Quarterly Investment Perspective

Still Standing: The Nuanced Resilience of the Economy and Markets

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Executive Summary

- **The economy and markets displayed striking resilience in the first half of 2023, especially given the continued reverberations of last year's shocks.**
- **We believe that inflation is declining and that a severe recession remains unlikely, although the strength of the economy has become less certain. That said, the Fed is close to finishing its hiking cycle and will ease if the economy appears vulnerable.**
- **We maintain our view that bonds and equities can continue their recovery, and we continue to recommend a modest portfolio overweight to equities with a heavy tilt to the U.S. One area of strength that we expect to persist is semiconductors along with other related products tied to artificial intelligence.**

As the aftershocks of 2022 have continued to reverberate in 2023, the resilience of the economy and markets has been striking. Our base case for the year has been that the economy could avoid a severe recession and that both equities and bonds would post a recovery as worst-case scenario outcomes were not realized. While that view is largely on track, the strength of the markets has surpassed expectations. In 2023, U.S. equity markets are up 16%, global equities are up 12%, and high-quality bonds have returned 1.3% as market interest rates have trended lower.[1] The fact that the U.S. experienced three of the four largest bank failures in history this year underscores this resilience. But bank failures are an example of a sharply higher cost of capital, and we think that the odds of additional aggressive Fed hiking are much lower, which is positive for the overall outlook that we set out at the beginning of the year. A representative 70/30 Balanced Growth model portfolio returned 10% in the first half of the year, modestly ahead of its benchmark.[2]

In this Quarterly Investment Perspective, we discuss the nuances of the resilient economy and markets, which are summarized in Exhibit 1. We have a high degree of confidence that inflation is declining, but the strength of the economy looks more precarious, even as a severe recession remains unlikely. The Fed is close to finishing its hiking cycle and will keep rates high as long as it can; we believe it will respond if the economy shows vulnerability, and indeed, Fed members already have provided support through banking backstops and direct funding starting in March. Structural growth themes related to artificial intelligence (AI) go some way to offsetting the risks around higher interest rates.

Exhibit 1: Outlook and Update for Key Indicators

Key Takeaway: A resilient economy looks to slow alongside easing inflation.

	Year-End 2022	Initial 2023 Expectation	2023 Progress
Economic Growth	Fear of deterioration	Slower growth	Resilient
Labor Market	Tight	Rebalancing	Signs of rebalancing
Inflation	Elevated but cooling	Easing	Slow deceleration
Fed	Nearing cycle end	Pause	Data dependent

Source: Bessemer Trust

[1] Returns are year-to-date price returns as of June 30, 2023.
[2] Please see disclosures on page 8 for a description of the balanced growth portfolio.

Additional discussion topics in this issue include an update on the importance of semiconductors in the economy and our portfolios as well as related geopolitical factors.

Overall, investor positioning remains skewed away from risk assets in favor of cash with historically bearish positioning suggesting that equities and bonds can remain supported even as a high cost of capital makes the economy vulnerable to shocks and keeps the outlook nuanced.

