Quarterly Investment Perspective

Undercurrents Surfacing:

Economic Bifurcation, Supply-Side Gains, and China Decoupling

BESSEMER TRUST

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Executive Summary

- The year is off to a great start, but three key undercurrents that could limit or extend this economic cycle are growing more pronounced: economic bifurcation into winners and losers, the often-overlooked supply dynamics driving the economy, and China decoupling.
- The Federal Reserve should start an easing cycle from restrictive levels that have been weighing disproportionately on certain parts of the economy. Further improvements in supply dynamics should support both lower inflation and economic expansion.
- Within portfolios, we maintain a modest overweight to stocks relative to bonds with an emphasis on the U.S., industrials, healthcare, and technology (including artificial intelligence). Within fixed income, we have a longer duration than our benchmarks, and we have upgraded credit quality across bond portfolios.

The S&P 500 has crossed 5,000 for the first time. Equity market volatility is low with the CBOE Volatility Index (VIX) at 15 versus its five-year average of 21, and economic data indicate continued above-trend growth.

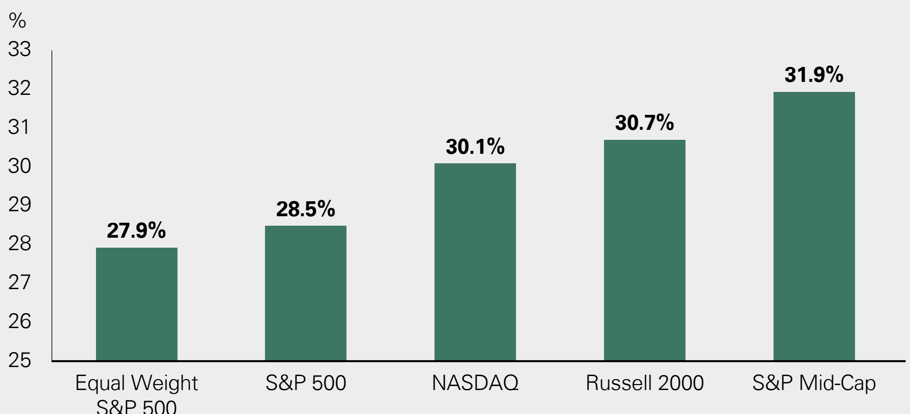
In many ways, it has been a smooth and positive start to the year for financial markets. However, as we reflect on the market and economic landscape, or the current "wave in a highly unusual cycle" as detailed in our year-ahead outlook, it has become apparent that several undercurrents — both positive and negative — are becoming more pronounced. We devote this Quarterly Investment Perspective to addressing three important developments that could limit or extend this economic cycle.

We begin with the undercurrent most likely to cut this cycle short — economic bifurcation. While overall growth has been strong, it belies offsetting extremes beneath the surface. Growth is accelerating in some sectors, such as those fueled by artificial intelligence (AI)-related enthusiasm; meanwhile, some interest-rate-sensitive sectors and consumers are feeling pressure.

Strong markets in the last six months have reflected the idea that the Federal Reserve (Fed) will ease this year (Exhibit 1). Whether it eases seven times, as was priced at the end of 2023, or three, as is currently expected, the key

Exhibit 1: Equity Index Returns (10/27/2023 – 3/28/2024)

Key Takeaway: Equity markets have rebounded, though underneath the surface lies a complex reality characterized by offsetting extremes.



As of March 28, 2024. October 27, 2023, marked the recent bottom in the S&P 500 that was subsequently followed by a broad market rally in anticipation of interest rate cuts. Returns represent total returns.

Source: Bloomberg

is that the Fed starts its easing cycle from restrictive levels that are weighing disproportionately on certain parts of the economy. The weakest links in the economy may be the most important, as we have seen in previous crisis periods. We discuss this bifurcation in "The Haves and Have-Nots — the Economy and the Markets" section on page 3.

The second undercurrent is that the U.S. economy is not solely demand-driven, and important supply-side gains have developed since the end of the pandemic. In some cases, we've seen a reversion to more normal supply conditions, and in others, a meaningful improvement from pre-pandemic norms. We view these dynamics as supportive of a continued expansion in the economy, and they are yet another reason why the Fed can ease rates even as overall economic growth levels remain strong. Senior Investment Strategist Bree Sterne explores this more positive element of the cycle beginning on page 7.

In addition to investing in AI trends, which we discuss in our portfolio positioning recap below, we view tangible infrastructure investments as a key avenue to take advantage of structural trends tied to the supply side of the U.S. economy. Director of Real Assets Anthony Liparidis details our approach to this exciting space in the private markets on pages 12–13.

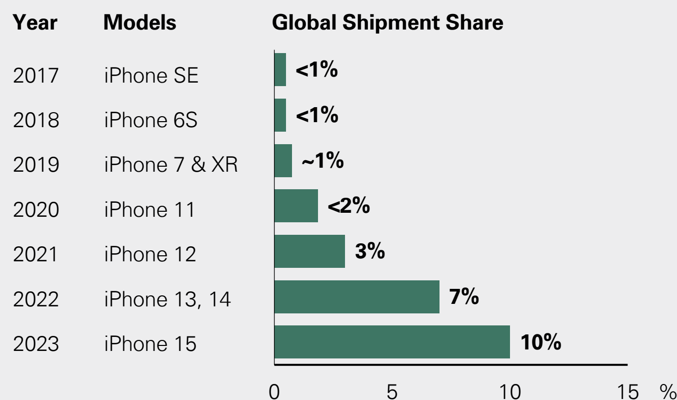
The third undercurrent is China. We have devoted a lot of attention to China in the past year. Given that our direct China exposure constitutes less than 3% of our portfolios, it's reasonable to wonder why we continue to focus on the country!

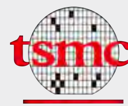
Since it opened its door to foreign businesses in the late 1970s, China has been an increasingly large contributor to global GDP. The country can play an outsized role in turning points for the global economy, exhibiting a high correlation to the economies to which it has exported an increasingly larger share of goods.

Even as we have focused on China's economic troubles of late, an undercurrent now surfacing is that weakness in China is *not* dragging down the world with it; rather, this weakness is creating tailwinds for certain countries and markets across the globe (Exhibit 2). While this dynamic has been in the background since the 2018 U.S.-China trade war and the pandemic, it is more pronounced now. The U.S. is perhaps the largest beneficiary of a weak China as flows from China have helped U.S. equity markets of late. Beginning on page 14, Senior Investment Strategist Tom Wicks delves into these developments, other key beneficiaries, and how Bessemer is taking advantage of the opportunities a weak China provides.

Exhibit 2: iPhone Production in India and Company Examples of Expansion in Manufacturing Outside of China

Key Takeaway: China's recent economic troubles may create meaningful economic tailwinds for certain countries across the globe.





- TSMC announced plans to build a second Japanese plant to begin operation by the end of 2027, raising the total investment in Japan to $20B.
- TSMC has invested $40B to expand capacity in Arizona.

- AWS plans to invest more than $5B in Mexico to launch an infrastructure region.

- Over the course of five years, Intel expects to invest more than $100 billion in the U.S. to expand capacity and capabilities in Arizona, New Mexico, Oregon, and Ohio.

As of February 29, 2024.

