Quarterly Investment Perspective

What Really Matters in 2015

Rebecca Patterson, Chief Investment Officer

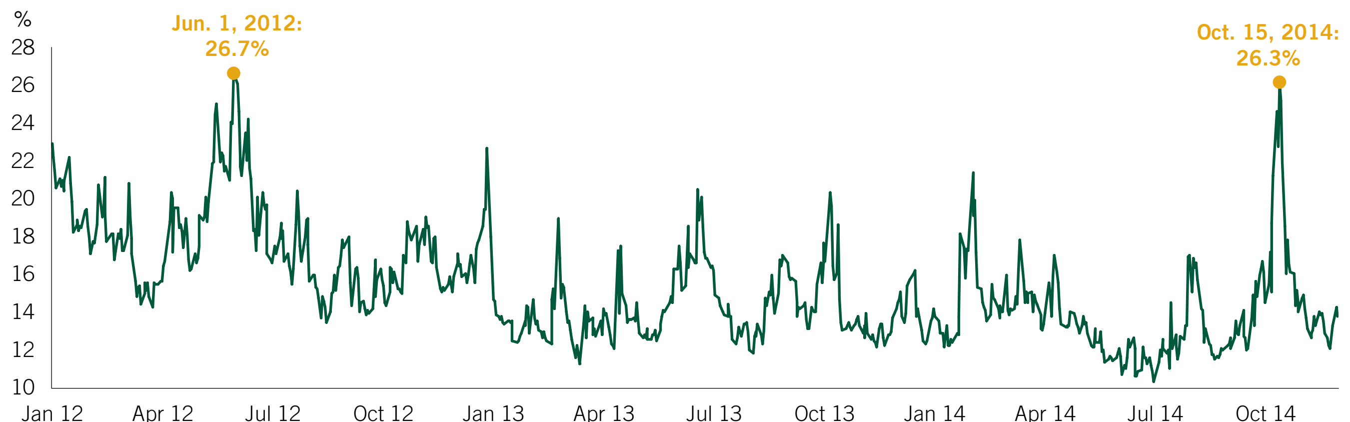
A year ago in this publication, we opined that 2014 would be a year of increased volatility, with catalysts potentially coming from changes in U.S. monetary policy, geopolitical developments, and election-related shifts in sentiment. Broadly speaking, those expectations became reality, albeit more in the second half of the year: The VIX, a well-known measure of implied U.S. equity volatility, surpassed 26% in October, a level last seen in June 2012 (Exhibit 1).

Increased volatility was not limited to U.S. stocks. Elections in countries such as India and Brazil triggered sharp swings in local equity and currency markets, as investors' views on respective domestic policies and economic outlooks adjusted. Meanwhile, geopolitical uncertainty also sparked surprising market moves. Perhaps most notably, the escalation in tensions between Russia and Ukraine contributed to a 14.5% fall in the German stock market, the DAX, helping to push both German 10-year government bond yields and the Russian ruble to record lows (Exhibit 2). Oil prices were also volatile in the second half of the year, fluctuating the most since 2008 as increased U.S. production and a laissez-faire OPEC (Organization of Petroleum Exporting Countries) prompted Brent crude to collapse nearly 40% during the year to a low below $70 per barrel.

As we noted in last December's *Quarterly Investment Perspective*, volatility does not necessarily mean negative portfolio returns. In the 12 months through end-November, our Balanced Growth model portfolio (a diversified global portfolio with a roughly 70/30 stock/bond risk profile) returned 5.3%, outperforming its benchmark (4.5%).

