# WINDWARD CAPITAL

*Risk Averse Asset Management*

## 2014 Fourth Quarter Review

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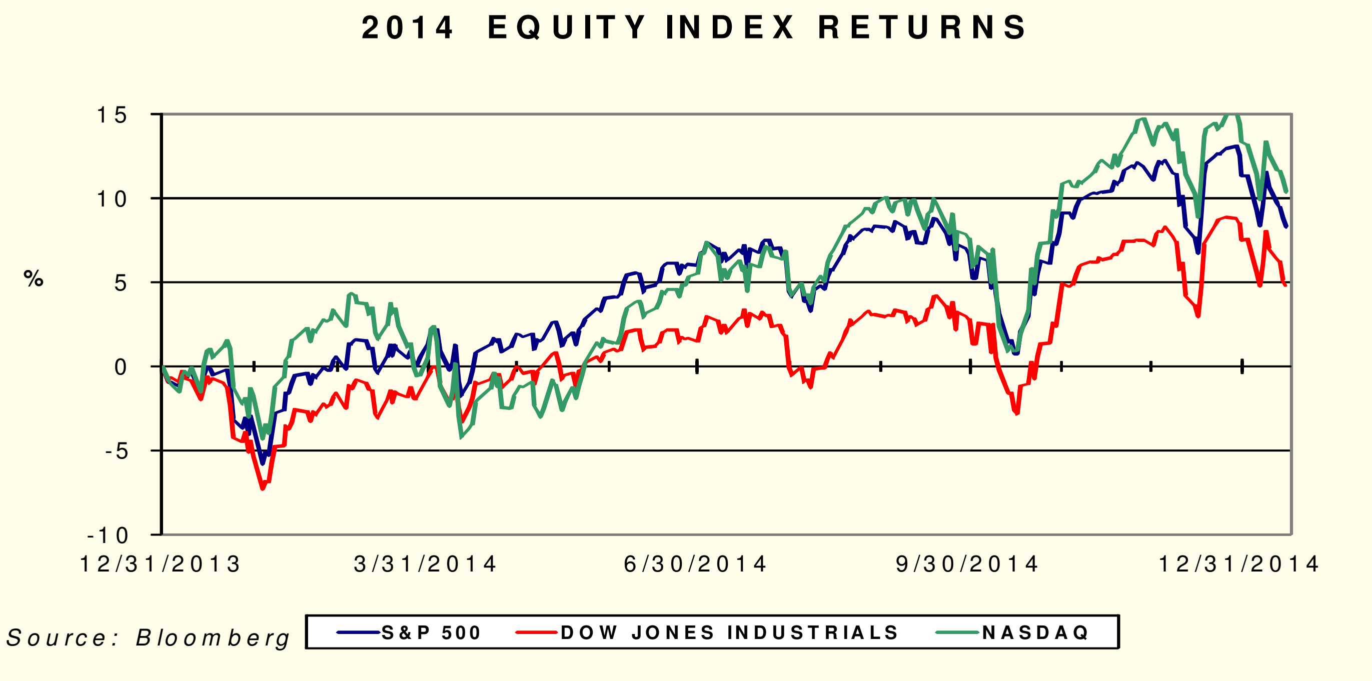


## *Bent, But Not Broken*

Although the global financial markets experienced heightened volatility during 2014 due to a variety of global macroeconomic, geopolitical, and central bank policy issues, U.S. equities generated positive returns: for the Fourth Quarter of 2014 the Standard & Poor's 500 Index (S&P 500), Dow Jones Industrial Average (DJIA), and NASDAQ Composite Index (NASDAQ) increased +4.93%, +5.20%, and +5.76%, respectively, and for the year increased +13.68%, +10.04%, and +14.83%, respectively. These returns occurred despite intra-period declines of –7.5% (mid-October), –5% (mid-December), and –4% (late-December 2014 to mid-January 2015).

As you know, for some time *Windward* has retained an out-of-consensus view of slowing economic, labor, and profit growth. Our decades of experience with economic and financial market cycles led us to the conclusion that investors were prone to abandon sound investment disciplines at market extremes because the one-directional nature of the prevailing trend made anything but permanent extrapolation seem like "a bad bet." We believe that recent financial market action continues to validate our view that this may be becoming more of a "two-way market," where stocks go both up *and down*, reflecting greater uncertainty and resulting in a concomitant increase in volatility.

