Quarterly Investment Perspective

The Euro Turns 20

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Executive Summary

- **The euro marks its 20th birthday on January 1, with plenty to both celebrate and regret**
- **Looking ahead, we see growing cyclical and structural headwinds for the euro and European Monetary Union (EMU) — we remain comfortable staying underweight euro-denominated assets in portfolios**
- **Overall, we are positioning for 2019 to be a continuation of 2018, with late-cycle volatility and tightening financial conditions limiting equity returns**

I arrived, excited and early, at our London office's currency trading desk to kick off 1999. After years of failed policymaker attempts and investor speculation, the euro was here, replacing 11 national currencies. The day marked a critical step toward greater European integration and an inflection point for financial markets (Exhibit 1).

Two decades later, my colleagues and I still spend a lot of time considering the euro, not to mention the economies, markets, and companies it influences, directly and indirectly. After all, the euro area today (the region composed of countries in the European Monetary Union, or EMU) has nominal gross domestic product (GDP) of roughly $13.8 trillion, making it the second-largest economic bloc in the world after the U.S. The euro itself has become the second-most-traded currency after the U.S. dollar, and hundreds of the world's largest public companies are headquartered in the euro area.

In this edition of our *Quarterly Investment Perspective*, we use the euro's 20th birthday as an opportunity to look both backward and forward. I was a "euro believer" in London in 1999 and for much of the last 20 years. However, that enthusiasm has increasingly turned to caution looking to the future, as both cyclical and structural headwinds build. The euro and EMU may well muddle through to yet another next big birthday, but risks to that scenario warrant staying notably underweight euro-denominated assets. Bessemer portfolios remain substantially tilted toward U.S. equities, while overall equity exposure is in line with a client's benchmark.

Exhibit 1: 1999 European Monetary Union (EMU) Members: The Euro

Germany *(mark)*	**France** *(franc)*	**Italy** *(lira)*	**Spain** *(peseta)*
Portugal *(escudo)*	**Austria** *(schilling)*	**Belgium** *(franc)*	**Ireland** *(pound)*
Luxembourg *(franc)*	**Netherlands** *(guilder)*	**Finland** *(markka)*	

European Integration Highlights Since 1972

- **April 1972:** European central bank governors agreed to create the "Snake in the Tunnel," a mechanism through which respective currencies would trade within narrow limits against the dollar (failed after 1973 oil crisis shock).
- **March 1979:** European Monetary System (EMS) proposed; allowed for an Exchange Rate Mechanism (ERM) that set rates for member currencies toward a basket currency, called a European Currency Unit. (U.K. joined ERM in October 1990.)
- **1985:** Schengen Agreement signed to phase out internal border checks within participating European countries.
- **1986:** Single European Act adopted; allowed for establishment of single market across a number of European countries; completed in 1992.
- **December 1991:** Maastricht Treaty signed to establish an economic and monetary union including a single currency and central bank. Countries joining the union would need to meet inflation, public debt, interest-rate, and exchange-rate targets.
- **1992-1993:** ERM crisis ensued, with some member states forced to leave (including Italy and U.K.) and others devalue (Spain and Portugal). In August 1993, ERM bands were widened to allow for relatively greater currency volatility.
- **December 1996:** Stability and Growth Pact signed to provide budget deficit and debt guidelines for currency union members.
- **June 1997:** ERM II process established to help currencies to converge ahead of euro launch.
- **January 1999:** European Monetary Union and euro currency launched with 11 participating countries.
- **July 2000:** European Council agreed to allow Greece to enter EMU in 2001.
- **January 2002:** Euro used as legal tender in participating countries, replacing national banknotes and coins.
- **2008-2015:** EMU membership expanded to include Slovenia, Cyprus, Malta, Slovakia, Estonia, Latvia, and Lithuania.

The Euro's Peaceful Mission

In a sense, the euro was conceived decades before 1999 and represents a political as much as an economic goal. The genesis for the euro was the death and destruction caused by two world wars. European leaders, believing that greater economic integration could help avoid further conflict, signed the Treaty of Paris in 1951, forming the European Coal and Steel Community (ECSC). By creating a common market and single authority for steel and coal production — instruments of war — the ECSC was meant to tie these countries' fortunes more closely together. A further key step was taken in 1957, when the Treaty of Rome was signed by Belgium, France, Italy, Luxembourg, and West Germany, creating the European Economic Community (EEC). This framework allowed for a customs union, a European court of justice, and common agriculture and transportation policies. It also proposed to create a single market for goods, services, labor, and capital across member states' borders. The thinking, again, was that countries reliant on each other to succeed economically would be more focused on sustaining peace.

The following decades saw European leaders continue integration efforts, albeit with enthusiasm waxing and waning, and some serious tests along the way. Perhaps the best-known test was "Black Wednesday" in 1992, when the U.K. was forced to withdraw the pound from the euro's predecessor, the Exchange Rate Mechanism, at an estimated cost to the country of around 3.4 billion pounds (see more integration highlights above).

Taking Stock of the Euro at 20

In its first year, in 1999, many doubted EMU and the euro — perhaps not surprisingly given previous failed attempts, including ERM. Such concerns probably contributed to the fledgling currency losing 15% of its value against the dollar in its first 12 months of trading.

And yet, two decades later, the euro is very much alive, and the EMU has successfully survived a number of trials, including the Great Financial Crisis of 2008-2009 and the European Debt Crisis of 2011-2012, the latter centering on southern EMU members.

