



## 2Q21 Market Overview: Summer Wind

With the Covid-19 pandemic in retreat in some—but certainly not all—parts of the world, financial markets were swept by a warm breeze of optimism as spring turned to summer, with many broad-based indexes improving upon their early-year gains during the second quarter. Notably, the reflation trade that had prevailed since September appeared to lose steam; many of the themes that dominated the markets' initial pandemic rebound returned to the fore over the past few months, as investors returned their focus to growth stocks from value stocks and to large caps from smaller names, with a bias toward US-listed companies.<sup>1</sup>

As we know, the summer wind can be a fickle friend; buoyant feelings can come undone quickly, and there are no lack of potential catalysts for such a shift in attitude as the second-order consequences of the battle against Covid and its economic impacts continue to unfold. Given the many potentially destabilizing uncertainties that persist, we think it's likely that at some point investors, businesses and policymakers may be making their decisions in a more complex macroeconomic environment.

### Key Takeaways

- The rebound in business confidence during the second quarter was striking, though much of the anticipated improvement in economic activity may already be priced into markets.
- Recent inflation data is ratcheting up the pressure on the Federal Reserve and providing the first real test to its recently adopted inflation-targeting policy framework.
- Asian markets—China and Japan, in particular—failed to participate in the second quarter updraft, highlighting the value of geographic diversification.
- Given the uncertainties ahead, we believe the all-weather approach of First Eagle's Global Value team—which focuses on resilient businesses across sectors and geographies available at what they believe to be attractive valuations—is well positioned for whatever may come next.

*Views expressed are as of July 7, 2021.*

1. Source: FactSet; data as of July 1, 2021.

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Business confidence historically has often signaled future GDP growth, but full market valuations suggest this economic advance may already be priced in.

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If authorities tighten fiscal and monetary policy prematurely, they risk stifling the recovery; if they keep fiscal and monetary policy too easy for too long, they may increase the potential for inflation in a low-growth world (aka, stagflation).

## Ultra-Easy Policy Has Buoyed Risk Assets

Equity markets in general built upon their strong start to 2021 during the second quarter. The MSCI World Index rose 7.7% in the second quarter after its 4.9% gain in the first, for example, while the S&P 500 Index added 8.5% to its first quarter advance of 6.2%. The success of risk assets year to date can be traced in part to a striking rebound in business confidence.<sup>2</sup> Despite the propagation of Covid variants, large regional imbalances in vaccine rates and still-significant slack in global employment, a number of purchasing managers indexes worldwide reached new multiyear peaks during the second quarter, suggesting high spirits in corporate boardrooms after a deeply depressing 2020.<sup>3</sup> Historically, business confidence has often signaled future GDP growth.

While we cannot be certain of the duration of these high levels of confidence and stock prices, we suspect they may be shorter-lived than the market appears to anticipate; in our view, the economic recovery may already be fully priced in. The MSCI World Index trades at approximately 20 times forward earnings estimates, and those estimates represent a roughly 20% increase from the prior peak levels of earnings in 2018 and 2019, which strikes us as extreme.<sup>4</sup> We would say the same for the increase in commodity prices, many of which exceeded their prior cycle peaks during the quarter.

Unsurprisingly given the stimulus-fueled pace of the economic recovery, we've seen the emergence of some supply-chain bottlenecks. Anecdotally we are also hearing from our portfolio companies about difficulties in hiring and about rising prices for raw materials. Energy has perhaps been the one commodity where the price increase surprised people on the upside. Meanwhile, we have heard very little bottom-up concern about fiscal unsustainability—likely because corporate margins have benefited from ultra-easy fiscal policy. As the recovery progresses and the stimulus eventually moderates, we will probably see a more complex picture emerge and, more likely than not, some moderation in business sentiment.

Government authorities face a sort of Catch-22. If they tighten prematurely, they may stifle the recovery before full employment is reached. On the other hand, if they keep fiscal and monetary policy too easy for too long to avoid derailing the asset recovery, they could increase the potential for inflation in a low-growth world (aka, stagflation). As we learned from the 1970s, stagflation can have very negative effects on both stocks and bonds. Without a fiscal consolidation or increase in labor productivity, continuation of the current very easy policy may lead to a series of much tougher future choices and outcomes.

