

Investment Insights

Thoughts on Rising Interest Rates



David Rossmiller
Head of Fixed Income

Jeffrey Rutledge
Portfolio Manager

Margaret Waters
Director of Real Assets

John McMinn
Investment Strategist

Highlights

- The U.S. Federal Reserve raised interest rates in March for the third time in this cycle and signaled more to come this year and in 2018
- In this note, we review our expectations for the Federal Reserve in the year ahead — our base case is that tightening will occur, more likely in line with or by less than current expectations
- Rising interest rates are not a major threat to traditional bonds or real estate investments, though both areas require thoughtful strategies to manage through tightening monetary policy
- In contrast, we are less constructive on Real Estate Investment Trusts (REITs) in the current environment

After some fits and starts in recent years, last week saw the U.S. Federal Reserve not only raise policy interest rates by another 25 basis points (the third hike this cycle) but also, importantly, reinforce its intent to increase rates two more times this year and potentially three additional times in 2018. It seems, barring some unexpectedly large, negative shock, that the U.S. monetary-tightening cycle is finally underway in earnest.

We frequently discuss monetary policy in the context of our outlook for equities — the largest piece of many clients' portfolios. In this note, we briefly review our

expectations for the Fed over the rest of 2017 and into 2018. We also want to address what we believe higher U.S. interest rates could mean for some other parts of the investment universe that perhaps garner less frequent attention: in particular, bonds, real estate, and real estate investment trusts, or REITs.

The Fed — Where From Here?

While the Fed is clearly in a hiking cycle, the broader U.S. monetary policy stance remains relatively accommodative. In fact, the *real* policy rate — the nominal fed funds rate minus the U.S. core inflation rate — remains firmly negative. The Fed also continues to maintain an inflated balance sheet of nearly \$4.5 trillion, acting to depress longer-term interest rates, which in turn helps boost both corporate and consumer borrowing through lower mortgage rates and other types of longer-term financing. These benefits, thus far, have caused equity markets to look past the gradual increase in interest rates, since many investors feel the flat trajectory of Fed hikes doesn't pose much risk to the momentum of U.S. economic growth. That's by design. In the slow march toward a neutral policy stance, the Fed has the luxury of hiking only when there is enough confidence in the economy to withstand higher rates.

As 2017 began, we expected the Fed to hike two or three times during the calendar year, and that continues to be our view given the current macroeconomic landscape. While we believe it is possible the Fed could hike again this summer and once more by year-end, a couple risk factors around mid-year could cause the Fed to move more slowly. If the French elections in April and May cause significant market volatility, the Fed may want to delay rate hikes in order to avoid exacerbating global market uncertainty, which in turn could risk spilling over to the real U.S. economy. Meanwhile, in the U.S., potential uncertainty around the debt-ceiling negotiations (which are expected to peak later this spring or early summer) could also cause the Fed to pause.

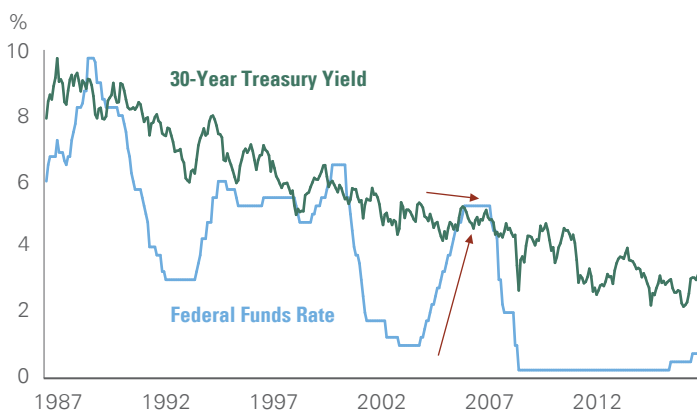
Thoughts on Rising Interest Rates

The primary risks to this gradualist policy-tightening view would be 1) that the economy starts to grow at a much quicker pace, suggesting a path toward “overheating,” and 2) that inflation breaks out of its recently reasonable (or as the Fed calls it, “symmetrical”) range. Both these possibilities would likely force the Fed to tighten in order to control excesses (instead of simply returning to a neutral policy rate). With persistently sluggish growth prospects and a notable lack of inflation pressure outside the U.S., we feel these risks are rather distant.

Bond Markets — No Need to Run for the Hills

In a normal tightening cycle, long-term interest rates tend to rise with Fed policy rates until investors perceive growing risks of an economic downturn. Occasionally — when the Fed is either fighting decisively against potential inflation or, in contrast, moving cautiously in a stable-inflation environment — long-term interest rates (i.e., 10- to 30-year Treasury Bond yields) can actually *decline* as the Fed raises rates. Exhibit 1 shows the rate-tightening cycle following the tech-bubble crash, when long-term rates declined as the Fed began to tighten policy.

