BESSEMER TRUST

Quarterly Investment Perspective

What Will Emerge in 2016

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Executive Summary

- **Financial markets in 2015 were driven primarily by three factors: the U.S. dollar, oil prices, and emerging markets (namely China)**
- **As we look to 2016, we expect the dollar and oil to fade as investor focal points while emerging markets stay front and center**
- **We head into the new year still cautious on emerging markets, but constructive on cyclical assets more broadly**

While we pride ourselves on being forward-thinking and longer-term investors, the end of the calendar year is always a good time for reflection. What dominated portfolio returns this past year? Did we successfully foresee the respective trends or were we surprised? What could we have done better?

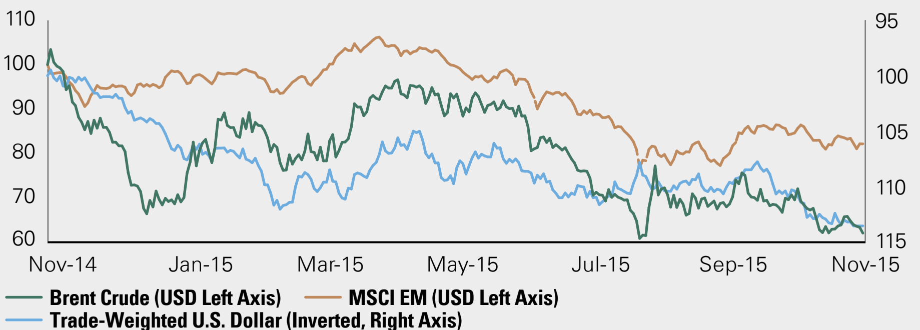
In a nutshell, we would say that three main forces drove markets in 2015: a plunge in oil prices, an unexpectedly sharp rise in the U.S. dollar, and concerns about emerging markets, led by China. In the 12 months through end-November, Brent crude oil lost nearly 40%, the trade-weighted dollar climbed 14%, and emerging market equities (defined by the MSCI Emerging Market Index) dropped approximately 15% in U.S. dollar terms, consisting of -7% from local equity market moves and -8% from currency weakness (Exhibit 1).

Fortunately, we had directionally positioned for these trends. We were overweight the dollar versus our benchmark, with specific hedges in equity portfolios to protect against euro and Japanese yen weakness. We were underweight emerging markets and commodities (both hard commodities and commodity-related equities). Strong security selection, especially in our Large Cap Strategies and Small & Mid Cap equity mandates, also added to performance relative to our benchmark.

At the same time, we underestimated the drag on certain U.S. equity sectors from the fall in oil prices and rise in the dollar (despite correctly highlighting in 2014 the risk of China allowing the renminbi to weaken, in what could prompt more

Exhibit 1: Emerging Market Equities, Oil, and U.S. Dollar Linkages

Key Takeaway: Three main forces drove financial markets in 2015: a plunge in oil prices, a sharp rise in the U.S. dollar, and concerns about emerging markets.



As of November 30, 2015.

Source: Bloomberg, Federal Reserve Board, MSCI

Emerging Themes for 2016

As we look ahead, we expect to see lingering fallout from the strong U.S. dollar and lower oil prices. Historically, these shocks can take several quarters to work their way through corporate and economic channels. However, we also see some light at the end of these particular tunnels as financial markets are now discounting a lot of the bad news from these forces and because we do not see further dramatic moves coming from either.

"strong-dollar" angst). In retrospect, we would have been better off reducing our U.S. equity holdings, and adding more to our exposures in the euro area and Japan, where currency-hedged equities performed relatively better during the year.

Through end-November, our Balanced Growth model portfolio, which is diversified with a roughly 70/30 stock/bond risk profile, continued to outperform its benchmark on a 1-, 3-, and 10-year basis. For the last 12 months, global equities weakened slightly while bonds largely strengthened; U.S. municipal bonds returned in excess of two percent, helped by the Federal Reserve holding steady for much of 2015. Our broad tilt toward equities and away from fixed income was not supportive of overall performance for the time period, partially due to the sharp, albeit short-lived, equity selloff in late August and September.

Emerging Themes for 2016

As we look ahead, we expect to see lingering fallout from the strong U.S. dollar and lower oil prices. Historically, we have seen that these shocks can take several quarters to work their way through corporate and economic channels. However, we also see some light at the end of these particular tunnels as financial markets are now discounting a lot of the bad news from these forces and because we do not see further dramatic moves coming from either. In the U.S. dollar's case, we forecast further appreciation as the Federal Reserve's tightening diverges from continued monetary easing in the euro area and Japan. However, we believe dollar gains will come much more slowly (please see *Will the Buck Stop Here?* November 18, 2015, for more detail). As for oil, increasing global demand and declining U.S. supply should help create a floor for prices, though we are not expecting any quick or marked oil recovery in the year ahead.

That leaves emerging markets (EM). What does the year ahead hold for China, among others? In this edition of our *Quarterly Investment Perspective*, we focus on 2016 through an emerging market lens. Can emerging markets return to their glory days of the 2000s after five years of disappointing growth and underperforming developed market equities, or has something structurally broken? Even without any EM holdings in a portfolio, how much can emerging developments impact investors? What EM countries and issues stand out in the year ahead?