A "two-way" market is ultimately healthy in that it shakes out speculative excesses via market participants who are non-dedicated, short-term investors. Since most market sell-offs are usually indiscriminate in nature, they often create opportunities for long-term investors like *Windward* to purchase high-quality businesses for client portfolios at a discount. As a consequence, we welcome the opportunity to take advantage of any future market weakness.

Since *Windward* has always taken a long-term view in selecting its investments for client portfolios, there are times when we appear to be "wrong" in our choices—at least over the short-term. This is especially true today given the virtual dominance of the equity markets by high-frequency algorithmic trading programs which, by definition, trade in and out of stocks by the millisecond. However, our long-term track record continues to validate our approach, which focuses on owning businesses that meet our criteria of quality, growth, and value.

The recent bout of volatility in financial markets occurred in an environment of rising uncertainty regarding the global macroeconomic growth outlook and mounting geopolitical tensions. Recent manufacturing Purchasing Managers' Indices (PMIs) have indicated a loss of economic momentum, especially in Europe, but also in other weak spots, including Japan, China, and major emerging market economies (e.g., Brazil, Russia).

One major exception to this softer macroeconomic outlook is the United States, where recent data point to a more sustained recovery, and the economy remains a bastion of relative strength.

As we have been warning for some time now, since the Financial Crisis of 2008-2009, the global macroeconomy has been facing a slow-growth environment underpinned by a dearth of demand and a surfeit of supply—increasing the risk of deflation. Unfortunately, these underlying fundamentals have been obscured by central bank policy actions, which have distorted the primary input to natural price discovery—i.e., interest rates.

As a result, abnormally-low interest rates have created significant mal-investment in a variety of asset classes, driving their prices to levels that do not represent their true underlying values. In addition, this monetary "reflation policy" has become less effective over time and has contributed to an exclusive prosperity that has penalized savers and distorted the divide between those that own assets and those that do not. Since we believe that the secular debt, demographic, and structural headwinds exposed by the Financial Crisis have not been addressed in a globally-coordinated fashion, the emergence of divergent macroeconomic developments on a country-specific level has the potential to create divergent monetary policy responses, which may result in significant asset dislocations and further financial market volatility.

One of the most obvious examples of this dynamic is the decline that has occurred in the commodity complex since 2011, in general, and in the Energy sector over the last six months, in particular.

## *Supply or Demand?*

The price of crude has fallen by –60% over the last six months. Energy represents only one component of a commodity complex that has been under significant pressure over the last few years (others include copper, iron ore, and coal). In our opinion, these declines are the result of a combination of the slow pace of global economic growth—more than 25% of the world's economies are experiencing a recession or less than +1% real Gross Domestic Product (GDP) growth—and the aforementioned distortions created by central bank monetary policies.

Gentle declines in the price of oil are typically benign—a "tax cut" for companies and consumers alike (each $10 drop in the price of crude has historically added +0.3% to GDP growth over the following year). Price crashes, however, are a different story. This usually signals global stress—increasingly dangerous in today's economic environment because of the potential for a deflationary shock.

Saudi Arabia has clearly shifted its historical strategy, aiming to force high-cost producers out of business across the globe (rather than defend OPEC cartel prices by slashing its own output to offset rises in supply) and is trying to squeeze three enemies: Iran, Russia, and the "Caliphate." The implications of these moves are significant. If crude prices stay low for long, almost all of the major oil producing countries will have to start dipping into their foreign reserves to fund their welfare states and military apparatus. The "fiscal break-even" per barrel oil price needed to cover budgets are \$130 for Iran, \$115 for Algeria and Bahrain, \$105 for Iraq, Russia, and Nigeria, and almost \$100 for Abu Dhabi. This means that these countries will have to sell holdings of foreign bonds, stocks, and gold to plug the gap. The scale of this liquidation could be significant (and it comes at a time when China has stopped accumulating reserves for other reasons, taking away the biggest global source of incremental asset purchases).

