WINDWARD CAPITAL

Risk Averse Asset Management

2015 First Quarter Review

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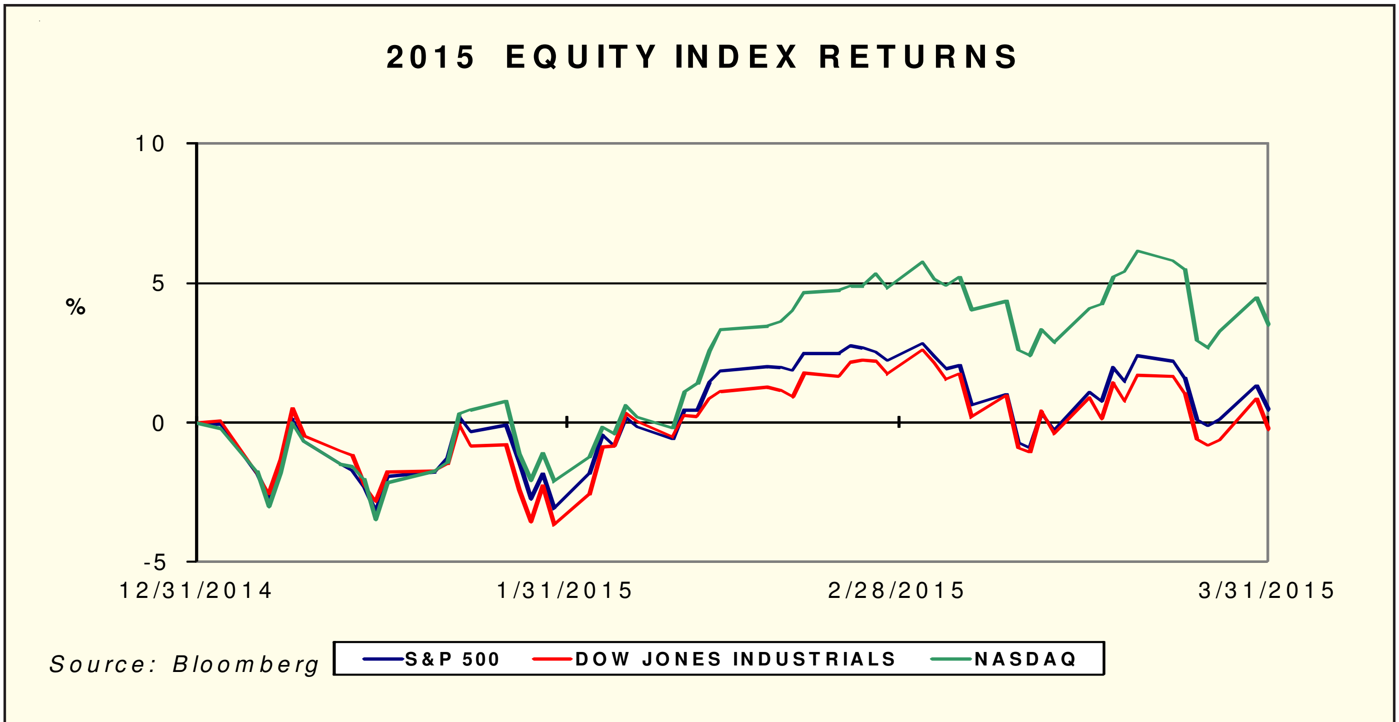

Context

"There is nothing new in the world except the history you do not know."

—Harry S. Truman
33rd President of the United States

The major U.S. equity markets started 2015 with significant volatility: on a monthly basis, January's returns were down approximately –3%, February's were up over +5%, and March's were down over –1%. For the First Quarter of 2015, the Standard & Poor's 500 Index (S&P 500) and Dow Jones Industrial Average (DJIA) were virtually flat, returning +0.95% and +0.33%, respectively, while the NASDAQ Composite Index (NASDAQ) returned +3.86%—primarily due to *Apple Inc.*, which is the largest component of the NASDAQ and was up +13.17% for the Quarter.

This volatility reflected a continuation of the global macroeconomic and geopolitical issues that we have discussed with you numerous times over the last several years, including: the direction of central bank monetary policy actions, foreign exchange cross-currency dynamics, geopolitical tensions, sustainability of the Eurozone, the outlook for corporate revenue and earnings growth, global supply/demand imbalances, and collapsing commodity prices. Although none of these issues are new, their dynamics will continue to evolve over time and serve as a constant reminder of the risks inherent in today's investment environment.

