed securities at a rate of $95 billion per month (Quantitative Tightening), further increasing supply.

Besides Treasury upping the size of its bond auctions, it is notable that the recent rise in long-term bond yields also came after a downgrade of the U.S. credit rating, analysts began revising upward this year's Federal deficit, and Congress nearly shut down part of the government over a failure to pass spending bills.

The Federal deficit is estimated to have risen to over 7% of GDP in fiscal 2023 (after adjusting for accounting distortions related to student debt). That is larger than any U.S. deficit since 1930 outside of wars and recessions—and is occurring at a time of low unemployment and strong economic growth. A rising term premium could reflect concerns regarding the implications for the deficit during an economic downturn.

Unfortunately, while much of the debate about limiting U.S. government debt assumes that rising debt is a consequence of profligacy on the part of Washington policymakers, the problem is, in fact, mainly structural. America is forced to choose between rising debt and higher unemployment largely because of the level of income inequality in the country—exacerbated by the large U.S. trade deficit—that has sharply reduced the consumer demand for products from American businesses and manufacturers.

The rise in income inequality is the key driver of debt. Because the wealthy save a much larger part of their income than do workers or the middle class, and use a much smaller part for consumption, rising income inequality automatically reduces overall consumption and forces up savings by effectively transferring income from high consumers (ordinary Americans) to high savers (the wealthy).

As long as Americans are willing to accept high levels of income inequality and large trade deficits, this is the trade-off the U.S. must continue to suffer. To get debt under control without raising unemployment, Americans must eliminate downward pressure on demand by reversing several decades of policies that favor income inequality or that allow foreign trade surplus countries to dump their excess savings and excess production into the U.S.

As we discussed in our *Windward Capital 2023 Second Quarter Review*, for countries to run surpluses that are a significant percentage of their GDPs, the rest of the world must run combined deficits equal to a proportionate percentage of its collective GDP (i.e., trade must balance). Although the details of trade finance can be quite complex, the important thing to know about this balance-of-payments relationship is that it restrains global demand: countries with trade surpluses generated by suppressed domestic consumption (like in China—and in Germany and Japan, too, for that matter) export their excess savings to trade deficit countries that have open capital markets (like the U.S.) via foreign capital inflows. Because there is already no shortage of investment capital in most trade deficit countries, these capital inflows instead result in higher unemployment or debt in the deficit countries than would otherwise be the case in a more balanced trade relationship. This matters greatly to a world that is wrestling with weak secular demand.

"No" Landing?

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—as noted above by the issues related to the ongoing supply/demand imbalance in the fixed income markets. 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. It is very difficult for an inflation-targeting central bank to walk away from interest rate hikes when underlying inflation has not yet demonstrated persistent progress towards its target.

Over the coming months, then, the Fed will continue to be dependent upon the incoming data and the evolving outlook for the U.S. economy as it looks beyond the peak in inflation for compelling evidence that inflation is moving *down* toward their +2% longer-run goal.

That being said, based upon our analysis, we continue to believe that the Fed is near the end of this monetary tightening cycle. The Fed, though, through its rhetoric and policy moves, has indicated that it remains committed to holding rates at a restrictive level for an extended period of time to create sustained downward pressure on the labor market, in particular. And the guidance in their Summary of Economic Projections with regard to the unemployment rate and real GDP growth in 2023 and 2024 look very much like they are forecasting a recession as a result. If the current disinflationary trends that we are seeing in the recent economic data persist, the Fed's hawkish reaction function (i.e., commitment to driving the unemployment rate higher than necessary) may become less defensible and could become the key monetary policy concern of 2024—especially if the Fed potentially holds rates "higher for longer" and/or bond market participants keep long-term rates high.

As we have noted in the past, it is important to remember that monetary policy works with long and variable lags, and that at some point, therefore, it would be appropriate for central banks to slow the pace of monetary tightening and assesses how their cumulative policy adjustments are affecting their economies and inflation. (In the U.S., the Fed has indeed been slowing its pace of Fed Funds interest rate increases and, in fact, paused at its June 14 and September 20 meetings.)

Unfortunately, central banks have moved 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 have been excessive in their actions to raise interest rates and that the effect of all of this tightening will be a global recession.

Indeed, despite the Fed's moderation in the pace of rate increases and its recent pauses, based upon real-time forward, rather than lagging, indicators, some economists believe that the Fed, in particular, 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.

We continue to monitor the economic data on an ongoing basis.

Good News

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 for International Settlements
Bloomberg
Congressional Budget Office
Council of Economic Advisers
Federal Reserve Banks of Atlanta, New York, San Francissco, and St. Louis
International Monetary Fund
Organisation for Economic Co-operation and Development
Reuters
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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