Investment Insights

Portfolio Positioning Amid Recent Market Moves

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Highlights

- Bessemer mandates entered 2020 with moderately less risk versus strategic benchmarks in part due to the expectation that volatility would be higher than it was in 2019.
- In this note, we provide context on the developments regarding the coronavirus, which has been the immediate trigger of the past week's sell-off; compounding factors have included increased uncertainty in the U.S. political landscape and heavy positioning in certain equity sectors, in our view.
- The market is most focused on the negative hit to business and consumer spending and sentiment resulting from industry and government response to the virus.
- We expect weak economic growth in the first quarter and earnings of many multinational companies to suffer from complications in global supply chains.
- Our base case is for stimulative central bank actions and increases in economic demand in 2Q and 3Q to offset 1Q weakness, leading to greater volatility in the coming months but not a weaker 2020 in aggregate.
- Given our already somewhat defensive positioning, the changes in Bessemer mandates in recent weeks have been tactical and at the margin as we continue to monitor and analyze the changing landscape.

Bessemer client portfolios entered 2020 with modestly defensive positioning — in the form of a modest overweight to protective assets, a U.S. equity overweight, and a meaningful allocation to minimum-volatility equity strategies — as we had expected a pickup in market volatility. Holding defensive positions into the recent equity drawdown has allowed Bessemer portfolio managers to make tactical adjustments to portfolios and to increase exposure to high-quality businesses at the margin.

Coronavirus Disease 2019 (COVID-19): Scale, Severity, and Uncertainty

First and foremost, our sympathies are with all who have been affected by this virus. Given the varying intensity of coverage across social media and traditional media sources, it is helpful to keep this viral outbreak in context. In what follows, we provide historical facts in order to compare COVID-19 to similar outbreaks.

The virus first appeared in the city of Wuhan, the capital of Hubei province. As of February 24, 82% of the global cases remain in that province. Deaths due to COVID-19 are also highly concentrated in Hubei province, where 95% of all global fatalities have occurred. The fatality rate is higher in Hubei (2%-4% of cases) than in the rest of China (0.7%), indicative of an extremely stretched public health care system in the province.

COVID-19 is more contagious but less deadly than SARS. As of February 25, 97% of global cases of COVID-19 are still within mainland China, despite the virus having surfaced in late December. The latest data suggest a mortality rate of 3.36% for COVID-19, which is lower than the 10% SARS mortality rate and the 30%+ for more virulent flus like MERS and avian influenza. Notably, SARS and MERS, similar coronaviruses, were both contained once their means of spread were well understood (Exhibit 1).

Exhibit 1: Pandemics in the 20th Century

Pandemic	Virus Type	Estimated fatality ratio	Estimated number of deaths worldwide
1918-1919	H1N1	2-3%	20-50 million
1957-1958	H2N2	<0.2%	1-4 million
1968-1969	H3N2	<0.2%	1-4 million
2012	MERS	34.4%	858
2013	H7N9	37.1%	212
2002-2003	SARS	10%	774
1976-	Ebola	66% ave.*	1,605

*Varies from 25% to 90%.
Source: World Health Organization

With respect to scale, SARS sickened 8,098 people, and 774 died across 27 countries. As of February 25, COVID-19 has sickened 80,346 people, of which 2,705 have died across eight countries. Of those infected, 27,878 have recovered from COVID-19, according to Johns Hopkins CSSE[1]. When global health authorities methodically tracked and isolated people infected with SARS in 2003, they were able to bring the average number of people that each contagious person infected down to 0.4, enough to stop the outbreak. This strategy is currently being employed and appears to be working within China given the falling number of new cases reported outside of Hubei over the past week.

For further context, as it relates to influenza in the U.S., the U.S. Centers for Disease Control and Prevention (CDC) has reported over 29 million flu illnesses, 280,000 hospitalizations, and 16,000 deaths from the flu during the current influenza season.[2]

COVID-19 ranks high in uncertainty at present given that new cases are originating outside of the epicenter of the outbreak and we are just passing the peak of flu season[3]. One factor is international travel and supply chains that are more interconnected than ever. Additionally, with an incubation period estimated to be between two and 14 days, according to the CDC, quarantine efforts are more difficult with respect to COVID-19. This contrasts with an incubation period of two to three days for influenza and five days for SARS.