In the U.S., it has been six full years since the equity markets bottomed in March 2009. In order to counter the 2008 Financial Crisis, the burden of catalyzing economic growth was firmly laid on the shoulders of monetary authorities in the face of fiscal inertia. As a result, the U.S. Federal Reserve (Fed) embarked on an aggressive zero percent interest rate policy (ZIRP) and infused massive liquidity into the financial system by way of Quantitative Easing (QE). This has produced a steady domestic economic growth rate of about +2.5% (as measured by U.S. Real Gross Domestic Product [GDP] data), compared to the previous +3.0–3.5% secular rate of growth experienced over the last several decades.

Unfortunately, the domestic economic recovery has not been balanced; so, to many, the benefits of a +2.5% growth rate have failed to "trickle down." Although the labor market is much improved compared to six years ago, the recovery has primarily benefited those who own assets (like real estate, bonds, and stocks) while the middle class has been pressured by increases in the costs of the necessities of life that have outstripped gains in incomes and salaries.

The U.S. housing market's recovery has been muted—although home prices have firmed and now lie at or near the previous peaks (particularly on the coasts and in upscale communities). In part, this has occurred because of the rise of new categories of home buyers: institutional investors and hedge funds (who planned to rent out the units), and foreign nationals (looking to extract currency from their home countries). Though mortgage rates remain low, rapid rises in home prices coupled with still relatively rigid lending standards have diminished overall organic demand in the face of weakening affordability.

The domestic auto market has also recovered from a near-death experience, saved by government intervention and fueled by aggressive sub-prime lending and the need to replace an aging fleet.

Domestic inflation remains quiescent. The U.S. government's inflation indices have been muted; but, as mentioned previously, the costs of necessities have steadily risen. In addition, the reduction in interest rates has disadvantaged the savings class (retirees and maturing baby boomers). This has likely had some impact on economic growth as savings-starved elderly consumers cut back on expenditures or hoard cash.

Within a historical context, the issues that the global macroeconomy faces today are not new by any stretch of the imagination. The actors and the Dollar amounts may have changed, but the underlying dynamics have remained relatively constant over time. Indeed, although history may not *repeat* itself, it certainly does *rhyme*. Many of the current global challenges have occurred at some point in the past—perhaps in somewhat different form, or even centuries ago. However, they are rarely unprecedented.

As students of history and of the financial markets, embracing and understanding these risks within their historical context is what allows us to successfully navigate through them. 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, at the most elemental level of investing—the individual company—there are some good things happening. Specific companies are taking advantage of the changes in their operating environment to create long-run opportunities for their businesses. Those leading companies that weathered the worst of the Financial Crisis have superior business models that are well-positioned to withstand potential shocks to the system.

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 increase the value of your portfolio with less volatility by focusing on specific companies' fundamentals. Our results over the course of a market cycle demonstrate our success.

Better Late?

On January 22, the European Central Bank (ECB) launched its long-awaited quantitative easing (QE) program, finally joining the global central bank "QE club." Monthly asset purchases of €60 billion will be carried out until at least September 2016 for a total balance sheet expansion of approximately €1.1 trillion ($1.3 trillion). The ECB has at last decided to utilize its final monetary weapon: massive and open-ended balance sheet expansion through the purchasing of sovereign and agency debt, with the goal of fighting deflation and stimulating the Eurozone economies.

As we have discussed previously, we have serious doubts about the effectiveness of QE in the Eurozone:

- ✓ Ultimately, QE is not that different from what the ECB has already been doing—it is just a liquidity injection on a larger scale. The problem with previous injections is that they have become trapped within the banking sector. Eighty-five percent of lending to non-financial corporations in the Eurozone comes from bank loans (the amount in the U.S. is less than half of this). Eurozone banks continue to deleverage, are capital constrained, and are facing a host of new regulatory requirements (Basel III). As a result, they do not want the risk of lending to uncertain markets (such as companies within struggling Eurozone states). Even if the money gets to non-banks, they simply lack the facilities and relationships to really transmit this to the real economy due to lack of broader capital markets lending.

- ✓ Government borrowing costs are already at record lows, with many edging into negative yield territory. The average yield curve of borrowing costs in the Eurozone is half that in the U.S. and U.K. when those countries launched their QE programs. Borrowing costs have come down significantly in the Eurozone during the last two years but have not translated into a boost to inflation or to economic growth. Fundamental structural impediments to growth, such as inflexible labor markets, low investment, poor innovation, legal uncertainty, and burdensome business regulation, are just a few of the factors holding back Eurozone economies. QE will not change this dynamic.

