Without a Net

The fiscal and monetary response to the Covid-19 pandemic was unprecedented. While this extraordinary accommodation buoyed businesses and individuals as economic activity ground to a near-complete halt in many areas, it also promoted market distortions and areas of speculative excess that call to mind previous market bubbles.

Historically low interest rates heightened the appeal of long-duration growth stocks and their promise of future cash flows. Relative market valuations—both growth versus value stocks and US versus international names—ballooned, and the resulting concentrations in global indexes suggest portfolios benchmarked to them may have heightened exposures to geography, sector and individual stock risk.

A more nuanced dynamic emerged in 2021, however. With inflation pressures once considered "transitory" proving far more persistent than many—including the US Federal Reserve—anticipated, interest rates grew more volatile as bond markets sought to read the tea leaves of policy response. Equity market leadership rotated between growth and value stocks—and to a lesser extent, between US and international stocks—in step with the direction of real interest rates.

Continued volatility would not be surprising, especially given Russia's recent invasion of Ukraine. Further, without the safety net of highly accommodative policy, the tailwinds that drove the outperformance of certain areas of the equity markets for most of the past 13 years may begin to recede—and perhaps become outright headwinds.

KEY TAKEAWAYS

- The massive fiscal and monetary response to the onset of Covid-19 in early 2020 laid the groundwork for a surge in growth stocks and drove relative valuations between growth and value indexes to record levels.
- Markets grew more nuanced going in 2021, with style leadership alternating between growth and value. Real interest rates appear to have been the primary driver of relative performance, with higher rates prompting a rotation into value-oriented stocks and sectors, and lower rates favoring growth.
- Increased hawkishness among central banks in response to persistently elevated inflation has pushed nominal interest rates back to pre-pandemic levels. The resulting higher discount rates and other potential headwinds suggest richly valued areas of the market may represent unfavorable risk-reward tradeoffs going forward.
- Though markets appear to have grown more complicated, particularly with Russia's recent invasion of Ukraine, First Eagle remains focused on the construction of all-weather portfolios that seek to create resilient wealth and mitigate the permanent impairment of capital in the face of complexity and uncertainty.

Views expressed are as of February 28, 2022.

Market Distortions Persist

While the emergence of the novel coronavirus in early 2020 quickly brought an end to the longest bull market in US history and triggered the deepest global recession since World War II, the massive fiscal and monetary policy response to it sparked a furious comeback in risk assets. The initial beneficiaries of this policy largesse were growth stocks—and a narrow cohort of very large tech-related US companies in particular.

A certain degree of value/growth bifurcation made sense. Many of the more mature, physical components of the economy—whose participants tend to populate value indexes—were subject to a near-total shutdown of activity while the "new economy" thrived. Meanwhile, very low Treasury rates translated into very low discount rates used to derive the present value of future cash flows, promoting the multiple expansion of businesses promising growth many years ahead. That said, the magnitude of growth's outperformance in 2020 almost defied belief given the strong long-term correlation between major growth and value indexes. The Russell 1000 Growth Index outpaced its value analog by nearly 3,600 basis points that year, for example, and similar trends could be seen in global indexes.[1]

These trends drove relative market valuations to historical extremes, as evidenced by the price ratios of US value and growth stocks and US versus non-US stocks (Exhibits 1 and 2, respectively). They also exacerbated distortions that emerged following the global financial crisis; for example, the concentration of US equities in the MSCI World Index grew to almost 70% by year-end 2021—from 48% at the end of 2009—despite the US accounting for less than 20% of global economic activity.[2] This combination of elevated valuations and high country, sector and stock concentrations suggests portfolios benchmarked to major indexes may be susceptible to increased risks.

Exhibit 1. Historically Low Discount Rates Pushed the Relative Valuation of Growth Stocks to New Highs

Price Ratio of Russell 1000 Growth Index to Russell 1000 Value Index, January 1978 through February 2022

Source: Bloomberg, First Eagle Investments; data as of February 28, 2022.

