

Market Update

Developments in Europe and the U.S.

Background

Yesterday brought two notable developments. First, European policymakers concluded their 14th summit meeting in the last 21 months with a highly awaited agreement aimed at stemming the euro-zone debt crisis. Second, the U.S. reported its ninth consecutive quarter of positive GDP growth.

Europe's Plan

Despite widely publicized divisions among governments, particularly Germany and France, policymakers sought to demonstrate their commitment to stabilizing Europe through a three-pronged plan:

- **Greek debt haircut.** Banks agreed to take a “voluntary” 50% loss on the face value of their Greek bonds. This measure seeks to reduce Greece’s debt level to 120% of GDP by 2020, down from about 150% currently.
- **Recapitalization of the banking system.** European leaders agreed to require major banks to achieve 9% core capital levels by June 30, 2012, which will necessitate about \$150 billion in additional capital. Most likely, banks will initially look to raise funds in the capital markets and through asset sales, before turning to government monies as a secondary source.
- **Increase in the rescue fund.** Leaders agreed to raise the previously announced European Financial Stability Facility (EFSF) to nearly \$1.5 trillion, in part by attracting investments from China, Japan, and other countries. This rescue fund will help finance Greece’s latest aid package, support the issuance of government debt in troubled countries via partial guarantees to investors, and make loans to help recapitalize banks.

Our Perspective on Europe

Unlike the earlier one-off bailouts of various euro-zone countries, the latest agreement represents a move toward a systemic response to the two-year-old sovereign debt crisis. By finally acknowledging the long-apparent reality that Greek bonds are not worth their full stated value, and by increasing the region’s firepower to stave off an uncontrolled default, this package largely takes the worst-case scenario off the table. About one month ago, President Sarkozy of France and Chancellor Merkel of Germany increased their visibility in this crisis and pledged decisive action; this week’s developments vindicate their efforts.

Nonetheless, we continue to believe that full resolution of the euro zone’s serious debt issues will be a messy process with additional setbacks. We would highlight three concerns:

- It will be difficult to obtain agreement on all the critical details that will bring the plan to life. Unresolved questions include the following: How will the 50% haircut be implemented? Will Europe meet its goal of having China and other countries co-invest in the EFSF rescue fund? And will \$150 billion prove sufficient to eliminate European banks’ capital shortfall? As the difficult work proceeds, philosophical differences among the 17 euro-zone countries will likely flare up, especially in regard to the terms that Germany will require from its southern neighbors in return for the big expenditures it will need to underwrite.
- The sizable reduction of Greece’s debt could be perceived as a reward for reckless debt growth. The Greek citizenry may not follow through on its commitments to pay taxes and reduce government headcount, and the debt haircut may send an inadvertent message to other over-leveraged countries within the euro zone that excessive debt might be forgiven.

- While the much-publicized agreement buys important time for European leaders, it stops short of providing a clear road map to fiscal union. The official summit statement promised to “strengthen the economic union to make it commensurate with the monetary union” through another summit in March 2012, but the eventual outcome is unknowable now. As long as the common currency is not backed by stronger fiscal linkages (e.g., issuance of euro bonds supported by tax revenues), the region will remain at risk of periodic economic rifts.

As a result, we do not believe this agreement sounds an all-clear signal for the region. European leaders still have much work to do in hammering out critical details, and markets will likely continue to probe for weaknesses to assess how policymakers will respond. Moreover, this week’s developments will still leave Europe with too much sovereign debt, too little global competitiveness, and too few drivers of long-term economic growth. Nonetheless, the latest agreement is a relief to investors and a notable step in the right direction toward a more stable, unified Europe.

U.S. GDP Growth

The U.S. economy expanded at a 2.5% annual rate in the third quarter, an acceleration from the second quarter’s 1.3% gain.

Our Perspective on the U.S.

The ninth consecutive quarter of growth propelled the U.S. economy to its highest level of overall activity in history, just surpassing the prior peak achieved in the fourth quarter of 2007.