Exhibit 1: Volatility in Perspective

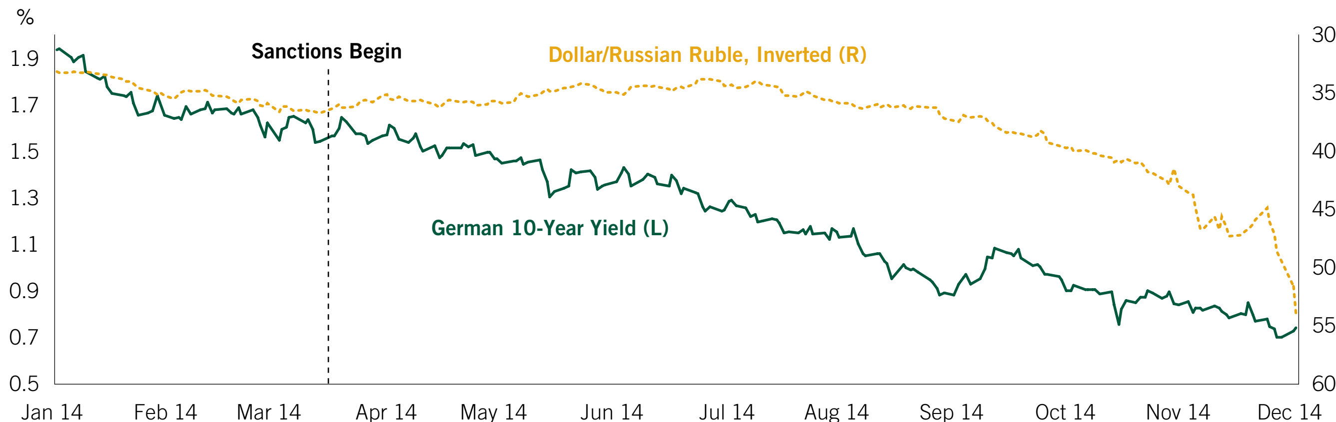
Chicago Board Options Exchange SPX Volatility Index



As of December 2, 2014.
Source: Bloomberg, Chicago Board Options Exchange

Exhibit 2: Russia/Ukraine Conflict Weighed on Germany

Russian Ruble and German Bund Yields



As of December 2, 2014.
Source: Bloomberg

Contributing to those returns was an overweight to equities generally, with a sizable tilt towards U.S. equities, a large U.S. dollar overweight across the portfolio, and underweight exposures in both small-cap equities and fixed income. In addition, strong security selection proved helpful in many strategies, namely large-cap equities. Indeed, at a time when active management has been under greater scrutiny, our actively managed U.S. Large Cap value sleeve outperformed the S&P 500 by 3.3% (over the 12 months through end-November).

Of course, there are always things we could have done differently. While we only had 3% of our Balanced Growth portfolio in commodities, the oil-driven selloff late in 2014 weighed on returns. Further, even though it was helpful to be underweight traditional bonds in 2014, our expectation that U.S. yields would continue to edge higher proved wrong. Along with a strategic bias to hold more higher-quality credits, we saw our fixed income mandates underperform their benchmarks in 2014.

Looking to 2015: All About the Fed?

Fixed income is likely to remain front and center for investors in the year ahead, given that the U.S. Federal Reserve is widely expected to start raising short-term interest rates for the first time since 2006. Market valuations currently do not suggest anything dramatic in the works. Quite the contrary: As of early December, federal-funds futures were suggesting short-term interest rates would not rise for the first time until October 2015, and would reach a mere 50 basis points in January 2016. Meanwhile, economists' consensus forecasts (published on Bloomberg) implied a 10-year U.S. Treasury yield heading towards 3.25% by the end of 2015, only 25 basis points above levels seen at the end of 2013, and still nearly 300 basis points below the 10-year yield on average over the last 50 years.

With both near- and longer-term yields expected to increase by only a few basis points over the coming year, it is striking how sensitive investors have been to shifting monetary expectations. We think such anxiety stems from at least two related factors. First, a rate hike would mark the U.S.'s first major step away from the exceptionally easy monetary policy of the last decade — the next regime for U.S. interest rates will likely feel unlike anything experienced in the post-World War II era. As such, investors fear that historical analysis won't provide many clues this time around in thinking through rate-hike implications. Second, many investors remain unsure

the U.S. economy, with annual real GDP growth averaging around 2.3% since 2009, will be able to continue to heal alongside any monetary tightening.

So what does Bessemer Trust expect the Fed to do in 2015? And how could markets react?

- **Policy interest rates.** The Federal Reserve, in our view, is conflicted. On one hand, the U.S. is heading towards full employment. Based on that part of the Fed's mandate, rate hikes should probably start by the middle of 2015. Many Fed officials also seem inclined to move back towards a more normal interest-rate regime to help ward off potential asset bubbles that are created as investors stretch for yield. That said, the Fed also knows that the current unemployment rate (5.8%) reflects a large number of people dropping out of the labor force (or a low "participation rate"). Further, the other part of the Fed's mandate — inflation — seems very well anchored, even looking beyond the recent fall in commodity prices.