Source: Amazon, Apple, FactSet, Intel, Jefferies, Ministry of Commerce, TSMC

The Haves and Have-Nots — the Economy and the Markets

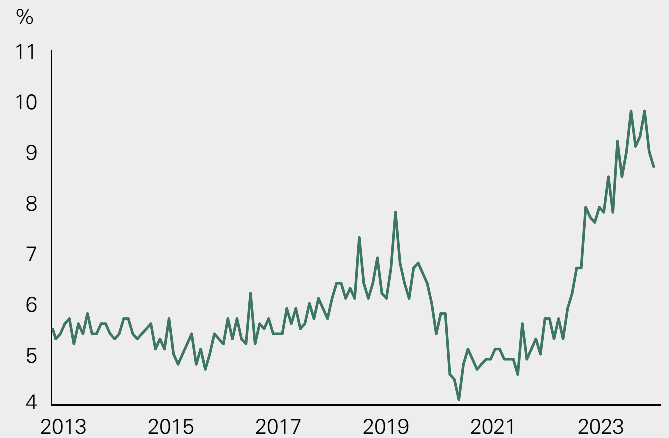
Although it seems as though current Fed policy has not had a large negative impact on markets or the broad economy, high price levels and elevated interest rates have bifurcated the economy into winners and losers.

For example, large cap growth stocks have been beneficiaries in the current environment given their relative insulation from the effect of elevated rates as well as the advancements and continued interest in artificial intelligence.

This represents a fascinating shift in investor psychology as low rates were once thought of as the driver of growth-oriented stock outperformance. In our view, it is the extreme nature of both eras of monetary policy that created this imbalance — zero interest rates for nearly 10 years on one end, and over 500 basis points of interest rate increases in a very short period of time on the other. It is clear to us that the current interest rate environment is impacting both markets and the real economy. Exhibit 3 shows the debt maturity schedule for various market segments, with smaller companies more exposed to still elevated interest rates. The rising cost of debt is also accompanied by a rising interest expense on the debt, as highlighted in Exhibit 4.

Exhibit 4: NFIB Small Business Average Interest Rate Paid on Short-Term Loans

Key Takeaway: Interest expenses are at historically elevated levels for small businesses.



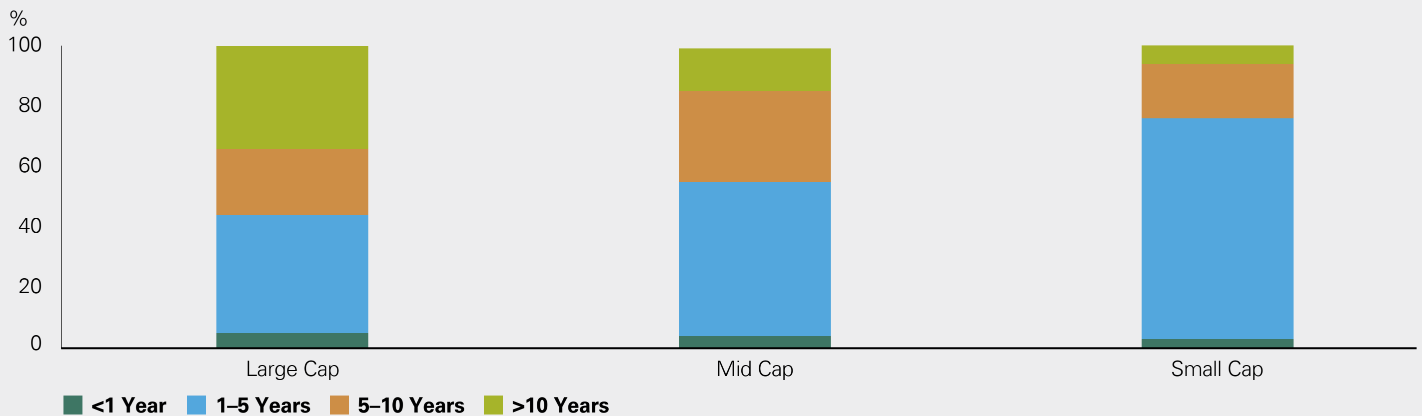
As of February 29, 2024.

Source: Bloomberg, National Federation of Independent Business (NFIB)

For that reason, cumulative small cap stock performance has trailed that of large cap stocks by nearly 40% over the past three years and has *never* been more negatively correlated to interest rates.

Exhibit 3: Debt Maturity Schedule by Market Capitalization

Key Takeaway: Smaller companies are more exposed to elevated interest rates.



As of March 14, 2024. Large cap is the S&P 500. Mid cap is the S&P 400. Small cap is the S&P 600.

Source: Bloomberg

Within the real economy, consumer spending patterns are exhibiting similarly contrasting trends. Although overall consumption remains solid with real personal consumption expenditures up 2.2% year-over-year in 2023, lower-end consumers are feeling pressure as rising prices are leading to increased spending on essentials, such as food and energy. Food spending, for example, represents 31% of the lowest quintile's income and only 8% of income for the highest quintile. This leads to a dynamic where lower-end consumers remain focused on inflation as a top concern whereas higher-end consumers have moved on to focus on political discord (Exhibit 5).

The combination of higher prices and lower real incomes is the actual concern, in our view, as lower inflation has not led to improvements in those two categories for most Americans.

Moreover, subprime credit card delinquency rates have breached 15% for the first time in well over a decade (Exhibit 6).

The labor market is another area where cracks may be developing under the surface. Job gains of 275K exceeded consensus expectations of 200K in the February establishment survey. However, the household survey, which is used to calculate the unemployment rate, saw the number of employed people fall 184K and the unemployment rate rise to a two-year high, from 3.7% in January to 3.9% in February.

Additionally, downward revisions to the January and December payroll report indicate that the labor market has not been as robust as it has appeared on the surface in recent months. Job gains continue to be narrow, driven primarily by the healthcare, government, and leisure and hospitality sectors. There have also been meaningful supply-side factors (see pages 7–10).

While some sectors, including technology, have witnessed significant appreciation, other areas that are perhaps more representative of the real economy, such as small caps, are still struggling with the reality of higher inflation and interest rates. For example, as shown in Exhibit 7, large cap earnings expectations have risen while mid and small cap earnings expectations have stagnated.

Even within the large cap universe, earnings growth for Q4 2023 was buoyed by a few mega-cap AI-related companies. Without them, earnings growth for the market would have been negative. This group may continue to bolster the overall index with four of the Magnificent Seven expected to deliver earnings growth of around 80% compared to only 3% for the rest of the market in Q1 2024.

Even with higher earnings expectations for some of the largest companies, the forward price-to-earnings spread between the Russell 2000 and S&P 500 is now in its

Exhibit 5: Top Concerns by Income Cohort

Key Takeaway: Low- and middle-income consumers are most concerned with inflation while high-end consumers are concerned with the political environment.

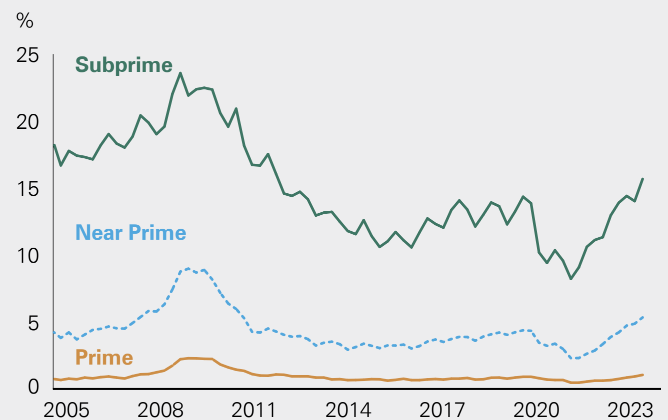
	Low-Income Consumer	Middle-Income Consumer	High-End Consumer
Top Concern	Coping with Inflation	Coping with Inflation	Political Environment

As of January 31, 2024.

Source: AlphaWise Consumer Pulse Survey, Morgan Stanley Research

Exhibit 6: Credit Card Delinquency Rates by Credit Score

Key Takeaway: Consumers with subprime credit scores are struggling to make credit card payments.



As of September 30, 2023. Delinquency measures the fraction of balances that are at least 30 days past due, excluding severely derogatory loans. Prime refers to credit scores above 719, near prime between 620 and 719, and subprime below 620.

