BESSEMER TRUST

Quarterly Investment Perspective

Japanification Investing

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Executive Summary

- **Recent decades have seen Japan at the forefront of several significant macroeconomic trends, from process- and technology-led growth to sustained deflationary pressures, to deteriorating demographics and increasingly ineffective monetary policy**
- **While all countries have their unique characteristics, Japan's situation may help us more effectively think through other countries' futures**
- **Among a handful of major economies, we see the U.S. as relatively more immune to what many now call Japanification; Europe, meanwhile, appears much more likely to repeat some of Japan's history**
- **Understanding these trends underscores our current portfolio bias toward the U.S. and away from Europe and Japan but also helps us identify risks that could alter those preferences**

The last several decades have seen Japan lead the world in a number of significant macroeconomic and policy trends:

- Forty years ago, in 1979, Japan's process- and technology-led growth boom was reflected in Sony Corp. launching the iconic Walkman — for the next decade, the portable music product dominated competitors.
- By the mid-1980s, Japan's economic ascent and global reach triggered U.S. anxiety and backlash, culminating in trade and currency wars.
- The 1990s saw a number of Japanese policy errors that exacerbated a prolonged period of economic stagnation and contributed to a deflationary mindset among businesses and households.
- The Bank of Japan subsequently adopted zero interest rates and early forms of quantitative easing in the late 1990s; central bank equity purchases followed in 2010.
- Also starting in 2010, Japan's population began to decline, importantly with fewer workers relative to retirees.

Japan's history rhymes with a number of trends unfolding today around the world, leading more economists to explore what is increasingly called Japanification. In this edition of our *Quarterly Investment Perspective*, we first briefly review what Japanification means, then consider which other major countries share those characteristics (Exhibit 1). Importantly, we attempt to extrapolate these macroeconomic trends to some key investment implications.

Exhibit 1: Japanification Markers

Key Takeaway: Europe is exhibiting more signs of Japanification.

	Population Trend	Inflation Trend	Debt/GDP	Monetary Policy
Japan	↓	↓	↓	↓
Euro Area	↘	↘	↘	↓
U.S.	↔	↔	↘	↘

Arrow direction and color reflect severity of "Japanification" in each economy, with red most severe. Horizontal arrows reflect two-way risk for the respective economy's variable.

Source: Bessemer Trust, International Monetary Fund (IMF)

While demographics, deflation, and debt define Japanification, so too do culture and policymaking.

Overall, our analysis leaves us comfortable shying away from meaningful Japanese exposure in client portfolios and, through a Japanification lens, viewing developed Europe with notable caution. We continue to see reasons why the U.S. economy and markets can avoid many of Japan's challenges, but recognize that this requires timely, appropriate policy decisions that support America's entrepreneurial culture.

As with all our quarterlies, we conclude with a review of recent performance and our positioning as we head toward 2020. Since mid-July, we have been modestly underweight equities versus our benchmarks.

Defining Japanification

While various authors include different characteristics when defining Japanification, at least three variables are consistently highlighted:

- **Demographics.** If economic growth is a function of labor, capital, and productivity, a shrinking workforce, all else equal, suggests slower growth ahead. Japan's population pyramid, with fewer workers per senior citizen (or "dependency ratio"), exacerbates this headwind by channeling more government resources to healthcare and elderly-related social safety nets relative to other, potentially more growth-enhancing initiatives, such as infrastructure. The country's elderly dependency ratio, already high at 40%, is projected to exceed 90% after 2050.
- **Deflation.** After Japan's equity market bubble popped in 1989, pulling down inflated real estate and land values and making many companies insolvent, a prolonged period of business and household caution and related stagnant growth ensued. A self-reinforcing loop, with slow growth limiting spending and investment, added to a deflationary mindset. Without expectations for higher wages or prices, incentives to reduce savings were limited. The Bank of Japan (BoJ) has experimented with a variety of traditional and nontraditional policy steps to change the nation's psyche and these underlying economic trends, but thus far with very little success. Analysis by the San Francisco Federal Reserve showed that "after Japan introduced a negative policy interest rate in 2016, market expectations for inflation over the medium term fell immediately.... Essentially, the market appeared to treat negative rates as bad news, perhaps because investors were concerned that the BoJ's unprecedented move meant that economic conditions were worse than thought." Despite all of the BoJ's interventions, annual Japanese consumer price growth has averaged just 0.1% since 2000.
- **Debt.** Without more tax revenue to fund government programs, Japan has had to borrow — gross government debt at 237% is the highest debt ratio in the developed world and is projected to slightly increase by 2024, according to International Monetary Fund projections. With interest rates so low, servicing the debt has been manageable thus far. Further, most debt is held domestically — both of these factors

have helped prevent a debt-related financial crisis. That said, the debt also acts as a huge constraint on the government. It must focus on preventing interest rates from rising in such a way that debt service costs become problematic; at the same time, any fiscal steps taken to reduce the country's debt and deficits can easily slow growth, only further reinforcing the cautious, savings-centric mindset. It is not surprising to us that when we looked at the last 35 years, nearly two-thirds of the movement in real 10-year Japanese interest rates could be explained by two "Japanification" variables: gross government debt levels and the working-age population.

An incremental approach to policymaking has only reinforced Japanification.

In addition to these "three Ds" above, our research suggests other meaningful contributors to Japanification, particularly the country's history, culture, and politics.

Every country is a function of its history. In Japan's case, history has influenced a culture where focus on the group rather than the individual, stability, and homogeneity are prioritized (looking at the nation in a generalized way). These traits have fed through to numerous aspects of family life, business, and government. The makeup of Japan's population is one example. As a percent of the country's total population, immigrants and their children represent less than 2% of Japan's population, versus 14% of the United States' population. Foreign workers as a percent of the total workforce today are 1.3% in Japan compared with 14% in the U.S. While Japan's government is taking steps to attract more immigrant workers to ease its demographic challenges, it is from an extremely low base and very incrementally, in part to preserve another cultural priority — stability.

