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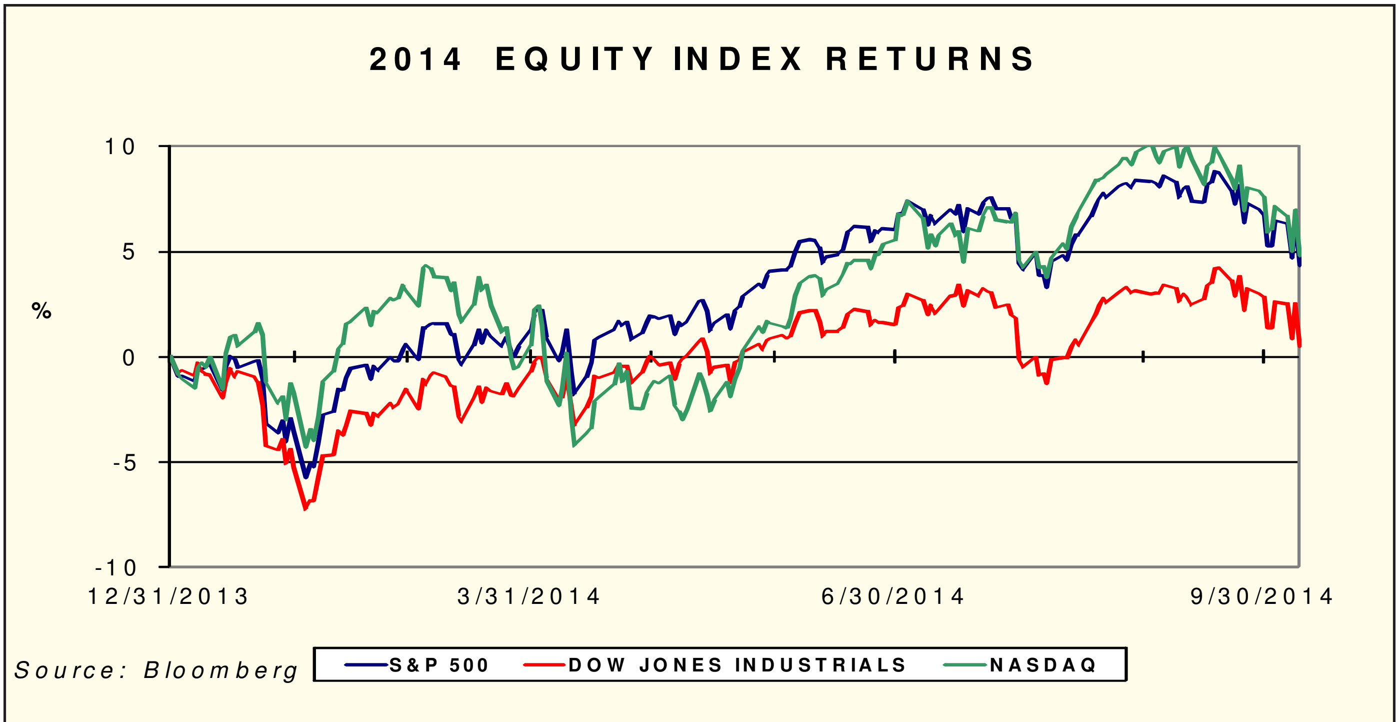

Common Sense

"The stock market is at an all-time high, but economic activity is not at an all-time high."

—Sam Zell
American Investor
September 03, 2014

During the Third Quarter of 2014, the major domestic equity markets experienced significant volatility: starting in July, the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) declined approximately –4%, subsequently rose approximately +6% to new all-time highs, and finally fell nearly –5%. This volatility has accelerated during the first half of October. Despite this increased volatility, the S&P 500, DJIA, and NASDAQ managed to return +1.13%, +1.87%, and +2.24%, respectively, for the Third Quarter of 2014 and remain in positive territory year-to-date.

As the equity indices marched to new all-time highs, we noted in our Second Quarter Review that market participants appeared to be overly complacent despite a variety of risks that we have highlighted numerous times in the past, including:

- ✓ Global macroeconomic growth remains anemic due to a surfeit of supply and a dearth of demand.
- ✓ At the same time, global savings continue to rise.
- ✓ Extraordinary measures taken by central bank policymakers are still distorting the inputs to

natural price discovery mechanisms, artificially enhancing asset valuations and incentivizing unproductive investment activities.

- ✓ The eventual "normalization" of monetary policy may result in unforeseen and unintended consequences.
- ✓ Overall corporate revenue growth is weak, and corporate profit margins (+70% above historic averages) are vulnerable to mean-reversion.
- ✓ The schism between the minority (that own assets) and the majority (that do not) continues to grow.
- ✓ Demographically, the aging population remains an important constituency that will continue to be penalized by zero (or negative) interest rate policies; economically, the increase in this "savings class" will have significant ramifications.
- ✓ U.S. consumer purchasing power remains exhausted, as stagnating real wage growth confronts the higher costs of the necessities of life.
- ✓ Geopolitical risks (Ukraine, Iraq, Israel/Palestine) are ascendant.

