Insights

October 2021

3Q21 Market Overview: Against Perfection

Equity market dynamics in third quarter 2021 suggested to us that investor confidence may have begun to wane even as widespread vaccine distribution prompted many jurisdictions to adapt their approach to managing the risk of Covid-19. While the MSCI World Index was flattish for the three-month period, September's decline—the first down month for the index since January—highlighted the challenges that may be ahead for investors.

After the stimulus-fueled rebound from the depths of the Covid-19 dislocations, the capital markets, in our view, appear to have entered a more complicated phase as 2021 nears an end, the result of a variety of historical aberrations and growing imbalances. With equity markets priced for very high expectations even after a ho-hum third quarter—and a range of economic, policy and geopolitical risks looming—we are proceeding cautiously, seeking pockets of long-term opportunity for resilient wealth creation.

Key Takeaways

- While equity valuations suggest little room for error, mounting input cost pressures threaten the very high profit margins that have supported corporate earnings growth.
- With "transitory" inflationary pressures proving to be quite persistent, the Federal Reserve has grown increasingly hawkish. With tapering and rate hikes on policymaker radars, caution may be warranted in an environment of uncertain future liquidity.
- China's re-embrace of "common prosperity" may improve the country's socioeconomic balance, but a sweeping realignment of power between the government and business risks upsetting a private sector that has been key to economic and job growth, with unknown potential impacts on the country's—and the world's—economic trajectory.
- We continue to position our portfolios for resilience from the bottom up, targeting companies that we believe offer the opportunity for durable wealth creation over the long term.

Views expressed are as of October 12, 2021.

Pronounced Risks and Elevated Valuations in Equity Markets

The unusual circumstances we find ourselves in today are exemplified by the coexistence of negative real interest rates and very low levels of risk premia like credit spreads. Under normal conditions, low or negative real interest rates are the result of some sort of macro distress, and credit spreads widen to reflect the perceived greater risk of default in such uncertain environments. This was clearly evident upon the outbreak of Covid-19 in early 2020, as the nominal yield on the 10-year US Treasury hit modern-era lows, real rates turned negative for the first time since 2013, and credit spreads spiked to levels not seen since the global financial crisis.[1]

Today, while nominal Treasury yields have since about doubled off their 2020 trough, they remain far closer to the record low than the historical average, repressed by unabated central bank stimulus; combined with markedly higher inflation readings, this has kept real rates well into negative territory.[2] Credit spreads have retightened, approaching the levels first seen when the central bank stepped into the primary and secondary bond markets last year.

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Equity markets, meanwhile, appear priced with little room for error. Not only is the S&P 500 Index, in particular, trading at a high multiple of trailing earnings, these earnings are the product of a generational peak in profit margins.[3] Mounting cost pressures—whether it's from commodity prices or logistical bottlenecks or supply chain breakdowns or labor availability problems—suggest that these very high margins may be at risk even as economic growth persists.

Despite low interest rates and low risk premia, we have a hard time accepting that investment risk is low at this point. We've exited this recession with a much higher stock of debt to GDP than we entered with or than before the global financial crisis, and legislation winding its way through Congress would further add to that. Fiscal deficits have pulled back from 2020 but remain very high—the Congressional Budget Office forecasts a federal budget deficit of more than 13% in 2021[4]—and the Federal Reserve has kept the stimulus flowing even as employment conditions have improved markedly and recent inflation reports have come in at multi-decade highs. While Federal Reserve chair Powell and other board members have been consistent in their contention that the current pricing pressures are transitory, even the world's most powerful policymakers cannot lay claim to a crystal ball. The Fed, in fact, has grown more hawkish in recent meetings, and there are suggestions it may begin to taper its monthly bond purchases before the end of 2021 and potentially hike the federal funds rate as early as next year. While the impact this would have on global markets remains to be seen, our experience over the past decade-plus suggests caution is warranted.

