BESSEMER TRUST

Quarterly Investment Perspective

Navigating an Evolving Crisis

Holly H. MacDonald
Chief Investment Officer

Executive Summary

- **The COVID-19 global pandemic is bringing significant hardship for individuals and families, communities, healthcare providers, companies, and economies; policymakers are taking bold action to alleviate the pressure.**
- **As investors better understand the global economic impact, we expect markets to gradually find their footing as attractive valuations reach compelling levels.**
- **Global policymakers providing wide-ranging support at unprecedented speed is a positive development.**
- **We favor a measured approach to asset allocation; we recommend maintaining moderately defensive target weights with an increased emphasis on stocks with long-term appreciation potential.**

The COVID-19 pandemic has upended daily lives around the globe, and our thoughts are with our readers as we all navigate this unfolding crisis. The health and safety of our clients and employees are of utmost concern. In this *Quarterly Investment Perspective*, we share our views on the current situation, discussing how past crises inform us about the current one and how we are responding within client portfolios.

Looking Back to Look Forward

Careful examination of previous crises and disruptions can help us better understand what may happen from here. While every cycle is different, certain principles provide a time-tested roadmap to how periods of disruption can eventually move into recovery. With this in mind, we believe the COVID-19 shock will be resolved in time. We note four steps in the cycle:

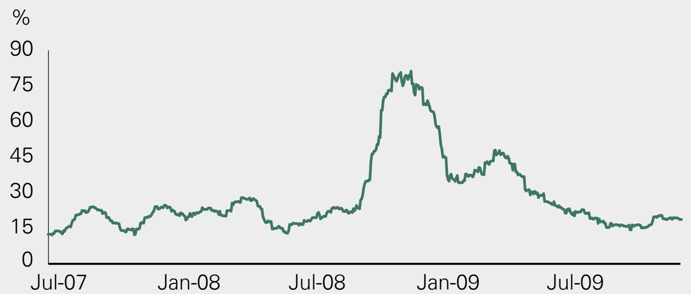
1. People come together, setting aside provincial interests.
2. Policymakers take bold action — sometimes trading short-term pain for long-term gain.
3. Investors stop trading on emotion and start to evaluate longer-term opportunities. Capital flows into attractive assets.
4. Recovery takes shape.

Exhibit 1: S&P 500 Volatility

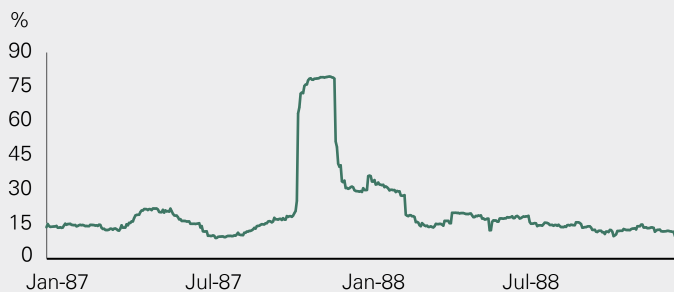
Key Takeaway: In past crises, volatility spiked, but ultimately diminished.

COVID-19 and Oil Shocks (February 2020–Present)

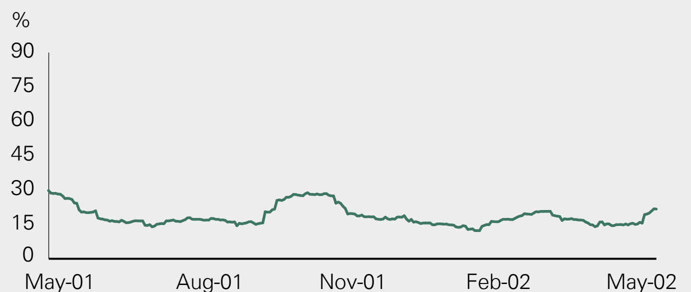
Global Financial Crisis



Black Monday (October 19, 1987)



September 11 Terrorist Attacks



As of March 24, 2020. Reflects annualized rolling 30-day realized volatility.