- ✓ While the size of purchases is larger than what was anticipated, the ECB is still on course to purchase less than one-third of what the Bank of England (BOE) and the Fed did (as a percent of GDP) under their QE programs.

- ✓ Because of the structure of the Eurozone, approximately €275 billion of the ECB's QE purchases will be flowing into Germany—a country which has no shortage of liquidity or credit and which is already operating at a surplus. Despite being flush with cash, German banks and investors have been reluctant to put money into struggling Eurozone countries.

- ✓ ECB President Mario Draghi cited the "portfolio rebalancing channel" toward higher-risk assets as an avenue through which QE will work. We remain unconvinced. Given the reliance on bank lending noted above, the corporate bond market in the Eurozone is fairly small (one-sixth the size of the U.S.). Institutional investors (likely targets for such rebalancing) currently hold 48% of their assets in government bonds but only 7% in corporate bonds. For this to work, the ECB will literally have to overhaul all existing investment paradigms in the Eurozone—this also means fighting against regulation which mandates certain risk weights and asset distributions.

Notwithstanding these constraints, there are some ways in which Eurozone QE could have a short-term positive impact:

- ✓ The primary benefit will likely be through the exchange rate channel. The Euro has already weakened and is likely to continue to do so with the sustained flow of QE. The weakening of the Euro over the past year has helped boost European exports. Of course, this does not tackle the problem of internal divergences between the core and periphery, not least because core countries such as Germany and Netherlands are likely to benefit the most from a weaker currency. Furthermore, as Japan has demonstrated since 2012, a weaker currency does not always boost exports, especially if there is a lack of demand.

- ✓ The "signaling effect" of the program may also be significant—particularly since it surprised markets by being larger than expected and partially open ended (the ECB can extend its purchases beyond September 2016 if it does not see a significant positive inflation shift).

However, the practical impact of the ECB's QE program may also be limited by two other little-discussed factors regarding the fixed income markets: a dearth of new supply and a lack of willing sellers. Reduced government spending is contributing to a global dearth of sovereign debt. (For example, net fixed income issuance from Eurozone governments will be negative for the first time in 2015, once the ECB's plan is taken into account.) Global demand for debt securities, however, may outstrip supply by about $400 billion in 2015, according to our calculations. As a result, competition for ECB purchases may come from banks requiring bonds to meet regulatory rules, pension funds that need to match their liabilities, passive investors who track debt indices, and other central banks which buy European securities as part of their balance-sheet management programs. The resulting bond scarcity makes hoarding of the safest Euro-area securities by banks, insurers, and pension funds all but inevitable.

As a result, Eurozone sovereign debt holders might not want to sell their bonds to the ECB for a variety of reasons:

Regulation This applies to a wide range of investors but particularly banks and institutional investors. For banks, government bonds continue to have a risk-free rating and are, therefore, very attractive to hold. With progress towards the Basel III rules being ramped up in the next few years, there is little reason for them to sell off government bonds when anything they replace them with will be less useful for capital purposes. Similarly, institutional investors, such as insurance companies and pension funds, are required to hold a certain quality of instrument and cannot shift substantially towards holding riskier assets.

Lack of alternatives With global fixed income yields at record historical lows due to low inflation and significant central bank intervention, those investors that do sell their bonds will find it difficult to find any investments that offer higher returns. Ultimately, they may believe it is better to remain in asset classes which are liquid and appreciating in price than risk liquidating them and facing an unenviable choice between much higher risk or very low returns.

Lack of demand for other forms of lending Given that the Eurozone economy continues to struggle, it is not clear that there is a significant level of demand for banks to lend to households and corporations. If there were clearer demand factors, then banks, in particular, may be more inclined to sell off some of their government bond holdings and lend the money out.

ECB negative deposit rate We have warned previously that this may ultimately conflict with an ECB QE program. Fundamentally, if investors liquidate their bond holdings, they will end up with cash parked at the ECB. Although this may only be for a short period of time, it will still incur a cost of –0.20% (the ECB deposit rate).

Overall, our view is that the ECB's QE program is too little, too late: the Eurozone has already drifted into deflation and is very nearly into a triple-dip recession. It comes after six years of mass unemployment that has ravaged southern Europe, eroded the job skills of a rising generation, left hysteresis scars, and lowered the growth trajectory and productivity speed limit of these countries for the next several decades. More importantly, the structural issues facing the construct of the Eurozone cannot be solved through QE: monetary union without fiscal or political union is ultimately doomed to fail.

