

Quarterly Investment Perspective

Can the U.S. “Triple Threat” Continue?



Rebecca H. Patterson, Chief Investment Officer

Living in New York City and working just minutes from Broadway, one often hears about the rare and wonderful “triple threat” — someone who excels in three areas on stage: acting, dancing, and singing.

The U.S. became a financial markets’ triple threat in the first quarter, with the U.S. dollar, U.S. government bond yields, and U.S. equities all rising in tandem — something that rarely occurs for any sustained period. Indeed, the last time we saw these U.S. assets climbing in a Rockettes-like lockstep for a quarter or longer was 2005 (Exhibit 1).

In trying to ascertain whether these trends can continue, we find ourselves asking four key questions about the U.S.’s future — focused on housing, energy, politics, and monetary policy. Below we tackle each question in turn, hoping to provide some insight on our portfolios in the process.

Can Housing Lead the U.S. Back to “Normal” Growth?

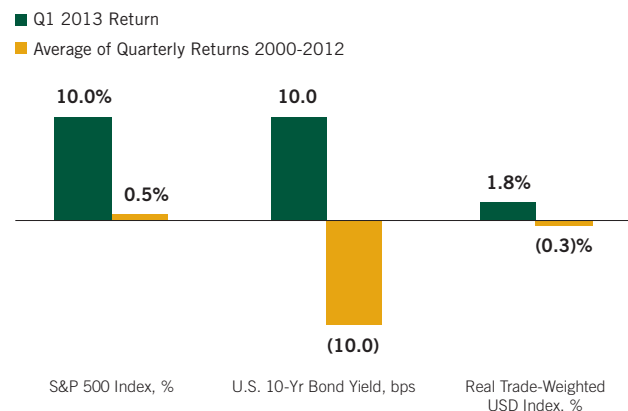
Home prices across the U.S. have been gradually improving since early 2012 after falling the preceding six years. Indeed, prices rose nearly 7% in 2012, looking across the country broadly (S&P/Case-Shiller data). A number of factors have come together to

drive the recovery to date, including reduced home supply, lower home prices, sharply reduced borrowing costs (mortgage payments fell some 45% over the last six years), relatively better income levels and credit scores, and good-old household formation (kids “leaving the nest”).

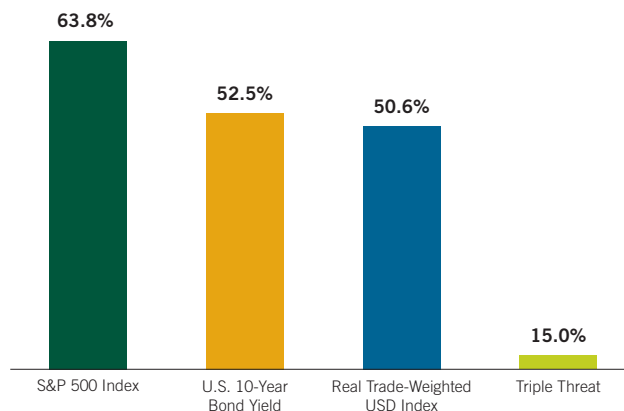
Looking forward, we believe the recovery will continue. New home supply will emerge only slowly, and U.S. monetary policy seems likely to anchor mortgage rates at least for the near term. Meanwhile, a continued, albeit gradual recovery in the labor market will help both income (for down payments)

Exhibit 1: U.S. Assets Were a “Triple Threat” in the First Quarter

a. Q1 2013 versus History



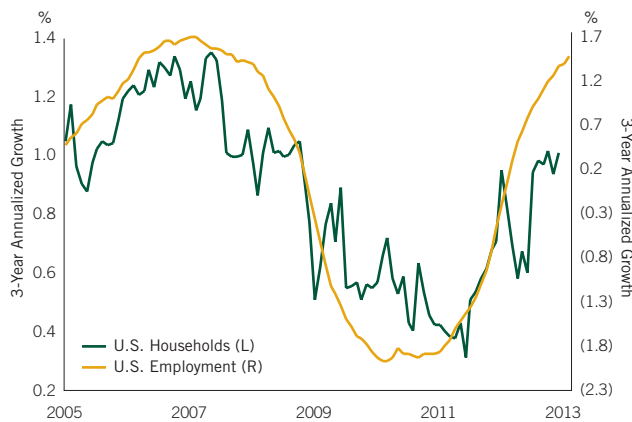
b. % Quarters with Positive Returns, 1973-2013



As of March 31, 2013.
Source: FactSet, Federal Reserve

and household formation (the two tend to trend together — junior is more likely to leave home once he is getting a regular paycheck; Exhibit 2). We would not be surprised to see U.S. home price gains in 2013 match or even surpass those from 2012.