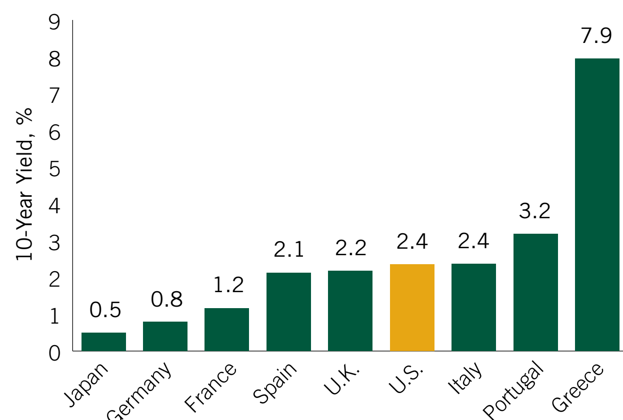
  We believe that the Fed will raise rates in 2015, but only very cautiously and slowly — it does not want to be held responsible for tipping the economy back into recession. Risks are tilted towards the policy rate ending this cycle well below the Fed's own forecast of 3.75% (the so-called terminal rate). That said, we would not rule out a first hike (to a 25- to 50-basis-point range for the fed funds rate) as early as the central bank's June meeting — that is, a touch earlier than consensus. Such a move would assume that labor and inflation trends are sufficiently supportive in the coming months.

- **10-year Treasury yields.** While short-term rates and even bond yields out two or five years are being driven primarily by U.S. monetary policy expectations, the "benchmark" U.S. Treasury yield — the 10-year bond yield — is increasingly influenced by other forces. First, even though the Fed has stopped building its balance sheet (now around $4.5 trillion), it is expected to maintain that balance in the year ahead, which requires significant purchases as older bonds mature. Second, as European and Japanese central bankers have suggested more easing and have pushed their own bond yields down further, the U.S. bond market has looked attractive by comparison. Even with a yield under 3%, the U.S. 10-year Treasury is a "high yielder" nowadays compared with Japanese, German, and even Spanish and Italian equivalents (Exhibit 3). Global fixed income investors, looking for every extra basis point of yield available, could easily put additional capital in U.S. bonds in 2015, helping to hold down longer-term U.S. yields.

  We expect U.S. 10-year bond yields will rise in the year and years ahead, leaving us inclined to stay underweight traditional fixed income in portfolios. That said, these other forces suggest this will be a very slow grind higher. We believe that 10-year yields will ascend more gradually than consensus estimates, potentially reaching only 4% over the coming two or three years.

- **Currencies.** We have had a high-conviction view for some time now that the U.S. dollar was in a cyclical uptrend. That view holds going into 2015, in part because of what we expect to be a continuation of diverging central bank policies.

Exhibit 3: U.S. Yields Attractive by Comparison



As of December 2, 2014.
Source: Bloomberg

While the Fed is heading for "lift-off" in terms of increasing policy rates, most of the developed world's central banks are headed the other way. In particular, the Bank of Japan announced in late October that it would increase the pace of its asset purchases in an effort to boost inflation, weakening the yen in the process. Meanwhile, the European Central Bank (ECB) is already purchasing covered bonds and asset-backed securities, and is increasingly hinting at full-blown quantitative easing. Whatever steps may occur in 2015, it's clear that the ECB would prefer a weaker euro to fight deflation risks and boost exports. (We estimate longer-term fair value for the euro versus the dollar around 1.15 – 1.20, versus levels in early December around 1.23.)

As we discussed in our July 2014 *Quarterly Investment Perspective*, we also expect the dollar to benefit from an improving balance of payments and a still-attractive long-term valuation. We confidently enter 2015 overweight the U.S. dollar, and specifically short the euro and yen, including via our Strategic Opportunities mandate.

- **Commodities.** A stronger dollar often weighs on commodity prices, and rising U.S. interest rates boost the dollar, so one could assume Fed tightening is also bad news for commodities. Historically that has often been true, though much more so for precious metals such as gold than other commodities (Exhibit 4). Why the difference? One possible reason is that gold has no yield; when U.S. yields rise and become more attractive, the opportunity cost of holding gold also increases. Another reason for the stronger, negative relationship between gold and interest rates could be inflation sentiment. If the Fed is tightening policy, investors may feel less of a need to hedge inflation risks, reducing their desire to hold real assets such as gold.

Exhibit 4: Impact From a 1% Increase in Real 10-Year Yields

Commodity	Impact on YoY Returns
Index	2.8%
Brent Oil	6.0%
Gold	(1.6)%

As of December 2, 2014.
Impact is estimated from a regression using data between 1991 and 2014.
Source: Bloomberg, Chicago Mercantile Exchange

For broader commodities, the link with rising rates has been less significant. Indeed, the link even reverses with crude oil — there have regularly been instances where oil prices and interest rates have climbed together. We believe that is at least in part because improving global growth will often increase oil demand at the same time that it increases the need for tighter monetary policy. The bottom line may be that, as we think about the Fed (and the dollar) in 2015, we have to temper any commodity optimism — especially for gold and other precious metals. We are also keeping in mind the myriad other drivers of this asset class (energy and agriculture in particular).