Similarly, Japan's culture has meant that, historically, many women did not work, or would work until having children but then retire or move to part-time roles to focus on traditional family duties (group over the individual). Demographic and growth challenges, not to mention international pressure on individual companies for greater diversity, have led to policy shifts in recent years to encourage more women to work. And while today, women's labor participation in Japan is actually higher than that of the United States, a large cohort leaves the workforce after having children, finds itself limited in career opportunities, and/or faces pay gaps versus male peers that are notably larger than in other developed countries. (Japan's male/female pay differential for full-time employees is reportedly the world's third highest — exceeded only by South Korea and Estonia.)

Tradition and culture have heavily influenced Japanese corporate behavior as well. The idea of stability has fed into a system that still allows for "lifetime employment," with workers joining a firm out of school and staying through retirement. Companies, rather than fire these so-called regular workers during a downturn, may cut wages or focus more on temporary and part-time workers for any needed layoffs. Partly as a result of this system, firms may have less flexibility to shift resources in an effort to improve efficiency and profitability, in turn weighing on the attractiveness of some Japanese equities (see *Investment Insights,* "Japanese Equities: Progress Underway, but Challenges Remain").

None of this is to say that these Japanese cultural characteristics are necessarily negative. As with any society, cultural attributes can be seen from different angles. Consider a few examples:

- Lifetime employment in Japan has limited joblessness versus global peers during recessions. In 2009, for instance, Japan's unemployment rate peaked around 5.4%, versus nearly 10% for the U.S.
- Japan's cultural biases, while perhaps not encouraging for entrepreneurs, have allowed for relatively less income inequality — this is reflected in Japan's Gini coefficient, which is notably below that for the U.S. or the U.K.
- A culture of incremental change and stability has limited needed immigrant workers and large policy changes, but has helped avoid some of the recent populist backlash against such workers across Europe and the U.S.
- Overall, despite stubbornly slow economic growth and demographic decline, the GDP per capita in Japan remains high (Exhibit 2). For many Japanese, cultural norms and economic headwinds have not prevented a very comfortable quality of life (as well as a long life; Japanese life expectancy is the highest in the world).

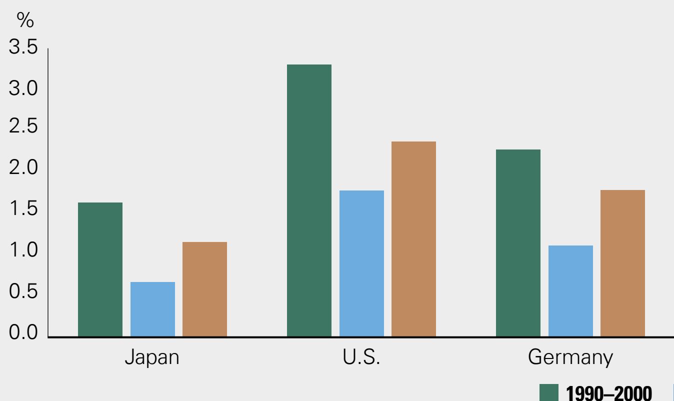
Indeed, the relative contentment of many Japanese may actually reinforce Japanification — if voters are happy, they are less likely to demand large and/or immediate changes from elected officials. Japanese policymaking, aside from the high-profile launch of "Abe-nomics" under Prime Minister Shinzo Abe in 2012 and 2013, has been decidedly incremental. In an effort to limit public debt growth, for instance, Japan's government modestly increased consumption taxes (VAT) from 3% to 5% in 1997 and again in 2014 (5% to 8%), with another increase implemented October 1, 2019 (to 10%) — the latest despite the fact that the previous increases triggered one-off GDP growth declines that helped reinforce a savings mindset.

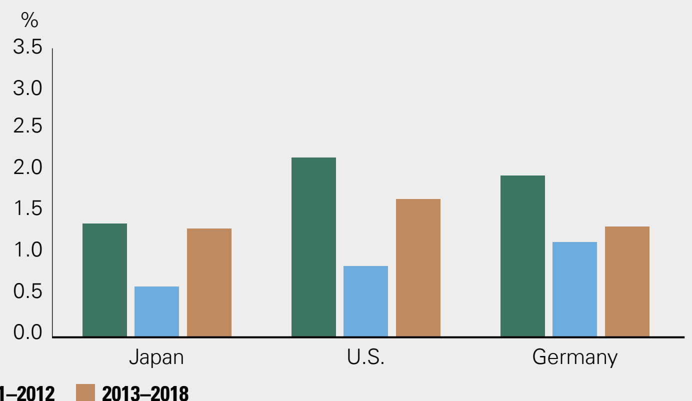
Japanese government officials have suggested to us that they know steps taken since Abe's election (including easier monetary policy, "flexible" fiscal policy, and labor market and corporate reforms) are likely to help growth and inflation trends only over the very long term — possibly decades. Our sense is that they are simply not comfortable with the political and cultural risks of forcing more change, more quickly — at least for now.

Meanwhile, we believe the BoJ is now boxed in somewhat in that higher inflation, unless fueled by a significant growth pickup, has become problematic as the likely

Exhibit 2: Real GDP Growth vs. Real GDP Growth Per Capita

Key Takeaway: Japan's economy has grown at a slower rate than developed-market peers, but in recent years, GDP per capita growth has been comparable.





As of December 31, 2018. Note: Figures are average growth rates.

Source: Goldman Sachs, Haver Analytics, United Nations

resulting rise in interest rates would quickly increase debt-interest payments. Slightly higher inflation alongside better growth would be good — any other reason for higher inflation and interest rates could worsen Japanification.

