Quarterly Investment Perspective

Go Big and Go Home?

Corporate Spending and the Economic Expansion

Holly H. MacDonald
Chief Investment Officer

Executive Summary

- **We believe corporate spending will support the current economic expansion, allowing us to maintain our modest overweight to equities.**
- **Despite a complicated policy backdrop, current capital spending trends are strong and are poised to get even stronger as evidenced by recovering corporate profits, increasing business confidence, and optimistic capital spending plans.**
- **Bessemer portfolio teams continue to see strong business results at the company level, which support a capital spending boom across both public and private markets.**

As summer days roll into a fall that looks at least a little different than most of us anticipated, we are heartened to see several pillars of strength in the economic expansion that keep us optimistic about the return potential of portfolios in coming quarters.

In this Quarterly Investment Perspective, Investment Strategist Bree Sterne, Associate Portfolio Manager Andrea Tulcin, and I explore what we believe is the most important of these pillars right now: corporate investment.

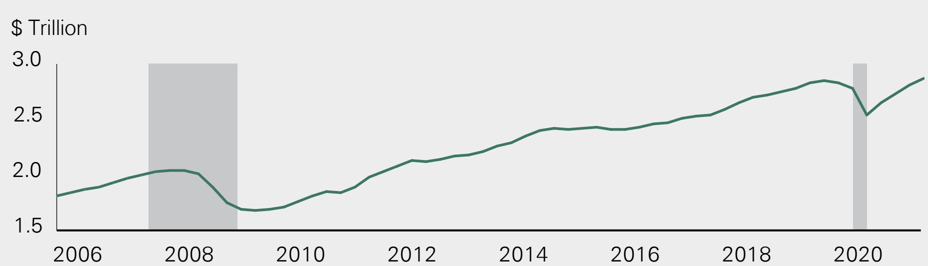
This economic cycle began when the world started to emerge from lockdown last summer, with fiscal and Federal Reserve stimulus igniting the expansion. But government stimulus only goes so far, in our view, and the key to how broad, deep, and persistent this recovery will be is tied to the actions of private corporations.

How confident will companies be to make investments in their businesses? As they take the plunge to build a new factory, employ a new technology, or hire additional workers, they do so with the goal of improving their productivity and increasing their output. In other words, as Warren Buffett has said, "Investing is laying out money now to get more money back in the future." This investment also has follow-on benefits to the broader economy — helping other corporations and consumers, often with a "multiplier" effect that allows the economic cycle to be stronger and longer than would otherwise be the case.

We see good reason to be optimistic that corporate spending will support this economic expansion (Exhibit 1), allowing us to maintain our modest overweight to equities despite various risk factors. Many elements of the current backdrop are conducive to such investment; as Bree analyzes on pages 4 to 7, we are seeing evidence that corporate spending this cycle can be more like the expansion of the 1990s than the post Great Financial Crisis (GFC) recovery in 2009 and beyond. We

Exhibit 1: U.S. Real Total Capital Expenditures

Key Takeaway: Capital spending has bounced back sharply since the pandemic.



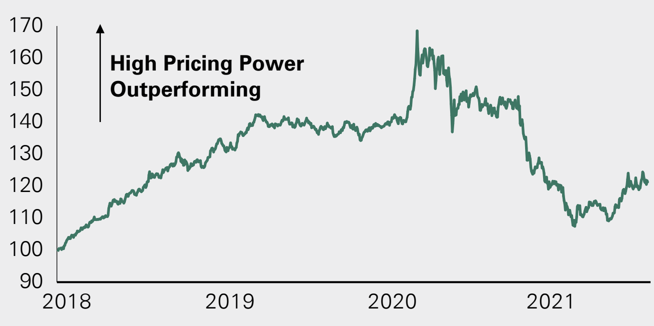
As of June 30, 2021. Note: Grey bars depict recessions.
Source: Cornerstone Macro

are expressing this view both in our overall asset allocation as well as in the specific companies we own, which Andrea details on pages 8 to 10. All in all, while there are always concerns and unknowns for investors, the underpinnings of the recovery are strong and encouraging to us.

First, a word on other elements of the macro landscape and performance. Concerns regarding the spread of the Delta variant, a shifting outlook for China, and questions on the trajectory of Fed and fiscal stimulus have weighed on market sentiment in recent weeks; in recent days, heavy equity positioning in certain sectors has added to volatility into quarter end. Our assessment is that reopening will continue, especially in the U.S., given prevalent vaccinations and greater knowledge about how to manage risks related to COVID-19. That said, the market was likely too optimistic earlier this year regarding how quickly life would return to "normal," and our security selection reflected a more complicated reality, helping our relative returns in the past quarter. Specifically, higher-quality companies, with pricing power being one measure of quality, have again begun to outperform (Exhibit 2), allowing a representative Balanced Growth portfolio to catch up to and surpass its benchmark, posting close to 10% returns on the year.