EM 101: Then and Now

Before looking specifically at 2016, it is worth stepping back to discuss emerging markets more generally. What makes an economy or financial market emerging versus developed? The International Monetary Fund (IMF) notes, "This classification is not based on strict criteria …" and has "evolved over time." Currently, the IMF sees emerging markets as having relatively lower per capita income and less diversified exports than their developed market counterparts. For example, Saudi Arabia is emerging because of oil-export reliance even though it has relatively high per capita income. Further, the IMF considers EM as less integrated into the global financial system. The IMF and MSCI (a well-known equity index provider) each includes about two dozen countries as emerging markets. Both lists

include the largest EM, often called the BRICs: Brazil, Russia, India, and China. These four countries' total nominal gross domestic product (GDP) represented 64% of the IMF's total EM GDP as of 2014.

The last few decades have seen material changes among emerging markets: economies have grown, currencies have become more free floating, local bond and equity markets have developed, and in many cases, central banks have adopted more western-style inflation-targeting policies. In 1990, emerging economies represented 22% of nominal global GDP; by 2014, that figure had risen to 39% (Exhibit 2). These developments have occurred alongside technology improvements and lower regulatory and trade barriers. All have combined to give EM more weight on the global economic stage.

Greater integration into the global economy has meant that investors benefitted less from EM diversification: correlations between developed and emerging equity markets have trended higher during the last few decades as developed and emerging countries have done more business with each other and as EM has played an increasing role in global growth.

Today, we have reached a point where the largest of the emerging markets — China — has become the world's second-largest economy and could even replace the U.S. as *the* largest within a few decades. With that in mind, emerging economies and financial markets can drive developed markets as much as the other way around. The global equity swoon in August and September of 2015 had as much to do with policy changes and uncertainties in China as anything else (see *China's Growing Pains*, October 1, 2015). But how does that happen? After all, emerging equities represent only nine percent of the MSCI All-Country World Index (ACWI), in part given the lack of large publicly traded companies in these countries. At first glance, it seems like a poor use of time to focus on two dozen countries and dozens of companies

Emerging Markets Have Changed

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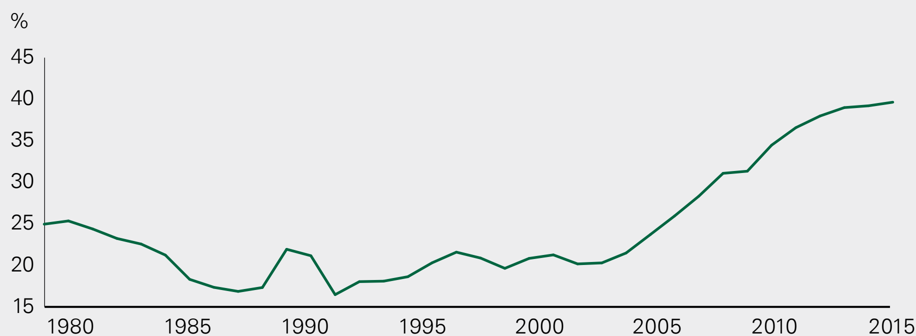
Exhibit 2: Emerging Market GDP as a % of World GDP

Key Takeaway: Emerging economies' share of global GDP has risen markedly in the last two decades.



As of November 30, 2015. Calendar years 2014 and 2015 data reflect IMF estimates. Values are in nominal U.S. dollars.
Source: International Monetary Fund

Interconnected Markets

The world today is increasingly interconnected: investors cannot view benchmark country weightings as black and white. Many companies are domiciled in developed economies but do a material amount of business with emerging customers — their revenues can be more influenced by trends internationally than at home.

for what might be a very small piece of an overall portfolio. Better to forecast, correctly, the U.S. and Europe's economies and stock markets as the U.S. accounts for 53% of the MSCI's ACWI, followed by Europe at 22% (Exhibit 3).

While that might sound like good common sense, it would be a mistake, for a few reasons. First and most importantly, the world today is increasingly interconnected; investors cannot view benchmark country weightings as black and white. Many companies are now domiciled in developed economies but do a material amount of business with emerging customers — their revenues can be more influenced by trends internationally than at home. The same holds true for entire countries. Germany, for instance, is China's biggest trade partner in Europe, while China is Germany's biggest non-European Union export market after the U.S. In recent years, German companies have created joint ventures with Chinese firms and shared technology in return for access to Chinese consumers, especially for luxury German vehicles. A view on Germany's equity market must take into account trade trends with China.

