Investment Insights

A Bumpy Fall?

BESSEMER TRUST

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Highlights

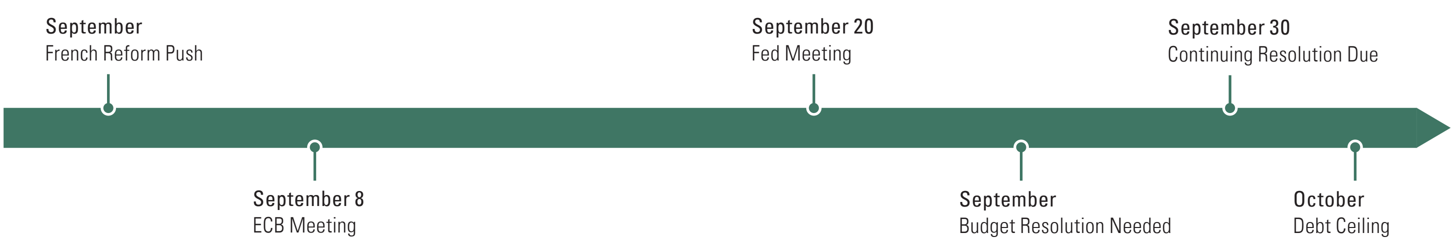
- While June and July saw rising equity markets and low volatility, August got off to a choppier start due to tensions with North Korea and within Washington
- Looking ahead, the fall season brings an additional set of potential event risks, this time in the U.S. and to a lesser degree in Europe
- Our base case is that any policy-related hiccups will be short-lived with market implications limited, though broader and potentially unforeseen geopolitical risks remain a wild card that warrant close attention
- Defensive strategies within portfolios should help us navigate any short-term volatility, although we're still ready to consider additional tactical allocation shifts if needed

Until the second week of August, investors had a pretty peaceful summer. Even after the verbal spat between North Korea's Kim Jong-un and U.S. President Trump rattled markets, global equities still gained just over 2% between June and mid-August, helped by stronger-than-expected corporate earnings (particularly in the U.S.) and the continuation of synchronized growth around the world. However, more recent uncertainty over the stability of the White House administration, particularly after President Trump disbanded his business councils, has kept investors on guard.

Thus far, the administration has remained resilient in the face of numerous challenges, and equities have taken these issues in stride. The next several weeks could see additional market volatility, though not just because of escalating geopolitical or White House concerns, but also because of potential fiscal and monetary policy developments. With equities up more than consensus expected year-to-date, valuations in both equity and fixed income markets elevated, and implied volatility measures creeping up from low levels, it wouldn't take much to lure investors to the sidelines, at least on a tactical basis (Exhibit 1).

Bessemer client portfolios are already somewhat defensively positioned, neutral equities versus their strategic benchmark. Further, within that equity exposure, we view our bias toward the U.S. (U.S. stocks tend to outperform overseas peers during times of market stress) and our managed-volatility positions as helpful to navigate what may become

Exhibit 1: U.S. and European Fall Event Risk Highlights



Source: Bessemer Trust

choppier waters. That said, if any risk events were to change our underlying economic views, we would also consider asset allocation shifts to fine-tune our overall risk profile.

What are we watching that has us on high alert? There are always things that can go wrong for the economy or markets, whether driven by geopolitics, policy, or an unforeseen catalyst. What's striking about this September is how many potential problems could surface in a relatively short time after a strong market run, increasing the risk for at least some tactical profit-taking. Below we review our top September "alert" list.

Market Event Risks in the U.S. This Fall

September 20: Federal Reserve policy meeting and press conference. The Fed has led the major central banks' exit from extraordinary monetary policy, starting to raise short-term interest rates and ending growth in its balance sheet in 2015 (although holding its balance sheet steady since at an impressive $4.5 trillion). This September could mark another key moment for U.S. monetary tightening: the Fed has increasingly hinted that it will announce the start of balance-sheet reduction at the coming FOMC (meeting decision due at 2 p.m. EST and press conference to follow).

