Investment Insights

Positioning Around Summer Market Storms

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Highlights

- This summer, investors have contended with a slew of notable market events and uncertainty arising from trade tensions, technology company earnings, and central bank moves, among other factors.
- We share our thoughts on these topics as well as portfolio implications.
- An overweight to the U.S., some defensive exposures, and active stock selection should help successfully navigate the current environment, in our view.

While summer is the time when folks try to slow down and take vacation, it can also be a time of heightened market volatility, not least because of reduced trading volumes. This summer has kept Bessemer's Investment Department particularly busy. Whether trade wars, technology-sector earnings surprises, or central bank shifts, we are trying to avoid the market's version of summer storms and continue to hold the right balance of defensive exposures with securities and allocations that will help grow our clients' capital.

In this *Investment Insights*, we share our thoughts on some of the summer's higher-profile developments, including trade, technology, and central bank policy. Overall, we believe our portfolios are positioned well to manage through this period, thanks in part to a U.S. overweight, very active and thoughtful selection around technology securities, and a number of equity exposures meant to reduce volatility. Below we discuss each key issue in turn.

U.S.-China Trade War: Currency on Center Stage

Despite retaliatory ping-pong of trade rhetoric and actions between the U.S. and China that continued into August and seems likely to persist at least into U.S. midterm elections, our base case remains that trade wars will not escalate so far that they severely dampen economic growth.

Certainly, the rhetoric is unnerving. The Trump administration last week asserted that it would consider more than doubling proposed tariffs on a further $200 billion worth of Chinese goods to 25%, up from 10%. At the same time, the U.S. Congress passed a defense bill that gives the government greater power to review Chinese corporate deals for security implications and further regulates U.S. technologies that can be sent abroad. Beijing responded that China would "have to retaliate to defend national pride and the people's interest."

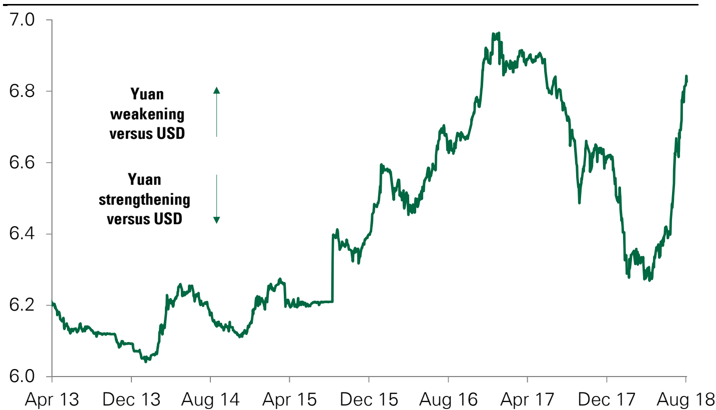
We see signs that a worst-case outcome can still be avoided. Just last week, National Economic Council Director Larry Kudlow said that high-level discussions are continuing between the U.S. and China. Meanwhile, last Friday, a series of announcements from China indicated officials are unlikely to depend primarily on a weaker currency to support exports in the face of tariffs.

It is worth discussing the currency markets in a bit more detail. We have pointed out in recent research that China has levers to pull in a trade war (see our July 6, 2018, *Investment Insights*, "Trade War"). In addition to the trillions of dollars of U.S. government debt that China holds, the ability to quickly subsidize exporting firms and boycott U.S. products, and ease fiscal and monetary policy, it also can take an interventionist approach to its currency, the renminbi or yuan (CNY). While the People's Bank of China (PBOC) moved away from targeting the yuan solely versus the U.S. dollar (USD) in recent years, opting instead to manage its currency against a basket of key trading partners, the USD versus CNY exchange rate remains an important currency pair to monitor. As trade tensions escalated in

the second quarter of this year, the yuan was falling more versus the U.S. dollar than historical currency relationships would have indicated, suggesting Chinese officials were actively weakening the currency to help mitigate trade-related damage to exporters (Exhibit 1). (We note, however, that CNY depreciation this year follows strong yuan gains against the dollar in 2017; we would not yet characterize the current yuan trend as extraordinary.)

Exhibit 1: Chinese Yuan per U.S. Dollar

Key takeaway: China may use its currency as a "release valve" for trade pressures.