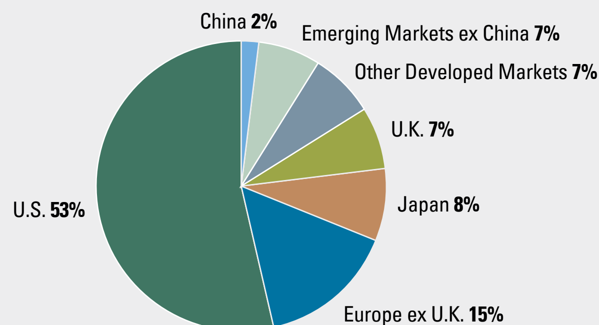
Secondly, EM countries can account for a disproportionate share of tail risk in the global economy, in part because of less stable political systems or other social infrastructure, and so are important for U.S. investors to consider. The escalation in Middle East tensions and the related rise of Islamic State (ISIS), the Arab Spring, and Russia's annexation of Crimea (a region in Ukraine) are examples of geopolitical events that temporarily dominated global sentiment, while China's economic swings clearly were relevant to market performance in 2015 (see page 8). Having a sense for where issues may arise and impact global sentiment is important from a broad investment portfolio perspective.

Additionally, given that emerging markets have tended to be more volatile than developed markets, they can provide greater upside or downside risks to an overall portfolio than the market or economy size would suggest. The stark underperformance of EM in recent years has been significant enough to

Exhibit 3: Country and Regional Equity Weights in MSCI ACWI

Key Takeaway: Emerging market equities account for a relatively small proportion of global equities in benchmark indexes.

Adjusted outstanding market capitalization



As of November 30, 2015. All data reflect MSCI Investable Market Indexes (IMI).

Source: MSCI

affect the overall performance of diversified investors who were overweight. This is one reason we have been underweight for the better part of the last two years. We note that valuations of EM are now leading some analysts to suggest that the year ahead may mark a shift: a rebound in EM could help returns for a broad global portfolio (Exhibit 4). At some juncture we believe that an EM overweight could be advisable, but as we note in the following pages, we believe it is too early to turn bullish.

Finally, the reduction in market liquidity in recent years, especially in fixed income-related markets, has meant that more investors will hedge, or protect against losses, with one country or market for an underlying position in another. China and Japan are good examples. Investors wanting to protect portfolios from losses in mainland Chinese equities — a market that is relatively less developed — may use options or other financial strategies tied to a more liquid, developed market such as Japan, where trading costs are likely to be relatively lower. Brazil and Mexico provide an example of intra-EM hedging. Investors may want to buy Brazilian equities after the last few years' steep losses but may also want to protect against further weakness in the Brazilian currency, the real. Given the lack of liquidity and cost of selling the real, those same investors may choose to sell the Mexican peso instead as a sort of proxy hedge. The peso is cheaper to sell than the real, in part because of lower local interest rates, greater trading volumes, and the ability to deliver pesos in international markets.

The bottom line is that it is not enough to focus solely on the world's largest economies, given their outsized roles in traditional financial benchmarks. We have to follow emerging markets for direct investment opportunities and to monitor potential spillovers to global growth, markets, and investor sentiment.

Reduced Market Liquidity Leads Investors to Look for Hedges

The reduction in market liquidity in recent years, especially in fixed income-related markets, has meant that more investors will hedge, or protect against losses, with one country or market for an underlying position in another.

Exhibit 4: Emerging Market Equities Valuation Metrics

Key Takeaway: From a valuation perspective, select emerging markets are starting to look attractive, but other headwinds remain.

	Current				10-Year Average			
	Price to earnings	Price to book	Price to cash flows	Dividend yield	Price to earnings	Price to book	Price to cash flows	Dividend yield
Brazil	10.2x	1.0x	4.8x	4.0%	*10.4x*	*1.6x*	*6.4x*	*3.6%*
China	9.3x	1.1x	7.0x	3.3%	*11.7x*	*1.8x*	*7.8x*	*3.1%*
India	17.3x	2.7x	11.9x	1.7%	*16.1x*	*2.8x*	*11.6x*	*1.5%*
Indonesia	14.0x	2.4x	10.2x	2.7%	*13.2x*	*3.0x*	*8.8x*	*3.1%*
Korea	10.3x	0.9x	5.2x	1.9%	*9.7x*	*1.2x*	*5.9x*	*1.7%*
Mexico	18.2x	2.4x	9.8x	2.0%	*15.5x*	*2.6x*	*8.6x*	*2.1%*
Russia	5.5x	0.5x	2.9x	5.4%	*7.0x*	*1.0x*	*4.8x*	*3.2%*
South Africa	15.9x	2.3x	11.7x	3.3%	*12.5x*	*2.3x*	*9.0x*	*3.6%*
Taiwan	11.9x	1.4x	7.3x	4.2%	*14.2x*	*1.7x*	*8.0x*	*3.9%*
Turkey	8.5x	1.1x	6.7x	3.4%	*9.7x*	*1.5x*	*6.8x*	*3.2%*

As of November 30, 2015. All valuation ratios are forward 12 months as estimated by analysts and brokers.

Represents the top ten constituents of the MSCI Emerging Markets Index by market capitalization.

Source: MSCI

Investors Must Look Beyond the World's Largest Economies

It is not enough to focus solely on the world's largest economies, given their outsized roles in traditional financial benchmarks. We have to follow emerging markets for direct investment opportunities and to monitor potential spillovers to global growth, markets, and investor sentiment.

