BESSEMER TRUST

A Closer Look

Bonds and Late-Cycle Investing

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In Brief

- **We recently shifted assets to fixed income within Bessemer portfolios, reducing but not closing our underweight exposure to traditional bonds.**
- **While we acknowledge that bond prices are already high, we believe that the combination of negative interest rates overseas and late-economic-cycle issues in the U.S. warrants holding more of these defensive assets.**
- **Risks to bonds include a significant increase in inflation or sales from large foreign holders, both of which we view as unlikely.**

In recent years, we at Bessemer have not been shy about our underweight exposure to traditional bonds versus our clients' portfolio benchmarks. We saw bonds as expensive and widely held, and we were wary of risks posed by the Fed tightening cycle. Instead, our portfolios emphasized assets we felt would generate higher returns.

Part of the reason for our recently announced asset allocation shift is a desire to move capital into bonds to reduce, but not close, the underweight versus benchmarks across portfolios. In this *A Closer Look*, we address the two key developments behind our change in thinking — the overseas interest-rate environment and the U.S. economic cycle outlook — as well as key risks to bonds that we continue to monitor.

Warming Up to Bonds as the Economic Expansion Matures

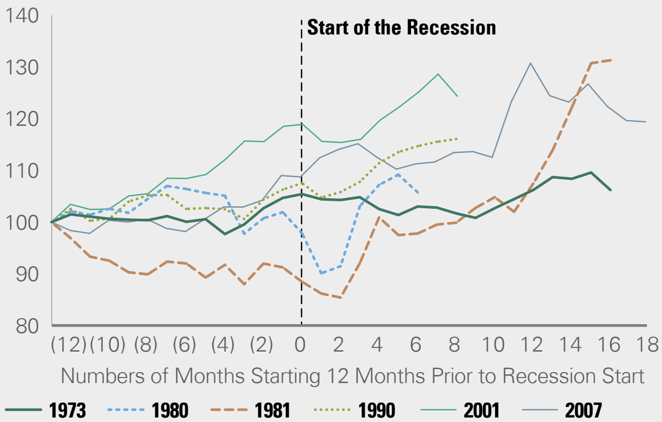
The most compelling reason to reduce an underweight bond position relates to our view on the U.S. economic cycle. Generally speaking, in periods of slower economic growth and U.S. recessions, Treasuries and other high-quality fixed income assets tend to outperform risk markets (equities in particular) significantly. Importantly, this outperformance starts well before the U.S. economy actually tips into recession.

In Exhibit 1, we show the performance of a government bond total return index around U.S. recessions. With the exception of 1980/81, which saw inflation reach 15% and the fed funds policy interest rate jump to 20% at the upper target band, total bond returns have been well in positive territory even before a recession took hold.

Looking at 10-year Treasury bonds for example, in all recessions since 1973, excluding 1980/81 (which we believe was unusual given the oil-price and inflation issues at the time), returns reached 10% on average prior to the onset of recession, with another 6% in gains

Exhibit 1: U.S. 10-Year Government Bond, Indexed to 100 12-Months Prior to Recession Start

Key Takeaway: Bonds have typically gained in the months leading up to a recession and also during the recession.



As of June 30, 2009. The returns are based on a total return index. Recession dates are determined by the National Bureau of Economic Research.

Source: Global Financial Data, National Bureau of Economic Research

to be realized over the life of the recession (Exhibit 2). This compares to double-digit equity losses into recessions around these periods.

Every economic cycle is different; history is a start for analysis but never a perfect guide to the future. Clearly, today's environment is different than prior periods in light of current yields for the majority of high-quality U.S. government and municipal debt. The average 10-year government bond yield since 1972 is 6.60% versus 1.86% today. If the U.S. were to dip into recession, expected returns would likely be more muted compared with periods when yields were much higher. Essentially, yields have less room to fall, or prices to rise (please see "Bonds 101" on page 6 for more details on bond basics). In our view, assuming modest Fed hikes this year and next, ahead of an eventual recession, bond returns could remain in the 2% to 3% annualized range in the coming years, which could be a strong outperformance versus equities and other risk markets in the immediate lead-up to and onset of a recession.