Lower energy prices will also impact the U.S. shale oil industry, which has lifted U.S. (liquids) output from 7 million barrels per day to 11.6 million barrels per day since 2008, and turned the country into one of the world's biggest energy producers. Several U.S. oil and gas companies have been amassing huge debts drilling for marginal output in increasingly difficult regions. The fossil fuel nexus has spent \$5 trillion since 2008, and much of this is at risk if crude remains at a low price for an extended period of time. There are already substantive signs of stress in the high-yield credit markets due to the impact of lower oil prices on highly-levered energy companies.

Perversely, despite the risks to the investments made in the U.S. Energy sector's renaissance over the last several years, we expect a continued increase in capital flows *into* the U.S. as America remains one of the safest havens in an uncertain world. In general, these flows are bullish for U.S. stocks, high-grade bonds, and the Dollar.

Importantly, the recent downward oil shock will also create a meaningful economic challenge to those countries that are dependent on higher energy (and other commodity) prices: so-called "rentier states," which derive all or a substantial portion of their national revenues from the rent of natural resources to external clients. Not only will the commodity price drop adversely impact these countries' Gross National Products (GNP), it will also serve to threaten their ability to meet social spending targets—and therefore holds the potential for both economic (slowing global growth) and social unrest (witness Russia and Venezuela).

In addition, lower oil prices have an immediate negative impact on inflation. Oil is pervasive as a commodity, and the decline in price is global; so the rate of inflation around the world attributable to energy costs will fall. In some places, lower oil prices will cause the inflation rate to decline by meaningful amounts. (In the Eurozone, lower prices will increase the struggle that Europeans have with a zero inflation threshold.)

In fact, the combination of a strong U.S. Dollar and weak commodity prices has led to sizeable depreciations of the currencies of net commodity exporters (and of emerging markets, in particular). In some cases, these global factors have interacted with country-specific vulnerabilities. For example, the Brazilian Real depreciated amid uncertainty associated with their Presidential election and a general weak economic outlook. Economic sanctions against Russia and a worsening of the conflict in Ukraine led the Ruble to plummet dramatically.

These trends lead to several central bank policy-related questions: How can central banks raise interest rates when inflation is ebbing and the most pervasive commodity in the world (oil) is falling in price? How does the Federal Reserve (Fed) segue to a policy of tightening and raising interest rates when one of the most substantial growth sectors in the U.S. (Energy) is retrenching due to falling prices? As the Fed moves from a neutral, post-tapering stance to tightening slowly, will the decline in energy prices cause them to repeat the error of the 1937 Fed hike during the Great Depression? If the decline in commodity prices is primarily a demand, not supply, issue (as we believe), would it not be more appropriate for the Fed to implement *additional* Quantitative Easing (QE) measures?

Despite recent Federal Open Market Committee (FOMC) member rhetoric, we expect the Fed to respond to these developments over time by extending and slowing the rate at which they achieve "normalization" of policy. **As a result, we forecast that the current low interest rate environment will extend for a longer period of time than the market consensus expects.** Although selective energy-related high-yield debt may come under increasing pressure because it is supported by higher energy price levels, non-energy-related high-yield debt may strengthen due to some cost relief for the businesses that benefit from the fall in energy pricing. Additionally, U.S. government bonds and investment-grade corporate debt may strengthen due to a "flight to safety," leading to lower American bond yields.

Outside the U.S., central bank policymakers are responding by easing: the Bank of Japan (BOJ), European Central Bank (ECB), People's Bank of China (PBOC), and Swiss National Bank are all moving towards lower interest rates for a longer period of time. A number of them are seeking ways to expand QE: Japan has done so in a dramatic way, while the ECB is still struggling with its implementation. The trend around the world in central banking is lower, longer, near zero, with an extended future of short-term and intermediate interest rates at extraordinarily low levels. As a result, we believe it is possible that most global interest rates (especially in the developed economies) will be near zero or very low for the rest of the decade.

The implications for investors and financial markets are historic and remarkable.