Exhibit 2. International Stocks Have Been Overlooked in Favor of US Equities

Price Ratio of MSCI EAFE Index to S&P 500 Index, January 1970 through February 2022

Source: Bloomberg, First Eagle Investments; data as of February 28, 2022.

1. Source: FactSet; data as of December 31, 2020.
2. Source: International Monetary Fund; data of as December 21, 2021.

Recent Equity Market Performance Has Tracked Real Interest Rates

Perhaps lost in the significant outperformance of growth in the immediate aftermath of Covid-19 relief has been the emergence of a more nuanced dynamic over the past year-plus. Throughout this period, market leadership has alternated with market leadership alternating between growth and value stocks (and, to a lesser extent, between domestic and international stocks). Notably, these rotations in leadership have been coincident with the direction of real interest rates.

> Market leadership has alternated between growth and value.

After climbing to levels not seen since 2011, real rates (as represented by the yield on 10-year Treasury Inflation Protected Securities, or TIPS) in late 2018 began to pull back and have been deeply negative for most of the past two years. As shown in Exhibit 3, the relative performance of value and growth stocks has closely followed movements in real yields, during both their steady descent as well as the volatility experienced more recently. As rates crept higher, markets rotated into value-oriented stocks and sectors; when rates pulled back, assets flowed back to growth.

We note five distinct phases to the performance of equity markets since the beginning of 2021, as indicated in Exhibit 3.

1. **January through mid-May.** Late-2020 indications that a Covid-19 vaccine was near helped fuel a reflation rally that continued well into 2021, with outperformance by cyclical stocks and sectors hardest hit by pandemic-related shutdowns. *Real yields rose; value outperformed.*

2. **Mid-May through August.** The emergence of the Covid-19 Delta variant called into question upbeat economic assumptions. *Real yields declined; growth outperformed.*

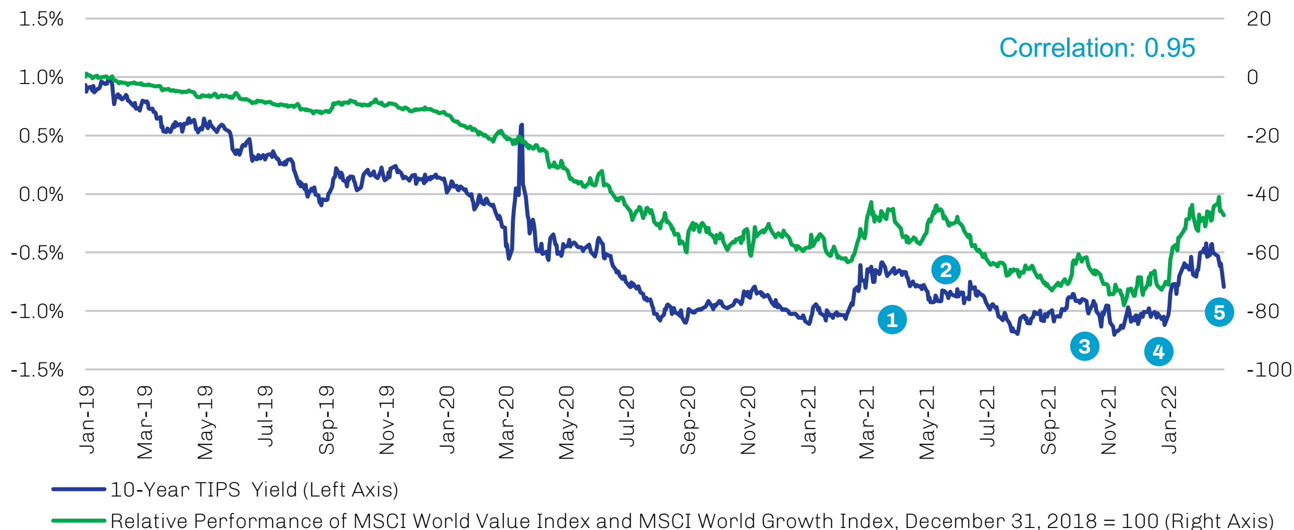
3. **September through mid-October.** Persistently high inflation prints prompted the Federal Reserve to walk back its insistence that price pressures were "transitory." *Real yields rose; value outperformed.*