Which EMs Matter in 2016

As we consider how financial markets will behave in the year ahead, we think about where potential economic and political catalysts could originate. We can never rule out that a small island in a storm (think Cyprus in 2013 or Greece in 2014) could create at least short-term global contagion. But in general, we want to focus more of our attention on the larger economies and markets, and/or places where we see more obvious potential catalysts. Below we briefly touch on our Top Seven for 2016, walking through our base-case economic and market views for the year ahead as well as risks to watch and why each country matters. The BRICs top our list, but we also consider Saudi Arabia, Turkey, and Argentina for 2016.

Brazil: Politics Will Continue to Dominate

Need to know: The combination of economic recession, high inflation, and a weak fiscal backdrop is likely to continue for Brazil in 2016. Following a contraction of more than three percent in 2015 that contributed to a nine percent decline in the local Bovespa equity index and a 30% decline in the local currency, the real, Brazil's economy is likely to slow further in 2016 amid increasing unemployment, falling real wages, tighter credit conditions, and a reduction in government spending. Historically low levels of business and consumer confidence, as well as political uncertainty stemming from ongoing corruption investigations and the beginning of an impeachment process against President Dilma Rousseff, further complicate the near-term outlook. The good news may be that a lot of bad news is now discounted; GDP estimates for 2016 are in the -3% range already and inflation should come off its double-digit pace in 2016, though remaining well above the central bank's 4.5% target.

We believe Brazil will present compelling investment opportunities in equity and fixed income markets over the medium term, with real interest rates among the highest in the world at around four to five percent and equity markets approximately 40% lower in U.S. dollar terms during the past two years. Simply put, valuations are becoming compelling. However, the beginning of an impeachment process suggests that political turmoil will persist for the coming quarters and remain a suppressant on economic activity; as such, we remain patient. Many industry and political leaders also remain embroiled in criminal and civil litigation, and downside macro risks remain due to a lack of fiscal improvement.

What to watch: Domestically, politics will remain front and center, as the lower house impeachment hearings could take several months depending on whether congress convenes during the usual January to February recess. A two-thirds vote is necessary to send the matter to the senate. If the senate considers the impeachment, Rousseff will step down from her seat for this time period, leaving the vice president with executive powers.

A change in political regime would be a medium-term positive but a continuance of the current vice president's PT party rule or prolonged uncertainty is likely a negative. Additionally, October will bring municipal elections, which will help shape sentiment toward the next congressional and presidential elections currently set for October 2018. Finally, lack of reform progress could lead to more sovereign-rating downgrades (Standard & Poor's downgraded Brazil to junk status in September 2015).

Why it matters: Externally, Brazil remains sensitive to perceptions around Chinese growth and commodity prices: more than 17% of Brazil's total exports go to China, its largest trading partner. Further, Brazil was the seventh-largest economy in the world in 2014, surpassing Italy, Russia, and Canada and is the largest South American economy. A recession in Brazil puts a dent in global growth.

Russia: A Geopolitical Wild Card

Need to know: The backdrop for Russia was volatile in 2015 as declines in oil prices and geopolitical tensions related to Ukraine and, more recently, Syria were only partially offset by some signs of relative improvement in

economic fundamentals. A 12% fall in Russia's currency, the ruble, versus the U.S. dollar offset about half of the local Russian equity gains for international, non-foreign exchange-hedged investors.

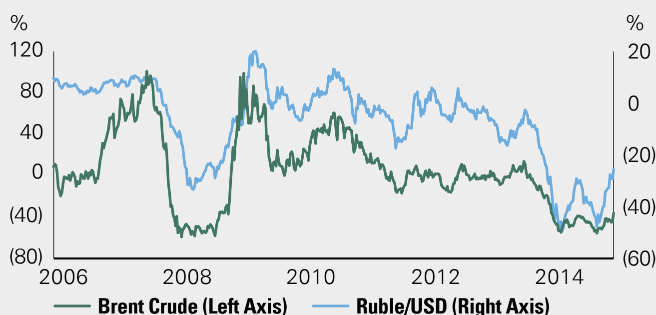
We believe that Russia will be on somewhat firmer economic footing in 2016 as ruble weakness has allowed for improvements in the current account and portfolio-flow dynamics. Versus GDP of -3.8% in 2015, growth should be modestly positive, though still below one percent in 2016, while inflation should decline to the mid-single digits from more than 12% in 2015. The fiscal situation remains a point of concern, but we do not expect any sovereign credit issues in our baseline scenario.

The improvement in growth, inflation, and capital-flow dynamics in Russia should support the ruble versus some other EM currencies, but we would not recommend adding exposure versus the dollar at this stage, and we remain doubtful that energy prices will improve enough to bring material ruble support in the short term (Exhibit 5).

At the same time, geopolitics remain a significant risk as the flareup in Turkey-Russia tensions challenges any meaningful improvement in Russia's relations with the West despite a shared interest in combating ISIS in Iraq and Syria. In our view, local equity valuations are not compelling given lackluster energy prices and political uncertainty, despite the expected moderate improvement in macro fundamentals.