There are clearly some reasons to call EMU a success:

- Since EMU began, member economies have seen borrowing costs converge (lower) and inflation generally moderate. For example, 10-year Italian government bond yields have averaged less than 4% since switching from the lira to the euro, compared with 7% on average over the previous six years.
- Partly because of lower borrowing costs, euro area GDP per capita, a measure of household well-being, has risen 57% from the euro's launch to more than $35,600 in 2017.
- EMU participants like the euro: 74% of respondents in an October 2018 survey said they thought the euro was good for the region — this tied the record high since the surveys began in 2002 (Exhibit 2).
- More countries have wanted to join: Since 1999, the union has expanded from 11 to 19 countries. As of mid-2018, more were on a path to membership, including Bulgaria, the Czech Republic, Croatia, Hungary, Poland, and Romania.

Other successes are more qualitative. Importantly, the euro area has been able to speak with one voice over the last 20 years, particularly on certain economic matters via its European Central Bank (ECB) president (currently Mario Draghi). This has made global policymaking more efficient and has given more weight to the collective "European view" on pertinent issues, rather than many potentially differing views from separate, smaller economies. In addition, and perhaps most fundamentally, Europe has not seen any major regional military conflict since the Treaty of Rome. While we cannot necessarily attribute cause and effect, it does appear that integration supported decades of peace.

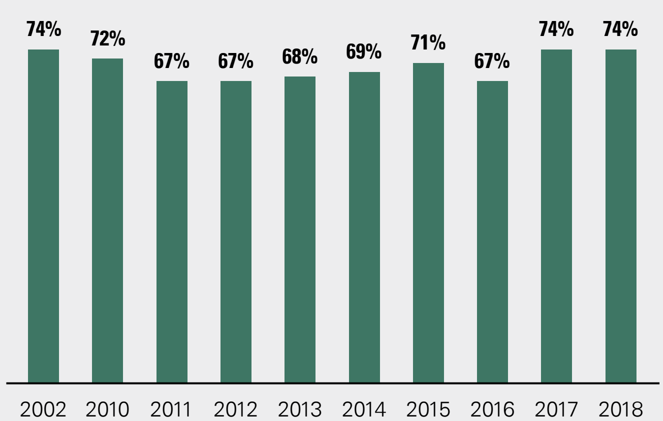
No one would call the euro an absolute success, however. Some critics feel EMU hasn't gone far enough with integration — they suggest the euro will remain vulnerable without a European finance minister and EMU fiscal authority, harmonized bond markets, regional burden sharing in times of market distress, and/or a regional bank deposit insurance system (the latter currently a proposal).

Others see greater integration needs more as political, suggesting that public support to transfer power from countries to pan-European bodies first necessitates more democracy and transparency. (As an aside, I spent time in Strasbourg, France, in the early 1990s, interning at the Council of Europe while pursuing graduate studies and seeing firsthand where some of this criticism comes from. How many young adults across the euro area know exactly what duties are performed by the European Parliament versus the European Council, the European Commission, the European Central Bank, or the European Investment Bank ... among others?) Even within each institution, there can be confusion — consider the European Parliament: In an attempt to appease national interests, members of Parliament and their staff regularly migrate between Brussels and Strasbourg for meetings, all at the cost of the taxpayer. No wonder many voters perceive a democratic void.

Perhaps the biggest, core challenge for the euro area is finding the balance between national versus regional political and economic needs, while giving

Exhibit 2: Percent of Respondents Supportive of the Euro

Key Takeaway: Support for the euro is currently high, reaching levels seen when surveys began.



As of October 2018.

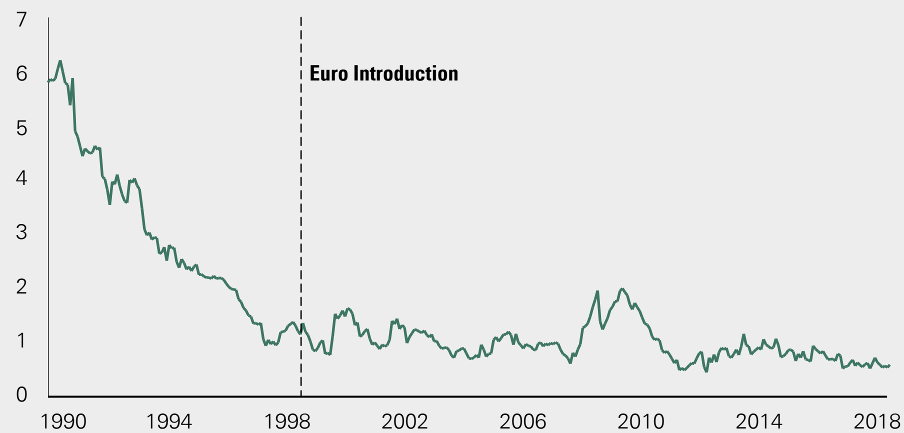
Source: European Commission

The last decade has seen countries diverge economically, often due in part to specific national considerations.

Exhibit 3: Convergence of Inflation Rates Among Original EMU Members

Key Takeaway: EMU members' inflation rates converged ahead of euro adoption.

Standard Deviation of Annual Inflation Rates



As of October 31, 2018. Inflation is measured using CPI. Includes the following countries: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. The Netherlands is excluded from February 2016 on due to an absence of data.