In our view, the underlying causes for the recent market volatility lie with the recognition of these risks as well as a variety of fundamental global macroeconomic issues, including:

- ✓ Global macroeconomic growth is weakening. Italy, France, Spain, Russia, and Japan are in recession. European real Gross Domestic Product (GDP) growth is perilously close to zero, and a Japanese-style deflation is threatening the region. China's economic growth is decelerating.
- ✓ The European Central Bank (ECB) faces the ongoing challenge of structural issues in the European Monetary Union (EMU). The ECB may be running out of options and could be unable to spur growth in the Quarters ahead. Indeed, any meaningful reversal in European sovereign debt yields could crimp European Union (EU) economic growth and develop into broadening systemic risks.
- ✓ Geopolitical pressures are rising (Ukraine, ISIL, etc.), threatening trade and economic growth.
- ✓ In the U.S., housing activity continues to pause, and its foundation is fragile. Increased bank capital requirements could further pressure the U.S. housing market as banks tighten lending standards. The automobile industry is exhibiting signs of peaking: supplies of inventory are high and increasing, and aggressive incentives are being offered by car dealers and manufacturers to spur sales.
- ✓ A strengthening U.S. dollar is muting the U.S. economy's prospects by hobbling export competitiveness and growth.
- ✓ Domestic economic growth remains sub-par and below "escape velocity," and sustainable growth absent central bank largesse still seems in question.
- ✓ Inflation continues to run below the Federal Reserve's (Fed's) projections, and, with the U.S. dollar strengthening and commodities collapsing in recent months, measured inflation is likely to continue lower rather than higher.
- ✓ U.S. Personal Consumption Expenditures (PCE) appear to be weakening. Payroll growth has fallen for the past three months, and spending fell in July and August.

Given the recent increase in financial market volatility, we believe that current market conditions provide an ideal moment to highlight the distinction between investment and speculation.

Sound *investment* is: (a) the purchase of an expected stream of future cash flows that will be delivered to the investor over time, where (b) the price paid today will result in an acceptable long-term return if those expected cash flows are delivered, and (c) the expectations are set using assumptions that allow a reasonable margin of safety. As the legendary investor Benjamin Graham observed long ago, "Operations for profit should not be based on optimism but on arithmetic."

Speculation, by contrast, is the purchase of a security with the expectation that its price will increase. Speculation relies much less on calculation than on psychology, particularly of two forms: (a) expected changes in sponsorship, and (b) expected changes in risk aversion. Sponsorship essentially reflects a gradual increase in the eagerness of other individuals to participate in an advance (or in the case of a panic decline, to avoid further losses). A speculative advance rides on the wave of increasing eagerness of others to hold the security, who in turn expect even further price increases and even greater eagerness by others. Changes in risk aversion can also feed speculative waves. When investors are very risk averse, prices drop today and expected future rates of return increase in order to compensate investors who continue to hold the security. Conversely, when investors become risk-seeking (as they have in recent years based on the belief that central banks have the ability to prevent any negative event), prices advance today and expected future rates of return are compressed, leaving no compensation for potential risks down the road.

Unfortunately, there has recently not been a lot of *investing* going on in the financial markets. In fact, the most recent equity market highs were primarily driven by narrow advances in more speculative, price-momentum stocks. Despite the movement higher in the broader indices, greater than 50% of the stocks in the NASDAQ and in the Russell 2000 (Small Capitalization) Indices have declined –20% or more from their peaks in the last 12 months. We believe that this recent correction is long overdue, and that the decline in the more speculative elements of the market may complete this leg of the bull market and be the perfect setup for another advance into the historically seasonally-strong part of the calendar (November through April). As a result, we welcome the opportunity to take advantage of any investment bargains that may arise during this period.

"Considerable Time"

Now that the U.S. Federal Reserve is winding down its asset purchase program, investor focus has been redirected toward the Federal Open Market Committee's (FOMC's) discussions about framing the processes and procedures for returning interest rates to a level consistent with its statutory mandate of stable inflation and maximum employment.

Recent FOMC meeting minutes reveal the Committee's desire to "normalize" interest rates and to employ, as its primary policy instruments, Interest on Reserves, the Federal Funds rate, and, of course, the Discount Rate. Importantly, discussions also touch on the conditional, data-dependent nature of the economic developments required to signal that it is time to start returning policy to normal and on how the Committee hopes to proceed. In particular, the FOMC favors a simple, gradual approach accompanied by clear communications.