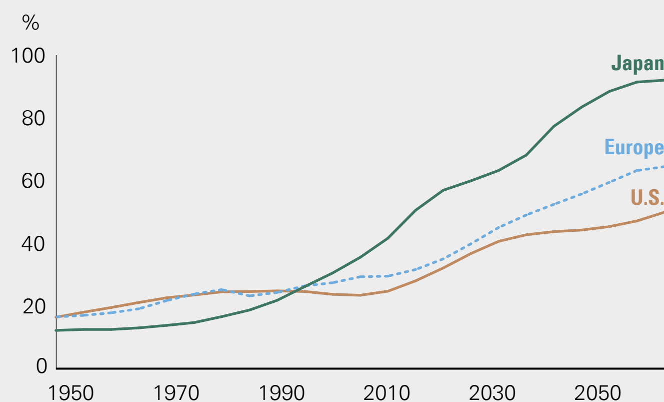
Japanification Going Global

The fact that strong labor markets and consumers have proven insufficient to lift inflation or government bond yields across developed markets in recent years has raised questions about whether Japanification is spreading.

Every country is unique, of course. But we do see some of the same characteristics and trends that have led Japan to its current state evident in other corners of the world — especially in developed Europe. (With an eye on the length of this research note, we have limited our analysis just to three economies but would certainly consider further exploration of the theme, especially around China.)

Exhibit 3: Old-Age Dependency Ratio — Population Aged 65+ per 100 Population Aged 25–64

Key Takeaway: Similar to Japan, Europe and the U.S. face aging populations in the coming decades.



Source: United Nations

- **Demographics.** Using United Nations data and projections, Europe is following a demographic path very similar to Japan's.

  Japan's working-age population has shrunk by more than 12% since the early 1990s and is expected over the coming decades to fall at an annual rate of 1%, a 25% overall decline by 2048.

  Using 2008's global slowdown as a starting point, Europe is on track to see its working-age population contract by 0.5% per year, or a cumulative decline of 15% by 2048. Europe's dependency ratio is similarly set to increase — with the degree of change most pronounced in Italy, followed by Germany and Spain. While Europe historically has been more welcoming of immigrant workers, backlash from an unexpectedly large immigrant wave in 2015 suggests that, going forward, this may not be as politically easy a "fix" for an aging, shrinking population (Exhibit 3).

- **Deflation.** Since the euro was launched in 1999, euro area consumer prices have risen by an average 1.7%, not far off the European Central Bank's (ECB) 2% target. That said, policymakers have struggled with that goal; inflation turned negative in 2009, 2015, and 2016 and held below the ECB target 74% of the time, despite the central bank cutting interest rates to negative levels in 2014 and launching quantitative easing efforts in 2015.

  Importantly, and similar to Japan, negative interest rates and extremely low borrowing costs have not resulted in the degree of consumer spending improvements expected or a shift out of fixed income to equity or other investments. Instead, a Japan-like savings mentality appears to have become more entrenched. Today, despite an unemployment rate in the euro area at 7.6% (a decade low), the region's saving rate remains around 12%.

- **Debt.** While the overall debt/GDP ratio for the euro area is around 85%, a fraction of the same metric in Japan, there is massive dispersion in debt levels within the European Monetary Union (EMU). At one end of the spectrum, Estonia's debt/GDP is 8%; Greece, meanwhile, has a debt/GDP ratio of 183%, and Italy's is 132%. Based on the Maastricht Treaty, EMU members have pledged to keep government debt at or under 60% of GDP; as of early 2019, nearly two-thirds of those countries were in violation of that policy.

  Europe's challenge with debt is therefore different from Japan's and likely not as dire given the Maastricht rules (assuming the rules remain credible). As we noted

Significant policy decisions in Europe can at times require months or even years of deliberations to reach agreement among member states.

in our First-Quarter 2019 *Quarterly Investment Perspective*, "The Euro Turns 20," the monetary union's bigger hurdle is the lack of business-cycle and economic synchronicity among its members. A country like Italy, with slow growth and high debt levels, would likely benefit from easier monetary policy while northern neighbors like the Netherlands do not require easier policy at the moment (Dutch consumer price inflation is running at 2.5% year-on-year, while the country's unemployment rate is below that of the monetary union overall).

That gets us to history, culture, and policymaking in Europe. "The Euro Turns 20" briefly reviewed the history that led to the monetary union and continues to shape culture and policymaking today.

One of those defining qualities, in our view, is consensus building. Significant policy decisions in Europe can at times require months or even years of deliberations to reach agreement among member states. While this creates broad support for most policies, it also means that decisions may not come as quickly as needed.

Consider the 2008-2009 financial crisis. The U.S. Federal Reserve started cutting interest rates in September 2007; the ECB's first cut in the economic downturn occurred more than a year later and only after a final hike in July 2008. Looking back at those months, a former ECB board member said that the central bank acknowledged slowing growth at the time but was worried about keeping inflation expectations anchored, so was hesitant to quickly follow the Fed's lead.

An aversion to inflation alongside a penchant for rule-following and controlled borrowing are additional defining characteristics of Europe's largest economy, Germany. While hyperinflation and large government debt loads are a century in Germany's past, they still shape German policymaking today. Indeed, in 2011, Germany's top official at the ECB resigned, in part due to his displeasure at the central bank's decision to buy government debt to help member states rather than forcing those states to reduce spending and adhere to Maastricht guidelines.

While different from Japan, the euro area's history and cultural biases result in a similar policymaking outcome: a tendency for decisions and actions that may prove more incremental than what is required to fight a crisis. Should policy responses prove lacking, the risks, in our view, become higher that Europe develops a Japan-like entrenched mindset of caution, exacerbating a low inflation and low interest-rate environment for a prolonged period.

The United States, meanwhile, shares some Japanification attributes but more directionally than in degree.