Source: Bloomberg, International Monetary Fund

up key policy tools — the currency and policy interest rate — to regional oversight. This balance is made easier when EMU member economies are fundamentally similar and monetary policy is appropriate for all. That was generally true when the euro was first introduced, as policymakers had been forced to "converge" their economies in order to participate in the 1999 launch (Exhibit 3).

Those leaders had hoped that EMU membership would continue to reinforce economic convergence while countries also abided by the so-called Growth and Stability Pact, the latter setting budget-deficit and public debt rules, also meant to keep the participating economies from drifting apart.

However, the last decade or so has seen countries diverge economically, often due in part to specific national considerations. At times, this meant that EMU members broke the pact (including Germany and France, countries seen as the leaders of monetary union). Budget deficits have exceeded 3% of GDP when national governments wanted to support growth, for instance, and often that deficit spending helped push debt-to-GDP levels over the pact's 60% limit.

Italy: A Case Study

Italy, the third-largest EMU economy, provides a timely case study to appreciate the euro's challenges, bringing them out of theory and into reality. Italy has been in the headlines this past year as an unexpected populist coalition government came to power and subsequently tried to push through fiscal stimulus. The proposed budget was rejected outright by the European Commission — the first such rejection since EMU's launch. Italian assets have fallen in value as political worries have risen.

How did Italy get here? To answer the question, it's best to go back to the euro's beginning. In mid-1998, Italy had reached most of the necessary convergence targets to enter EMU. Consumer price inflation was low, the lira's volatility was tolerable, long-term interest rates were considered acceptable, and the budget deficit was modest, at 2.7% of GDP (Exhibit 4).

However, government debt was high: over 110% of GDP versus the pact's targeted 60% of GDP or less. In our view, the decision to let Italy join the euro, given that important data point, showed the political nature of the project. Italy had been a "founding member" of European integration efforts — it was important for the region to have this country participate in this critical next step. Italy was also (and still is) a key southern ally for France in negotiations on European issues with Germany and other northern peers. Finally, Germany might have preferred a euro that reflected a bit of Italy — the sum of the parts for EMU would likely create a weaker currency that would benefit German exporters versus the stronger Deutsche mark. It was noteworthy when Italy got the green light in 1998 to join EMU that European officials highlighted that Italian debt was moving in the right direction, and that Italy had promised to ensure additional convergence. (We note that Greece's entry into EMU, in 2001, was received by investors at the time as an even more egregious political "fudge" and that subsequent government admissions revealed how far off Greece actually was from being economically in sync and able to thrive within the EMU framework.)

The decision to let Italy join the euro showed the political nature of the project.

Exhibit 4: Italy's Economy, 1998 versus 2017

	1998	2017
Real GDP per Capita	$34,270.8	$34,751.9
Unemployment Rate	11.3%	11.0%
Consumer Price Index (YoY)	1.7%	0.9%
Government Debt/GDP	110.8%	131.2%
10-year Government Bond Yield	3.47%	1.75%

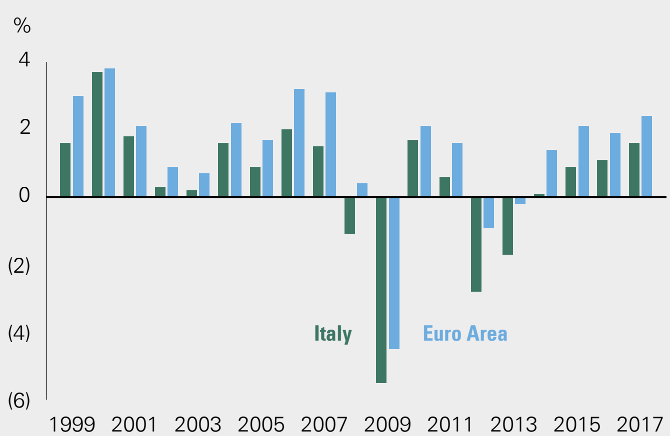
Source: Bloomberg, Eurostat, IMF, ISTAT

In the subsequent two decades, Italy was pushed and pulled by a number of forces, leaving it in recession in four years and with annual growth of less than 1% in an additional six years — struggling or contracting for half of its EMU membership so far (Exhibit 5). That's significantly worse than the monetary union's overall track record. As of 2018, Italy's unemployment rate was 10.6%, and GDP was on track for the year to grow by 1%; that compares with 8.3% and 1.9%, respectively, for the euro area overall.

Some of the reasons for Italy to be lagging euro area peers are what we'd call "homemade." Italy frequently changes its government. Indeed, since 1999, Italy has had a new prime minister on average every other year (including Silvio Berlusconi, who has served as prime minister four times since the mid-1990s). Without a strong mandate and with so little time in office, Italian leaders have struggled to push through needed reform — and have it stick. The country ranks poorly on education, its judicial and regulatory systems, as well as on tax collection. Indeed, the World Economic Forum placed the country's competitiveness at 43 in a 2018 global survey (compared with top-five rankings for the Netherlands and Germany). The difficulty in starting a local business has led to many Italians with secondary degrees leaving the country in search of better opportunities.

Exhibit 5: Euro Area and Italian GDP Growth, Year-Over-Year

Key Takeaway: In the two decades since joining the EMU, Italy has struggled with economic growth, with recessions or sub-1% growth about half of the time.



As of December 31, 2017.

