Quarterly Investment Perspective

Honing in on the Economic Slowdown

BESSEMER TRUST

Holly H. MacDonald
Chief Investment Officer

Executive Summary

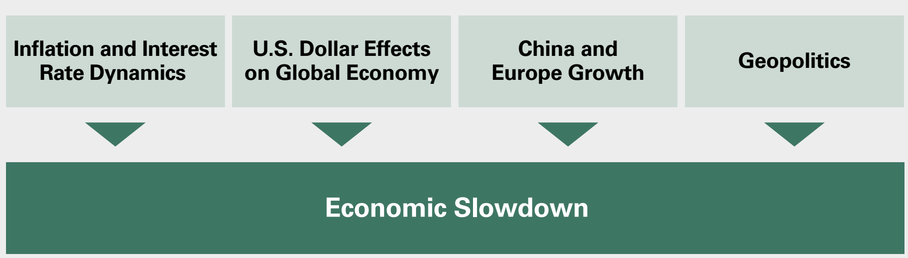
- **Given the complicated backdrop, market volatility remained high in the third quarter, with stocks ultimately finishing the three months modestly lower than where they began. Many trends drove the roundtrip — some improving, some worsening, and some holding steady.**
- **What do all of these trends mean for the economy? While we expect the slowdown to continue, we still believe a severe recession is unlikely. Some underlying components are encouraging and not consistent with a significant downturn, even as negative factors dominate the dialogue.**
- **In terms of portfolio positioning, we are significantly overweight the U.S. and emphasizing exposure to high-quality companies, which we believe are the most resilient in a slow-growth environment.**

The number of factors complicating the economic landscape is large and continues to evolve daily. Since the time of our last Quarterly Investment Perspective, "Navigating a Complex Market Environment," a few factors have improved modestly, while some have worsened, and others have remained steady. Improvements include a decline in energy prices from the highs, notable easing of supply chain obstructions, and some signs of peaking inflation and U.S. rate expectations, albeit with both remaining at high levels. Meanwhile, the effects of Fed hiking are clearly wrangling the economy: U.S. housing has slowed markedly, and more recently, the strong dollar is wreaking havoc on other countries, especially Japan and the United Kingdom (U.K.), whose currencies have plummeted and whose fiscal and monetary policies are in flux. At the same time, some areas remain unchanged: the U.S. labor market is tight, liquidity is mixed, and sentiment, by many measures, is near all-time lows. The economy is slowing, but a slowing economy does not necessarily lead to a severe recession. As we discuss in this paper, there are constructive elements in the consumer and corporate outlook that can offset negative factors. Especially considering that financial assets have at least partially priced in a slowdown in activity, we are comfortable holding high-quality stocks and bonds, which can outperform cash over time.

We hone in on the economic slowdown in this Quarterly Investment Perspective, focusing on the factors that we see as currently most relevant in determining how severe the economic slowdown becomes. As we note in Exhibit 1, inflation and interest rate dynamics in the U.S. remain the issue

Exhibit 1: Factors Complicating Economic Slowdown

Key Takeaway: Many factors are complicating the slowing growth environment.



Source: Bessemer Trust

at the top of the pecking order as the Fed continues to respond to contemporaneous inflation prints with aggressive hikes. As noted in our last publication, the Fed's overall framework for policy is to tighten financial conditions to a point that the economy slows and, in turn, the labor market cools while stickier inflation calms down. The Fed's calibration of policy faces evolving challenges. Rate hikes permeate the economy over time and certain signposts emerge with a lag. For example, while housing prices may start to cool more quickly, surveyed rental inflation takes months to appear in the official inflation numbers. Also, as the cost of capital increases, companies take time to slow employment searches or even lay off workers. In addition to the intended effects, the policies are having the unintended consequences of triggering stresses across the world. For unrelated reasons, there is slowing in China and Europe, which we also explore, with each tied to geopolitical developments that remain relevant.

This is not a short list of challenges and uncertainties, and we are continually revisiting our base case of a controlled slowdown or moderate recession in the U.S. At the same time, notable points of stability are often overlooked in economic and market discussions of late. While the low-income U.S. consumer is feeling the brunt of inflation, consumption overall remains intact while average cash levels are still high. The corporate sector in the U.S. is also healthy: Profitability is near all-time highs, and margins have room to give without signaling broad contraction. We explore these topics as well in the pages that follow.

