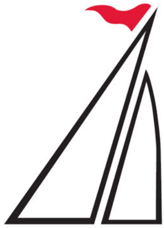
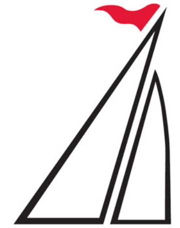


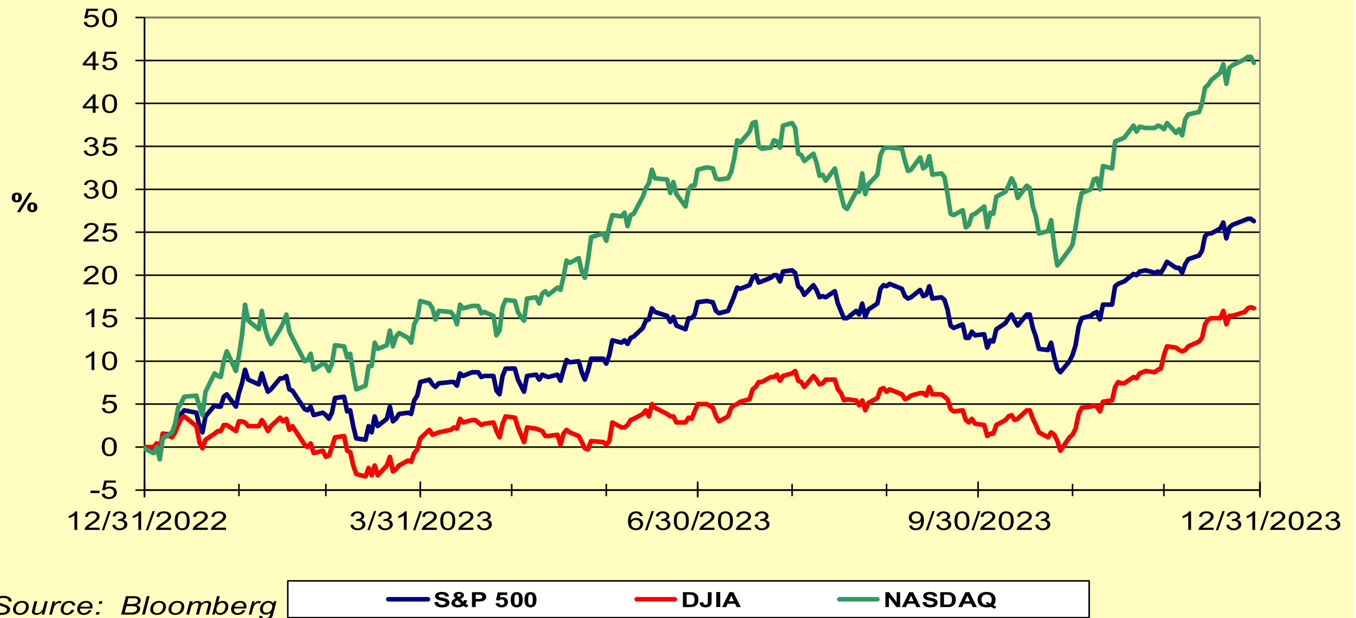
WINDWARD CAPITAL

Risk Averse Asset Management

2023 Fourth Quarter Review



Volume 28, Issue 4 January 16, 2024



Panic Buying

"Disaster has a way of not happening."

— Byron Wien (1933 - 2023)
American Investment Strategist

Despite a variety of ongoing global macroeconomic, geopolitical, and financial risks, the major U.S. equity market indices rebounded from their Third Quarter declines, with the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) advancing +11.68%, +13.09%, and +13.84%, respectively, for the Fourth Quarter of 2023. For 2023 Year-to-Date, the S&P 500, DJIA, and NASDAQ returned +26.26%, +16.18%, and +44.70%, respectively, ending the year near historic highs before declining modestly at the beginning of 2024.

As of December 31, 2023, the major U.S. equity market indices are still anywhere from +119% to +126% above their 2020 coronavirus pandemic lows, and from +39% to +58% above their pre-pandemic highs, demonstrating significant resilience given the historic—and unprecedented—global events of the last few years.

