Quarterly Investment Perspective

2024 Outlook: Another Wave in a Highly Unusual Cycle

Holly H. MacDonald
Chief Investment Officer

Executive Summary

- **Despite a significant rebound in markets and above-average returns in 2023, uncertainty persists as this highly unusual economic cycle continues to unfold.**
- **In 2024, above-trend growth is set to slow alongside lower inflation, allowing the Fed to ease sooner rather than later. We expect a severe recession to be avoided, and non-recessionary rate cuts can be supportive for both equities and bonds.**
- **There are likely to be bumps in the road, especially because consensus has turned decidedly more positive in the past year.**
- **Bessemer portfolios start the year with a modest overweight to equities but with some cautious elements in our positioning. These include a focus on U.S. equities, reduced cyclical exposure, a longer duration in bond portfolios, and higher credit quality allocation.**

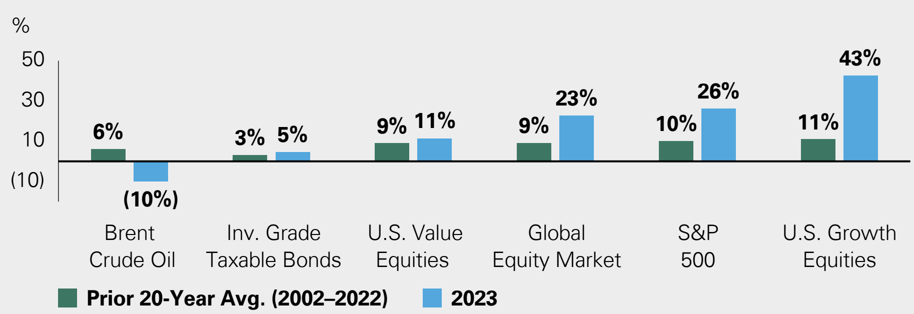
With 2023 now in the rearview mirror, we continue to grapple with a key question: Why don't we all feel better?

Reality was certainly far more positive than most 2023 forecasts. Ninety-one percent of CEOs surveyed in late 2022 expected a recession, but growth consistently surprised to the upside during the subsequent quarters. Markets also recovered a significant amount of 2022's decline and delivered returns above long-term averages, with the S&P 500 ending 26% higher led by a robust rebound in growth stocks. Companies continued to deliver earnings in the back half of 2023, with S&P 500 third-quarter earnings up nearly 6% year-over-year. While the Fed kept hiking interest rates and the U.S. deficit was increasingly in focus, rates fell sharply across the entire yield curve in the last three months of 2023, helping bonds deliver relatively strong returns (Exhibit 1).

Heading into 2023, we predicted that the U.S. economy would avoid a widely forecasted deep recession, but even our above consensus expectations were outpaced by growth that was well above trend. Our overweight to equities and continued preference for higher quality stocks added value after a difficult 2022, but we were surprised by the robustness of overall stock market returns, especially growth stocks, which were up over 40%. Banking woes earlier in the year were also a surprise, although we did expect the aftershocks of aggressively tighter monetary policy to be a dominant story. Amid the disruptions, however, the economy and financial markets proved resilient.

Exhibit 1: 2023 vs. 20-Year Annualized Asset Class Performance

Key Takeaway: The year 2023 saw above-average long-term returns across most asset classes.

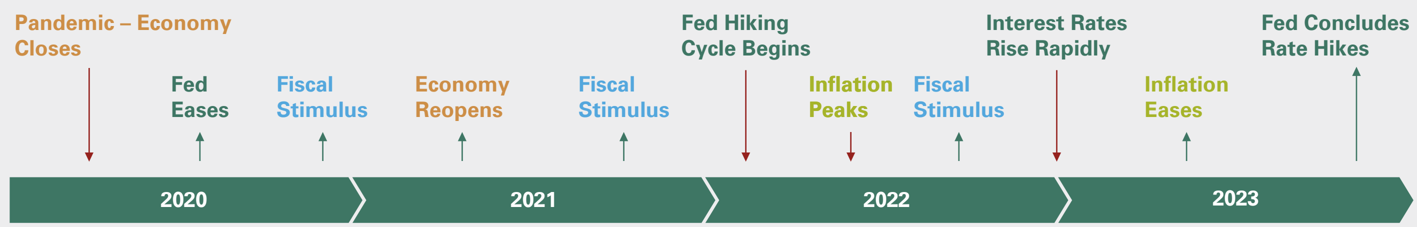


As of December 31, 2023. Returns look at total return of each asset class where applicable. The asset class performance is measured using the following indices: value equities (Russell 1000 Value), growth equities (Russell 1000 Growth), global equity market (MSCI AC World IMI), U.S. investment grade taxable bonds (ICE BofA 1-10 Year AAA-A U.S. Corporate and Government Index).

Source: Bloomberg

Exhibit 2: Timeline of Major Shocks and Policy Responses

Key Takeaway: This has been a highly unusual economic cycle.



As of December 31, 2023.

Source: Bessemer Trust

At the same time, about 70% of Americans believe the economic outlook is getting worse, a statistic that is unchanged since 2022, and confidence levels remain in the lower range of the prior five years, even as consumers continue to spend. Certainly, the advent of high inflation in 2022 is part of the answer — even as inflation rates fell notably in 2023, essential household goods and services remain 20% above pre-COVID levels. While lower-income consumers feel it most acutely, some median-income earners now believe the American Dream is out of reach: 75% of homes for sale are too expensive for them as housing affordability has hit a record low. Adding fuel to the fire are longer-term trends that seem to have worsened. Political polarization has reached levels not seen since the 1970s as Americans' trust in institutions has fallen to an all-time low of 26%, and geopolitical risk has risen to the forefront amid two major wars and a shift toward a multipolar world.

As we have contemplated the outlook for 2024, it has been helpful to frame these seemingly inconsistent developments to gauge how they will evolve in the year ahead. One key perspective is that due to the pandemic itself and the subsequent policy response, this economic cycle has been highly unusual, making direct comparisons to prior cycles risky. Often, business cycles are framed neatly by a recession on one end, Fed easing and an expansion in the middle, and overheating and another recession on the other end. Fiscal stimulus is generally a factor but has tended to be more pronounced in periods of economic contraction.