Source: Federal Reserve Bank of New York Consumer Credit Panel/Equifax

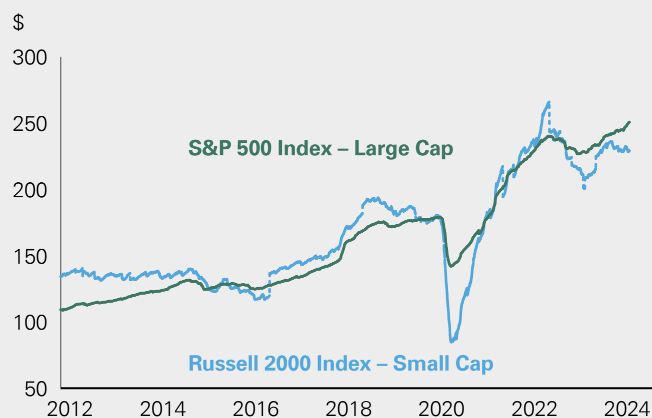
13th percentile as investors prefer business models that are less likely to be impacted by higher inflation and interest rates. Still, interest-rate-sensitive components within large cap, such as commercial real estate, are experiencing challenges in today's environment.

As the Fed considers the appropriate policy for this environment, we think it is key for the Fed to focus on segments of the economy that it can control, namely those tied to interest rates, and avoid getting distracted by those it cannot control, such as AI.

A key question going forward is what the catalyst for a sustained broadening of equity market participation will be — including better performance from mid and small cap indexes. In recent years, a pattern has emerged in the relationship between market breadth (as measured by the percentage of stocks above their 200-day moving average) and interest rates. As interest rates rise, market breadth has historically deteriorated and vice versa. The correlation between market breadth and interest rates has not been this negative in 30 years. We think an inflation-driven shift in investor psychology could be behind this relationship — concerns of high inflation drive rates higher, leading to a concentration of capital in businesses perceived to be less rate sensitive. Given our view that current monetary policy is negatively impacting growth more than many believe, inflation and interest rates are likely to fall as we move through the rest of the year, leading to an expansion in market breadth.

Exhibit 7: S&P 500 and Russell 2000 Next-12-Month Earnings

Key Takeaway: High price levels and interest rates have bifurcated the economy into clear winners and losers, as large- and small-cap earnings expectations diverge.



As of March 14, 2024.

Source: FactSet

Portfolio Positioning

The key tenets of our market outlook remain in place, serving as the primary drivers of our positioning. A continued moderation of inflation, even if bumpy, should allow the Fed to cut interest rates as the economy continues to grow, albeit at a slower pace. Further improvements in supply-side dynamics, as we discuss in the next section, will support the coexistence of both lower inflation and economic expansion.

Given this view, we maintain a modest overweight to stocks relative to bonds, while continuing to target companies that can maintain pricing power and earnings growth as the economy slows (Exhibit 8).

Despite select opportunities overseas, U.S. equity markets have more companies that exhibit the characteristics we think are most valuable in this market: quality, steady earnings growth, pricing power, and exposure to long-term growth trends and innovation.

Bessemer portfolio managers still see value in several mega-cap AI-related companies, such as Nvidia, Microsoft, and Alphabet, but portfolios are also positioned to benefit from exposure to companies that are less obviously associated with the AI boom — such as Broadcom, Gartner, RadNet, and Jabil, to name a few.

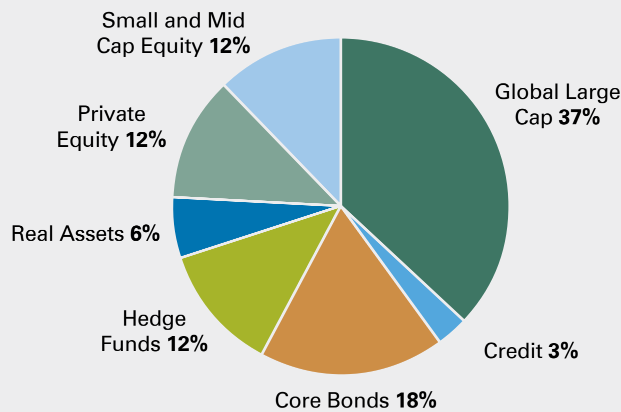
Gartner, for example, has seen a large increase in demand for its consulting services to help companies optimize investments in AI technology.

Industrials have become our biggest sector overweight, with representation in areas such as aerospace and defense, specialty manufacturing, and infrastructure services.

Bessemer portfolios also are overweight healthcare and technology versus benchmarks.

Exhibit 8: Balanced Growth 70/30 with Alternatives

Key Takeaway: We maintain a modest overweight to stocks relative to bonds, while continuing to target companies that can maintain pricing power and earnings growth as the economy slows.



As of February 29, 2024.

Source: Bessemer Trust

In fixed income, we have a longer duration than our benchmark as we believe interest rates have peaked for this cycle. We expect credit spreads to remain historically tight, so we have upgraded credit quality across our bond portfolios. We would look to increase exposure to credit if spreads were to materially widen from current levels.

As our investment platform continues to evolve, we have been able to introduce some exciting additions to start 2024. Given the higher interest rate environment and the opportunity for additional interest rate volatility going forward, we launched a short-term bond strategy that can serve as a great alternative for investors looking to outperform cash over a market cycle while maintaining the flexibility of shorter-maturity investments. Within equities, we made some adjustments that further align our exposures and market views, and we also added a new emerging markets manager that we believe will provide a core exposure in the asset class with a focus on companies with sustainable growth and sound corporate governance.

Hedge Funds and Private Markets

We expect the market environment will continue to be favorable for hedge funds. Continued uncertainty around geopolitics and monetary policy supports dispersion across asset classes, sectors, and securities and provides unique opportunities for skilled hedge fund managers. Strategies that have less directional exposure, a disciplined investment process, and strong risk management should deliver attractive risk-adjusted returns.

We believe family-owned businesses managing through transitions, as well as early-stage innovation, remain enduring sources of compelling investment opportunities in the private markets. For example, the explosion of artificial intelligence (AI) is creating opportunities for venture capital investors to back entrepreneurs building related applications, as well as for real assets investors with the specialized expertise to develop new data centers that can handle AI's massive computing demands.

Supply-Side Dynamics Impacting Inflation's Path

Bree Sterne, Senior Investment Strategist

In the aftermath of the pandemic, the U.S. economy experienced the worst bout of inflation in several decades as supply chain disruptions and labor shortages compounded the underpinnings of higher inflation, massive fiscal stimulus and aggressive monetary policy. Remarkable progress has been made on the inflation front over the past two years, driven in part by improvements on the supply side of the economy. Supply chains normalized after pandemic upheaval, and workers came off the sidelines to fill vacancies. The result was an economy that defied expectations that lowering inflation had to come at significant economic cost, and the U.S. economy experienced disinflation alongside solid economic growth and a strong labor market. We are optimistic about the path of continued disinflation given the potential for incremental supply-side improvements as well as easing demand — a backdrop that should allow the Fed to cut interest rates several times this year.