- **Global equities.** History may not prove terribly useful in this unusual economic cycle. But as a starting point for analysis, history would suggest that the onset of a Fed tightening cycle, and the accompanying uncertainty, might cause the equity rally to pause — but not undergo a sustained retreat. Thinking more about the current backdrop, we feel we need to separate thoughts on U.S. and non-U.S. equities. Similarly, overseas, we need to distinguish between developed and emerging-market equities.

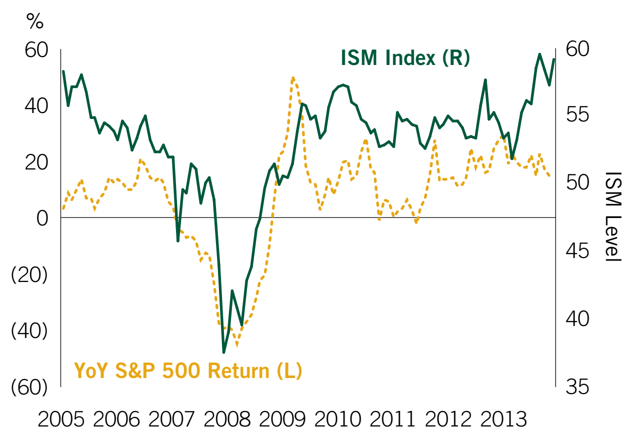
We enter 2015 still constructive on U.S. equities. A modest acceleration in U.S. growth in the year ahead, in turn fueled by relatively low commodity prices, an improving labor market, rising but still-low interest rates, and more supportive fiscal policy, all should help earnings. Historically, the S&P 500 posted positive annual returns

when the U.S. business confidence (the "ISM") was above 50, suggesting an expanding economy (Exhibit 5). Also potentially helping earnings are modestly rising wages — historically, U.S. corporate profit margins have not fallen until wages were rising at 4.5% to 5% a year, whereas currently, they are closer to 2%. That all said, higher valuations could slow the pace of further equity gains: The 12-month forward price-to-earnings ratio stood just over 16 as of the end of November, above a 10-year average of 13.8.

Overseas, still-easing monetary policy and generally weaker currencies should help sentiment towards a number of developed markets. That said, developed equity valuations are not unusually low; they do not suggest potential for substantial outperformance versus the U.S. in and of themselves. To see other developed markets sustainably "beat" the U.S. in 2015, we would first want to see positive growth surprises; even then, we would want to own these markets in currency-hedged terms. Outside the U.S., our largest equity overweight heading into 2015 is in Japan (removing yen where possible). We would be more likely to consider adding to Europe exposure (euro hedged) should we see large-scale quantitative easing from the ECB (possibly in the first quarter), especially if coupled with more positive business and consumer confidence trends and a pickup in bank lending. Even without major ECB action, European exporters should start to see a lift during the year thanks to competitiveness gains.

Exhibit 5: U.S. Business Sentiment and S&P 500

Year-Over-Year Equity Price Return, ISM Composite



As of December 5, 2014.
Source: Institute for Supply Management Business Confidence Index, Standard & Poor's

Emerging equities are in a different camp in 2015 — we want to continue approaching these companies and their countries very selectively. Rising U.S. rates and a stronger dollar often lead to weaker emerging currencies. The currency trends fuel inflation and can force tighter local monetary policy, which cools growth sentiment. None of this is helpful for local equity sentiment or returns. Should the stronger dollar and rising U.S. rates weigh further on commodities, that would impact emerging "commodity exporters" even more — countries like Russia and Brazil. Large energy importers such as India could benefit, but they would still face possible currency headwinds. Given that many emerging currencies are more challenging to hedge in a portfolio, we would likely need to think about each emerging equity opportunity in light of the total return it would bring our portfolios in U.S. dollar terms. For now, we remain modestly underweight emerging equities, with most of our exposure tilted towards emerging Asia (those countries generally benefit from falling commodity prices).

Beyond the Fed

The probable hike in U.S. interest rates should prove the defining event for the global economy and financial markets in 2015. After all, the U.S. represents more than 20% of the global economy, has the world's most liquid bond market, and serves as an "imported" policy anchor for many other countries.