While viral outbreaks have always been a part of the human existence, it is worth noting that incredible progress has been made in the fields of epidemiology and medical technology over time. According to Thomas J. Bollyky, director of the global health program at the Council on Foreign Relations:

"For the first time in recorded history, bacteria, viruses, and other infectious agents do not cause the majority of deaths or disabilities in any region of the world. Since 2003, the number of people who die each year from HIV/AIDS has fallen by more than 40 percent. Deaths from malaria, tuberculosis, and diarrheal diseases have declined by more than 25 percent each. In 1950, there were nearly 100 countries, including almost every nation in sub-Saharan Africa, South Asia, and Southeast Asia, where at least one-fifth of children died — most of them from infectious diseases — before their fifth birthday. Today, there are none."[4]

COVID-19: A Transitory Shock to Global Growth

As the case count of COVID-19 has spread outside of China over the past week, the potential for increased

[1] https://gisanddata.maps.arcgis.com/apps/opsdashboard/index.html#/bda7594740fd40299423467b48e9ecf6
[2] https://www.cdc.gov/flu/weekly/index.htm
[3] https://www.cdc.gov/flu/weekly/index.htm
[4] https://www.theatlantic.com/ideas/archive/2020/02/coronavirus-spreading-because-humans-are-healthier/606448/

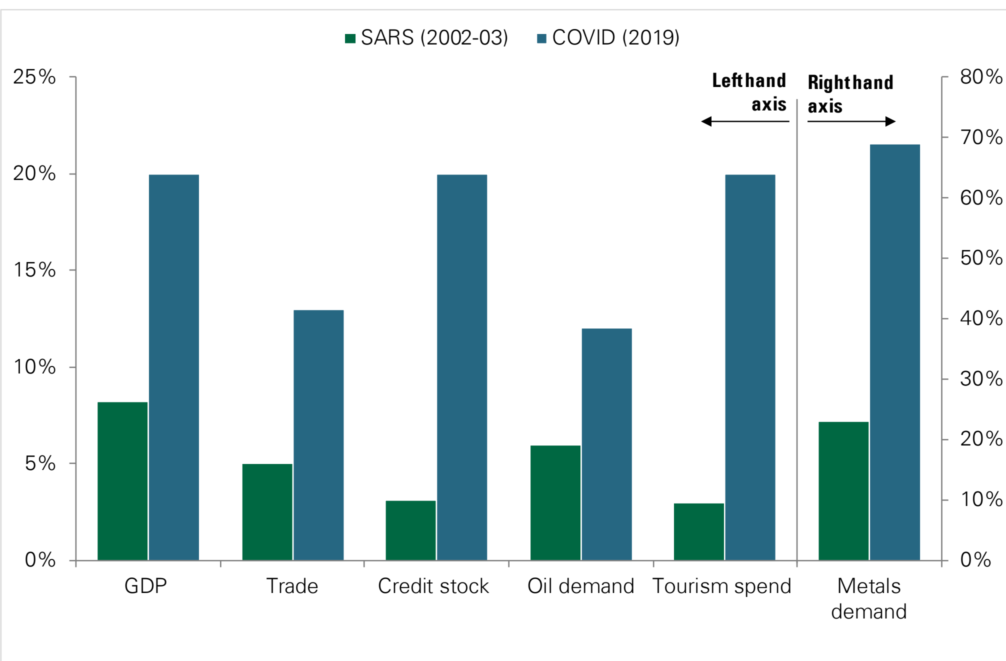
disruption across global economic sectors has increased. As a result, markets have priced in further easing from central banks, investors have reached for higher-quality assets (namely U.S. Treasuries), and safe havens (such as gold) have rallied.

While news of the increasing case count outside of China is concerning, it was only a matter of time before the virus spread internationally given its relatively long incubation period and the highly integrated nature of global supply chains. Given the interlinking of global economies and the ease of international travel, infections are able to spread more easily than ever before. However, at the same time, people are generally healthier than ever and have access to better healthcare than they have historically, which is likely to limit the fallout from unexpected events such as COVID-19.

As governments work to curtail the spread of the virus, as they have done with past outbreaks (e.g., SARS in 2002-2003, H5N1 in 1997), production is slowed and consumption is reduced in the areas most affected by the outbreak. However, as health officials gain further understanding about the nature of the virus and both production and consumption resume, there is often a very sharp rebound in activity when looking at similar instances throughout history.

The primary channels of economic disruption are largely via reduced tourism flows (into and out of China but also more broadly), reduced import demand from China (already seen in the most recent trade data with Korea), restrictions imposed by third countries to avoid spreading of the virus, and consumer confidence effects. As China's global economic footprint has increased since SARS (Exhibit 2), the amplitude of the decline in growth is set to be larger than it was in 2002-2003. Central banks are acutely aware of this fact and are monitoring the situation closely. Should the recovery in Chinese demand be more "U-shaped" than "V-shaped," we would expect increased action from central banks in an effort to cushion global growth more forcefully.