It appears that 2023's particularly strong finish was primarily due to financial market participants' fear of missing out on current, and future, equity market advances that may result from a potential U.S. economic "soft landing" that could be facilitated by an expected easing of the U.S. Federal Reserve's (Fed's) monetary policy in 2024. Whether these expectations will be fully met remains uncertain, however.

It is important to recognize that 2023's 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 as of December 31, 2023, represented 26.3% of the total Index (and are, notably, all in the Information Technology sector). As a result, although the market-weighted S&P 500 was up +26.26% in 2023, the S&P 500 on an equal-weighted basis was up only +13.84% 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"). (Indeed, during the Fourth Quarter of 2023, the market-weighted S&P 500 and the equal-weighted S&P 500 were up by nearly the same percentage: +11.68% and +11.85%, respectively.) 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 uncertainty regarding the duration of tighter 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 in-

vesting 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.

The Last Mile

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.

Many components of inflation appear to have peaked and are declining rapidly. However, certain inflation statistics (core inflation levels, in particular) appear to be persistent and remain above the Fed's +2% longer-run goal: over the 12 months ending in November 2023, total Personal Consumption Expenditures (PCE) prices rose +2.6% (down from the June 2022 peak of +6.8%); excluding the volatile food and energy categories, core PCE prices rose +3.2% over the same period (down from the February 2022 peak of +5.4%). Although the "last mile" of the journey to the +2% inflation target may prove more challenging because 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, *decelerating*.

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 December 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 sta-

bility 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.

Solid

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 +4.9%, +2.1%, and +2.2% in the Third, Second, and First Quarters of 2023, respectively, after increasing +2.6% and +3.2% in the Fourth and Third Quarters of 2022, respectively. The outsized rate of growth in Real GDP in the Third Quarter of 2023 primarily reflected an upturn in exports and accelerations in consumer spending and private inventory investment that were partly offset by a deceleration in nonresidential fixed investment. Notably, subsequent economic data suggest that Real GDP growth has slowed from that strong Third Quarter pace.

The employment situation remains strong. The remarkable run of monthly post-pandemic job gains continued in December 2023 as the U.S. economy generated 216,000 new jobs, while the unemployment rate remained steady at 3.7% (still near a historic low). For 2023, 2.7 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 funds remaining from 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 340,000 to 180,000 and is down significantly from its mid-2020 peak. Although 2.7 million new jobs were created in 2023, this is down from 4.8 million jobs added in 2022. In addition, although December 2023 Nominal Average Hourly Earnings growth on a year-over-year basis remained strong at +4.1%, it has decelerated from a peak of +5.6% in March 2022.

Although this slowdown should relieve upward pressure on "supercore" inflation, 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. He has 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.

Pivotal?

The resolution of pandemic-induced supply/demand disruptions and the lagging impact of tighter monetary policy are continuing to contribute to an easing

of inflationary pressures. The ideal scenario for the U.S. economy (and the financial markets) would be an "immaculate disinflation"—whereby inflation decreases without causing a recession or significant unemployment increases. Monetary tightening cycles are always fraught with challenges, however, and, although an economic "soft landing" is probable, the risk of recession still exists.

Unfortunately, central banks have moved so rapidly that, as they put their rate hikes in place, there really has not been enough time for them to judge what the feedback effects are on the global macroeconomy. As a result, an increasing number of economists think that monetary policymakers may 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 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 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.

That being said, based upon our analysis, we continue to believe that the Fed is near the end of this monetary tightening cycle.

Over the coming months, 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 continuing to move *down* toward their +2% longer-run goal on a sustainable basis.

The 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 so far. As we have noted in the past, however, 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 done just that by not raising rates at its last three meetings (in September, November, and December 2023). In fact, in its latest Summary of Economic Projections, the Fed has signaled a potential pivot by forecasting its intention to *lower* the Fed Funds rate by 75, 100, and 75 basis points in 2024, 2025, and 2026, respectively—although the specific timing and actual amount of these cuts remains data dependent.