Exhibit 2: Improving Labor Market = More Household Formation = More Home Buying



Employment data as of February 28, 2013; households as of December 31, 2012.
Source: FactSet, U.S. Department of Labor, U.S. Census Bureau

What does this housing recovery mean for the broader U.S. economy? Housing only plays a small direct role, accounting today for about 3% of GDP. Even at the pre-crisis peak, it only accounted for a bit more than 6% of GDP. That said, housing trends heavily impact consumer spending, which in turn represents around 70% of GDP. Think about the average American’s balance sheet: As of late 2012, mortgages represented more than 70% of total liabilities, while homes represented 25% of assets. Not surprisingly, lower mortgage payments and rising home values have made Americans wealthier. That has helped confidence and consumption.

We see these housing trends continuing in 2013 — critical for our constructive view on the U.S. economy and supportive of our housing-related investment exposures (equities, municipal bonds, and non-agency mortgage-backed securities, or MBS). However, large fiscal drags (including higher payroll taxes and the recently announced sequester) seem likely to prevent any more meaningful GDP acceleration that could change the Fed’s current course.

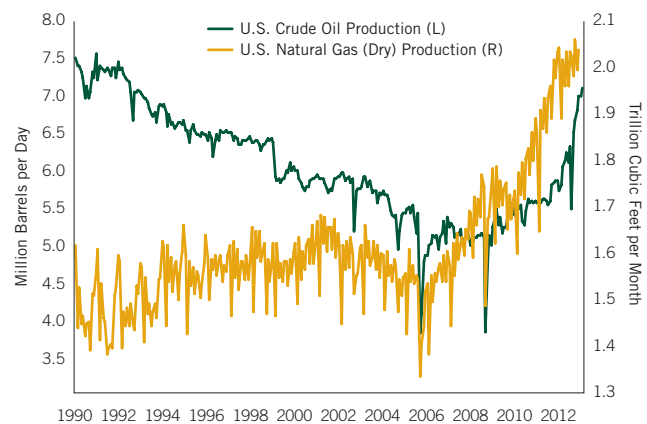
Whatever the degree of support that comes from housing in the year and years ahead, it is worth asking what “normal” economic growth should be for the U.S. today. While there is ample debate over estimates of longer-term trend GDP growth, most center around 2-2.5%, down from annual growth rates averaging 3.3% over the last 50 years.

How Do Structural Changes in Energy Impact Our U.S. Economic View?

Economists who believe that U.S. growth rates could improve in coming years often point to energy, and specifically, the various benefits that could accrue from increased production of oil and natural gas made possible by horizontal drilling and hydraulic fracturing, or fracking. These practices have helped producers extract oil and gas from rock formations that previously were uneconomical to develop.

After a multi-decade decline, these technologies helped U.S. crude oil production bottom in 2008: It has since hit a 15-year high of 7 million barrels a day, while natural gas output has hit an all-time high (Exhibit 3). The International Energy Agency (IEA) said last year that if current trends continue, the U.S. could become the largest global oil producer by around 2020 and a net oil exporter by around 2030.

Exhibit 3: U.S. Oil and Gas Production Hitting New Highs



Crude oil production data as of February 28, 2013; natural gas as of December 31, 2012.
Source: Bloomberg, U.S. Department of Energy

The IEA’s assumption about current trends is a big one — it remains far from clear how production could be impacted by regulatory changes in coming years. (Indeed, the future of U.S. energy is worthy of its own, more detailed research note, which we plan to publish later in 2013.) For now, though, we want to at least briefly consider some of the channels through which this latest U.S. energy boom could impact the broader economy.

- **Job creation.** Certainly, stories about energy-related job growth in places like North Dakota are dramatic — between July 2011 and July 2012, it was the fastest-growing U.S. state with a jobless rate just over 3%. Still, the overall employment impact on the U.S. economy from oil and gas extraction is modest. Relevant labor-market sectors accounted for about 0.5% of total non-farm employment as of last year.
- **Capital spending.** While energy industries are not labor intensive, they are capital intensive. More production requires significant new structures and equipment. Indeed, oil and gas extraction in 2012 accounted for some 10% of all U.S. business capital spending, up from 4% a decade earlier.
- **Support for consumers.** Oil markets are global — more production in the U.S. does not necessarily translate into lower prices at the pump. That said, greater natural gas supplies, to the degree they translate into lower or at least steady prices, do help the consumer a bit — natural gas fuels nearly a quarter of U.S. electricity generation.
- **Support for manufacturers.** Much has been said about the so-called U.S. manufacturing renaissance and the link between manufacturing and energy technologies. While lower natural gas prices have helped firms that have significant gas costs, more important in recent years have been the relative change in labor costs and the weaker U.S. dollar. Chemical firms are a notable exception here, as many benefit from cheaper natural gas (including more exports).

