Initial Thoughts on Russia's Invasion of Ukraine

In the early-morning darkness of February 24, Russia launched a barrage of airstrikes toward strategic targets across Ukraine—including the capital Kyiv.

By daybreak, Russian armored columns were on the ground throughout Ukraine, having entered the country from points east (Russia), north (Belarus) and south (Russia-controlled Crimea). While rising tensions between the neighboring nations—and, by extension, between Russia and the US—suggested that some sort of military incursion by Russia was all but inevitable, the magnitude of the initial foray was more extreme than many thought likely. The full-scale attack now underway appears intent on forcing regime change in Ukraine as well as its demilitarization. It also may represent the next stage in a geopolitical shift that could be highly impactful for asset markets and currencies, both in the near term and for years down the road.

What follows is our initial reaction to the events on the ground and their potential impacts on global economic activity and financial markets, as of February 24, 2022.

KEY TAKEAWAYS

- The US and its allies are enacting significant economic sanctions in response to Russia's invasion of Ukraine. The impact of these actions—and Russia's potential response to them—is uncertain and represents a significant risk to the global economy and financial markets.
- Markets appear to have been pricing in a strong possibility of armed conflict in Ukraine for the past several weeks, with investors generally eschewing risky assets for relative safe havens like gold and the US dollar.*
- Technology stocks have dropped sharply year to date, while energy stocks—buoyed by a sharp increase in the price of oil—have jumped. Within equity markets, investors have generally favored value over growth.*
- Trading activity on the day of the invasion highlighted the uncertain environment, as US stocks opened sharply lower before whipsawing well into positive territory by the afternoon. The CBOE Volatility Index hit its highest level in more than 15 months.*
- First Eagle's exposure to the combatants in the Ukrainian conflict is negligible. Portfolios managed by the Global Value team have negligible direct exposure to companies based in Russia or Ukraine and an exposure of less than 1.3% on a revenue basis.*

* Source: Bloomberg; data as of February 24, 2022.
Views expressed are as of February 24, 2022.

US and NATO Response Limited to Economic Sanctions, for Now

A direct military response from the US or NATO seems unlikely at this early stage, though ongoing financial aid and the shipment of weapons and other provisions to Ukraine is likely to increase. Instead, the US, UK and European Union will rely on large and far-reaching sanctions as their cudgel of choice. The first to act, US President Biden announced a range of actions targeting Russia's banking system, its political elite and oligarchs, and state-owned companies, all designed to hurt Russia economically in both the near term and over time by suppressing economic activity, promoting inflation, raising borrowing costs and cutting off its manufacturers from a range of vital high-tech inputs.[1]

While other potential measures remain on the table, the most notable of these carry significant risk of self-harm, particularly for the EU given its economic ties with Russia; Russia accounted for 4.8% of the EU's trading activity in 2020 and was the source of 26% of its oil and 40% of its natural gas.[2] Cutting off Russia from the SWIFT system of international financial exchange, for example, would all but close a major destination of EU exports. It would also curtail the ability of EU nations to import oil and gas from Russia, likely sending already-lofty energy prices sharply higher on the Continent and introducing another supply uncertainty to the global market.

The invasion calls into question the future of energy supply in Europe. Only a few days ago Germany halted its Nord Stream 2 pipeline project, which was currently in the testing and certification phase of development after completing construction in September 2021. Long a point of disagreement between the US and Germany, the pipeline was intended to allow Russia to deliver natural gas directly to Germany (and, thus, Europe) via a pipeline running under the Baltic Sea, rather than its current land route via Ukraine. As the Ukraine conflict intensifies, Europe likely will increasingly depend on large liquefied natural gas (LNG) exporters like the US and Qatar for its needs. European efforts to diversify away from its Russian reliance in recent months has helped the US become the world's biggest LNG exporter for the first time.[3]

Markets De-Risk in the Face of an Uncertain Economic Landscape

Right now, there certainly are more questions than answers in terms of geopolitical dynamics and their potential impact on financial markets and the global economy. Markets appear to have been pricing in a strong possibility of armed conflict in Ukraine for the past several weeks, with investors generally eschewing risky assets for relative safe havens, as shown in the table on the following page.[4] For example:

- The yield on 10-Year US Treasuries fell to as low as 1.85% on February 24, only to finish close to the 2% level seen the day before. Yields remain much higher year to date on expectations of aggressive tightening by the Federal Reserve in the face of persistently high inflation.
- The US Dollar Index moved higher, as currency traders appeared to look past the country's twin deficits in favor of exposure to the global reserve currency.
- Fixed income markets have fallen less than equities year to date despite the move higher in Treasury yields. The Bloomberg US Aggregate is off 4.1% compared to a 9.8% decline in the S&P 500 Index and a 9.9% fall in the MSCI World Index.
- Within equity markets, investors generally favored value over growth, as the MSCI World Value Index (-5.2%) has outpaced MSCI World Growth Index (-14.7%) significantly year to date.
- Technology stocks have borne the brunt of the equity market selloff, with the NYSE FANG+ Index losing 16.3% year to date. In contrast, energy stocks—buoyed by a 25% increase in the price of oil—have jumped 16.5%.

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- Gold has played its historical role as a potential store of value in challenging times, with the Bloomberg Gold Index advancing 4.1% year to date. In contrast, bitcoin—viewed by some as a potential successor to gold— has declined 16.4% as measured by the Bloomberg Galaxy Bitcoin Index.

1. Source: The White House; as of February 24, 2022.
2. Source: European Commission; data as of December 31, 2020.
3. Source: *The Wall Street Journal;* as of February 17, 2022.
4. Source: Bloomberg; data as of February 24, 2022.

Anticipation of Armed Conflict Among Factors Weighing on Risk Assets Year to Date

US Equity	YTD through Feb 24, 2022	Feb 9, 2022, through Feb 24, 2022
S&P 500 (Total Return)	-9.8%	-5.1%
NYSE FANG+ Index	-16.3%	-6.8%
Russell 1000 Value	-5.7%	-4.6%
Russell 1000 Growth	-14.1%	-5.3%
Russell 2000	-11.0%	-2.4%

Fixed Income	YTD through Feb 24, 2022	Feb 9, 2022, through Feb 24, 2022
Bloomberg Global Aggregate	-4.0%	-1.3%
Bloomberg US Corporate High Yield	-4.6%	-1.5%
Bloomberg US Aggregate	-4.1%	-0.9%
S&P/LSTA Lev. Loan Index	-0.5%	-1.0%

Global Equity	YTD through Feb 24, 2022	Feb 9, 2022, through Feb 24, 2022
MSCI World	-9.9%	-5.5%
Consumer Discretionary	-14.8%	-7.9%
Consumer Staples	-6.1%	-3.8%
Energy	16.5%	-2.5%
Financials	-3.6%	-8.1%
Health Care	-10.3%	-4.1%
Industrials	-11.6%	-5.6%
Technology	-14.3%	-5.5%
Materials	-6.2%	-3.5%
Communication Services	-12.7%	-4.1%
Utilities	-8.0%	-4.1%
REITs	-12.9%	-3.0%
MSCI World Growth	-14.7%	-5.4%
MSCI World Value	-5.2%	-5.5%
MSCI EAFE	-9.6%	-6.5%
MSCI EAFE Growth	-16.0%	-6.2%
MSCI EAFE Value	-2.9%	-6.8%

Real Assets	YTD through Feb 24, 2022	Feb 9, 2022, through Feb 24, 2022
FTSE Gold Mines	5.5%	8.2%
Bloomberg Gold Index	4.1%	4.3%
Bloomberg WTI Crude Oil	25.4%	5.0%
Bloomberg Galaxy Bitcoin Index	-16.4%	-13.1%
US Dollar Index Spot Rate	1.4%	1.5%

Source: Bloomberg; data as of February 24, 2022.
Past Performance does not guarantee future results.