- **Demographics.** The U.S. continues to see population growth, driven in large part by immigrants and their families. That said, the U.S. is still experiencing a Japan-like shift in its demographics, with the country

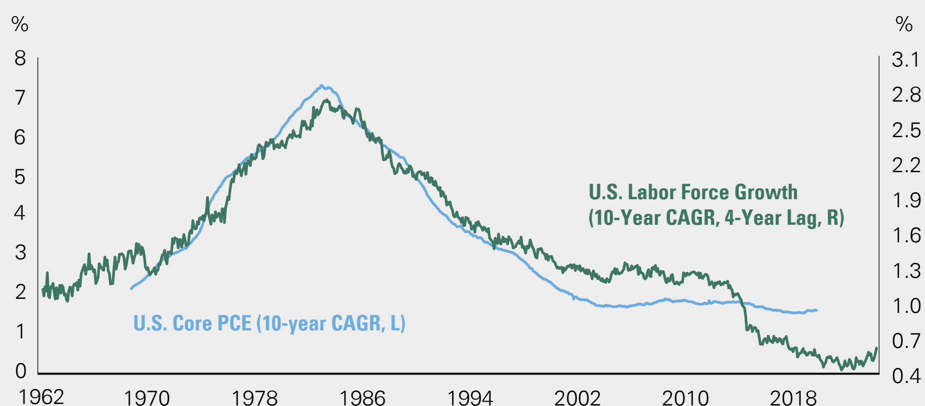
overall skewing older. Between 2014 and 2050, the 65-and-above U.S. population is expected to climb from 15% to 22% of the total, while the elderly dependency ratio is expected to rise from roughly 28% today to 36% in 2050. This is still a lower expected ratio (in 31 years) than that of Japan today. However, the likely path of the population pyramid still warrants notice, as trends in Japan have contributed to greater government debt, slower economic growth, and lower interest rates. Especially if the U.S. were to substantially curtail immigration, a faster deterioration of the dependency ratio could unfold.

- **Deflation.** Recent U.S. inflation trends have echoed those of the euro area, although to a lesser degree. Using the Fed's preferred measure, core personal consumption expenditures (PCE), inflation has risen an average 2.1% since 2009, but with readings below the Fed's 2% target more often than not over the period, despite unusually easy monetary policy (both low interest rates and QE) and an extremely tight labor market (unemployment rate below 4%) (Exhibit 4). Recent months have seen increased investor doubts whether more easing can effectively change U.S. inflation and inflation expectations — most likely influenced by watching the lack of inflation in Europe and Japan despite extreme monetary efforts. Appreciating those challenges overseas, a number of Fed officials are discussing possible changes to the central bank's inflation mandate that could be used in an effort to avoid a Japan-like deflationary mindset, potentially to be implemented in 2020.

A number of Fed officials are discussing possible changes to the central bank's inflation mandate that could be used in an effort to avoid a Japan-like deflationary mindset.

Exhibit 4: U.S. Labor Force Growth and Core PCE

Key Takeaway: Despite a tight labor market and easy monetary policy, inflation has remained relatively low in recent years.



As of July 31, 2019 for PCE and August 31, 2019 for labor force growth. PCE stands for Personal Consumption Expenditures.

Source: Bloomberg, U.S. Bureau of Labor Statistics

- **Debt.** While nowhere near Japan levels, U.S. debt has grown steadily in recent years, initially via stimulus following the 2008-2009 crisis and more recently via generous fiscal spending and tax cuts under President Trump. U.S. gross government debt as a percent of GDP reached 106% last year, more than double 2008 levels. The nonpartisan Congressional Budget Office (CBO) forecasts that federal debt held by the public will increase from 78% in 2018 to 93% of GDP by 2029, with federal revenues allocated to pay for entitlement programs (including those to support the elderly) and interest payments on federal debt expected to rise from 85% in 2018 to 97% of total revenues by 2029. This prediction is noteworthy as it suggests fewer government funds for longer-term growth-enhancing initiatives such as education, training, research, and infrastructure.

While these "Ds" are more benign than what exists today in Japan, what may differentiate the U.S. even more is culture and policy. Again, this is not meant to suggest that American cultural or policy biases are all good and other countries' are bad. **But in the context of Japanification, certain U.S. norms may prove helpful, including a cultural acceptance of failure, an innovation ecosystem, light labor-market regulations, and relatively rapid policy decision-making.** This latter piece of the puzzle merits a caveat, however. While the U.S. usually doesn't need time to build consensus like Europe, and doesn't perhaps prioritize social stability to the same degree as Japan, it faces a different challenge: extreme partisanship that could stymie needed fiscal or other policy actions.

To the degree the U.S. sees further slowing in growth and lower interest rates that influence consumer and business behavior and threaten a negative feedback loop, government officials need to agree on timely countermeasures. Monetary policy alone will not be enough, and indeed, as Japan has shown, could even prove damaging. Just in August, the director of the University of Michigan consumer sentiment survey stated, "The main takeaway for consumers from the first cut in interest rates in a decade was to increase apprehensions about a possible recession.... Consumers concluded, following the Fed's lead, that they may need to adopt a precautionary spending outlook in anticipation of a potential recession."

Japanification Investing

Understanding the drivers of Japanification, and where these trends are going across key economies, can help us make better investment decisions. As mentioned earlier, we know that, at least historically, deteriorating demographics have contributed to slower economic growth and less inflation, while large debt overhangs have limited policy flexibility. Below, we consider some key implications for fixed income, equity, and currency markets.

Fixed income. We believe that demographics, deflation, and debt together have directly and indirectly influenced the multi-decade trend lower in Japanese government bond yields — from 6% at the start of 1990 to -0.28% at the beginning of September this year for 10-year JGB yields. As yields fell (and prices increased), Japanese bonds posted positive annual calendar-year returns 92% of the time between 1990 and 2015.[1] More recently, though, such returns have been more and more limited and the asset class less and less compelling. Indeed, the BoJ's yield-curve control policy introduced in September 2016 explicitly anchored both short- and longer-term yields, with the 10-year government bond (JGB) yield in an incredibly tight range of 0.15% to -0.28%, while short-term policy rates have been -0.10%. At this point, and looking ahead, at least for longer-term investors like ourselves who are not forced to adhere to global bond benchmarks, there is little reason to consider Japanese debt for portfolios, given other opportunities in this asset class. **We are not in the habit of seeking returns via negative-yielding bonds becoming even more negative, even with possible help from currency fluctuations.**

European fixed income is more nuanced, given that each of the 19 EMU member states offers national debt instruments. As of early September, government debt out to 10 years (and in some cases beyond) had negative yields with the exception of Cyprus, Portugal, Spain, Italy, and Greece. Even then, yields on these countries' government bonds were extremely low, in part as investors searched for any positive yields in the region and in part on expectations that ECB bond purchases would keep yields low for the foreseeable future (Exhibit 5). Indeed, even in Italy, in the middle of a domestic political crisis and with high debt levels, a 10-year bond yield was less than 1% in early September, below a comparable 10-year U.S. Treasury bond yield. While a positive return could be had should

[1] Japanese bond performance is measured using the Bank of America Merrill Lynch Japan Government Index.