Source: Bloomberg, Eurostat

Italy's domestic challenges have been compounded by external forces, including technology and globalization. A report in 2017 by the Organization for Economic Cooperation and Development (OECD) found that a skills gap made Italy poorly suited to benefit from technological advances. Partly as a result, productivity in Italy has stagnated, weighing more generally on economic growth (Exhibit 6). Simultaneously, Italy's domestic challenges have left it in a more difficult position to compete in a more global marketplace. Many of the small, family-owned businesses in particular found themselves ill-suited to compete against China after the latter joined the World Trade Organization in 2001 and increasingly became an alternative, lower-cost producer of manufactured goods.

A third, important component of Italy's difficulties has been EMU itself. In the years where Italian growth struggled and voter pressure on politicians to help increased, Rome was constrained. The Growth and Stability Pact limited fiscal efforts, while monetary stimulus (including a weaker currency) was out of Italy's control (ECB policy is set for the currency bloc rather than any one or a few countries). One could argue that Italy by itself would likely have pursued easier monetary policy in the last decades and may have benefitted from a weaker currency, which would have been helpful given about 30% of Italian GDP is represented by exports.

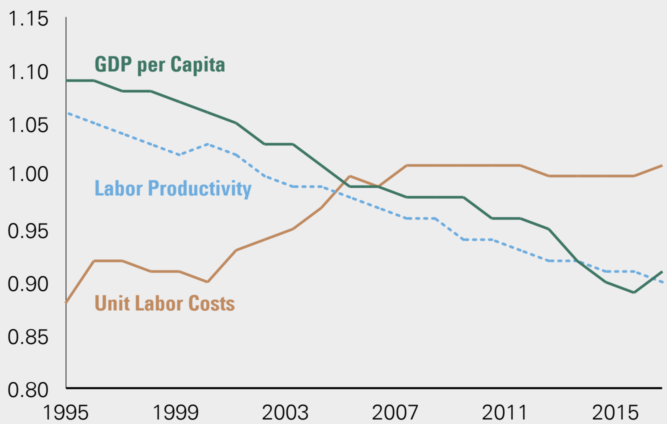
Without sufficient growth, the country has struggled to meet debt-interest payments without eating into other government-spending areas. This has made it even more difficult for any additional needed federal spending on education, training and infrastructure, for instance.

Opinion polls regularly suggest that Italians want to stay in the euro. However, those same polls show a frustration in Italy with euro area rule setting. A Eurobarometer survey taken in May showed only three in 10 Italians felt their voices counted within the European Union (EU). It's not surprising, then, that the government that took power in 2018 included the populist coalition, The League and the Five-Star Movement, led by the League's Giuseppe Conte. The government, taking its cue from voters, has voiced wariness about euro area policymaking where one size does not fit all, and wants to pursue more fiscal stimulus even if it means breaking EMU rules and risking the consequences.

Exhibit 6: Labor Productivity, Labor Costs, and GDP per Capita

Key Takeaway: Labor productivity has been on the decline in Italy without a corresponding decrease in unit labor costs, which has weighed on economic growth.

Italy Relative to the Euro Area



As of 2016. GDP per capita is measured in U.S. dollars and is reported as Italy's GDP per capita as a share of the euro area's. Labor productivity is measured as real GDP per hour worked and is a share of Italy's relative to the euro area's. Labor costs are measured as unit labor costs (average cost of labor per unit of output) by persons employed, indexed to 100 in 2010, and is Italy's relative to the euro area's.

Source: OECD

The bottom line: Managing an economy to keep voters happy is difficult to begin with, especially given the tectonic forces of globalization and technology. Added to that challenge are restrictions imposed by the EMU on fiscal and monetary policymaking. Especially for countries like Italy, where governments may not last long or have mandates to pursue needed longer-term reforms, this combination of events means that economies (and citizens) may have to pay a hefty price in return for the benefits of EMU membership. EMU is optimal when member states' economies are truly in sync, idiosyncratic challenges are limited, and policymakers have the mandate to push for greater monetary union reforms.

The Euro's Next Decade: Does Something Have to Give?

European leaders publicly acknowledge that EMU is a work in progress. As we look at the coming years, will that unfinished business — more integration, reform, and transparency, and more economic convergence — prove too high a bar? Or will the euro muddle through and potentially get stronger?

We do not rule out the latter — after all, the euro and EMU have confounded many well-respected, dubious investors and academics for 20 years. However, a number of both shorter-term cyclical and slower-moving structural challenges leave us increasingly cautious about EMU. This isn't to say that there will not be attractive, selective investment opportunities in Europe in the coming years — no doubt there will be, especially over shorter time periods. But looking at where one can deploy capital over the medium term, we believe the risks to the euro area are growing and merit staying underweight the region.

The euro area's business cycle. In the coming year, we (and consensus) believe the euro area should see modest, positive GDP growth. Understanding the risks to that view necessitates a deeper dive into the details.

Trade. The euro area is well integrated with the global economy, with more than 40% of the region's GDP represented by exports (nearly a third of those exports go to the U.S. and China). That means a sharp downturn in either or both of the world's largest two economies will weigh heavily on Europe through trade and financial linkages. If we believe the U.S. faces a rising probability of recession in the coming year or two, and that China's economy is structurally slowing, history would suggest we look for euro area slowing as well. That is currently what is expected by consensus forecasts for 2019, even including fiscal stimulus expected in the U.S., China, and euro area. Using consensus forecasts from economists compiled on Bloomberg, U.S. real GDP growth is expected to moderate in 2019 to 2.6%, from 2.9% in 2018, while the euro area slows from an estimated 1.9% in 2018 to 1.6% in 2019 (Exhibit 7).