Exhibit 5: Oil and the Russian Ruble: Year-Over-Year % Return

Key Takeaway: The ruble is directional with oil prices, tending to appreciate when oil rises and vice versa.



As of November 30, 2015.

Source: Bloomberg

Russia's Importance to Investors

As of 2014, Russia was the world's tenth-largest economy; its growth trends have a measurable impact on the world. Perhaps more importantly, though, Russia is a key geopolitical wild card, impacting investor sentiment and, indirectly, global financial markets.

What to watch: In addition to commodity prices and geopolitical issues, we will monitor the government's ability to rein in fiscal spending ahead of the September 2016 parliamentary elections.

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India: Market Upside Requires More Reform

Need to know: After several years of being identified as one of the EM countries more vulnerable to Fed tightening and other potential shocks, India has become one of the brightest EM spots in the past two years. Growth exceeded seven percent in 2014 and surpassed China's growth rate in 2015 at an estimated 7.5%. To be sure, declines in commodity prices were a boon for this large oil importer, but underpinning the strength has been a wave of significant reforms driven by Prime Minister Modi and the BJP party. Inflation has declined to close to five percent while the current account deficit has contracted from five percent of GDP in 2012 to one percent in 2015.

Meanwhile, India's central bank, the Reserve Bank of India (RBI), has boosted reserves by buying U.S. dollars and selling India's currency, the rupee or INR, to prepare for Fed tightening and related EM outflows. While the INR has been among the strongest of the EM currencies this year, it has still depreciated five percent versus the U.S. dollar, in part due to the RBI's intervention.

The macro backdrop for India remains supportive into 2016, with growth likely to stay in the seven percent range even as the positive shock from weaker oil prices fades. However, the risk for India is that it is a consensus overweight in investors' equity portfolios, with much of the positive story priced into markets, in our view. Indian

equities performed in line with the broader EM complex this past year despite the strong growth and reform momentum. We believe that if the government loses traction on its reform agenda, it is likely that investors will lighten equity and currency exposure.

What to watch: The winter session of parliament in the next month will provide guidance on the government's ability to make progress on the much-awaited Goods and Services Tax and Bankruptcy Law despite a resurgent opposition. Also, even though the rupee is poised to once again outperform versus other EM currencies, RBI intervention should drive moderate depreciation versus the U.S. dollar, complicating the strategy for owning INR or holding Indian equities as a dollar-based investor.

Why it matters: India is the second-largest emerging economy after China; trends in the country can meaningfully impact broader emerging market financial strategies and overall EM portfolio returns.

China: The EM Elephant in the Room

Need to know: Investors are entering 2016 with lowered Chinese-growth expectations. Consensus estimates published on Bloomberg suggest GDP growth continuing to moderate, from 7.3% in 2014 to 6.9% in 2015 and a forecast of 6.5% in 2016. The slowdown comes alongside government efforts to transition the economy: reducing reliance on government investments and exports and increasing support from consumers. While the transition broadly appears to be working — consumers accounted this year for a greater share of GDP than manufacturing — the challenge for the government is to manage the speed of these transitions so that the manufacturing and government investment slowdowns do not overwhelm a pick-up in consumption, potentially resulting in a so-called hard landing.

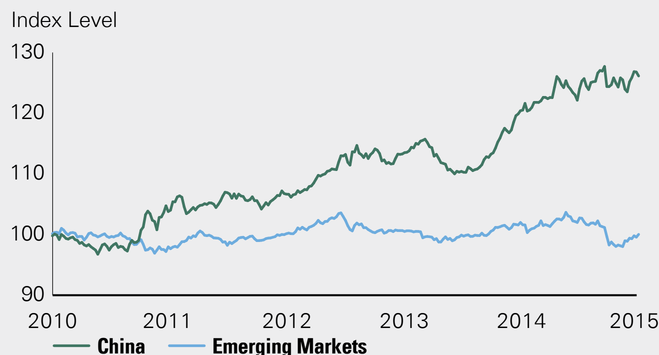
During the coming months, we believe that the recently announced monetary and fiscal stimulus (largely aimed at boosting consumers) should help prevent the structural growth slowdown from occurring more rapidly than what is already expected. At the margin, we believe investors would view relative China "stability" as good news, looking not just at Chinese markets but at China's impact on the rest of the world. That said, we are also cognizant of the risks around China's multiple transitions: not only the makeup of economic growth, but also development of local financial markets, the slow opening of the country's capital account, and what appears to be Chinese leaders' desire to shape how the country is seen and treated on a global geopolitical stage.

What to watch: We will track a number of China-related issues in the year ahead. On the growth side, we do not put much weight on government GDP figures, which are increasingly seen as "managed" by the government rather than an accurate reflection of the economy. While we do not ignore official releases, we put more emphasis on private-sector releases such as business sentiment surveys — manufacturing and service sector purchasing managers' index (PMI) reports — and guidance from developed market companies with significant business interests in China. Data from neighboring countries such as Taiwan, Singapore, and South Korea export orders and business sentiment, for instance, can provide useful insights about Chinese demand.