Exhibit 5: Japan and Euro Area 10-Year Government Bond Yields

Key Takeaway: Euro area bond yields are following a pattern similar to those in Japan.

As of September 2019. Note: Horizontal axis represents years. Year 0 is 1989 for Japan and 2008 for Europe.

Source: Bloomberg

yields fall further in Europe, especially alongside a stronger euro versus the dollar (assuming portfolios are dollar based), we do not see opportunities here as compelling. Bond prices supported by a search for yield and ECB policy in places like Italy do not, in our view, adequately reflect the country's risk. Unlike Japan, fundamentally challenged euro area member states cannot quickly cut interest rates or weaken their currency if the need arises.

Meanwhile, the U.S. bond market seems to be going through a period of yield convergence toward the levels of Japanese and European counterparts. As was the case for Japan for much of the 1990s and 2000s, U.S. Treasury yields have been trending lower, with higher prices and still-positive yields resulting in respectable total returns (in the mid- to high-single digits so far in 2019).

As we look ahead, **we believe the probability is relatively low that the U.S. embraces negative short-term interest rates, in part as a number of Fed officials have already cautioned about risks for U.S. money markets from such policy. That said, both near term (as the U.S. economy slows and the Fed eases further) and longer term (as demographic trends potentially influence both U.S. growth and inflation expectations), we would not be surprised to see U.S. yields biased lower still.**

Certainly, more Treasury issuance is likely given growing budget deficits. That said, we do not see this as likely to result in higher yields, for at least two reasons. First, Treasuries still provide more attractive yields and vastly better liquidity than other developed-market government bonds, resulting in sustained foreign and domestic demand (even if some foreign central banks are diversifying away from Treasuries, there are only so many places they can go). Second, domestic investors have structural needs for U.S. bonds in order to meet specific targets (liability matching for insurance companies and pensions, defensive asset ratios for financial firms).

All this is to say that our base case is for diminishing but still positive returns from U.S. Treasuries over the coming years. We would reconsider our view should U.S. policy materially change (significantly fewer immigrants exacerbating the demographic decline, for instance). We also have to acknowledge that over this longer-term horizon, periods of negative bond returns could result (as was the case in Japan) should inflation suddenly pick up (either because of stronger growth or a supply shock like higher oil prices). In such cases, however, our investment team would adjust holdings to manage risk.

Equities. We are global investors and, as such, always consider individual companies for their specific attributes wherever they reside. We do not want to rule out a potentially great investment simply because of its home country. That said, there are periods when macro considerations like country of domicile and currency can dominate bottom-up, company-specific features — that means we need to think about equities in Japan, Europe, and the U.S. with Japanification in mind, even if other external forces (such as the current trade war) are also significant.

Broadly speaking, Japanification includes rock-bottom interest rates, which intuitively sounds bullish for stocks, as low rates in and of themselves suggest lower refinancing costs, higher profitability, stronger earnings (lower discount rates), and reduced default and downgrade risks. Low bond yields could also push investors to look beyond bonds to stocks in a search for attractive returns.

That said, we know that "why" interest rates are high or, in this case, very low matters a lot. Low interest rates, when employed to fight deflation and stimulate anemic growth (two Japanification characteristics),

Banks with cautious mindsets and challenged net interest margins have been reluctant to lend — even more so given the modest economic growth backdrop.

suggest an environment where corporates may struggle to generate revenues. Performance of Japanese equities in recent decades supports this point. As we highlighted in our September 3 *Investment Insights,* "Japanese Equities: Progress Underway, but Challenges Remain," the country's stocks have lagged most other global peers for most of the last few decades, with interest rates and other aspects of Japanification doing more harm than good.

Consider the Japanese banking sector. The strategy of borrowing at lower short-term interest rates to profit from lending at higher longer-term rates has been challenged by low/negative interest rates along the yield curve.

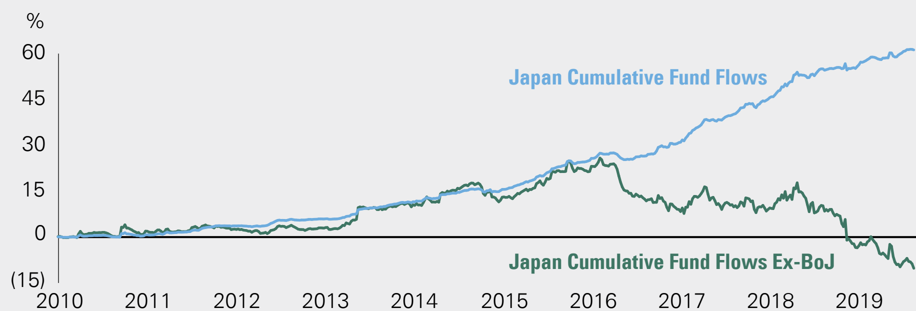
Partly as a result, banks with cautious mindsets and challenged net interest margins have been reluctant to lend — even more so given the modest economic growth backdrop.

Poor performance of financials is material — the sector accounts for 11% of the overall TOPIX equity index. While a smaller piece of the market than the industrial sector, banks play an outsized role in Japan in that they can create a negative economic and equity market feedback loop if they are not thriving, as they are the main conduit in the country for corporate and household borrowing.