Exhibit 7: Real GDP Annual Growth Forecasts

	2018	2019
U.S.	2.9%	2.6%
Euro Area	1.9%	1.6%
China	6.6%	6.2%

As of December 7, 2018. Represents Bloomberg composite forecasts.

Source: Bloomberg

Consumption. Private consumption is the other largest contributor to overall euro area GDP growth, and signs into 2019 are modestly positive. As of November, euro area business confidence surveys (PMIs) had softened from earlier in the year but remained near 53 — a level that implies some growth but without overheating risks. The region's unemployment rate, meanwhile, at just over 8%, is the lowest in about a decade and indicates support for household spending. Against this backdrop, the ECB is set to end its asset purchases at year-end but not start reducing its balance sheet anytime soon. It is discussing a possible rate hike in 2019 (current deposit rates stand at negative 40 basis points), but that will depend heavily on inflation, which remains below the central bank's target. Put another way, overall monetary policy is going to be less easy but still very far from restrictive. As a result, loan growth should remain supportive in 2019, barring some shock that hurts consumer and business sentiment meaningfully.

In terms of what risks could be — both positive and negative — we would start again with the ECB. The ECB has bought roughly €2.6 trillion worth of assets and cut short-term interest rates to negative levels in an effort to keep borrowing costs low. While planned steps for 2019 are incremental, there is a risk that other bond purchasers (especially for countries like Italy) may not sufficiently fill the ECB void — pushing government bond yields higher as a result and creating greater headwinds for government debt servicing and banks that hold large bond inventories. The ECB, seeing stubbornly low inflation, however, could decide to postpone rate hikes and/or introduce additional loans (long-term refinancing operations, or LTROs) to provide cheap capital to banks as an incentive to lend to regional businesses. The latest round of LTROs is set to mature in June 2020.

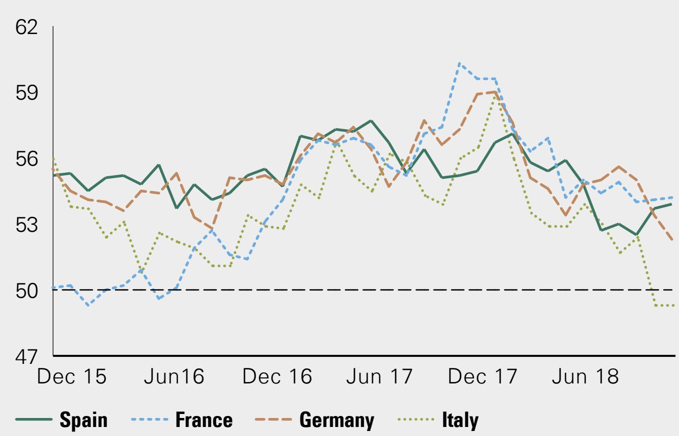
Trade also creates two-way risks in the year ahead. Will the U.S. pursue tariffs on European autos, as has been threatened? That would hit Germany's economy particularly hard. Even without that step, increased tariffs from the U.S. on China would weigh on Europe, as Europe is notably exposed to Chinese growth. Likewise, a prolonged trade truce and/or Chinese growth stabilization in 2019 would likely provide a measure of lift to European GDP, mainly via exports and sentiment.

Other risks in 2019 are more country specific. The details of Brexit, and the fallout after end-March, while more important for the U.K. economy, will clearly have spillover to the rest of Europe as well. Uncertain politics in Spain, France, Italy, and others can impact sentiment and economic activity (Exhibit 8). The good news here is that leaders from a number of euro area countries, under pressure from voters, plan some fiscal stimulus in 2019. Fiscal policy should prove moderately more constructive in 2019, although that may simply offset some of the drag from less accommodative monetary policy.

A final pan-European risk in the year ahead is the May European parliamentary (EP) election (taking place May 23-26). This election, held every five years, allows citizens to directly choose 751 legislators based on party (not country). The Parliament creates laws for the European Union (28 countries, including EMU members) and influences the EU budget. For the first time in its history, the EP election could matter — the risk is that populist parties gain enough seats to stymie any needed regional reform efforts. This risk seems higher should the political issues noted above remain unresolved and the economy remain sluggish into May.

Exhibit 8: Composite PMIs, Major European Economies

Key Takeaway: Political uncertainty has weighed on business sentiment in some of Europe's large economies recently.



As of November 30, 2018. PMI stands for Purchasing Managers' Index. PMI readings above (below) 50 indicate an expansion (contraction) in business activity. Composite PMIs include the manufacturing and services sectors.

Source: Bloomberg, Markit

Exhibit 9: Euro Stoxx Returns (in EUR) and GDP Growth

Key Takeaway: While European equities have generated positive returns in the majority of years in the last decade, they have generally not performed well when economic growth has decelerated.

	Total Return	Price Change	Real GDP	Change in Real GDP
2009	24.6%	19.2%	(2.4)	(0.3)
2010	(2.6%)	(6.0%)	2.4	4.8
2011	(14.2%)	(18.7%)	0.5	(1.9)
2012	16.7%	12.9%	(1.1)	(1.6)
2013	20.6%	16.5%	0.7	1.8
2014	3.9%	1.2%	1.6	0.9
2015	7.4%	3.8%	2.0	0.4
2016	3.5%	0.7%	2.1	0.1
2017	9.4%	6.3%	2.7	0.6
2018 YTD	(6.1%)	(10.2%)	1.7	(1.0)

As of December 4, 2018. GDP reflects the annual growth rate in real GDP in the fourth quarter of each given year. The change in real GDP reflects the year-over-year change since the previous year.