That said, there is very little about a 2015 Fed rate hike left to the imagination. Fed officials, in an effort not to upset markets or growth sentiment when "lift-off" occurs, have taken communication efforts to a new level. The more transparency they provide, the greater the chance

that a shift in the U.S. interest-rate cycle will prove a "non-event" for cyclical assets like stocks (or so the Fed officials hope).

Markets always react more to what is *not* expected — that is, what is not already discounted in valuations. The Fed is incredibly important, but looking at 2015, there are other catalysts that may move markets even more, simply because they aren't discussed on a daily — or hourly — basis, as is the case with the U.S. central bank.

On Our Radar Screen in 2015

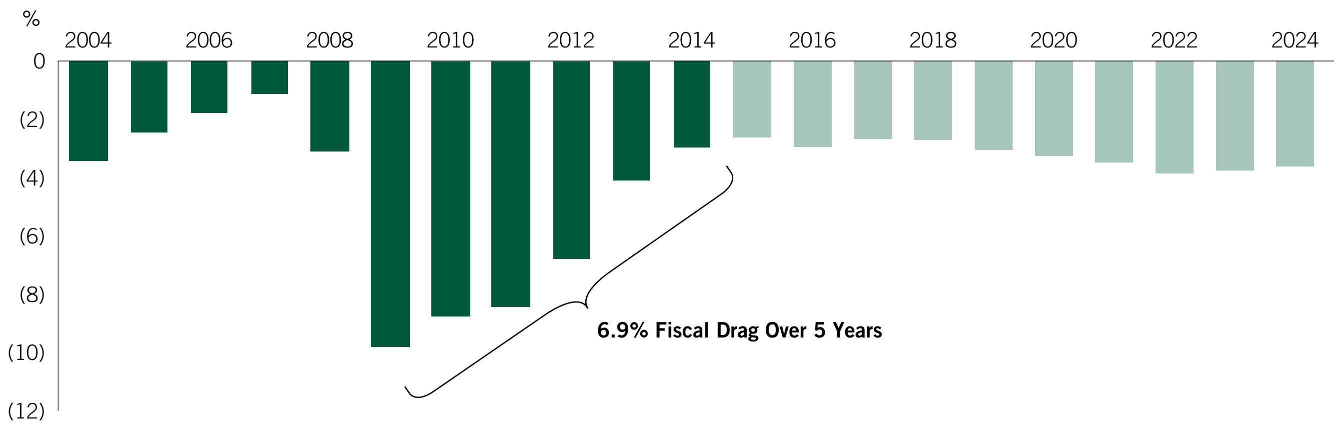
U.S. Public-Sector Stimulus

One positive surprise we could see in 2015 is stronger-than-expected U.S. growth, even accounting for a Fed rate hike or two. Currently, U.S. GDP growth is estimated to rise from approximately 2.2% in 2014 to 3.0% in 2015, with forecasts skewed somewhat towards sub-3% targets. What could give us an extra lift? Lower-for-longer oil prices could certainly help U.S. consumers, as could more relaxed mortgage guidelines (which could help support housing activity and prices). A third variable that has captured our attention, though, is the public sector. Recent years have seen the U.S. tighten fiscal policy, including via the 2013 "budget sequestration" that prompted large annual cuts to federal spending (Exhibit 6).

We believe a few forces could help federal spending pick up in the coming year. First, the U.S. budget deficit has narrowed more quickly than many expected; indeed, it is projected to reach 2.6% of GDP in the coming year, the best outcome since 2007. The need for immediate further tightening has receded. Second, U.S. politicians are aware of their generally lackluster opinion-poll approval ratings and are looking for ways to gain support into the 2016 elections. Fiscal stimulus would be one way to improve voters' outlooks. Interestingly, looking back at past U.S. electoral cycles, the year before a presidential election year has regularly seen relatively greater fiscal stimulus, regardless of the party in power or whether it was a president's first or second term. While just speculation at this point, we would not be surprised to see some sort of reduction in the planned sequestration. Fewer defense-spending cuts could prove particularly popular with both parties at a moment when overseas tensions are running high. Infrastructure spending might be another possible stimulus area.

Exhibit 6: U.S. GDP Less at Risk From Fiscal Drag

Federal Deficit as a % of GDP



As of August 27, 2014.
Fiscal 2015 to 2024 deficits reflect Congressional Budget Office estimates.
Source: Congressional Budget Office

Beyond federal spending, we'd note that state and municipal spending has already started to climb off post-crisis lows, thanks in part to an uptick in tax revenues. Looking ahead, we would expect to see, both locally and federally, more jobs created by the public sector. This should add to momentum for the U.S. consumer broadly — something that could help U.S. equities rally in 2015 beyond what is already discounted.