4. **Mid-October through December.** New Omicron variant began to spread rapidly, raising concerns of economic disruption and calling into question central banks' ability to reduce accommodation. *Real yields declined; growth outperformed.*

5. **December through February.** With Omicron proving to be less virulent than previous strains and inflation readings continuing to climb, the Fed signaled plans to pull back accommodation aggressively in 2022. *Real yields rose; value outperformed.*

Also worth noting is that index returns in general have grown more muted and volatility has risen since September 2021 as markets try to process a range of uncertainties. These include not only persistent inflation and the removal of policy support, but also low risk premia across a variety of assets, concerns about the Chinese economy and the seemingly never-ending battle against Covid-19. Meanwhile, Russia's invasion of Ukraine and the impact of the resulting economic sanctions has sent risk assets on a wild ride and driven the CBOE Volatility Index higher.[3]

Exhibit 3. Equity Markets Are Actively Pricing in Movements in Real Interest Rates



Source: Bloomberg; data as of February 28, 2022.

3. Source: FactSet; data as of February 28, 2022.

Waning Stimulus May Intensify Risks and Present Opportunities

While Russia's invasion of Ukraine in late February introduced a new and highly unpredictable wrinkle, we remain highly attentive to how markets and consumers react to waning fiscal and monetary stimulus in 2022. The massive fiscal spending that buoyed economies worldwide through the worst of the pandemic's disruptions is slowly fading from view. Meanwhile, a string of elevated inflation prints—well above target in most G20 nations and at a 40-year high of 7.5% in the US[4]—appears to have forced the hands of monetary policymakers. The Fed, for example, aims to wind down its asset purchase program by March 2022, with federal funds rate hikes likely to start sometime after that, perhaps accompanied by the start of a balance sheet runoff. Of course, Russia's aggression—and how that conflict plays out—complicates the decision-making process for the Fed and other central banks.

Fiscal tightening likely will pressure corporate profit margins and earnings, while less accommodative monetary conditions may push interest rates and credit spreads—whose very low levels helped suppress the cost of capital and promoted multiple expansion in equity markets—to more normal levels. Since the late 1960s, the price of the S&P 500 Index relative to CPI-adjusted trailing peak earnings has been as high as it is today only one other time—during the late-1990s dot-com bubble.[5] High current multiples imply that equity market returns going forward are likely to fall short of the approximately 8% they have averaged over the past century.

Looking ahead, we see a range of possible outcomes, their likelihoods dictated largely by the aggressiveness of Fed policy, the impact of continued fiscal tightening on household spending and various "animal spirits,"[6] and the reaction of asset prices to slower money supply growth. Though we wouldn't hazard a guess as to which scenario may transpire, some combination of higher interest rates and/or risk premia—and, thus, a higher discount rate—would not come as a shock.

As has been evident periodically over the past 14 months, higher rates can weigh on the market's valuation of the longer-duration cash flow streams typical of growth stocks. Looking deeper into market history, as shown in Exhibit 4, shows that periods of rising interest rates have been favorable for value stocks compared to growth, particularly over longer time periods. Further, it appears likely to us that many of the forces that have relative market performance in recent years may lose their influence—if not become outright headwinds to the assets they once favored—as we move forward. If the cost of capital moves up, multiples could go down. If profit margins tighten, earnings comparisons may suffer. And if money supply growth moderates, the effects of nominal rebasing may fade away, potentially causing liquidity challenges in markets.

> The forces that have been driving relative performance in recent years may turn into headwinds as we move forward.