Should growth slow faster than expected, we would expect more stimulus: we see room to cut local interest rates and/or increase government spending further. One possible stimulus we hope *not* to see is a sudden, material devaluation of the Chinese renminbi (five percent or greater as a one-off step). During the prior four years, while the renminbi (RMB) has weakened about 1.1% against the dollar, it has climbed about 20% against a broad basket of key trading partners, leaving local exporters notably less competitive (Exhibit 6).

Exhibit 6: Emerging Markets vs. China Renminbi Nominal Broad Effective Exchange Rates

Key Takeaway: During the last four years, the renminbi has climbed about 20% against a broad basket of key trading partners.



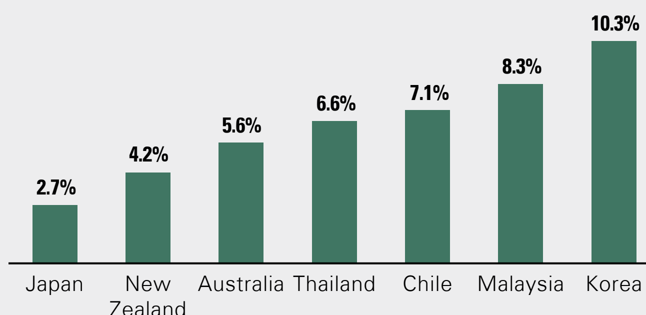
As of November 30, 2015.

Source: Bloomberg, J.P. Morgan

Now that China has made its currency somewhat more market-driven and has been told by the IMF that the renminbi is effectively at fair value, we certainly would not be surprised to see the central bank allowing for some RMB depreciation. Our base case is that this will happen, slowly and during an extended period of time, for two reasons. First, a gradually weaker RMB would create less risk of political backlash at a time when China is trying to polish its reputation as a global leader; the year ahead is China's turn to oversee the Group of 20 policymaking meetings. In addition, the IMF has told China that the renminbi will be part of its currency basket, but implementation is not due until autumn 2016. A sudden, disruptive policy change (akin to August 2015) could delay the IMF move. Finally, a sharp RMB devaluation would be more likely to trigger "copycat" moves by trade competitors, pushing up the U.S. dollar and raising fears about both a possible EM crisis as well as a loss of competitiveness for U.S. exporters.

Exhibit 7: Exports to Mainland China as a Share of GDP in 2014

Key Takeaway: A weaker renminbi would have an impact on China's key trading partners.



As of November 30, 2015.

Source: International Monetary Fund

Why it matters: China is the EM elephant in the room. Even if a number of other variables can impact global markets, China's size and links to a variety of asset classes and continents make it critical to follow.

Below we highlight what we see as a few of the most relevant links to note.

Commodities: China's economic transition away from manufacturing suggests that commodity demand could moderate further, keeping pressure in particular on base metals. That impacts not just the commodities themselves but also respective companies (commodity producers but also firms involved in processing and transporting commodities, among others) and even countries. Exports to China (namely copper) account for nearly ten percent of Chile's GDP, for instance. Fewer copper pipes for construction in China can meaningfully shape Chile's overall economy.

Currency: Especially if sudden and/or significant further weakening in China's renminbi would likely result in weaker currencies across a number of other economies, including but not limited to Korea, Malaysia, Chile, Thailand, Australia, New Zealand, and Japan (Exhibit 7). We would expect all this to result in broad upward pressure on the U.S. dollar, with a subsequent hit to sentiment around U.S. multinational firms. The stronger dollar could also, at the margin, add downward pressure on commodity prices broadly, potentially leading to speculation about policy shifts in producing countries such as Saudi Arabia. Finally, if a sharp RMB fall forced China's central bank to intervene to manage capital flight, China would likely be forced to sell U.S. Treasuries from its reserves, possibly putting upward pressure on U.S. yields.

Investor sentiment: Perhaps as much as anything else, sudden and/or unexpected events in China — especially given China's importance for the global economy — can upset investor sentiment broadly. A disappointing economic report from China, for example, can instantly weigh on equity markets from Asia to Europe to the Americas. The fact that government data is questioned and the leadership structure is fairly opaque only adds to what feels to us like a perennial sense of caution around the country and its future.

Saudi Arabia: New Leadership and Energy-Policy Questions

Need to know: While a relatively small country from a nominal GDP or domestic markets perspective, we expect Saudi Arabia to be an EM focus next year for several reasons. First, the kingdom's policy on oil production is a main determinant of the supply side of crude markets globally. Current production is close to its all-time high of 10.2 million barrels per day, and the question is whether production will be reduced to support prices. Particularly with Iranian supply coming to market next year and

U.S. supply just starting to edge lower, a continuation of current Saudi policy would keep a lid on crude prices, at a minimum. Second, there has been increased speculation regarding a shift in Saudi Arabia's currency regime. The local Saudi currency, the riyal, is currently pegged at 3.7525 riyal per U.S. dollar, and some market participants are positioned for a break in the peg such that the riyal would weaken. As the kingdom derives more than 80% of fiscal revenue from energy sales, a weaker currency could help offset the strain of lower oil prices on local budgets. We do not rule out a currency regime change but see it as a very low probability, as any benefit to local fiscal balances could easily be offset by foreign investor uncertainty and a possible capital flight from local markets.