Lower Inflation, Slower Growth Allow for End to Fed Hiking Cycle

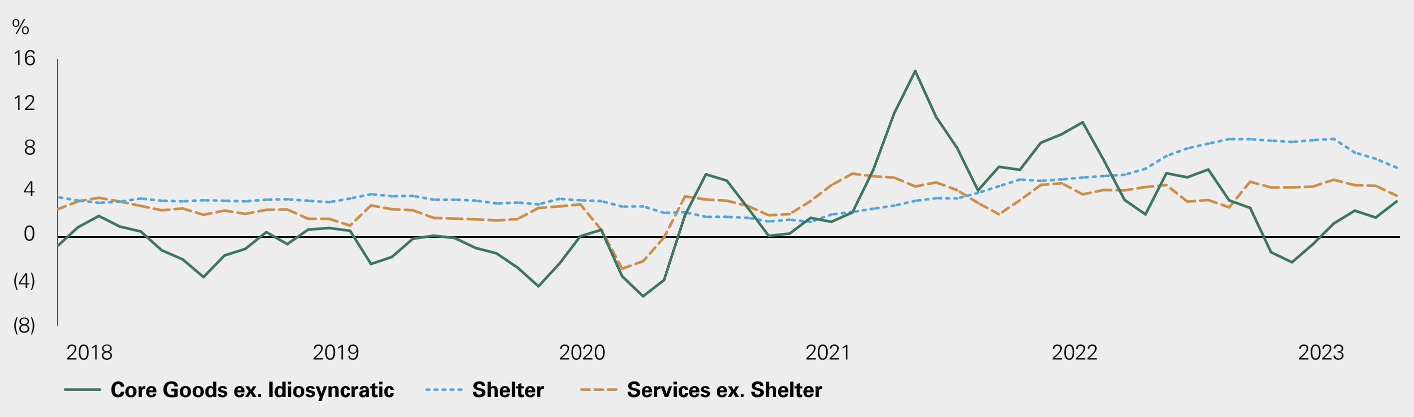
High inflation, aggressive and variable Fed hiking, and resulting concerns of a severe recession have continued to recede in 2023. We provide a brief update on each below.

Inflation: Lower shelter costs to add to downside momentum. The downtrend in inflation is clear and should gain momentum in the coming months (Exhibit 2). Core goods prices (which accelerated due to stimulus payments), excess demand for particular pandemic-related items, and supply chain challenges have now corrected, albeit with continued volatility on a month-to-month basis. Shelter prices have been slower to revert in part because of the way the data is calculated; the turn in the core data is clear and all the more compelling in light of the plummet of forward-looking shelter data. For example, Zillow rent prices peaked at 16% year-over-year in February 2022 and are now running at 4%. Higher interest rates have slowed activity in the housing market, which is feeding into additional price metrics. Other service prices appear to have plateaued around 4% and are most responsive to the labor market. While the labor market remains strong, there are declines in the number of job openings, and nominal earnings have ticked down from 6.7% in July 2022 to 6.0% in May.

Given the numerous ways of calculating inflation and the inherent lags in the analysis, it can be helpful to take a step back. Headline inflation reached nearly 10% a year ago. The concern at the time was not just the extremely high level of inflation but that there was no turn in sight. Additionally, inflation expectations were rising, which can produce higher actual readings. While the Fed focuses most on core PCE (personal consumption expenditures), high energy and food prices were driving headline and inflation expectations. Now, headline inflation is less than half of what it was a year ago. Aside from the detailed outlook on individual constituents, excess money in the system from stimulus payments is drying out, with

Exhibit 2: Main Components of U.S. Core PCE Inflation

Key Takeaway: Inflation remains elevated, though peak inflation is likely behind us.

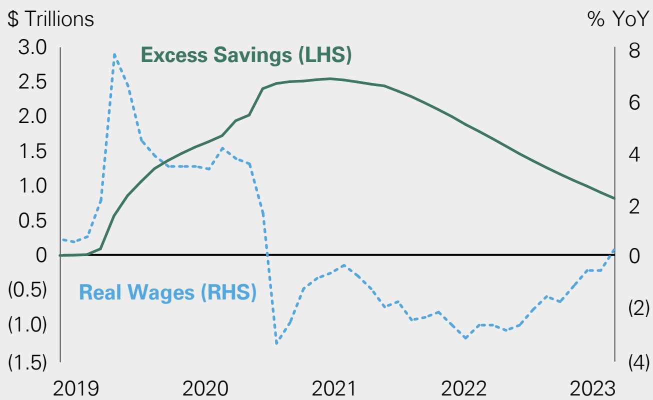


As of May 31, 2023. Core goods basket excludes idiosyncratic items including pharmaceuticals, tobacco, and jewelry. Services exclude energy services and shelter prices. Data reflects 3-month SAAR (seasonally adjusted annualized rate).

Source: Bloomberg, Bureau of Economic Analysis

Exhibit 3: Excess Savings and Real Wages

Key Takeaway: Consumers are spending down excess savings, but real wages are increasing as inflation declines.