Exhibit 2: Companies With High Pricing Power Relative to Companies With Low Pricing Power — Normalized From 1/1/2018

Key Takeaway: High pricing power stocks have outperformed low pricing power stocks in recent months after falling sharply.

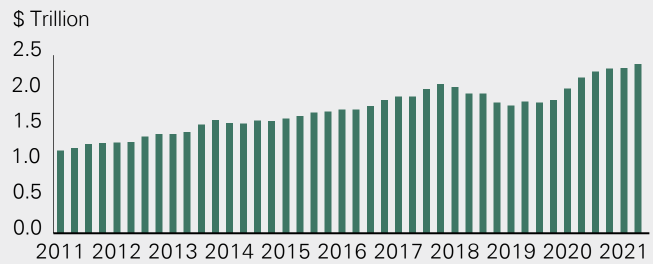


As of August 31, 2021. Note: The index is created by using Goldman Sachs' High Stable Gross Margin index (GSXUSHGM), minus Goldman Sachs' Low Variable Gross Margin index (GSXULVGM). Normalized relative return from January 1, 2018.

Source: Goldman Sachs

Exhibit 3: Cash and Cash Equivalents Held by Nonfinancial Companies in the S&P 500

Key Takeaway: S&P 500 cash balances sit at elevated levels thanks to improving corporate profits as well as debt and equity issuance, allowing companies to invest for growth as well as return cash to shareholders.



As of August 31, 2021. Cash includes short-term investments and long-term marketable securities.

Source: Bloomberg

China bears monitoring closely for the global outlook as recent local government crackdowns have been significant and are hurting both foreign flows and domestic growth. China is too important to ignore, and we spend a lot of time making sure we are engaging with the right external partners. Currently, Chinese stocks make up less than 3% of our equity exposure. That's because Bessemer internal portfolio managers reduced exposure to China earlier this year and are finding better opportunities in other regions. Bessemer equity portfolios have 75% of their exposure in U.S.-domiciled companies, the highest U.S. share we have had in recent history.

Meanwhile, inflation continues to be sticky at relatively high levels. We think this will encourage the Fed to begin tapering later this year as other central banks globally are also taking steps to remove accommodation. Price pressures should subside to some degree as supply and demand imbalances normalize, and we take these dynamics into account within sectors and as they relate to individual companies within our equity portfolios.

The policy environment in the U.S. is not necessarily straightforward either, with tax increases and some changes from the Fed on the horizon, but the backdrop is supportive enough to allow the economic expansion to continue, in our view.[1]

[1] We are cognizant of the hit to corporate profitability a probable higher corporate tax rate would likely have in the coming year. However, there is a nuance related to investing that is worth noting. In 2017, Congress changed its policy on amortization of investment in plants and equipment to allow companies to immediately expense their capital investments. In the House tax plan, investment is the one area not being adversely impacted. This provision runs out after 2022, and combined with a higher corporate tax rate, there may be impetus to bring forward investment into the coming year.

For those interested in more detail, our last Quarterly Investment Perspective provides a comprehensive update of our views, and subsequent Weekly Investment Updates and Investment Insights explore these themes amid recent developments.

Three Macro Trends Supporting Corporate Investment

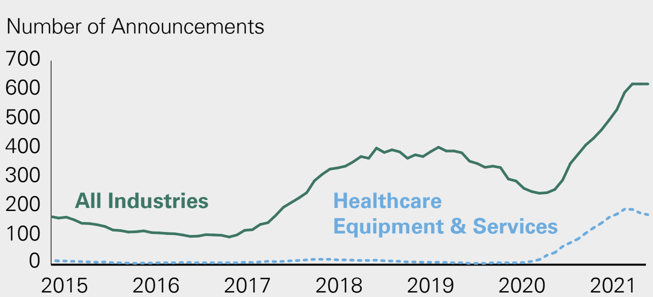
Tying together the macro backdrop with the outlook for corporate spending, we highlight three supporting factors before presenting our more detailed analysis on the spending itself:

Go big? Corporate cash levels are high. The first point is fairly basic — companies have the money to spend. Stimulus over the past year and a half, low interest rates and ample demand for corporate debt, and some savings from business changes due to COVID-19 have left balance sheets well positioned. There is plenty of cash to see continued return to shareholders in addition to capital expenditures (capex). See Exhibit 3 on page 2.