Source: Bloomberg

When considering these growth drivers and risks together, we are left feeling underwhelmed about the macroeconomic backdrop in Europe in 2019. But what does that mean for regional equities, if anything?

Euro area equities (the Euro Stoxx index) have posted positive returns in seven out of the last 10 years, with positive returns coming in two years even with very meager GDP growth (below 1%). That said, in years where growth was decelerating, as is the consensus view for 2019, equity returns were negative with two exceptions: 2009 (coming out of the crisis) and 2012 (the euro area debt crisis, when ECB President Draghi announced his “whatever it takes” policy to help growth) (Exhibit 9). We know history is never a perfect guide, but this starting point does not suggest adding European equity risk is prudent — especially as a positive policy shock from the ECB or other bodies appears unlikely.

Equity valuations in Europe, meanwhile, are attractive but not exceptionally so given risks in the region. Euro area price-earnings ratios looking at the year ahead have come down in 2018 (now at 12.5 versus 14.9 at the start of the year); this compares to a long-term average of 14.0.

What about currency effects? 2018 has seen the euro weaken more than 5% against the dollar, making the divergence between U.S. and euro area equity performance even greater in dollar terms. History suggests that a narrowing growth gap between the U.S. and euro area could provide support for the euro; however, we are skeptical that this trend change, were it to occur, would be pronounced enough just on relative economic performance to lure significant capital out of U.S. assets into European peers.

We believe that a strongly outperforming 2019 for European equities and the euro would likely require more than the consensus view. Stars would need to align on one or more of the following:

Brexit Basics

What is it? Brexit, the U.K.'s intent to exit the European Union (EU), will continue to influence market sentiment into the new year. The decision made in a June 2016 national referendum was followed by the two-year exit negotiation process kicking off in March 2017. Brexit is scheduled to take place on March 29, 2019.

What is happening now? The U.K. and EU agreed in the fall on the terms of the exit (known as the Withdrawal Agreement), although the U.K. approval led to two resignations, including the cabinet's Brexit secretary. Next, U.K. members of Parliament need to approve the deal. Only after that will the European Parliament vote on the terms.

U.K. parliamentary approval could take a few tries. In a worst-case outcome, there could be "no deal," in which the U.K. would exit the EU without a clear transition plan or new rules of the road. Some are hoping for a second referendum, which might result in the U.K. choosing to "remain" in the EU; for that to occur, the government would need to put forward legislation and get support from a majority in the House of Commons (this scenario is possible but seems unlikely at the moment). The bottom line: It's still very messy and unclear exactly where the U.K. will be in March.

Assuming Brexit occurs, what comes next? If the U.K. and European parliaments both approve the Brexit deal and it occurs in March, a 21-month transition period will begin. This is to allow time to finalize and implement new trade and other agreements between the U.K. and EU, as well as the U.K. with other bodies. As with talks over the last year or so, this period is expected to be contentious.

How does this matter for economic and market views in 2019 and beyond? The uncertainty created by the increased risks heading into June 2016, in our view, warranted reducing portfolio exposure to the U.K. We expected the pound in particular to weaken, as the U.K. runs a large current-account deficit (currently around 3.5% of GDP) and requires foreign capital inflows to offset trade outflows and support the currency. With Brexit, we expected foreign investors to be more wary of committing capital to the U.K. So far, that view has played out. The pound has lost some 12% against the dollar since June 2016, and a similar amount on a trade-weighted basis (Exhibit 10). Just looking at 2018, choosing the FTSE rather than the S&P 500, including currency effects, meant a return difference of 15 percentage points (through December 10).

As we look ahead, by spring, we should have greater clarity on the contours of Brexit. Still, the 21-month transition period means a degree of lingering uncertainty, all likely to limit U.K. growth and asset prospects (though we would acknowledge that a lot of bad news is now discounted into local valuations). As the U.K. and the rest of EU are key trading partners, any unexpected slowdown in the U.K. would create an external headwind for "mainland" European economies. As of 2017, about 44% of all U.K. exports went to other EU members, and more than 53% of U.K. imports come from the rest of the EU. We'd also note that the coming year will see a new European Parliament and Commission, potentially impacting the tone of future negotiations in different ways from what we have experienced thus far.

- Notably stronger Chinese growth that benefits Europe (possible given substantial Chinese stimulus, but this is not our base case);
- A resolution of the trade war that lifts global investor sentiment and reduces interest in U.S. "safe haven" assets;
- Much-better-than-expected news out of Brexit and/or Italy.

Bottom line: We see two-way risks around European equities in 2019 but do not see enough evidence to warrant changing our current underweight allocation. If anything, we would consider reducing Europe exposure further, both for the above-noted cyclical reasons but also more structural concerns.

Europe's Structural Headache

There is strength in numbers. This statement, in our view, sums up why euro area members will try to keep the EMU together, whatever challenges come their way. As a whole, they have much more clout on the global stage, whether discussing economic, military, environmental, or other policy issues.

The challenges to making EMU successful are not to be underestimated, however. This extends beyond the cyclical, near-term risks already mentioned to structural issues including policy constraints, demographics, and immigration.

Policy constraints. In the effort to keep budget deficits and government debt levels roughly aligned within EMU, policymakers have created guardrails that could limit fiscal stimulus to help member states when the next big economic downturn occurs. That puts a relatively greater onus on monetary policy — and the ECB could also find itself constrained.