Source: Bloomberg

The specifics of each cycle are obviously different. For example, during the global financial crisis of 2008-2009 (hereafter referred to as the "GFC"), the primary drivers were the housing price bubble and failed mortgages, which had severe negative impacts throughout the financial system. This time, the negative effects are the result of behavior changes — like cancellations of cultural events, business interruptions, and social distancing. As we write this, we are moving through steps one and two of the cycle: Policymakers are taking bold actions to help avoid a cascade of business failures and provide support to corporate funding markets.

In past crises, as asset valuations reach more compelling levels, financial markets eventually find their footing; investors see the nascent signs of a turnaround and begin to believe a recovery can take shape. We believe we are not yet at this point but are getting closer. Putting the current period in context, Exhibit 1 highlights stock market volatility in past crises, including Black Monday in 1987, September 11, and the GFC. Volatility today is already in the range of these past crises. Fortunately, the elevated levels of volatility did ultimately recede in each past crisis, but this took time, most notably during the GFC.

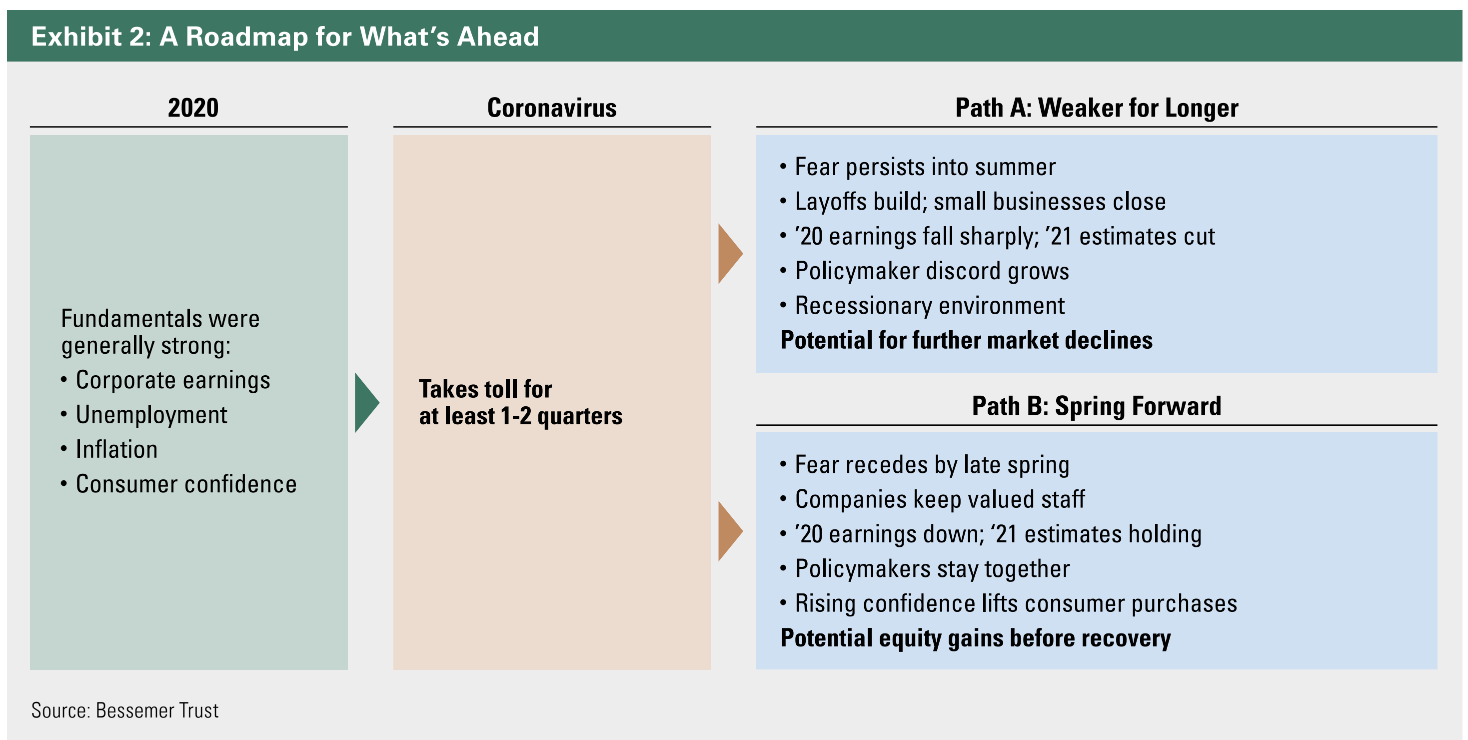
Where Do We Go From Here?

