BESSEMER TRUST

A Closer Look

Portfolios and Politics Across the Pond

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In Brief

- **While European headlines have been more benign in 2018 relative to 2017, several recent developments are worth highlighting as they relate to the positioning of Bessemer mandates.**
- **Ongoing Brexit negotiations between the U.K. and European Union (EU) are limiting growth while lifting inflation; we are comfortable remaining underweight U.K. equities and the currency versus benchmarks.**
- **The challenges in forming a German coalition government create "mixed messages" for investors: On a positive note, more fiscal stimulus is likely in the coming year or so; more negatively, the government is relatively less focused on needed EU reforms.**
- **After March elections, Italy is still struggling to form a government; while not unusual for local politics, the potential for anti-austerity, EU-skeptical parties in power at the margin could hurt investor sentiment toward the country and even region.**

While the vast majority of recent news headlines have focused on U.S. politics, several important political stories have been unfolding in Europe. In this *A Closer Look*, we travel across the Atlantic to first recap recent political developments in Italy, Germany, and the U.K., and share our perspective on them, then discuss how these events, along with other factors, are influencing our investment strategy in the region. Overall, Bessemer equities are underweight Europe, though still comprising 11% of a Balanced Growth 70/30 portfolio.

Germany: Fiscal Stimulus Coming

Political recap: Germany's federal elections in September 2017 saw incumbent Chancellor Angela Merkel's coalition government, the Christian Democratic Union (CDU) and Christian Social Union (CSU), win the greatest number of seats versus other coalitions and parties but not enough to gain majority in the Bundestag. It took CDU/CSU the next four months to form a new coalition government large enough to have a majority. After one failed attempt to do so with the Free Democratic Party and Green Party, the CDU/CSU officially formed a "grand coalition" with the Social Democratic Party of Germany (SPD) on March 14. Combined, these three parties (CDU/CSU and SPD) hold 399 of the 709 seats in the Bundestag. The new government is expected to remain in place for roughly three years (the next federal election must be held no later than October 24, 2021).

Our view: While the financial-market reaction would suggest the German election and eventual government coalition were a non-event, we would argue that, under the surface, there is a lot happening.

Perhaps most important to note is the loss of centrist votes to populist parties on the left and right. Specifically, the CDU/CSU lost 65 seats, and SPD had its worst result since World War II, receiving 20% of the votes (or 153 seats). The far-right and anti-EU populist party Alternative for Germany (AfD) received the third-greatest number of votes at 12.6% after CDU/CSU and SPD, giving the party 94 seats in the Bundestag. While the AfD is not expected to generate significant political instability in the near term, the growing inflation of this party and obvious frustration shown by voters were a wake-up call for Merkel ahead of the 2021 general election. As a result, policy priorities changed significantly. Instead of using her last term as Chancellor to focus on strengthening the EU and monetary union, it appears that Merkel is spending her last political capital shoring up support for centrist parties at home, to ensure that future governments do not veer far from CDU/CSU values.

Merkel, for instance, is pushing for fiscal stimulus in the coming year aimed at making middle-class Germans less anxious about their evolving citizenry (i.e., the recent influx of refugees). The government has said it will spend more on education, social housing, and defense and provide extra financial support for local areas most affected by the refugee influx. It also plans to lower taxes. What's surprising and, on its face, "un-German" about this is the timing: Germany's economy does not need stimulus currently. The economy is growing at a healthy clip, up from 1.3% in the fourth quarter of 2015 to 2.9% year-over-year in the fourth quarter of 2017. Meanwhile, the unemployment rate is at its lowest level since 1991 at 5.3%, and business and consumer surveys support a continued positive economic outlook. Rather than save these fiscal bullets for the next crisis or recession, Merkel is using them now to help ensure her party stays in power after she is gone from the scene.

Near term, such stimulus is good news for German equities. However, the flip side of the new German policy focus is the risk that structural European reform is pushed to a back burner. Certainly, Merkel and French President Emmanuel Macron have a positive working relationship and are keen to strengthen the region. As they represent the two largest economies in the EU, this is very important from an economics and markets perspective. However, Merkel now has another priority (one might argue that Macron is increasingly facing backlash at home as well on the reform front, and may also need to shift his near-term focus from regional to local). In recent decades, Germany and France have led pan-European reform efforts, often dragging other countries along. Not using the current, stronger growth backdrop to take more steps to reform EU member states and/or policies leaves the region more vulnerable in the years ahead — maybe sooner than the consensus expects, as the European Central Bank (ECB) could be tapering asset purchases and no longer holding down borrowing costs as soon as later this year.