Go home? Geopolitical developments are encouraging reshoring of supply chains. The recent shifts in domestic Chinese policy have compounded already strained relationships with U.S. firms in the wake of COVID-19 and a more antagonistic stance from both the Trump and Biden administrations. The physical distance between the U.S. and China and increasing labor costs in China have already been hurdles to supply chain management. Reshoring announcements have spiked in the past year, especially for healthcare companies given the extra sensitivity of the sector to these challenges (Exhibit 4). We expect these trends to continue and to drive greater investment within both the U.S. and Europe.

Exhibit 4: U.S. Reshoring Announcements (Trailing 12-Month Sum)

Key Takeaway: U.S. reshoring announcements accelerated in the second half of 2020 and into 2021 as a result of COVID-19 and fiscal policy support.

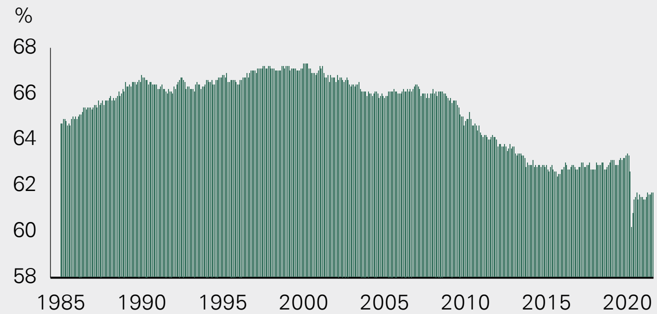


As of June 30, 2021. Reshoring data tracks websites and news articles for mentions of U.S. reshoring, expansion, and other key words.

Source: UBS

Exhibit 5: U.S. Labor Force Participation Rate

Key Takeaway: The U.S. labor force participation rate has been steadily declining since 2000, falling more sharply due to the pandemic.



As of August 1, 2021.

Source: FRED

Labor force challenges may drive investment to improve productivity. As we have discussed in recent publications, we believe much of the increase in prices is related in some way to the specific nature of the COVID-19 shock, and as reopening continues, much of the mismatch in supply and demand will normalize. At the same time, we are seeing wages increase, and structural elements of the labor market suggest even greater pressure on wages over time. A full analysis of the labor market is beyond the scope of this paper, but we offer a few observations to suggest companies may be starting to realize that wages are unlikely to fall anytime soon: Immigration of skilled workers has declined and looks unlikely to reverse, the U.S. population is aging, and the labor force participation rate has been falling (Exhibit 5). In the near term, these dynamics may create concerns regarding cost pressures and add to uncertainty; over a longer time horizon, however, we would argue that they help make the case for productivity-enhancing investments into physical plants and technology systems to allow each worker to contribute more. This is a theme we will monitor over time and explore further in future publications.

Bree Sterne
Investment Strategist

The Past, Present, and Future of Capital Spending

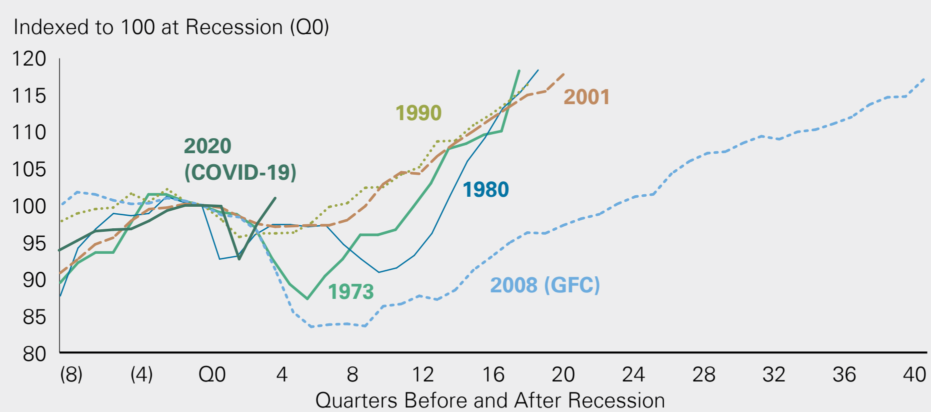
Driven by many of the factors that Holly discussed in the previous section, business investment in the U.S. and Europe has accelerated markedly in the recent COVID-19 recovery. Investment has been largely driven by technology spending but has recently broadened to include more traditional capital expenditures, such as equipment and infrastructure spending. Current capital spending trends are strong and poised to get even stronger as evidenced by recovering corporate profits, increasing business confidence, and optimistic capital spending plans. Robust capital investment will be crucial in ensuring the current economic recovery maintains strength after the fiscal stimulus and reopening-driven spending boost fades. Importantly, further business investment will help lift productivity and fuel economic output.