Saudi Arabia's policy decision about oil clearly will be relevant for Bessemer clients, as portfolios today are underweight commodities including oil and energy-related equities. A shift in the currency regime, meanwhile, would be relevant as it would likely trigger broader U.S. dollar appreciation versus other EM currencies and across the board, as investors could use this episode as a benchmark for how other EM countries may react to a prolonged period of weak commodity prices and growth. Regardless of a peg change, we are positioned for modest, further dollar appreciation.

What to watch: Beyond oil prices and the local currency, we are closely following regional political and geopolitical issues. Saudi Arabia has a strong interest in preventing ISIS from establishing a presence within its borders; leaders have been meeting with Russian and U.S. policymakers in this effort. Saudi Arabia is also in the midst of a generational leadership change. King Salman bin Abdulaziz is giving power to his next generation, including his son, who now oversees the economy and military. Such change creates less certainty around policy, including energy policy. Separately, tensions between Saudi Arabia and Iran are perennially at risk of escalation, which in a worst-case scenario could impact the Strait of Hormuz, a major channel for global oil supply.

Why it matters: Saudi Arabia remains the world's largest oil exporter and one of the world's top three largest producers. Political developments within the kingdom, with regional neighbors and with other oil producers can impact crude oil prices, with implications across asset classes and countries.

Turkey: At the Crossroads of East and West

Need to know: Despite various structural improvements in the economy in recent years, Turkey remains vulnerable to swings in broader EM investor sentiment because of a large current account deficit (about five percent of GDP), which leaves the country reliant on international inflows. Similar to India, Turkey is a large importer of commodities; oil's price decline has supported domestic consumption and GDP. This positive has been largely offset by the drag of political uncertainty in the past year, leaving real GDP around three percent.

In terms of politics, 2015 saw major presidential and parliamentary elections. The ruling A.K. Party won surprisingly decisive victories in both, reducing some uncertainty. However, in recent weeks, the exclusion of Ali Babacan from the new A.K.P. cabinet triggered another bout of concern given he was a stable, well-respected voice on economic policy within the party. Also, high interest rates, including bank lending rates that have increased by 400 basis points in the past three months alone, suggest tight credit conditions for business and consumers will continue through gradual U.S. monetary tightening.

What to watch: We are keeping an eye on how the A.K.P. steers domestic and international policy in the beginning of its new term. While some consolidation of power suggests domestic political stability in Turkey, it is unclear how economic structural reform will be prioritized. We also would note the importance of and uncertainty around Turkey's international stance on key global issues.

Why it matters: Turkey is probably most important for international investors given its location at the true crossroads of the East and the West, and can be a bellwether indicator for geopolitical tensions between the two. Turkey's downing of a Russian plane in November was a setback for broader negotiations about Syria and ISIS. Meanwhile, Turkey is at the forefront of the Syrian refugee crisis, a key issue for Europe in 2016.

Argentina: Light at the End of a Long, Dark Tunnel?

Need to know: After at least 12 years characterized by an unorthodox economic policy that isolated Argentina from global financial markets, a new administration following the October 2015 elections brings the hope of

a major shift in course and potentially new investment opportunities in the coming years. During the Nestor and Christina Kirchner administrations, a populist framework created numerous obstacles for the local economy and for international investors: below-potential growth in the low single digits, inflation in the 30% range, a politically charged central bank, a bifurcated currency regime with multiple rates, another default on international debt, and litigation with "hold-out" creditors, which has made it impossible for Argentina to access, fully, international markets.

What to watch: Mauricio Macri, the former chief of government of Buenos Aires and the new president, campaigned as a centrist with a return to economic orthodoxy as a key tenet of his platform. He has indicated that a deal with "hold-out" creditors is possible in 2016, a development that would reopen Argentina's debt markets and signal a more general opening of Argentina for international investors.

Why it matters: It is early to declare a sea change for Argentina due to poor near-term economic prospects and the difficulty of radically changing policies that were so long in the making and for which there is still ample support in congress. However, given Argentina's plentiful natural resources, high yields, and potentially attractive corporate and sovereign valuations, we expect it to be a market to watch in 2016 and beyond for investment opportunities across its markets.

EM Bottom Line in 2016: Selective and Still Cautious

As we head into 2016, we remain underweight emerging markets across asset classes — equities, debt, and currency. We acknowledge in equities and currencies that valuations generally are becoming more compelling, and in at least some cases, countries' weaker currencies have helped to support exports as current account balances are improving. For some EM, relative calm around China and a bottoming process in energy prices could be a sufficient catalyst for some investor buying.