Looking across Japan's stock market, investor interest has been hampered by at least two other Japanification-related factors: relatively low profit margins, which have been capped by executives' inability to raise prices or cut costs (full-time workers), and perhaps ironically, Bank of Japan's equity exchange-traded fund (ETF) purchases. While BoJ buying is clearly supportive overall for local stocks, it means that individual securities may not consistently reflect underlying company fundamentals and that prices could be distorted. Over the last four years, net mutual fund and ETF flows into Japanese equities have been completely explained by central bank buying — non-BoJ flows have been negative, limiting overall returns and showing that policy actions have been far from sufficient to turn investor sentiment (Exhibit 6).

Exhibit 6: Cumulative Fund Flows in Japan

Key Takeaway: Excluding the Bank of Japan (BoJ) ETF purchases, investors are net sellers of Japanese equities in recent years.

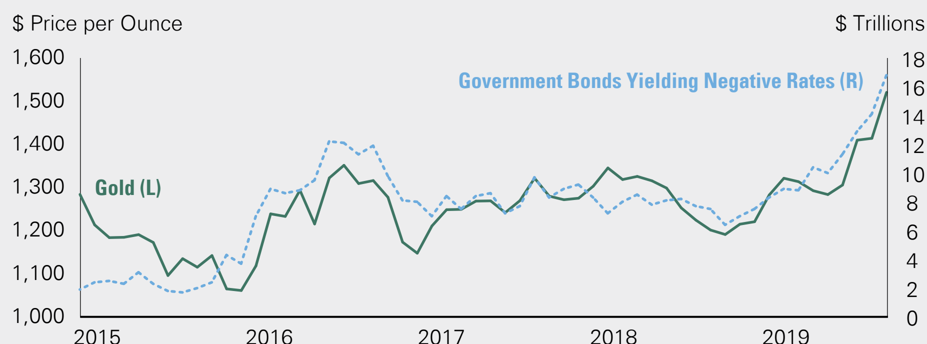


Data represents Japanese cumulative fund flows as a percentage of AUM as of July 31, 2019.

Source: Flows & Liquidity, J.P. Morgan

Exhibit 7: Gold and Negative-Yielding Global Government Bonds

Key Takeaway: Gold prices have risen alongside negative-yielding bonds in recent years.



As of August 31, 2019. Bonds measured using Bloomberg Barclays Global Aggregate Negative Yielding Debt.
Source: Bloomberg

> Increasingly, European banks are being forced to pass through negative interest rates to different types of clients; this risks deposits leaving and households hoarding cash or looking for alternative defensive assets.

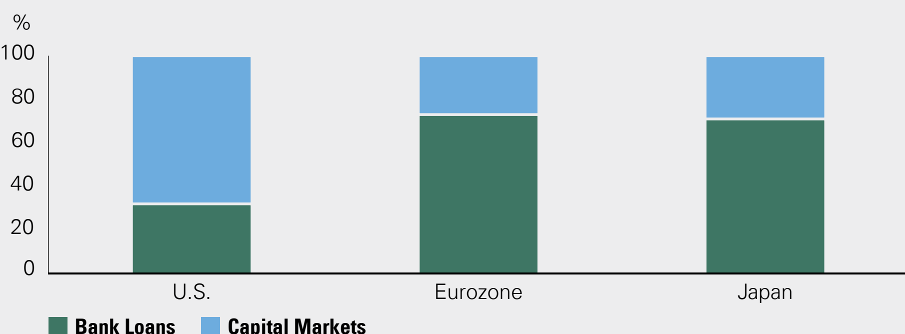
European equities face a similar challenge to their Japanese peers: banks. The ECB announced in September that it would "tier" increasingly negative short-term interest rates to help mitigate the risk to regional banks' net interest margins. That said, negative rates and a flatter yield curve remain, and like Japan, banks play a large role in Europe. With the vast majority of European corporate financing and household borrowing going through banks, the health of the banks and their willingness to lend can have a meaningful impact on the broader economy. Increasingly, European banks are being forced to pass through negative interest rates to different types of clients (rather than absorb this cost themselves) — this risks deposits leaving and households hoarding cash or looking for alternative defensive assets (it's not a surprise that gold prices have risen alongside the value of negative-yielding government bonds, Exhibit 7). Further, the banking sector is the largest within the European equity index, representing 17% of the total. Over the last decade, the broader European equity market has struggled to rise without participation of regional banks: Indeed, the index's annualized performance has increased by 5.2% over the past decade while the banking sector declined by 1.6% (global equities are up 9.3% annually over the same time period).

There is an additional European banking angle worth noting when thinking about Japanification: the link between the region's banks and EMU members' debt. European banks tend to hold substantial amounts of government debt; in the case of Italy, local banks had about 30% of total government debt at the end of last year. When fears of government instability or easier fiscal policy increase, investors often sell the local debt; falling bond prices in turn hurt the banks' balance sheets and make them more cautious. Less bank lending weighs on sentiment toward growth — this can quickly create what some investors now call a "doom loop" between bank share prices and bond yields. ECB policy to buy members' bonds (QE) helps support bond prices and hence banks; however, with a limited supply of available European

We see risks in the future that growing debt burdens and fiscal uncertainty in some euro area countries will feed back into bank equities, weighing ultimately on the broader regional equity market.

Exhibit 8: U.S., Eurozone, and Japanese Corporate Debt Sources

Key Takeaway: Given well-developed debt capital markets, the U.S. economy relies less on bank lending than does Europe and Japan.



Source: AFME, BoJ, Deutsche Bank Research, ECB, Fed, SIFMA

debt and some ECB members hesitant to expand asset purchases as Japan has done, we see risks in the future that growing debt burdens and fiscal uncertainty in some euro area countries will feed back into bank equities, weighing ultimately on the broader regional equity market.