This time around, after the global economy essentially shut down for months in the spring of 2020, massive easing and fiscal stimulus occurred at unparalleled levels (Exhibit 2). A reopening of the economy caused additional complications, including supply chain stresses and commodity price spikes exacerbated by Russia's invasion of Ukraine. At least two additional massive fiscal spending programs followed the first, which typically doesn't occur when the economy is growing. Inflation spiked to levels not seen in decades but came down meaningfully over the course of last year. This is a highly unusual cycle with very few, if any, apt comparisons. Even the high inflation period of the 1970s is not a good parallel given the conditions described above.

Volatility itself is unsettling, and the last few years have not been lacking in this regard. The unusual nature of this cycle has caused extreme swings in key economic and market indicators. The money supply, for example, reached an all-time high of 27% growth year-over-year and now is in negative territory. Neither scenario is normal, and the swings in money supply can help account for many of the other extreme moves witnessed in the past four years (Exhibit 3).

Underlying aspects of the economy also have shown a greater degree of dispersion in this cycle given the extreme nature of the shocks (Exhibit 4). This creates waves of acceleration and deceleration across various sectors at different times, adding to a feeling of uncertainty.

For example, while one could argue that the technology sector was in a recession in 2022, it surged in 2023 due to greater stability in interest rates and enthusiasm for artificial intelligence advancements. Meanwhile, housing remained quite weak in 2023 after booming in 2020 and 2021.

Markets are no exception to these trends, with the median sector dispersion in the S&P up about 30% in the past few years relative to the prior 10, and the one-year rolling

Exhibit 3: Economic Indicators: Long-Term Average, High and Low Since 2020

Key Takeaway: Shocks in this cycle have led to extreme moves in key indicators.

Indicator	10-Year Average	High (2020–2023)	Low (2020–2023)
Goods Prices (YoY%)	1.3%	12.3%	(1.1%)
Money Supply (YoY%)	7.2%	26.9%	(4.5%)
1-Year Fed Funds Expectations	1.5%	5.4%	0.0%
10-Year Yield	2.3%	4.9%	0.5%
Deficit Projections	(5.8%)	(15.0%)	(5.2%)
Growth vs. Value	7.0%	45.0%	(23.0%)
U.S. Recession Probability Forecast	32.0%	100.0%	10.0%

As of December 19, 2023. Growth vs. value represents a 12-month rolling average return differential.

Source: Bloomberg

average return differential between growth and value factors ranging wildly from +45% to -23% in this period versus the 10-year average of a relatively steady 7%.

As we enter 2024, we expect another wave in this highly unusual cycle to keep uncertainty high as the tug-of-war between economic growth and lower inflation unfolds. Although economic data remains decidedly mixed, weaker retail sales, falling consumer confidence, slowing wage growth, the lagged impact of higher interest rates, and dwindling pandemic stimulus will likely weigh on the current pace of economic expansion.

A critical part of our view, though, is that a severe recession remains unlikely. The economy is supported by strong consumer and corporate balance sheets, a solid labor market, and a general lack of major imbalances that often immediately precede significant economic downturns.

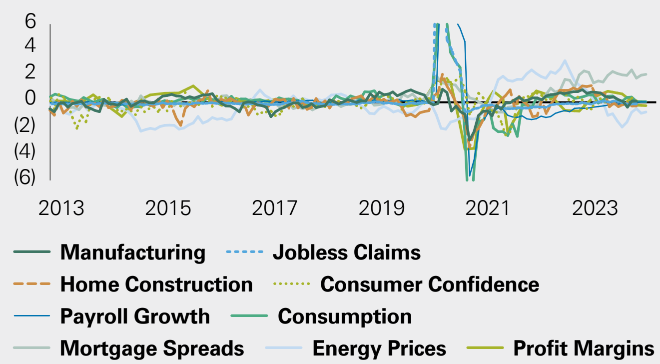
Importantly, the Fed is finished hiking and is positioned to respond quickly and even aggressively if the growth outlook deteriorates. Indeed, the decline in inflation could motivate the Fed to ease sooner rather than later amid only slight economic softening, and likely will be encouraged to do so in an election year.

We note that, while inflation remains above target, it is largely being held higher by shelter costs. Excluding the shelter component, the three-month core CPI reading is just under 2%. Asking rents are quickly falling, which should pull shelter costs down in the coming quarters. Core services ex-shelter, another component of consumer prices keeping inflation elevated, may also be poised to moderate. Specifically, transportation services (27% of core services ex-shelter) are driven by motor vehicle insurance, which should fall along with the large decrease in used car prices.

We dedicate this Quarterly Investment Perspective to addressing the complexity of yet another wave in this highly unusual cycle, focusing on areas we believe are most

Exhibit 4: Dispersion in Economic Activity Across Indicators and Sectors

Key Takeaway: There have been waves of acceleration and deceleration across sectors.



As of November 30, 2023. Represents standard deviation in trend growth rates since 1978. Positive numbers indicate deceleration and increasing recession likelihood; negative numbers indicate acceleration versus steady state growth rates.

Source: Bloomberg

Exhibit 5: 2024 Outlook vs. 2023 Trend

Key Takeaway: In 2024, above-trend growth is set to slow alongside lower inflation in the U.S., allowing the Fed to cut interest rates; however, geopolitical tensions and challenges in Europe and emerging markets are likely to persist.

	4Q 2023	2024 Outlook
U.S. Growth (p. 4)	Resilient	Slowing
U.S. Inflation (p. 7)	Easing	Lower but nonlinear
Federal Reserve (p. 8)	Pivoting	Pause then cutting
Geopolitical Risk (p. 9)	Elevated	Volatile but contained
European Growth (p. 10)	Sluggish	Muted
Emerging Markets (p. 11)	Challenged	Dispersion by country

As of December 31, 2023.