Exhibit 1: Long-Term Bond Yields versus Fed Policy Rates



As of March 15, 2017.

Source: Bloomberg

Some investors will argue against owning bonds in a rising-rate environment. After all, yields and bond prices move in opposition — higher yields mean lower prices and vice versa.

While we certainly would not argue against this math, we think holding bonds in a tightening monetary policy world is notably more nuanced. One can still earn a positive return and hold an important defensive asset in a portfolio when rates are rising. With the Fed’s focus on achieving neutrality (rather than halting excesses), what is called a barbelled yield-curve strategy, which avoids the worst impact of rising rates (in the middle of the yield curve) while taking advantage of the higher yields of longer-term bonds, is likely to outperform cash as policy rates rise.

When the economic cycle finally rolls over into a downturn, lower-quality, higher-yielding instruments will likely suffer, while high-quality bonds should continue to produce attractive returns that help offset losses in riskier asset classes.

It pays to be wary of high-yielding strategies as rate hikes continue and the business cycle gets long in the tooth. When credit spreads (the difference between corporate bond yields and government Treasury yields) are narrow — as they are now — it takes only a modest spread widening or credit deterioration to more than offset any yield advantage over safer bonds. The easiest money in credit markets is available during a recession, when credit spreads are wide (and it’s difficult for most people to step in and buy); when investors feel comfortable with the credit environment and spreads are tight, as they are now, a cautious strategy is warranted.

As the Fed normalizes its policy rates, given the risks to an expensively priced credit environment, the rational approach is to hold a bit more exposure to high-quality bonds as insurance against market volatility. During the past year, Bessemer has added incremental exposure to high-quality bonds in client portfolios, while still remaining slightly underweight relative to benchmarks. Overall, our bond portfolios have shorter duration than what is suggested by benchmarks.

Real Estate — Long-Term Rates Are Key

The year 2017 could mark a transition for private U.S. real-estate markets, given higher interest rates and concern that supply is becoming an issue in certain sectors and markets for the first time since 2008. While a hike in U.S. interest rates may not appear to be a positive for U.S. real estate, it is also not the negative force that one may assume.

Relative to history, today's wide yield spreads across the real estate sector should help to mitigate the initial impact of interest-rate rises. A moderate rise in U.S. interest rates would be a sign of stronger U.S. economic growth. With stronger growth, if we calculate the implied 10-year Treasury yield — 10 years in the future, to where the market is pricing it in 2027 — we can calculate the magnitude of expected rate rises. This “10-year-by-10-year forward” rate, as traders call it, is 3.63% (vs. 2.52% today), showing a continued benign environment for long-term rates.

In addition to interest rates, technology will also increasingly impact real estate, benefiting certain sectors, including industrials, while having an adverse effect on other sectors, particularly retail. To position the *Fifth Avenue Real Assets Fund 3* portfolio for these mild headwinds, we have invested the real-estate allocation with a focus on strategies with the goal of creating durable cash flows that can be sold forward to yield-oriented buyers. These strategies have three focal points:

1. Invest alongside an opportunistic acquirer who is able to exercise patience and discipline in acquiring high-quality, cash-flow-producing assets in or near major markets. Ideally, these are purchased at a discount to replacement cost, establishing a profitable cap-rate spread through asset improvements and prudent use of leverage.
2. Look for non-traditional, highly fragmented, and demographically driven real estate sectors. Demand for these tends to be “needs based” and/or “life event” driven and is less dependent on economic cycles.

3. Beyond U.S. exposure, partner with managers targeting investments in Asia — primarily in Tokyo, Seoul, and Hong Kong — where demographic drivers, as well as recovery within targeted real-estate sectors, are creating opportunities.

For many investors, the only feasible way of accessing real estate with sufficient levels of diversification is through indirect investment. In addition to investment in private funds, investors can gain access through the public markets via REITs.

Real Estate Investment Trusts (REITs) — Expensively Valued

REITs offer investors exchange-traded, liquid ownership in real estate assets providing steady streams of equity income via dividend distributions. Regulations provide REITs with tax-exempt status in exchange for their distributing at least 90% of taxable income in the form of dividends. REITs provide investors with access to a broad swath of income-producing real-estate classes, including commercial and residential properties, malls, industrial and health-care facilities, and personal storage, to name a few.

REIT performance is often — but not always — inversely correlated with prevailing interest rates, given the significant current-income streams associated with the asset class. Thus it should come as no surprise that REIT performance has been quite strong in recent years, as interest rates steadily declined. When rates began their recent rise, and capital flowed to higher-yielding assets, REIT indexes underperformed substantially.

Recently, investors have asked about REITs' relative attractiveness given their recent underperformance. We remain cautious for two reasons:

1. Our base-case view is that interest rates are likely to continue their gradual upward trend, pushing down REITs' principal value.
2. REIT valuations remain above their historical norms.