- **Trade balance and U.S. dollar.** While the U.S. produces a lot of energy, it consumes even more — hence the country’s energy-related trade deficit (equal to about 2% of GDP). New production technologies should help reduce energy imports, all else equal, which supports GDP growth and the dollar (in recent decades, a 1% reduction in the U.S. current account deficit lifted the trade-weighted dollar by 1.5%). However, we would be reluctant to forecast that the U.S. will completely eliminate its energy trade deficit anytime in the foreseeable future, and/or become a commodity exporter in such a significant way that it changes the way the U.S. currency is traded. Indeed, when it comes to the dollar and the triple threat continuing, we believe relative central bank policy is likely to play a much more important role this year than oil-driven changes in the U.S. trade balance.

Pulling these different elements together, we believe energy production is very meaningful for parts of the U.S. economy (both regions and sectors), but only modestly supportive for the broader growth picture, at least looking near term. Our exposure to energy ranges from crude oil exposure in the Real Return allocation, to related private and public equity investments that are tied to the implications of horizontal drilling and fracking.

Has U.S. Political Gridlock Started to Recede?

Recent months have seen Congressional approval ratings hovering around 14% — near all-time lows and perhaps reasonably so. Over the last few years, Washington became increasingly polarized, leading to hotly debated, last-minute decisions around critical issues such as the country’s debt limit and fiscal policy.

Some of the reasons behind this polarization — including redistricting (sometimes referred to as “gerrymandering”) and self-sorting by voters (selecting districts to live in where neighbors are

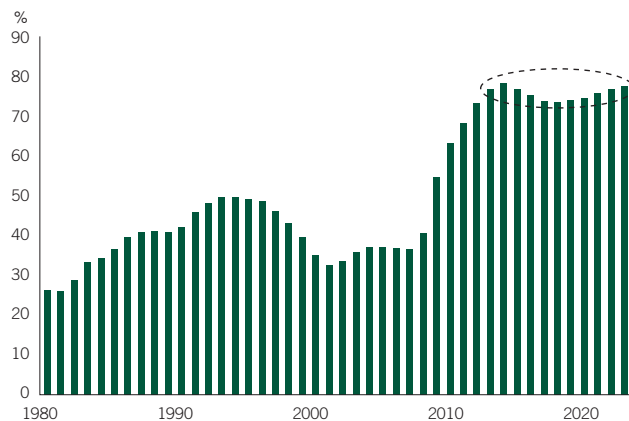
politically like-minded) do not seem likely to change anytime soon. But with the spring season comes hope, and three recent decisions in Washington lead us to wonder if maybe we have at least started to see less gridlock. First, the year-end "fiscal cliff" (a combination of tax and spending changes that would have sharply and abruptly slowed GDP growth) was moderated and included some compromise over taxes. Second, the debt ceiling, which was set to be hit in the first quarter, was extended to this summer. Third, the Continuing Resolution (CR), which allows for funding of government programs, was also extended from end-March to September. These latter two decisions were meant to give Congress and the White House time to discuss a more comprehensive fiscal plan, potentially leading to the first real budget the U.S. would see in five years. (Recent years have had stop-gap CRs instead.)

There are certainly reasons both parties might want to try harder to reach across the aisles — first and foremost, 2014 mid-term elections. Generic ballots suggest the Republican-controlled House faces potential losses, while history does not bode well for Democratic senators. (Historically, the incumbent party has lost an average of six Senate seats during the mid-term election in a president's second term.)

We will see. What transpires between now and early this autumn (the debt ceiling is now likely to be reached around August and the CR deadline is September) will almost certainly influence the U.S. economy, mainly through consumer and business confidence. One critical issue for us will be the sequester — the \$1.2 trillion in spending cuts to be implemented over the next decade that took effect in March and could still be renegotiated. The good news about the sequester is that it helps stabilize U.S. debt/GDP for the next five to eight years, reducing risks of near-term sovereign credit downgrades (Exhibit 4a). The bad news, meanwhile, is threefold. First, it does nothing to address the largest, longer-term budget challenge for the country: healthcare-related costs. The Congressional Budget Office projects that entitlement spending plus net interest on U.S. debt will overtake expected tax revenue by 2027 with current policies in place (Exhibit 4b). Second, the new debt projections could remove a sense of urgency in Washington to address the politically difficult issues that ultimately will need to be part of a broader fiscal solution. Finally, there remains considerable uncertainty around whether Congress will act to change the size and/or specifics of the sequester — what is discounted today by consumers, corporations, and investors could change in the months ahead.