Source: Bessemer Trust

likely to have the biggest impact. Our core views and the many topics we cover are included in Exhibit 5. I am delighted that many of Bessemer's strategists have contributed to this Quarterly Investment Perspective as a diversity of views is one of our key advantages in tackling the challenges that markets face every day. Our chief investment strategist, Jeffrey Mills, and I detail Bessemer's portfolio positioning on page 12.

Overall, we enter the year overweight equities given our view that the economy can avoid a severe recession and stocks can perform well in an environment of non-recessionary rate cuts, as is typically the case. That said, just as we leaned against the consensus view that a recession was all but certain heading into 2023, we again find ourselves questioning the prevailing narrative that a soft landing is assured. There will be bumps in the road, and we are poised to adjust portfolios as needed. For now, our somewhat more cautious view versus what has become consensus can be seen in our overweight to the U.S., reduced cyclical exposure, and longer duration relative to benchmarks and higher credit quality in bond portfolios. Continued uncertainty in markets also bodes well for hedge fund allocations, and we see persistent long-term value in our private markets program.

U.S. Growth Outlook: Can Consumers Continue to Carry the Load?

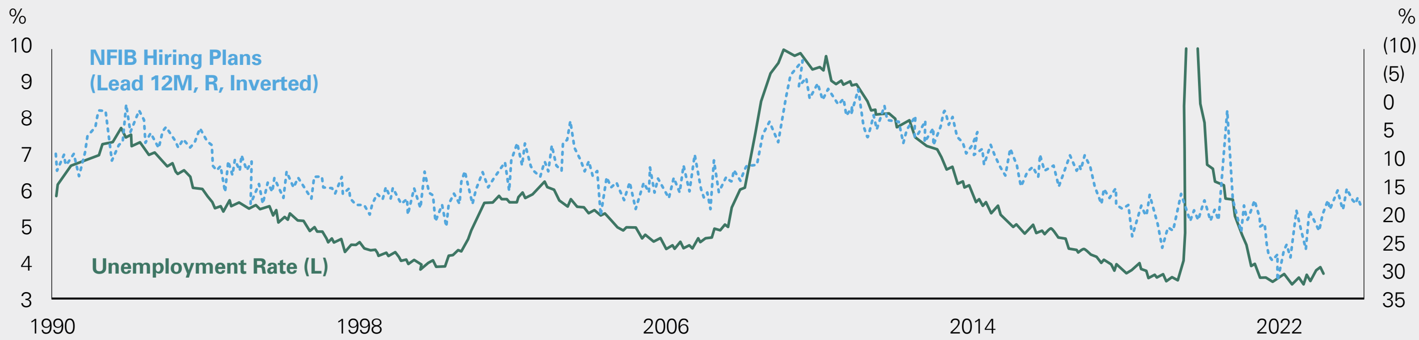
Jeffrey Mills, Chief Investment Strategist

Dire economic forecasts for 2023 proved to be wrong. Slowing inflation, rising real wages, residual fiscal stimulus, and excess savings fueled the consumer and extended the current economic cycle.

Consumer demand remains a key support for economic growth, and the labor market is the most important variable in assessing the sustainability of current levels of consumption. Economic growth rates ebb and flow, but without a significant deterioration in the employment picture, a recession is unlikely. We see a softening labor market as we move into 2024, driven in no small part by the lagged effect of restrictive monetary policy. That said, current readings are more consistent with a downshift in economic growth rather than an

Exhibit 6: Small Business Hiring Plans vs. Unemployment

Key Takeaway: Forward-looking signs, such as small business hiring, point to further weakness in the labor market.



As of November 30, 2023. The NFIB Small Business Hiring Plans Index measures the intentions of small businesses to increase employment.

Source: Bloomberg

imminent recession. Evolving labor market dynamics will be a significant input into our analysis of risk exposure in portfolios throughout the coming year.

Assessing current labor market dynamics. The U.S. economy was adding 204k jobs on a three-month rolling basis through November of 2023 — a level well below the 2023 high of 334k seen at the start of the year. For perspective, the current rate is still above the 20-year median of 184k, so although there is clear evidence of slowing, the data is not particularly alarming when compared to historical standards. Similarly, the U.S. "quits rate," a measure of how confident people are that they can find a new job, has declined from 3.0% to 2.3%. Again, this is an indication of softening but still above the long-term average of 2.0%. It is important to also acknowledge the increase in undocumented workers among the people joining the labor pool, an increase to the labor supply that is not incorporated in official reported data.

Looking ahead, we see signs of additional weakness consistent with our view that economic growth will continue to moderate. For example, small business hiring plans as represented by the National Federation of Independent Businesses tend to lead the unemployment rate by 12 months (Exhibit 6). This relationship would signal a rising unemployment rate in 2024. Additionally, credit availability often leads initial unemployment claims by six months. Given the rapid tightening of lending standards in the Senior Loan Officer Opinion Survey, we would expect unemployment claims to rise from current levels. Additional labor market softness is necessary for stocks to move higher — easing wage pressure would be interpreted as easing inflation pressure, allowing the Fed to shift to a more dovish bias.

Several labor market indicators are flashing warning signs. For example, the Sahm Rule is an often-cited labor market indicator with a strong history of signaling imminent recession. The rule states that whenever the three-month moving average of the unemployment rate rises 0.5% above its trailing 12-month minimum, the U.S. economy is already in a recession. The current reading is 0.30% above the 12-month minimum, a level that has historically indicated the possibility of a coming recession. This is certainly indicative of rising unemployment; however, we believe context is important. In this case, the labor force has expanded by a historically high 2% in the past 12 months. The flow of workers from "not in the labor force" to "unemployed" is less concerning than if the increase in the unemployment rate was all being driven by layoffs. Therefore, although this is a clear indication of softening in the labor market, concluding that a recession is imminent may be premature. This helps inform our current portfolio positioning, which includes a modest overweight to equities.