## *Patience*

The Fed ended its QE program in October. This program has boosted the Fed's balance sheet by nearly +60% to $4.5 trillion since September 2012. At the same time, the Fed kept the Federal Funds rate at the zero lower bound and indicated that it would be "patient" with regard to raising short-term interest rates.

In her most recent press conference after the December 2014 FOMC meeting, Fed Chairwoman Janet Yellen explained that "patience" was only likely guaranteed through the next "couple" of meetings (later clarified to be two). She dismissed falling market-based inflation expectations as reflecting inflation "compensation" rather than expectations. She dismissed the disinflationary impulse from oil, calling it transitory and drawing attention to the expected positive implications for U.S. growth. She indicated that inflation did not need to return to target (i.e., 2%) prior to raising rates—only that the Fed needed to be confident it would continue to trend *toward* target. She was unconcerned about the risk of contagion either via Russia or high-yield energy debt.

**In short, Yellen dismissed virtually all of the reasons that we expect will cause the Fed to delay rate hikes past its expectation of mid-2015.** Our sense is that the Fed sees an accelerating U.S. economy and, combined with the long lags of monetary policy impacts, worries that it will not be long before they are behind the curve with regard to interest rates.

**However, we believe that it may be some time before the Fed raises rates and that, if it does, the increase would be de minimis.** Factors that may keep the Fed on hold include: (1) the impact of the oil shock on core inflation may be more than expected, (2) rising labor force participation stabilizes the unemployment rate and wage growth continues to move sideways or lower (as the most recent employment report indicated), or (3) global macroeconomic uncertainty increases. As a result, our estimate of the Fed's policy interest rate one year from today is somewhere close to 0.5%, a slight increase from the present range of 0.0% to 0.25%. Still, the structure of that forthcoming policy rate remains open to debate given the possibility for a global deflationary shock that may ultimately necessitate a return to some form of QE.

## *"Negative Inflation"*

Due to continued deterioration in the Eurozone economy, the ECB may be on the verge of loosening its monetary policy stance further. In fact, long-term government bond yields in the Eurozone fell to record lows after a speech by ECB President Mario Draghi on November 21, wherein he stressed that the ECB will do whatever is required to raise inflation and inflation expectations by adjusting the size, pace, and composition of its asset purchases if its previous policies prove to be insufficient.

As we have been warning for some time, Eurozone authorities have so mismanaged monetary and fiscal strategy that the whole European Monetary Union (EMU) currency bloc has now tipped into deflation, further raising the prospect of a multi-billion Euro intervention by the ECB to try to prop up the sluggish economy.

Although recent statistics show that prices in the Euro area in December were –0.2% lower than a year earlier, this scarcely captures the significance of what has been happening over the last 18 months: deflationary forces have been gaining a grip on all of the peripheral South European crisis states. The December data were far short of the ECB's target of just under 2% inflation and is the first time the Euro area has experienced outright deflation since 2009. Energy prices slumped –6.3% compared to a year ago, driven by the large decline in oil prices. Meanwhile, the cost of industrial goods and food was flat in the Eurozone last month, while prices for services rose +1.2%. Excluding the oil slump, prices were up +0.6% from December 2013. Five-year inflation swaps, which the ECB uses to measure the market's inflation expectations, fell to a fresh low of 1.48% (having touched 3% at the start of 2014).

As a result, Eurozone bond yields have plummeted to record lows in anticipation of a QE blitz. German five-year yields dropped below zero for the first time ever. Italian, Spanish, and Portuguese yields have seen spectacular drops. The French state can now borrow for five years at a rate of 0.13%, and Ireland can do so at 0.32%. **Nothing like this has been seen in European history since the 14th century**.

Draghi has stated that a slip into deflation "cannot be ruled out completely" and admitted that the bank is at mounting risk of breaching its price stability mandate. He said the ECB is "making technical preparations" to boost its balance sheet in early 2015, but offered no fresh clues on how much it will be or whether the measures will include full QE in the form of sovereign bond purchases. Investors have taken his comments as a strong hint of QE as soon as this month, even though he repeated his usual caveat that new measures will be undertaken only "should it become necessary to further address risks of a too prolonged period of low inflation." His interview may have been the trigger for the latest dash for EMU sovereign debt.