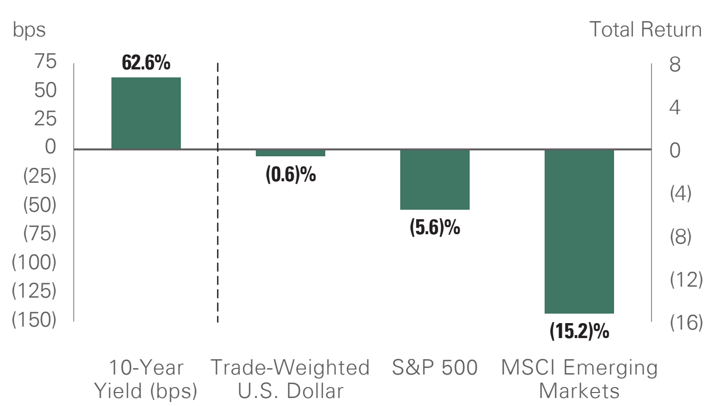
Recent years have seen temporary market jitters when the Fed announced what was perceived as a major monetary step. Perhaps the best-known example is the May 2013 "taper tantrum," when talk by then-Fed Chairman Ben Bernanke of exiting quantitative easing resulted in the S&P 500 falling almost 6% between May and September and a similarly timed spike in U.S. yields and the dollar. This cocktail of domestic market reactions had global reverberations, especially in emerging markets (Exhibit 2).

If just talk of tightening pulled equities down so sharply, what happens when the balance sheet actually starts to shrink? The question is not as straightforward as it might seem. Suggesting this time will be smoother are several factors:

- Better Fed communication. A Fed tapering this time around is widely expected by investors. In contrast to Bernanke's 2013 remarks, there should not be much of a surprise from this meeting.
- Stronger economic backdrop. In contrast to 2013, today the world is seeing broader-based, stronger economic growth.
- Improving corporate earnings. Helped in part by the brighter global growth backdrop, the latest U.S. reporting season saw both earnings and sales handily beat consensus expectations, with sales beats at their highest level in a decade.

All that said, we do not see this announcement as risk free. Credit markets, which closely follow movements in bond markets, have increasingly rich valuations, vulnerable to any sudden rise in U.S. Treasury yields. While spreads on high-yield debt versus government bonds have widened somewhat over the past couple weeks, they remain near multiyear lows. On a related note, implied and actual market volatility also remains near multidecade lows. Further, equity prices and valuations are higher, both globally and in the U.S. In our view, that leaves equities relatively more vulnerable to negative shocks (such as sharply higher borrowing costs that could follow Fed tightening).

Exhibit 2: Performance Following the Taper Tantrum, S&P 500 Peak to Trough



As of June 24, 2013. S&P 500 reached its peak on May 21, 2013 and its trough on June 24, 2013. Equity returns are in U.S. Dollar and reflect the total return gross dividends. Trade-weighted U.S. dollar is measured using the Federal Reserve Major Currency Index. Emerging Markets is measured using MSCI Emerging Markets.

Source: Boomberg, Federal Reserve, MSCI, Standard & Poor's

Our base case is that the Fed wants to slowly exit its very accommodative monetary policy — reflecting a much stronger job market — and to build ammunition to have ready when the next recession eventually occurs. Still, the Fed doesn't want to move too quickly, especially with inflation pressures still very muted. The inflation part of its mandate suggests a "go slow" approach — no one at the Fed wants to tighten too far, too fast and risk triggering market volatility that could seep into the underlying economy.

The Fed's Balance Sheet in Numbers

- Pre-crisis, the Fed held less than $1 trillion in assets on its balance sheet. Today, that total is just shy of $4.5 trillion, an increase of 390% over nine years due to quantitative easing.
- As of August, the Fed held 56% of its assets in Treasurys and 40% in mortgage-backed securities (MBS). The remaining 4% consists of loans, currency, or other debt securities.
- The Fed owns approximately one-third of the MBS market and 20% of the Treasury market.
- The Fed intends to reduce the size of its balance sheet by limiting principal reinvestments to amounts exceeding $6 billion/month for Treasurys and $4 billion/month for MBS, to be increased by $6 billion and $4 billion, respectively, every three months until the caps reach $30 billion/month for Treasurys and $20 billion/month for MBS.
- The Fed's balance sheet may remain large for years to come, with some analysts and even Fed governors suggesting the balance sheet could remain above $2.5 trillion years from now.

September 30: Budget appropriations bill/ continuing resolution. When U.S. legislators return from summer recess on September 5, one of their top priorities will be passing a budget appropriations bill by the end of the month (the end of the fiscal year). Appropriations could be at a new level for the next federal fiscal year (fiscal 2018), or a continuing resolution (CR) provides budget authority for federal agencies and programs to operate under already existing fiscal 2017 appropriation spending levels and guidelines. Without an agreement in place, the government can be forced to shut some nonessential programs and agencies down.