U.K. Election and European Sentiment

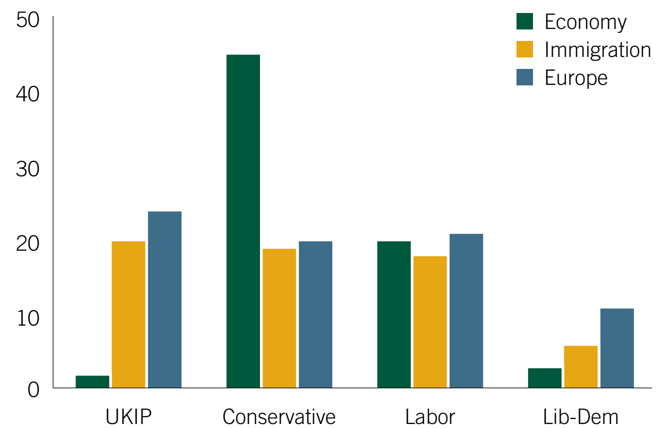
The United Kingdom is due to hold a general election in 2015, most likely in May. Elections in major countries are always important for investors to watch, as related policy shifts can impact economic sentiment and local market performance. This particular vote has additional significance, though, as its outcome could have ramifications for Europe more broadly.

Back in early 2013, British Prime Minister David Cameron promised to hold a referendum in 2017 on the U.K.'s membership in the European Union (E.U.) if his Conservative Party won a majority at this coming election. Cameron has said he would prefer the U.K. to remain in the Union, but that he would continue pushing for reforms that would transfer more decision-making back to London from Brussels.

As of early December, opinion polls suggested that Cameron's party was effectively tied with the main opposition Labor Party. Perhaps more importantly, the relatively new U.K. Independence Party (UKIP) was gaining substantial ground, seen in recent polls as the strongest of the main parties on both European and immigration issues (Exhibit 7). Further UKIP support in the year ahead could push the Conservative Party to take a harder line towards the E.U., since a popular component of UKIP's platform is a pledge to "leave the E.U. and take back control of our borders."

Exhibit 7: Which Party Has the Best Policies On...?

Public Poll, U.K.



As of September 30, 2014.
Source: Ipsos Market & Opinion Research International poll, September 2014

A 2015 win by the Conservatives, especially if coupled with notable UKIP support, could easily fuel speculation about what people are increasingly calling "Brexit" — Britain exiting the E.U. While we believe an actual exit by Britain is very improbable, potential speculation and its market impact should not be understated. The European Union is the U.K.'s largest trading partner: Exports to the E.U. account for 16% of U.K. GDP. Financial links are equally critical, with London being the financial center not just for the U.K. but for all of Europe.

Even before a referendum, the U.K. would almost certainly try to negotiate with European partners to gain more autonomy and reduce payments made to the E.U. They would likely do this while seeking to preserve as many benefits as possible of the European "single market," including trade as well as common regulatory policy and free movement of capital and labor.

That said, the uncertainty around the potential costs and benefits of a "Brexit" could hinder new foreign direct investment to Britain, not to mention portfolio flows. This would be poorly timed given the widening U.K. current account deficit (at 5.2% of GDP in

mid-2014, the largest gap in recorded history). It could also keep investors focused on similar efforts in other parts of Europe. We would keep a close eye in particular on France's Euro-skeptic and anti-immigrant National Front, led by Marine Le Pen. Jitters about cohesion within the E.U. and European Monetary Union could weigh on capital flows into European markets (as was the case for the U.K. into the Scottish referendum this past September).

The Weaker Yen, Asia, and Global Trade

Among the world's largest economies, Japan has seen the largest move in its currency this past year, helped by a very aggressive asset-purchase program (the Bank of Japan announced in October it would aim to increase its monetary base by ¥80 trillion per year, or roughly 17% of GDP). The yen has fallen some 13% against the U.S. dollar in 2014, pulling USD/JPY up to 121, a level last seen in mid-2007. Yen weakness has lifted hopes for Japanese exporting firms and the broader economy. Perhaps not surprisingly, then, the Nikkei equity index has gained 10% in the year through early December (in local currency terms).