As noted earlier, short-term policy rates have not risen since 2011 and are now negative — there will not be much room for the ECB to cut if a contraction occurs in the next year or two. The balance sheet, meanwhile, is at an all-time high, and ECB President Draghi has suggested that even if purchases stop in January, balance-sheet reduction is not likely to occur anytime soon. In the next crisis, there are valid questions over how much bigger the balance sheet could grow from current levels, what officials would tolerate, what additional securities officials might purchase, and how much of an impact the exercise would have on investor sentiment.

We acknowledge that the ECB has shown creativity. When it found itself running out of eligible national government bonds to buy in recent years, it added to its list of eligible securities regional and local government debt as well as EU supranational bonds, asset-backed, corporate, and covered bonds. The central bank also offers long-term loans (LTROs) to banks to encourage corporate and household borrowing. Still, certain EMU members do not want the ECB to help countries that aren't following the rules, as such action could encourage bad behavior by other countries (so-called moral hazard). If Italy, for instance, were to find itself in a debt-related crisis, the ECB could buy debt only if Italy applied for help and agreed to a reform package (which likely would include politically difficult deficit-reduction measures that could slow growth over the near term).

We assume in the next downturn, the ECB will again get creative in an effort to ensure the euro's survival. Those steps will likely have to go beyond the central bank's current arsenal, may be taken by a relatively new ECB leader (Draghi's term ends in October 2019), and require approval from all EMU members. Compared with the Federal Reserve, we feel the ECB will have a much more difficult time fighting the next recession.

Generational leadership. If the euro's roots are in World War II, support for the euro, in part, depends on voters and leaders appreciating why the monetary project was started and should endure. That

Exhibit 10: British Pound-U.S. Dollar (GBP/USD) Exchange Rate and Trade-Weighted GBP

Key Takeaway: Brexit uncertainty has contributed to a weaker pound.

As of December 6, 2018.

Source: Bank of England, Bloomberg

appreciation, in our view, is increasingly at risk as European citizens and policymakers with memories of the war or post-war era retire (like Germany's Angela Merkel, who will leave as chancellor by 2021 at the latest) or die (someone born in 1945 is 73 years old today). European leaders are getting younger: Austria's leader was born in 1986, Ireland's in 1979, Estonia's in 1978, France's in 1977, Greece's in 1974, Italy's in 1964 (the Italian prime minister is now 54 years old while his number two, Luigi Di Maio, is 32 years old). This is not to say that a new generation will not respect the history of EMU. However, the passing of time and lack of firsthand experience with the difficulties Europe faced coming out of the war could change leaders' perceptions and priorities. In the crisis, will there be the "whatever it takes" attitude voiced by 71-year-old ECB President Draghi?

A parallel comment can be made for European citizens — while most support the euro in general, there is definitely fatigue with Brussels (where many pan-European institutions are located and decisions are made) and less appreciation for the historical importance of EMU. That fatigue and desire for more opportunity at home are partly why populist parties have found more support — voters are looking for a different style of leadership to effect change. As the crisis in Greece in 2015-2016 showed, such change increasingly overlaps with the risk that a country exits EMU and undermines the broader project.

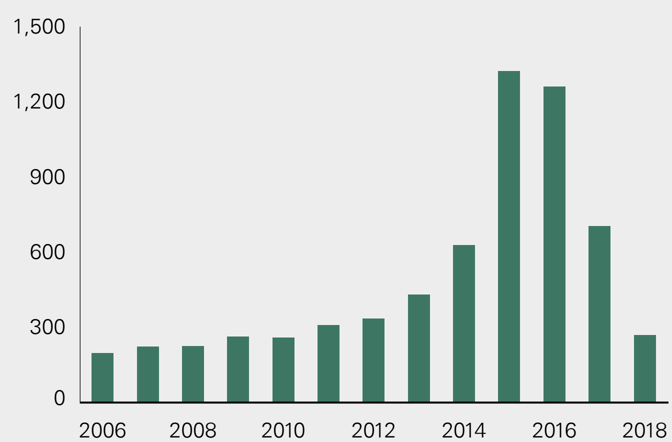
Demographic trends. A generational leadership change is not the only demographic trend challenging EMU in the years ahead. In addition, Europe's labor pool is shrinking. Government data show that the EU's working population (20-64) started falling in 2013 and is expected to continue to decline for the foreseeable future (through at least 2060). This trend has at least two macro implications for Europe: lower potential GDP and higher government pensions and other age-related costs. The ECB's vice president in 2015 called this "a sort of collective demographic suicide" that could cause "protracted low growth."

Without more children or people working longer, one way to cushion this hit is immigration. However, that channel, for now at least, looks structurally blocked. The 2015 surge of refugees resulting from unrest and war in North Africa and the Middle East left several European countries feeling strained to pay for and assimilate everyone. In 2015, about 1.2 million first-time asylum applications were registered in the EU versus an average of 265,000 per year in 2008-2011 (Exhibit 11). Today, regional opinion polls rank immigration as the top concern in France, Germany, Italy, Denmark, Sweden, and Greece, ahead of employment, the broader economy, or terrorism.

While the pace of immigrants to Europe has slowed from 2015, the overall trend is unlikely to change given demographics in the Middle East and Africa, the latter expected to see half of the world's population growth through 2050. People will continue to look for better opportunities for themselves and their families — that means northern migration into Europe. If Europe can successfully manage the inflows, it can help support growth. If it will not or cannot for economic, social, or political reasons, it will reinforce the drag to growth from demographics.