Italy: Political Instability to Persist Awhile Longer

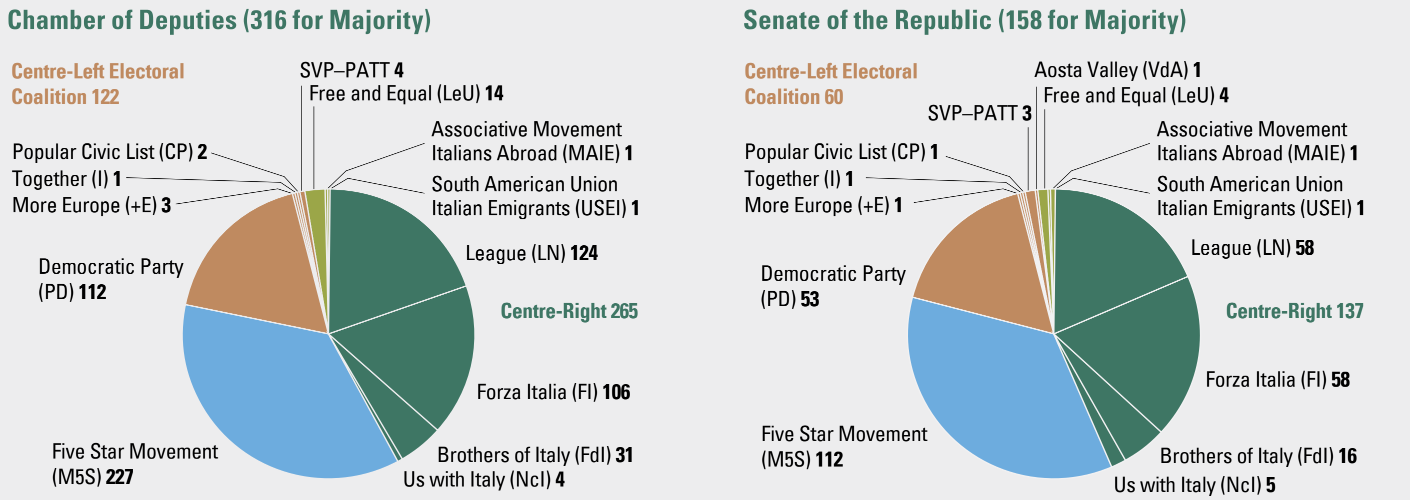
Political recap: Voters in Italy's March 4 general election chose 630 members for the Chamber of Deputies and 315 for the Senate. These two houses make up the Italian Parliament and essentially perform the same functions, with key differences being the membership criteria and rules for election. What matters about this election is that (1) no single party or coalition gained a majority in either house, and (2) populist parties Five Star Movement (M5S) and Lega Nord (LN) fared better than expected. M5S is Italy's largest anti-establishment party and gained the most votes of any single party (227 and 112 for Chamber and Senate, respectively). This party's base is primarily located in Southern Italy and the islands, where M5S collected the greatest number of votes in almost every region (Exhibit 1).

Formed in 2009 by former comedian Beppe Grillo and internet strategist Gianroberto Casaleggio, M5S pledged to introduce a minimum income, repeal the EU's 3% fiscal deficit-to-GDP rule, simplify the tax system, reduce bureaucracy, reform the pension system, ally with Southern European countries to end fiscal austerity, and repatriate illegal immigrants. M5S has previously advocated for pulling Italy out of the EU, but its stance has softened recently, with party leader Luigi Di Maio having publicly stated that Italy should not leave the euro.