Fed Chairwoman Janet Yellen has repeatedly emphasized her focus on the U.S. employment data. She has highlighted what we currently know and do not know about labor market dynamics and how those answered and unanswered questions are impacting the FOMC's assessment of current market conditions. She has not only explained why the headline unemployment rate is not capturing what is truly happening in labor markets but also moved beyond that simple measure to consider a host of other issues. These include: labor market slack and difficulties in measuring it; the recent changes in the labor market participation rate; the problem of the chronically unemployed; the role of people who are employed part-time but want full-time jobs; labor market flows in terms of quits and hires; workforce demographics and the impact of an aging workforce; the disappearance of so-called middle-skill jobs; the impact of disability rates, retirements, and school enrollments; and finally, the effects of the recession on wages and productivity gains.

But she has also moved beyond just that discussion of key labor market issues to devote attention to how they are shaping the formulation of monetary policy. Implicit in her view is the dual role that labor market conditions and the measurement of slack are playing from a policy perspective. Her attention is focused mostly on the Fed's dual employment/inflation mandate, and here she emphasizes the goal of promoting full employment in a way that broadly improves labor market conditions, rather than just seeking to lower the unemployment rate.

Chairwoman Yellen talks about "false dawns" in employment. She notes that wages are barely rising. The jobs market is not yet drawing back the millions who dropped out of the system. The labor participation rate is still stuck at a nearly 40-year low. "The recovery is not yet complete. We need to be careful to make sure the economy is on a solid trajectory before we consider raising interest rates," she has said.

She seems to be signaling that, despite the labor market improvements that have occurred, considerable slack remains, and, therefore, rates will remain low until greater improvement is evident. To be sure, Yellen and other Federal Reserve officials have taken great pains to emphasize that monetary policy will definitely depend upon incoming data.

In addition to the employment data, other economic indicators are likely to regain focus in the policy debate and outlook, including output, consumption, and investment.

- ✓ *Output*
  U.S. real GDP divided by the total population (or output per capita) has grown at a constant rate over the long run. A striking feature of the most recent recession is the sharp and persistent contraction in economic activity. Output per capita took about five and a half years to come back to its pre-crisis level and, as of the Second Quarter of 2014, is about –15% below its pre-crisis trend. In addition, the growth rate appears to have dropped significantly: between 1955 and 2007, output per capita grew by +2.2% annually, on average; after contracting at an average annual rate of –2.5% between 2008 and 2009, growth resumed at a more moderate pace of +1.6% annually since 2010.

- ✓ *Consumption*
  U.S. real Personal Consumption Expenditures per capita is highly correlated with output, but typically less volatile. During the last recession, consumption per capita also contracted sharply and subsequently resumed growth at a more modest pace. The figures for consumption are very similar to those noted for output above.

- ✓ *Investment*
  U.S. real Gross Private Domestic Investment per capita is also highly correlated with output (although much more volatile), and it contracted significantly during the last recession. As opposed to output and consumption, investment per capita has been growing above its pre-crisis growth rate since the end of the recession. However, it has not yet fully recovered and remains –27% below trend.

The evolution of output, consumption, and investment contrasts with the ongoing improvement in labor market conditions and the stability of inflation. This leaves open the question as to what types of monetary policies will be favored in the near future. Will policymakers interpret the persistent contraction in economic activity and drop in growth as evidence that the economy still has not recovered and is below its potential? Or will they interpret this behavior as a permanent effect of the crisis, which government policy alone may not be able to overturn?

Approaching a historic turn in U.S. monetary policy, Janet Yellen has staked her tenure as chair of the Federal Reserve on a simple principle: she would rather fight inflation than another economic downturn. Interviews with current and former Fed officials indicate that Yellen and core decision-makers at the U.S. central bank are determined not to raise interest rates too early and risk hurting the fragile U.S. (and global) economy. The nightmare scenario she wants to avoid is hiking rates only to see financial markets and the economy take such a hit that she has to backtrack. Until the Fed has raised rates off of the zero bound, it would have little room to maneuver if the economy threatened to head into another recession.

Inflation, on the other hand, is a familiar foe that Fed officials say they are confident they can control with conventional policy tools. If the Fed were to generate too much economic growth and higher inflation, that is a much better situation than one of a faltering economic recovery and the need to rely on even more unconventional tools. The risks of moving too soon include snuffing out an already tepid housing market recovery with higher mortgage rates, depressing business investment and durable goods purchases, and triggering sudden declines in asset prices. And after extraordinary efforts to support the U.S. economy after the Financial Crisis, there would likely be little appetite among fiscal conservatives on Capitol Hill to use fiscal policy to counter a fresh recession, making it all the more important for Yellen to avoid helping to cause such a reversal. As a result, we believe that the hurdle for the Fed raising interest rates is a lot higher than the consensus expects.