Exhibit 11: Total Non-EU Asylum Applicants in the EU-28 Member States

Key Takeaway: Immigration has been a top concern of many EU citizens since a surge of refugees in 2015.



As of June 30, 2018.

Source: Eurostat

Final Word: 2018 Performance and 2019 Positioning

This past year can be broken into three distinct periods (Exhibit 12). The first three months of 2018 saw synchronized global growth and equally synchronized (and volatile) equity markets. The second period — from April through early October — saw U.S. assets significantly outperform overseas assets, with U.S. stocks gaining while non-U.S. equities suffered losses (often substantial). The final quarter of 2018 saw synchronization back again to a degree, with similar volatility to the first quarter.

While a number of forces are always at work driving market trends, we would highlight two key themes that defined 2018: central bank policy and trade. In the case of the former, the continued tightening by the Federal Reserve removed liquidity from the system, which in turn contributed to the more volatile market conditions. It also supported the dollar, which contributed to emerging-market pressure in particular. Meanwhile, the increased rhetoric (April) and then action by the U.S. in its trade war with China exacerbated the U.S.-overseas performance difference. The U.S. is hurt relatively less by the trade war than many other countries and enjoyed a growth "offset" via the large fiscal stimulus and tax cuts passed in 2017 and early 2018.

The "re-synchronization" of markets into year-end appears to have been driven by a quick rise in U.S. bond yields in early October but also continued trade uncertainty and fears that the slower overseas growth could create contagion back to the U.S.

A representative Balanced Growth portfolio (70/30 equity/bond risk) saw absolute returns influenced by some of the large broad market swings during the year, unfortunately pulling returns lower into year-end. However, we were able to hold most of our relative outperformance (versus the benchmark) throughout the year, helped by an aggressive U.S. equity overweight, inclusion of defensive exposures within equities and across mandates, and some strong security selection.

Exhibit 12: U.S. versus Non-U.S. Equities

Key Takeaway: 2018 has seen three distinct periods — in the first and last, global equities were relatively synchronized, while in the middle, U.S. equities significantly outperformed non-U.S. equities.

Indexed to 100 on December 31, 2017

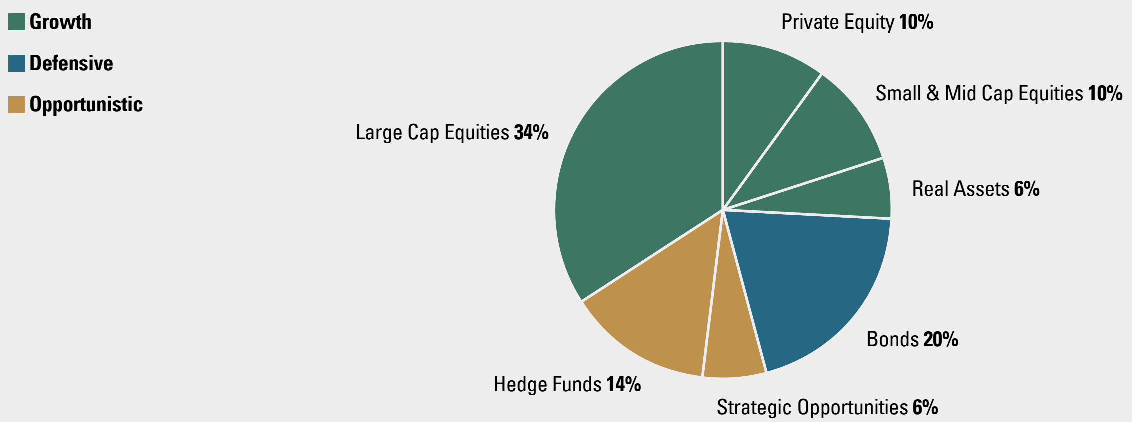
As of December 7, 2018. U.S. Equities measured by MSCI USA IMI and Non-U.S. Equities by MSCI ACWI ex USA IMI. Reflects total return net dividends in U.S. dollars.

Source: Bloomberg, MSCI

As we look to 2019, consensus forecasts already discount slower global growth and corporate earnings. We agree directionally with that view but see two-way risks around it. Lower oil prices, for instance, could create a positive growth catalyst via consumer spending and less aggressive Fed tightening. On the other hand, a deterioration in the trade war and/or greater emerging or European market stresses could create global spillovers that limit earnings even more than expected.

For now, we are comfortable with our asset allocation, including our notable underweight exposure to the euro area. However, as the cycle gets increasingly mature, we expect our next asset allocation shift will be to reduce portfolio volatility further. As much as we want to participate in meaningful opportunities for our clients, we equally want to make sure we protect their irreplaceable capital to the best of our ability.

Bessemer's Positioning (70/30 Risk Profile with Alternatives)



Positioning as of December 1, 2018. This model displays Bessemer's Balanced Growth with Hedge Funds and Private Assets target portfolio allocation guidelines. Each client situation is unique and may be subject to special circumstances, including but not limited to greater or less risk tolerance, classes, and concentrations of assets not managed by Bessemer, and investment limitations imposed under applicable governing documents and other limitations that may require adjustments to the suggested allocations. Model asset allocation guidelines may be adjusted from time to time on the basis of the foregoing or other factors. Alternative investments, including Bessemer private equity, real assets, and hedge funds of funds, are not suitable for all clients and are available only to qualified investors.

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