Stronger Capital Expenditure Recovery vs. History

Business investment appears to be making a much faster rebound relative to the recoveries that followed past recessions. Prior capital expenditure recoveries took an average of three years to reach pre-recession levels. For instance, in the cycle following the Great Financial Crisis, capex remained well below its long-term trend as the recovery was followed by sluggish aggregate demand, persistently low inflation, and weak investment growth. In contrast with the last expansion's sluggish pace, business investment is now showing notable signs of resurgence more similar to the recovery in the 1990s but with an even faster pace, surpassing its pre-recession level in the second quarter of this year (Exhibit 6).

Exhibit 6: U.S. Real Investment

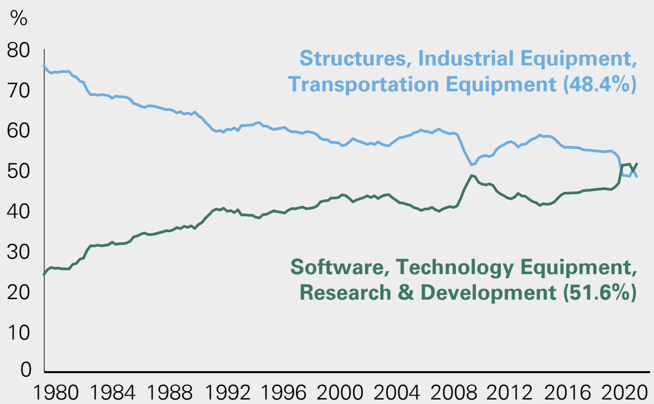
Key Takeaway: The current capex recovery is faster relative to prior expansions.



Source: BEA, Haver Analytics, Morgan Stanley

Exhibit 7: Capex Components as a Percentage of Total Capex

Key Takeaway: New economy capex is taking share from old economy capex.



Source: Cornerstone Macro

COVID-19-Fueled Investment

Though economic uncertainty often dampens capital spending, an economically disruptive event such as COVID-19 can support investment growth. The pandemic accelerated many structural trends and abruptly drove shifts in how we live and work. Companies were forced to minimize contact between workers and consumers, which resulted in a rapid increase in spending on technology to enhance productivity.

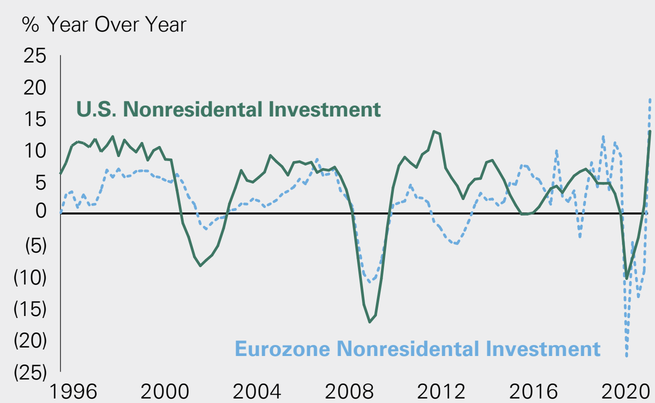
Business investment in technology equipment, software, and research and development has been especially strong in the recent recovery. Technology-oriented capex barely weakened during the COVID-19 recession and is now at a record high. The structural trend toward “new economy” capex, including research and development, technology equipment, and software, and away from “old economy” capex, including transportation and industrial equipment, had already been taking place but was further accelerated by the pandemic (Exhibit 7). Technology equipment, software, and research and development now comprise the three largest components of overall capex in U.S. GDP.

Broad Capital Spending at Present

While the recovery’s capital investment cycle was led by technology spending, industrial equipment capex is now accelerating as well. The combination of an economy that is running hot alongside robust demand and supply chain constraints is incentivizing business investment. Strong consumption is continuing to drive demand as the economic cycle transitions from early to mid-cycle. Typically, as the economic cycle moves further into its recovery, the driver of demand shifts from consumption to investment as companies look to meet future demand. Businesses are now looking to boost productivity and output in response to the robust demand environment and to counter cost pressures on margins.

U.S. real total capex hit an all-time high in the first quarter of 2021 — the only major GDP component to do so — driven by both hard capex, including machines and factories, and intangible capex, such as software. Core capital goods orders have been climbing fairly consistently for months, with nondefense capital goods orders recording gains in 13 of the last 15 months. Nonresidential fixed investment, often used as a proxy for business spending, increased 13% in the second quarter, led by growth in software and technology equipment spending (Exhibit 8).