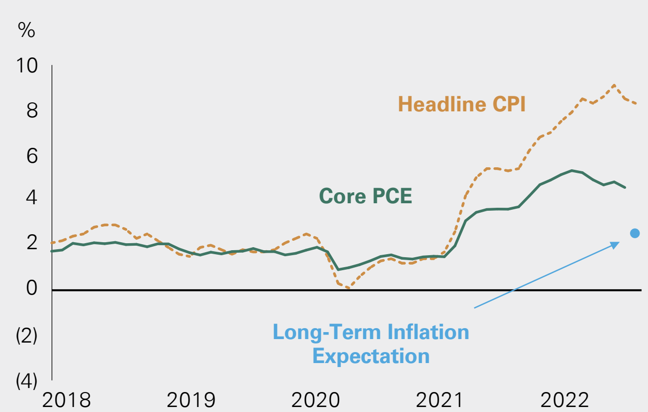
There are few asset classes that are not experiencing volatility and weakness. While Bessemer portfolios rebounded through most of July and all of August, both bonds and equities weakened again in September. Toward the conclusion of this paper, we discuss our portfolio positioning. Our emphasis has been on sticking with high-quality companies that we are confident can navigate a complicated macroeconomic backdrop; most of these companies are in the U.S., and U.S. exposure is relatively insulated from some of the more extreme geopolitical and other risks on the horizon. We have continued to upgrade portfolios and maintain the more defensive and commodity-oriented exposure that we have added throughout the year. This has been our preferred approach rather than adding to bonds in light of scenario analysis around the potential evolution of the slowdown. Alternative investments remain an important part of our platform and are providing some degree of safe harbor for qualified clients whose situations allow for giving up some liquidity in a portion of their portfolios.

Inflation and the Fed: A Race to the Peak

The Fed is now clearly focused on price stability and fighting inflation. The shift also has contributed significantly to market volatility, as the interest rate market has adjusted pricing for subsequent Federal Open Market Committee (FOMC) meetings following each inflation reading. This process may not be over, and monthly inflation data is volatile. At the same time, inflation looks to have peaked, as even with the recent upside surprises versus consensus, the June level in headline CPI and the March high in core PCE were not breached (Exhibit 2).

Exhibit 2: Inflation Metrics and Expectations (Year-Over-Year)

Key Takeaway: Inflation is showing signs of peaking; long-term expectations remain anchored.



Headline CPI as of August 31, 2022. Core PCE as of July 31, 2022. Long-term inflation expectation calculated using 5y5y USD inflation swap as of September 26, 2022.

Source: Bloomberg

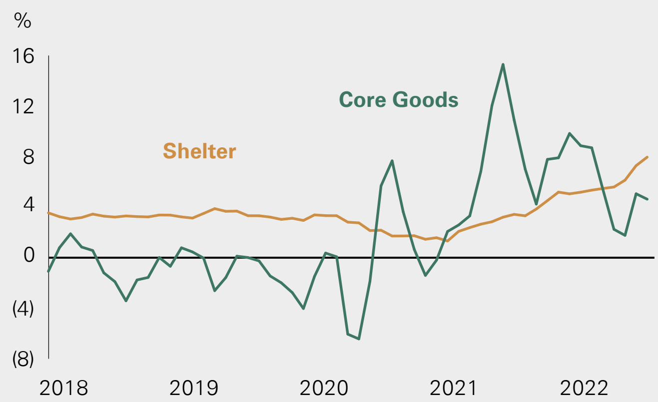
A closer look at the underlying drivers of inflation shows that core goods are decelerating significantly while other components, such as shelter inflation, are still proving persistent (Exhibit 3). The decline in goods prices is consistent with demand normalizing following a more sustainable economic reopening in most of the world, in turn easing pressure significantly on supply chains. Energy prices and food prices have also come off of their highs, though continued elevated risks in Europe suggest that energy prices are unlikely to fall significantly further from current levels (see page 6).