Trading activity on the day of the invasion highlighted the uncertain environment facing investors. Stocks in Asia and Europe were already down sharply when US markets opened, and US stocks initially followed suit. By the end of the day, however, major indexes in the US had retraced their losses to finish well into positive territory. The Nasdaq, down more than 3% at one point, finished 3.3% higher, while the S&P 500 shrugged off a 2.5% slide to gain 1.5%. The CBOE Volatility Index hit its highest level in more than 15 months.[5]

While we don't care to attempt to predict the future, it appears likely the Russian invasion and retaliatory actions to it—not to mention any subsequent Russian response—could potentially disrupt global trade and financial activity for some period of time and may also serve as a recessionary shock. Already-high inflation may be biased still higher as a result of these disruptions, with prices on a wide range of commodities continuing to climb. And it's not just oil: Russia and Ukraine together account for one-third of the world's wheat exports, one-fifth of corn exports and nearly 80% of sunflower oil production.[6]

5. Source: FactSet; data as of February 24, 2022.
6. US Department of Agriculture; data as of November 9, 2021.

With inflation high and growth levels threatened, the risk of stagflation has increased, which, as we saw in the 1970s, can have very negative effects on both stocks and bonds. Though policymakers are constrained in their ability to respond to this threat, markets suggest the potential impacts of the Ukraine conflict may soften the Fed's stance; fed funds futures as of February 24 assigned a 13% chance to the Fed announcing a 50 basis point hike following its March policy meeting, down from 33% on February 23.[7]

First Eagle Seeks to Build Portfolios that Mitigate the Impact of Adverse Events

First Eagle's exposure to the combatants in the Ukrainian conflict is negligible. Portfolios managed by the Global Value team have negligible direct exposure to companies based in Russia or Ukraine, and an exposure of less than 1.3% on a revenue basis (the largest of which come from investments in the consumer staples sector and, to a lesser degree, technology and energy).[8]

In *The History of the Peloponnesian War*, Thucydides wrote that "The course of war cannot be foreseen." Applying this truism across a range of potentially adverse market events, we seek to construct all-weather portfolios that seek to create resilient wealth and mitigate the permanent impairment of capital in the face of complexity and uncertainty.

As always, we seek to build resilience in our portfolios from the bottom up, identifying individual companies that we believe have the potential for persistent earnings power by virtue of possessing a scarce, durable asset—a tangible or intangible factor that in our view provides it with a long-term operational advantage and is highly difficult to replicate. The persistent free cash flow of companies with scarce assets may provide a cushion against challenging environments while potentially creating opportunities to enhance their competitive position against less-resilient businesses.

As a complement to these companies, we want consistent exposure to an asset that may mitigate the impacts of a tail state of the world. We believe gold's proven ability to maintain its purchasing power over the long term combined with its countercyclical price dynamics, versatility, resilience and long duration make it the most compelling form of potential hedge against both the seen and unseen risks facing portfolios. Meanwhile, the cash and cash equivalents that are a residual of our bottom-up investing approach provide us with optionality when volatile markets reveal attractively priced investment opportunities.

The Global Value team's commitment to diversification, ballast like cash and gold in certain portfolios, and defensive equity positioning has served as a headwind to relative performance for portions of the post-global financial crisis period. However, we firmly believe this same approach may prove its mettle in the more complicated investment environment—characterized by massive debt levels, the need to unwind stimulus in the face of decades-high inflation, the risk of additional Covid-19 variants and many others—that had emerged even before the first Russian missile was launched.

> Portfolios managed by the Global Value team have negligible direct exposure to companies based in Russia or Ukraine, and an exposure of less than 1.3% on a revenue basis.

7. Source: CME Group; data as of February 24, 2022.
8. Source: FactSet; data as of February 24, 2022.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

The opinions expressed are not necessarily those of the firm. These materials are provided for informational purposes only. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice. Any statistics contained herein have been obtained from sources believed to be reliable, but the accuracy of this information cannot be guaranteed. The views expressed herein may change at any time subsequent to the date of issue hereof. The information provided is not to be construed as a recommendation to buy, hold or sell or the solicitation or an offer to buy or sell any fund or security.

Past performance is not indicative of future results.

Risk Disclosures

All investments involve the risk of loss of principal.

There are risks associated with investing in securities of foreign countries, such as erratic market conditions, economic and political instability and fluctuations in currency exchange rates.

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.

A 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. "Value" investments, as a category, or entire industries or sectors associated with such investments, may lose favor with investors as compared to those that are more "growth" oriented.