U.S. Equity Market Outlook

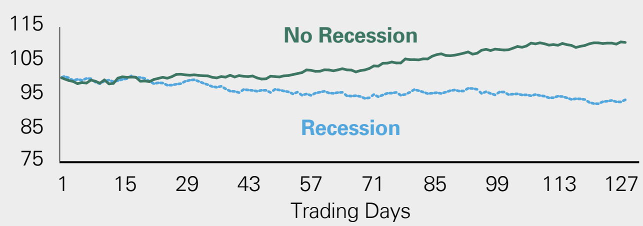
Jeffrey Mills, Chief Investment Strategist

Investors are currently assuming a near perfect mix of cooling inflation and stable demand combined with pricing power. We see this in consensus expectations for 12% earnings growth *and* 150 basis points of rate cuts in 2024. Although some combination of cooling inflation and stable demand is not unreasonable, we believe earnings growth may fall below current expectations as inflation continues to moderate amid slowing economic growth. Disinflationary trends could pressure corporate margins from current historically elevated levels as wage increases remain sticky, making earnings forecasts unreachable. At the same time, an outright contraction of earnings seems unlikely in the absence of a recession.

We believe earnings growth will be critical to equity market returns in the coming year, as an expansion of valuation multiples should not be relied on to drive stocks higher. That said, valuations are far more attractive when looking outside of the largest companies in the S&P 500. We see opportunity for more significant multiple expansion in those companies as many of their valuations remain below long-term averages. We see this when comparing the S&P 500 market cap weighted index (current next-12-month P/E of 19.5 versus a 10-year average of 17.6) with the equal weighted index (current next-12-month P/E of 16.1 versus a 10-year average of 16.4).

Exhibit 7: S&P 500 Performance Six Months Following the First Rate Cut

Key Takeaway: Equity markets perform well following the first rate cut, absent a recession.



As of December 31, 2023. Data includes all hiking cycles since 1980 and is sorted by periods where a recession follows or does not. Excludes COVID as a recession. S&P 500 returns are normalized to 100.

Source: Bloomberg

The path of monetary policy will continue to be of primary concern for equity markets. Particularly with several rate cuts expected in 2024, the ultimate catalyst for those cuts will be critical in determining the impact on stocks. If inflation continues moving lower without a significant deterioration in the economy, we could see some policy fine-tuning that would include non-recessionary rate cuts. In such a scenario, equity multiples could expand, helping push stocks higher than we currently expect. Conversely, if rate cuts are in reaction to rising unemployment and a contraction in growth, history would indicate stock returns well below average (Exhibit 7). Our base case includes non-recessionary rate cuts as inflation falls, allowing the Fed to shift focus back to the growth side of its dual mandate.

The result is positive yet below consensus earnings and valuation multiples that could remain near current levels but are unlikely to materially expand. In a scenario where anxiety over the economy, monetary policy, and politics remains high, we are actively targeting companies with both stable and growing earnings, high profitability, and solid free cash flow within the quality style we favor. This means a bias toward growth over value, as growth stocks typically have earnings profiles that are materially less cyclical. We also maintain a tilt toward the U.S. given its relatively large opportunity set of quality businesses.

Regarding the U.S. dollar, it was range bound for most of 2023, and we expect similar stability in 2024 given a series of opposing forces. The Federal Reserve's dovish pivot toward rate cuts may limit any dramatic dollar appreciation. However, we believe other central banks may eventually follow suit, reducing the probability of significant downward pressure caused by widening interest rate differentials. The dollar's inherent safe-haven status combined with the continued uncertainty surrounding other major economies should also limit any significant downside. Global risk aversion could even spur brief periods of strength, particularly if geopolitical tensions flare. We believe this combination of forces will create a relatively stable range for the dollar as we move through 2024.

Inflation: Navigating the Last Mile

Madeline Simone, Investment Strategies Analyst

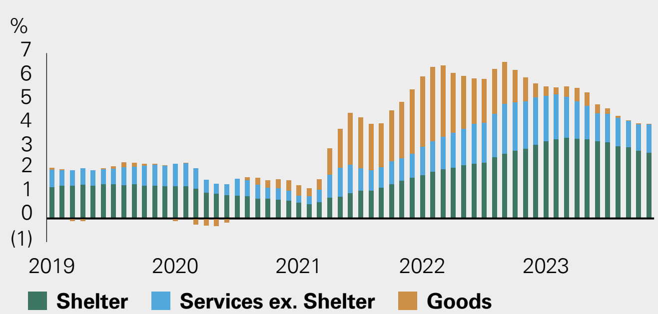
Although progress slowed in the second half of the year, the downtrend in inflation proved durable in 2023, and upward price pressures have been less broad-based. Looking ahead in 2024, we believe inflation will continue to decline, though we caution the descent is likely to be slow and nonlinear.

When analyzing the inflation outlook, it is key to focus on its three distinct components — core goods, core services excluding shelter, and shelter. The decline in goods prices due to a normalization in supply chains and weakening demand due to a shift in consumption preferences from goods to services post-COVID has been the primary driver of the move lower in inflation (Exhibit 8). As consumption patterns normalize, evolving consumer preferences may shift back to goods and result in a nonlinear path for disinflation.

Looking ahead, a sustained move lower in inflation will have to come from a deceleration in shelter and services prices, which appears likely given the progress we have seen in real-time indicators. Zillow rent prices, which often lead shelter prices, peaked at 16% year-over-year and have declined to 3% currently. The annual pace of acceleration in shelter prices has eased slightly from 8.2% to 6.5% and looks poised to fall further given the typical relationship with real-time rents.

Exhibit 8: Contributions to U.S. Core CPI (YoY%)

Key Takeaway: Inflation dynamics should continue improving in 2024 as shelter and service prices ease.



As of November 30, 2023.

Source: Bloomberg

Exhibit 9: Current Inflation Rates vs. Three-Month Annualized Rate

Key Takeaway: Recent monthly inflation readings point to a further downtrend in inflation.

	Current Rate	3-Month Annualized Rate
CPI	3.1%	2.2%
Core CPI	4.0%	3.4%
PCE	2.8%	1.4%
Core PCE	3.3%	2.2%

As of November 30, 2023.