Exhibit 2: REIT Performance During Periods of Rising Interest Rates

From	To	Length (Months)	10-Year Treasury Yield			REIT Return	S&P 500 Return	Relative Performance: REIT versus S&P 500
			Period Begin	Period End	Change			
1/18/96	6/12/96	17	5.52%	7.06%	154 bps	4.74%	10.00%	(5.25)%
10/5/98	1/12/00	15	4.16%	6.79%	263 bps	2.26%	46.23%	(43.97)%
11/7/01	4/1/02	5	4.18%	5.43%	125 bps	15.19%	2.75%	12.43%
6/13/03	9/2/03	3	3.11%	4.60%	149 bps	8.01%	3.38%	4.64%
6/1/05	6/28/06	13	3.88%	5.24%	136 bps	19.95%	3.66%	16.29%
12/30/08	4/5/10	15	2.05%	3.99%	193 bps	52.15%	33.32%	18.83%
10/7/10	2/8/11	4	2.38%	3.74%	135 bps	9.73%	14.38%	(4.65)%
7/24/12	12/31/13	17	1.39%	3.03%	164 bps	7.03%	38.11%	(31.08)%
7/8/16	12/15/16	5	1.36%	2.60%	124 bps	-8.47%	6.20%	(14.67)%
Average		10			160 bps	12.29%	16.04%	(5.27)%

As of March 15, 2017.

REIT represents the Dow Jones Equity All REIT Total Return Index.

Source: Bloomberg

We examined REIT sector returns versus the broader market during the nine instances in the past two decades when U.S. 10-year rates rose at least 100 basis points (Exhibit 2).

The REIT sector underperformed the S&P 500, often materially, during five of the nine periods examined. We offer the following observations regarding the remaining four periods of outperformance (shaded):

- During the two instances with rising rates in the 2002-03 period, REIT outperformance is likely explained by the magnitude of dramatic declines in the technology, telecom, and related sectors following the bursting of the tech bubble.
- REITs' outperformance during the period January 2009 through April 2010, coincided with the significant post-financial-crisis market recovery. This seems counter-intuitive given REITs' defensive, "risk-off" characteristics. However, since the crisis was caused by excessive leverage on over-inflated property values, it makes sense that REITs' decline into the bottom of the crisis would be followed by a similarly significant

recovery. Because REITs focus on high-quality, cash-flowing properties — and behave more like bonds than lower-quality property — confidence quickly recovered.

REITs' high absolute valuations, coupled with gradually rising interest rates (and REITs' tendency toward negative correlations to such movements), suggest caution on the sector overall.

Conclusion

Higher policy rates do not necessarily impinge on the prospective returns of high-quality bonds or real estate, which can perform with reasonable resilience until a rate-hiking cycle substantially constrains economic growth. The Fed has indicated it is not trying to put the brakes on the economy but is attempting only to bring policy rates slowly up to a neutral level. While higher-volatility credit strategies such as below-investment-grade credit and REITs aren't directly threatened by gradually higher policy rates, we feel they are expensive at current values. We are closely watching these asset classes and prudently managing exposures.

Our Recent Insights

[The Dollar Under President Trump — A Closer Look](#)

(March 2017)

[Dow Surpasses 20,000 — Investment Insights](#)

(January 2017)

[Inflation Checkpoint — Investment Insights](#)

(January 2017)

[The Sun Also Rises — Quarterly Investment Perspective](#)

(First Quarter 2017, [Video Available](#))

[2016 Elections: First Thoughts — Investment Insights](#)

(November 2016, [Video Available](#))

[A Tale of Two Tails — Quarterly Investment Perspective](#)

(Fourth Quarter 2016, [Video Available](#))

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 100 years. Through comprehensive investment management, wealth planning, and family office services, we help clients achieve peace of mind for generations.

This material is for your general information. It does not take into account the particular investment objectives, financial situation, nor needs of individual clients. This material is based upon information obtained from various sources that Bessemer Trust believes to be reliable, but Bessemer makes no representation or warranty with respect to the accuracy or completeness of such information. Views expressed herein are current only as of the date indicated, and are subject to change without notice. Forecasts may not be realized due to a variety of factors, including changes in economic growth, corporate profitability, geopolitical conditions, and inflation. Bessemer Trust or its clients may have investments in the securities discussed herein, and this material does not constitute an investment recommendation by Bessemer Trust or an offering of such securities, and our view of these holdings may change at any time based on stock price movements, new research conclusions, or changes in risk preference.

ATLANTA • BOSTON • CHICAGO • DALLAS • DENVER • GRAND CAYMAN • GREENWICH
HOUSTON • LONDON • LOS ANGELES • MIAMI • NAPLES • NEW YORK • PALM BEACH • SAN FRANCISCO
SEATTLE • WASHINGTON, D.C. • WILMINGTON • WOODBRIDGE

[Visit us at bessemer.com](http://www.bessemer.com)