The ECB is reportedly considering three possible options for buying government bonds ahead of its January 22 policy meeting. One option is to pump liquidity into the financial system by having the ECB itself buy government bonds in a quantity proportionate to the given member state's shareholding in the central bank. A second option is for the ECB to buy only triple-A rated government bonds, driving their yields down to zero or into negative territory (the hope is that this would push investors into buying riskier sovereign and corporate debt). Finally, the third option is similar to the first, but national central banks would do the buying, meaning that the risk would "in principle" remain with the country in question.

Unfortunately, there are not enough bonds to buy from certain countries if the ECB sweeps into the market on a grand scale. Importantly, as the largest member of the Eurozone, there would be an acute shortage of German debt since Berlin plans to run a budget surplus this year and will therefore be *retiring* bonds gradually instead of *issuing* them.

In addition, ECB QE actions remain a political minefield. The German Bundesbank continues to resist QE, arguing that lower oil prices are a shot in the arm for the real economy and therefore make monetary stimulus less necessary—even if it depresses headline inflation. Michael Fuchs, a leader of the ruling Christian Democrats and a close advisor to German Chancellor Angela Merkel, warned Draghi recently that QE would merely take pressure off the crisis states and allow them to delay reforms. He stated that the ECB should not be in the business of propping up peripheral debt markets. Add to this renewed fears of a Greek exit from the Eurozone and growing anti-Euro political sentiment in Spain, France, and Italy, and the complexity of the situation escalates dramatically.

As a result, the ECB may be forced to accept a compromise on QE, either by scaling back the magnitude or by accepting a formula where the national central bank of each EMU state buys only the bonds of its own government, with no pooling of risk, as mentioned above. This would be highly risky, however, because it would further fragment the Euro system, and might cause markets to have second thoughts about the stimulative effects of QE. Yet Germany remains adamant that there must be no fiscal union by the back door.

We reiterate our stance that the EMU, as currently implemented, remains dysfunctional: a currency union of disparate cultures with no treasury or political authority to guide it has resulted in paralysis, with feedback loops entrenching divisions over time. An EU superstate, with economic and political sovereignty to be exercised jointly remains a Utopian vision. There is no popular groundswell anywhere for such a vaulting leap forward, and it would imply a technocrat dictatorship beyond democratic control if ever attempted. The Northern European creditor states have spent the past four years methodically preventing any durable pooling of risk or any step towards fiscal or political union, necessary ingredients for a viable EMU.

## *Pedal to the Metal*

On October 31, the Bank of Japan (BOJ) surprised markets by stepping up its Quantitative and Qualitative Easing (QQE) program as it raised the central bank's target for enlarging the monetary base from ¥60-70 trillion to ¥80 trillion a year. (That program was already considerably more aggressive than that of the Fed, relative to the size of the economy.) If implemented, this will increase the BOJ's balance sheet over the course of the next year by nearly +30%. On the same day, Japan's Government Pension Investment Fund (GPIF) announced a rise in domestic equity weights and an increase in foreign asset holdings for its portfolio. Financial markets reacted positively to the policy changes in Japan: on the announcement day, Japanese equity prices rose by almost +5% and the Yen fell by around –3% against the U.S. Dollar.

These steps were taken as the BOJ's assessment of the economic outlook was reduced. The BOJ estimate for GDP growth in 2014 is +0.5%, down from +1.0% previously. The sales tax increase earlier in the year hurt economic growth more than expected, and it seems increasingly unlikely that an additional tax increase planned for this Spring will be implemented. The central bank and the Japanese government appear to want to boost stock market prices in order to improve consumer and business sentiment, which is needed if the economy is to resume its recovery. Premier Shinzo Abe's government may also introduce some stimulative fiscal policy measures in the near future.

The BOJ has stunned the world with a fresh blitz of stimulus, pushing QE to unprecedented levels in a bid to drive down the Yen and avert a relapse into deflation. This may threaten a trade shock across Asia in what amounts to currency warfare, risking serious tensions with China and Korea, and tightening the deflationary noose on Europe. The unstated purpose of BOJ Governor Haruhiko Kuroda's reflation drive is to lift nominal GDP growth to +5% per year. The finance ministry deems this the minimum level needed to stop a public debt of 245% of GDP from spinning out of control. The intention is to erode the debt burden through a mix of higher growth and negative real interest rates, a de facto tax on savings.