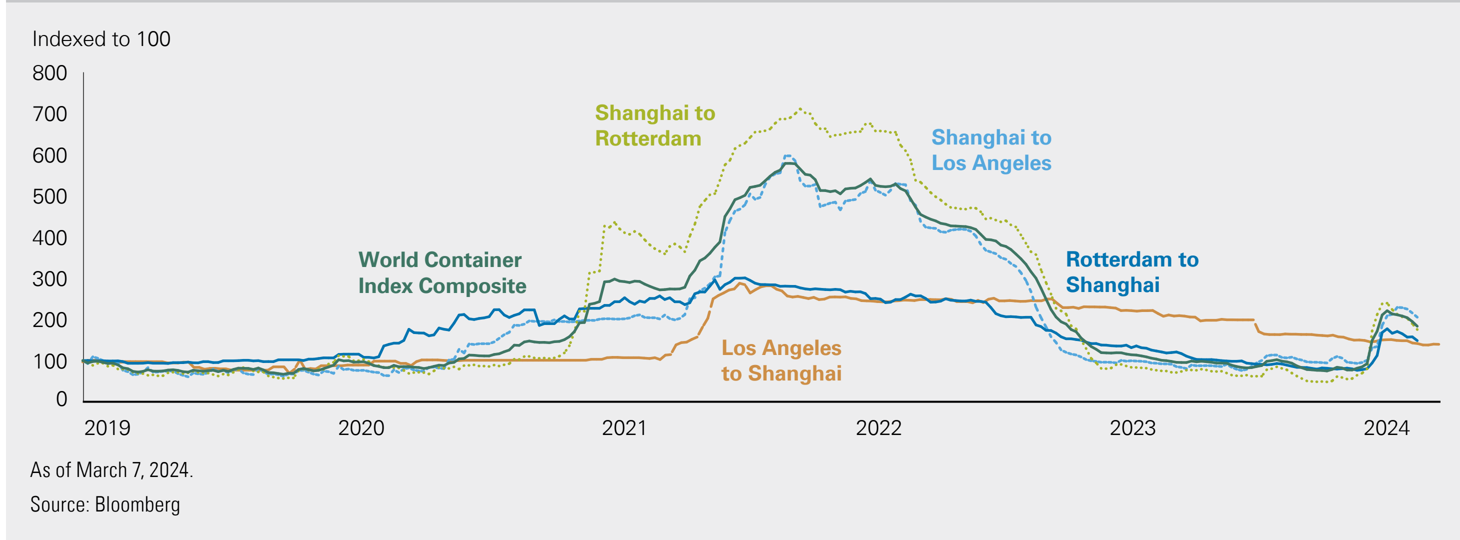
Supply Chains: Finally, Almost Back to Normal After Pandemic Disruptions

Disruptions to global supply chains weighed on goods production and contributed to inflationary pressures during and in the aftermath of the COVID-19 pandemic. Harsh lockdowns in China, which resulted in plant shutdowns and delays at ports, reverberated globally given China's central role in global manufacturing and supply chains. For example, China has seven of the world's 10 busiest ports, and 30% of the world's shipping containers touch Chinese ports as much of the global manufacturing output runs through China in some way.

Supply chain pressure has improved dramatically since the post-pandemic reopening as evidenced by shorter delivery times, easing order backlogs, and lower input costs. The Fed Supply Chain Pressure indicator, which peaked in December 2021, is now largely in line with its pre-COVID average. Meanwhile, the composite shipping

Exhibit 9: World Container Shipping Rates, USD per 40-Foot Container (Indexed to 100 on January 3, 2019)

Key Takeaway: Despite recent supply chain disruptions, prices are far lower for most major shipping lanes compared to the height of the pandemic.

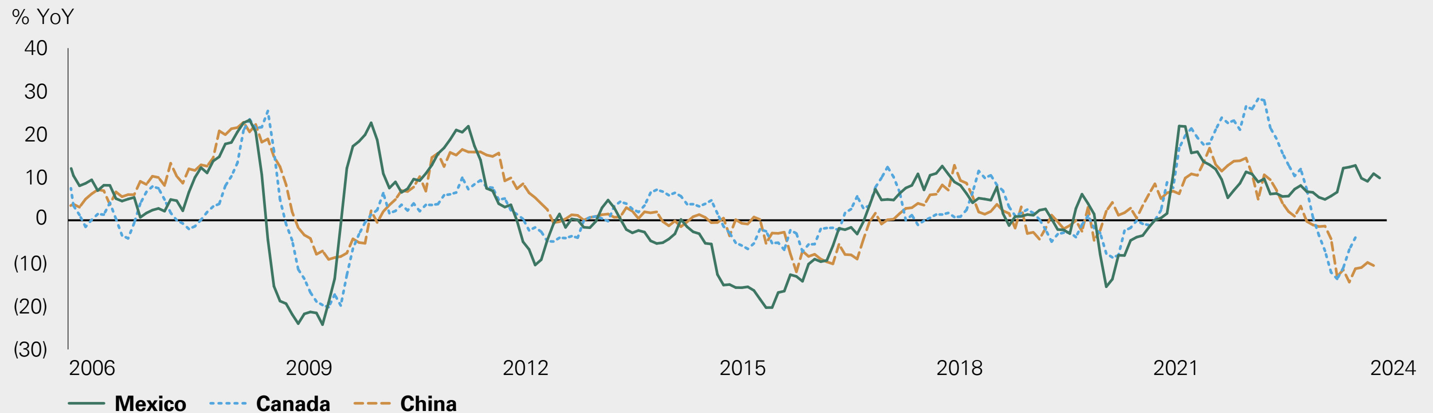


As of March 7, 2024.

Source: Bloomberg

Exhibit 10: Export Prices of the Top Three Suppliers of U.S. Goods (by Country)

Key Takeaway: Disinflationary impulses from U.S. trading partners should have placed downward pressure on U.S. goods prices.



As of January 31, 2024 for Mexico. China as of December 31, 2023. Canada as of September 30, 2023.

Source: Exante Data

rate for a 40-foot container, which peaked in September 2021 at $10,377, is currently $3,161 versus the 2019 average of $1,420 (Exhibit 9). After goods comprised roughly half of the total core CPI at its peak of 6.6%, the goods component is now no longer contributing to inflationary pressure within core CPI, largely due to supply chain improvements.

Looking toward the rest of this year, we see the potential for further disinflationary pressure as China's exporting deflation permeates the global economy. Price spillovers from China can contribute to U.S. goods deflation as lower producer prices in China pass through to U.S. consumer prices (Exhibit 10). Chinese producer and export prices dropped by over 10% in 2023, the largest decline since 2005. Despite decreased trade between the U.S. and China since the onset of the trade war in 2018, goods imports from China still account for roughly 13% of U.S. imports. Therefore, lower Chinese producer prices have been driving the cost of these imports down and contributing to disinflation in the U.S., which can be seen in the prices of final consumer goods. To the extent that China seeks to increase exports in order to boost growth, a move that would potentially be aided by subsidized state-directed loans, Chinese companies could inundate foreign markets with more automotive, consumer electronics, and other manufactured goods — an action that would likely pressure goods prices lower in many foreign markets. We discuss the complexities of China's role in global markets beginning on page 14.

Disruptions to shipping routes in the Middle East placed global supply chains back in the spotlight at the start of 2024, when Houthi militants launched missile strikes on container ships traveling through the Red Sea to protest Israel's military campaign in the Gaza Strip. The Red Sea is the only route to the Suez Canal, one of the world's most heavily used shipping lanes, linking Europe and Asia. About 12% of global trade passes through the canal, including as much as 30% of container traffic. The attacks have forced many shipping companies to reroute traffic around the southern tip of Africa, a diversion that can add anywhere from 10 days to a month to shipping times and, in turn, lead to higher costs. While the longer routes are adding time and cost to maritime transit, supply chains are not nearly as tight as they were during the COVID era, and excess capacity is dampening the impact of shipping disturbances, unlike during the pandemic. Therefore, we expect only a modest impact from higher shipping costs due to disruptions in the Red Sea.

Labor Supply: Increased Labor Supply Easing Wage Pressures

After falling rapidly during the initial COVID shock, labor demand subsequently outpaced supply during the rapid economic rebound seen in 2021 and 2022. In turn, the excess labor demand resulted in heightened job vacancies and contributed to inflationary wage pressures (Exhibit 11). The jury was out at the time as to how many people would reengage in the labor force, a factor we were watching closely and writing about in our publications. We now know more conclusively that as the pandemic receded more fully in 2023, additional labor supply returned to the market, helping to ease wage inflation even as economic growth and labor demand remained robust. The decrease in the jobs-to-workers gap from 6.2 million as of April 2022 to 2.4 million as of February 2024 highlights the progress made toward rebalancing the labor market.