A breakdown of the GDP report reveals the following:

- The biggest positive contribution came from a 2.4% increase in personal consumption, up from 0.7% in the prior quarter. Despite an elevated unemployment rate and a depressed housing market, consumers have remained resilient. We believe a sharp reduction in household debt service as a percent of personal income is a key factor.
- Businesses made larger-than-expected investments in equipment and software, in part due to a temporary tax provision allowing accelerated depreciation of these expenditures.
- Increased world trade helped U.S. exports grow 4% in the quarter, bringing their cumulative gain since mid-2009 to 23%. Global companies headquartered in the U.S. are benefiting from strong competitive positions and growth in emerging economies.
- Government spending made no overall contribution to economic growth, with higher federal outlays offset by cutbacks from state and local governments.

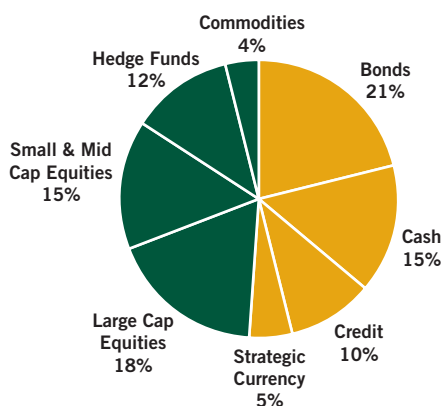
Even as this report revealed continuing economic growth, it does not guarantee that the U.S. economy will avoid a slowdown in coming quarters. Notably, personal consumption grew faster than worker income, which is an unsustainable trend. Moreover, low consumer and corporate confidence, some reductions in earnings forecasts, and recent indications that inventories are growing faster than new orders all suggest an increased risk of recession. If this outcome develops, we would expect a milder downturn than the deep recessions of 1974, 1982, and 2008 because companies haven’t over-hired, corporate balance sheets are generally in robust shape, and monetary policy is unusually accommodative.

Our Positioning

For some time, we have been closely monitoring policymaker actions, viewing them as key determinants of the economic and investment outlook — and therefore our investment strategies. While the European announcement provides some measure of clarity, there are significant hurdles ahead. Moreover, it is still unclear whether U.S. policymakers are prepared to take much-needed steps toward appropriate spending and tax policies. Rhetoric remains heated. However, we have heard reports of serious discussions within the Congressional committee charged with identifying \$1.5 trillion in deficit cuts by late November.

Foremost on our minds as we set our investment strategy is our central objective of participating meaningfully in rising markets while limiting losses in falling ones. Even as we have been unsatisfied with recent portfolio declines, we remain convinced that we have built a prudent mix of defensive and growth-oriented assets (Exhibit 1).

Exhibit 1: Portfolio Positioning



Reflects Balanced Growth allocations as of October 21, 2011.

For some time, we have held elevated cash levels, which we raised further in the third quarter as economic risks built. This cash level now stands at 15%, well above the normal 3-4% level. In total, cash, bonds, currencies, and credit investments represent a higher-than-normal 51% of our Balanced Growth model portfolio. At the same time, we retain exposure to growth-oriented assets such as equities, commodities, and hedge funds, which will likely benefit over time if worst-case economic scenarios miss the mark as we expect.

While we know this positioning will mean trailing in sharp rallies, we are more focused on building a prudent allocation in a period of elevated uncertainty than on competing with a particular set of benchmarks over a short time period.

We stand ready to make significant changes to our positioning based on market levels and developments around the world. Moreover, we believe the changes to our large cap portfolios slated for late November — adding a lower volatility approach through Large Cap Core and utilizing several complementary managers in Large Cap Strategies — will be an important enhancement to our strategy.

This week's developments reinforce our belief that the euro zone will persevere, the U.S. economy will avoid a deep downturn, and positive actions by policymakers can gradually restore confidence. Nonetheless, we are convinced that risks remain, and we must maintain a well-diversified approach positioned for periods of both strength and weakness.

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