Investment Insights

Hurricanes, Missile Tests, and a Debt Deal: Update on Fall Risks and Positioning

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Highlights

- Over the past month, several notable events have occurred in the U.S., namely back-to-back hurricanes in Texas and Florida and the passage of a temporary debt ceiling bill, which delays any substantial debate on the topic until the fourth quarter.
- On the international front, geopolitical risks remain elevated as North Korea has continued to test its ballistic missile and nuclear weapon programs, although tensions at the time of publication have temporarily subsided.
- Bessemer mandates have adjusted positioning at the margin to account for recent developments; we remain neutral equity risk versus the benchmark with a somewhat smaller overweight to U.S. markets.

Since our mid-August piece highlighting upcoming risks, *A Bumpy Fall?*, there have been significant events, such as continued missile and nuclear weapons tests in North Korea, as well as two severe hurricanes that have caused varying degrees of devastation in Texas, Florida, and the Caribbean. Although volatility rose modestly in mid-August and the first week of September as a result, equity markets have since rebounded and reached new highs, while both realized and implied volatility measures have declined as market sentiment has improved. That said, many of the issues that have been large drivers of market sentiment over the past several quarters, such as tax reform, infrastructure spending, the debt ceiling, and North Korea, have either been temporarily placated or delayed, but not resolved. The next several months will likely be a crucial time across a number of domestic and international fronts; the following sections provide our latest thoughts along with our portfolio positioning as we adapt to these changing economic and financial conditions.

Hurricanes Complicate Economic Data and Policy Backdrop

While the tragedy in human terms from the two hurricanes was profound, the U.S. found some solace in the fact that Hurricane Irma was not quite as catastrophic as weather models had initially predicted. The most recent estimates show that the two hurricanes combined caused upwards of $200 billion in damage, roughly on par with that of Hurricane Katrina in 2005. The years and months ahead will require significant repairs and rebuilding. These estimates often do not account for the lost wages, productivity, and economic output that occurs in the immediate aftermath of these events. Already we have seen a large spike in jobless claims, although these should dissipate as the recovery process takes hold.

From an investment perspective, these events require that adjustments be made to economic expectations, as they will likely serve as a drag on growth for the intermediate term. Some forecasts show a haircut of as much as 0.5% from Q3 GDP growth, which in our view is a very realistic possibility. While federal aid and insurance payments will allow many to begin rebuilding, thus providing a boost to growth in the subsequent months, this process and its economic implications are often lengthy, while the more negative, immediate effect is rapid and concentrated. Additionally, the impact on certain sectors of the economy that were already showing pockets of softness, such as autos, will make it difficult to ascertain the true trend of the industries in question given the economic distortions these events will cause. These challenges are not lost on New York Federal Reserve President Bill Dudley, who noted in recent remarks that "it's possible that the hurricanes could have an effect on the timing of short-term rate increases."

One near-term silver lining is that President Donald Trump and Congress have agreed to delay the debt ceiling discussions until at least later this year, removing one immediate risk for investors. However, the combination of lingering uncertainty regarding the ultimate fate of the debt-ceiling as well as complications from financing hurricane-recovery efforts reduces the probability of any near-term comprehensive tax reform and infrastructure legislation getting completed in the near-term. These incremental developments could have knock-on effects for domestic monetary policy, interest rates more broadly, as well as the U.S. dollar.

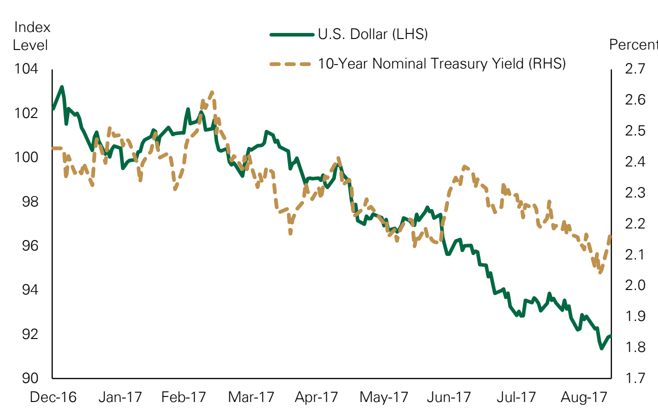
Fed Policy: Likely to Remain Cautious Amid Economic Data Uncertainty

While Treasury yields have rebounded modestly since the first week of September, expectations for another Fed rate hike by year-end remain below 40%. We are skeptical that the Fed will look to raise the federal funds rate at or before the December FOMC meeting unless inflation continues to trend closer to their 2% objective and economic activity remains at or above current levels. That said, we do expect that the Fed will begin the process of normalizing its balance sheet at next week's FOMC meeting, although the immediate financial market impact from this development should be minimal, as is generally expected by most investors.

The recent news of Fed Vice Chairman Stanley Fischer's resignation adds an additional element of uncertainty, as most market participants did not expect him to resign so early given he still had eight months remaining in his term. The continuity of FOMC leadership is a potential risk we have been highlighting since late last year, and it remains a potential complicating factor for markets. The role of the Fed chair is also in a state of flux, as many investors do not expect Chair Janet Yellen to serve another term, and the administration has given few hints about who the final candidate will be to replace her if she does in fact leave, not to mention several other seats on the Board of Governors which remain vacant.