Exhibit 8: Nonresidential Fixed Investment Is Accelerating

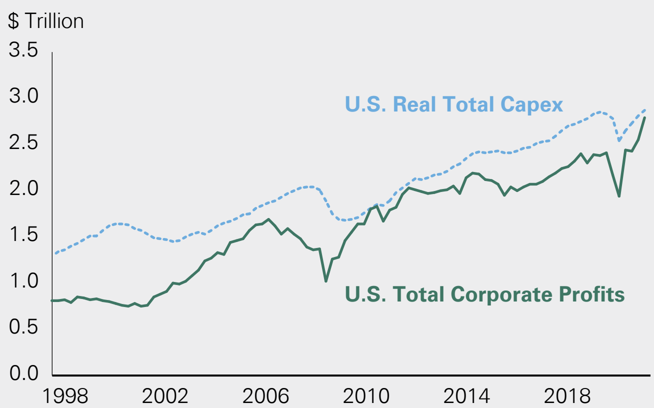


As of June 2021.

Source: Barclays, Datastream, Department of Commerce, Goldman Sachs

Exhibit 9: Total U.S. Corporate Profits and U.S. Real Total Capex

Key Takeaway: Corporate profits tend to lead capital spending.



Source: Cornerstone Macro

In Europe, the expectation for 2021 capital spending is at its highest level since 2006, and nonresidential corporate capital investment is also forecast to surpass pre-pandemic levels by year end. These data points, combined with stabilizing COVID-19 cases and leading indicator momentum, inform our view that a recovery pattern similar to that of the U.S. will unfold in Europe.

Many Drivers of Capex

Beyond fiscal stimulus-driven support, capital spending receives an even more powerful boost from private sector capex. Business profits particularly have tended to lead capex fairly consistently over time, and corporate capex has accordingly remained on an accelerating path given the strong rebound in corporate profitability (Exhibit 9). Healthy corporate balance sheets provide additional support for capital expenditures. Elevated cash levels are driving companies to make plans to use this cash to invest for growth. Meanwhile, easy Fed policy has helped keep interest costs low for U.S. corporates, and bank lending standards have continued to improve, which helps incentivize management to consider capex opportunities.

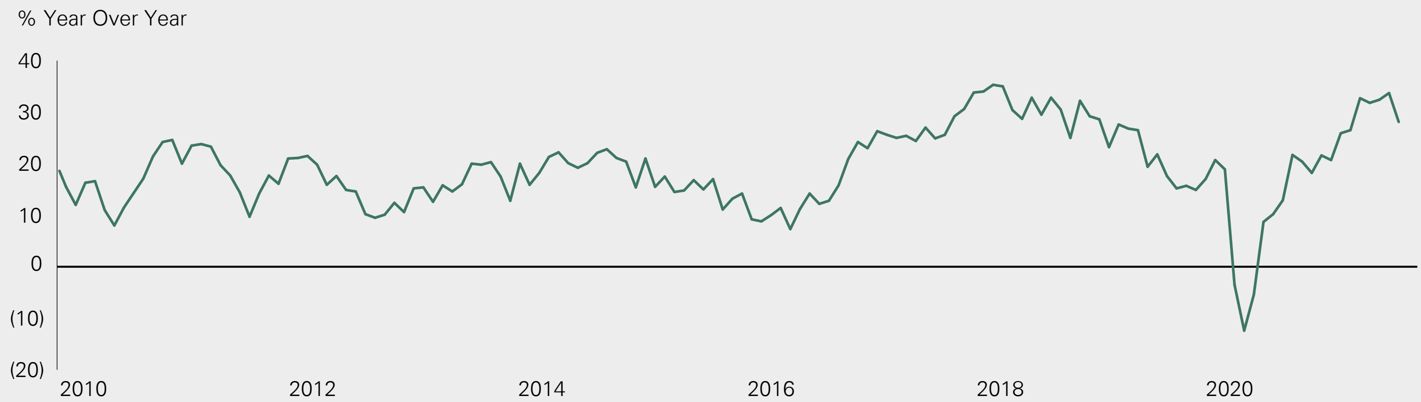
Robust demand and supply chain dynamics have further driven the need for more equipment, infrastructure, and technology. Capacity utilization rates have continued to move higher, recently moving above the long-term average. Furthermore, equipment shortages are being cited as a key factor limiting production. COVID-19 very clearly brought into view the costs of supply chain risk. Global supply chains have remained stressed for nearly two years since COVID-19 disruptions began given ongoing economic starts and stops around the world. The pandemic has served as an additional catalyst that propelled spending in supply chain resiliency, especially technology. For example, factory automation has seen an inflection in digital capabilities that could provide a structural tailwind for U.S. manufacturing.