Wages are sticky at elevated levels but appear to be leveling off. One of the most problematic aspects of inflation is shelter inflation given that it constitutes approximately 17% of core PCE and 42% of core CPI and is likely to continue increasing for several months. It is important to note that there are meaningful lags in housing costs and aggregate inflation data. While both home prices and, according to alternative data, rents appear to have peaked in April, shelter inflation in the aggregate national inflation series may still show strength in the quarters ahead. In sum, while inflation likely has peaked, it could take several months before the downward trend gains significant momentum. We also note that in the background, money supply growth peaked more than a year ago and has been falling notably, which is a strong if unprecise longer-term indicator of lower inflation to come.

The Fed's future path will evolve with the upcoming data on the economy and inflation. At the same time, it is key that the Fed has now implemented the majority of this cycle's rate increases. With a 75-basis-point hike for November and 50 basis points for December expected by the market and reflected in the prices of short-dated fixed income, interest rate volatility should be declining over the coming few months. Indeed, the Fed has come a long way in terms of hiking rates relative to inflation expectations one year out, taking real rates from negative, or highly expansionary, territory to a positive level (Exhibit 4). These positive real rates raise the bar for investment and ultimately push companies and households to save. Savers begin to recognize that they are compensated to save relative to inflation, ultimately slowing the flow of money and

Exhibit 3: Core Goods Inflation vs. Shelter Inflation

Key Takeaway: While core goods inflation is showing signs of slowing, shelter inflation remains sticky.



As of July 31, 2022. Core goods basket excludes idiosyncratic items including pharmaceuticals, tobacco, and jewelry. Core goods versus shelter inflation chart data looks at 3-month SAAR (seasonally adjusted annualized rate).

Source: Bloomberg, Bureau of Economic Analysis

investment. This path contrasts with Europe and Japan, which have not moved the needle on real rates. Some emerging market countries, such as Brazil, on the other hand, have been quicker and more aggressive in their rate hikes.

Additionally, it is important to note the global differences in policy and the related ramifications. For example, currency volatility has accelerated, and the strength of the dollar could pose risks to global stability, as the ongoing volatility in the U.K. and, to a lesser extent, Japan is showing. As we write this publication, the situation in the U.K. is especially tenuous and highlights that the Fed may need to begin to incorporate global stresses into its framework for evaluating the efficacy of aggressive rate hikes going forward.

For the U.S., the concern in the market is somewhat less focused on the specific magnitude of additional Fed hikes this year but rather the fear that the Fed will need to keep rates high given overly persistent inflation with a slower growth trajectory. This backdrop prompts the worry of the Fed triggering a severe recession, essentially committing a "policy error." This is the main risk to our more sanguine view on

Exhibit 4: Global Real Rates

Key Takeaway: U.S. real rates have already priced in more interest rate changes relative to other countries, as interest rate volatility is likely to slow in coming months.

Country	1-Year Interest Rate Swap	1-Year Forward Inflation Expectations	1-Year Real Rate	Real Rate 1-Year Ago
United States	4.60%	3.20%	**1.40%**	(3.50%)
Europe	2.60%	5.20%	**(2.60%)**	(3.50%)
Japan	0.04%	1.30%	**(1.30%)**	(0.50%)
Brazil	12.90%	5.20%	**7.70%**	0.10%

As of September 26, 2022. Europe, Japan, and Brazil use headline consumer price index for one-year inflation expectations while U.S. uses Core PCE. Real rates one year ago for U.S. likewise looks at one-year interest rate swap minus core PCE, while Europe, Japan, and Brazil look at one-year interest rate swap minus headline inflation.