The last government shutdown in September 2013 left about 800,000 federal workers at home for 16 days. It followed disagreements within Congress and between Congress and the White House regarding spending — particularly for the Affordable Care Act. Between mid-September through early October, on fears (and then confirmation) of the shutdown, the S&P 500 fell about 4% (those losses were recouped within the subsequent two weeks).

This time around, one of the main challenges to a successful appropriations bill is the president's pledge to increase funding for a southern border wall and border security. Republicans know they will not get Democratic Party support for this spending, at least without some sort of quid pro quo. One possible compromise, according to media reports, could be an agreement by Republicans to lift spending caps for certain Democrat priorities in exchange for spending put toward the wall and border security. (To note, Senate passage of appropriations or a CR requires 60 votes; at least eight Democrats would be required.)

Another twist on a potential CR is duration: if Congress is getting close to end-September with little agreement in sight, it could instead try to pass a shorter-term resolution (maybe through year-end) to buy more time for negotiations.

Investors who saw that the 2013 CR conflict only resulted in limited, temporary market weakness may be inclined to ignore deadline-related posturing this time around. Comments from most legislators suggest they believe a shutdown could hurt them with voters in next year's midterms; most will want to avoid a shutdown if possible. Taking another perspective, however, investors could instead see this CR process as broadly symptomatic of Washington's inability to pass needed legislation and one too many risk events to stay the course in September.

Budget resolution. In addition to a CR to fund the government, Congress also needs to agree on a budget resolution, a measure (not law and not presented to the president) passed by both houses of Congress that sets out the Congressional budget in an outline, blueprint format. Importantly, a budget resolution can include language that is used by Congress to approach policymaking under what is known as the reconciliation process. Reconciliation allows passage of budget-related legislation within a certain period with only a simple majority and precludes filibustering. Critically, this allows the party in power to reduce the need for bipartisanship in pushing both spending and tax goals.

This fall's budget resolution is particularly important as successful tax reform or tax cuts pledged by President Trump and the Republican Party will almost certainly first require reconciliation authority. The sooner this step is taken, the sooner members of Congress can seriously progress on taxes, with a hope of passing legislation before 2018 midterm election campaigns begin in earnest. Quick progress on the budget resolution is not a given, however. Among other challenges, media reports suggest that House Budget Committee Chairwoman Diane Black may resign to run for governor of Tennessee. This could potentially slow progress as a replacement would need to be identified and installed to run the committee.

For investors, perceptions that reconciliation is being materially delayed could weigh on sentiment since it would reduce the prospects for growth-stimulative tax changes in the year ahead.

Debt ceiling. At some point around late September or early October, the U.S. will hit what's known as its debt ceiling, the self-imposed cap on what the federal government can borrow to meet its obligations. Even if a CR is passed and Congress has authorized spending, if a debt ceiling is hit, Treasury cannot borrow to provide the funds needed to run operations already authorized by the government.

The U.S. Treasury Department has suggested that mid-October is a drop-dead moment for the ceiling (this assumes certain levels of tax payments which are difficult to predict with accuracy). While there has been talk that Treasury could prioritize payments to delay hitting the ceiling, our understanding is that selecting payments would still in effect be considered a default, which in turn would get notice from credit agencies and investors.

If House Speaker Paul Ryan cannot get support from the Republican Freedom Caucus and/or other members of the Republican Party (some of whom have voiced a desire for any ceiling increase to be tied to spending cuts), he may need Democrat votes to increase the debt ceiling. That Democrat support may get tied to specific party goals (such as domestic spending initiatives). One idea that is circulating in Washington is to lift the debt ceiling for a short period (two to three months) to give legislators more time to reach an agreement — similar to logic that might be employed for appropriations or a CR.

In 2011, Congress failed to raise the debt ceiling until the last possible moment; Standard & Poor's rating agency downgraded the sovereign credit of the U.S. for the first time in the country's history in part for what it called poor governance. The S&P 500, into and during this period, declined by some 16% and took nearly six months to recover those losses. A somewhat counterintuitive "safe haven" rush to U.S. bonds (in part via selling overseas assets) pulled U.S. 10-year Treasury yields down sharply and the trade-weighted dollar up almost 8% between end-July and late September.