Bright Capex Outlook

The outlook for capital spending is expected to improve, in our view, given positive signals for forward-looking measures. Forecasts for core durable goods, regional manufacturing data, and business surveys indicate capacity utilization will climb, leading to additional capital spending. Capex expectations from the New York Fed, Philadelphia Fed, Richmond Fed, Dallas Fed, and NFIB (National Federation of Independent Business) business surveys — all of which ask about capital spending plans for either three or six months into the future — are all above their historical averages (Exhibit 10). Company commentary further supports a positive near-term outlook. Earnings calls have recently discussed capex plans at a higher rate than average.

Exhibit 10: Regional Fed Capex Outlook Surveys

Key Takeaway: Capex intentions in the U.S. support a positive outlook.



Source: Bloomberg; Cornerstone Macro; Philadelphia, Richmond, New York, Kansas City, Dallas Fed Manufacturing Capex Outlook (equal weighted average)

Capital Spending Supports Economic Recovery

Robust capital investment will be key to sustaining the post-COVID-19 economic recovery during the transition from waning fiscal stimulus support to the private sector driving growth. While consumption has been a large driver of GDP in recent years, business investment is emerging as a powerful source of U.S. economic growth. It is important to note that capex was a major driver of GDP from 1950 to 1980. Healthy capital spending and capex-driven productivity growth will be especially important for the next phase of the economic expansion given the potential for tax increases, wage pressure, and continued supply chain disruptions to weigh on profit margins.

Capital spending is providing a favorable tailwind for U.S. equities and an especially strong backdrop for companies that benefit from the positive feedback loop of higher capital expenditures. Increased “new economy” capex is providing broad support for companies to boost productivity and corporate profits. Meanwhile, increased traditional “old economy” capex will support industrial-related companies’ earnings trajectories.

Andrea R. Tulcin
Associate Portfolio Manager

Portfolio Exposure to Capital Spend Cycle

Second-Quarter Results Support Further Investment

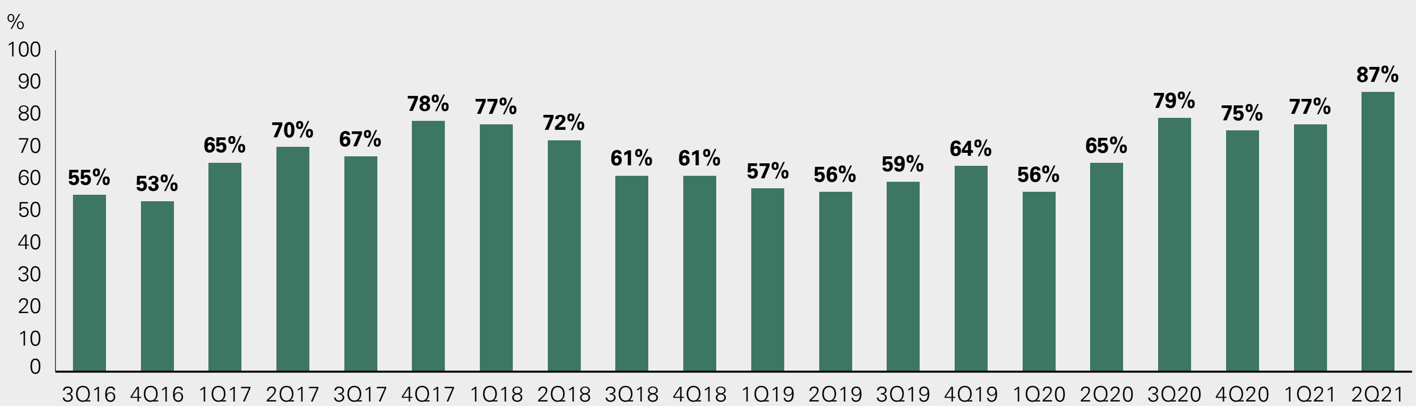
Bessemer portfolio teams are seeing strong business results at the company level, which supports a capital spending boom across both public and private markets. In U.S. public markets, companies have been reporting very strong financial results — more than 85% of companies in the S&P 500 released second-quarter results that surpassed consensus expectations for both revenue and earnings (Exhibit 11). This is the highest percentage of companies reporting revenues ahead of estimates during any quarter since 2008, when Factset began tracking the variance between consensus forecasts and actual results.