Source: Bloomberg

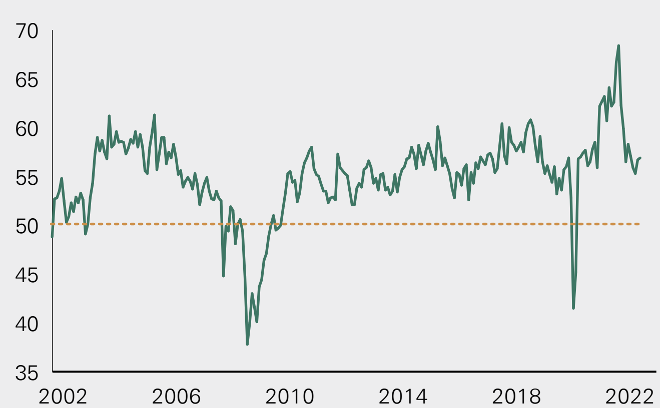
the state of the U.S. economy than some in the media and academic circles. We put some probability on this outcome yet note that the Fed under Chair Powell has shifted its framework for evaluating growth and inflation several times and could very well do so again. Some relief on inflation, which we expect, could give the Fed cover to look to forward indicators as it has more commonly in the past. While the economy is clearly slowing, a severe recession remains a low likelihood, in our view.

U.S. Economic Update: Slowdown Continues, but a Severe Recession Still Unlikely

Moving beyond inflation and the Fed, an analysis of the underlying components of the U.S. economy yields some encouraging signs consistent with continued growth. Services contribute close to 80% of U.S. GDP and remain robust. Americans overall are employed, wages and incomes are at strong levels, and the consumer continues to spend (Exhibit 5). This spending, in turn, has helped support profitability for corporations, which remains intact at high levels. Interestingly, these profits have allowed companies to continue expanding capital expenditures despite the uncertainty on the market and economic outlook. Many of the trends we discussed in our Quarterly Investment Perspective from Q3 2022 remain relevant, such as onshoring, driving activity in this space. While overall corporate profitability suggests there is room for margin compression from historically high levels, declining profitability can be an imprecise leading indicator of recession. Importantly, margins typically decline for at least several years before a sustained economic contraction (Exhibit 6).

Exhibit 5: ISM Services Index

Key Takeaway: Services contribute 78% of U.S. GDP and are robust, supporting profits.

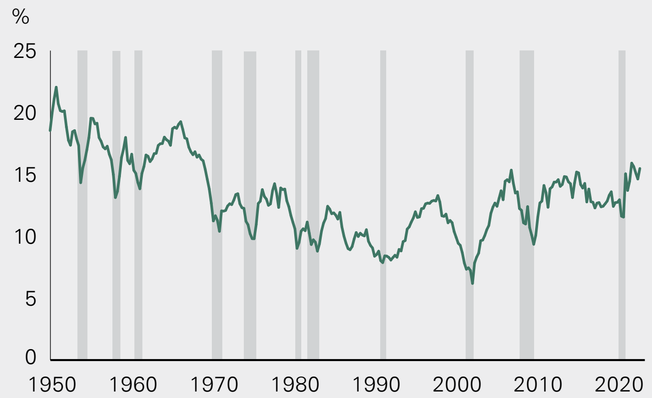


As of August 31, 2022.

Source: Bloomberg

Exhibit 6: Domestic Non-Financial Profits as a Share of Output

Key Takeaway: Currently, profit margins remain robust, indicating that companies have been able to pass on higher input costs.



As of June 30, 2022.