As of August 3, 2018
Source: Bloomberg

A weakening in the Chinese currency, as well as local equity markets, has been one of the drags on broader risk sentiment into this summer, in turn causing the U.S. dollar to strengthen more broadly (the trade-weighted dollar has gained roughly 5% so far this year). A similar circular dynamic in August of 2015 and January 2016 was one of the reasons that global equity markets were so soft in those periods. More specifically to the U.S., a stronger dollar, all else equal, can be a short-term drag on the performance of multinational U.S. companies that earn a decent percentage of revenues overseas (Exhibit 2). Put another way, a sudden, large CNY depreciation can have ripple effects well beyond local Chinese markets — even dragging down U.S. equities in the process.

The good news here is that, at least for now, Chinese leaders are suggesting they will use the currency only as a "release valve" of sorts for trade pressures but do not intend to pursue a major CNY devaluation. Indeed, our perception is that China is focused relatively more on direct fiscal stimulus (i.e., government spending) to offset trade drags. A sense by investors that China will support overall GDP in the face of trade wars is critical; stability in the world's second-largest economy is helpful for global sentiment generally, and specifically for China's key trading partners and commodity prices.

Bessemer portfolios have retained an overweight position to U.S. markets versus benchmarks due to the more defensive nature of the U.S. dollar and equities and also the cyclical momentum, which remains stronger in the U.S. than overseas at this juncture. The strength of the U.S. dollar in this context and outperformance of U.S. markets have been additive to Bessemer's relative performance so far in 2018.

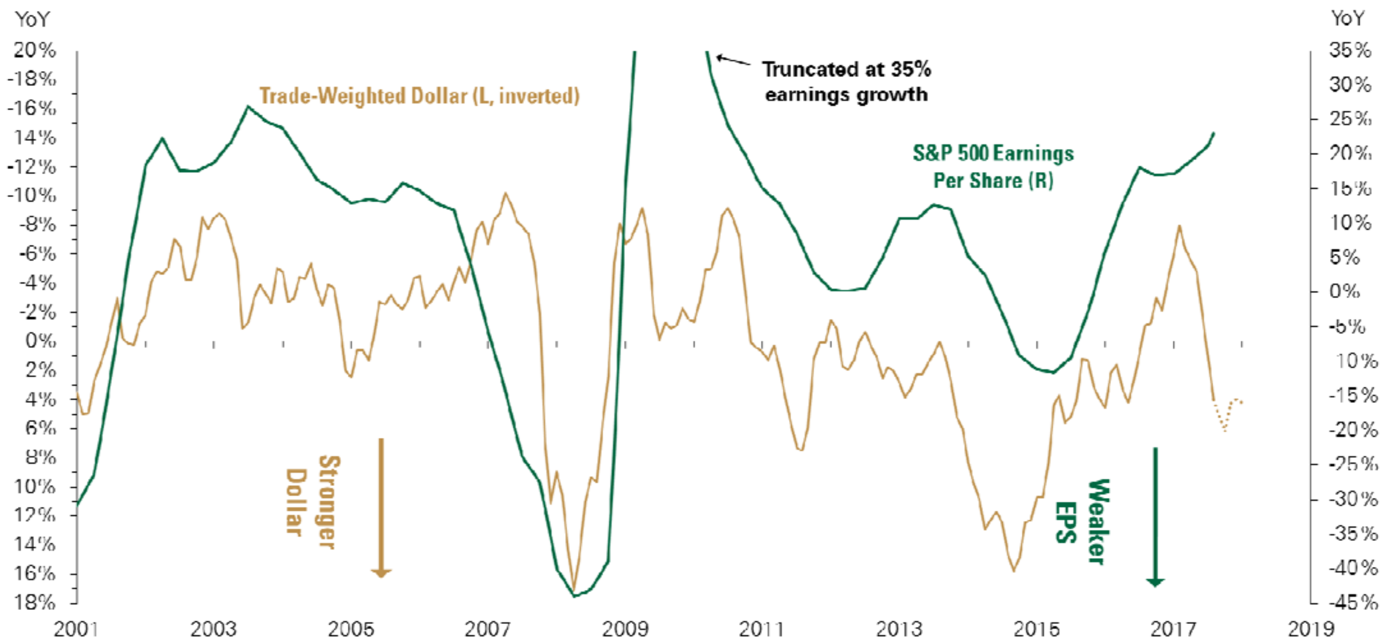
Tech Volatility Rears Its Head, Emphasizing the Importance of an Active Approach

