

# Market Perspectives

## Resurgence of Volatility

### Background

After a year of strong gains for growth-oriented assets, investors have in recent weeks endured unusual market turbulence. Sharp drops for global stocks, credit securities, commodities, and many currencies have been followed by partial recoveries, unnerving many investors.

The resurgence of volatility raises a number of questions:

### Q: What's behind the turbulence?

Troubling headlines on Greece's fiscal problems, the European Union's uneven response, rising government debt levels, uncertainty regarding financial reforms, China's efforts to rein in its frothy real estate market, geopolitical risk in the Korean peninsula and Middle East, and the environmental disaster in the Gulf of Mexico have all weighed on investor sentiment. But ultimately, we think potential problems at European banks are the root cause.

### Q: Are we concerned about the condition of Europe's banks?

Yes. The highly intertwined European banking system results in many banks having substantial exposure to public and private debt in Greece and elsewhere. A fresh wave of loan losses would further destabilize an already shaky system, potentially leading to a banking crisis. European banks generally have more leverage than their American competitors, have been slower to acknowledge their loan losses, and are less transparent about their financial health. Moreover, banks in Europe provide a larger portion of total credit than banks in the U.S., where alternatives like the credit markets play a larger role.

### Q: Does this mean we are headed for a replay of the financial crisis of late 2008?

No, we don't think so. To be sure, European problems are an echo of the 2008 credit crisis centered in the U.S. But we see notable differences in today's backdrop:

- Policymakers were slow to recognize banking problems in 2008 and take needed action, but they are now on full alert to keep the banking system functioning with stimulative policies.
- In 2008, longer-term bonds yielded little more than short-term paper, which compressed bank earnings. Today, the yield curve is very steep, enabling banks to book significant profits from their core operations, thereby replenishing their capital levels.
- LIBOR (London Interbank Offered Rate, the interest rate at which banks can borrow from one another) surged to 4½% above T-bills in 2008. While the bank rate has risen from its lows earlier in the year, it currently stands at less than 1%, suggesting the financial system is not under extreme stress.
- In 2008, large corporations had serious trouble accessing overnight financing. Today, they are rolling over their commercial paper with ease.

European troubles will likely remain an issue for some time to come, constraining global economic growth and contributing to further market choppiness. Nevertheless, we expect investors' worst-case fears to dissipate gradually. A positive step could be public disclosure of the results of "stress tests" for European banks. Similar tests in the U.S. last year helped turn around investor sentiment by clarifying each bank's financial health. This disclosure enabled investors to understand how much new capital was needed to refortify each bank's balance sheet, a key step in helping those institutions tap the marketplace to raise this capital and stanch the crisis.

We will be watching closely how European officials respond to developments as they unfold. Were a major bank to fail, there would be significant implications for the world financial markets and economies. But it appears policymakers finally understand the severity of the potential crisis in Europe and are ready to take extraordinary measures to restrain it.

### **Q: But even if Europe muddles through, aren't there potential negative implications for U.S. corporations?**

Yes. Europe's problems could spread in two ways:

- **A weaker euro could crimp profit margins.** As European companies become more competitive globally because of the lower euro, some U.S. firms may experience market share erosion. In addition, U.S. companies whose costs are in U.S. dollars and revenues are in euro will likely face some pressure on their margins versus last year.
- **Slower European economic growth could curb demand for U.S. exports.** Overall, U.S. companies generate about 10% of their revenue from exports to Europe. Spending in the region will likely remain constrained until some of the uncertainties fade.

As a result of these factors, an earnings estimate for the S&P 500 Index that would otherwise have been \$85 could potentially fall to about \$83. Applying a 15x multiple to those figures suggests a reduction in an estimated fair value for the index from 1275 to 1245 — still well above current levels.

### **Q: How much damage have the markets' recent declines done to this year's investment returns?**

Global stocks declined about 7% year to date through June 1. Investors employing broad diversification within their portfolios have fared better. For example, our Balanced Growth portfolio — representing a global mix of equities, fixed-income securities, credit investments, commodities, and hedge funds — is down about 3% over this period.

### **Q: What strategies have hurt and helped client portfolios this year?**

Three factors have hurt our returns:

- **Global exposure.** The U.S. market has substantially outpaced the developed and emerging markets so far in 2010. Our portfolios' geographical diversification has hampered our results in this environment, but we remain convinced of its longer-term benefit.
- **U.S. Large Cap returns.** We underperformed the S&P 500 Index largely because we had limited exposure to the more cyclical companies in the consumer and financial sectors that performed especially well.
- **Commodity exposure.** Despite the global economic recovery, inflation has remained under control. Commodities have fallen about 11% year to date with particular weakness in agriculture, which has pressured the Real Return Fund.