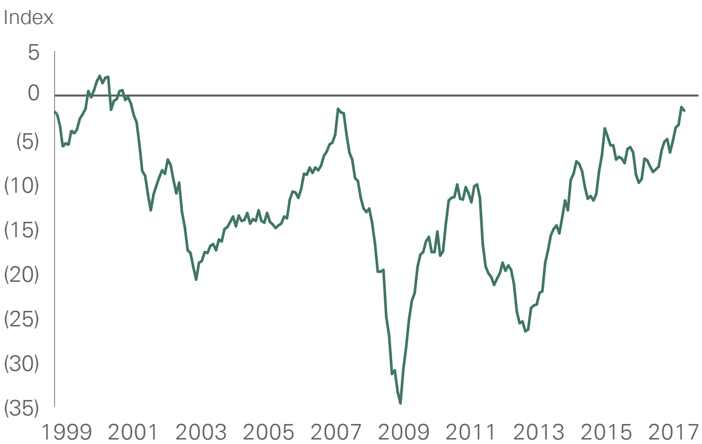
Voter irritation at past debt-ceiling conflicts has resulted in more members of Congress today publicly saying they do not want to use this as a negotiating tool. Investors remain somewhat skeptical, which is reflected in short-term bond markets that have already priced in some risk of a temporary disruption; T-bill yields are elevated around October and November versus levels before and after those months. Our fixed income portfolio managers took defensive steps to reduce exposure to this period earlier this summer in case this risk were to become at least a short-term reality.

European Event Risks in September

While important policy-related U.S. events will likely be front and center for investors in the coming weeks, we would also highlight at least two more events worth noting on the other side of the Atlantic: a potentially critical central bank meeting and a key reform litmus test in France.

September 7: European Central Bank (ECB) policy meeting and press conference. Over the summer, ECB officials increasingly telegraphed their willingness to start reducing the size of asset purchases following notable improvements in the eurozone economic backdrop, including faster and more broad-based growth, falling unemployment rates, and relatively less

Exhibit 3: European Commission Consumer Confidence Indicator for the Eurozone



Source: Bloomberg

downward pressure on prices. Indeed, the summer saw regional consumer confidence rise near the highest levels seen since the monetary union (EMU) was launched in 1999 (Exhibit 3).

An announcement at the September ECB meeting that shrinking asset purchases could commence early in 2018 may not seem like a big deal: after all, the ECB will still have extraordinarily accommodative monetary policy (short-term deposit rates will still be negative and the balance sheet will still total over four trillion euros). However, just speculation of a first, small step away from extreme policy was enough over the summer to lift German government bond yields, which in turn helped to lift euro currency higher against most peers (to a point that it has started to weigh on sentiment toward European exporting firms).

Confirmation at the September meeting that a slowing in asset purchases will commence (seen as likely in January) will reinforce investors' sense that central banks more broadly are at a policy inflection point, led by the U.S. Federal Reserve. Given what is already expected by investors, the risk around the ECB meeting will be in the details: how much more euro strength will the ECB tolerate given that currency appreciation will work against the central bank's inflation goal? How quickly will asset purchases be tapered? Is there a goal for ending QE? When might interest rates first be increased — during or after QE ends?

Bessemer portfolios increased European equity exposure during and immediately following the May-June French elections, as we had confirmation that political risks there were at least receding. That said, portfolios today remain modestly underweight the region — we do not see equity valuations as particularly compelling vis-à-vis U.S. peers at this stage, and we would view further euro gains as an increasing headwind for many regional firms. We also believe that in periods of market stress, eurozone equities are relatively more vulnerable than U.S. stocks, in part due to the dollar and U.S. bonds' "safe haven" status as well as U.S. market liquidity.

September 12: Potential French union strikes against proposed government reform. French President Emmanuel Macron came to power this past spring in part on pledges for reform, including steps to reduce labor-related costs for employers and to create more jobs. Such reforms have repeatedly been tried by past French leaders, usually to fade away in the face of fierce union opposition. Macron, helped by an unexpectedly strong parliamentary mandate, is trying again in September. During the month he hopes to pass a series of measures toward these reform goals by executive order. French equities have rallied this year on hopes of change that could support faster growth and greater corporate profits. As of mid-August, those hopes were reflected in somewhat stretched valuations: a French equity index (CAC) 12-month forward price-earnings ratio (P/E) was 14.7 versus a historic median around 13.9. Broader eurozone valuations were similarly elevated as of August.

The risk here is that hopes are disappointed, that even with strong leadership and parliamentary support, unions prove even stronger and reforms again fail. This sort of sentiment shift would likely see valuations negatively reviewed and local confidence suffer — both would likely weigh on regional stocks, at least at the margin.

With special thanks to Meghan Shue and John McMinn for their contributions.

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