Source: Bloomberg

The decline in services inflation is highly dependent on the rebalancing of the labor market given the correlation of service prices and wages. Given that we expect further labor market rebalancing, the decline in wages should continue to ease service price pressures. Various indicators point to further labor market rebalancing, such as the jobs-workers gap, which has halved from six million to three million.

Though we expect disinflation to continue, returning to the Fed's 2% inflation target is likely to be a slow process; the Fed is currently projecting a return to the 2% target in 2026 for core PCE. However, the Fed noted at its December meeting that cuts could come before the Fed's 2% inflation target is reached, marking an important shift in flexibility around returning to target. Encouragingly, the three-month annualized rate of 2.2% for core PCE shows evidence that recent price trends are consistent with expectations for lower inflation in 2024 (Exhibit 9).

The Federal Reserve: Starting the Descent

Dartagnan Howell, Investment Strategies Analyst

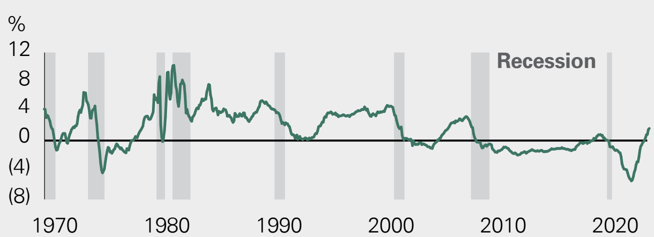
The Federal Reserve was able to gradually decelerate its pace of interest rate hikes throughout 2023 as inflation continued to trend toward its 2% target. We believe the final rate increase for this cycle occurred in July, with the Fed now more clearly articulating its view that the current level of rates is sufficiently restrictive (Exhibit 10). We expect prior interest rate hikes to further slow the economy in 2024, helping to solidify inflation's downward trend.

Looking forward, it is important to understand that even as the Fed keeps its policy rate unchanged, falling inflation will put upward pressure on *real* interest rates, further tightening financial conditions and pressuring the economy. As a result, the Fed has made a clear pivot in messaging, recognizing that with inflation trending lower it can now shift its focus from solely combating higher prices to also managing policy in a way that would mitigate risks of a major increase in unemployment. We believe this will result in rate cuts as the economy continues to grow, a scenario that would likely provide further support for stocks. Historically, the first rate cut also leads to lower interest rates across the yield curve, a condition that would benefit our current long duration positioning.

Although, in theory, the Federal Reserve operates free from political influence, we expect policy will err on the side of supporting the economy in an election year. Furthermore,

Exhibit 10: Real Interest Rates (Fed Funds Rate Minus Core PCE)

Key Takeaway: The Federal Reserve believes that interest rates are now in restrictive territory.

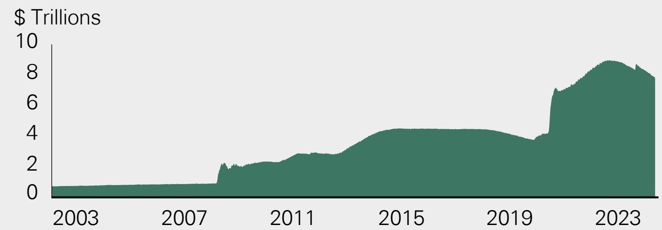


As of October 31, 2023.

Source: Bloomberg

Exhibit 11: Federal Reserve Balance Sheet (Total Assets)

Key Takeaway: The Federal Reserve is expected to continue quantitative tightening even as it cuts interest rates.



As of November 29, 2023.

Source: Federal Reserve Economic Database

given the elevated nature of debt servicing costs for the United States government (currently approaching 16% of tax revenues), the Fed may be incentivized to push rates lower if inflation remains contained.

Another, less discussed, element of monetary policy is the progression of quantitative tightening (QT). QT is expected to continue even as the Fed starts cutting interest rates (Exhibit 11). The Fed has set a higher threshold for halting QT compared to adjusting interest rates. The goal of QT is to gradually reduce the Fed's large balance sheet, although its bond holdings are expected to remain above pre-pandemic levels. A reduction of the balance sheet should put some upward pressure on rates, but we believe the net result of QT and slower economic growth/rates cuts will be downward pressure on rates.

Throughout 2024, the largest influence on the direction of monetary policy will be the trajectory of both economic growth and inflation. The Fed will therefore continue to be data dependent in driving interest rate policy. An unexpected reacceleration of economic growth and/or higher than forecast inflation would dictate a more hawkish policy than currently anticipated. We do not believe that is the most likely outcome, but it is an important risk that we continue to monitor and stand ready to adjust exposures as needed.

Geopolitics and Policy: Tensions and Risks Persist

Bree Sterne, Senior Investment Strategist

Geopolitical and political developments remain top of mind given two major wars, the ongoing shift to a multipolar world order, and a year ahead poised to see elections impacting roughly half the world's population, including the U.S. While geopolitics and policy can loom large in the short run, affecting certain sectors or countries, the stock market has proven resilient over the long term, often moving higher regardless of perceived turmoil.

Geopolitics. Geopolitical risk is elevated amid three global conflicts, notably wars in Eastern Europe and the Middle East and ongoing tensions between the U.S. and China.

Without a near-term overt military victory or diplomatic solution in sight, the Russia-Ukraine conflict could become an extended war of attrition. The war is a key geopolitical risk factor for the European economy given the region's dependence on imports of energy and commodities as well as exports of finished goods and services.

The Israel-Hamas war could keep tensions between the West and Iran elevated and disrupt cooperation between Israel and Saudi Arabia. Our base case is that the conflict remains contained, but it presents an ongoing risk of escalation in the region with the potential to affect commodity prices, especially oil.