Referring back to several pieces we have written on the topic of late (*"R&R," Quarterly Investment Perspectives* and *Building our Defenses*), our view is that the U.S. is late in the economic cycle but that a recession is not likely in the next 12 to 18 months without some unexpected, material shock. As a turn in the cycle nears, though, incrementally reducing the underweight to bonds is one part of building the defenses of client portfolios. While the reasons for holding an underweight position in bonds have not changed significantly in that yields are still low, moving closer to the end of the cycle is a reason to take the portfolios one step closer to neutral on this protective asset class.

Changes in the Global Landscape Have Made U.S. Debt Relatively More Attractive…

A critical factor that has changed in recent quarters is the global point of comparison for U.S. debt yields. Central bank negative interest rate policy in many pockets of Europe and in Japan has caused yields across the curve (different bond maturities) in those regions to decline significantly, such that U.S. Treasury yields, in comparison, have looked much more attractive. Relative to a simple average of Japanese and Eurozone 2-year yields, U.S. 2-year yields now offer more than 100 basis points (bps) versus being roughly equivalent as recently as 2014. While this is not much of a consolation for savers

Exhibit 2: Average Total Return Before and During Recessions

	10-year Government Bond	Municipal AAA Bonds	Corporate Bonds	S&P 500
12 Months Prior to the Recession	10%	7%	8%	4%
During the Recession	6%	4%	6%	(12)%
Annualized Return Excluding Recessions*	7%	6%	9%	14%

As of March 31, 2016. The following recessions were used to calculate the returns: 1973, 1991, 2001 and 2007. Recession dates are determined by the National Bureau of Economic Research. Due to insufficient data, the 1973 recession does not include corporate bonds.

*Annualized rate of return uses monthly data beginning in January 1972, except for corporate bonds (returns for which are incorporated beginning in April 1975), and excludes returns 12 months before and during recessions. The returns are based on total return indices.

The following indices were used: USA 10-year Government Bond Total Return Index (10-year Government Bond), USA Municipal AAA Bonds Total Return Index (Municipal AAA Bonds), and Bank of America Merrill Lynch US Corp Master (Corporate Bonds).

Source: Bank of America Merrill Lynch, Bloomberg, Global Financial Data, National Bureau of Economic Research, Standard & Poor's in the U.S., for foreign private investors — such as asset managers, pension funds, or individuals — that difference in yield has been meaningful and makes Treasuries and other high-quality U.S. debt more attractive.

U.S. Treasury Department data that track foreign flows into the U.S. market show steady increases from private investors as the U.S. yield has moved higher on a relative basis versus Japan and the Eurozone (Exhibit 3). We also see the same trend in general fund inflows to Treasury and Agency money-market mutual funds.

We believe the trend of negative interest rate policy will persist as activity and inflation data remain muted for the developed world outside of the U.S. This indicates that the risks of U.S. yields moving materially higher are less than they were in the past several years in light of these international developments and wall of demand from foreigners.

…at a Time When Net Supply Has Been Declining

The pull of global factors on U.S. yield levels comes at a time when overall U.S. fixed income supply is diminishing. Projections are for total fixed income net issuance in 2016 to decline to the lowest levels since the financial crisis in 2008. Total U.S. fixed income net supply in 2009 reached over $2 trillion, and for 2016 it should be around $1.2 trillion. Meanwhile, coupon payments expected on outstanding debt should reach almost the same level. This means that if investors holding U.S. dollar debt reinvest their coupon payments, they would buy all net new supply. This constitutes a very favorable supply backdrop that, at the margin, supports prices.