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Geopolitical risks, meanwhile, are pronounced and can be traced most prominently to China. Chinese equities finished the third quarter down about 30% from their February peak, a decline prompted in part by concerns about increased regulation across both economic sectors and the day-to-day lives of the Chinese people.[5] President Xi Jinping has publicly re-embraced the concept of "common prosperity" first put forth by Mao Zedong in the 1950s; he has reasserted the Chinese Communist Party's primacy over, in particular, large private companies and the oligarchs who lead them in an effort to narrow the country's tremendous wealth gap. While such measures may improve China's socioeconomic balance, a sweeping realignment of the power between the government and business risks upsetting a private sector that has been key to economic and job growth, with unknown potential impacts on the country's—and the world's—economic trajectory.

1. Source: Federal Reserve Bank of St. Louis; data as of October 12, 2021.
2. Source: Bloomberg; data as of September 30, 2021.
3. Source: FactSet; data as of September 30, 2021.
4. Source: Congressional Budget Office; data as of July 1, 2021.
5. Source: FactSet; data as of September 30, 2021.

With a property market that accounts for 29% of China's economic activity according to one study, Xi's resolve may be tested by a potential turn in the country's real estate cycle.[6] We have long talked about the risk in China of malinvestment in real estate, and recent government efforts to curtail credit growth in the space—estimated at more than $5 trillion[7]—have resulted in liquidity issues among some of the country's most heavily leveraged developers. This includes Evergrande Group, China's largest issuer of junk bonds, which in recent weeks has missed interest payments on two dollar-denominated issues and seen the pricing on its debt fall to distressed levels.[8] A wave of defaults in this sector could have global implications.

We don't know if these changes are fundamental or if China will reverse course and soften its regulatory rhetoric in order to forestall economic disruption, as it has sometimes done in the past. But China has now entered a risk category that we would describe as non-linear.

Prudence Is Paramount

Given the risks we have discussed, we believe this is clearly a time for prudent investing. At First Eagle, our commitment to prudent investing resides in part in our allocation to gold and gold-related equities in many of our portfolios as a potential hedge against disruptive events. Gold in many ways serves as an indicator of risk perception; the limited risk premia evident in equity and fixed income markets can also be seen in the weakness in the gold price this year. Despite the headwinds that gold has faced, we remain confident in its value as a potential hedge. In fact, we believe gold currently appears to be a value version of itself given its price relative to other investment options such as real interest rates, bitcoin and risk assets like growth equities.

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From the bottom up, we are trying to selectively identify pockets of long-term opportunity for resilient wealth creation in the face of markets priced for very high expectations. This may include companies that stand to benefit from a fuller return to pre-Covid norms in areas like travel and hospitality, energy, retail, real estate and a number of others. It also may include high-quality names that could benefit from secular changes in their industries, whether it's cloud computing or lasers or trucking.

6. Kenneth S. Rogoff and Yuanchen Yang, "Peak China Housing," NBER Working Paper Series (August 2020).
7. Source: *The Wall Street Journal*, Nomura Holdings; data as of October 10, 2021.
8. Source: *The Wall Street Journal*; data as of October 10, 2021.

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Investment in gold and gold-related investments present certain risks, and returns on gold-related investments have traditionally been more volatile than investments in broader equity or debt markets.

The principal risk of investing in value stocks is that the price of the security may not approach its anticipated value or may decline in value.

All investments involve the risk of loss of principal.

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The MSCI World Index is a widely followed, unmanaged group of stocks from 23 developed markets and is not available for purchase. The index provides total returns in U.S. dollars with net dividends reinvested.

The Standard & Poor's 500 Index is a widely recognized unmanaged index including a representative sample of 500 leading companies in leading sectors of the U.S. economy and is not available for purchase. Although the Standard & Poor's 500 Index focuses on the large-cap segment of the market, with approximately 80% coverage of U.S. equities, it is also considered a proxy for the total market.

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