Tragic

On January 25, Greece's general election saw a landslide victory for the Syriza party, Europe's first government with an anti-austerity mandate. Since that time, there has been increasing uncertainty regarding the status of Greece within the Eurozone—especially as it relates to the country's debt obligations.

The Northern European power structure has issued stern and inflexible warnings to Greece. In their view, Syriza's triumphant radicals must pay the country's debts and stick to the letter of the "Memorandum" imposed by the European Union (EU)/International Monetary Fund (IMF)/ECB Troika. If Premier Alex Tsipras breaches the terms of Greece's bailout, Europe has threatened to cut off €54 billion of support for the Greek banking system and force the country out of the Euro. Relations between Greece and Europe's creditor powers are dangerously close to a breaking point. Both sides have issued ultimatums—each insisting angrily on entrenched positions and lashing out at each other with barely-concealed animosity.

Although it is being framed as such, in our view the European debt crisis is not a conflict among nations. All economic systems generate volatility whose balance sheet impacts are mediated through different political and economic institutions, which usually include domestic monetary policy and the currency regime. With the creation of the Euro as the common currency among a group of European countries, monetary policy and the currency regime could no longer play their traditional roles in absorbing economic volatility. As a result, for much of the Euro's first decade, a series of deep imbalances developed among various sectors of the European economy. Because Europe's existing economic and political institutions had largely evolved around the national sovereignty of individual countries, and also because the inflation and monetary histories of individual countries varied tremendously before the creation of the Euro, it was almost inevitable that these imbalances would manifest themselves in the form of trade and capital flow imbalances between countries.

Most currency and sovereign debt crises in modern history ultimately represent a conflict over how the losses from the resolution of the crises are to be assigned among two different groups. On the one hand are creditors, owners of real estate and other assets, and the businesses that benefit from the existing currency distortions. On the other hand are workers who pay in the form of low wages and unemployment and, eventually, middle class household savers and taxpayers who pay in the form of a gradual erosion of their income or of the value of their savings. Historically, during currency and sovereign debt crises, different political parties come to represent one or the other of these groups, and whether they are of the left or of the right, they are able to capture the allegiance of these groups.

Except for Greece, in Europe the main political parties on both sides of the political spectrum have until now chosen to maintain the value of the currency and protect the interests of the creditors. It has been the extremist parties, either on the right or on the left, who have attacked the currency union and the interests of the creditors. In many cases these parties are extreme nationalists who oppose the existence of the European Union.

While we believe that distortions in the savings rate are at the root of the European crisis, many have understood the crisis primarily in terms of differences in national character, economic virtue, and as a moral struggle between prudence and irresponsibility. This interpretation is intuitively appealing, but it is almost wholly incorrect. To the extent that the European crisis is seen as a struggle between the prudent countries and the irresponsible countries, it is extremely unlikely that Europeans will be willing to implement necessary debt forgiveness.

Indeed, Syriza's victory in Greece has reignited the name-calling and moralizing that has characterized much of the discussion on peripheral Europe's unsustainable debt burden. We think it is obvious that Greece simply cannot repay its external obligations, and that, ultimately, it is going to receive substantial debt forgiveness.

Some important points worth noting:

(1) The Euro crisis is a crisis of "Europe," not of European countries. It is not a conflict between Germany and the Club Med countries about who should be deemed irresponsible, and so should absorb the enormous costs of nearly a decade of mismanagement. There was plenty of irresponsible behavior in every country, and it is absurd to think that if German and peripheral European banks were pouring nearly unlimited amounts of money into countries at extremely low or even negative real interest rates, especially once these initial inflows had

set off stock market and real estate booms, that there was any chance that these countries would not respond in the way every country in history, including Germany in the 1870s and in the 1920s, had responded under similar conditions.

(2) Until now, the "losers" in this system have been German and peripheral European workers. In the future, German and peripheral European middle class savers and taxpayers will be impacted as European banks are directly or indirectly bailed out. The winners have been banks, owners of assets, and business owners, mainly in Germany, whose profits were much higher during the last decade than they could possibly have been otherwise.

(3) In fact, the current European crisis is strikingly similar to nearly every currency and sovereign debt crisis in modern history, in that it pits the interests of workers and small producers against the interests of bankers. The former want higher wages and rapid economic growth. The latter want to protect the value of the currency and the sanctity of debt.