We, like all investors, are analyzing what the future holds and what that means from an economic, and therefore investment, perspective. We are not forecasting an immediate rebound. The landscape will likely worsen before it gets better, and the human toll may be enormous. It is important to note, however, that coming into the crisis, economic fundamentals were strong and the financial system was healthy, with banks holding fairly low levels of leverage. Consumers across the income spectrum were seeing rising wages and had stronger balance sheets than they did before the GFC. The labor markets were exceptionally strong, and inflation was benign (Exhibit 2).

As we see it, there are two potential paths forward as we move through the fallout from the virus. Path A is a less optimistic scenario. In this case, containment takes longer than expected, and fear persists. Smaller businesses struggle, and many close, with large layoffs inevitable. Big companies struggle as well; earnings drop significantly in 2020, and weakness carries over into 2021. A multi-quarter recession ensues. In this scenario, we see potential for further market weakness as stocks fail to find a footing.

Path B is a brighter scenario, and is our base case. Here, containment efforts are more productive. Companies are able to navigate the crisis with significant fiscal and monetary support. They are able to largely maintain operations, holding onto valuable employees. While 2020 earnings take a substantial hit, and a recession occurs, 2021 profitability looks closer to pre-crisis. Pent-up demand helps to accelerate the recovery.

Exhibit 2: A Roadmap for What's Ahead



Source: Bessemer Trust

Central banks are monitoring funding markets carefully, and we have seen many step up with significant measures to bolster liquidity.

Historically, we note that markets have tended to price in an economic recovery very early, or even before the actual turnaround. Said another way, the stock market almost always bottoms and heads higher when economic news is still grim.

Where We Are

As we write this, new cases of COVID-19 continue to spread globally (outside of the original outbreak in the Hubei province of China). While the Chinese government has been able to largely contain the virus, other governments are struggling to varying degrees. Social distancing has taken hold across the world, with schools, churches, events, tournaments, and travel shutting down. Researchers and scientists are working at light speed on vaccines and treatment options.

Financial markets have reacted swiftly as investors try to gauge the ultimate impact of the virus on the economy. Market movements that historically occurred over a period of months have happened within just weeks. In the fallout, we have seen some of the largest daily capital flows ever between asset classes — for example, outflows from corporate and emerging market debt, and inflows to government bonds, cash, and gold. Automated trading strategies, which have grown mightily in the recent decade, have been a factor in exacerbating the dramatic market movements.

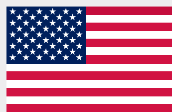
Markets are now pricing in a recession across asset classes as a result of the economic shutdown and the extreme difficulties seen across travel, leisure, and other service-related industries of all sizes. The contraction is likely to be very sharp and deep between the first and second quarter. Roughly a third of the U.S. labor force works in industries directly affected by the coronavirus, including retail, entertainment, travel, tourism, restaurants and energy. A staggering 3.3 million workers filed for unemployment insurance the week of March 21. This figure is materially higher than the prior record, which was 695K in 1982. Given the economic turmoil in the short run, further layoffs are undoubtedly on the way.

Promising COVID-19 Treatments

While vaccine efforts are energetically underway, trials and approvals will take time. Treatment options to lessen the severity of symptoms are promising, however. Given the severity of the situation, treatment options are primarily focusing on using existing drugs to treat COVID-19. Some are antiviral drugs that have already been approved and are being tested for COVID-19 use, such as chloroquine and hydroxychloroquine, and some are newer drugs not yet approved, such as remdesivir. Of the current options, remdesivir, produced by Gilead Sciences and originally developed as a broad-spectrum antiviral for the Ebola virus, is the most promising option for critically ill patients. It is being trialed in the U.S. and abroad on moderate to severe cases and also being made available to patients in emergency treatment situations. Another explorative treatment option in trial utilizes blood plasma of recovered COVID-19 patients to boost the immune systems of current patients by infusing them with antibodies.

Importantly, the World Health Organization's clinical-trial protocol is designed to be flexible and allow researchers around the world to pool their results over time. Very encouraging is the statistic that China alone has more than 80 clinical trials launched to test coronavirus treatments. In the U.S., the Trump administration is working with the Food and Drug Administration to streamline the trial process and allow it to move faster.