If and when the Fed does raise interest rates, it is unclear what impact this will have on the rest of the world. A vast wash of dollars flooded the global financial system when the Fed cut rates near zero and then bought $3.5 trillion of bonds. This flow may now reverse. How the Fed proceeds will arguably have more amplified effects than at any time since the end of the fixed-exchange Bretton Woods regime in 1971. (This is the paradox of 21st century globalization.) Monetary largesse in the developed world has destabilized emerging economies in many ways—one of which is to force them to choose between internal credit bubbles or surging currencies (most opted for bubbles as the lesser evil). Now these countries must brace for the potential for a secular rise in global borrowing costs.

Emerging markets went into a tailspin last year at the first suggestion of Fed bond tapering. There was a sudden stop in capital flows. The "Fragile Five" (Turkey, Indonesia, India, Brazil, and South Africa) were punished for current account deficits. The Fed subsequently backed down, and the storm passed. There was a second "taper tantrum" earlier this year as the Fed finally began to pair back its $85 billion monthly purchases under QE3. This too settled down. Those like India and Mexico that took advantage of the calm last Fall to boost their defenses were largely unscathed. Chairwoman Yellen has since recruited former Bank of Israel veteran Stanley Fischer to be her number two, partly to navigate the impact of Fed policies on the emerging markets.

Great uncertainty remains, therefore, as to how markets—both domestic and foreign—will react to any Fed policy move or even to a hint that a policy move is imminent. A sharp market reaction—and it is not unreasonable to fear that rates could jump precipitously as holders of large portfolios of low-yielding bonds dump them abruptly to avoid capital losses—could destabilize markets and derail the recovery. However, we believe that such a reaction would be short-lived. The Fed (and other global central bank policymakers) is fully aware of these issues and that both the U.S. economy and economies in the rest of the world are facing various headwinds that could pose problems for growth. In addition, they know about the numerous and significant geopolitical issues which could further contribute to increased market volatility and threaten the recovery. As a result, these authorities will do everything within their power to prevent and/or mitigate negative consequences from their monetary actions. We, therefore, fully expect that the Fed will maintain its zero interest rate policy for an extended period of time—if not indefinitely.

Release the Kraken!

Recent economic data from Europe has been relatively weak. Significantly, this weakness has now extended to the previous bastion of strength, Germany: German factory orders plunged –5.7% in August, the most since 2009. Manufacturing shrank in September, with new orders falling at the fastest pace since 2012, according to a survey of purchasing managers. Business confidence as measured by the Ifo Institute for Economic Research fell to the lowest level in almost 1 ½ years, while unemployment increased for a second month.

At the September 04 European Central Bank (ECB) policy meeting, President Mario Draghi, as expected, announced further interest rate cuts in a radical attempt to drive down the Euro and unveiled a broad purchase program of private sector assets (asset-backed securities [ABS] and covered bonds [CB]) to lift the Eurozone out of its economic slump—but stopped short of full-fledged quantitative easing (QE). Unfortunately, we do not believe that these most recent measures, in and of themselves, will have a significant impact on ameliorating the Eurozone's difficulties.

As we have explained in the past, interest rates are already so low in the Eurozone that the new cuts will not have much, if any, impact. Furthermore, a variety of market rates (particularly in the periphery) are largely detached from the ECB's main rate, making any changes mostly insignificant from an economic or financial perspective. The main motivation for the new cuts, therefore, appears to be symbolic: these interest rate cuts show a clear change from the ECB's previous position that, "for all practical purposes, we have reached the lower bound." This highlights the ECB's ability and willingness to overturn entrenched positions and respond to weaker-than-expected data. (Markets have periodically questioned the ECB on this front, and as such, it is a useful and important message for the ECB to send.)

The ABS and CB purchase program may also not have much impact. The market in this area remains small in Europe. Clearly, the motivation is to expand it and help drive funding channels outside of banks (over 80% of funding to non-financial firms in the Eurozone still comes through traditional bank funding channels). Despite being a purchase program, the focus remains on credit easing: the aim is to encourage banks to lend more by making it easier for them to sell repackaged loans as securities.

A significant point is that the asset purchases will be wider than originally thought and will include securities such as Residential Mortgage Backed Securities (RMBS). There is a much larger pool of RMBS than other types of securities. While this will increase the potential size of the program, it is still unlikely to be large enough to generate any significant inflation or credit easing: banks remain hesitant to lend in the periphery due to a number of risks (and the upcoming Asset Quality Review), while demand remains hampered by overall economic weakness.