As of May 31, 2023.

Source: Bloomberg, Federal Reserve

M2 now contracting 4% from a peak expansion of 27% in February 2021. Additionally, inflation expectations are well contained, as evidenced by the decline in TIPS breakevens and other market-based indicators. In the background, inflation is still above the Fed's target, and high prices are a challenge for many individuals and parts of the economy, but inflation itself is moving in the right direction.

Growth: Consumer strength persists as activity indicators slow. So far, growth has been stronger than we expected for the year; we still anticipate additional economic slowing but a severe recession to be avoided. Strength in consumption has offset inventory drags to keep GDP around 2% in 2023 so far. Robust labor markets and excess COVID related savings have helped consumers continue spending at higher price levels. While we note that savings are dwindling and the labor market is softening, we think declining inflation in the context of steady wage gains is an important offset: Consumers' wages in real terms are now positive (Exhibit 3). Overall, we expect consumption to remain relatively steady despite a shift in the proportion that consumers spend on goods versus services. Please see our Investment Insights "Consumer Resilience Persists, Though Nuances Have Emerged" by Investment Strategies Analyst Madeline Simone for further details.

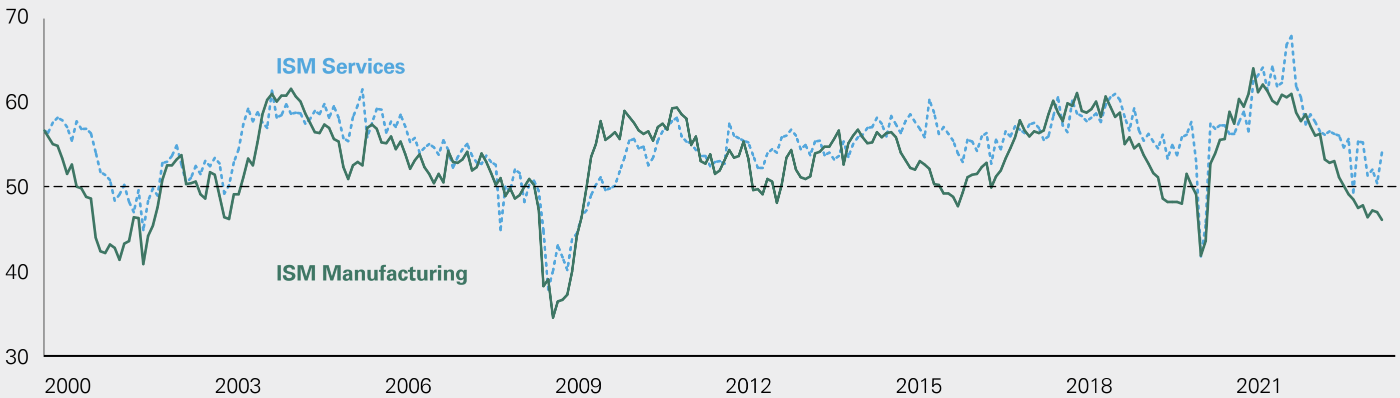
We expect growth to be slower going forward as the effect of higher rates continues to work its way through the economy. Indicators of service and manufacturing activity point to contraction, and future demand components indicate continued weakness (Exhibit 4). We address concerns about banking in the following section; overall, these also point to weaker activity but look unlikely to drive a severe risk-off environment. On the non-U.S. front, worst case outcomes this year were avoided for Europe with a mild winter amid the ongoing war in Ukraine. Still, higher rates are having a similar effect there and are likely to weigh on European growth. China reopened quickly out of the gates, but that momentum has subsequently slowed; we do not expect a boost to global GDP from China stimulus or activity as the government is primarily focused on mitigating downside risk across all areas. Overall, while there is investment occurring across many sectors, some of which is structural, the cyclical backdrop continues to point to slowing.