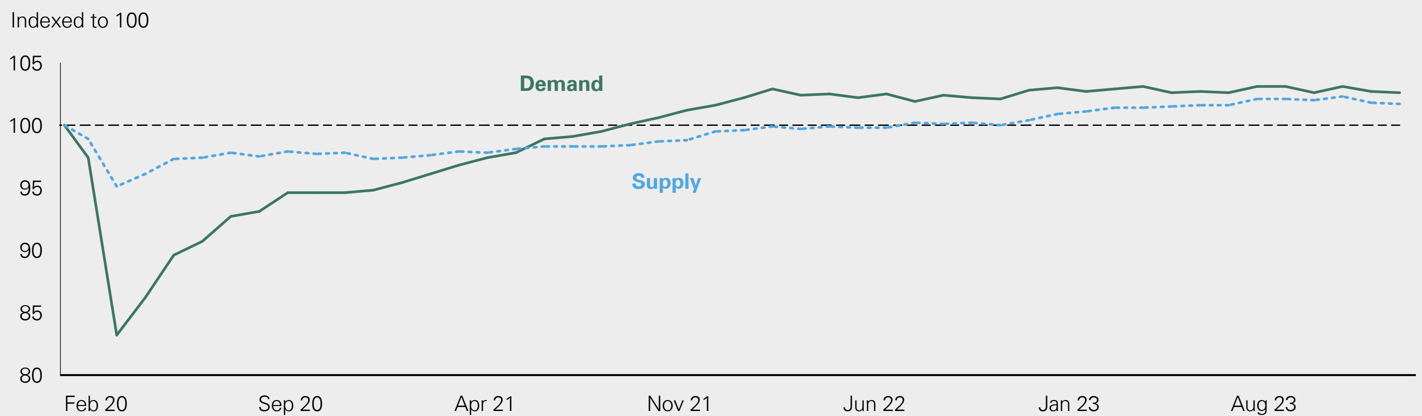
The increase in labor force participation has primarily come from an influx of prime-age workers (aged 25-54), immigrants, and those who left the labor market for pandemic-related reasons, such as a health issue or a need to care for dependents. The prime-age labor force participation rate rebounded from 82.5% in December 2022 to a high of 83.5% with several subcohorts, including prime-age women, reaching new record levels. While most of the groups that left the labor market during the pandemic have largely returned, one subset remains missing — older workers, many of whom likely retired early. The participation rate for those 55 and older is still roughly two percentage points below the level seen in February 2020. We are looking into the dynamics of this age cohort more carefully and will comment more extensively in future publications.

Labor supply is likely growing even faster than the official statistics imply. Illegal immigration does not show up in the labor supply or jobs data, but it is included in the official consumption and spending data as it is difficult to disaggregate the consumption of specific groups. In this way, illegal immigration artificially pushes some measures of productivity higher; the numerator of production is more accurate than the denominator of the number of workers, which does not reflect people operating outside of official records.

Labor force growth and participation gains have been critical to supporting above-trend economic growth as well as easing inflationary pressures. Fed Chair Powell

Exhibit 11: Labor Supply and Labor Demand

Key Takeaway: Since the post-pandemic economic reopening, labor demand has outstripped supply, but the gap is narrowing.



As of January 31, 2024. Indexed to 100 on February 29, 2020. Labor demand is equal to employment and job openings. Labor supply is the U.S. Employment Civilian Labor Force.
Source: Bloomberg

has highlighted how supply-side improvement was a key reason the economy held up so well in 2023 despite the Fed's aggressive interest rate hiking campaign. Increased labor supply led to new workers filling excess job vacancies, resulting in wage disinflation. As a result, job openings moved down from a peak of 12.2 million in March 2022 to 8.9 million in January 2024, and the U.S. Employment Cost Index (ECI) for the fourth quarter of 2023 was 4.2%, down from its peak of 5.1% in the second quarter of 2022.

Currently, labor markets are much looser compared to the end of 2022, yet they remain tight by historical standards. Looking ahead, the decline in services inflation is highly dependent on the rebalancing of the labor market given the correlation between service prices and wages. We are focused on metrics of labor market tightness, such as quits rates and unemployment, and labor market prices, including wage growth, rather than just labor market growth (for example, payrolls) since labor market tightness and prices reveal whether supply is out of balance with demand.

In our view, the rapid pace of U.S. labor force growth, especially accelerating participation rates, is unlikely to persist, but 2024 could still see above-trend supply side gains. This growth could be driven by incremental gains in labor force participation, additional supply growth from immigration as well as productivity improvements. We address these factors in turn below.

- **Participation gains**. After rapidly increasing as the pandemic ebbed, labor force participation rates stabilized across many demographic groups toward the end of 2023. While it is very unlikely that the same acceleration in participation rates will be repeated this year, it is possible that some prime-age participation rates could increase further within certain cohorts. For example, the availability of flexible and remote work may have raised the ceiling for the prime-age labor force participation rates for those with caregiving responsibilities. Additionally, while some older workers who retired during the pandemic may return to the labor market, we expect the aging population to continue to weigh on labor supply (see "Inflation and Secular Trends" on page 11), especially as favorable market conditions have enabled the accumulation of healthy retirement savings and solid home equity. On balance, we expect mild improvement in some cohort participation rates to offset the broader trend of an aging population.

- **Supply growth**. With labor force participation gains dwindling, the question turns to whether supply growth can provide a tailwind for further disinflation. Labor force supply growth was very strong in 2023, aided by increases in cross-border labor supply. The Congressional Budget Office data indicates that 3.3 million net immigrants arrived in the U.S. in 2023. This likely understates the full number substantially. Unlike rising participation rates, a rising population and increased immigration add both to labor supply as well as labor demand because a person adds to demand regardless of status but adds to labor supply only upon entering the labor force. With immigration boosting supply given the rise in available workers in the economy, as well as increasing demand because those people consume goods, the net effect on inflation is dependent on the balance between supply and demand. Therefore, immigration can be disinflationary so long as the labor supply increases more than the labor demand grows. Because many of those joining the labor force are low-end consumers, we estimate a marginal impact on demand, at least initially, compared to a larger impact on labor supply, especially since many of these workers are joining parts of the labor market that have experienced the highest wage pressures in recent years, largely in lower-income services. While future immigration levels remain uncertain given the potential for policy change, we anticipate the level of cross-border labor supply to remain elevated this year relative to historical averages, even if moves to stem undocumented migrants crossing the border lower new labor supply for 2024 versus 2023.

- **Productivity.** In addition to rising labor force participation rates and increasing supply growth, productivity increases can also exert disinflationary pressure as firms counteract elevated employee costs with additional output. Labor productivity has been

rising in recent quarters with productivity in the third quarter of 2023 increasing at its highest rate since 2020. Economists hypothesize that productivity has been running higher than normal since the pandemic for a few reasons, including better labor market skill-matching after pandemic-fueled labor market churn, hybrid and remote work-related efficiency gains, and technological advances. Finally, while artificial intelligence is still in its early stages, the technology is expected to positively contribute to enhanced labor force productivity (see "Inflation and Secular Trends" below). Looking ahead, we see the potential for higher-than-normal productivity gains to exert further downward pressure on inflation.

Inflation and Secular Trends

Several structural trends are likely to be contributing factors for the trajectory of inflation over the long term. Many of the structural forces that have helped keep inflation subdued over the past few decades are still present. However, it is important to note that nuanced developments within demographics, globalization, and fiscal policy could increasingly contribute to mixed inflationary pressures over the next decade relative to the past decade.