In addition, there could be conflicts between these new policies and previous announcements—in particular, there is a potential conflict between the negative deposit rate (now at –0.20%) and the upcoming liquidity injections from the Targeted Long-Term Refinancing Operations (TLTROs) and asset purchases. The latter will (in theory) significantly increase the amount of excess liquidity on banks' balance sheets. However, the former is meant to discourage banks from holding this excess liquidity at the ECB. As we have noted before, unless this liquidity is removed from the banking system (primarily by being invested in assets not held by banks), it will end up on some banks' balance sheets and back at the ECB.

Despite Draghi's protestations that all of these measures are complementary, this seems to us to be a contradiction. The outcome will likely be a further compression in asset yields (despite some yields already being at the lowest level in modern history) and a jump in prices: banks will seek to find any liquid assets where they can hold excess cash in order to avoid the penalty ECB deposit rate. Many will also likely take advantage of the Euro carry trade to access higher returns elsewhere (which may at least help weaken the Euro further). But the hope that banks will increasingly lend to each other and to the real economy, thereby pushing up the velocity of money and easing the flow of credit more broadly, is unlikely to happen any time soon, in our opinion, as the monetary transmission mechanism in the Eurozone remains broken.

We remain unconvinced that these programs will do much to boost inflation, growth, or even credit supply in the Eurozone. Importantly, we believe that—except for full-blown QE—the ECB has exhausted its toolkit. Draghi admitted as much, saying that "there is no fiscal or monetary stimulus that will produce a significant effect" without serious and comprehensive structural reform within the Eurozone. The onus has now shifted to governments, with expectations rising for action. For the first time since 2012, pressure is increasing for Eurozone governments to reassess the institutional structures of the union and take action to pool further sovereignty. It appears to us, however, that, absent a more significant crisis, it will be difficult for the member countries to relinquish their independence willingly.

With regard to outright QE, the obstacles remain substantial. The ECB has been unable to secure German political consent for a genuine reflation strategy. Germany's member on the ECB board indicated only two months ago that QE is unthinkable except in an "emergency," and Germany believes that no such emergency exists. Given staunch German opposition, pushing forward on QE remains a tough task. As a result, the ECB is trying to buy time with half-measures, hoping that global recovery will lift Europe off the reefs without anything material being done. Although they may be successful with this approach, we believe that there is a significant probability that Europe will instead remain trapped, with high unemployment, increasing sovereign debt-to-GDP ratios, and a chronic deflationary malaise as households pay down debt and reduce demand for credit. (Half of the Eurozone was in deflation over the four months from March to July [annualized], with Italy down to –1.6%, Belgium –1.5%, Spain –1%, and France –0.4%, levels that make it harder to stop debt ratios from rising.)

With regard to QE, Draghi said he hopes to increase the ECB's balance sheet back towards the levels of 2012 (€3.1 trillion). That equates to a €1 trillion increase. Much of this will be in the form of cheap loans to banks (TLTROs) in exchange for collateral. As the International Monetary Fund (IMF) has said, this is not remotely akin to QE because the ECB is not taking the risk on its own balance sheet. As a result, the monetary mechanism is entirely different, and far less powerful, than the operations undertaken by the Bank of Japan and the Fed.

Although the cut in the discount rate to –0.20% is clearly intended to drive down the Euro, this policy measure has unintended consequences. Europe's money market funds, for example, are struggling to stay afloat as negative interest rates drain the industry's lifeblood, with many at risk of crippling downgrades by the rating agencies. Some funds have already begun to signal that they may not be able to repay investors' money in full.

It is a very rare occurrence for a money market fund to fall below par. It was a major shock to confidence when the Reserve Primary Fund in the U.S. announced in September 2008 that it had "broken the buck" due to exposure to *Lehman Brothers*. One of the reasons the Fed never cut rates below zero was concern about the knock-on effects for America's $2.1 trillion money markets. It is no longer clear whether the European money market funds can safely eke out a positive return as the ECB's negative rates spread through the financial system. Money market funds place their cash in a mix of short-term debt instruments, with some at the overnight rate. The average maturity is 45 to 60 days, and they are not allowed to lend beyond 397 days. As a result of the negative discount rate, much of Europe's €900 billion money market industry is sliding under water, and we can expect an exodus over the next two months as maturities expire.

The significance of the industry is that it provides corporations with a safe place to park cash, with enough liquidity for instant extraction, if need be. The funds spread the money across a very wide spectrum of assets and are therefore safer than bank accounts. As such, the funds play a key role in the European financial system. Corporate treasurers are sitting on significant amounts of cash. If they decide, instead of utilizing money market instruments, to lock up the money for six months or more in longer-term debt in order to get a positive yield, it could end up discouraging investment.