Meanwhile, LN, founded in 1991 and also referred to as the League, gained a sizeable number of votes, making the party one of the top three by number of seats received along with M5S and the more centrist Democratic Party. Despite being another populist party, this party's base and message are distinct. LN is considered anti-South and anti-immigration, and its base is primarily located in the North, especially in the Veneto and Lombardy regions. In the 2018 election campaign, LN advocated for a flat tax rate of 15%, free state-funded daycare, the legalization and taxation of prostitution, tighter control on immigration, and rejection of a bill granting Italian citizenship to those born and educated in Italy with non-Italian parents. One similarity between M5S and LN is open criticism of the EU, particularly regarding the fiscal rules.

Exhibit 1: Italy's General Election Results

Key Takeaway: In the recent Italian election, no single party or coalition gained a majority in either house.



As of March 21, 2018.
Source: Italy's Ministry of Interior

As of mid-May, all attempts to form a coalition government had failed and speculation was increasing that a new election would need to be called.

Our view: Until a coalition forms, incumbent Prime Minister Paolo Gentiloni's government will remain a caretaker. While frequent Italian elections and a revolving-door set of politicians is not very unusual in Italy, investors are still starting to get nervous, primarily because this political limbo is occurring at a time when Italy needs to pass its 2019 budget. Without passage, funding cannot get approved, and the government in theory could be forced to shut down. Most likely, the president (Sergio Mattarella) could postpone elections until a budget is passed, but this could be seen by many in Italy as undemocratic.

When (we assume we'll get there) a new government is successfully formed, at the moment it seems likely that LN and M5S are included, suggesting potentially more noise around EU norms and fiscal policy into the end of this economic cycle. Currently, Italy's government deficit, at -2.3% of GDP in 2017, is within the Union's rules. That said, government debt as a share of GDP is the second highest in the EU after Greece and well exceeds the 60% limit at 132%. Recall that, during the 2008–2009 crisis and then the European crisis of 2011, European states with problematic debt and deficit levels saw the greatest stress, as investors demanded higher yields to compensate for the country risk, and as capital fled local equity markets. If Italy feels such stress, as the third-largest economy in the EU after Germany and France, it could spill over to more caution toward the entire European Union.

Significant Uncertainty Around Brexit Remains

Political recap: On June 23, 2016, Great Britain voted to exit the EU, with 51.9% of the voters in favor of the referendum. Since then, the country has been in a transitional state, working with the EU to determine the U.K. and EU's future relationship. Article 50 of the Treaty on European Union was invoked by Prime Minister Theresa May on March 28, 2017. This marked the official start of the U.K.'s withdrawal period from the EU and set March 29, 2019, as the official exit day. At that point, the transition period will officially begin; it is set to end in December 2020.

In March, the EU and U.K. announced that a transition agreement had been reached. The status quo remains in place through the transition period, with the U.K. losing its voting rights at the EU level. The U.K. will be required to implement all new EU regulations and directives during this time and will remain subject to free movement of labor within the EU, European Court of Justice jurisdiction, and budget contributions to the EU. Additionally, EU citizens will be granted the same rights as those arriving before March 2019. The U.K. will be permitted to sign but not implement trade deals with non-EU countries during the transition period. The agreement does not include a mechanism by which the transition period can be extended; this is a key point because the two most contentious issues, Ireland and trade, remain unresolved and will be worked out during the transition period, ending December 2020 (see box below for more details).

Brexit: The Future of Ireland and Trade Continue to Be Unknown

- **Ireland**: Northern Ireland is part of the U.K. and shares a border with the Republic of Ireland. The Republic of Ireland is an independent nation and member of the EU. Northern Ireland, which voted 44% in favor of leaving the EU, wants to maintain a free flow of people and goods via its physical border with the Republic of Ireland. Politically, May needs support from pro-U.K. Northern Ireland members to pass Brexit legislation, so it is in her best interest to come to a solution to the border issue that appeases Northern Ireland's demands. That said, May has also stated that she will not sign an agreement that divides Northern Ireland and the U.K. To date, the U.K. and the EU have agreed to the EU's "backstop" option that will keep Northern Ireland a part of the EU's customs territory, which was previously rejected by May. This solution of sorts will remain in the legal withdrawal text until the U.K. presents an alternative for avoiding a hard border.

- **Trade**: The U.K. has stated that it would like mutual regulation recognition on a scale similar to that of Norway. Norway is a member of the European Economic Area (EEA), along with Iceland and Liechtenstein, and is a part of EU's single market. Switzerland is also a member of the single market system but is not a member of the EEA or EU. All of these countries accept the free mobility of people. The current U.K. government seems unwilling to accept this stipulation, but the EU is highly unlikely to grant full access to the single market without it.