Demographics. An aging population has historically been considered deflationary as consumers have tended to spend more during their prime income-producing years than during retirement. Therefore, assuming older people spend less than younger people, if life expectancy is increasing and the share of the population that is older is growing, aggregate demand should shift lower, and in turn, inflation should decline. However, it is important to note that between the potential for labor shortages given a relatively smaller working-age population, a wealthy baby boomer cohort reaching retirement age, and rising healthcare costs for the aging population, demographic trends may increasingly provide mixed inflationary pressures.

(De)Globalization. The globalization of supply chains, especially the integration of China into the world trading system, placed downward pressure on prices in recent decades. However, the rate of expansion of global supply chains seen in recent decades is unlikely to be repeated; globalization has plateaued and is reversing in some ways. While it is very difficult to untangle a deeply complex web of global supply chains, trade patterns are shifting, and protectionist trade policies are increasing. While reshoring has the potential to contribute to inflation in certain sectors, nearshoring or friendshoring supply chains to geopolitically aligned nations can still allow for low production and transportation costs.

Technology. Technological innovation has a deflationary economic impact through productivity enhancement and downward pressure on unit costs. The pandemic accelerated the adoption of new digital technologies, which have likely contributed to disinflation pressure. Technological advancements in software, digitization, and ultimately artificial intelligence are likely to further accelerate rates of production and reduce the need for manpower, providing further disinflationary tailwinds.

Government policies. Increasing government deficits financed through borrowing can stimulate economic growth and, in turn, inflation. Stimulus checks and tax credits during the pandemic were certainly factors behind the inflation surge in 2021-2022. Looking ahead, we note that the cause of the increase in the deficit is important. Deficits that rise due to lower tax revenue or increased government spending on debt are less likely to contribute to inflation relative to direct economic stimulus. Furthermore, immigration policies have the potential to increase or constrain the labor supply, which affects inflation, as discussed on pages 9–10.

Inflation and Infrastructure

Anthony G. Liparidis, Director of Real Assets

The U.S. economy is enabled by a vast network of infrastructure — transportation, energy, and digital communications — that was built decades ago and has struggled to keep pace with new demands. The U.S. population has almost doubled since the 1960s, yet infrastructure investment trended down for decades. Reversing this trend, in November 2021, the Bipartisan Infrastructure Law (BIL) directed $1.2 trillion of federal funds toward infrastructure projects. More than $300 billion, or approximately one quarter, of this budget had been funded by the second anniversary of this law's signing, according to Brookings. Construction of BIL-funded projects is expected to last beyond 2026, when the legislation expires.

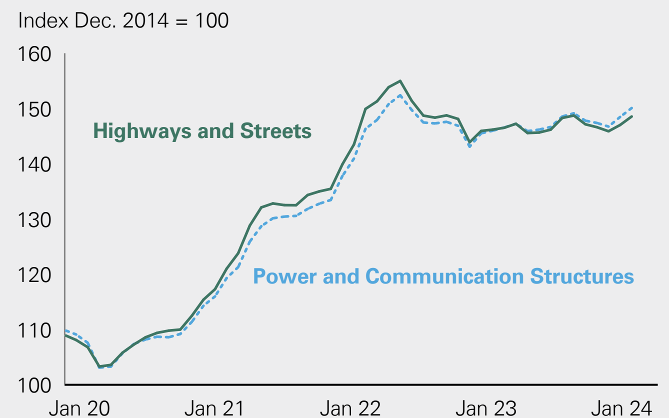
As more states and localities put these federal dollars to work, industries that support infrastructure development have experienced inflationary pressures, resulting in sharp price increases through the end of Q3 2023. Skilled labor and materials were in higher demand. Unemployment in the construction industry fell and remained low by historical standards. Two infrastructure-specific commodity indexes within the Producer Price Index that track material inputs in the roadway, energy, and communications industries are both up at 34% between January 2021 to January 2024, which is well in excess of the CPI's growth over the same period (Exhibit 12).

Material prices in the construction industry began stabilizing in the fourth quarter of 2023 and have continued to do so, driven in part by businesses establishing reliable supply chains and acclimating to a new normal. This stabilization trend contrasts with the turbulence experienced in prior years. According to a recent report by Gordian, construction costs dropped 1.3% from Q3 2023 to Q1 2024, led by a 3.5% fall in material costs as major commodity materials continue to stabilize. After seeing rapid increases during the pandemic, structural steel, conduit, and copper wire prices began to stabilize below their three-year highs during this period. Labor costs, however, experienced a 2.7% gain over the same period driven by a shortage of skilled workers.

Despite recent stabilization, the current environment emphasizes the need for infrastructure investors and service companies to remain resilient and prepared, acknowledging the possibility of localized material and labor cost increases driven by mega projects, labor shortages, and geopolitical events. The dynamic interplay of factors shaping pricing trends highlights the importance of investing capital with experienced professionals who are accustomed to assessing and proactively managing risks.

Exhibit 12: Producer Price Index by Commodity — Net Inputs to Highways and Streets as Well as Power and Communication Structures

Key Takeaway: As more states and localities put federal dollars to work, industries that support infrastructure development have experienced inflationary pressures.



As of February 29, 2024. Net inputs exclude capital investment, labor, and imports.

Source: Federal Reserve Economic Database

Bessemer's Infrastructure Allocation Within Private Real Assets

Infrastructure assets are often considered within investment portfolios for their inflation hedging characteristics in that they typically possess contractual or regulatory inflation protection on earnings. At Bessemer, we seek infrastructure investments that provide compelling opportunities beyond an inflation hedge. Even as inflation cools, we see structural supports for infrastructure investments. Bessemer, in its Real Assets Program, partners with external managers who invest in infrastructure assets that can retain value through economic cycles.

Three important elements distinguish Bessemer's approach to investing in infrastructure:

First, we maintain a wide aperture across sectors — digital communications, transportation, power, fuels, waste to energy, water, and social services — where opportunities compete for capital and stand to benefit from the largest secular trends, including artificial intelligence, energy transition and decarbonization, and supply chain diversification.

Second, we are focused primarily on the middle market, where we believe opportunities with multiple levers of value creation that have greater potential for equity upside exist with business plan execution, appropriate growth, and proper financial and risk management.

Third, we emphasize assets that maintain a leading market position with high barriers to entry, benefit from a geographic or other strategic or competitive advantage, are difficult or materially more expensive to replicate, and provide predictable or contracted cash flows.

Potential Value Drivers in Infrastructure

Highlighted below are two recent investment examples held within the portfolios of infrastructure managers partnered with Bessemer's Real Assets team.

- **Digital infrastructure.** Investment in privately held EdgeConneX, a leading global data center provider serving the fastest-growing customer segments: the cloud, content, and network ecosystems. With a global footprint, operating and developing over 60 data center facilities across North America, Europe, APAC, and South America, EdgeConneX addresses both hyperscale and edge demand, which are both experiencing significant growth and are the most thematic parts of the data center sector. Bessemer's external manager EQT is expected to contribute to EdgeConneX's growth through its active approach to ownership, implementing a full suite of value creation initiatives including growing EdgeConneX's existing markets, executing on strategic M&A, and continuing to innovate and optimize the business. EdgeConneX also benefits from positive industry tailwinds, such as artificial intelligence, cloud adoption, and data consumption.
- **Aviation transport.** Investment in privately held Signature Aviation, the largest operator of fixed base operations at airport terminals and provider of essential support services for business and private aviation, including refueling, handling, and storage. Bessemer's external manager Global Infrastructure Partners is actively working with the company's management team to standardize operations and continue to capture market share, as well as position the firm to serve a growing need for decarbonization solutions to meet sustainability goals.

In sum, while infrastructure investments are impacted by inflation, we believe compelling returns in private markets can be achieved by being highly selective, partnering with the most successful established managers and promising emerging managers, focusing on opportunities presenting multiple levers of value creation, and taking prudent risks.