Exhibit 3: Select Monetary and Fiscal Actions Taken By World Authorities



U.S.

- Significant interest rate cuts, quantitative easing and emergency liquidity support measures
- Over $2 trillion in fiscal stimulus packages including direct payments to citizens, expansion of unemployment insurance, support to small businesses
- Public-private partnerships to tackle testing challenges

China

- Rate cuts and lower reserve requirements for banks; increase in bond issuance
- Sigificant expenditure on coronavirus testing and treatment
- Support to SMEs including delay in fee collection, rent deduction, tax delay/deduction
- Adjustments to unemployment insurance, like delayed collection or reduction

Europe

- Large economic stimulus packages by German, Italian, French governments; EU stimulus package expected
- ECB buying bonds and expanding loans to SMEs; additional rate cuts expected
- Broader eurozone economic stimulus expected

As of March 31, 2020. SME stands for small and medium enterprises.

Source: Media reports

Unprecedented Monetary and Fiscal Policy Response

As noted, global policymakers are taking bold actions, working both to protect the health and safety of citizens and to ensure the smooth functioning of the broad financial system (Exhibit 3). On the monetary side, global central banks are aggressively cutting interest rates and enacting stimulus packages. Monetary policy developments suggest that central banks are going to supply markets with unlimited liquidity throughout this turbulent environment. On the fiscal side, governments are rushing to the aid of small businesses and citizens, trying to help them weather the storm by enacting various measures, such as direct stimulus payments, expanded unemployment insurance, and low-interest loans. As a result of recent fiscal and monetary policy actions, the U.S. and Europe together have committed more than $3 trillion in fiscal and monetary stimulus. One important aspect of the current joint policy support is that monetary and fiscal measures in coordination are able to amplify the policy response. Coordinated measures like these should help alleviate the pressure on the economy over time.

Ensuring the health of the financial system is critical to keep capital flowing to businesses and individuals as the crisis continues. Central banks are monitoring funding markets carefully, and indeed, we have seen many step up with significant measures to bolster liquidity. In the U.S. in particular, the Federal Reserve's support has occurred at a rapid pace, sending a clear signal that it is prioritizing market stability and its dual mandate goals (price stability and maximum sustainable employment) over protection against its own risk of financial loss.

Elise Mordos
Investment Strategies Analyst

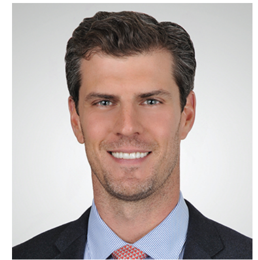
The Fed's Actions in Historical Context

To provide context for how quickly policymakers are responding to the current crisis, we compare today's Federal Reserve actions with those during the GFC. Looking back to that period, the U.S. economy began showing signs of financial distress in 2007. Freddie Mac announced that it would no longer buy the most risky subprime mortgages and mortgage-related securities in February, and two of Bear Stearns' hedge funds were bankrupt by July. The Fed, concerned about the stability of the financial system soon thereafter, lowered the federal funds rate and primary credit rate. The Fed would go on to cut rates nine more times, eventually reaching the 0.0%-0.25% range by December 2008.

The Fed also began implementing programs to improve market liquidity in 2007 and into 2008. They included the following: Term Auction Facility (TAF) in December 2007, Term Securities Lending Facility (TSLF) in March 2008, Primary Dealer Credit Facility (PDCF) in March 2008, and Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) in September 2008. Swap lines between the Federal Reserve and other central banks — like the European Central Bank, Bank of Japan, Bank of England, Swiss National Bank and Bank of Canada — were increased numerous times to alleviate liquidity issues in response to higher demand for the U.S. dollar. Quantitative easing (QE) began in November 2008; the first-round QE primarily included purchases of mortgage-backed securities (MBS) and Treasury securities. The Fed went on to conduct two more rounds of QE and Operation Twist (a program whereby the Fed used the proceeds of its sales from short-term Treasury bills to buy long-term Treasury notes). These market operations continued until October 2014.