(4) Historical precedents suggest two very obvious things. First, as long as peripheral Europe suffers from its current debt burden, it does not matter how intelligently and forcefully it implements economic reforms (austerity). It will not be able to grow out of its debt burden and must choose between two paths. One path involves many more years of economic distress as ordinary households are slowly forced to absorb the costs of debt—sometimes explicitly but usually implicitly in the form of financial repression, unemployment, and debt monetization. The other path is a swift resolution of the debt as it is restructured and partially forgiven in a disruptive but short process, after which growth will return with vigor. Second, it is the responsibility of the leading centrist political parties to recognize these options explicitly. If they do not, extremist parties either of the right or of the left will take control of the debate and convert what is a conflict between different economic sectors into a nationalist conflict or a class conflict.

Whatever happens, Greece has once again become the Eurozone's testing ground. Anti-establishment parties across the bloc, such as Podemos in Spain and Front National in France will be watching the negotiations closely. Allowing Greece a compromise could well spur them on and signal a huge shift in the bloc's approach to the crisis. Equally, refusing to compromise could undermine their proclamations of change. That said, it could also further fuel the popular backlash against EU-mandated austerity.

Whatever the outcome of the negotiations, there is a sense that this time is different. There is a stark divergence between two entrenched positions. The implications will be felt across Europe: most observers understand that the Greek debate is not just about Greece, but also about whether or not several other countries—Spain, Portugal, and Italy (perhaps even France)—will have to restructure their debts with partial debt forgiveness. While a compromise could still be possible, it will be quite painful to reach and will imply someone taking big steps back from their previous stance.

Debt restructuring is a process that involves increasing the value of the obligations and operations of the restructuring entity. It can be done well, it can be done badly, and it can be done disastrously, but it is a financial operation with a clearly defined goal of improving the overall wealth of stakeholders; and while it is reasonable that stakeholders negotiate the ways in which this additional wealth will be allocated, the negotiation should not prevent the restructuring. The purpose of a debt restructuring, then, is *to reduce or eliminate the uncertainty associated with the resolution of the debt* because this uncertainty automatically reduces value and future growth. This is known as "financial distress costs."

The ways in which a country incurs financial distress costs include:

- ✓ Workers understand that unemployment is likely to rise and remain high, so they tend to cut back on spending. They also tend to unionize, and their unions become more militant in their relationship with business.

- ✓ Ordinary households worry about future income or consumption tax increases, so they too cut back on spending. Because they also worry that their savings will be confiscated to pay the debt—most usually in the form of inflation, financial repression, currency depreciation, or frozen deposits—they often withdraw their savings from the domestic financial system.

- ✓ The best educated, the young, and people with the most valuable skills emigrate as the excess debt weighs down future growth prospects.

- ✓ Small- and medium-sized companies, fully aware that during crises wealthy businesspeople often bear the brunt of public anger, worry about being expropriated or forced to pay higher taxes, so they disinvest and become reluctant to hire additional workers even in the exceptional cases when they need them.

- ✓ Large companies and multinationals also worry about expropriation and taxation, so they disinvest or move operations abroad.

- ✓ Banks worry about deteriorating collateral values and cut back on risky lending.

- ✓ Exporters worry about currency depreciation or confiscatory rules on foreign currency, so they drive down inventory and reduce the amount of earnings they repatriate.

- ✓ Wealthy households move money abroad to avoid higher income or asset taxes.

- ✓ Foreign and local creditors reduce loan maturities and raise interest rates.

- ✓ Policymakers respond to the increase in social and political instability by shortening their time horizons.

These changes in behavior in response to rising uncertainty about how debt will be resolved are probably the most damaging impact of a debt crisis because they erode not just economic institutions but also social and political institutions. They can also be intensely self-reinforcing, so that as stakeholders respond to rising uncertainty, their responses collectively increase debt, reduce growth, and exacerbate balance sheet fragility, all of which only increase uncertainty.

Because most European policymakers stubbornly refuse to consider what seems to have become obvious, there is a very good chance that Europe is going to repeat the history of most debt crises: after many years of denying that they are insolvent, and many years of promises that reforms will be implemented that will set off enough growth to resolve the debt, policymakers will be forced either to change their positions or they will be forced out by voters—simply because economic conditions will have deteriorated so drastically that a restructuring can no longer be forestalled.

