Investment Insights

Asset Allocation Shift: Reducing Risk

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Highlights

- While we do not see a U.S. or global recession as imminent, the ongoing global growth slowdown along with significant risks makes us skeptical that equities will post material, sustained gains from here.
- January's equity recovery following December's extraordinary sell-off provides an opportunity to increase defensive holdings as part of our medium-term process to prepare portfolios for the next sustained downturn.
- We are moving to a modest equity underweight (versus strategic client benchmarks) and increasing exposure to high-quality fixed income.
- We remain significantly tilted toward U.S. equities and have increased exposure to managed-volatility equity strategies to further manage late-cycle volatility.

As we regularly highlight at Bessemer, we do not believe we can time the markets. We do not know on what day, or even what week or month, equities will peak and begin a sustained pullback, akin to 2001 or 2008, or at what index level a stock market has bottomed and should be bought aggressively. Barring an incredibly large, unexpected shock that radically and suddenly changes the economic landscape, you won't see us suddenly shift portfolios by 180 degrees, given our longer-term focus and investment horizon.

We are confident, however, that thoughtful economic and financial analysis can help us more effectively evaluate the probabilities of various market outcomes. That, in turn, should help us adjust portfolios that appropriately balance risk and return for our individual clients' needs at different points in time. At the end of the day, our goal is to participate meaningfully when times are good but limit downside in periods of stress so that we can better compound longer-term returns.

Understanding Upside/Downside for Stocks and Bonds

What does our economic analysis say today? Our proprietary model suggests a 60% chance of a U.S. recession beginning sometime in the next six to 12 months; that's up from a year ago but still below levels that historically coincided with sustained, large equity losses. That forecast is helped in large part by American consumers, in turn supported by low interest rates, relatively little household debt, and robust labor markets.

Further, we know that the economic cycle and equity rallies, despite nearing records for their longevity, could find additional supports. China, the world's second-largest economy, is taking multiple steps to boost growth — in part, we believe, so the country can successfully meet its 2020 goal of doubling nominal GDP and per-capita income from 2010 levels. Meanwhile, clarity on trade rules and tariff levels between China and the U.S. could result in more companies implementing longer-term plans, boosting growth via capital spending or hiring. Even without such clarity, equities might get at least a small lift from continued share repurchases.

While encouraging, recession probabilities can change quite quickly, and historically, equities usually have commenced sustained declines several months before a recession began. As we look at the year ahead, we see a growing number of risks that could weigh further on growth, raising recession probabilities and limiting potential returns for stocks. This relationship is reflected to a degree in the correlation between perceived policy uncertainty and equity volatility — the disconnect between these two variables today is noteworthy (Exhibit 1).

Below we highlight some of the key issues informing our view.

Trade. U.S. President Trump and Chinese President Xi both seem focused on supporting growth in their respective countries. With that in mind, and given how trade headlines impacted global equities in recent months, we are increasingly hopeful that the countries can find a way to avoid a further worsening of the trade war, if not by the March 1 deadline, then soon thereafter.

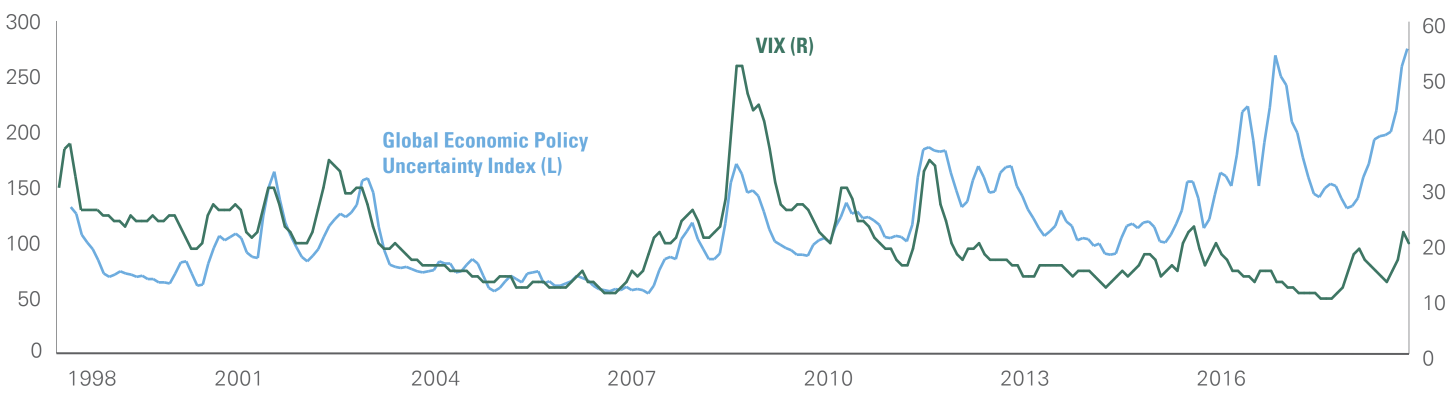
That said, such progress, in our view, does not remove all related risks for the global economy or markets. First, we could envisage a scenario in which the U.S. wants to ensure that China "plays by the rules" on whatever trade agreement is reached. This could entail regular checks to enforce the deal — with higher tariffs an ongoing threat if China doesn't meet U.S. objectives. Without longer-term certainty around the trade rules, it's less likely that companies will make costly, longer-term investments that could be threatened by suddenly higher tariffs. As a result, even with trade progress, subsequent capital spending may not necessarily follow.