While the U.S. and China have recently pursued efforts to stabilize their relationship, the structural nature of the competition between the two countries persists, especially as it relates to technology and security. Longer term, a significant reversal appears unlikely as movement toward a multipolar world gains traction. Still, we note that the process of shifting supply chains, or decoupling, is both complex and slow-moving as supply chain adjustments often involve lengthy evaluation periods in addition to building and moving plants and equipment. Despite declining U.S. import dependence on China, China continues to produce roughly one-third of the world's manufactured goods, and 30% of the world's shipping containers pass through Chinese ports.

Historically, geopolitical events have often had short-lived market and economic impacts, largely due to the minimal impact of the world's conflict zones on global output, trade, equity markets, and raw material production. For example, the S&P 500 declined 11.6% after the 9/11 terrorist attack but fully recovered from this drawdown within two months of the attack. Russia's invasion of Ukraine proved to be an exception largely because the commodity spike compounded other structural inflationary pressures. While many purely geopolitical spikes are short-lived, elections and fiscal policies can have longer lasting implications for markets.

U.S. election. Though the 2024 election is nearly a year away, current polling indicates that a Trump-Biden rematch appears likely. With the economy set to be a top issue for voters, we highlight that every president who has avoided a recession during the two years preceding reelection has won, and every president who oversaw a recession during those years lost reelection.

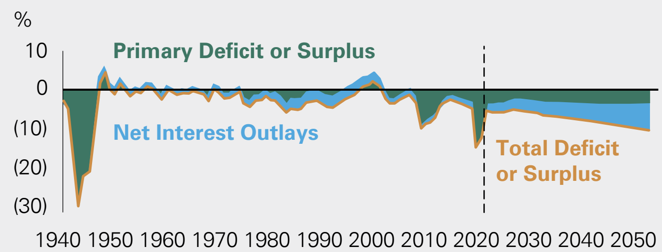
Congressional dynamics appear to set the stage for a split Congress as both chambers could reverse control. The Senate map is tilted in favor of Republicans with Democrats defending far more competitive states. Meanwhile, a favorable setup in the House for Democrats could flip the chamber as nearly four times as many Republicans are defending swing districts.

Our base case for the 2024 election is a divided government regardless of the presidential outcome, and therefore limited legislative prospects. Even in the event of a red or blue wave, we view the likelihood of either party gaining more than 60 Senate seats as extremely low, thus limiting the potential for sweeping policy changes that aren't primarily budgetary.

U.S. debt. The rise in long-term interest rates combined with widening deficits and heightened fiscal discord in Congress has renewed questions about the sustainability of rising government interest costs. The U.S. has incurred a significant debt burden as it has spent more than it has received in tax revenue in the past few decades (Exhibit 12). As this debt is refinanced at higher rates, the interest cost on the debt is set to march higher. While the borrowing trends of the U.S. government are concerning from a longer-term perspective, we believe the U.S. funding cost risk is well mitigated by the critical and central roles of the U.S. dollar and Treasury market within the global financial system. Even though supply and demand imbalances in the Treasury market have been one factor impacting the term premium, the outlook for the economy and Fed policy remains the most important driver of yields, in our view. We note that over long periods of time, rising deficits and yield levels do not have a strong correlation. Still, we remain mindful that the decision surrounding the expiration of the 2017 tax cuts will be an important factor in 2025. For more information, please see our "Politics, Policy, and Markets: Short- and Long-Term Implications" Investment Insights.

Exhibit 12: U.S. Budget Deficit as a % of GDP

Key Takeaway: The U.S. deficit has risen in recent years and is set to increase further.



As of June 30, 2023.

Source: Congressional Budget Office

Europe: Headwinds Set to Continue

Tom Wicks, Senior Investment Strategist

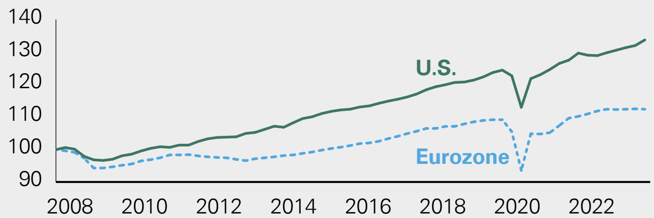
As the Federal Reserve and European Central Bank (ECB) announced their monetary policy decisions last November, the economic backdrops of the two regions were a study in contrast. While the U.S. saw its economy power ahead of forecasts in 2023, Europe faced sluggish growth hampered by the continuing effects of the Russia-Ukraine war, sticky inflation, weaker global trade, and faster effects from rises in interest rates (Exhibit 13). The U.S. saw third-quarter (QoQ) GDP growth, after adjusting for inflation, come in at a staggering 4.9% on an annualized basis while the eurozone, in contrast, saw its economy contract by 0.1%. While both regions have likely completed their rate hikes, our view is that European growth is likely to be slower than U.S. growth.

The ECB faces a difficult job. Eurozone interest rates, at 4.5%, are at their highest level in over 20 years, and their effects on the region are being felt more sharply than in other parts of the world. The European mortgage landscape is typically characterized by a high proportion of adjustable-rate mortgages, which means consumers there feel the effects of rate rises more quickly and to a greater degree than consumers in countries where fixed-rate mortgages are more common. It is a similar story on the corporate side, where European businesses have a greater reliance on bank-based financing, which is characterized by floating rate loans that have seen borrowing costs increase as rates have risen, as opposed to fixed-rate corporate debt typically issued outside Europe, where corporations were able to take advantage of record-low post-pandemic interest rates to lock in their cost of borrowing.

The ECB faces another challenge: the wide disparities in inflation among its EU member countries. The Netherlands, for example, saw prices drop 0.4% year-on-year (YoY) in October whereas France saw inflation running at 4.0% YoY. For the euro region as a whole, we expect both headline and core inflation to continue to trend down as the impact of the 2022 Russia/Ukraine energy spike lessens. The ECB's primary mandate is price stability, unlike the Fed, which manages a dual mandate that includes "maximum employment." The danger for Europe, if inflation does prove to be stickier than expected, is that the ECB holds rates higher for longer in its inflation battle to the detriment of the European economy. Navigating these differences will require a delicate balance, leading to a greater risk of a policy error for the ECB.

