FIRST EAGLE
INVESTMENT MANAGEMENT®

1Q21 Market Overview: Mirror, Mirror

Sentiment during first quarter 2021 seemed to coalesce around the view that the economy and investment markets were well on their way back to normal following the massive but brief disruption from the Covid-19 pandemic. A relatively smooth vaccine rollout in the US buoyed hopes that a reversal of lockdowns and a normalization of social mobility was near, which combined with a third round of stimulus checks and other fiscal and monetary policy support could unleash a wave of pent-up demand among American consumers limited in their discretionary spending outlets for more than a year, fueling a spike in economic activity.

This unfettered optimism helped extend the reflation trade that emerged last September into the first few months of the new year. Recent equity market performance in many ways has been a mirror image of the dynamics that dominated in the immediate aftermath of the Covid-19 selloff in 2020. The initial stages of last year's market recovery were driven primarily by outsized gains in large, mostly US companies able to leverage the global shift to a virtual economy amid widespread lockdowns. In contrast, the subsequent reflation trade has been marked by a rotation in leadership from growth stocks to value stocks and from the US to include other developed and emerging markets. Similarly, investors in recent months demonstrated a preference for those market sectors that had been beaten down during the pandemic and are now expected to benefit from a renewal in economic activity, including energy, financials and materials.[1]

Key Takeaways

- The reflation trade that emerged in late 2020 persisted through the first quarter of 2021. A relatively steady vaccine rollout in the US combined with a steadfastly accommodative Federal Reserve and ongoing fiscal support had investors hopeful of strong economic growth in 2021, to the benefit of economically sensitive stocks.
- While we welcome the recent broadening of the market recovery, there are a variety of factors—the potential emergence of meaningful inflation not the least of them—to suggest potential frailty in the near- and longer-term performance of equity markets.
- In a forward market environment that could offer more modest returns, it may be prudent to assume actively generating alpha will be more important than merely capturing beta. At First Eagle, we specifically target sources of alpha that we believe have the potential unfold over longer time horizons.

Views expressed are as of April 7, 2021.

1. Source: FactSet; data as of April 9, 2021.

While there are signs to suggest we are in the sweet spot of cyclical recovery—which historically has been a reliable source of years-long positive drift in equities—a number of key near-term considerations for market performance give us pause.

Economic Growth Is Likely to Impress in 2021, but Concerns Persist

We are among the many observers who believe the US economy is headed for a high rate of growth in 2021; a faster-than-expected rebound from the Covid-related recession could enable the country to avoid the permanent loss of output that had been widely feared. And while there are signs to suggest we are in the sweet spot of cyclical recovery—which historically has been a reliable source of years-long positive drift in equities—a number of key near-term considerations for market performance give us pause. The rate of money creation is likely to trend lower as we cycle through the effects of the initial quantitative easing measures and authorities turn their attention to the bloated debt burdens that have resulted. Talk of higher corporate tax rates in the US may weigh on investor sentiment and ultimately profit margins if they are enacted, while the regulatory architecture across multiple jurisdictions appears poised to become less business friendly. Finally, if 2021 earnings establish new high-water marks as forecast by FactSet consensus, impressive year-over-year comparisons will be more difficult for companies to come by beginning in 2022.

Meanwhile, the uncertain trajectories of interest rates and inflation cast a pall on the intermediate-term outlook. The yield on the 10-year US Treasury increased sharply during the first quarter to reach 1.7%, though the backup merely brought it back to pre-Covid levels.[2] The Fed has anchored short-term rates at zero and is committed to keeping them there until full employment is achieved and above-target inflation emerges, consistent with its new flexible average inflation-targeting policy framework. Super-low policy rates, while intact, are likely to keep downward pressure on the 10-year Treasury, but the current slope of the yield curve suggests that the yield is likely to shift higher once we exit this easing cycle. Signs of this bias, which is not typically a positive for equity market valuations, can be seen in the 30-year Treasury trading at yields above its 2019 average. Meanwhile, market-based inflation expectations in the US have rebounded—the five-year, five-year forward inflation expectation rate ended the quarter at levels not seen since late-2018[3]—and pronounced price increases are evident across the commodity complex, from metals to agriculture to oil.

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The direction of long-term interest rates and inflation remain a source of spirited debate among economists and investors. Those skeptical of a meaningful shift higher in prices point to inflation expectations that are firmly anchored by the Fed, the deflationary impact of technology, the latent need for fiscal tightening in the face of a massive global debt overhang, and the downtrend in the velocity of money over the last decade as reasons to believe pricing pressures will remain in check. The other side of the argument cites the monetary supply shock from Covid-response policy, a decline in sources of cheap labor globally, the seeming lack of political will for fiscal restraint, and the massive fiscal budget deficit as evidence inflation may be biased higher. Given that 2021's fiscal deficit as a percentage of GDP is expected to be the second highest since World War II, exceeded only by 2020's shortfall,[4] the current negative output gap could quickly turn positive and lead to pricing pressures.

2. Source: FactSet; data as of April 9, 2021.
3. Source: Federal Reserve Bank of St. Louis; data as of April 9, 2021.
4. Source: Congressional Budget Office; data as of April 9, 2021.

With stock multiples high and bond yields low, however, we think it would be prudent to assume far more modest returns from equities in the future. We also think it would be prudent to assume that actively generating alpha in such an environment will be more important than merely capturing beta.

Looking to Generate Alpha, not Merely to Capture Beta

While we may appear to still be in the early stages of a recovery from Covid, massive monetary and fiscal stimulus over the past year may have brought gains forward, which would imply a tougher road ahead. That said, the dispersion of potential outcomes is significant, and we do not seek to bet the farm on any one state of the world playing out. With stock multiples high and bond yields low, however, we think it would be prudent to assume far more modest returns from equities in the future.

We also think it would be prudent to assume that actively generating alpha in such an environment will be more important than merely capturing beta. Many investment managers approach alpha as a byproduct of the near-term subversion of market expectations, as something they can harvest by overweighting particular sectors at the right time, for example, or by identifying individual stocks poised to deliver a positive earnings surprise in the coming quarter.

First Eagle, in contrast, seeks alpha that unfolds over longer time horizons. We look for businesses that we believe possess scarce tangible or intangible assets, as these advantaged positions may potentially be expanded or improved upon at a measured pace to create a positive drift in intrinsic value that compounds over the years. Further, we believe long-term benefits can be derived from businesses that maintain disciplined expense management, reinvest prudently in their advantaged assets, and either return excess cash flows to shareholders or use it to engage in valuation-sensitive mergers and acquisitions to promote growth. Finally, we invest in these companies only when we can do so at a discount to our estimate of intrinsic value, which we arrive at through meticulous research that seeks to distinguish the true economics of a company from its reported earnings.

Meanwhile, gold and gold-related securities continue to be an important source of ballast in many of our portfolios as well as a source of deferred purchasing power in the face of ongoing fiat currency debasement. Gold has a 50-plus-year track record of outperforming the dollar, as growth in the money supply has outpaced that of gold by many multiples since the decline of the Bretton Woods system in the early 1970s.[5] While the price of gold has declined steadily since peaking in early August—no surprise given the increase in real interest rates over this period—we believe it remains the best potential hedge for our portfolios against a range of adverse market and economic outcomes in an uncertain world.

5. Source: Bloomberg; data as of April 9, 2021.

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