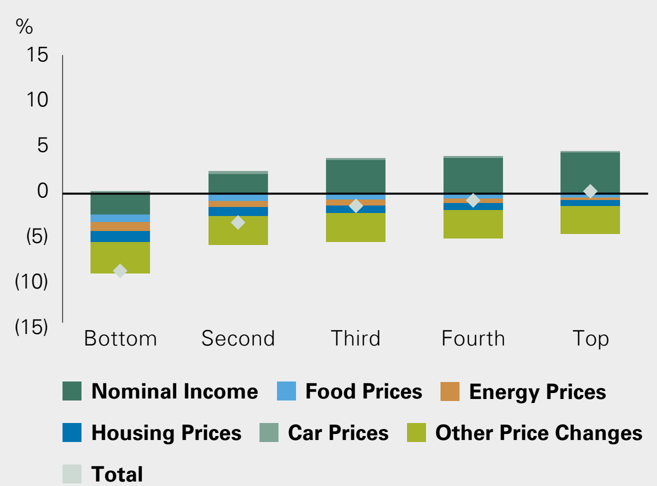
Source: RDQ Economics

One area of sincere concern in the U.S. economic outlook is how poorly low-income consumers are faring in light of higher inflation. Real income levels for this group are about 10% lower than they were last year, while the hit from inflation has been much more benign for higher-income groups, where wage gains have helped offset some of this pressure (Exhibit 7). This dynamic is relevant for politics and policy and for consumption trends for various items, with demand for branded staples starting to come under pressure in favor of generics, for example. For the overall U.S. economy, however, it is important that the top three income quartiles make up 82% of consumption and appear steady. Also, a closer look at credit card delinquency data shows only a modest increase for even the lower-end consumers in contrast to the lead-up to the 2008 recession, which showed marked increases (Exhibit 8).

The U.S. economy remains in a fluid situation as data normalize from distortions over the past few years. The economy is clearly slowing, and there are some data points consistent with historical periods of modest recessions. Monetary policy is tightening, resulting in an inverted yield curve. Financial conditions have notably weighed on housing activity and manufacturing. Consumption is slowing from elevated levels, reflecting depressed consumer sentiment and falling real incomes, and the global economy remains in the middle of an energy price shock. Bessemer's proprietary recession model acknowledges these dynamics, placing a higher-than-average probability of recession over the coming years. Importantly, however, long-run probabilities are subject to change, and current recession probabilities remain low. Many of the indicators mentioned above are normalizing from COVID distortions. Consumer balance sheets remain strong, and the labor market — probably the most important economic indicator — rests at some of the strongest levels in U.S. history by a variety of measures. While recession is not our base case in the short run, the economic outlook will remain sensitive to incoming data over the quarters ahead given the heightened economic volatility. It is also important to note that this economic environment is at least partially incorporated into financial market pricing.

Exhibit 7: Change in Real Disposable Income by Income Quintile From 2021Q4 to 2022Q4 Forecast

Key Takeaway: Lower-income consumers are feeling the brunt of inflation.

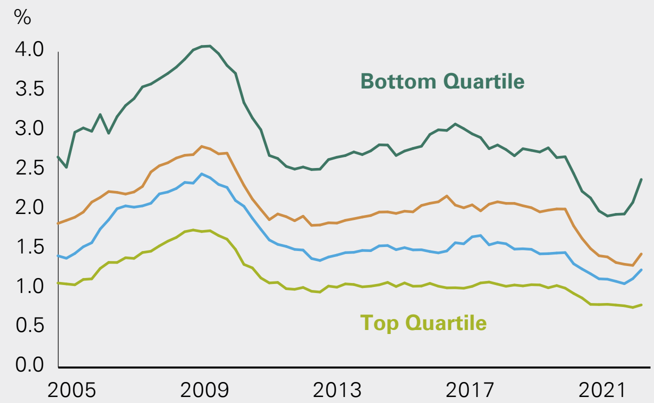


As of June 30, 2022.

Source: Census Bureau, Department of Commerce, Goldman Sachs

Exhibit 8: Credit Card Flow Into Delinquency by Zip Code Income Quartile

Key Takeaway: Delinquencies are below prior periods of economic stress.



As of June 30, 2022. Chart shows percentage of balances transitioning into delinquency by zip code income quartile, four-quarter moving average.

Source: Equifax; Internal Revenue Service, Morgan Stanley, New York Fed Consumer Credit Panel, Statistics of Income

Politics and Geopolitics: U.S. Is the Best House in a Bad Neighborhood

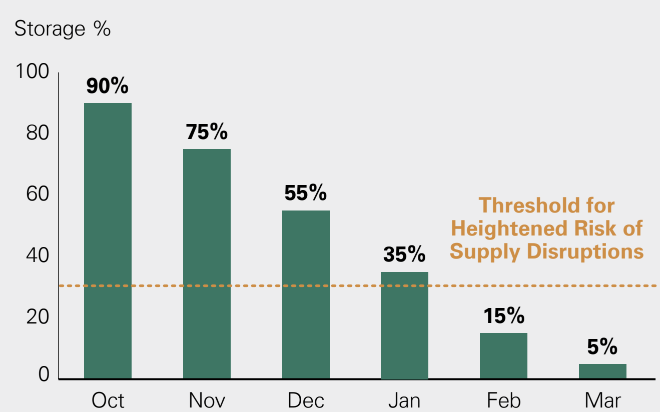
With so much focus on the challenges in the U.S. at the moment, it may be hard to find a silver lining. One observation is that as difficult as the conditions are domestically, the relative outlook is more constructive than it is for other key regions, such as Europe and China. Additionally, the political backdrop in the U.S. is likely to improve from a markets perspective following the resolution of the midterm elections, which will stem some degree of uncertainty and likely deliver a divided government.