The recent combination of peak inflation statistics, strong economic data, and monetary policy rate pauses (with a forecast for policy easing) has increased the optimism among financial market participants for an "immaculate disinflation" and resulted in a significant *loosening* of U.S. financial conditions, potentially undermining the Fed's objective. Since late October 2023 through the end of the year, the major U.S. equity market indices have rallied anywhere from +16% to +19%, and yields on U.S. Government Bonds with longer-dated maturities (i.e., 10-, 20-, and 30-years) have fallen by approximately 100 basis points (from over 5.00%, previously).

The degree to which participants' optimistic outlook aligns with future economic reality—and the Fed's reaction function—could have significant near-term ramifications for the financial markets.

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

Repo'd

A brief jump in U.S. overnight lending rates in December could be a forerunner of potential strains in money markets this year as the U.S. government sells more Treasuries to cover its deficits.

There was a sudden rise early in the month in the rate for borrowing cash overnight in the market for short-term funds, a move that was not mirrored in the rate charged by the Fed to take in excess cash. A divergence between the two rates, which historically track each other closely, raises concerns over the potential for broader strains in market lending rates for banks and customers, as cash becomes scarcer after years of excess liquidity.

This event has increased attention on a corner of the money markets known as the "repo," or repurchase, market. This acts as a benchmark for broader lending, from bank credit to leveraged trades, by setting the short-term cost of swapping high-quality collateral such as U.S. Treasuries for cash. Repo rates and central bank policy rates historically track each other closely, but the signal sent by the repo market has been largely distorted during the past decade because the Fed flooded the system with cash by buying trillions of Dollars of U.S. Treasuries. Money market funds parked that excess cash overnight at the Fed.

But since the Fed stopped buying Treasuries 18 months ago, investors have been left to pick up the slack. This has raised concerns that the increased supply of Treasuries expected in 2024 will overwhelm the shrinking pool of spare funds, straining liquidity in money markets.

For the Fed, the issue is judging the optimum level of liquidity in the market. Central bankers fear too much will encourage speculation and risk taking, while too little could choke off lending and economic growth.

In the move earlier in December, the Secured Overnight Financing Rate, or SOFR, rose as much as 0.09 percentage points above the 5.3% paid by the Fed to users of its overnight reverse repurchase (ON RRP) facility. Although SOFR has since returned to a more normal spread, the incident sparked memories of the market dislocation of September 2019, when soaring repo rates caught the Fed off guard and forced it to flood markets with billions of Dollars of additional cash.

If rates in these markets are squeezed sharply higher or stay high for a prolonged period—perhaps due to upward Federal deficit funding pressure in 2024—it could send shockwaves through the financial system by raising borrowing costs and squeezing the profitability of leveraged trading positions.

One indication of excess liquidity in the financial system is the money parked at the Fed in its ON RRP facility. Balances have fallen from a peak of $2.6 trillion at the end of 2022 to approximately $700 billion currently as rising rates on other short-term instruments, such as U.S. Treasury bills, have lured investors into more profitable trades. A key for money market functioning next year will be the pace at which ON RRP continues to fall as well as how easily markets are able to cope with the rise in Treasury issuance. (On average, the U.S. Treasury will have to raise the size of its regular sales by more than 20% in 2024.)

Another factor for money markets next year will be the Fed's program of Quantitative Tightening (QT), through which it is reducing the portfolio of Treasuries and mortgage-backed bonds it has acquired. As you may recall, in June 2022 the Fed stopped replacing securities that mature—reducing general demand for bonds by $95 billion a month. It is unclear when the Fed may slow, or pause, QT, but a jump in repo market rates could force the central bank to bolster liquidity in some way because of the risk of strains to the wider financial system. Although the Fed has since introduced a standing repo facility to help the market in times of sudden strain, this would only help ease, but not entirely remove, any rise in rates.

Although this may seem like an esoteric topic for discussion, persistent funding pressure (via high repo rates) could result in a deleveraging event with broader financial market implications and is something that bears monitoring.

If You Know, You Know

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 Francisco, 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

NOTES

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.

WINDWARD CAPITAL MANAGEMENT CO.

Risk Averse Asset Management

www.WindwardCapital.com

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

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

Robert Nichols, PhD
CEO / Portfolio Manager

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