Overall U.S. corporate earnings results have been strong, offering fundamental support to equities and offsetting other macro and geopolitical headwinds that have contributed to headline volatility. After remarkable technology-sector equity performance in 2017, this year has brought bouts of significant profit-taking, as high valuations have coupled with heightened regulatory concerns. Volatility could be seen during second-quarter earnings as Netflix, Facebook, and Twitter struggled after reporting results, while Amazon and Apple shares reacted positively to their strong earnings. After more than doubling its stock price so far this year, Netflix traded moderately lower after announcing disappointing subscriber additions. Facebook had a historic sell-off after missing revenue and user growth estimates, losing $119 billion in market cap in the biggest one-day loss for a single U.S. stock. While earnings results have been uneven for some technology firms, Amazon saw growing high-margin revenue and record profits, driven by the company's newer services businesses.

Large movements in the so-called FAANG stocks (Facebook, Apple, Amazon, Netflix and Alphabet [Google parent]) affect the overall market as these tech behemoths now make up nearly 15% of the S&P's market cap (Exhibit 3). With increased passive flows in recent years, many index and exchange-traded funds (ETFs) have poured capital into these tech companies, fueling concerns about overcrowding. Client portfolios are overweight Amazon, Google, and Netflix, and market weight Apple.

Exhibit 2: S&P 500 Earnings Growth Versus Trade-Weighted U.S. Dollar

Key takeaway: A strong dollar can weigh on U.S. corporate earnings.



The trade-weighted U.S. dollar is measured by the Federal Reserve Broad Dollar Index.
Source: Bloomberg

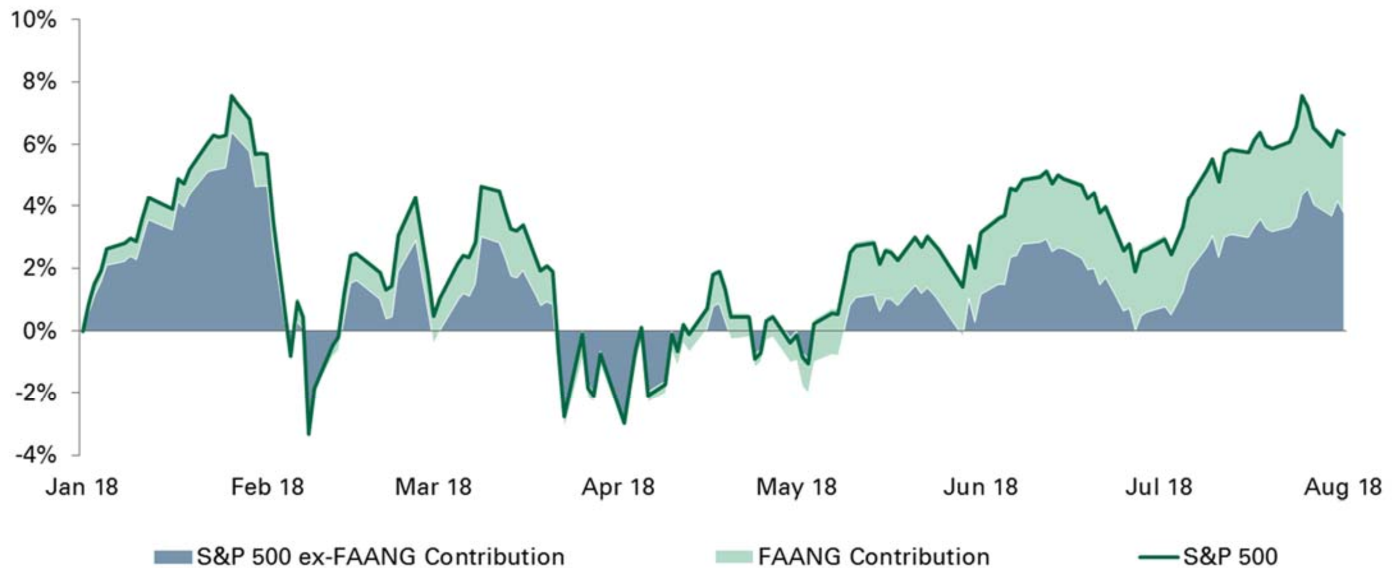
While it has not proven to be a sustainable trend, Facebook's sharp sell-off seemed to act as a catalyst for a rotation away from growth toward value, prompting the biggest three-day change in value versus growth since May 2009. The recent move in relative performance between value and growth shares was a notable reversal in the 10-year growth-over-value run in the U.S. market. Despite moving down with the broader sector initially, names like Google, Amazon, and Apple exhibited relatively lower volatility and were quick to reverse direction and surge ahead as buyers stepped in.