The latest move—already dubbed QE9—sent the Yen plummeting to as low as ¥121 against the Dollar, the weakest in seven years. The currency has fallen –40% against the Dollar, Euro, and Korean Won since mid-2012, and –50% against the Chinese Yuan. Japan is, in effect, exporting its deflationary pressures to the rest of Asia, and it is not clear whether other countries in the region can cope with this given their issues with overcapacity and debt. **As we indicated several years ago, a currency war was always possible, and such an outcome risks sending a wave of deflation across the world from Asia.** As each country resorts to a beggar-thy-neighbor policy in moves similar to the 1930s, deflation is dumped in the lap of any region that is slow to respond (currently the Eurozone).

The BOJ's new stimulus is a disguised way to soak up some $250 billion of government bonds that will be coming onto the market as Japan's $1.2 trillion state pension fund (GPIF) slashes its weighting for domestic bonds to 35%. This avoids a spike in yields—the nightmare scenario for Japanese officials. The GPIF will have to buy $90 billion of Japanese equities and $110 billion of foreign stocks to lift its weighting to 25% for each category. This will be a shot in the arm for global markets but is also a clever way for Japan to intervene in the currency markets to hold down the Yen. The BOJ has, in effect, outsourced its devaluation policy, shielding it against accusations of currency manipulation.

Japan has to tread carefully. The world turned a blind eye to the currency effects of Kuroda's first round of QE because the Yen was then seriously overvalued. This is no longer the case. The risk for Premier Abe is that further bursts of stimulus may be taken by critics as an admission of failure—though, in reality, it is far too early to judge whether the country has closed the chapter on its two Lost Decades. What seems certain is that Japan was sliding headlong into a debt compound trap before Abe launched his "Hail Mary" pass into the monetary policy unknown.

Monetary policy works with famously long and variable lag times, and no major country in the post-war era has ever attempted such a radical experiment in money creation, or attempted quite so brazenly to monetize so much of its public debt. Interestingly, broad M3 money in Japan has been growing at a rate of almost +5% over the last three months (seasonally adjusted), suggesting that the foundations for a strong recovery six-to-twelve months later may be coming into place. If there is a further increase in M3, Japan could enjoy an economic surge not seen since the 1980s.

## *What Do Yuan?*

China has for the first time warned openly about the excessive strength of the Chinese Yuan—a sign that the country may be shifting its exchange rate policy as deflation takes hold and currencies slide across Asia. The country has quietly joined Asia's escalating currency wars, steering the Yuan down by –2% against the Dollar since early November. This looks increasingly like a move to protect itself against Japan's dramatic devaluation and against weakening currencies in Korea and other key Asian states. The Yuan is no longer fixed to the dollar but remains linked through a "soft peg." It has therefore been forced sharply upwards even though the Chinese economy is slowing and the country is losing global competitiveness.

China is sliding uncomfortably close to deflation. Producer prices are falling at a rate of –2.7% as excess plant in steel, cement, chemicals, coal, and solar lead to price wars. The headline inflation rate has dropped to 1.4%. Any action to devalue the Yuan has the effect of exporting China's deflation to the rest of the world, especially to Europe where the authorities are struggling to defend themselves. The source of the currency shock comes from Japan. The Yen slide has become increasingly threatening over recent months as Japan's exporters start to cut prices rather than pocketing the exchange rate gains as higher profit. Emerging market jitters have led to a further currency sell-off in a string of countries, from Russia to Indonesia, India, Thailand, and Malaysia. The effect is to leave China stranded in a sea of devaluation.

Where China faces a problem, like many other countries, is in the relationship between debt and deflation. In a deflationary environment, unless productivity growth rates are high, it is very difficult to keep the value of assets rising in line with the value of debt. There is a natural tendency for asset values to decline in line with deflation, whereas the nominal value of debt is constant (and, when interest costs are added, the nominal value of monetary obligations actually *increases*). Of course, if the value of debt rises faster than the value of assets, by definition wealth (equal to equity, or net assets, in a corporate entity) must decline. This is why highly indebted countries and businesses struggle especially hard with deflation.