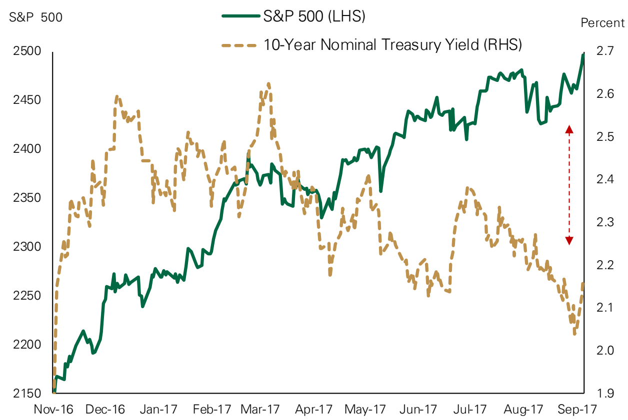
The combination of a lack of inflationary pressures in the domestic economy and an absence of progress on fiscal stimulus and/or tax reform has caused expectations for interest rate hikes to decline and Treasury yields to fall since the beginning of the year. This dynamic has also served to weigh on the U.S. dollar, which has depreciated notably since January, although as previously noted, both yields and the dollar have since bounced modestly off their respective September lows as shown in Exhibit 1. Ironically, this paradigm, often referred to as the "goldilocks" economy, where slow and steady growth and a lack of inflation keep the Fed at bay, has allowed for continued equity market gains and a period of exceptionally low volatility as demonstrated in Exhibit 2. In a situation like this, it doesn't take much for growth to sputter and stall (which would negatively impact equities), and conversely, if a number of growth-positive policies are passed and inflation expectations and interest rates quickly reset higher, financial markets could become more volatile as they adapt to a new economic landscape.

Exhibit 1: The U.S. Dollar and 10-Year Treasury Yield Since the Start of 2017



Source: Bloomberg

Exhibit 2: 10-Year Treasury Yield and S&P 500 Since the U.S. Presidential Election



Source: Bloomberg

Geopolitical Risks Continue to Lurk in the Background

As highlighted in recent pieces, our base case remains that the North Korean situation will not escalate into a full-blown military confrontation. For better or worse, game theory demonstrates that U.S. military options are limited due to a confluence of factors, which explains why the U.S. has largely relied on intensive diplomacy and sanctions to achieve our geopolitical objectives on the Korean peninsula, essentially since the armistice was signed in 1953. The recent reduction in tensions gives us optimism that both sides recognize the ultimate futility of a large-scale military conflict. Accordingly, volatility has declined over the past week and risk sentiment has improved, which has helped to provide the tailwinds for equity markets to reach new all-time highs earlier this week.

Although the North Korean risks have abated for the moment, our current view is that geopolitical risks remain higher than markets are currently pricing. A number of intractable issues around the world bear careful monitoring, not the least of which is Iran's growing influence in the Middle East, which has caused its neighbors to grow increasingly wary. It is also no secret that the Trump administration desires to take a hard stance against Iran following what it perceived to be a "bad deal" with the Iranian nuclear agreement, and it remains to be seen how the White House will approach this issue given the limited international support it is likely to receive in terms of modifying it.

Portfolio Positioning

While our equity allocation remains overweight the U.S., we have been making adjustments to our positioning throughout the year to accommodate changing economic and financial market conditions and expectations, and as a result, we have moderately reduced our U.S. exposure, which peaked in the first quarter of 2017. Consistent with our focus on protecting our clients' capital in down markets, we continue to maintain defensive strategies due to our view that the economic cycle is mature, valuations remain elevated, policy uncertainty is climbing, geopolitical tensions are high, and we face several months of choppy economic data in the aftermath of the recent hurricanes.

The U.S. dollar could continue to trade in the recent range, or even depreciate further over the next couple of months given that the Fed will likely be on hold, but our longer-term view remains generally constructive on the U.S. and the dollar due to the fact that the domestic economy remains fundamentally sound. Additionally, we expect that some form of tax reform and possibly infrastructure spending will get done, even if it takes place in 2018; the upside from these developments will likely far outweigh the temporary underperformance the U.S. has experienced in light of the recent dollar depreciation and strong returns in emerging markets. Hurricanes, fiscal policy legislation, and market corrections are difficult to forecast in terms of timing and impact, but history has shown that they all happen with some regularity, and thus it is best to be well prepared for when they do occur.

Our Recent Insights

A Bumpy Fall? — Investment Insights (August 2017)

Inflation Checkpoint — Investment Insights (July 2017)

Lessons from the Peak — Quarterly Investment Perspective (July 2017, Video Available)

Latin America in Focus as Brazil Stumbles, Venezuela Simmers, and Mexico Rebounds — Investment Insights (June 2017)

Bitcoin and Technology — Investment Insights (June 2017)

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