Japanese policymakers look poised to do even more in the year ahead, in an attempt to firmly establish inflation at or above 2%. We estimate longer-term fair value for USD/JPY around 120, but would not be surprised to see the yen weaken beyond that. Currently, consensus forecasts on Bloomberg put USD/JPY between 105 and 135 at the end of 2015. One surprise in the year ahead might be a yen at the weak end or even beyond the consensus range. USD/JPY at 150, anyone?

Such a move, which would reflect nearly a doubling of the dollar-yen exchange rate from late 2012, might be music to the ears of investors in Japanese exporting firms, especially if they have "hedged" out yen risk (as we have where possible at Bessemer). If the yen slide were gradual and occurred against a backdrop of improving global growth, it could prove benign. But that positive outcome is not a given.

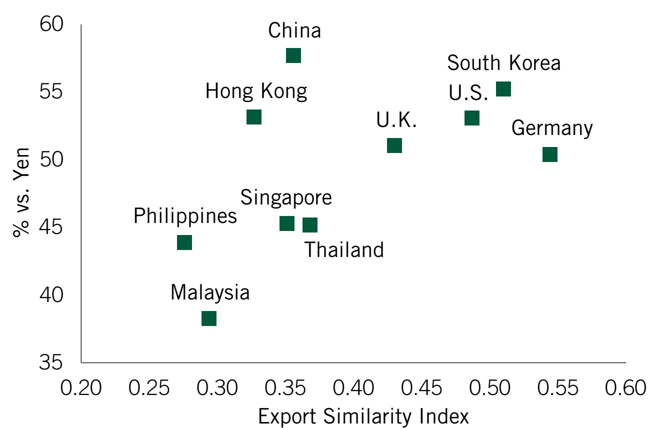
Indeed, history would suggest one might worry about a devaluation of one of the world's most-traded currencies. When the dollar last stretched towards 150 against the yen, back in the late 1990s, that yen weakness contributed to what became a pan-Asian financial crisis, ultimately undermining Asian economies enough to worry investors about global growth. What may have started in Thailand eventually helped take U.S. equities sharply lower in the autumn of 1998.

The good news today is that Asian markets are much more developed and their currencies are more flexible than they were back then (many had "fixed" exchange rates against the dollar in the 1990s). Further, their economies have more tools to deal with external shocks — such as dramatic yen depreciation — and many have diversified manufacturing bases in different countries to reduce competitive pressures.

Nonetheless, such yen weakness will still be felt, and poses some risk. Exhibit 8 shows countries with similar exports to Japan's (horizontal axis), and how those countries' currencies have moved against the yen in recent years (vertical axis). A country like South Korea (top right corner of chart)

Exhibit 8: Export Similarity Index and Currency Appreciation vs. Japan

September 2012 – December 2014



As of December 4, 2014.
Source: Bloomberg, International Monetary Fund

clearly faces headwinds — the Korean won has appreciated some 50% against the yen since late 2012, while it competes against Japanese exports frequently.

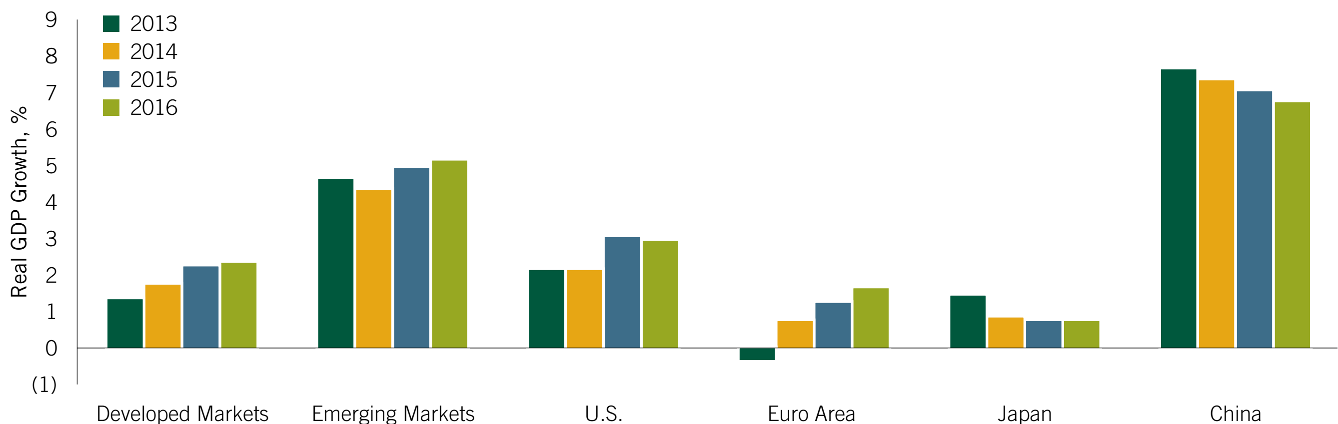
While it is certainly not our base case, we would watch policymaker comments for any hint that 2015 could see some sort of "trade war" erupt between these Asian powers. Alternatively, we could envisage China deciding, in an effort to retain competitiveness vis-à-vis Japan and support growth, to allow the Chinese renminbi to weaken on a more sustained basis. Note that the Chinese currency has generally been on a strengthening trend since 2005. If all these countries tried to keep up with Japan and weaken their currencies, and European currencies were falling as well (led by the euro), U.S. exporters might start to pressure members of Congress to take protectionist action to help them compete. In the run-up to the 2016 U.S. elections, our somewhat cynical view would be that at least some members of Congress might listen and act. This could prove damaging to investors — historically, trade wars have coincided with declining equity markets.