The Fed's lightspeed movement during the current crisis likely reflects lessons learned from the GFC. The Fed's recent action has been bold and fast. The first rate cut in response to the virus was March 3, and the Fed unleashed multiple measures, many of which were enacted in a single week (March 15) as the number of COVID-19 cases grew exponentially in the U.S. These included a slash in the fed funds rate to 0%, significant Treasury and MBS purchases, a Commercial Paper Funding Facility, a Primary Dealer Credit Facility, and a Money Market Mutual Fund Liquidity Facility. On March 23, the Fed expanded these programs and added others, including a Primary Market Corporate Credit Facility to fund new corporate debt and a Secondary Market Corporate Credit Facility for outstanding corporate bonds. The Fed also opened up swap lines with numerous other central banks in response to high demand for the U.S. dollar as it did during the GFC.

Signs of Stress in Credit and Funding Markets



JP Coviello
Senior Investment Strategist

As the global economy slows due to coronavirus-related shutdowns, corporations have greater liquidity needs amid lower revenues. Companies have drawn on credit lines to ensure that they have enough liquidity to manage fixed costs throughout this business disruption, and this has incited a surge in the cost of borrowing U.S. dollars globally. The Fed has provided support by increasing the size and lowering the cost of U.S. dollar swap lines with foreign central banks. However, we may need to see even broader action from central banks in order to carry the market through this period of uncertainty.

While stress is surfacing in the U.S. dollar funding markets, we can also see the market's view of implied defaults appearing in the credit markets (Exhibit 4). High yield bond prices have plummeted, exacerbated by a shock to oil prices (discussed in the next section). With nearly 12% of the high yield market comprised of energy-related companies, operating with West Texas International (WTI) crude oil around $20/barrel is neither easy nor profitable for the majority of U.S. producers. High yield energy spreads are now about 21%, up from around 6.5% at the start of 2020. However, it's not only an energy story. Travel and leisure companies, airlines, and the restaurant industry have all been acutely affected by travel bans, border closures, and social distancing. Excluding energy, high yield spreads are around 7.7%, up from around 3.0% at the start of 2020.

Exhibit 4: U.S. High Yield Minus 10-Year Treasury Yield

Key Takeaway: Signs of stress are appearing in credit markets.

As of March 24, 2020.
Source: Bloomberg

Bree Sterne
Investment Strategist

Energy Market Disruption

Compounding the COVID-19 situation and equity market volatility is a significant disruption in energy markets. Brent crude has declined roughly 65% this year to $23/barrel on the prospect of additional crude oil flooding an already well-supplied global energy market.

At the start of March, investors had largely expected OPEC+ (Organization of the Petroleum Exporting Countries and allies including Russia) to announce additional oil production cuts in response to the impact of the coronavirus epidemic on oil demand. Further limiting production would have supported oil prices that had already been pushed lower. However, Russia declined to agree to Saudi Arabia's proposal, in part over concerns that it would allow U.S. producers to increase their market share. In retaliation to Russia's unwillingness to participate in cuts, Saudi Arabia announced its plans to cut oil prices and boost production, opening the crude oil flood gates and launching a global oil price war with substantial geopolitical and investment implications.

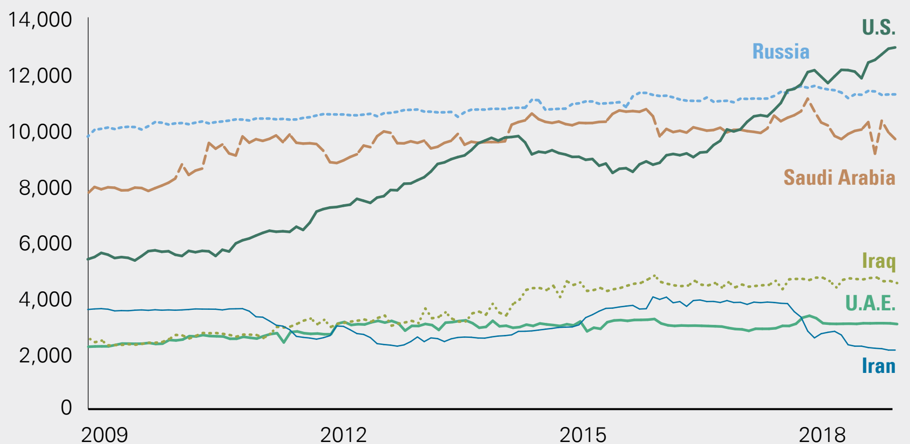
Before this supply shock, oil prices had already declined on the back of signs that the spreading coronavirus will limit global growth and dampen oil demand. The Trump administration has announced

Exhibit 5: Oil Market Developments Adding to Volatility

Key Takeaway: The U.S. has become a major oil producer over the past decade; lower oil prices can therefore increasingly hurt the economy.

