Investment Insights

Year-End Storms

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Highlights

- The year-end market selloff is not unprecedented but extraordinary; while we could see risks brewing and took incremental actions to reduce volatility before and during Q4, Bessemer portfolios were certainly impacted.
- From here, our focus is on taking the best next steps — staying clear-eyed about valuations, market drivers, risks, and opportunities.

Thursday night brought an unexpectedly strong storm to the New York City area. While inclement weather had been forecast, many hadn't expected the degree of wind and rain that ensued. We couldn't help but compare a somewhat sleepless night with the year-end market rout we are experiencing. We knew volatility would rise late cycle; we appreciated the risk of Fed tightening, of trade wars, of contagion to the U.S. from slower growth overseas. And, indeed, we have taken a number of steps both before and during 2018 to try to manage those headwinds without leaving portfolios unable to participate if markets could continue to grind higher (which they did for a good deal of this past year). Our managed-volatility equity exposure and U.S. overweight have clearly helped, albeit on a relative-performance rather than absolute-performance basis.

What we could not predict was the exact timing of this market storm or its exact force. Year-end always sees market liquidity dry up as fewer investors are trading. That usually means that market reactions to buying/selling are exaggerated more than during normal liquidity environments. What feels different this time is the intraday swings in markets — we believe there are likely structural factors at play here, at least to a degree.

First, since 2008-2009, large financial firms (investment banks, etc.) have been subjected to new regulations that require them to hold more "safe capital." While that makes the financial system more sound in many ways, it does have another effect — it means that banks may be less willing and/or able to provide liquidity to the markets in periods of stress, such as this past quarter.

Second, the last decade or so has seen notable growth in algorithmic trading strategies that focus more on short-term momentum than fundamental valuation metrics. Without other investors to smooth or offset these flows, which intuitively feels the case today, "algo" trading can dominate intraday swings, which certainly has not helped broader investment sentiment.

At this juncture, we are focused on a few questions. How much longer can the selling persist? What catalysts could lead to a market recovery? What other steps should we take and why? The last thing one ever wants to do in a situation like this is let emotion and sensational media headlines cloud judgment. We focus on facts and scenarios and try to appreciate the probabilities of different paths playing out.

We thought it might be useful to share a few thoughts to some of the above questions.

- Large selloffs mean that a lot of "bad news" is discounted into market valuations. That makes a recovery more likely unless the macro environment continues to steadily deteriorate beyond what's now expected. One report we read this week reminded us of this: Paul Samuelson was quoted saying that "Wall Street has predicted nine of the last five recessions." That certainly feels true now (as it did in the sharp 2015-2016 selloff, which was then followed by a healthy market bounce). We know global growth is slowing into 2019 — but are we about to head into a recession? With the Fed getting less hawkish and China continuing to take multiple steps to stimulate, an imminent recession is still not our call. (Overnight, Chinese officials said that "significant" cuts to taxes and fees were planned for

the year ahead while monetary policy was signaled to get easier.) And when the market has fallen as it has in recent months, historically at least, it has recovered (as the feared recession did not occur) the vast majority of the time.

- What catalyst could lead to this hoped-for recovery? In some cases, it is an event — one we would watch early next year is any signs of encouraging China-U.S. trade talks, for instance. In other cases, algos may get a "signal" that market conditions are overdone and are programmed to start going the other way. Technical traders are seeing an increasing number of such signals in the market this month; for example, when looking at the percentage of the S&P 500 trading under the 200-day moving average, we are at levels not seen since the 2014-2015 oil collapse or the 2011 debt ceiling/U.S downgrade, both of which signaled good buying opportunities.

  Other fundamental investors may increasingly see value in specific companies (Nike's earnings report yesterday, e.g., solidly beat expectations on strong revenue growth, and the stock rallied nicely on the news), sectors, or even whole markets and start buying the dip — just this week, we saw two large firms publish "buy" and "equity overweight" recommendations. For context, the S&P 500 P/E multiple of about 15x is at levels not seen since August 2013, when consumer/business sentiment and GDP growth were below where they are today. Better liquidity conditions and annual portfolio rebalancing by certain institutional investors in January could also play a role. A less restrictive Fed could serve as a catalyst as well —as mentioned in our *Investment Insights*, "Fed Raises Rates Again, Contributing to End-of-Year Market Volatility," earlier this week, we believe the Fed left itself room to adjust course and hike less over the course of next year; comments from New York Fed President John Williams today indeed supported this view.

- What if it just gets worse? As noted earlier, the world is never certain — we have to think in terms of scenarios and how to adjust portfolios for different outcomes. The year ahead could see trade talks break down as well as political uncertainty in the U.S. and/or overseas worsen; deficit and debt-ceiling issues could cause more political disruption (indeed, we are on the brink of a potential partial government shutdown as we write this). Brexit could be a worst-case scenario; wealth destruction caused by the equity fall could weigh more than expected on consumer and business sentiment. This is all very possible, though we know none of this would occur in a vacuum — all would elicit reactions (such as a change in central bank policy to support growth or further OPEC oil-production cuts to support prices).

Right now, the media and many market watchers can't help but focus on the "just getting worse" mentality — it helps people make sense of the market and justify their concerns. We're not saying it cannot happen — indeed, we are thinking about portfolio steps we can take should this worst-case odds grow further. However, like the still-ongoing storm, we also know these changes in sentiment can happen quickly, especially once valuations have declined so much and real value starts to appear (as we believe is the case now).

Our base case for 2019 is that bouts of volatility are likely to continue as central bank policy evolves. However, we also believe global growth, while slowing, will remain positive and likely support corporate earnings to a degree that is no longer appreciated in market valuations. We believe the next substantial allocation shift we make in portfolios —using a medium-term view —will be further de-risking. For now, portfolio managers continue to adjust positions based on the opportunity set that storms like this can create.

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