The trade deal between the EU and Canada may provide a framework for what the U.K. could negotiate without allowing for the free movement of people. The Comprehensive Economic and Trade Agreement (CETA) took seven years to complete, with the first five to negotiate the deal and next two to ratify across all EU member nations and Canada. This trade deal mostly focuses on goods, eliminating 98% of tariffs. With regard to trade in services, CETA permits some free flow of trade in services but does not liberate this sector altogether. The deal does not permit a free flow of people or include a mutual recognition of standards, and all goods still need to go through customs.

The EU also has a free trade deal with South Korea and is working to complete one with Japan. South Korea-EU talks began in 2011, and the deal was ratified in 2015. The Japan free trade deal negotiations began in 2013, and the European Parliament and EU member states are now in the process of ratifying it.

A U.K./EU trade agreement is expected to apply to goods but not services because the EU is highly unlikely to accept a free trade of services without free movement of people. Services make up 41% of U.K. exports to continental Europe, and financial services make up 25% of U.K. services exports. A loss of free trade in services to the U.K. would directly affect the country's growth rate and have multi-order effects.

Our view: The uncertainty related to Brexit is likely to remain a drag on U.K. growth and a key factor for related markets in the years to come. Even though companies now know that the status quo will remain in place until December 2020, they do not know how to plan beyond that point. Additional uncertainty relates to the fact that implementation of such deals can take many years, as exemplified by the free trade deals between the EU and Japan, and South Korea and Canada. The EU and the U.K. have set a hard deadline of less than three years from now for a deal to be finalized, and this agreement is expected to be far more complex than the EU's deals with Canada, South Korea, and Japan.

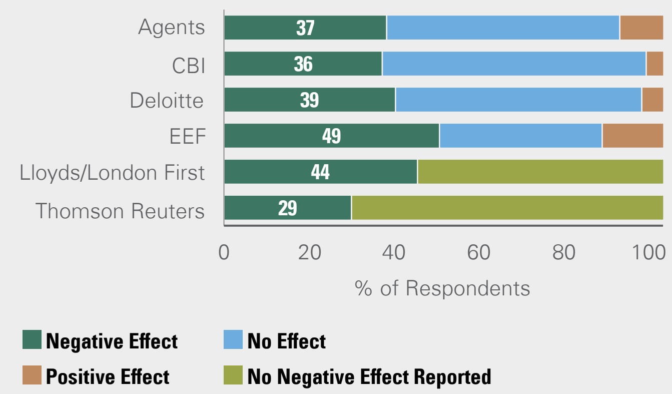
The combination of the U.K.'s economic dependence on the EU and the importance of the Ireland issue put the U.K. in a weak bargaining position and further complicate the landscape. Meanwhile, tension is growing within the U.K. regarding what the final withdrawal deal should look like. May supports a hard Brexit. In April, the House of Lords passed an amendment to the EU Withdrawal Bill by 335 votes to 224; if finalized, this modification would allow members of Parliament to send ministers back to the negotiating table if they vote against May's Brexit deal. This development could prove to be a major obstacle in achieving a hard Brexit and highlights the vulnerability of May and her party.

Despite the market's immediate negative reaction to the Brexit referendum, some U.K. economic indicators have remained relatively strong. Business confidence has held relatively steady, and GDP growth, while slowing, is still positive (from 2.0% in third-quarter 2016 to 1.4% in fourth-quarter 2017). The unemployment rate has been trending down since November 2011, from 8.5% to 4.4% in December 2017, although this seems in part due to a sharp slowdown in migration of labor into the country as much as a strong job market.

Even if some headline economic data seem benign, we believe the reality of what Brexit means for the future of the U.K. economy is beginning to surface. The Bank of England (BoE) is highlighting inflation that is resulting from labor shortages in sectors reliant on migrants. The BoE has also stated that uncertainty around Brexit has resulted in notably weaker business investment growth. Some economists have noted that, in combination, these drivers have reduced potential GDP for the U.K. by 0.2%–0.3%. A series of surveys asking businesses about the impact of Brexit on their investment plans indicate that about a third of U.K. companies have either held off or are limiting investments due to the uncertainty of what a post-EU U.K. will look like (Exhibit 2). Clarity on this issue is not expected in the near term, so productivity growth will likely remain subdued in the coming quarters.