Definitions

One cannot invest directly in an index. Indices do not incur management fees or other operating expenses.

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.

NYSE FANG+ Index is designed to represent a segment of technology and consumer discretionary sectors consisting of highly-traded growth stocks of technology and tech-enabled companies such as Facebook, Apple, Amazon, Netflix and Alphabet's Google.

Russell 1000 Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-value ratios and higher forecasted growth values. The Russell 1000 Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap growth segment.

Russell 1000 Value Index measures the performance of large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. The Russell 1000 Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment.

Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. The Russell 2000 is constructed to provide a comprehensive and unbiased small-cap barometer and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.

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.

MSCI World Growth Index is designed to capture large and mid cap securities exhibiting growth style characteristics across 23 developed market (DM) countries. Growth investment style characteristics are defined using long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate, and long-term historical EPS growth trend and long-term historical sales per share growth trend.

MSCI World Value Index is designed to capture large and mid cap securities exhibiting value style characteristics across 23 developed market (DM) countries. Value investment style characteristics are defined using book value to price, 12-month forward earnings to price and dividend yield.

MSCI EAFE Index is an unmanaged total return index, reported in U.S. dollars, based on share prices and reinvested net dividends of companies from 21 countries and is not available for purchase.

MSCI EAFE Growth Index captures large and mid cap securities exhibiting overall growth style characteristics across developed markets countries around the world, excluding the US and Canada. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend. Developed markets countries include Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK.

MSCI EAFE Value Index captures large and mid cap securities exhibiting overall value style characteristics across developed markets countries around the world, excluding the US and Canada. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield. Developed Markets countries include Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland and the UK.

Bloomberg Global Aggregate Bond Index is a broad-based benchmark that measures the global investment grade debt from 24 local currency markets, including treasury, government-related, corporate, and securitized fixed rate bonds from both developed and emerging markets.

Bloomberg US Corporate High Yield Bond Index is composed of fixed-rate, publicly issued, non-investment grade debt, is unmanaged, with dividends reinvested, and is not available for purchase. The index includes both corporate and non-corporate sectors. The corporate sectors are Industrial, Utility, and Finance, which includes both US and non-US corporations. The index is presented here for comparison purposes only

Bloomberg US Aggregate Bond Index is a broad-based benchmark that measures the investment grade US dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS and CMBS.

S&P/LSTA Leveraged Loan Index measures the performance of 100 large loan facilities meeting specific inclusion criteria. The index is modified market value-weighted and is fully rebalanced semi-annually. In addition, the index is reviewed weekly to reflect pay-downs and ensure that it continually maintains 100 loan facilities.

The FTSE Gold Mines Index Series is designed to reflect the performance of the worldwide market in the shares of companies whose principal activity is the mining of gold. The FTSE Gold Mines Index encompasses all gold mining companies that have a sustainable, attributable gold production of at least 300,000 ounces a year and that derive 51% or more of their revenue from mined gold. The Index is unmanaged, is available with dividends reinvested and is not available for purchase.

Bloomberg Gold Index Formerly known as Dow Jones-UBS Gold Subindex (DJUBSGC), the index is a commodity group subindex of the Bloomberg CI composed of futures contracts on gold. It reflects the return of underlying commodity futures price movements only and is quoted in USD.

Bloomberg Crude Index is a subindex of the Bloomberg Commodity Index, is intended to reflect the performance of crude oil as measured by the price of futures contracts of West Texas Intermediate sweet, light crude oil. The performance of the crude oil futures market is normally very different than the performance of the physical crude oil market. The Bloomberg WTI Crude Oil subindex will reflect the performance of its underlying crude oil futures contracts, including the impact of rolling, without regard to income earned on cash positions.

Bloomberg Galaxy Bitcoin Index is designed to measure the performance of one bitcoin traded in USD. The index is owned and administered by Bloomberg Index Services Limited and is co-branded with Galaxy Digital. Bitcoin pricing is sourced from the Bloomberg Bitcoin Crypto Fixing Rate (CFIX). The CFIX was launched in May of 2018; prior data was provided retroactively by Bloomberg.

US Dollar Index indicates the general international value of the US dollar by average the exchange rates between the US dollar and major world currencies.

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