However, it's plausible that fixed income markets are anticipating future fiscal tightening and its impact on productivity. The 10-year US Treasury drifted steadily lower since its March high point above 1.70% and ended the second quarter at around 1.45%, while both commodity prices and business confidence have shown signs of softening as we move through the early summer.<sup>5</sup> Shorter-term yields, meanwhile, broke higher in response to the unexpectedly hawkish dot plot that emerged from the Federal Reserve's June policy meeting. Hemmed in below 0.20% for most of the past year-plus, the yield on the two-year US Treasury approached 0.30% as the quarter drew to a close, flattening the yield curve.<sup>6</sup> This move was accompanied a stronger dollar, moderation of long-dated inflation expectations and a dip in the gold price.

2. Source: FactSet; data as of July 1, 2021.

3. Source: Institute for Supply Management, International Federation of Purchasing and Supply Management, IHS Markit; data as of July 9, 2021.

4. Source: MSCI, FactSet; data as of July 1, 2021.

5,6. Source: Federal Reserve Bank of St. Louis; data as of July 9, 2021.

Despite the massaging of market expectations, the Fed remains data dependent in its decision-making and likely will maintain a wait-and-see approach before taking steps to unwind its extraordinary stimulus. It's important to note that the central bank recently adopted an inflation-targeting policy framework. Rather than tightening monetary conditions in anticipation of inflation pressures and the approach of full employment, as it had in the past, the Fed will tolerate—if not actively seek—above-target inflation for some period to achieve its target rate as an average over time. However, there is some concern that the longer rates stay low in the face of mounting inflation and strong economic growth, the more we risk a violent upward adjustment at some future point.

### A More Balanced View of the World

Another point of note in the first half of 2021 was the weaker tone of Asian equity markets. Both China and Japan lagged in the second quarter and stand well below early 2021 peaks despite the broad strength in global equity markets.<sup>7</sup> In Japan, the weakness may be due to delays in its vaccine rollout in the face of building concerns over the delta variant. China has started to become less accommodative as Covid recedes further in the rearview mirror, while its regulatory structure has grown more complex. Given that China was the first to experience Covid, the first to bring it under control and now the first to pull back on stimulus, the Chinese equity market's experience this year ought to serve as a warning against complacency.

To us, these regional disparities highlight the value of diversification. To an exceptional degree, global stock gains in recent years have been driven by the performance of US companies, which has skewed the composition of global indexes; at the end of the second quarter, for example, US stocks comprised nearly 70% of the MSCI World Index. Meanwhile, the MSCI EAFE Index, which does not include US equities, still trades below its 2007 peak even as the S&P 500 has nearly tripled.<sup>8</sup> It is obvious that very large technology-related US companies (like the FAANG stocks<sup>9</sup>) have dominated key areas of the new economy, but it is equally obvious to us that good companies have regularly appeared in domiciles around the world. Stock weightings in the MSCI indexes are based on current market capitalizations, but allocations in our global portfolios are based on a longer-term—and, in our opinion, more balanced—view of the prospects for individual stocks.

Regional performance has varied over time, and it seems reasonable to expect a reversion to longer-term norms at some point, especially if the economic strength of the United States forces authorities to pull back on stimulus ahead of other developed markets. But geography is just one dimension of diversification. The all-weather approach of First Eagle's Global Value team—marked not only by broad geographic diversification but also diversification across and within sectors—acknowledges the uncertainties ahead as the consequences of the Covid-19 response continue to play out.

For example, financials, one of the largest sectors across many of our broadly diversified portfolios, is quite diversified in its own right, featuring an array of smaller industry subsets like holding companies, regional banks, niche insurers and asset-light financial services businesses. In contrast, while we have tended to have less exposure to the information technology sector than the index, we have built a solid position in the space—including a strong presence in cloud software and semiconductor manufacturing—without paying for hypergrowth technology concept stocks. And by focusing on resilient businesses available at what we believe to be attractive valuations, we feel our portfolios are well positioned for whatever may come next.

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The Global Value team's all-weather approach—marked not only by broad geographic diversification but also diversification across and within sectors—acknowledges the uncertainties ahead as the consequences of the Covid-19 response continue to play out.

7. Source: FactSet; data as of July 1, 2021.

8. Source: MSCI, Standard & Poor's; data as of July 1, 2021.

9. The acronym FAANG is used to represent a cohort of highly traded growth stocks of technology and tech-enabled companies, such as Facebook, Apple, Amazon, Netflix and Alphabet (Google).

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