Recent volatility points to the importance of looking at the tech sector on a name-by-name, active basis, in our view. While the FAANG stocks often have been grouped together, they represent vastly different investment opportunities with varying dynamics. We were not surprised, for instance, that despite moving down with the broader sector midsummer, names like Google, Amazon, and Apple exhibited relatively lower volatility and were quick to bounce back. We believe high-quality technology companies that are dominant leaders with a sustainable competitive advantage within their respective industries will outperform in spite of market choppiness.

Even with the recent weakness, the technology sector has been one of the best performers this year. While we continue to monitor the market to see whether it is approaching peak growth, we believe the current technology environment points to the importance of active management. Active managers can beat the market by owning stocks with long-term growth prospects and high-quality business models that will outperform through continued market volatility. Our clients are less exposed to Facebook relative to other large technology stocks with minimal exposure in Sands Capital (the large-cap growth equity subadvisor in the Large Cap Strategies equity portfolio) and an underweight position versus the benchmark in the Balanced Growth portfolio. Client portfolios remain overweight Amazon.

Exhibit 3: FAANG Contribution to S&P 500 Total Return, Year-to-Date

Key takeaway: A large portion of the S&P 500 return recently has come from the FAANG stocks.



FAANG refers to Facebook, Amazon, Apple, Netflix, and Google.
As of August 1, 2018.
Source: Bloomberg

G-3 Central Banks – A Long, Winding Withdrawal of Liquidity

The Federal Reserve (Fed), the European Central Bank (ECB), and the Bank of Japan (BOJ) remain in focus this year, as the market begins to contemplate a life without significant liquidity stemming from low rates and asset purchases by the three major central banks. Over the past few weeks, these banks held monetary policy meetings, with the relatively most important developments from the BOJ. While the policy moves seem minor, the shift in direction away from quantitative easing is significant.

Specifically, the BOJ has been targeting its yield curve (the difference between short- and long-term government bond yields) such that short-term rates are around -0.1% and 10-year yields are around 0%. The bank widened the band around the 10-year yield target to -20 basis points to 20 basis points, effectively allowing for slightly higher long-term interest rates. Meanwhile, the central bank stated that it will increase or decrease ETF purchases (part of its asset-purchase program) based on market conditions — in a sense, introducing a form of guidance to the market on future quantitative easing and making future actions more data- and market-dependent relative to recent years. It is estimated that the central bank now holds around 4% of all outstanding shares on the Japanese TOPIX index. The bank's -0.1% policy balance rate has remained unchanged since January 2016 (it was previously at 0.1%).

Similar to the Bank of Japan, the ECB is slowly moving in the direction of withdrawing liquidity but maintains an overall accommodative stance. There were no notable changes at the midsummer ECB meeting. The central bank has kept a negative interest rate policy since March 2016 and continues to suggest it will persist at least through summer 2019. Further, it has explicitly stated that it will continue beyond that with negative interest rates to achieve its inflation target if price gains are "below, but close to, 2% over the medium term."

While using short-term rate guidance to help limit any euro currency appreciation (which in turn could hurt exports), the ECB is noting that the eurozone economy is improving enough to warrant fewer asset purchases. It began decreasing its asset purchase program (APP) in January and is set to end the program in December, but will reinvest principal payments from securities purchased under APP for an extended period of time. Put another way, the ECB balance sheet (now around EUR 4.6 trillion) will stop growing but instead will hold steady for some period of time.