In European public markets, we also have seen strong corporate results. Looking at aggregated earnings compared with the previous five years, the second quarter of 2021 saw the highest percentage of earnings "beats" and lowest percentage of earnings "misses" compared with historical STOXX600 figures over this period, according to Factset.

On the back of better financial results, business confidence is soaring (Exhibit 12), and the combination of accommodative financing conditions, pent-up savings, and demand for both labor and output in excess of supply is a favorable environment for many companies to increase spending.

Exhibit 11: S&P 500 — Percentage of Companies Reporting Quarterly Revenues Above Estimates

Key Takeaway: More than 85% of S&P 500 companies that reported second-quarter sales exceeded estimates, an incredibly high number of companies to do so.

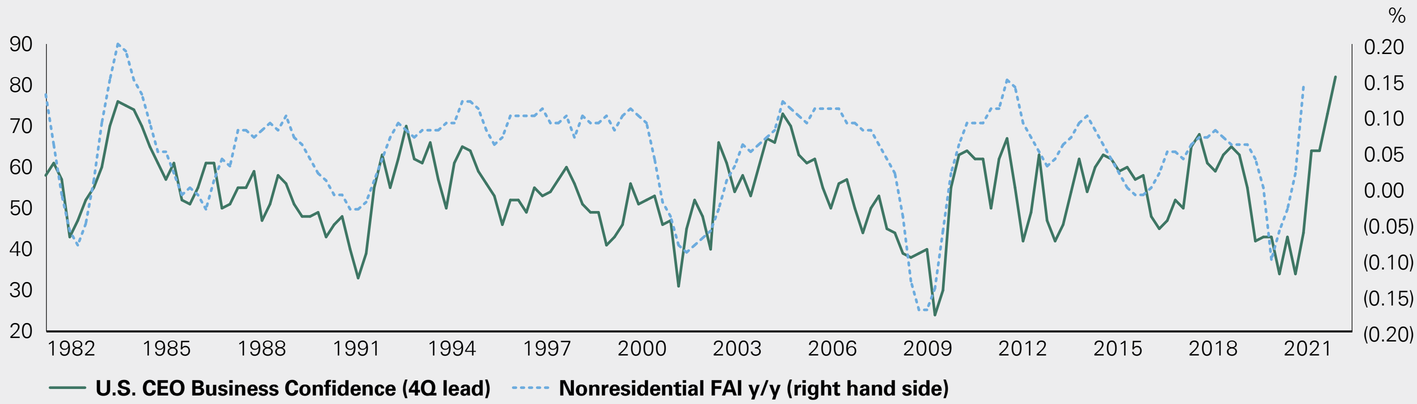


As of September 7, 2021.

Source: Factset

Exhibit 12: U.S. Business CEO Confidence Level Leads Fixed Asset Investment (FAI) by a Year

Key Takeaway: Nonresidential fixed investment has followed business confidence to its highest levels since the GFC, and the same should happen going forward.



As of June 30, 2021.

Source: Barclays, Bloomberg, Datastream

Semiconductor Spending Spree

In certain sectors, our equity portfolio teams are already seeing a step-up in investment alongside management commentary that asserts a positive outlook for continued spend.

Bessemer portfolios have broad equity exposure to the semiconductor industry, where a material acceleration in capital investment is taking place. Existing supply chain bottlenecks arising from pandemic-induced shifts in demand have delayed production and shipment of capital goods while the proliferation of technology in artificial intelligence, cloud computing, electrification, and digital transformation continues to increase demand. Thus, semiconductor companies are seeing the need to speed up manufacturing and position for emerging technology production by increasing investments in new capacity to rebuild inventories and attempt to meet burgeoning demand.

During its first-quarter earnings call, the management team of Texas Instruments, a semiconductor company held in both Bessemer's U.S. Select and Large Cap Core portfolios, confirmed higher capital spend levels over the next two to three years. Accordingly, the expectation for the company's capital investment in each of the next three years has increased to a higher level than what the company has spent in any of the past 10 years.

Bessemer's Large Cap Global portfolio holds Taiwan Semiconductor Manufacturing Company (TSMC), a semiconductor manufacturer that has committed $100 billion in capital spend through 2023. This commitment implies a 65% increase in spend in 2021 and growth of 10% and 5%, respectively, in the following two years. These figures do not include the potential for two additional semiconductor fabrication plants, implying spend level is likely to increase from here.

TSMC's global manufacturing expansion strategy is centered on keeping pace with the structural increase in long-term semiconductor demand. While Taiwan will continue to be the company's home base and center of research and development, it is spending to increase its presence in the U.S. (Arizona) and in China (Nanjing).