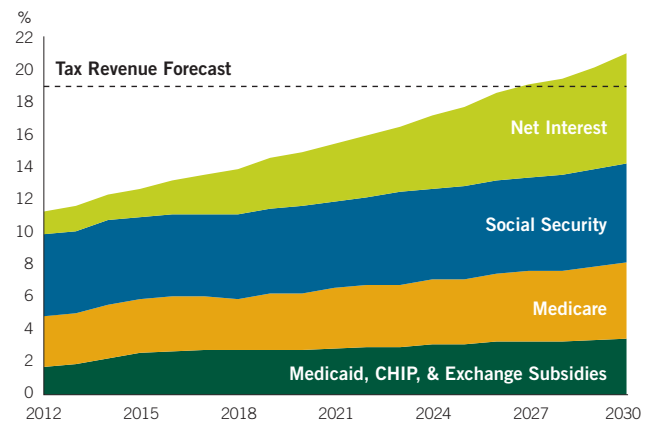
Exhibit 4: Better Near-Term Debt/GDP Should Not Reduce Focus on Longer-Term Fiscal Issues

a. Federal Debt as a Percentage of GDP



As of December 31, 2012.
Source: Congressional Budget Office

b. Long-Term Budget Outlook

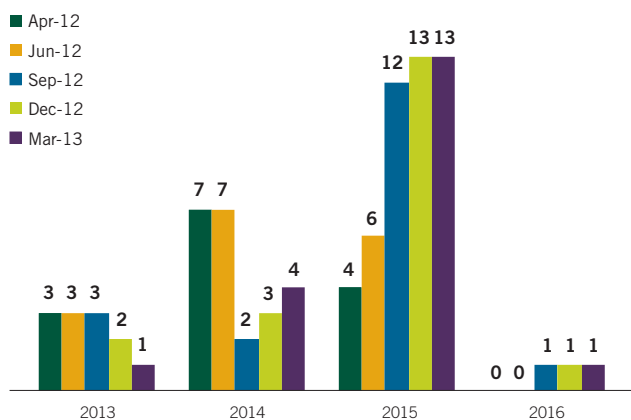


How Does the Fed View the Growth Outlook, and What Does That Mean for Monetary Policy and Markets?

Recent years have seen unprecedented steps taken by central banks around the world, including the Fed, to support growth. Such steps have created an unusual amount of uncertainty about future policy and its macro consequences. Central bankers, trying to alleviate this uncertainty, have become increasingly transparent about what drives policy decisions. In the U.S., such transparency has come via more frequent press conferences, more detailed economic forecasts, and numerical targets for growth (the unemployment rate) and inflation (the personal consumption expenditure deflator, or PCE).

With all that in mind, it’s fairly easy to know how U.S. central bankers view the economic outlook — they believe the U.S. economy is improving, thanks in part to housing, but at an insufficient pace (thanks in part to fiscal policy) and without undue price pressures to warrant a policy shift. Indeed, at the March Federal Open Market Committee (FOMC) policy meeting, the majority of the 19 participants continued to see 2015 as the appropriate time to first raise short-term interest rates, a view largely unchanged from the December 2012 meeting (Exhibit 5).

Exhibit 5: Fed in No Hurry to Raise Interest Rates
FOMC Participants’ Assessment of Appropriate Policy Firming



Reflects March 2013 FOMC meeting.
 Source: Federal Reserve

Well before the Fed signals that interest rates will rise, it will likely hint at a policy shift through a moderation of quantitative easing (QE) (the Fed currently buys \$85 billion per month of U.S. Treasuries and MBS). Any market perception that QE is set to slow or end would likely see U.S. government bond yields rise on a more sustained basis and potentially for a prolonged period. Investors haven’t experienced such a bond-market trend for decades — yields generally have been falling since 1981.