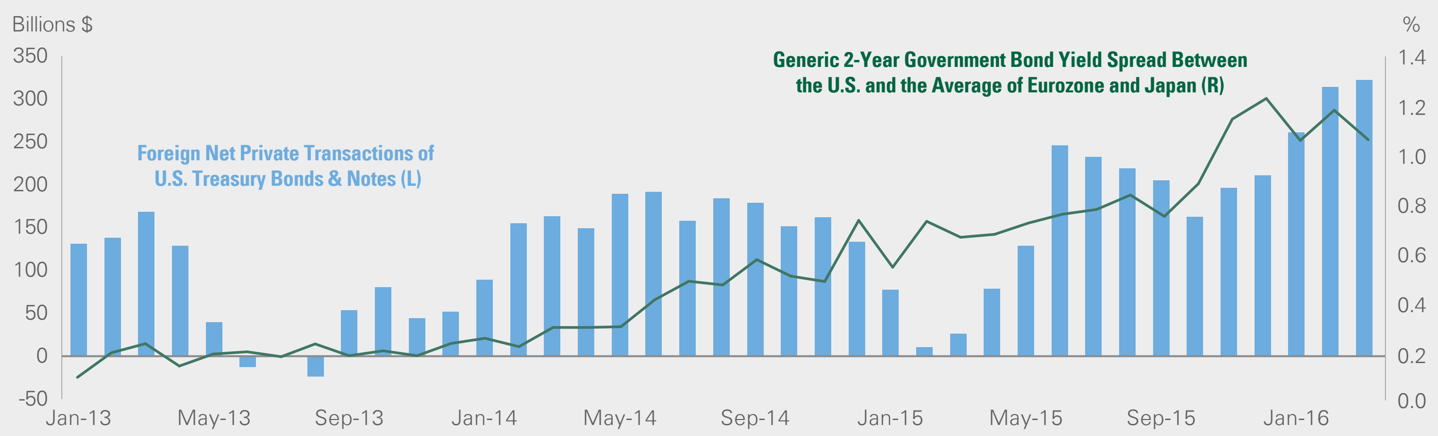
The biggest risk to this supply scenario relates to the political cycle. A new administration in 2017 may trigger an increase of U.S. Treasury issuance with plans for infrastructure development or other spending at the federal level. However, a likely divided Congress — with either a Republican or Democratic White House — would make it difficult to pass sweeping legislation from either party. This is a risk we will monitor as the candidates provide more specific information on their platforms around the summer conventions and into the general election.

Late-Cycle Considerations: Fed Hiking

An obvious consideration for bond holders in the current environment is the Federal Reserve's tightening cycle. After one hike in December 2015, the Fed has been on hold. Only a few weeks ago, the market had

Exhibit 3: Foreign Net Private Transactions of U.S. Treasury Bonds and Notes and 2-Year Government Bond Yield Spread

Key Takeaway: As U.S. bond yields have risen relative to the yields in other developed countries, capital has flowed into the U.S. bond market.



As of March 31, 2016. Net inflows are calculated using a rolling 12-month sum.
Source: Bloomberg, U.S. Treasury

all but priced out a Fed hiking cycle, only expecting an additional rate increase by the middle of 2017. In the last several weeks, however, the Fed has again returned the conversation to more aggressive hiking; we anticipate only gradual hikes in most scenarios.

The spike in market volatility earlier this year, alongside weaker data from Europe, Japan, and China, has highlighted the downside risks the Fed faces from raising rates quickly. We believe the Fed wants to avoid a scenario in which the market pushes the dollar strongly higher on the back of aggressive hikes, which would again bring into the spotlight concerns in commodities, China, and global activity levels. This is a shift in the Fed's view relative to what we and the market expected as of last year, when a more "normal" hiking cycle seemed likely. We believe the Fed is likely to raise interest rates in either June or July this year, with another hike in December if economic conditions remain supportive.