Beneficiaries of higher semiconductor capital investment include capital equipment companies such as KLA Corp., ASML Holding, and Tokyo Electron, which are held in Bessemer's U.S. Select and Large Cap Global portfolios. As suppliers of equipment to the semi complex, these companies' revenues are reflective of capital spend and are expected to compound at low double digits through 2024.

Infrastructure Demand Drives Spend

Another area where market demand is translating to higher spend is the U.S. rental equipment market. Bessemer's Large Cap Global portfolio holds United Rentals, the share leader in North American equipment rentals, which boosted revenue and profitability guidance for the year due to higher overall business volumes amid a tight supply of machinery. Due to accelerated demand for construction machinery and materials across many of its industrial end markets, United Rentals raised its capital spending by 22% in 2021 compared to 2019 and is expected to maintain healthy levels of spending over the next two years.

With the passing of an infrastructure bill, end-market demand for United Rentals could accelerate beyond the pandemic recovery. United Rentals has exposure to both traditional infrastructure, including roads, highways, bridges, and airports, as well as other public nonresidential spending, such as schools and hospitals. Matthew Flannery, the company's CEO, confirmed that most of the infrastructure categories in the Biden administration's current bill would benefit United Rentals or its customers.

Government infrastructure spending should also be advantageous for construction materials companies such as Vulcan Materials, which is held in Bessemer's Large Cap Core portfolio. Vulcan is the U.S.'s largest producer of aggregates such as stone, gravel, and sand, which should benefit from a recovery in U.S. construction spending. Further, Vulcan's largest states by revenue (Texas, Virginia, and California) are not only experiencing substantial demand for roadwork driven by growing populations and growing need for repairs, but they also have the budgetary resources to fund these needs.

More Automation Means More Investment

Additional beneficiaries of increased capital spend across Bessemer equity portfolios include electrical equipment holdings, such as Eaton, Siemens, and Schneider Electric. While these companies typically grow alongside GDP, secular tailwinds from industrial automation, digitization, and electrification should drive higher growth going forward. Revenues of each of these three companies are expected to compound at a minimum of 8% over the next three years, well above the rate of economic growth in the U.S. and Europe.

Exposure to Capital Spend at Different Stages of the Business Lifecycle

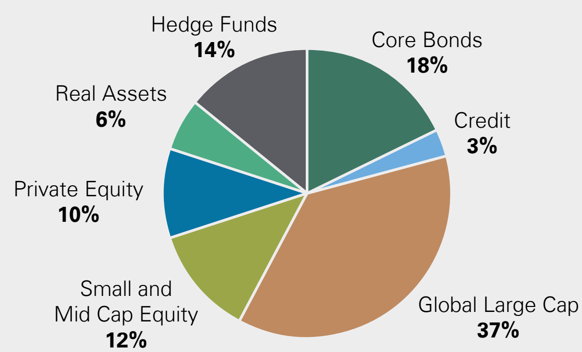
An uptick in capital spending is also happening at many of the later-stage companies within Bessemer's private equity program. A notable example is our program's investment in a Florida-based food distributor for mid to high end independent restaurants, hotels, and country clubs that sees an opportunity to increase its market share as smaller competitors struggle to recover. The company is pursuing growth initiatives that include a significant investment to boost warehouse capacity in its home market. This distributor's increase in capital spend to grow share is reflective of what Bessemer's private markets team is seeing with respect to heightened capital investment in secular growth markets as overall business conditions improve.

Conclusion

We intentionally left a question mark in our title, "Go Big and Go Home?," as it is difficult to gauge just how significant corporate investment will be in the coming years. The macro backdrop remains complicated, with tax and spending policies in flux in the U.S. and a less supportive environment for business in China developing simultaneously. That said, as we have discussed, from both a top-down strategy and bottom-up portfolio perspective, we see a strong case for a meaningful increase in corporate spending that can give legs to this economic expansion. Accommodative monetary policy can offset other policy hurdles. Continued reopening and greater activity levels will incentivize businesses to invest to ensure future capacity.

This backdrop remains supportive of growth-oriented assets, in our view, and informs our decision to maintain our modest overweight to equities versus strategic targets (Exhibit 13). While we recommend holding less in traditional bonds than long-term targets, we believe bonds continue to play an important defensive role in portfolios. As always, our clients' individual and family financial goals drive their individual allocations, and discussions with client advisors are key to those decisions. We will continue to navigate the investment landscape and welcome the engagement of our readers.

Exhibit 13: Bessemer Portfolio Positioning



Positioning as of September 30, 2021. 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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