Exhibit 2: China's Percent of Major Global Metrics

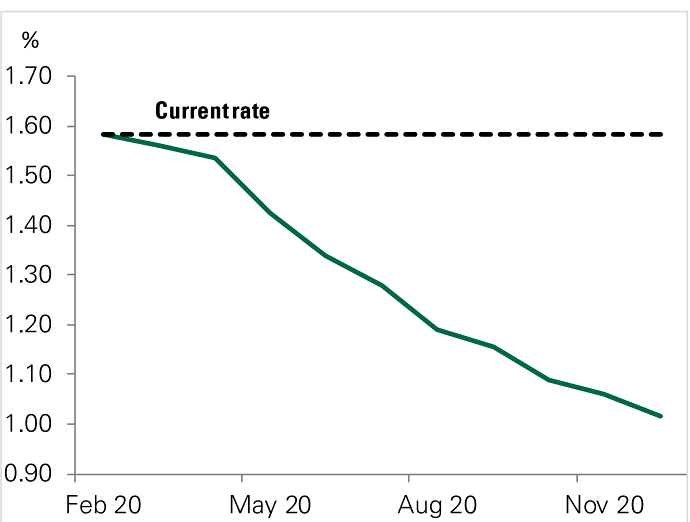


As of 2019. China's GDP share is PPP-adjusted share. Source: BIS, IMF, DOTS, IFS, Haver, Bloomberg, UBS

With the Federal Reserve intent upon "extending the expansion," we expect the Fed to remain active in expanding its balance sheet, as noted in our first quarter 2020 *Quarterly Investment Perspective*, "Turning Trends in 2020," and open to cutting interest rates should the impact of the virus turn out to be more material than expected. Recent Fed commentary on COVID-19 suggests that FOMC members need more information before making a move on monetary policy.

Interestingly, despite the U.S. being the most insulated from the virus, the Federal Reserve's interest-rate path has been repriced more than any other major central bank. Specifically, an additional 25–basis-point rate cut has been priced into the Fed's monetary policy path through year-end; the market prices the year-end fed funds rate at 1.0% (Exhibit 3). With 10-year U.S. real interest rates (nominal interest rates adjusted for inflation) declining below the lowest level seen in 2016, we expect the U.S. economy to experience a lagged effect of increased stimulus in an economy that is already in good shape.

Exhibit 3: Fed Funds Futures Implied Rate



As of February 25, 2020.
Source: Bloomberg

While the hit to first quarter real GDP growth is likely to be large in China, Chinese and global growth have the potential to snap back materially in the second quarter as production normalizes and restocking ramps up again. The export recovery in the aftermath of the phase one trade deal, which was underway before the outbreak, will likely reassert its trend. Continued policy easing will also provide support to the Chinese and broader global economy. Those economies which are most open and with the closest trade ties to China are likely to have more severe negative impacts in the short-term, but are also likely to rebound the most.

Flows, Politics, and Positioning

We believe the recent equity drawdown and rally in safe-haven assets was exacerbated by equity positioning (year-to-date inflows had been heavy in certain sectors and styles), strong performance in specific styles (the S&P 500 Growth Index had returned 8.6% in the first seven weeks of the year), and the percolation of political concerns in the U.S.

With Bernie Sanders emerging victorious in the Nevada caucuses with 46.6% support, nearly double the size of his roughly 25% finishes in Iowa and New Hampshire, Sanders leapt to a 65% probability of gaining the Democratic presidential nomination, according to PredictIt polls. As a result, investors have been forced to pay attention to his potential presidential policies. Technology, healthcare, and financial companies are in the crosshairs under a Sanders presidency, and a focus on these sectors has an outsized impact upon the broader S&P 500 index. These three sectors represent over 50% of the index (information technology at 24.1%, healthcare at 13.9%, and financials 12.4%).

While it is too early to tell how the Democratic race will shape up, we are monitoring developments closely, especially as it pertains to the state of U.S. and global economic indicators as we enter the summer months.

Positioning into 2020 was designed to buffer client portfolios from episodes of volatility after a very strong 2019. Defensive positions include an overweight to high quality fixed income, a significant overweight to the U.S. within equity portfolios, and an allocation to managed volatility equity strategies. In this context, market pullbacks can offer tactical opportunities for attractive entry points in businesses and assets where portfolio managers have long-term conviction. The changes in Bessemer mandates have been marginal to date in light of the already defensive positioning, and we will keep clients informed as to our views of the evolving situation.

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