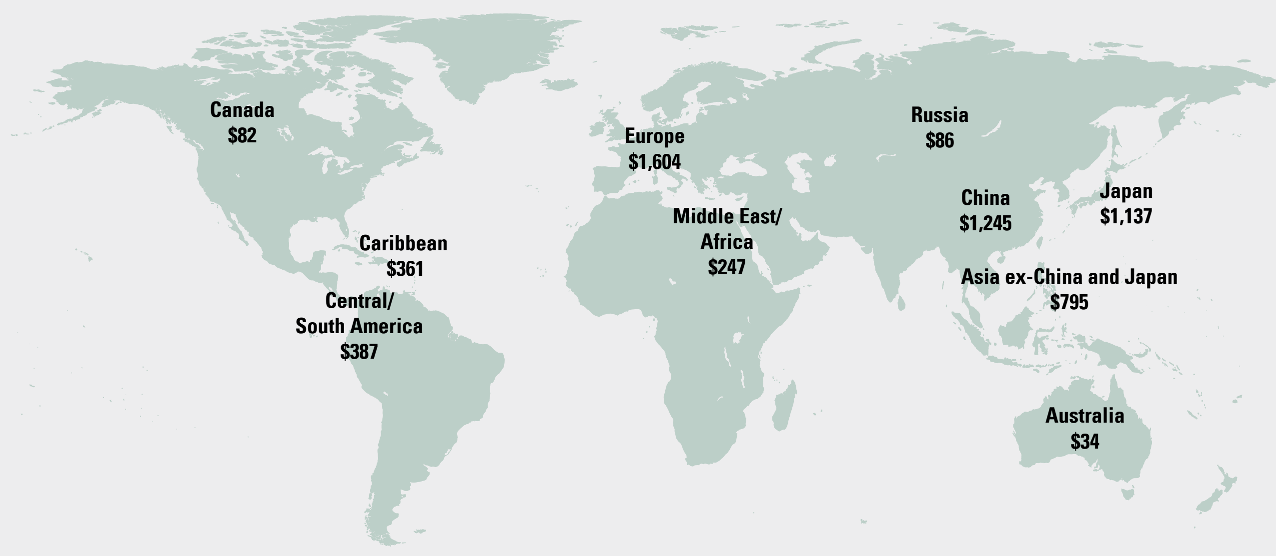
A slow Fed is unlikely to be a major hindrance to bond returns particularly because the market has come around to the idea that the economic cycle is maturing. Without robust growth expectations, investors are unlikely to price in an uptick in inflation to longer-dated bond yields, which would elevate yields and weigh on bond prices. A risk to this view could come in a scenario of stagflation, where inflation picks up even amid slow growth. While not impossible, we believe this is a low-probability risk, especially in the coming one to two years.

Other Risks: Petro-Dollar Selling or Chinese Selling of U.S. Dollar Reserves

Another risk to bonds, and one less discussed, is the potential for selling by large overseas holders of government securities. As discussed on page 3, foreign investors have been major players in the bond market in recent years as negative rates in other markets have made U.S. yield levels more attractive. Currency policies of foreign governments have also driven bond purchases. Most countries have a large portion of their reserves held in U.S. dollars as a tool for currency management. Intervening to weaken local currencies implies buying dollars, and officials have often parked these reserves in U.S. Treasuries given the liquidity the market offers. Notable holders of Treasuries include China and countries with significant oil reserves, as detailed in Exhibit 4 below.

Exhibit 4: Major Foreign Investors Hold $6 Trillion of US Treasury Debt

($ Billions)



As of March 31, 2016.

Source: Bloomberg, U.S. Treasury

Given the amount of outstanding U.S. Treasury debt in foreign hands, there is a risk of one or more of these countries selling a large share of their holdings. The most likely scenario in which China would do this would be if there is market pressure to weaken its local currency, the *renminbi* or CNY. Chinese officials may attempt to support CNY by selling U.S. dollar reserves (and, in the process, selling U.S. Treasuries) to buy CNY in various forms. This has occurred to a degree in the past year or so, leading to a decline in Chinese reserves of approximately $1 trillion, with $100 billion of that reduction occurring in January alone.