Exhibit 13: U.S. and Eurozone Real GDP Growth (Indexed to 100 in 2008)

Key Takeaway: The European economy has lagged the U.S. since the 2008–09 global financial crisis.



As of September 30, 2023.

Source: Bloomberg

Looking ahead, growth for the region will likely remain muted as the European economy continues to grapple with the effects of higher interest rates, a softening labor market, changing trade patterns, geopolitical tensions, and elevated energy prices. With sluggish growth and sticky inflation, a period of stagflation in Europe in 2024 cannot be discounted.

Bessemer equity portfolios maintain an underweight to European equities relative to their respective benchmarks. While valuations appear cheap relative to the U.S., they do not look as attractive once the differences in market composition are taken into account. For more on this topic, please see our August 2023 Investment Insights "Spotlight on Europe: Renaissance or Reckoning?"

Emerging Markets: Lower Inflation and Varied Economic Growth

Calvin C. Huang, Senior Investment Strategist

Emerging markets (EM) countries had another challenging year in 2023, with equity indices underperforming both U.S. and developed international markets. China, the largest component of the emerging markets index, struggled due to a combination of slowing economic growth, rising geopolitical tensions, and slumping property markets. EM ex-China fared better, but economic growth was still dampened by high interest rates, tight global financial conditions, and limited domestic fiscal support.

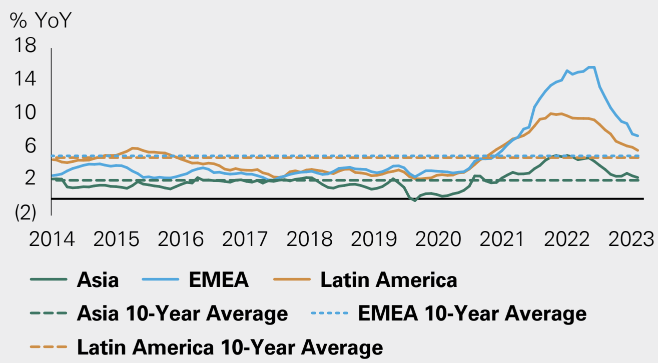
As we look ahead in 2024, we expect many of these headwinds to persist, along with a likely deceleration in developed market GDP growth. However, considering that emerging market countries span the globe, there is significant dispersion in the outlook across different regions and countries.

Inflation remains a key area of focus for this year, and we expect to see continued improvement across most countries. Higher interest rates along with easing supply chain and labor market pressures should help inflation moderate and move closer to longer-term averages. Emerging European countries have seen the biggest decline in inflation from 2022 peaks, but on average, levels remain high relative to historical standards (Exhibit 14). Asia and Latin America, to a lesser extent, have also made progress toward reducing inflation to stated targets. Declining inflation in combination with expected U.S. Federal Reserve interest rate cuts should allow more countries to ease monetary policy in 2024, which could provide a boost to global economic growth even though the absolute level of many policy rates would still be considered restrictive.

In Asia, China's long-term challenges — negative population growth, high aggregate debt levels, and rising labor costs — remain significant. However, we expect the environment to improve modestly next year as policy support momentum grows. Recently, the central government has shown a greater willingness to expand fiscal stimulus, such as issuing one trillion RMB of bonds to help shore up local government balance sheets. Also, loosening

Exhibit 14: Emerging Market Average Headline Inflation by Region

Key Takeaway: Inflation in Asia and Latin America is nearing long-term averages, and we expect further deceleration across all regions in 2024.



As of October 31, 2023.

Source: Bloomberg

monetary conditions helped boost Chinese consumer spending in the second half of 2023, and we expect private consumption related policy to remain supportive in 2024.

Outside of China, we believe technology-heavy South Korea and Taiwan should continue to benefit from artificial intelligence enthusiasm. With inflation largely under control, South Korea and Taiwan are in position to cut interest rates this year, which should improve domestic demand. An important development to watch for in Taiwan is the upcoming elections in January of this year. Market volatility and geopolitical tensions could increase if the ruling Democratic Progressive Party wins again.

India is a likely beneficiary of Western countries shifting supply chains out of China. The Indian government has been investing heavily in domestic manufacturing capacity and recently announced a $33 billion USD plan to incentivize multinational corporations to manufacture more products in India. India also has general elections in the spring of 2024, which could have an impact on the future direction of these policies.

In Latin America, we expect inflation to moderate further and more countries to start reducing interest rates in 2024. The one notable exception is Argentina, where inflation is likely to remain above 100% this year as the country continues to struggle with large government deficits, weak exports, and capital flight.

Overall, Bessemer's equity portfolios remain underweight emerging markets relative to the benchmark. While potentially lower U.S. interest rates in 2024 should benefit emerging markets' credit creation and capital flows, slowing global economic growth is a notable headwind, and financial conditions in many countries are still tight by historical standards. At the same time, we believe there are attractive investment opportunities at the individual stock level. We continue to favor high-quality companies supported by long-term consumer adoption trends and a lower exposure to geopolitical headwinds. For example, our largest holdings in China and India are dominant market leaders in digital media and financial services, respectively.

Portfolio Positioning: Stay the Course

Holly H. MacDonald, Chief Investment Officer, and **Jeffrey Mills,** Chief Investment Strategist

Heading into 2023, we believed that a moderation of inflation and the eventual stabilization of interest rates, combined with our view that a deep recession was unlikely, would favor stocks over bonds.

Looking into 2024, these key elements remain in place. With similar conviction, we believe that inflation is likely to move closer to the Fed's 2% target and that interest rates have peaked for this cycle. The question remains: Can this be true alongside an economy that continues to expand?

Our view is yes, although investors will need to see evidence that economic growth is slowing from its current pace because inflation remains elevated.

Falling inflation and lower interest rates in the absence of a severe recession should provide support for stocks. Some of this optimism is likely reflected in broad stock market indexes, but maintaining a modest overweight to equities with diversified positioning across various industries, sectors, and market capitalizations allows us to take advantage of the many opportunities that we believe still exist. For example, mid- and small cap stocks have significantly lagged the performance of larger companies, leaving many well-run smaller businesses attractively priced to generate solid long-term returns. In fact, outside the 50 largest companies in the S&P 500, valuations remain below historical averages.