Top Oil-Producing Countries

Thousands of barrels per day



As of January 31, 2020.

Source: Bloomberg, Energy Intelligence

its intention to take action by purchasing large quantities of oil for the government's strategic petroleum reserve; however, this was not included in the recent $2 trillion stimulus package and future plans are uncertain. Further, the U.S. is reportedly evaluating diplomatic intervention with the aim of convincing Saudi Arabia to cut production and threatening Russia with sanctions in an attempt to stabilize markets. While there is a chance that free-falling oil prices or an external mediator will push Russia and Saudi Arabia to come to an agreement to reverse course and compromise on supply cuts, investors are bracing for oil prices to remain under pressure in the coming months.

A decade ago, the U.S. economy might have substantially benefitted from lower oil prices, but as the U.S. has become a major oil producer (Exhibit 5) and global supplier, extensive oil price weakness can increasingly hurt the U.S. economy through its negative effect on the energy sector and energy-driven industries. We expect credit markets to be impacted more directly as low oil prices will stress test the creditworthiness of companies, as we noted earlier. In the short term, some producers have hedged this year's expected production against lower oil prices, providing some degree of buffer against lower prices. But after hedges run out, a wave of defaults and bankruptcies could contribute to further market stress.

Bessemer Positioning and Performance

Entering 2020, Bessemer client portfolios were modestly defensive in positioning after two asset allocation shifts in 2019. While we certainly did not anticipate a shock of this magnitude, we were concerned with late economic cycle dynamics. Defensive elements in portfolios include

Positive Pockets in the Economy Amid the Crisis

As the COVID-19 crisis progresses, we gain more clarity on implications for different sectors in the global economy. While some industries such as airlines, hotels, restaurants, and casinos have been essentially shut down, at least temporarily, there are some rays of light in terms of companies with business models that are positioned to help during the crisis, many to which Bessemer portfolios have exposure:

- Companies that facilitate computer software infrastructure for the increasing number of individuals working from home, and the businesses in the supply chain of these frontline winners also benefit.
- Supermarket chains are also notable outperformers, as they benefit from consumers stocking up on supplies during quarantine periods.
- Pharmaceutical and biotechnology companies are on the frontlines trying to find vaccines and treatment options for COVID-19.
- Telehealth is a beneficiary of the social distancing initiatives as an increasing number of health providers are using this method to treat patients virtually. This is also being used by medical care professionals to treat COVID-19 patients in an effort to limit contagion and conserve personal protective equipment (PPE). Once patients experience the benefit of video discussions with doctors, it is possible this temporary boost in demand will become more structural.

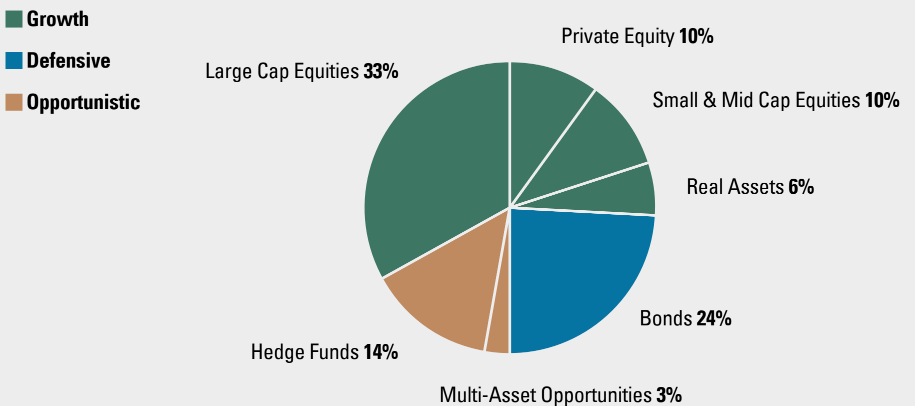
In the midst of this sudden onset of volatility and with so much riding on policy response, we favor a balanced longer-term approach rather than a significant shift in risk exposure.

an overweight position in protective assets, an overweight to the U.S. within equities, a focus on companies with solid balance sheets and ample cash flow, and an allocation to managed volatility equities. We remain well diversified, through both internal and external managers (Exhibit 6).