Interest rates: Fed ending hiking cycle and can ease if necessary. The backdrop of lower inflation and slowing growth puts the Fed in a position to end its rate hiking cycle and ease if necessary in the coming quarters. The increase in rates was dramatic and rapid, and a higher cost of capital continues to be felt in the economy. While much of the slowing is anticipated and indeed a goal of the policy, the significant bank failures earlier in the year were an unintended consequence and point to the hard-to-gauge risks of hiking further. The Fed in effect had to inject more liquidity into the system to backstop banks, which works in the opposite direction of its rate hikes. A July hike is increasingly priced, and the Fed is likely to deliver.

The Fed under Powell has shown itself able to shift frameworks for its policy quickly, moving from an extremely accommodative stance in real terms in 2021, when it deemed inflation as "transitory," to hiking aggressively in 2022. The Fed is not shifting its rhetoric and maintains a high forecast for future rates (Exhibit 5). But we do not expect any

Exhibit 4: ISM Manufacturing and Services

Key Takeaway: Forward-looking economic data have softened and point to a continued slowdown.



As of June 30, 2023. A reading above/below 50 generally indicates an expansion/contraction of the overall economy.

Source: Bloomberg

foreshadowing of future easing — easing works better as a surprise — and if weakness in the labor market emerges or an unexpected challenge to the economy arises, the Fed can shift quickly as it has in the past.

Structural Growth: A Closer Look at Semiconductors

While a strong economy can lift all boats, companies that control their own growth make for more compelling investments over time, especially so when broader GDP is subdued. Having an innovative and hard to replicate approach to a structural growth theme is one way to gain a competitive advantage. We discussed one such theme, artificial intelligence (AI), at length in our last Quarterly Investment Perspective. We anticipate an ongoing conversation with clients on this exciting area that we have been actively researching and investing in for years. It will take time to determine the winners and losers related to innovations in this space, and we are working on this from a macro and micro perspective as developments will affect both the broader economy and individual companies.

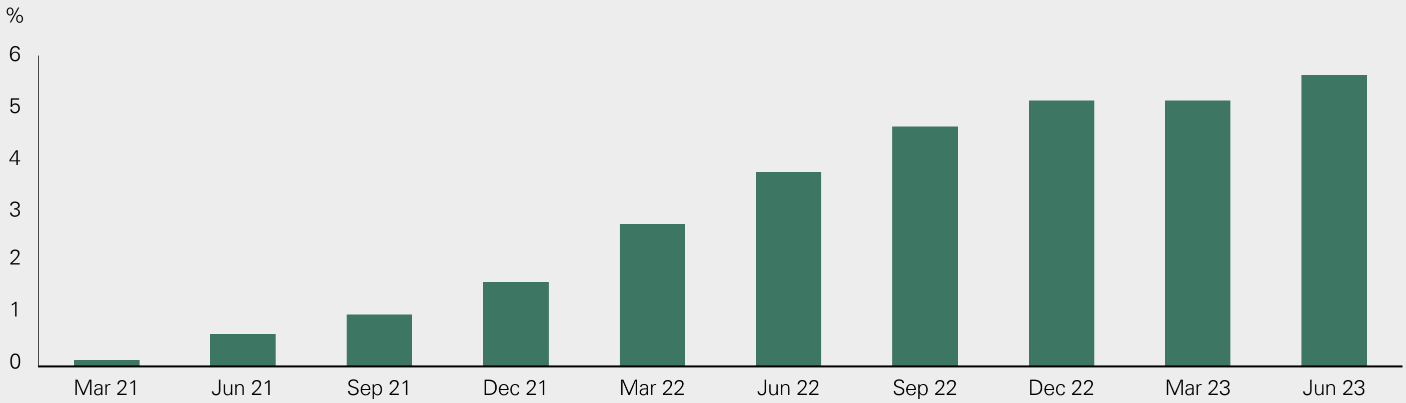
One winner, in our view, is semiconductors broadly, especially advanced logic chips and their associated value chain. Given the importance of data across industries, semiconductors are currently used in everything from washing machines to cars to self-directing missiles, and so, as a group, they are to a large extent more cyclical in nature, moving with the overall economy. The space is so large now that it almost warrants its own sector, and certain aspects are more structural than cyclical, in our view. The advanced logic chips necessary for AI fit in the structural category and have been in focus this year given headline product releases such as ChatGPT.