Monetary policy is as much about politics as it is about economics. It is about some of the ways in which wealth is created, allocated, and retained. Debt restructuring involves allocating wealth in the most efficient way. It does necessarily not mean, however, defaulting on payments. The only goal of a debt restructuring is to reduce the uncertainty associated with the resolution of the excessive and growing debt burden. There are many ways to do so, and in many cases they require significant debt forgiveness, but "pretend and extend" is not an effective strategy.

For now, we would argue that the biggest constraint to the Eurozone's survival is its debt. Europe will not grow, the reforms will not work, and unemployment will not drop until the costs of the excessive debt burdens are properly addressed.

Will She or Won't She?

Although specific central bank policy mandates may differ, most monetary authorities like to target full employment and low inflation through the use of interest rate policy in order to support the health of their country's economy. As a result, central bankers are constantly analyzing economic growth, employment levels, and wage increases, among other variables, in order to measure their progress toward achieving these mandates within the duality of fiscal/monetary policymaking.

Ever since the onset of the Financial Crisis in 2008, however, global central bank policymakers have used unprecedented and extraordinary monetary measures like QE and the zero lower bound (ZLB) in interest rates in order to support their economies by artificially lifting a variety of asset classes with the goal of triggering a "trickle down" wealth effect. Unfortunately, by disrupting the course of the business cycle through manipulation of the inputs to asset pricing, a lack of true, natural price discovery has resulted, distorting the value of many asset classes and not allowing for economic destruction and rebirth—necessary ingredients to the proper functioning of a healthy, free enterprise system. As a consequence, this has resulted in slow economic growth and has created a gap between asset prices and underlying fundamentals.

Given this backdrop, on March 18 the U.S. Federal Open Market Committee (FOMC) under the direction of Chairwoman Janet Yellen removed the word "patient" from its statement regarding the course of monetary policy, theoretically paving the way for future interest rate increases. At the same time, however, it reduced its forecast for U.S. economic growth, inflation, and unemployment. Especially important was the decrease in longer-run unemployment projections: the Fed's estimate of the Non-Accelerating Inflation Rate of Unemployment (NAIRU)—the level of unemployment below which inflation rises—is falling, something almost impossible to avoid given the lack of wage growth in the face of declining unemployment. These forecast changes caused the Fed to also lower their expected trajectory for interest rates. This is important in that financial market participants do not believe the Fed will pursue a higher interest rate policy path. Instead, financial markets are pricing in an economic "secular stagnation" scenario that projects a slower and lower path of interest rate "normalization" than currently anticipated by the FOMC. (The decline in long-term yields is also consistent with this view.) So, at the moment, financial market participants are saying the Fed has less room to maneuver than monetary policymakers believe.

There is, in fact, significant debate regarding the "equilibrium level of the real Fed Funds rate," which is defined as the rate consistent with full employment and stable inflation in the medium term. The "secular stagnation" view believes that the equilibrium rate will remain near zero for many years to come. (Some analysts even suggest a negative equilibrium rate.) Many believe that the U.S. has drifted into "secular stagnation," a period of chronically-low equilibrium rates due to a persistent weak demand for capital, rising propensity to save, and lower trend growth in the economy. A similar view holds that there is a "new neutral" for the funds rate of close to zero in real terms. Monetary policymakers are hostile to this notion, however, because it implies a narrow range to the effectiveness of their interest rate tools and suggests further asset bubbles: if real returns are indeed collapsing toward zero, then obtaining higher returns will require taking on more risk. Expect to hear more discussion about the equilibrium rate in the future.

The punditry has spilled much digital "ink" this year in its attempt to analyze and interpret the U.S. central bank tea leaves with regard to the pace of monetary tightening and its implications for global financial markets. As we have stated previously, since global macroeconomic growth, including that of the U.S., remains anemic at best, any increase in the short-term (Fed Funds) interest rate by the Fed, if and/or when it occurs, will be de minimis so as not to choke off what recovery there is. However, the consequences of a move by the Fed may have important global ramifications due to the economic and interest rate divergences that we discussed in our *2014 Fourth Quarter Review* and should, therefore, not be taken lightly.

One clear negative consequence of these divergences is reflected in the rise of the U.S. Dollar. As usual, most of the financial market action today occurs not in the equity or fixed income markets but in the foreign exchange markets—the largest financial markets in the world. (This is especially relevant given the recent move toward currency wars between the major developed nations.)