But such pressure on the renminbi would probably develop in periods of overall risk aversion in global markets, which are usually accompanied by U.S. dollar strength. This is important because in such periods, demand from other private institutions for Treasuries tends to increase, offsetting sales from China or other foreign central banks. In other words, even in the unlikely event that China does sell a significant amount of its U.S. debt, we believe other investors are likely to absorb the supply that hits the market, reducing the risk of U.S. yields rising significantly.

Recent headlines have also highlighted the risk of Saudi Arabia selling U.S. Treasuries, perhaps due to political considerations. The actual amount of debt that the Saudis hold is a subject of debate in and of itself, as news reports suggest holdings of $750 billion while hard data from the U.S. Treasury say it is a smaller $116.8 billion as of the end of March.[1] While it is difficult to put probabilities on politically motivated actions, we note that selling U.S. Treasuries would be complicated for the Saudis because their currency (the *riyal*) is pegged to the U.S. dollar, and repatriating that money would make that peg difficult to sustain.

In sum, Middle Eastern sales of U.S. Treasuries may pose a risk, but we still believe the probability of this occurring is relatively low.

A final consideration with regard to holders of U.S. debt is that the Federal Reserve itself holds over $4 trillion of domestic debt. Specifically, the Fed holds $2.46 trillion of U.S. Treasuries, $1.75 trillion of U.S. mortgage-backed securities, and $25.1 billion in U.S. Agency debenture securities, as of May 20.[2] The balance sheet more than quadrupled in size during the three rounds of quantitative easing initiated in the wake of the 2008/2009 financial crisis.

Importantly, even though the Fed has started to hike short-term interest rates, it has not reduced the size of its balance sheet by selling securities or leaving maturities and cash flows uninvested. The Fed continues to reinvest the proceeds from maturity payments on its bonds to maintain the balance sheet at this historically large level. There would be a high bar for the Fed to enact another round of quantitative easing even under one of the extreme scenarios outlined above, but it is worth remembering that the Fed is still one of the largest players in town when it comes to liquid U.S. bonds.

In conclusion, we at Bessemer have become less negative on high-quality bonds as the end of the economic expansion comes into sight, reducing our underweight relative to other asset classes. Global developments regarding negative interest rates and an analysis of the risks of higher interest rates suggest less downside to owning bonds than was the case in recent years. Meanwhile, to build defenses ahead of the economic turn, and possibly even shorter-term event risks, bonds are becoming more attractive.

[1] One possible source of the discrepancy is that U.S. Treasury data track where debt is held but not necessarily who specifically owns it. For example, flows from the Caribbean and the United Kingdom are very high because they are financial centers, and not because citizens of these countries themselves hold so much U.S. debt. It is well understood that a significant portion of petro-dollars from the Middle East is held in Europe, and the U.K. specifically.

[2] Source: Bloomberg, Federal Reserve website

Bonds 101

U.S. Treasury-issued debt serves as the backbone of the U.S. fixed income markets. Overnight interest rates are set by the Federal Reserve via the federal funds rate, which is reviewed at least every six weeks at Federal Reserve meetings, chaired by Janet Yellen. The rest of the interest-rate curve trades based on the federal funds rate as well as supply and demand factors, with the U.S. Treasury issuing debt out to 30 years of maturity. Municipalities issue debt backed by state funds or other vehicles, much of which accrues interest in a tax-efficient way for bond holders. Bond holders earn coupon payments (interest payments), usually semi-annually, but are also subject to principal gains/losses on bonds not held to maturity even on “risk-free” debt. When interest rates on a bond increase, the principal value of the bond decreases, and vice versa. (In other words, when yields go up, bond prices go down.)

Municipal and corporate bonds tend to trade at a “spread,” or higher yield, versus Treasury debt given the higher perceived credit risk. At Bessemer, our fixed income department views bond investments as a surrogate for irreplaceable capital. Accordingly, the team extensively researches credit risk before making an investment. There are both taxable and municipal platforms within the Bessemer fixed income group. The former currently has an overweight allocation to high-grade corporate debt. The Strategic Opportunities mandate also holds credit, but the emphasis there is on market dislocations rather than high-quality surrogates for cash.

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