The supply chain for semiconductors is complicated and global and, thus, vulnerable to geopolitical or other disturbances. While the U.S. is a dominant player in design and consumption, Taiwan and Korea are crucial for manufacturing, and China is key for end-product assembly. We are invested across the supply chain and show examples of key holdings in Exhibit 6.

Bessemer holding Nvidia is currently the world's most valuable semiconductor company, a status achieved due to its prominence in the field of accelerated computing. The company has established itself as a leader in the development of graphics processing units (GPUs), and its GPUs have led the market in training AI models. Cadence Design Systems is also a leading supplier of electronic design automation software, hardware, and intellectual property that automates the design and verification of integrated circuits or larger chip systems;

Exhibit 5: FOMC Median Projection for Year-End 2023 Interest Rates

Key Takeaway: Federal Reserve members dramatically changed their expectations for December 2023 interest rates during 2022.



As of June 14, 2023.

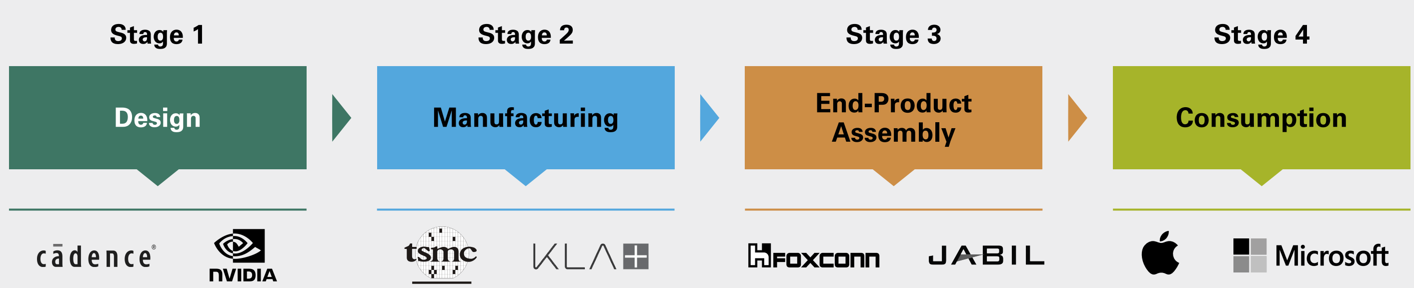
Source: Bloomberg, Federal Reserve

we believe that the company is positioned well to benefit from increasing chip complexity and technological innovation with respect to artificial intelligence. In terms of manufacturing, KLA is a key supplier of the manufacturing equipment necessary to produce these advanced semiconductors, and we believe that it is well positioned to capture increased demand for its process control and measurement tools as semiconductor fabrication capacity and chip complexity increase. After the semiconductor is assembled into its final packaging, end customers such as Apple incorporate these chip products into their devices to be sold to the public. Apple is a dominant player in the smartphone and personal computing markets where the consumer can access AI-enabled programs such as ChatGPT and Google's Bard on Apple devices.

Exhibit 6: Global Semiconductor Supply Chain and Key Bessemer Holdings

Key Takeaway: The supply chain for semiconductors is complicated and global.