Since the 2008 Financial Crisis, the Fed's use of unprecedented and extraordinary monetary measures (like QE and ZIRP) flooded the emerging economies with U.S. Dollar liquidity. This enticed Asian and Latin American companies to ramp up borrowing in Dollars at real rates near 1%, storing up a reckoning for the day when the U.S. monetary cycle would turn. (Contrary to popular belief, the world is more Dollar-denominated today than ever before: foreigners have borrowed $9 trillion in U.S. currency [up from $2 trillion in 2000]—outside of American jurisdiction and therefore without the protection of a lender-of-last-resort able to issue unlimited Dollars in extremis.) The result is that the global credit system is acutely sensitive to any shift by the Fed in its interest rate (and, by extension, Dollar) policy.

The implications are already visible as the Dollar rises at a parabolic rate, smashing the Brazilian Real, the Turkish Lira, the South African Rand, and the Malaysian Ringitt, and driving the Euro to a 12-year low. The Dollar index has soared +24% since July 2014, and +40% since mid-2011. This is a steeper rise than the Dollar rally in the mid-1990s—caused at that time by Fed tightening and by a U.S. economic recovery at a time of European weakness—which set in motion the East Asian crisis and Russia's default in 1998. As a result, Asian and Latin American companies are currently frantically trying to hedge their Dollar debts on the currency derivatives markets, which only drives the Dollar higher and feeds a vicious circle. The added twist is that central banks in the developing world have stopped buying U.S. bonds, after boosting their reserves from $1 trillion to $11 trillion since 2000.

If the Dollar continues its upward advance—as might be expected given divergent monetary policy across the globe—further downward pressure on U.S. core inflation is likely. This clearly throws a wrench into the Fed's plans: it would be hard to justify confidence in a higher inflation outlook (and rate increase) if core inflation continues to trend lower due to Dollar strength (and/or lack of wage gains).

In our view, the reasons the Fed wants to "normalize" interest rate policy are relatively mundane:

- ✓ They believe the economy is approaching a more normal environment with solid GDP growth and near-NAIRU unemployment. They do not believe such an environment is consistent with rates at the ZLB.

- ✓ They believe that monetary policy operates with long and variable lags. Consequently, they need to act before inflation hits 2% if they do not want to overshoot their target. (And, in fact, they have no intention of overshooting their target.)

- ✓ They do not believe in the secular stagnation story: i.e., they do not believe that the estimate of the neutral Fed Funds rate should be revised sharply downward. Therefore, a 0.25%, or 0.50%, or even 1.00% Fed Funds rate still represents "loose" monetary policy, by their definition.

The Fed could therefore be headed for a very uncomfortable place. The Dollar is rising, tightening financial conditions and placing downward pressure on inflation. At the same time, interest rates remain low while equity markets push higher, loosening financial conditions (arguably an equilibrating response to the rising Dollar). On net, the U.S. economy keeps moderately grinding upward, the labor market keeps improving (notwithstanding the most recent disappointing employment report), and the unemployment rate sinks lower. The FOMC would want to resist tightening in the face of low inflation, but they would be increasingly tempted to react to low unemployment. Moreover, concerns of financial instability would mount if longer-term rates remained low and equities pushed higher.

All in, the rising Dollar may be causing the Fed more headaches than they like to admit. To the extent that it is pushing inflation lower, the Dollar should be delaying the time to the first rate hike as well as lowering the subsequent *path* of rates. The Fed may have to respond to the so-called "currency wars" whether they like it or not, however. That said, they could ignore the inflation numbers given the tightening labor market and what they perceive to be loose financial conditions. As a result, the Fed could fail to see the precarious nature of the current environment and move forward with plans to normalize interest rates, increasing the risk of a policy error.

Unstoppable?

Despite these and all of the other issues that we have discussed in previous *Quarterly Reviews*, the U.S. equity markets have thrived. In fact, the S&P 500 has tripled since the March 2009 bottom. While corporate profits have more than doubled from the depths of 2009, liquidity has been the market's best friend. The infusion of liquidity coupled with ZIRP has been a potent mix for investors that has been manifested in valuation gains (expanding price-to-earnings multiples) that have surpassed the historic averages. Low interest rates, strong balance sheets, and access to the high-yield bond market have stimulated robust corporate share repurchase activity, which has not only buoyed earnings reports but has contributed to a dwindling supply of shares. U.S. corporations remain strong and are in the best financial condition in their history. They are safe havens and islands of prosperity in the global macroeconomic sea of risks noted above.