Exhibit 2: Surveys of the Impact of Brexit on Investment

Key Takeaway: Approximately one-third of U.K. companies are limiting investments due to Brexit uncertainty.



As of February 2018.

Source: Bank of England, Confederation of British Industry (CBI), Deloitte CFO Survey, EEF – The Manufacturers' Organisation, Lloyds Bank/London First and Thomson Reuters

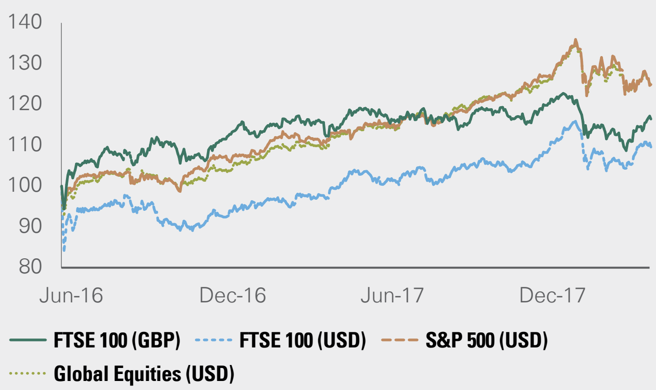
Market Implications and Our Positioning

The market's response to recent political events in Germany and Italy has been relatively muted, but the same cannot be said for the U.K. Brexit has had a material effect on British assets: As shown in Exhibit 3, both the S&P 500 and global equities have outperformed the U.K. FTSE index by 14% in U.S. dollar terms and around 8% in local currency terms since the Brexit vote.

The pound initially weakened following the Brexit decision, falling from 1.49 to 1.21 per U.S. dollar in January 2017. The currency has rebounded since then and is currently at 1.36, mostly due to broader dollar weakness. Still, the pound remains near Brexit lows versus the euro. British currency losses have pushed up inflation in the U.K., in turn forcing the Bank of England to raise interest rates

Exhibit 3: FTSE 100, S&P 500, and Global Equities Performance Since Brexit — Indexed to 100 on June 23, 2016

Key Takeaway: Since the Brexit vote, U.K. equities have underperformed the S&P 500 and global equities.



As of April 25, 2018. Performance reflects the price return only. Global equities are measured using MSCI ACWI IMI.

Source: Bloomberg, MSCI

(November saw the country's first rate hike in more than a decade). Expecting lingering economic uncertainty and currency risk, Bessemer portfolios went underweight U.K. equities and the currency around the Brexit vote and continue to maintain that stance today.

Meanwhile, market reactions to unfolding political developments in Germany and Italy have thus far been much more muted, probably in part as economic implications of the party shifts have been relatively smaller — a bit more fiscal stimulus in Germany, a bit more potential fiscal pushback in Italy. In Italy's case, it's also worth noting that a change in leadership is very common. Gentilioni's government was the 65th for the country since the start of 1946 — that's nearly a new government every year. Despite all the change, Italian growth trends have tended to follow the economic trends of Europe more broadly (Exhibit 4). Such a consistent historical pattern likely gives investors some comfort that whatever unfolds next, it's not likely to (a) last very long or (b) take Italy on a materially different path from the rest of Europe.

That is not to say we do not want to continue to follow regional developments. Italy's high debt-to-GDP ratio leaves it vulnerable to higher interest rates, as debt servicing costs could quickly eat into other areas of government expenditures (investors often gauge this risk via the difference, or spread, between Italian bond yields and yields on what are viewed as safer German bonds, see box on page 7). Meanwhile, a reduced focus on European reform by Germany creates a greater risk that the monetary union will face the next global recession without the defenses it needs (in particular, a stronger European banking system).

Overall, Bessemer portfolios are underweight European (ex-U.K.) equities and the euro. Politics, at least for now, is not a major factor behind this decision; instead, our overweight to the U.S. mathematically makes it challenging to NOT be underweight other major regions of the world. The portfolio tilt toward the U.S. stems from two disparate forces. First, the recent, very large

Exhibit 4: Italian Consumer Confidence

Key Takeaway: Consumer sentiment in Italy is high versus historical levels, in-line with broader European consumer and business survey data trends.