For Europe, the energy crisis related to the devastating war in Ukraine and associated events looks to enter a dangerous phase this winter. Natural gas prices there are off their highs of the summer, but current stores do not appear sufficient to meet typical winter demand. If Russia's gas supply is cut off from the rest of Europe, it is very likely that there will be a significant supply crisis by February (Exhibit 9). This is a known factor and is likely playing into the game theory of Russia and the various parties supporting Ukraine's efforts. The situation is evolving rapidly with Ukrainians appearing to make some gains as Putin escalates his troop builds and threats of greater force. While a surprising resolution is possible, we anticipate the war and uncertainty related to it will remain a drag on European growth through at least this winter.

While much of the focus has been on Europe, we note that geopolitical risks related to China have been increasing. Specifically, Chinese-Taiwanese tensions have escalated meaningfully. The number of times China has violated Taiwan airspace in the past month has more than quadrupled versus historical trends (Exhibit 10). There may be many reasons for this acceleration, but our base case is that China is unlikely to bring Taiwan under its influence in the next several years. Additionally, Chinese official flows have become more relevant in global currency and commodity markets as well as in U.S. interest rate and real estate markets. In light of these risks, Bessemer portfolios have reduced exposure to companies within the region, resulting in an even greater underweight relative to the benchmark.

Exhibit 9: Russia Gas Cut-Off Scenario for the European Union

Key Takeaway: Europe looks to enter a precarious phase this winter.

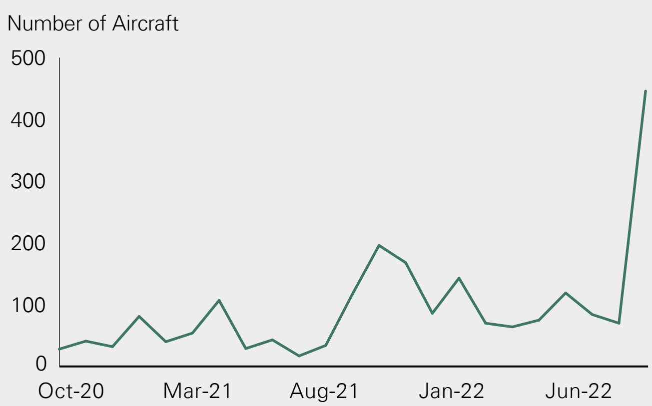


Looks at a potential evolution of European Union gas storage levels in event of complete Russian supply cut, from October 2022 assuming 90% storage levels.

Source: IEA

Exhibit 10: Chinese Military Aircraft Violating Taiwan Airspace

Key Takeaway: China-Taiwan tensions have escalated meaningfully.



As of August 31, 2022.

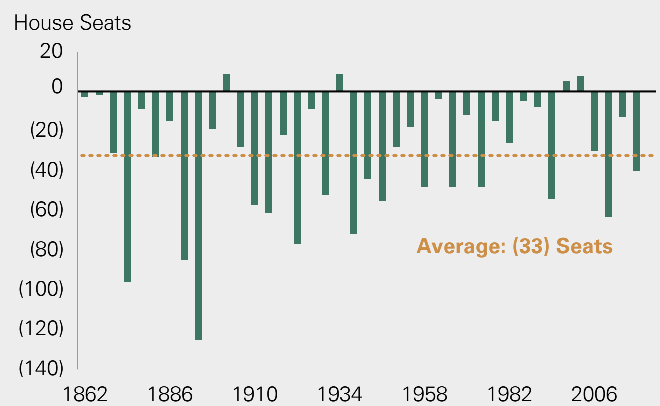
Source: Republic of China Ministry of National Defense