What rising yields mean for portfolio returns is far from simple. If yields are rising, but slowly and alongside improving economic growth and only moderate inflation pressure, many cyclical assets could still perform well. However, if yields rise against a stagflationary backdrop (stagnant growth and high inflation), investors could see very different portfolio dynamics, with many equities underperforming and capital shifting more towards commodities. A third scenario could be one in which the Fed decides to tolerate inflation beyond its numerical target for some period to ensure that growth is strong enough to withstand an environment with higher borrowing costs. In that case, could inflation increases be contained? And to add to the monetary question marks, who will be in charge? Fed Chairman Bernanke’s term ends in January 2014, and he may prefer to step down rather than to oversee the great QE unwind.

So what are investors to do? At Bessemer, we are always considering different scenarios, not only tied to central bank policy, but also other key market themes like housing and energy, or material risks like a supply-driven oil-price spike. We want to ensure that we are thoughtful, but also prepared and proactive in shifting allocations to best preserve our clients’ capital and participate in investment opportunities.

During the first quarter, relative improvements in U.S. housing and politics, alongside signals that the Fed was comfortably on hold, influenced our

decision to reduce exposure to U.S. high-yield debt and increase exposure to global large-cap equities — the latter tilted more toward U.S. stocks (Exhibit 6). The Global Opportunities mandate also raised exposure to non-agency MBS (as a portion of credit holdings). Those shifts, alongside a continued maximum underweight to high-quality government bonds, have thus far supported our 2013 performance. MBS is interesting as well because its floating-rate nature would make it relatively more attractive in a scenario where U.S. yields rise alongside at least modest GDP growth.

That said, we remain convinced that investing today requires a global mindset. So while this quarter's *Investment Perspective* is intentionally U.S.-centric, and while our latest asset-allocation shifts have increased our U.S. weightings, we continue to carefully watch for opportunities around the globe. Japan is a great case in point. While the S&P 500 closed the first quarter of 2013 up 10%,

Japan's Nikkei climbed even faster, up 19.3% in currency-hedged terms. Seeing this opportunity, our portfolio managers added yen-hedged Japanese equity exposure last fall — as of the end of March, we were modestly overweight Japanese equities versus our benchmark.

All in all, we're comfortable with our portfolio positioning, and for the first time since the 2008 global financial crisis, particularly looking at the U.S., we feel that market risks are beginning to wane. In equities in particular, valuations seem fair but not rich to us, while Fed policy and capital moving off the sidelines back into the markets should provide additional support going forward. A Rockettes-like celebration is still far from warranted — the global recovery remains uneven and underwhelming. However, we believe the U.S. triple threat may persist a while longer, in turn providing a measure of support for markets worldwide.

Exhibit 6: Asset Allocation Changes During First Quarter 2013

Balanced Growth Portfolio Asset Allocation

	12/31/2012	3/31/2013	Neutral	Expected Range
Cash/Fixed Income/Currency	20.0%	20.0%	30.0%	20 – 40%
Strategic Cash	0.0	0.0	5.0	
Fixed Income	20.0	20.0	25.0	
Equities	39.0%	44.0%	39.0%	30 – 50%
Global Large Cap	25.0	30.0	25.0	
Global Small & Mid Cap	14.0	14.0	14.0	
Inflation Assets	6.0%	6.0%	7.0%	4 – 10%
Real Return	6.0	6.0	7.0	
Opportunistic Assets	35.0%	30.0%	24.0%	15 – 35%
Global Opportunities	23.0	18.0	14.0	
Hedge Funds	12.0	12.0	10.0	
Total	100.0%	100.0%	100.0%	

As of March 31, 2013.

This model displays Bessemer's suggested model portfolio allocation guidelines. Each client situation is unique and may be subject to special circumstances, including but not limited to greater or less risk tolerance, classes and concentrations of assets not managed by Bessemer, investment limitations imposed under applicable governing documents, and other limitations that may require adjustments to the suggested allocations. Model asset allocation guidelines may be adjusted from time to time on the basis of the foregoing or other factors.

Alternative investments, including Bessemer private equity, real estate, and hedge funds of funds, are not suitable for all clients and are available only to qualified investors.

THIS PAGE INTENTIONALLY LEFT BLANK

This material is for your general information. It does not take into account the particular investment objectives, financial situation, or 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. The mention of a particular security or asset class is not intended to represent a specific recommendation, and our views may change at any time based on price movements, new research conclusions, or changes in risk preference.

Atlanta • Boston • Chicago • Dallas • Denver • Greenwich • Los Angeles • Miami • Naples
New York • Palm Beach • San Francisco • Washington, D.C. • Wilmington • Woodbridge
Cayman Islands • New Zealand • United Kingdom

Visit us at www.bessemer.com.

Copyright © Bessemer Trust Company, N.A. All rights reserved.