Even if a Chinese trade agreement is reached this spring that includes certain technology-related issues, the ongoing U.S. efforts to protect domestic technology dominance (for economic, military, and geostrategic reasons) could weigh on cross-border trade and capital flows, again creating a potential economic headwind. Washington is currently considering different steps (including a bipartisan-supported bill) that would restrict U.S. exports of "foundational technologies." If such proposals become reality and are broadly enough based, they could force some U.S. firms to alter supply chains, disrupting activity and potentially raising costs.

Finally on trade, China is the main event, but not the only show in town. The U.S. could launch global auto-import negotiations in the coming months. It's also currently reviewing certain trade agreements with India. Anecdotally at least, this U.S. administration seems intent on showing voters that it means business in getting better terms for U.S. companies, even if actual benefits from new trade deals — at least so far — can be debated.

Exhibit 1: Global Economic Policy Uncertainty and VIX Index

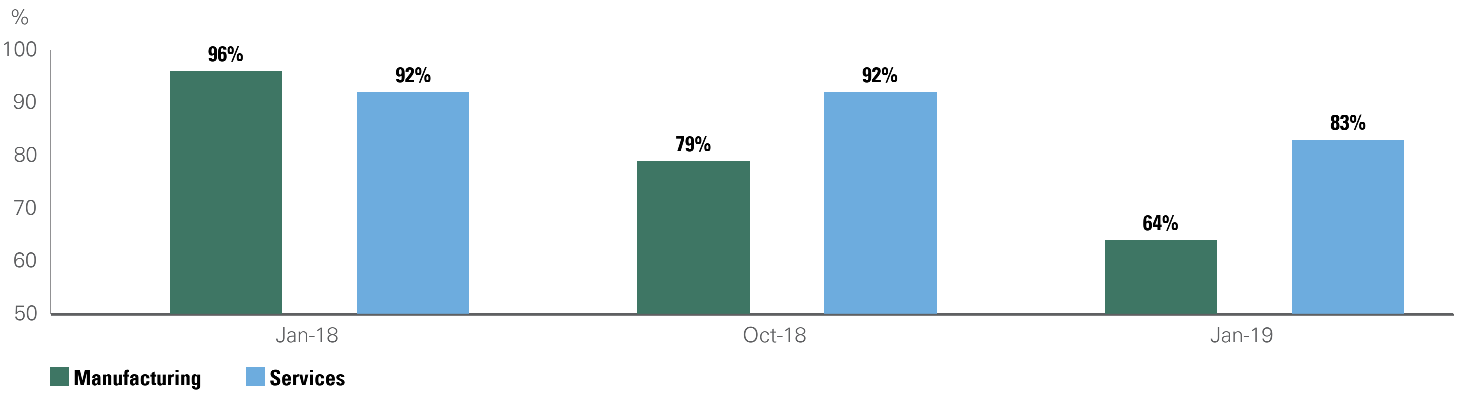
Key Takeaway: While global economic policy uncertainty has increased recently, equity volatility has not risen to the same degree.



As of January 31, 2019. Reflects three-month rolling average for both series.
Source: Baker, Bloom & Davis, Bloomberg, CBOE

Exhibit 2: Percent of Countries with Purchasing Manager Indices above 50

Key Takeaway: Business sentiment among global manufacturing firms declined markedly in the last twelve months.



As of January 31, 2019. A PMI reading above 50 indicates an expansion in business activity.
Source: Bloomberg, Markit

With trade uncertainty elevated, it's not surprising that sentiment among manufacturing firms, especially those with closer economic ties to China, has fallen sharply in recent months (Exhibit 2). Indeed, between October and January, about a third of the manufacturing-sentiment indices we track fell to levels suggesting contracting economic activity.

Brexit and Europe. As of this writing, the U.K. government has been unsuccessful in securing its parliament's backing for the terms under which it will exit the European Union (EU). No one wants the March 29 exit to occur with no deal at all, as the subsequent uncertainty for the U.K. and continental Europe would be extreme, very likely leading to a sharp slowing in growth on both sides of the English Channel. It's possible that the parliament will eventually give its approval to what many are describing as a relatively "soft" Brexit, either in March or at some point later this spring should talks be granted an extension (something that would require EU consent). There is also speculation that the U.K. will find a way to avoid Brexit altogether, though for now this seems more hope than a concrete plan.