Exhibit 4. Rising Treasury Rates Historically Have Favored Value Over Growth

Based on Changes in 10-Year US Treasury Rate, 1979 through 2021

		Cumulative Forward Excess Return of MSCI World Value versus MSCI World Growth		
Duration of Rate Increases	**Average Rate Increase over Time Period**	**One Year**	**Three Years**	**Five Years**
Three Months	0.42%	0.2%	-1.1%	5.1%
Six Months	0.59%	0.1%	-0.7%	4.7%
One Year	0.86%	1.6%	3.0%	7.5%

Source: Bloomberg, FactSet; data as of December 31, 2021.

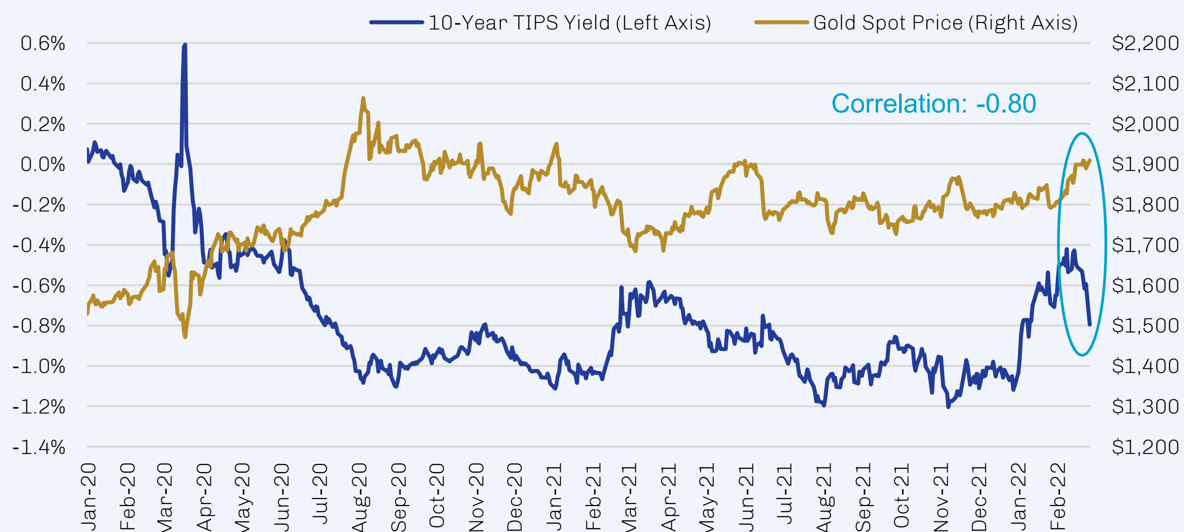
4. Source: Bureau of Labor Statistics; data as of February 10, 2022.
5. Source: Standard & Poor's; Robert J. Shiller, Yale University; First Eagle Investments; data as of December 31, 2021.
6. "Animal spirits" is a term popularized by John Maynard Keynes to describe the interaction of emotional factors like confidence, optimism and trust that sometimes override quantifiable fundamentals to shape the behaviors of investors and businesses.

Gold as a Potential Counterweight to Turbulence

The price of gold has historically traded inversely with real interest rates, and we believe that real interest rates are the most important driver of the gold price over the medium and long term. Real interest rates represent the opportunity cost of owning gold; since it pays neither dividends nor interest, gold is relatively expensive to hold when real interest rates are high and relatively inexpensive when real rates are low. While the past couple years mostly have borne out this relationship, gold has been resilient in the face of the most recent upswing in real yields, as shown in Exhibit 5. This suggests to us that anticipation of tighter monetary policy may already have been reflected in the price of gold as the metal began to derate in mid-2020.

Exhibit 5. Gold Has Been Resilient to the Most Recent Spike in Real Yields

10-Year TIPS Yield and Gold Spot Price, January 2020 through February 2022



Source: Bloomberg; data as of February 28, 2022. **Past performance is no guarantee of future results.**

Despite what feels like a robust economic recovery, we face a constellation of risks. Our crystal ball is murky at best, but we can say that the next 12 to 18 months will represent an acute test of the Fed and its credibility, with potential impacts on economies, risk assets, sovereign rates and currencies. While it's fair to say that the gold price hasn't moved higher to absorb those risks, 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.