On the plus side:

- **Defensive strategies.** Anticipating that a confluence of favorable and turbulent forces would create a back-and-forth market throughout 2010, we devoted a substantial portion of our allocation to defensive strategies. High-quality bonds have delivered returns of approximately 3% year to date.
- **Global Opportunities returns.** We have benefited from currency positioning, especially strength in emerging markets and weakness in the euro. In addition, our credit exposure — such as convertible bonds and mortgage-backed securities — limited losses during the equity downturn.
- **Non-U.S. Large Cap returns.** Our year-to-date outperformance of the EAFE Index has been aided by favorable security selection within Europe, especially in the consumer sector.

**Q: Have there been any portfolio shifts during this turbulent time?**

Given our overall investment positioning coming into the most recent period, we have not needed to make any rash changes. Nevertheless, we have made some adjustments within our portfolios.

In our global equity portfolios, for example, we reduced our exposure to cyclical areas, including energy and industrials. In so doing, we opted not to reinvest the cash generated by these sales immediately, given prevailing short-term market risks. As a result, cash in our global equity portfolios rose from our normal level of 2% to about 8%.

At the same time, recent selling pressure has moved some asset prices far below our estimate of their long-term fair value. For example, the Real Return Fund took advantage of turmoil in commodity markets by raising exposure to metals such as palladium, where prices have fallen nearly 20% in the last month even though long-term fundamentals appear strong.

Our investment teams will continue to make adjustments to capture new opportunities across a wide range of asset classes.

**Q: But aren't stocks just too risky right now?**

No, we don't think so. All of our research and experience suggests that owning stocks at today's prices should enable investors to earn attractive returns over time.

Human nature often drives investors in the wrong direction. For example, stock funds saw huge inflows at the peak of the technology bubble in 1999 at the expense of bonds, even though interest rates were attractive at the time and stock valuations stood at record highs. Now the opposite is happening. Investors have recently placed huge new inflows into bonds rather than stocks — despite the prevailing low level of interest rates and generally attractive valuations for stocks.

Indeed, fear is what creates outsized return potential. The only reason today's stock market provides an investor with an earnings yield of 7-8% at the same time that the government bond market offers only 3% is that many investors are responding to current uncertainty with an order to sell growth-oriented assets, such as stocks. While our holdings may not rally in a day or a month, we are convinced their long-term fundamentals are sound and their long-term return potential is favorable.

**Q: So what is Bessemer's overall view now?**

There is plenty to worry about. We fully expect markets to experience setbacks along the way, so investors need to own a well-diversified portfolio that is not dependent on any single scenario playing out.

Nevertheless, there are four key areas where our outlook differs from prevailing dire views.

- **Greece is not an accurate template for larger, more diversified European economies like France, Germany, Italy, Spain, and the U.K.** The aggregate economic activity of these five countries is 35 times that of Greece.
- **The global economic recovery will continue to improve gradually.** While Europe will struggle, the latest reports from a wide range of economies including the U.S., Japan, China, Brazil, India, Australia, Indonesia, Taiwan, Singapore, and Malaysia — home to a total of more than 4 billion people — reveal more robust economic recoveries than previously expected. Our most important economic indicators, such as the shape of the yield curve, suggest a double-dip recession is unlikely.
- **Neither inflation nor deflation is likely to run rampant in the next several years.** Factors arguing for higher prices are short-term interest rates of zero, sizable budget deficits, and growing demand for natural resources from the emerging world. But just as potent are factors arguing for lower prices, such

as constrained bank lending, weak wage growth, rising global competition in many industries, and surging corporate productivity from new technology. Without a surge in inflation, bond yields are unlikely to surge — so stocks and other aggressive assets should face limited competition from fixed-income assets.

- **Policymakers will avoid huge mistakes that would clobber economic activity.** Undeniably, policymakers have made some bad decisions in recent years: policies to boost homeownership rates were at the heart of the housing crisis; regulators overlooked the significant conflicts of interest at the rating agencies; not enough of the stimulus package went to infrastructure projects; and so on. Mostly, though, policymakers were creative and forceful in responding to unprecedented developments. The TARP program and bank stress tests helped the economy turn the corner, as did China's huge stimulus program. But most important may be what policymakers have refrained from doing — no schemes to nationalize the banking system, no massive protectionist programs, and no adoption of the dangerous banking proposals some in Congress have put forth.

Although macroeconomic concerns will linger, investors' fears of a repeat performance of 2008 will likely ebb in time. In its place should come a renewed focus on fundamentals. We will likely get a healthy reminder of corporate strength next month when second-quarter earnings season begins. Very strong reports are likely, driven by productivity levels that have never been better, as well as rising new order rates and recovering business investment. Job creation has already rebounded in many countries, and we're likely to see real improvement in the U.S. before long. There is no guarantee that investor attention will return overnight to the rising profits and attractive valuations that we see, but we are convinced that conditions for long-term investors will gradually improve in coming quarters.

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