The ECB is undertaking ever more complicated operations like these because it is unwilling (or unable) to launch a massive QE program: a €1 trillion blitz of sovereign bond purchases, starting immediately, with no restrictions. The reason it is not doing this is because Germany has a de facto veto on the ECB's policy measures, and there will be a challenge filed at the German Constitutional Court the moment any such action is taken. QE is, in Germany's view, fiscal union by the backdoor, an assault on the budgetary prerogatives of the Bundestag, and an evisceration of German democracy.

Our argument has always been that the EMU should be dismantled because it is a creeping danger to democracy and economic self-determination. We retain this view and believe that its ultimate dissolution would be a good first step toward revitalizing Europe. From this perspective, recent discord in Scotland and Catalonia, as well as the rising influence of political opposition groups in Italy, France, and Germany are signs that the affected populace can no longer endure the deleterious effects of EMU. In the interim, we believe that market events—and a deteriorating German economy—may, in the not too distant future, finally overwhelm Germany's fiscal conservatism.

Long or Soft?

We have always believed that the economic soft-landing/hard-landing debate wholly misses the point when it comes to China's economic prospects. It confuses the kinds of market-based adjustments we are likely to see in the U.S. or European economies with the much more controlled process evident in China. Instead of a hard landing or a soft landing, we believe that the Chinese economy faces two very different options, and that these options will largely be determined by the policies that Beijing chooses over the next several years: (1) Beijing can manage a rapidly declining pace of credit creation, which must inevitably result in much slower, although healthier, GDP growth, or (2) Beijing can allow enough credit growth to prevent a further slowdown, but, once the perpetual rolling-over of bad loans absorbs most of the country's loan creation capacity, it will lose control of growth altogether, and growth will collapse.

The choice, in other words, is not between hard landing and soft landing. China will either choose a "long landing," in which growth rates drop sharply but in a controlled way such that unemployment remains reasonable even as GDP growth drops to +3% or less, or it will choose what analysts will at first hail as a soft landing—a few years of continued growth of +6-7%, followed by a collapse in growth and soaring unemployment.

We have written many times in the past that what will largely determine the path China follows is the political struggle President Xi Jinping's administration will have in imposing the needed reforms on an elite that will strongly resist these changes—mainly because these reforms must necessarily come at the elites' expense.

Although we do not think that China's economy is currently adjusting quickly enough, we remain cautiously optimistic that Beijing knows what it must do and will be able to achieve it.

The key economic policy for China over the past two decades has been financial repression. There have been three components to financially repressive policies. First, by constraining the growth of household income and subsidizing production, China forced up its savings rates to astonishingly high levels. Second, by limiting the ways in which Chinese households could save, mostly in the form of bank deposits, Beijing was able to control the direction in which these savings flowed. Finally, Beijing controlled the lending and deposit rates and set them far below any "natural" level.

Very low interest rates had several important impacts. First, because they represented a transfer from net savers to net borrowers, they helped to exacerbate the split between the growth in household income (households are net savers) and the growth in GDP (which is generated by net borrowers), and so led directly to the extraordinary imbalance in the Chinese economy in which consumption, as a share of GDP, has declined to perhaps the lowest level ever recorded in history.

Second, by making credit extremely cheap for approved borrowers, it created among them an almost infinite demand for credit. Financial repression helped foster tremendous growth in economic activity as privileged borrowers took advantage to borrow and invest in almost any project for which they could get approval.

Third, when China desperately needed investment early in its growth period, this growth in economic activity represented real growth in wealth. But low interest rates, along with the moral hazard created by the implicit guarantee of nearly all approved lending, led almost inevitably to a collapse in investment discipline. Financial repression has been the main explanation for the enormous misallocation of capital spending we have seen in China during the past decade.

We suspect that over the next few months we are going to get very inconsistent signals about credit control. But as long as the People's Bank of China can continue to withstand pressure to lower interest rates further, we believe that China will move towards a system that uses capital much more efficiently and productively, and that much of the tremendous waste that now occurs will gradually disappear. Just as importantly, lower growth will not create social disturbance because Chinese households, especially the poor and middle classes, will keep a larger share of that growth.

China is still vulnerable to a debt crisis, but if President Xi can continue to restrain and frighten the vested interests that will inevitably oppose the necessary Chinese economic adjustment, he may even be able to get credit growth under control before debt levels make an orderly adjustment impossible.

What about the debt, which is the other great risk to an orderly and successful Chinese adjustment? There are two things China can do to address its substantial debt problem. First, it can simply transfer debt directly onto the government balance sheet so as to clean up banks, state-owned enterprises, and local governments, thereby preventing financial distress costs from causing Chinese growth to collapse. As long as this government debt is rolled over continuously at non-repressed interest rates (which will be low as nominal GDP growth drops), China can rebalance the economy without a collapse in growth. This, essentially, is what Japan did in the 1990s.