Client portfolios are generally negative in 2020 after significant appreciation in 2019. Bessemer mandates outperformed benchmarks in 2019, and most have continued to do so in 2020 on a preliminary basis. Moderately defensive positioning along with security selection — namely a focus on quality-oriented stocks and bonds — has driven some of the outperformance versus broader markets.

In the midst of this sudden onset of volatility and with so much riding on policy response, we favor a balanced longer-term approach rather than a significant shift in risk exposure, which is simply too difficult to time in a period of dramatic daily swings in markets. We are implementing tax-loss harvesting for taxable investors and a rebalance of exposures to target weights with an increased emphasis on stocks with long-term potential. Portfolio managers are actively enhancing their holdings — buying high-conviction companies at more attractive valuations and with strong

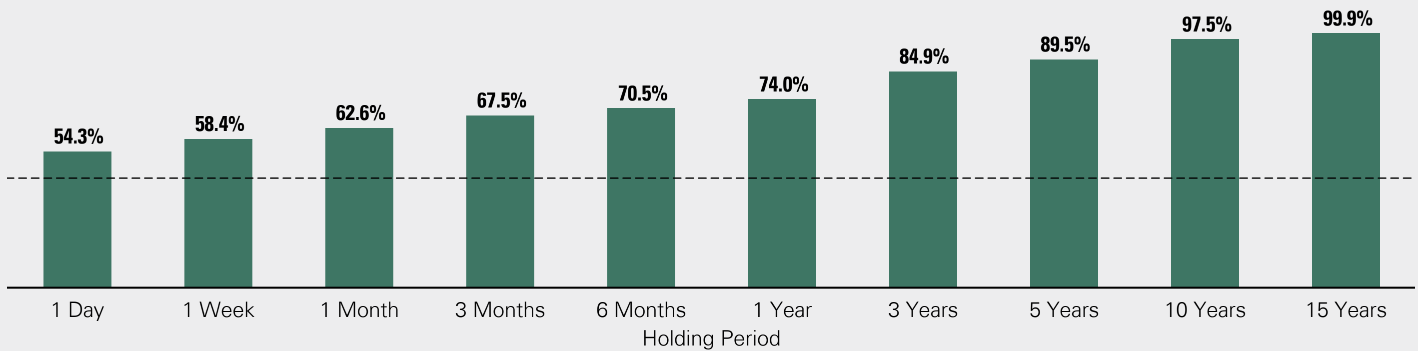
Exhibit 6: Bessemer's Positioning



Positioning as of April 1, 2020. 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.

Exhibit 7: Probability of Gains in U.S. Equities

Key Takeaway: Staying invested for the long term increases the probability of gains when investing in equities.



As of February 29, 2020.

Reflects daily and weekly data since 1950; monthly and yearly data since 1800.

Source: Global Financial Data, Standard & Poor's, Yahoo Finance

compounding potential, and trimming or selling those with elevated valuations or execution concerns. As we move forward, we are watching several metrics as we think about increasing overall risk exposure in portfolios, and those include solid dynamics in funding markets, visibility with regard to a peak in U.S. virus cases, and diminishing volatility in equity markets.

We want to reiterate the importance of staying invested. In difficult times, emotion often takes over, and an urgency to sell can take hold. It is critical to keep an eye toward the long term. As we discussed earlier, there have been multiple crises and subsequent stock market declines that investors have had to weather in order to earn the attractive long-term returns of equities. Timing the markets — consistently calling the peaks and troughs — is difficult if not impossible, while staying invested has historically worked in investors' favor (Exhibit 7).

To conclude, we know clients are counting on us, and it's a responsibility we feel deeply. While we look forward to the day when we can come back together in a physical space, we remain a cohesive team committed to helping your family. We encourage you to reach out to your advisor for any support you need. Thank you for your trust in us.

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