Supply Chains Shifting: Economic Challenges in China Create Opportunities Elsewhere

Tom Wicks, Senior Investment Strategist

Ideological and structural issues will likely continue to weigh on China's economic growth, creating opportunities for many countries as firms look to reshape the security of their supply chains.

Background

China faces a complex set of geopolitical, demographic, and economic challenges that include a glut of housing, high savings rates, soft consumption, deflation, and a declining population. The weight of these issues is dampening the country's economic growth (Exhibit 13). Calls for fiscal stimulus to kick start the economy have so far been ignored in Beijing as the leadership appears comfortable with a slower pace of economic growth and a reluctance to add fresh stimulus, perhaps with the idea that stimulus could help the economy in the short term but might create larger imbalances in the long term.

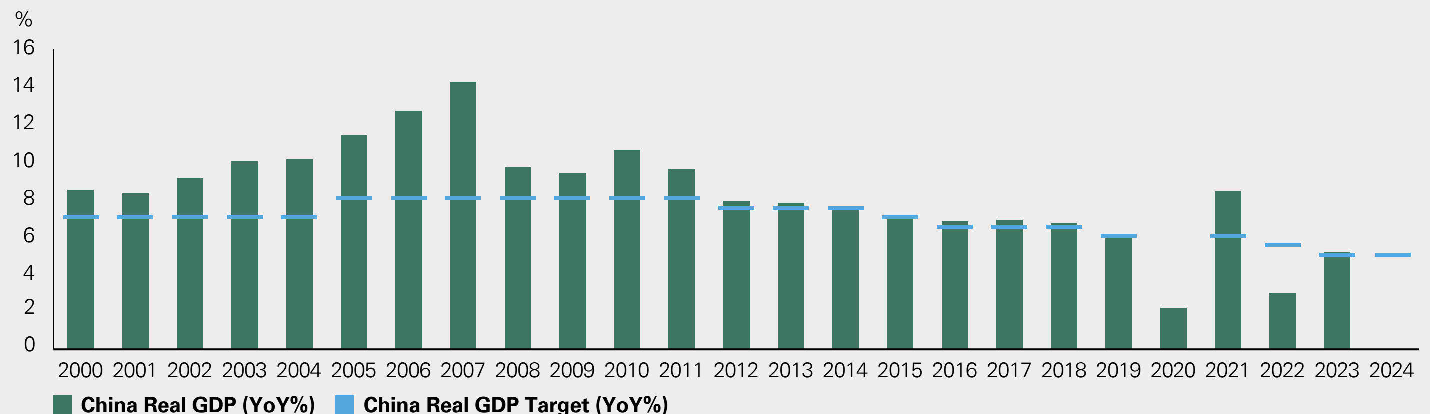
In addition to the longer-term structural challenges China faces, two distinct types of supply chain reconfiguration are underway, both of which are added headwinds for the country's growth.

The first — so-called nearshoring — is related to foreign companies strengthening the security and oversight of their supply chains by bringing the production of goods closer to the final consumer. This has become a focus following the supply chain disruptions driven by the COVID-19 pandemic.

The second type — known as friendshoring — is related to reducing the risk of being caught on the wrong side of a widening geopolitical divide by shifting the location of production to countries that are deemed to be friendly. Since 2017, the share of America's imports coming from China has fallen by more than a fifth to around 13% (Exhibit 14). While this figure may overstate the decline, as some goods will still originate in China even as they pass through other countries before entering the U.S., it is a meaningful shift.

Exhibit 13: China Real GDP and Real GDP Target YoY

Key Takeaway: China Real GDP recently falls short of meeting official targets, against a history of exceeding expectations.

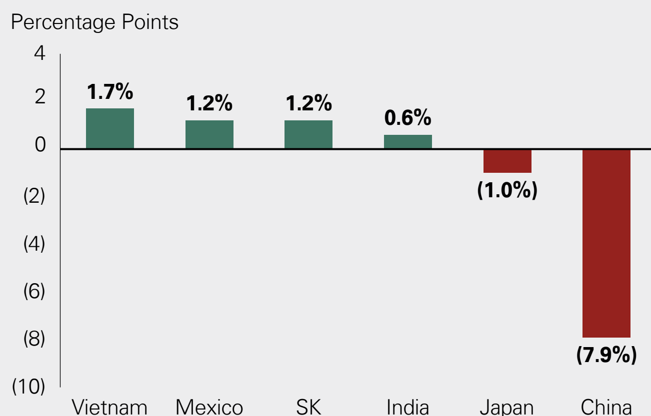


As of December 31, 2023.

Source: Bloomberg

Exhibit 14: Change in U.S. Nominal Imports by Country Since 2017

Key Takeaway: Other countries are benefiting on account of slowing Chinese imports to the U.S.



As of December 31, 2023.

Source: U.S. Census

For China, these shifts are important. The country has served as a major manufacturing hub for the world economy since the early 1980s, following reforms that welcomed foreign investment and led to the outsourcing of manufacturing operations to the country. Initially renowned for its low labor costs, China attracted companies seeking to lower their production expenses, particularly in industries such as clothing, toys, furniture, and cheap electronics. As China's economy has grown and developed, skills and wages have increased (from 30% of U.S. levels in 2000, based on purchasing power, to nearly 70% in 2019) as the country has moved up the manufacturing value chain. Exports now account for close to 30% of Chinese GDP.

China's manufacturing dominance, however, now looks to have peaked. With many firms pursuing "China plus one" manufacturing strategies, keeping some production in China but looking to diversify their production away from China in case China's expansive territorial desires continue, many emerging market countries are reaping the rewards.

Beneficiaries in the New World Order

Mexico

One of the clearest indications of shifting global trade patterns can be seen with Mexico. Needless to say, the length of time it takes to transport goods from Mexico into the U.S. is much shorter and less susceptible to disruptions compared to transport from Asia, where it can take weeks. So, in many ways, Mexico finds itself in an opportune position to capitalize on the reshaping of U.S. supply chains, both geographically and because of its lower-cost labor pool. The U.S., Mexico, and Canada Agreement (USMCA), which replaced the 25-year-old North America Free Trade Agreement (NAFTA), also has helped give Mexico the edge against the steep import tariffs that many goods from China now attract. The average tariff placed on goods from China is now around 19% (Exhibit 15, left side), creating significant incentives for firms to find ways around this tax.

As a result, it is not surprising that, for the first time in more than two decades, Mexico overtook China last year as the leading source of goods imported into the U.S. Data released by the U.S. Commerce Department in February show that the value of goods imported to the U.S. from Mexico rose nearly 5% last year to more than $475 billion. At the same time, the value of Chinese imports collapsed 20% to $425 billion.

To meet the growing demand for new manufacturing, Mexico has seen its industrial production surge. This construction boom has helped the economy begin to move away from a period of stagnation, and extrapolating recent trends, the country should see a healthy tailwind of economic growth in the coming years (Exhibit 15, right side). Bessemer portfolios have exposure to Mexican equities via our specialist emerging market sub-advisors.

Vietnam

One of the fastest-growing economies in Asia in 2023, Vietnam has seen a surge in foreign direct investment (FDI) this year, with over $4.3 billion invested in the first two months — a 38% increase from the same period last year. The country has become an increasingly popular destination for multinational corporations looking to relocate operations away from China, with large technology companies such as Alphabet, Apple, Dell, and Microsoft all investing significantly in the country in recent years.

Exhibit 15: Mexico Benefiting from Chinese Trade Tariffs

Key Takeaway: U.S. tariffs on Chinese exports have moved materially higher following the 2018 U.S.-China trade war.

Key Takeaway: To meet the growing demand for new manufacturing, Mexico has seen its industrial production surge.

U.S. Tariffs on Chinese and Rest-of-World Exports

As of April 1, 2023. Trade-weighted average tariffs are computed from product-level tariff and trade data.