The problem with this solution is that, although it is politically attractive (no wealth transfers from the elite to ordinary households), it does not fundamentally address China's debt problem, but rather simply rolls it forward. In that case, the burgeoning government debt will itself prevent China, once the economy is rebalanced, from ever regaining rapid growth.

A real solution to the debt problem may instead involve an initial transfer of debt onto the government balance sheet but an ultimate step to lower debt relative to debt capacity. This may involve using privatization proceeds to pay down debt, higher corporate taxes, and even higher income taxes if other forms of wealth transfer are robust enough to support them. One way or another, total government debt must be reduced, or at least its growth must be contained to less than real GDP growth.

Until recently, the Communist Party has responded to each economic slowdown with a fresh blast of loans, creating the potential for increasing debt problems. It appears, however, that Premier Li Keqiang is determined to drive through deep reforms and wean the economy off exorbitant levels of debt before the damage becomes irreversible. China's leaders have recently brushed aside warnings of an incipient credit crunch in the Chinese economy, and seem determined to purge excesses from the financial system despite falling house prices and the deepest industrial slowdown since the *Lehman Brothers* crisis. Industrial production dropped –0.4% in August from a month earlier. Electricity output has dropped –2.2% over the past year as the authorities continue to force dinosaur industries into closure, chipping away at excess capacity. New credit has fallen –40%, and there has been an outright contraction of trust loans and undiscounted bankers acceptances over the past two months, the result of a clampdown on parts of the shadow banking nexus.

There are signs of a Chinese "credit crunch"—albeit one engineered by regulators—with bond spreads for low-grade corporate debt trading at pre-default levels. In fact, credit has slowed so much over recent months that it is no longer growing faster than nominal GDP, a crucial inflexion point. The property market remains dazed, with sales down –13.4% in August. House prices have fallen for the past five months, with the effects spreading to related industries.

Premier Li has so far refused to blink, determined to drive through deep reforms and wean the economy off exorbitant levels of debt before the damage becomes irreversible. He recently said, "We are restructuring instead of expanding the monetary supply," warning markets not to expect easy money to ignite a fresh boom. It appears that the reformist regime led by President Xi is willing to tolerate lower growth provided that the economy continues to generate jobs. China's workforce is already shrinking, and the flow of rural migrants to the cities is slowing rapidly. It is a sign that the country may be hitting the "Lewis Point," when catch-up growth is exhausted—but it also lowers the risk of a social explosion.

The Communist Party's decision to rein in credit has global ramifications. The $25 trillion edifice is already as big as the U.S. and Japanese banking systems combined. As an example, the effects of China's industrial slowdown is a key reason why commodity prices have recently collapsed.

Whether President Xi will be able to maintain this new discipline given ongoing challenges remains an open question. The recent protests in Hong Kong (the Umbrella Revolution) regarding a decision by China's ruling Communist Party on the process for the next election of Hong Kong's top leader highlight this issue.

For China's Communist Party, the Hong Kong drama exposes the impossible contradiction of its current policies. As we discussed with you last year, President Xi launched a radical reform blitz at the Party's Third Plenum in November 2013, vowing to break the grip on the giant state-owned enterprises, sweep away a tangle of price controls, and move to a "mixed ownership economy." His reform program is intended to free China from its obsolete development model and help the economy transition to a rich, technologically-innovative, consumer society.

Yet, at the same time, he has doubled down on a one-party, one-ideology, authoritarian state. This is ultimately untenable. The Hong Kong protests demonstrate that demands for freedom rise with economic sophistication. Unless Beijing embraces the whole package of modern free thinking (i.e., democracy), China's economic leap forward will fail, leaving the country stuck in the "middle income trap." The role of the private sector and the free enterprise system is critical because innovation at the technology frontier is quite different in nature from catching up technologically. The Chinese government's dominance in key sectors, while earlier an advantage, is in the future likely to act as a constraint on creativity, which cannot be achieved through government planning.

Ultimately, if China can reform land ownership and the hukou system, enforce a fairer and more predictable legal system on businesses, reduce rent-capturing by oligopolistic elites, restructure the financial system (both liberalizing interest rates and improving the allocation of capital), and even privatize assets, +3-4% GDP growth can be accompanied by growth in household income of +5-7%, in our view. To us, this will be the primary determinant of whether the Chinese economic system will achieve long-term global success.

Lather, Rinse, Repeat

This has been an unusual year for the global economy, characterized by a series of economic, geopolitical, and market shifts—and the Fourth Quarter of 2014 is likely to be no different. We have discussed all of these issues in detail (and ad infinitum) over the last several years. Although most of these issues are slow-moving, that does not mean that they will not eventually become relevant.

Apparently unfazed by disappointing growth in both advanced and emerging economies—or by surging geopolitical tensions in Eastern Europe and the Middle East—equity markets have set record after record this year. This impressive rally has, until recently, ignored a host of historical relationships. In fact, correlations among a number of different asset classes have behaved in an atypical and, at times, unstable manner.