Pricing Power and Secular Growers

As economic growth and inflation slow, investors will pay a premium for companies with two key qualities — pricing power and earnings growth. In our view, many companies will find it more difficult to supplement slowing demand with higher prices, while historically cyclical businesses will find their earnings more impacted by an economic deceleration. Therefore, Bessemer portfolio managers are focused on owning companies exposed to powerful secular trends, such as cloud computing, artificial intelligence, aerospace and defense, and infrastructure to name a few. Exposure to companies such as Microsoft and Nvidia remains notable across our portfolios as they continue to lead some of the fastest growing industries in the world. In addition, we see opportunities in lesser-known businesses, such as Keysight Technologies, which provides software and hardware solutions to a diversified set of industries including the semiconductor, aerospace and defense, and automotive industries, among others. Consumer oriented companies that can raise prices even as inflation moderates should also be well positioned. Chipotle recently announced additional price increases across its menu, continuing to demonstrate pricing power even as other companies struggle to do so.

Overweight U.S. Equities

Given various challenges still plaguing many international economies, we are maintaining an overweight to U.S. stocks. Large developed international economies, such as Europe, for example, have leading economic indicators like manufacturing PMI that are deep in contraction territory. At the same time, wage growth is not showing any real signs of easing. European Central Bank President Cristine Lagarde has pushed back against the idea of considering rate cuts, citing that pressure around salaries is not declining. Although the U.S. economy is still at risk of slowing, the Fed has acknowledged additional flexibility around its policy path, and U.S. equity markets have a far higher percentage of companies exhibiting both pricing power and exposure to secular growth trends. That is not to say that we don't see any opportunities abroad. ASML Holdings, a semiconductor equipment company based in the Netherlands, is a good example of a quality company with impressive earnings growth.

Locking in Higher Rates

The most recent uptick in bond yields seems to be the final upward surge for this hiking cycle. While we strategically take a conservative approach to duration or interest-rate sensitivity, we extended the duration of bond portfolios to take advantage of these higher yields and maintained this positioning all year. We currently have a longer duration posture than our correspondingly conservative benchmarks and believe the Federal Reserve is comfortable with the current level of policy restrictiveness. In fact, as we monitor potential policy adjustments, we assess what would be a reasonable magnitude of interest rate cuts in 2024 in conjunction with incoming economic data. We expect the volatility of bond yields to continue to subside, barring a dramatic decline in economic activity, of which a key indicator is the state of the labor market. Higher yields and lower volatility provide both an attractive entry point and greater protection from interest rate movements, in contrast to the extraordinarily low yields of the recent past.

Corporate credit spreads have tightened recently and could widen as the economy slows. However, we are maintaining a moderate overweight exposure to high-quality bonds given the strong credit fundamentals of the sector and attractive overall yields. We will look to increase credit exposure if spreads widen from these levels.

Bessemer remains constructive on the municipal asset class as underlying fundamentals remain strong, supply should remain manageable, and demand will likely remain robust given onerous tax burdens. However, volatility will likely remain elevated, and municipals will likely continue to take directional queues from the Treasury market. The portfolio will also maintain an up-in-quality bias across a variety of sectors including state and local general obligation bonds, water and sewer providers, toll roads, and airports. We will also have exposure to top-tier issuers in higher education and healthcare, though we are much more selective given some of the macroeconomic pressures currently affecting those sectors.

Hedge Funds

We expect the market environment will be favorable for hedge funds. Elevated market volatility and a higher interest rate environment support dispersion across asset classes, sectors, and securities and provide unique opportunities for skilled hedge fund managers. Strategies that have less directional exposure, a disciplined investment process, and strong risk management should deliver attractive risk-adjusted returns.

Private Markets

This past year saw a return to historical norms across many parts of the private markets, including fundraising and investment activity. While realization activity, in general, was muted, strategic acquirers remained active buyers of private equity-backed companies in 2023, a trend we expect will persist. In particular, big pharmaceuticals appear set for continued activity, given sizable amounts of cash on their balance sheets and historically low valuations for their acquisition targets. Similarly, large traditional energy companies could continue the recent wave of consolidation as they seek to build scale to compete. With interest rates likely having peaked and pent-up mergers and acquisitions (M&A) activity on both the buy and sell sides, we expect a pick-up in sponsor-to-sponsor exit activity to add to strategic M&A. In addition, there are many venture-backed companies at a scale and state of maturation that could be attractive to the public markets and are ready to go public when the IPO window reopens. We are cautiously optimistic this will occur in 2024.

Longer term, we believe family-owned businesses managing through transitions and early-stage innovation remain enduring sources of compelling investment opportunities in the private markets. For example, the explosion of artificial intelligence is creating opportunities for venture capital investors to back entrepreneurs building related applications, including cyber security solutions for artificial intelligence, as well as for real assets investors with the specialized expertise to develop new data centers and edge networks that can handle artificial intelligence-driven computing demands.

Conclusion

Holly H. MacDonald, Chief Investment Officer

Thank you for reading our latest Quarterly Investment Perspective in what remains a dynamic market and economic environment. We will continue updating our clients in written communications, videos, and interactive forums and welcome your engagement.

Please reach out to your client advisor with any questions you may have.

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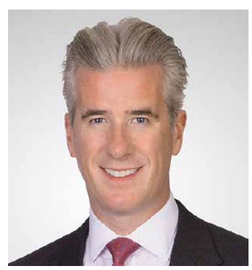

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Our Recent Insights

Quarterly Investment Perspectives
China and the U.S.: A Firsthand Perspective
(Fourth Quarter 2023)

Other Investment Research and Analysis
Revolutionizing Manufacturing: The Role of Industrial Automation — Investment Insights (December 2023)

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(September 2023)

Spotlight on Europe: Renaissance or Reckoning? — Investment Insights (August 2023)

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