Source: Peterson Institute for International Economics

Mexico Gross Fixed Investment Index, Non-Residential Construction

As of December 31, 2023.

Source: Bloomberg

The U.S. has become Vietnam's largest export market, and the country's opposition to China's expansive sovereignty claims in the South China Sea aligns with U.S. interests. Ties between the U.S. and Vietnam were boosted following President Biden's visit to the country in September 2023. During the trip, Biden signed a "comprehensive strategic partnership" with Vietnam's leader, Nguyen Phu Trong, specifying the need to support the "rapid development" of Vietnam's chip industry and to strengthen its position in the semiconductor supply chain. In a further sign of strengthening ties, Washington is building a new embassy in Hanoi at a cost of $1.2 billion, making it the most expensive U.S. diplomatic complex in the world.

The flow of investment is also moving in the other direction. VinFast, a Vietnamese EV maker, is currently building a $4 billion manufacturing complex in North Carolina, due for completion in 2025. The factory will produce more than 150,000 cars annually and is set to create 7,500 local jobs in the next decade.

The Vietnamese stock market is classified as a frontier market by the leading global equity index providers and, as such, is excluded from many emerging market mandates. Should the country get upgraded to emerging market status, it would attract significantly more foreign capital and potentially see a rerating in the valuation of many of its publicly listed companies. Bessemer's specialist emerging market equity subadvisors continue to monitor this development. Bessemer's private equity program has exposure to Vietnam through venture capital managers who focus exclusively on the Southeast Asia region.

India

In a world of sluggish growth, India is booming. The latest GDP data shows that the country's economic growth accelerated to 8.4% year-on-year in the fourth quarter of 2023, marking the fastest growth in six quarters and the third consecutive quarter of growth above 8%. This makes India the world's fastest-growing major economy and means it is on track to overtake Japan and Germany to become the world's third largest economy, behind the U.S. and China, by 2027.

In April, nearly 900 million Indians will be eligible to cast their votes in what will be the largest election in the country's history. Prime Minister Narendra Modi looks

set to secure a third term as he takes credit for recent economic strength, which will add political stability to the country.

India is home to about 10% of global iPhone production. Foxconn, the world's largest contract manufacturer and Apple's main supplier, has announced plans to double its investment in India over the coming years, with a goal of producing 50 million iPhones, some 25% of total iPhone production, in the country by 2025.

India recently announced a focus on increasing the country's semiconductor manufacturing base. The government has approved allocating up to $15 billion to help build three new semiconductor plants, including its first semiconductor fab facility. The U.S. semiconductor company Micron is already in the process of constructing a $2.75 billion plant in Gujarat that is expected to directly create 5,000 jobs and an additional 15,000 indirectly. Although these projects alone will not be large enough to significantly impact a country the size of India, they demonstrate the willingness of international companies to expand their footprints in the country.

Bessemer believes there is a multiyear runway of growth in India. Bessemer portfolios have exposure to India through publicly and privately held Indian companies. Our private equity program recently partnered with Novo Tellus, a Singapore-based manager with experience investing in and growing semiconductor and electronic supply chain companies with significant operations in South and Southeast Asia. Novo Tellus is in the late stages of finalizing a transaction that includes building out a precision manufacturing facility in India to serve global technology customers.

Japan

China stands as Japan's biggest trading partner, accounting for 20% of Japan's exports, making it highly susceptible to any slowdown in China's economic growth. A weak yen has helped boost demand for Japanese exports, and in contrast to China, regulatory reforms to the Japanese corporate sector are helping to support domestic equity markets. Recent wage inflation data has also given the Bank of Japan the impetus to raise interest rates for the first time since 2007.

Japan has a unique opportunity to take advantage of shifting trade patterns to help give itself a platform for economic growth and finally break free of the deflationary environment that has dogged it for over 20 years. The relative recent performance of the Japanese and Chinese equity markets reflects investors' perceptions of the two countries' differing economic outlooks. The benchmark Japanese Nikkei 225 Index recently reached a new all-time high, something it had not accomplished since December 29, 1989, whereas the Chinese CSI 300 Index recently touched lows not seen in nearly five years.

Bessemer's portfolio managers have recently become more cautiously optimistic on the outlook for Japan given enhanced pricing power for Japanese corporations, as well as rising incomes for consumers and additional structural reforms in the country. As a result, in the past few months, Bessemer's All Equity Portfolio has modestly increased its weight from 2% of the All Equity allocation to 4% relative to 6% for the benchmark.

South Korea

Commonly called a shrimp between two whales, South Korea is looking to tread a delicate balance with the rising tensions between the U.S. and China. South Korea is largely dependent on the U.S. for its national security but, at the same time, has a significant trading relationship with China. However, in a sign of shifting trade patterns, South Korean exports to the U.S. recently exceeded shipments to China for the first time in two decades (Exhibit 16). Although the trade flows reflect the relative strength of the U.S. economy and the weaker Chinese economy, it is evident that structural changes are afoot.

South Korea and the U.S. have a free trade agreement that began in 2012. The agreement allows Seoul to benefit from U.S. laws that increasingly restrict the use of batteries and other products made in other countries, including China. In June 2023, the U.S. Energy Department announced plans to lend up to $9.2 billion to a joint venture between the Korean battery manufacturer SK On and Ford Motor to help build three electric battery plants in Tennessee and Kentucky. The plant will produce batteries for Ford's future electric vehicles (EVs). The loan is part of President Biden's Inflation Reduction Act, a $400 billion plan to invest

in green technologies. The plants are scheduled to begin production in 2025 and will support up to 7,500 full-time jobs once operational.

Derisking Rather Than Total Decoupling of Supply Chains

The process of reshuffling supply chains is complex. While the trend to reduce dependence on China is growing, alternative manufacturing destinations present their own challenges, including issues related to workforce education, corruption, and inadequate infrastructure. The reality is that the world still very much relies on China for much of its manufacturing needs, with global production intertwined with Chinese supply chains and China still manufacturing about a third of the world's goods.

We are observing more of a derisking than a complete decoupling. Derisking comes with significant longer-term benefits for many other countries but does require, at least in the short term, some trade-offs in terms of efficiency and profit margins for corporations.

Despite the complexities involved, the momentum toward reshoring should continue, as evidenced by the significant increase in mentions of the term "reshoring" during corporate earnings calls in 2023, up some 400% since 2021. Although the shift is primarily driven by the private sector, public policy and tariffs are certainly speeding up the transition.

As discussed in our Q4 2023 Quarterly Investment Perspective, which describes Chief Investment Officer Holly MacDonald's research trip to the country last September, China is "simultaneously a significant partner, a strategic competitor, and a systematic rival to the U.S." The situation is complex and evolving over many years. We believe China is likely to remain a significant and important economic and geopolitical presence while seemingly likely walking more to the beat of its own drum.

Taken all together, we expect a slower rate of Chinese GDP growth in the future relative to the past with other emerging markets likely to see stronger growth.

It is important to note that despite China's large share of global GDP at roughly 20%, it only represents 2.2% of the world stock market. For context, Microsoft holds a 4% share of the world stock market. Bessemer maintains a slightly underweight position in Chinese equities relative to the global benchmark and continually evaluates the direct and indirect risks of investing in the country.

Exhibit 16: South Korea Exports to China and the U.S.

Key Takeaway: South Korean exports to the U.S. have overtaken China's for the first time since 2003.

As of December 31, 2023.

Source: Bloomberg

Parting Thoughts

Holly H. MacDonald, Chief Investment Officer

Thank you for reading our latest Quarterly Investment Perspective. As always, we will continue to monitor economic and market trends and provide our latest thinking in written communications, videos, and interactive forums. We welcome your engagement. Please contact your client advisor with any questions you may have.

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