Global Semiconductor Supply Chain

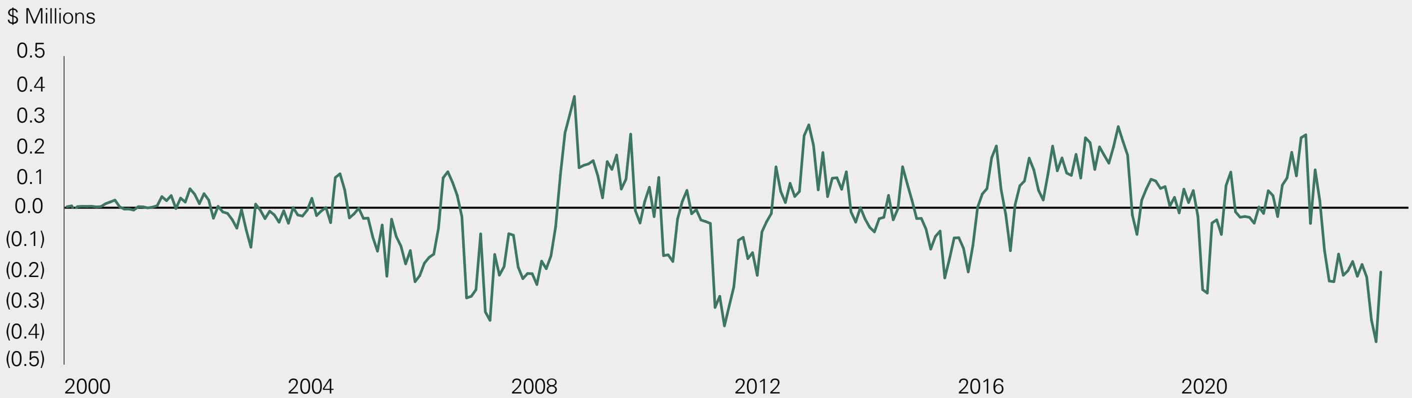


As of June 30, 2023. Bessemer's All Equity Model Portfolio maintains positions in each of these companies aside from Foxconn and Jabil.

Source: Bessemer Trust

Exhibit 7: S&P 500 E-Mini Positioning

Key Takeaway: Negative positioning may support continued gains.



As of June 27, 2023.

Source: Bloomberg

In our view, regardless of the overall end winners, with additional progress in artificial intelligence, the demand for semiconductors will continue to accelerate at a robust pace, and certain companies have dominant roles that are difficult to replicate given the expertise required to design and produce at scale. While valuations and cyclical considerations will affect our position sizing and near-term conviction, we anticipate this theme to persist in portfolios.

Positioning: Security Selection Can Mitigate Risks

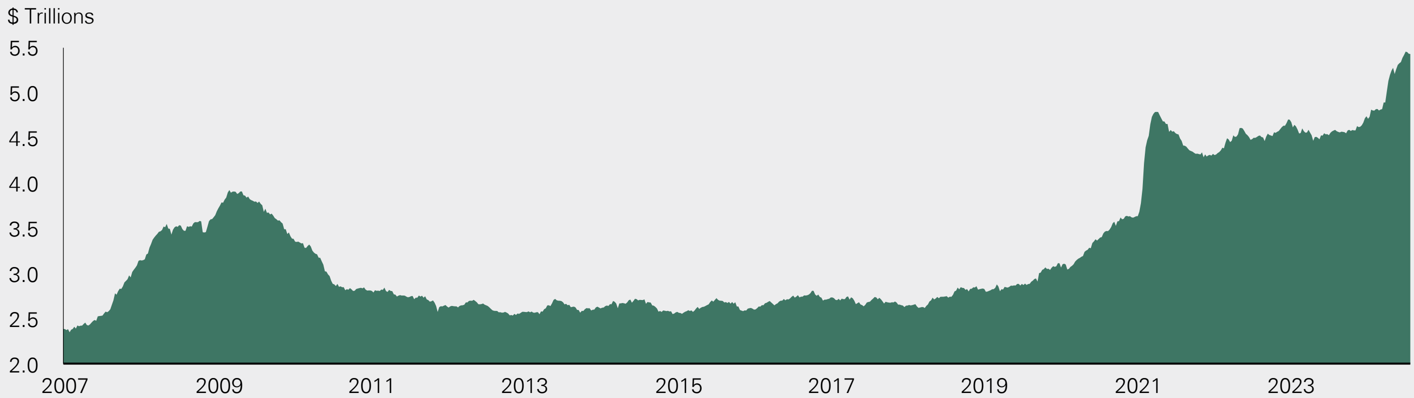
The economic backdrop is not extremely robust, but it is meaningfully better than many of the dire scenarios that became consensus in 2022. Activity is slowing, but we maintain our view that a severe recession will be avoided. Inflation is slowing, and while the labor market remains strong, signs of cooling are emerging. Uncertainties linger, but high-quality companies can continue compounding earnings in this environment. While slower growth and a high cost of capital make security selection all the more important, still-bearish positioning and record-high levels of cash suggest that markets can tick higher as the economy continues to inch forward (Exhibits 7 and 8). After a handful of technology stocks initially drove gains early this year, market breadth now is improving, with 62% of S&P 500 members above their 200-day moving average. Our overweight position in the technology sector detracted from performance in 2022, but its recovery has benefited portfolios this year.