Seeking Resiliency with an All-Weather Approach

We cannot help but notice that prudence—a key characteristic across First Eagle's product lineup—has not been rewarded of late. Our commitment to diversification, ballast like cash and gold in certain portfolios, and defensive equity positioning generally served as a headwind to relative performance in a period that incentivized riskier behavior.

A key element of our effort to create resilient wealth for our clients over the long term is the countercyclical deployment of capital. Backed by a benchmark-agnostic investment process, the Global Value team typically will exit or trim positions in "in-favor" businesses as they near our estimate of their "intrinsic value." Similarly, when their market price offers an adequate "margin of safety" (or discount to our estimate of intrinsic value), we will initiate or add to "out-of-favor" businesses we view to be of high quality but currently facing valuation pressures. This stands in direct contrast to market-cap weighted indexes—and the portfolios benchmarked to them—that build higher concentrations to stocks, sectors, styles and regions as their valuations expand, leaving them more susceptible to idiosyncratic risks.

> Companies with scarce assets are not immune from the rising cost of capital or inflation, but their ability to generate free cash flow may provide a cushion in challenging environments.

Our search for differentiated sources of risk and return has been well illustrated in recent years. For example, we were highly active during the pandemic-driven selloff in equities in early 2020 and during subsequent bouts of market volatility since. The dislocations allowed us to initiate positions in an eclectic mix of businesses; while some of these continue to face pandemic-related headwinds, we believe we are well positioned to benefit from the normalization of these companies' stock prices over time.

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. Companies with scarce assets are not immune from the impact of inflation pressures or the rising cost of capital, but their persistent free cash flow generation may provide a cushion against challenging environments while also creating opportunities to potentially enhance their competitive position against less-resilient businesses.

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

"Intrinsic value'' is based on our judgment of what a prudent and rational business buyer would pay in cash for all of the company in normal markets.

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.

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

CBOE Volatility Index is a measure of the 30-day expected volatility of the US stock market. It is based on the prices of options on the S&P 500 Index and is calculated by aggregated weighted prices of the index's call and put options over a wide range of strike prices.

MSCI EAFE Index is an unmanaged total return index, reported in US dollars, based on share prices and reinvested net dividends of approximately1,100 companies from 22 countries and is not available for purchase.

MSCI World Growth Index captures large- and mid-cap securities exhibiting overall growth style characteristics across 23 developed markets. 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.

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 US dollars with net dividends reinvested.

MSCI World Value Index captures large- and mid-cap securities exhibiting overall value style characteristics across 23 developed markets. 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.

Russell 1000 Growth Index measures the performance of the large-cap growth segment of the US equity universe. It includes those Russell 1000 companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium-term (two-year) growth and higher sales per share historical growth (five years). 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 the large-cap value segment of the US equity universe. It includes those Russell 1000 companies with relatively lower price-to-book ratios, lower I/B/E/S forecast medium-term (two-year) growth and lower sales per share historical growth (five years). The Russell 1000 Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment.

S&P 500 Index is a widely recognized unmanaged index including a representative sample of 500 leading companies in leading sectors of the US economy. Although the S&P 500 Index focuses on the large-cap segment of the market, with approximately 80% coverage of US equities, it is also considered a proxy for the total market.

The use of hedging techniques is speculative and there can be no assurances any hedging technique will be effective. Investment in gold and gold-related investments presents certain risks, including political and economic risks affecting the price of gold and other precious metals, like changes in US or foreign tax, currency, or mining laws; increased environmental costs; international monetary and political policies; economic conditions within an individual country; trade imbalances; and trade or currency restrictions between countries. The price of gold, in turn, is likely to affect the market prices of securities of companies mining or processing gold, and accordingly, the value of investments in such securities may also be affected. Gold-related investments as a group have not performed as well as the stock market in general during periods when the US dollar is strong, inflation is low, and general economic conditions are stable. In addition, returns on gold-related investments have traditionally been more volatile than investments in broader equity or debt markets.

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