While we are monitoring these trends, the short-term outlook is more likely to be influenced by China's growth in the coming quarters. The continued lockdowns stemming from its COVID-zero policy are suppressing growth. Real GDP reached 8.1% in 2021, and the median economist now expects 3.5% growth for 2022, down from an estimate of 5.2% to start the year. The combination of slower activity and additional policies targeted at housing market speculation have triggered a significant property downturn that in turn threatens to weaken growth further. It is unlikely that these policies shift ahead of important Communist Party meetings this month in which President Xi is expected to be named president for an additional five years. That said, we note that youth unemployment has risen sharply due in part to these policies: 20% of 18- to 26-year-olds are now unemployed. If social stability is a primary goal of the government, we believe they will need to support growth soon or risk instability from this angle.

Meanwhile, for the U.S., near-term political uncertainty is likely to fade following the midterm elections. Given the one-party dominance in the past two years, the market has focused in the background on the potential for additional stimulus that could trigger greater inflation pressures as well as tax changes that could complicate the investing and corporate landscape. Markets have historically preferred divided government, and we think that is the most likely outcome following the midterm elections in early November. Specifically, in our view, Republicans are likely to win the House of Representatives while the Senate remains more of a toss-up given the nuances of individual races, including the retirement of a number of Republican senators. The House has historically been more susceptible to national trends, with the party of the president on average losing 33 seats, a margin that would easily give the Republicans a majority this time around (Exhibit 11). Statistical work looking at the effect of presidential approval ratings and inflation-adjusted gas prices also suggests the incumbent party will lose a significant number of seats in these midterms. Please see "Midterm Elections — Markets, Policy, and Implications" from Investment Strategist Bree Sterne and Investment Strategies Analyst Madeline Simone for more details.

Exhibit 11: Number of Seats Won or Lost by an Incumbent President's Party in Midterm Elections

Key Takeaway: An incumbent president's party tends to lose seats in midterm elections.



As of December 31, 2018.

Source: Brookings Institute

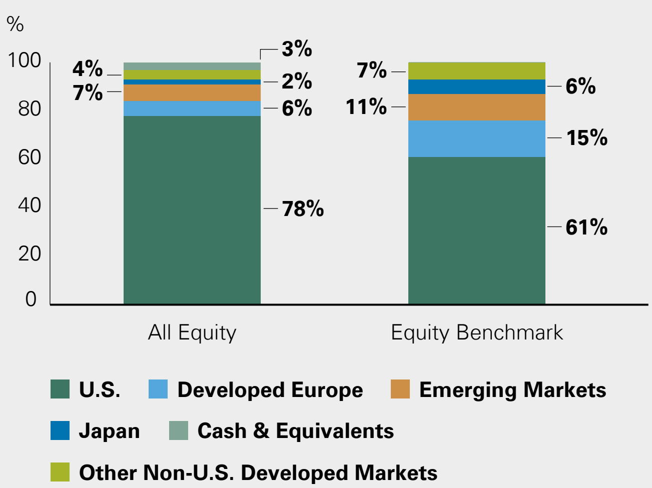
The takeaway from the evolution of geopolitical and political risks leaves the U.S. looking like the best house in a bad neighborhood and informs the portfolio positioning that we discuss in the section below.

Bessemer Positioning

Within equities, portfolios are significantly overweight the U.S. given the relative macro backdrop. An all-equity portfolio currently has a 78% allocation to U.S. equities versus 61% for its respective benchmark, one of the largest overweights to the region in recent history. We continue to emphasize exposure to high-quality (low debt levels, strong cash flow, high returns on capital) companies, which we believe can best ride out a slow-growth environment. Looking ahead, we expect the gap between high-quality and low-quality company performance to narrow, which is likely to benefit portfolios in the medium term.

Exhibit 12: All Equity Regional Weights

Key Takeaway: Bessemer has a strong U.S. overweight relative to the benchmark.



As of August 31, 2022. Figures may not sum to 100% due to rounding. "Other Non-U.S. Developed Markets" includes Canada, Israel, and Asia Pacific ex-Japan. The Equity Benchmark represents the MSCI All Country World IMI.