Taking these factors together, we continue to recommend a modest overweight to equities with a heavy tilt to the U.S. in portfolios given the relative macroeconomic outlook, assessment of risks, and proliferation of high-quality U.S. companies. We believe that bonds are a better risk mitigator than cash in portfolios now that the Fed can — and will, in our view — ease if the backdrop worsens. Most bond portfolios have durations longer than benchmarks given these dynamics. Additionally, a higher cost of capital should keep volatility above the last cycle average, which is more conducive to hedge fund performance. Private assets remain an important component of our long-term approach to diversified portfolios (Exhibit 9).

Of the known unknowns, the biggest risk to equity markets in our view continues to relate to interest rates and the unintended effects of past Fed hikes.

Exhibit 8: Total Money Market Fund Assets

Key Takeaway: Money market fund assets rise to an all-time high.



As of June 28, 2023.

Source: Bloomberg, Investment Company Institute

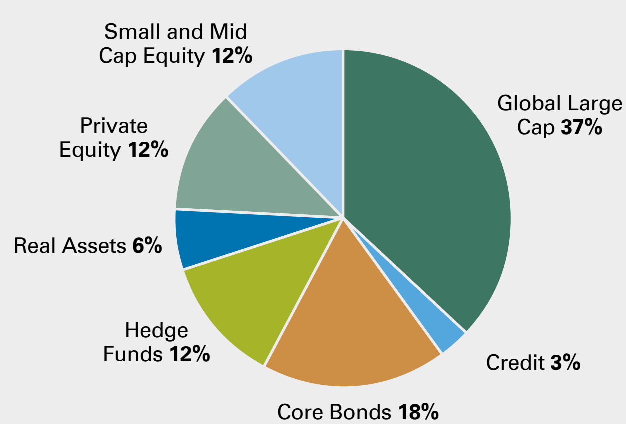
Stressed smaller and regional banks, especially those with specific commercial real estate exposures, can remain a drag on the economy through less lending and potentially disruptive capital raising events. While the Fed's backstops and ability to ease suggest a low probability of a widespread banking crisis, individual institutions may not be as steady. We take this into account in our security selection and are underweight banks overall. The analysis of our portfolio teams is key in this regard. Stress testing from regulators has been evolving and will now include a discussion of an "exploratory market shock" to better anticipate the evolving landscape; we note that in only two of the prior 10 years have regulators focused on risks from higher interest rates as there was greater concern with banks' ability to earn in a low-rate environment.

Of the unknown unknowns, geopolitics is at the top of the list per usual. Investments in the defense sector, including cybersecurity, are plentiful in our portfolios, and an uncertain landscape also skews our focus more to the U.S. than might otherwise be the case. Even with the challenges of our own political environment, the dollar remains the dominant base currency and the preferred destination of flight-to-safety funds.

Amid an uncertain backdrop, we continue to benefit from the long-term approach of our teams and our alignment with our clients' financial goals. Thank you for your trust in us, and please contact your advisor if we can help in any way.

Exhibit 9: Balanced Growth 70/30 Asset Allocation with Alternatives

Key Takeaway: We continue to recommend a modest overweight to equities with a heavy tilt to the U.S. relative to other areas.



As of June 30, 2023.

Source: Bessemer Trust

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