Excess capacity is a global problem, and not just a Chinese one, but the implications for monetary policy are very different in countries like China and Japan than they are for countries like Europe and the U.S.. The monetary and financial structures of some countries create a very different set of institutions than in others, and one result is that policy responses that might seem to make sense in the U.S. are actually harmful in China.

In the past, we have discussed the need for China to rebalance its economy so that the household share of GDP increases and the country remains on a more sustainable growth trajectory. As a reminder:

It is widely accepted that China's growth model has led to unsustainable internal imbalances and rising debt. China's previous double-digit GDP growth was primarily driven by state-sector investments. This model of growth favors heavy industries and infrastructure projects that lead to rapid growth. This investment-driven growth model has favored the growth of the state sector at the expense of the household sector. Along with an undervalued currency, low wages, and a financial repression "tax" on savers, consumers in China are bound to extremely high levels of savings to offset an absent social safety net. By extension, this means that consumption plays a growing but relatively minor role in China's GDP growth, a pattern that will continue if China's economy does not rebalance toward greater consumption and less investment. Due to the high levels of investment over the past couple of decades, additional capital spent on investment will lead to diminishing benefits. Resources become poorly allocated and inefficiencies arise, making the investments less and less viable. As this investment-driven model continues, the level of debt used for heavy investment projects will surpass their servicing capacity, leading to more illiquidity in the banking system and ultimately, a significant debt problem.

Indications are that the Chinese government has recognized these issues and is serious about rebalancing China's economy away from its over-reliance on investment. However, historical precedents suggest that this transition will be very difficult and may involve many years of much slower growth and rising uncertainty. Nevertheless, in November 2013, Chinese President Xi Jinping introduced the Communist Party's Third Plenum reforms, which included several key features designed to facilitate the Chinese economy's economic rebalancing. These features include: a new role for the government and market-driven resource allocation; state-owned enterprise reform; fiscal reform; integrated rural-urban development (land reform); democratic consultation; judiciary reform; anti-corruption; social media and internet management; a new State Security Committee; environmental protection (assigning custodian rights for natural resources to responsible parties); and a new small leading group to coordinate reforms.

China has only completed the first part of its rebalancing, whereby interest rates, wages, and the currency have all moved sharply closer to healthy levels—that is, levels at which the imbalances are no longer getting worse. However, Beijing has still not been able to control credit growth because to do so would cause GDP growth to drop much more sharply than the authorities are currently willing to tolerate. This is the next great challenge for the country. When the regulators finally do start to repair the country's overextended balance sheet (which has a much higher debt-to-GDP ratio than any other country at China's stage of economic development), we expect that annual GDP growth rates will continue dropping steadily.

Adjustments like these are always difficult (and have nearly always been harder than expected), but it is important to remember that they represent a critical part of the rebalancing process. Although the adjustment in growth is not symmetrical, it is healthy. In the case of China, for example, slowing GDP growth would cause Chinese household income growth to be higher and investment growth to be lower (after nearly 30 years of the reverse relationship) so that the impact of slower growth will be disproportionately smaller on consumption growth and larger on investment growth. This means that lower Chinese GDP growth will not be nearly as painful for Chinese households as expected, but that demand for inputs to the investment-driven side of the economy (primarily natural resources and basic materials) will decline.

## *Divergences*

In the coming years, we believe that "divergence" will be a major global macroeconomic theme, applying to both economic trends and to monetary and fiscal policies. As time progresses, these divergences will become increasingly difficult to reconcile, leaving monetary, fiscal, and political policymakers with a choice: either overcome the obstacles that have so far impeded effective action, or risk allowing their economies to become destabilized.

In our view, the resultant multi-speed global economy will be dominated by four groups of countries.