As of March 31, 2018.

Source: Bloomberg, ISTAT

fiscal stimulus, in our view, is likely to provide a one-off support to U.S. equities. One can see evidence of that already in corporate share buybacks. U.S. firms appear to be actively using tax-related windfalls to buy back shares (including Apple's planned $100 billion buyback). Wall Street estimates suggest total buybacks in 2018 could reach $650 billion. Beyond stimulus driving equities, portfolios are also tilted to the U.S. as a defensive measure. In particular, history has shown that in times of substantial market stress, U.S. equities tend to keep up or outperform other countries' equity markets, thanks in part to a stronger-dollar bias in these environments (this in turn helps USD-based investments relative to those in foreign currencies). The dollar tends to benefit into and during recessions from a flight to quality: both foreign investors seeking the liquidity and safety of U.S. government bonds and U.S. investors bringing capital home from overseas.

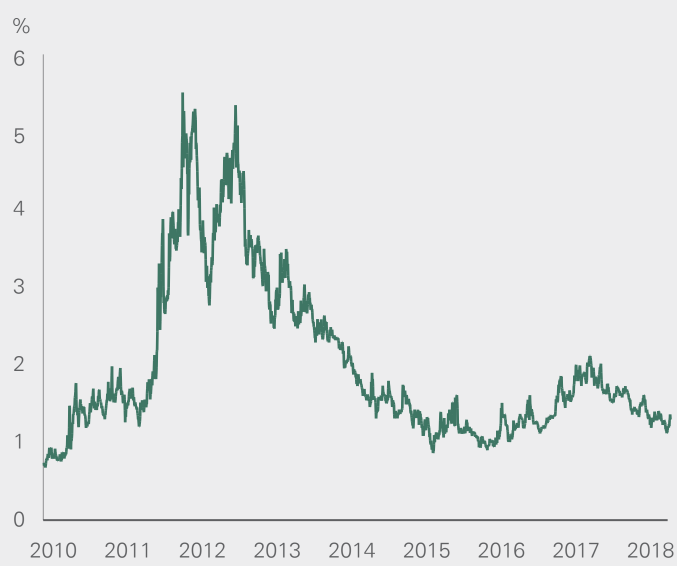
A Europe underweight does not mean Bessemer does not expect positive European equity returns this year. Indeed, the combination of strong growth (consensus estimates see growth of 2.3% this year versus 2.4% in 2017) and a still-accommodative central bank present a generally positive outlook for regional equities. Bessemer portfolios incrementally increased exposure to developed Europe ex-U.K. throughout 2017, and as of April 2018, regional stocks represented 11% of global holdings.

Bond Yields and Risk, Explained

A bond's yield presents a measure of risk. Generally speaking, the more risky the bond is, the higher the yield that an investor will demand as compensation for that risk, all else equal (risk can be seen, for instance, as the duration of the bond with longer-term bonds providing greater yields, or the issuer of the bond, with greater uncertainty around repayment leading to higher yields). Within Europe, German bonds are viewed as being secure, in large part due to the country's budget surplus. Italian bonds, by contrast, demand a higher yield due to the country's relatively weaker financial state (Exhibit 5). Italy's current 10-year bond yield was 1.93% in mid-May, while Germany's was 0.61%. The difference between the two (132 basis points) is called the spread and indicates how much more investors demand to hold a riskier bond (Italy). Widening spreads indicate that investors are growing more anxious about a country's debt. In 2011, the spread between Italian and German 10-year government bond yields widened to 5.53%.

Exhibit 5: 10-Year Government Bond Spread Between Italian and German Bonds

Key Takeaway: The spread between German and Italian government bonds has not notably risen in recent months, despite uptick in political uncertainty in Italy.



As of May 11, 2018.

Source: Bloomberg.

Our Recent Insights

A Primer on Bonds — A Closer Look (May 2018)

The Hype and Hope of Bitcoin and Blockchain — Quarterly Investment Perspective (Second Quarter 2018, Video Available)

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