Frankly, U.S. equities have benefited in recent years from Japanification trends overseas. Despite higher valuations, U.S. equities have looked relatively attractive when viewed through the potential for growth in revenues and profits.

Lower U.S. yields and a flatter yield curve have weighed on U.S. banks. But in contrast to Japan and Europe, the broader U.S. equity market relies more on the performance of the technology sector than the bank sector — the former accounts for 22.4% of the equity index, versus 13% for financials. In addition, the U.S. economy relies relatively less on banks for broader economic health and credit creation, given very liquid and well-developed capital markets (Exhibit 8). Even if banks may be less willing to make loans, companies can source capital directly from the marketplace.

Foreign exchange. Like stocks and bonds, currency values are influenced by a host of factors. In our July 2014 Quarterly Investment Perspective, "Common 'Cents' — All About the Dollar," we tried to show some of these key drivers — summarized in Exhibit 9.

As we think about what Japanification means for currencies, we can start with this schematic. In the case of Japan's yen, the country's current account (3.4% of GDP) has a meaningful surplus (Exhibit 10). That suggests a yen support as foreign entities need to buy the currency in order to purchase Japanese goods. The incentive, meanwhile, for large net capital flows into Japan generally has been limited in recent years. While equity valuations are relatively attractive and yields are low, foreign investors have been hesitant to add much Japanese exposure (as we explained earlier).

One interesting twist for the yen is central bank intervention. Before Abe's election in 2012, Japan had actively intervened in its currency markets to try to weaken the yen and support growth via exports. More recently, though, it seems the Bank of Japan is reluctant to use this tool, in part as the trade-weighted yen does not appear particularly overvalued and in part as Japanese officials appreciate that such action could result in backlash from a U.S. administration that has explicitly focused on currency manipulation.

When we put these pieces together, we are left with a currency that seems likely to stay in a range and is more sensitive to external forces (such as shifts in U.S. monetary policy or global growth). Japan's current account provides support while yen funding for carry trades in times of improving global sentiment will limit the normally positive currency impact from potential capital (equity) inflows. (To note, a carry trade denotes a strategy where the investor borrows low-yielding currencies such as the yen to buy higher-yielding currencies; assuming a stable exchange rate, the investor still earns the difference in the country's yields.)

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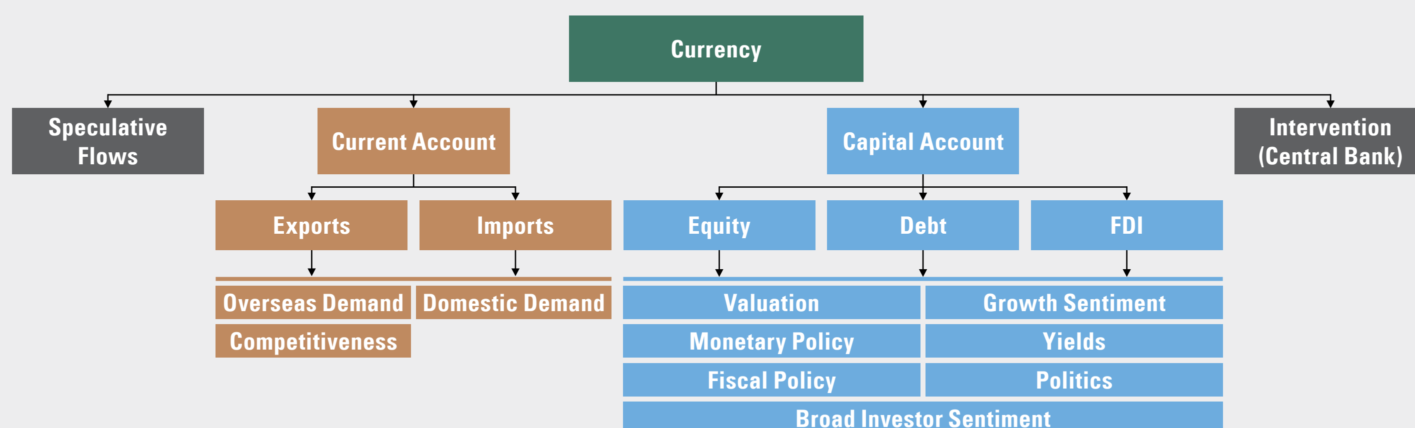
The euro is somewhat more complicated, as noted earlier, as one needs to consider the entire monetary union as well as the key member-state economies. Overall, the euro area has a current-account surplus near 2.7% of GDP (exacerbated by Germany, where the surplus is more than 7% of GDP). That suggests a measure of support for the euro, all else equal. Net capital flows into Europe have recently been constrained, with deteriorating sentiment toward the region's growth limiting interest in local equities, and with local funds either looking around the region for relatively more attractive bond yields (Greece, Italy) or leaving Europe altogether for higher yields overseas (including in the U.S.). The intervention angle is similar to Japan's: Even though the ECB has not intervened in its currency market since 2000, it has received criticism from the U.S. administration suggesting that monetary easing has in effect served to manipulate the currency for exporters' gain. We expect ECB intervention to

Exhibit 9: What Drives Currency Markets?



Source: Bessemer Trust

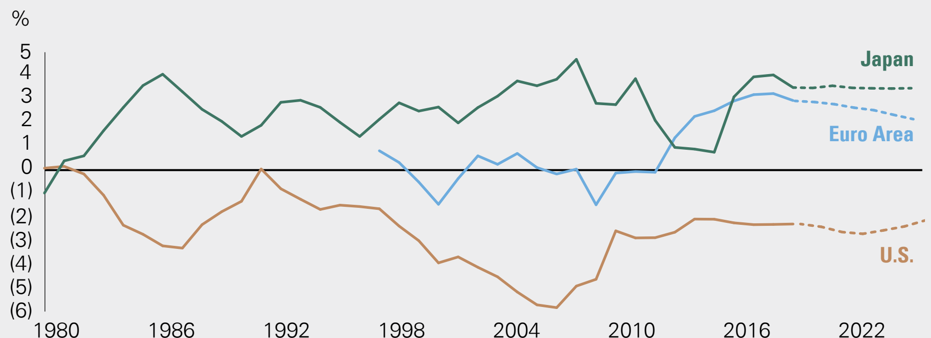
> The dollar has been helped by relatively strong U.S. growth and higher interest rates, in turn attracting capital.

support the euro is highly unlikely anytime soon. Beyond the U.S. retaliation risk, the trade-weighted euro remains significantly above levels that triggered ECB buying back in 2000. Overall, we see the euro in a similar position to the yen: Japanification trends suggest the euro is becoming more a reflection of external forces than internal catalysts (slow growth and low inflation, along with extreme low yields and policymaking biases, suggest relatively less room for positive local catalysts to change balance-of-payments forces).