Assuming some form of Brexit occurs, U.K. growth is biased to slow — the question is more degree than direction. The Bank of England, at its latest meeting in early February, reduced its domestic growth forecasts assuming only a mild Brexit. Even then, it expects quarterly growth of 0.3% or less at least until the end of 2019. In our minds, the risk is that Brexit proves more difficult than feared, that U.K. assets continue to struggle, and that Europe in particular (given strong trade and financial ties) feels some economic spillover. Note that in the case of Brexit, the exit is just the beginning — after that event the U.K. has roughly two years to "transition" to new trade arrangements with dozens of countries, in addition to figuring out how to minimize the shock to U.K. businesses in the new trading regime with continental Europe. Neither of these is likely to proceed smoothly, in our opinion.

Europe, meanwhile, faces plenty of risks beyond Brexit. Italy, the eurozone's third-largest economy, is technically in recession with an unstable government (less than a year into its administration). Across the region, populist parties (including those from Italy) could capture a larger number of seats in May European parliamentary elections, with implications for future structural reform as well as the region's leadership. Against this backdrop, the European Central Bank's monetary policy has held surprisingly steady. The ECB, in our view, has limited means to counter a crisis or broader regional slowdown with short-term interest rates still negative, the balance sheet plateauing but at a record high, and possible new lending effort for banks (so called LTROs) more useful if demand remains (please see our First Quarter 2019 *Quarterly Investment Perspective*, "The Euro Turns 20").

Geopolitical/political risks. Of course, the world always faces political and geopolitical risks; we are not suggesting that what we see today is unprecedented. That said, we have found that financial markets are relatively more sensitive to such uncertainties against a backdrop of slowing growth, which is where we are this year.

Of the risks we are monitoring, we would first highlight an unusually divisive U.S. political climate. The months ahead could bring fights over the U.S. debt ceiling, reminiscent of 2011 (which, in a worst-case scenario, could lead to concerns over the country's sovereign credit rating), in addition to congressional and other investigations tied to the White House and potentially more departures of high-level cabinet officials.

Outside the U.S., we would highlight the Middle East and Venezuela, since instability could lead to heightened fears over global oil supplies and, in turn, worries over higher inflation while growth is slowing.

When the Best Case Isn't Good Enough

Let's consider a "glass half full" scenario: The U.S. and China agree on a sustainable deal that caps tariffs, and additional trade tensions moderate, global growth stabilizes, and politicians find areas where they can work together. In such a scenario, we would expect global investor sentiment to improve and more capital to go to equities. Global growth would also skew higher.

In this scenario, which we do not rule out, we would expect the Federal Reserve to use its "flexibility" to augment its ongoing balance sheet reduction with a resumption of interest-rate hikes. After all, in such a scenario, tightening labor markets and a broadly strengthening economy would very likely tilt inflation risks higher. Such a "repricing" of U.S. monetary policy expectations, in our view, could in itself provide a cap on risk assets, such as credit and equities (currently, financial markets discount no change to federal funds rates in 2019 and a roughly 80% chance of a 25-basis-point cut in 2020). It could also push the U.S. yield curve (the difference between short- and longer-term U.S. government bond yields) back toward inversion, as shorter-term interest rates rise again. (Even now, there is only about 15 basis points between 2-year and 10-year Treasury yields.) Historical precedent, with curve inversion leading recessions (albeit with varying time lags), could also cap investor enthusiasm over equities.

Our clients have different goals, to be sure, but the vast majority do have at least one thing in common: They want to keep what they and their families have worked so hard to make. Limiting potential portfolio losses is critical if we want to compound returns over time. With that in mind, and with a maturing economic cycle and relatively greater downside risk, we started using pockets of market strength in 2016 to incrementally prepare for that next downturn. Steps so far have focused on tilting portfolios more to the U.S. and within equities, adding more "managed volatility" strategies (please see our Third Quarter 2018 *Quarterly Investment Perspective,* "The Defensive Playbook"). While we have generally taken a de-risking path in the last few years, this has not necessarily been a straight line — we have made tactical adjustments to increase risk at opportune times, such as in advance of tax reform.

We believe the current environment presents another opportunity for an incremental risk reduction. Specifically, we are lowering our exposure to equities by three percentage points to increase our allocation to fixed income. This will leave Bessemer mandates underweight equities versus strategic targets, although modestly so.

We believe the shift we are making today, along with other de-risking efforts, positions us well to navigate late-cycle market volatility. That said, we expect we will take additional incremental steps, possibly as soon as later this year, to prepare for the eventual, sustained equity bear market that will likely materialize alongside the end of the economic cycle.

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