Looking at the performance of the U.S. equity market, you would certainly think that American companies have a competitive advantage. Since the Spring of 2009, the U.S. market has risen over +200%, compared to +108% for the Eurozone, +118% for Japan, and +111% for the emerging markets. The Dollar has outperformed every major currency except the Swiss Franc. Despite its below-trend growth, U.S. GDP is +12.9% above its 2009 trough versus +3.8% for the Eurozone and +8.9% for Japan. U.S. GDP is +8.1% above its pre-crisis peak, while Europe and Japan are still below theirs. Although emerging markets were growing much faster than the U.S. before the Financial Crisis, this differential peaked at 6.5% in 2007 and has been shrinking ever since; it is now projected to be only 1.2% in 2015. Since 2007, per capita GDP has risen +14% for the U.S. and +185% for China (albeit from a very low base), but the Dollar gap with the Eurozone, Japan, and the emerging markets has actually increased. Both residential construction and exports for the U.S. have outperformed those sectors in Europe and Japan. Importantly, American economic improvement has been achieved in spite of a reduction in government spending as a percentage of GDP.

The U.S. accounts for 52% of the value of the world's publicly-traded equities. Since the Financial Crisis, earnings per share growth has been better in the U.S. than in other countries, with a higher return on equity and less leverage. Since 2007, U.S. productivity has improved +1.2% annually as a result of innovation, compared with +0.3% in the Eurozone and +0.5% in Japan. Immigration into the U.S. is also an important positive for future productivity growth as most developed economies' age demographics lengthen. The U.S. even has some competitive advantages in terms of manufacturing: Unit labor costs are less in the U.S. than in most industrial countries and substantially below those of the U.K. and the Eurozone. Only India, China, Thailand, and the Philippines have an advantage. On electricity costs, only Norway has an edge, while Europe and Japan have significantly higher power costs. While the U.S. has many social and government policy issues that are likely to continue for some time, there is little question that the performance of the economy since the Financial Crisis has been impressive compared to that of other industrialized countries.

However, as we have learned (sometimes painfully), an exceptional economy, just like an exceptional company, does not always translate into exceptional investment performance. Markets and stocks can become overvalued, and many believe the strong performance of the U.S. market over the past several years means that the indices will struggle going forward. The current bull market has lasted 72 months; the average since 1950 has been 57 months. Investor sentiment is very optimistic, which is usually a warning signal. Although unlikely in our opinion, interest rates may trend higher, which is usually a market negative. Finally, corporate revenue and earnings growth—important drivers of stock performance—have started to moderate.

However, while we are not in the business of predicting the stock market, it is interesting to note that U.S. Presidential Election Cycle equity market analysis performed on the last 181 years of data indicates that pre-Presidential election years (like 2015) have nearly always produced a positive return for the markets (the DJIA). U.S. Presidential elections every four years affect the economy and the stock market. Typically, each administration—Republican or Democrat—does everything within its power to pump up the economy so that voters are in a positive mood at election time. Data show that most bear markets take place in the first or second years of elections. Then, the market improves. Over the last 76 years, there has not been a single down year in the third year of a Presidential term since war-torn 1939, when the DJIA declined –2.9%. (The only severe loss in a pre-Presidential election year going back 100 years occurred in 1931 during the Great Depression.)

Regardless of these historical market-related technical data, in reality, the world is growing more dangerous and unsafe. Fundamental economic instability is at many corners of the globe, and that instability could lead to increasing political crises.

Although there are many issues facing the global economy, we believe that there are also historic generational investment opportunities being created in today's markets, and we continue to position *Windward* portfolios for these long-term opportunities while managing the risk associated with potential short-term volatility.

However, the complexities of today's investment environment should not be underestimated. We are currently witnessing historic events unfold within the context of ongoing secular global macroeconomic changes. As always, we believe that it is critical to differentiate among economic sectors that have long-term secular headwinds and those that have long-term secular tailwinds—as well as to recognize the short-term volatility associated with the debate over which is which. We must also take into account the impact of external "non-market" forces (eg., government intervention) and the "noise" from "investor psychology," which often obfuscates and confuses true underlying company-specific fundamentals.

Despite recent market volatility, 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.

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 web-site.

Our website provides the capability for clients to review their portfolios, their year-to-date realized capital gains, and expenses. Clients also have access to our weekend market comments. These reports are updated after 8:00pm 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 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 Boulevard, 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