The dollar, perhaps not surprisingly, is the flip side of this coin in many respects. The U.S. has a current account deficit (around 2.5% of GDP) that acts as a lid on the dollar's value (as Americans buy more from overseas than they sell, exchanging dollars for foreign currency in the process). Net capital flows to the U.S. remain positive, though recent years have seen a change within these flows: less net foreign direct investment (FDI) to the U.S. (in part as Chinese flows have largely stopped) and more interest in U.S. "yield" instruments (with a focus on government and corporate debt). These latter flows, and the dollar's short-term trends, have been sensitive to expectations for U.S. monetary policy. Also, in contrast to Japan or Europe, the conversation in the U.S. today around intervention is notable, with President Trump regularly expressing a desire to weaken the dollar (possibly via intervention) and members of Congress introducing legislative proposals that, in different ways, could achieve a weaker dollar. The dollar has been in an appreciating trend since 2011, helped by relatively stronger U.S. growth and higher interest rates, in turn attracting capital. That said, the dollar's rate against major trading partners today remains below levels that historically triggered broad policy responses. (The trade-weighted dollar is currently some 17% below its peak in 2002, Exhibit 11.) Near-term dollar weakness would most likely result from monetary easing that goes well beyond expectations and/or a sharp improvement in sentiment toward growth overseas, in turn pulling capital abroad.

Exhibit 10: Current Account Balance — Percent of GDP

Key Takeaway: The current accounts of Japan and the euro area reflect surpluses, providing support for currencies, though this is countered by other forces.



As of September 10, 2019. Dashed lines reflect IMF projections.

Source: Bloomberg, IMF

Exhibit 11: U.S. Trade-Weighted Dollar

Key Takeaway: The U.S. dollar, relative to other major currencies, is currently well below levels that historically triggered policy responses.

As of September 13, 2019. Trade-weighted dollar is measured using the Federal Reserve's major currency trade-weighted dollar index.

Source: Bloomberg, Federal Reserve

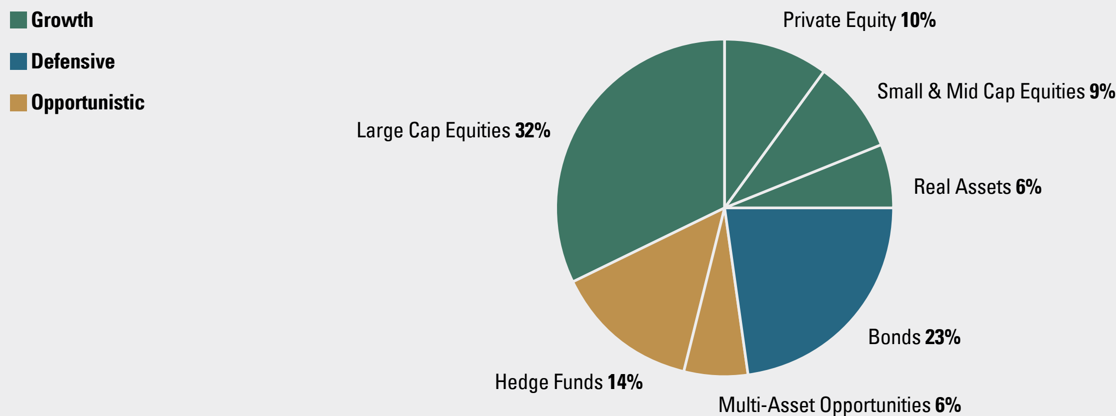
We believe equity upside has become more limited, and we are comfortable with a modestly underweight equity position.

Final Word: Third-Quarter Performance

The third quarter of 2019 was marked by market swings against a backdrop of slowing global growth and an escalation in the U.S.-China trade war, both exacerbated by poor liquidity conditions (especially in August). Overall, global equities were effectively flat for the quarter, with U.S. stocks continuing the outperformance they have seen all year relative to the rest of the world. A representative Balanced Growth portfolio (70/30 equity/bond risk) continued to outperform its benchmark. Within equities, performance was helped by overweight positions in the U.S. and in the technology sector, along with security selection within a number of mandates (though we would note that a violent rotation away from certain technology and "growth" oriented equities in early September reduced some of the quarterly excess returns).

In mid-July, with equities up sharply year-to-date, we took another incremental step to reduce portfolio equity exposure in favor of more defensive assets — moving three percent of our equity allocation to fixed income. Looking forward, we could see short-term equity gains helped by positive news on the global trade front, and as economic data start to come in better than beaten-down consensus expectations. Still, we believe equity upside has become more limited, and we are comfortable with a modestly underweight equity position. Persistent areas of uncertainty are limiting business enthusiasm to embark on major new projects or significant hiring, which in turn is restraining prospects for global growth. We maintain other defensive elements in portfolios, including the U.S. overweight, a quality bias, and exposure to managed volatility equities.

Bessemer's Positioning (70/30 Risk Profile with Alternatives)



Positioning as of September 30, 2019. This model displays Bessemer's Balanced Growth with Hedge Funds and Private Assets target 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, and 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 assets, and hedge funds of funds, are not suitable for all clients and are available only to qualified investors.

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