The first, led by the U.S., should experience continued improvement in economic performance on a relative basis. The U.S. economy, although not an island in an increasingly global macroeconomy, remains relatively strong. **The majority of U.S. corporations have taken advantage of the aftereffects of the Financial Crisis to improve both their operations and their financials and are, therefore, in the best condition they have ever been in the history of the United States**. **This combination of growth in the U.S. economy, low interest rates, low inflation, and corporate strength should continue to support an increase in the U.S. equity markets**.

The second group, led by China, will eventually stabilize at lower growth rates than recent historical averages, while continuing to mature structurally. They will gradually re-orient their economic growth models to make them more sustainable—an effort that occasional bouts of global financial-market instability will shake, but not derail—and they will work to deepen their internal markets, improve regulatory frameworks, empower the private sector, and expand the scope of market-based economic management.

The third group, led by Europe, will struggle, as continued economic stagnation fuels social and political disenchantment in some countries and complicates regional policy decisions in others. Anemic growth, deflationary forces, and pockets of excessive indebtedness will hamper investment, tilting the balance of risk to the downside. In the most challenged economies, unemployment, particularly among young people, will remain alarmingly high and persistent, destroying future productive capacity.

The final group comprises the "wild card" countries, whose size and connectivity have important systemic implications. The most notable example of these countries is Russia. Faced with a deepening economic recession, a collapsing currency, capital flight, and shortages caused by contracting imports, President Vladimir Putin will need to decide whether to change his approach to Ukraine and re-engage with the West to allow for the lifting of sanctions and the building of a more sustainable, diversified economy. (The alternative would be to attempt to divert popular discontent at home by expanding Russia's intervention in Ukraine. This approach would most likely result in a new round of sanctions and counter-sanctions, tipping Russia into an even deeper recession—and perhaps even triggering political instability or more foreign-policy risk-taking—while exacerbating Europe's economic malaise.)

Brazil is the other notable wild card. President Dilma Rousseff, chastened by her near loss in the recent Presidential election, has signaled a willingness to improve macroeconomic management, including by resisting a relapse into statism, the potential benefits of which now pale in comparison to its collateral damage and unintended consequences. If she delivers, Brazil would join Mexico in anchoring a more stable Latin America in 2015, helping the region to overcome the disruptive effects of a Venezuelan economy roiled by lower oil prices.

This multi-speed global macroeconomic environment will contribute to multi-track central banking, as pressure for divergent monetary policies intensifies—particularly in the systemically-important advanced economies. **The Fed, having already stopped its large-scale purchases of long-term assets, is likely to begin hiking interest rates, albeit nominally, some time during 2015 or 2016, at the earliest.** By contrast, the ECB may pursue its own version of QE, introducing a set of new measures to expand its balance sheet, while the BOJ will maintain its "pedal-to-the-metal" approach to monetary stimulus.

Of course, there is no theoretical limit on divergence. The problem, however, is that exchange-rate shifts now represent the only mechanism for reconciling these divergences, and the divide between certain market valuations and their fundamentals has become so large that prices are vulnerable to increased bouts of volatility.

For the U.S., the combination of a stronger economy and marginally-less accommodative (although still stimulative) monetary policy will put additional upward pressure on the Dollar's exchange rate—which has already appreciated significantly—against both the Euro and the Yen. With few other countries willing to allow their currencies to strengthen, the Dollar's tendency toward appreciation will remain strong and broad-based. Moreover, as it becomes increasingly difficult for currency markets to perform the role of orderly reconcilers, friction may arise among countries (i.e., currency wars).

**Fortunately, there are ways to ensure that these divergences do not lead to economic and financial disruptions. Indeed, most governments—particularly those in China, Japan, and the U.S.—have the tools they need to defuse the rising tensions and, in the process, unleash their economies' productive potential.** Avoiding the disruptive potential of divergence is not a question of policy design; there is already broad, albeit not universal, agreement among economists about the measures that are needed at the national, regional, and global levels. Rather, it is a question of successful implementation—and this will require significant and sustained *political* will.

Because the pressure on policymakers to address the risks of divergence will increase over the coming years, we anticipate that financial market volatility will remain the norm. Since markets of any kind can become, and stay, over-bought or over-sold for long periods of time, we believe that this is a time for investors to be selective. 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.

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.

## NOTES

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