These factors are sending the global economy into the final Quarter of the year encumbered by profound uncertainty in several areas.

Looming particularly large over the next few months are escalating geopolitical conflicts that are nearing a tipping point, beyond which lies the specter of serious systemic disruptions in the global economy. This is particularly true in Ukraine, where Russia and the West have yet to find a way to ease tensions definitively. Absent a breakthrough, the inevitable new round of sanctions and counter-sanctions would likely push Russia and Europe into a deeper recession, dampening global economic activity.

Even without such complications, invigorating Europe's increasingly sluggish economic recovery will be no easy feat. In order to kick-start progress, ECB President Mario Draghi has proposed a grand policy bargain to European governments: if they implement structural reforms and improve fiscal flexibility, the central bank will expand its balance sheet to boost growth and thwart deflation. If member states do not uphold their end of the bargain, the ECB will find it difficult to carry the policy burden effectively—exposing it to criticism and political pressure. Ultimately, we believe that outright QE or an EMU breakup is inevitable.

In the U.S., the Fed is set to complete its exit from QE—its policy of large-scale asset purchases—imminently, leaving it completely dependent on interest rates and forward policy guidance to boost the economy. The withdrawal of QE, beyond being unpopular among some policymakers and politicians, has highlighted concerns about the risk of increased financial instability and rising inequality—both of which could undermine an already weak economic recovery.

Complicating matters further are the U.S. Congressional elections in November. Given the likelihood that the Republicans will continue to control at least one house of Congress, Democratic President Barack Obama's policy flexibility will probably remain severely constrained for the remainder of his term—unless, of course, the White House and Congress finally find a way to work together. Thereafter, within short order, will be the Presidential election of 2016, generating additional policy uncertainty.

Meanwhile, in Japan, the private sector's patience with Prime Minister Shinzo Abe's three-pronged strategy to reinvigorate the long-stagnant economy ("Abenomics") will be tested—particularly with regard to the long-awaited implementation of structural reforms to complement fiscal stimulus and monetary easing. If the third "arrow" of Abenomics fails to materialize, investors' risk aversion will rise yet again, hampering efforts to stimulate growth and avoid deflation.

Systemically important emerging economies are also subject to considerable uncertainty. Brazil's presidential election this month will determine whether the country makes progress toward a new, more sustainable growth model or becomes more deeply mired in a largely exhausted economic strategy that reinforces its stagflationary tendencies. In India, the question is whether newly elected Prime Minister Narendra Modi will move decisively to fulfill voters' high expectations for economic reform before his post-victory honeymoon is over. And China will have to mitigate various financial risks if it hopes to achieve its Third Plenum reform goals.

The final source of uncertainty is the corporate sector. Indeed, an increasing number of firms have been deploying the massive amounts of cash held on their balance sheets: first to increase dividends and buy back shares, and then to pursue mergers and acquisitions at a rate last seen in 2007. The question is whether companies will also finally devote more cash to new investments in plant, equipment, and people—a key source of support for the global economy.

This is a rather weighty list of issues. Yet, until recently, financial market participants have largely bypassed them, brushing aside today's major risks and ignoring the potential volatility that they imply. Instead, investors have trusted in the steadfast support of global central bank policymakers, confident that the monetary authorities will eventually succeed in transforming policy-induced growth into sustainable, organic growth.

In the meantime, many U.S. corporations remain financially strong, with healthy balance sheets and strong free cash flow. During the Second Quarter of 2014, companies in the S&P 500 increased revenues and earnings by +4.2% and +10.8%, respectively, year-over-year. For the Third Quarter, revenues and earnings are expected to grow +4% and +5%, respectively—with every economic sector producing revenue growth, and only the Telecom Services sector not producing earnings growth.

With regard to the major central banks, there is no apparent economic or inflation acceleration that would cause the Fed or ECB to act (the current data do not support tightening). At year-end, the Fed will be at neutral, and the ECB will be at neutral or easing (if QE is implemented). Add that the Bank of Japan appears to be preparing for another round of QE, and the outlook for continued global monetary easing remains intact. The end result is that monetary stimulus worldwide remains positive, not restrictive.

The equity markets have made substantial corrections, and they could fall more. However, the U.S. economy continues to grow (albeit slowly), and we do not foresee a recession in the near term. To us, that means that the long-term upward bias in stock prices should continue. We believe, therefore, that the recent market volatility has created an exceptional opportunity to take advantage of the misunderstandings of myopic market participants and purchase high-quality businesses that meet our investment criteria.

As you know, your *Windward* portfolio does not 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

Despite the risks noted above, certain 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, 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 type 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 dependant 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.

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.

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