Final Thoughts for the Year Ahead

We enter 2015 feeling optimistic global growth will modestly accelerate, albeit unevenly (Exhibit 9). Indeed, U.S. economic output in the latter half of 2014 seemed to already be on that trend, increasing our confidence that the Fed will start its rate-hiking cycle next year, most likely in a slow, cautious manner. We are also confident that the year will bring surprises — some of which could be quite distinct from U.S. monetary policy. We have tried to share here a few of those potential surprises. Part of our job as investors, after all, is to think about different scenarios and the probability of those scenarios so we can position for opportunities and guard against risks.

Our base case heading into 2015 is that Fed tightening will not derail the U.S. economy. Rather, higher rates will likely only come alongside stronger U.S. growth. Central banks outside the U.S., meanwhile, will ease further — global liquidity will stay ample. With today's reasonable

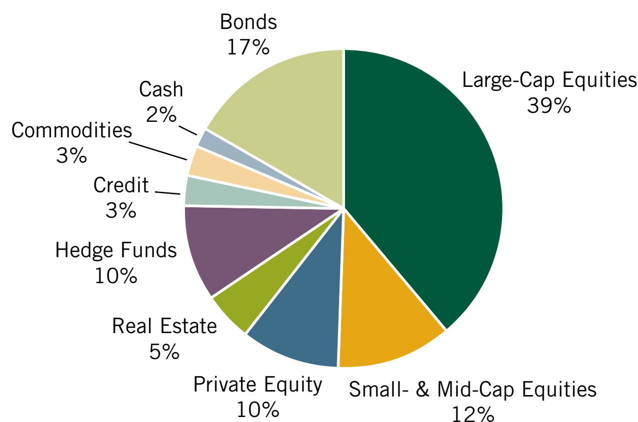
Exhibit 9: World Economic Growth



As of October 31, 2014.
Real GDP growth for calendar years 2014, 2015, and 2016 reflect IMF forecasts as published in the World Economic Outlook.
Source: International Monetary Fund

valuations, we believe equities can rally modestly further, and we remain overweight, with tilts to the U.S. and Japanese markets (Exhibit 10).

Exhibit 10: Balanced Growth Model Portfolio



As of November 30, 2014.
This model displays Bessemer's Balanced Growth with Hedge Funds and Private Assets exposure with 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, 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 estate, and hedge funds of funds, are not suitable for all clients and are available only to qualified investors.

This divergence between central banks, along with the U.S.'s improving balance of payments, suggests another good year for the U.S. dollar. We continue to have a significant dollar overweight across our portfolios and are retaining our underweight to traditional U.S. fixed income, looking to pick up some yield in select credit instruments like non-agency mortgage-backed securities.

Rising U.S. rates and the stronger dollar will act as headwinds for a number of emerging markets — the weaker yen could prove an additional challenge for major trade partners as well. For that reason, we are underweight emerging equities, with our portfolio managers looking selectively for opportunities.

Finally, commodities. While 2014's volatility in commodity returns was not welcome, we are reluctant to reduce our already modest exposure (3% in most portfolios) much further given: 1) the large drop in prices (the Bloomberg Commodity Index has lost more than 36% since mid-2011), 2) the modestly improving global-growth backdrop we expect to unfold in the year ahead, and 3) the potential for one-off supply shocks (possibly due to geopolitical events). That said, we fully expect that broad commodity gains in the year ahead will be limited to a degree by rising rates and a stronger dollar. We remain cautious on precious metals in particular.

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