However, with what we expect to be higher U.S. interest rates and a well-supported U.S. currency, it is hard to get enthusiastic just yet about emerging markets. What could change that view? One or more of the following:

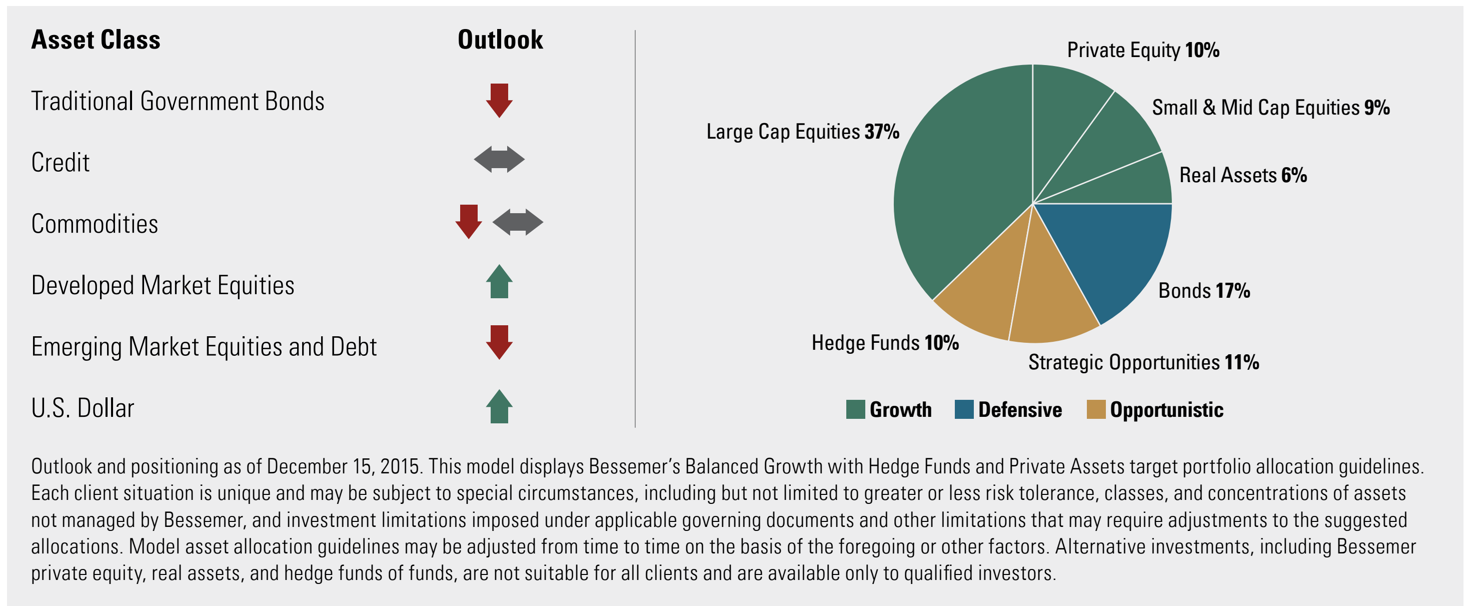
- A more-gradual-than-expected U.S. Fed and a weaker dollar, making emerging market bonds and currencies more attractive;
- Notably stronger growth from major developed markets that leads to greater export demand for EM producers;
- A stronger-than-expected Chinese economy that helps commodity price sentiment and major trade partners; and/or
- Political and/or policy reform within emerging countries that, alongside valuations, boosts sentiment around growth prospects (as could prove the case during the coming months in Argentina).

We certainly do not rule out that some of these scenarios could occur and change our currently cautious EM view. Until then, however, our focus on EM will be primarily to understand implications for our developed market holdings.

Looking beyond our emerging market positioning, we head into 2016 still underweight traditional fixed income and cautious on commodities broadly, though we may see selective opportunities during the year, including in energy as supply and demand move back toward balance.

We are also allocated to benefit from further dollar strength and equity gains — the latter tilted mainly to the U.S. and Europe and to a lesser degree Japan. Our equity view remains based on the argument that despite weakness among emerging markets and commodity-related countries and companies, equities should see support via still-abundant global liquidity (that leaves equity dividend yields more attractive than most bond yields), strong and still-improving developed market consumers (helped by weak oil prices), and valuations that are above average but far from extremes. Relatively calmer sentiment around China in the year ahead will also, in our view, support equities via better overall risk appetite. That all said, we realize that the U.S. economic cycle, leading the globe, is getting more mature (seven years of expansion and counting), and that the later stages of the economic cycle tend to see more volatility. With that in mind, along with the risk of more urgent Fed tightening should U.S. wages rise faster than expected, we are exploring how we might adjust asset allocations in the quarters ahead with our perennial goal in mind of participating in strong markets but protecting our clients' capital when cycles and markets turn.

Bessemer's Outlook and Positioning



Outlook and positioning as of December 15, 2015. This model displays Bessemer's Balanced Growth with Hedge Funds and Private Assets target portfolio allocation guidelines. Each client situation is unique and may be subject to special circumstances, including but not limited to greater or less risk tolerance, classes, and concentrations of assets not managed by Bessemer, and investment limitations imposed under applicable governing documents and other limitations that may require adjustments to the suggested allocations. Model asset allocation guidelines may be adjusted from time to time on the basis of the foregoing or other factors. Alternative investments, including Bessemer private equity, real assets, and hedge funds of funds, are not suitable for all clients and are available only to qualified investors.

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