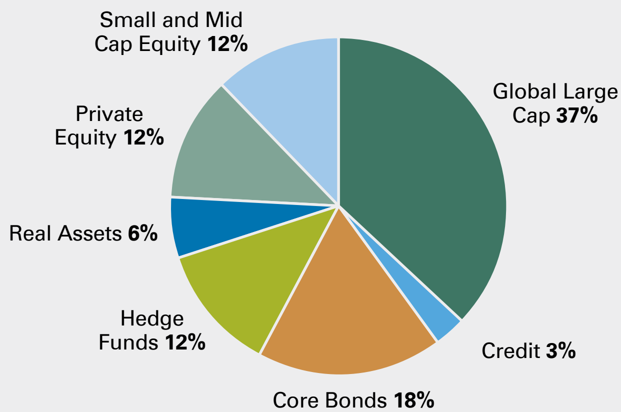
Source: Bessemer Trust

If the odds of a severe recession do increase, we will not hesitate to add to our bond holdings. For now, we are maintaining ample exposure to equities, with a focus on the defensive and commodity oriented equities we have added this year, which are better suited than cash or bonds for the current outlook, including still-high volatility in interest rates. We also have the flexibility to further buffer portfolios through adjustments to duration amid the evolving interest rate environment. While we acknowledge and are actively monitoring downside risks, we note that, with market positioning skewed so negatively, even modest changes in the Fed's stance could prompt a large market move, suggesting a focus on strategic asset allocations and modest shifts remains the preferred approach.

Furthermore, alternative investments can play a pivotal role in a key pillar of our investment philosophy: to both participate on the upside and protect on the downside. In a portfolio, private equity exposure may help provide qualified investors with added diversification and enhanced return potential over the long term. It also provides access to unique opportunities not available in public markets that can lead to a rate of return in excess of public markets. Historically, private equity has amplified participation in market upside, while hedge funds can aid with downside protection. Hedge funds can provide unique return streams that cannot be replicated with long-only strategies. Bessemer's hedge fund allocation has been constructed to add value relative to a purely liquid stock and bond portfolio over the course of an economic cycle. An integrated approach utilizing alternatives within an overall asset allocation has helped clients both participate and protect in a challenging year for markets.

Exhibit 13: Balanced Growth 70/30 With Alternatives Asset Allocation

Key Takeaway: Bessemer has recently increased its exposure to private equity and balanced its hedge fund allocation.



As of September 30, 2022.

Source: Bessemer Trust

Conclusion

The macroeconomic and market landscape remains complicated, yet a severe recession in the U.S. continues to appear unlikely to us. Even as the low-end consumer is challenged, services activity and corporate profitability are intact. As the Fed nears the end of its hiking cycle, we expect volatility to subside and the market again to reward higher-quality companies, which have lagged this year but tend to outperform over economic cycles. We are adjusting portfolios to adapt to this evolving backdrop while remaining true to our commitment to long-term preservation of capital and upside participation so that our clients meet their financial goals.

Our Recent Insights

Midterm Elections — Markets, Policy, and Implications — Investment Insights (August 2022)

Investment Deep Dive: A Roundtable With Bessemer's Fixed Income Portfolio Managers — Investment Insights (August 2022)

Investment Deep Dive: A Roundtable With Bessemer's Alternatives and EMS Portfolio Managers — Investment Insights (August 2022)

Investment Deep Dive: A Roundtable With Bessemer's Equity Portfolio Managers — Investment Insights (July 2022)

Navigating a Complex Market Environment — Quarterly Investment Perspective (July 2022)

Market and Portfolio Thoughts Around Fed Meeting — Investment Insights (June 2022)

Cooling a Hot Housing Market — Investment Insights (June 2022)

Inflation Update in Five Pictures — Investment Insights (June 2022)

To view these and other recent insights, please visit www.bessemer.com.

About Bessemer Trust

Privately owned and independent, Bessemer Trust is a multifamily office that has served individuals and families of substantial wealth for more than 110 years. Through comprehensive investment management, wealth planning, and family office services, we help clients achieve peace of mind for generations.