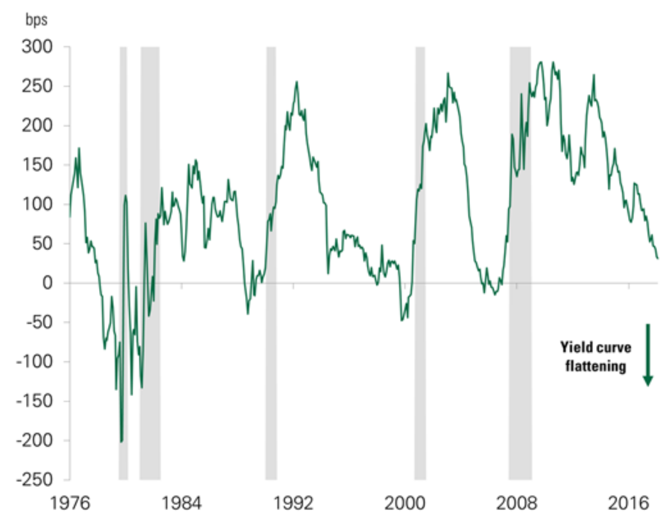
The movements of the BOJ and ECB are relevant for the broader risk markets given the support their easy policies have provided both to financial markets and broader economies. Additionally, shifts in policy overseas are relevant for the longer end of the U.S. Treasury curve (i.e., the 10-year yield). Given that the BOJ and ECB have pursued negative interest rates, there has been strong overseas demand for U.S. Treasuries, which are yielding relatively more. This demand, in turn, has been one of the factors keeping a lid on U.S. yields, with the 10-year struggling to see yields sustainably rise above 3%. To the extent that these foreign central banks only slowly withdraw liquidity amid low levels of inflation, we do not expect a rapid increase in longer-dated U.S. yields.

Meanwhile, Federal Reserve policy is most relevant for the front end of the U.S. yield curve. The central bank currently maintains policy rate bounds of 1.75% to 2.00% and continues to allow its balance sheet of securities to run off, announcing no major changes in its stance at its August 1 meeting. The FOMC statement highlighted the country's "strong" economic growth and labor market conditions and that overall and core inflation are "near 2 percent," which is the central bank's target rate. Tariffs and other global risks were notably absent from the statement. The market widely expects the Fed to raise rates to 2.00% to 2.25% at its September 26 meeting, and an additional hike by the end of 2018 is partially discounted in financial markets.

One area of focus for the market and the media has been the flattening of the U.S. curve (Exhibit 4). An inverted yield curve, or an environment where the 10-year yield falls below the yield of the front-end (say, 2-year) yield, historically has been a strong indicator of a recession to follow. We monitor the shape of the curve as one of a number of metrics to judge the probability of U.S. recession in the next year and note that, while the curve has been a reliable historical indicator, the timing of recession following an inverted curve has varied significantly. Indeed, past economic cycles have recorded meaningful equity gains in the period immediately following an inverted curve before a recession ensues. The Federal Reserve has been communicating some reasons why an inverted curve may not necessarily suggest a recession is around the corner, essentially saying that "this time is different." One reason cited has been the policy of other G-3 central banks, which has served to reduce what's known as term premium, or the difference in what you get as an investor from holding long-term bonds versus just rolling over short-term bonds.

Exhibit 4: Spread Between 10-Year and 2-Year Government Bond Yields

Key takeaway: The U.S. yield curve continues to grind lower.



As of July 31, 2018. Recessions indicated by gray bars.
Source: Bloomberg

Without getting into the details of this academic discussion, we note that there are indeed real economic challenges associated with an inverted yield curve, such as the difficulty financial institutions may have in making a profit by borrowing short term and lending to businesses and consumers when long-dated rates are below short-dated rates. Further, we are cognizant that the actual rates financial institutions are paying to borrow in short-dated markets are increasing more than the rates that the Fed officially controls.

Several factors, such as increased Treasury bill issuance in the front end of the curve as well as increased regulation of the money markets (which has pushed more investors to government rather than private funds), have increased the cost of borrowing for private companies.

We are monitoring this dynamic in addition to continued Fed tightening as one input into our view on the U.S. cycle. For now, we are comfortable with the defensive positions within portfolios, a neutral weighting to equities, and an underweight to high-quality fixed income as yields continue to nudge higher.

Trade War — Investment Insights (July 2018)

The Defensive Playbook — Quarterly Investment Perspective (July 2018)

Perspective on Asset Allocation — A Closer Look (May 2018)

Portfolio and Politics Across The Pond — A Closer Look (May 2018)

A Primer on Bond Yields — A Closer Look (May 2018)

The Hype and Hope of Bitcoin and Blockchain — Quarterly Investment Perspective (April 2018)

Trading Thoughts — Investment Insights (March 2018)

Investing in Deficits — A Closer Look (March 2018)

Sell-Off Accelerates; "Short Vol" Flash Crash? — Investment Insights (February 2018)

Inflation Checkpoint — Investment Insights (February 2018)

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