First Eagle Investments

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Insights

1Q22 Market Overview: The Fog of War

Facing threats from multiple directions—geopolitical strife, persistent inflation and shifting central bank policy among them—financial markets staggered out of the gates in 2022.

US stocks continued to demonstrate relative strength during what was a challenging quarter across geographies, losing 4.6% compared to the 5.2% decline in the MSCI World Index. Emerging markets were worse still, shedding 7.0%, and bond markets continued to struggle with rising interest rates. Value stocks outperformed growth names by a large margin across geographies, due in part to strength in the energy sector.[1]

The world is at war right now, and the reverberations of this conflict necessitate a reassessment of potential investment outcomes. Today's complex geopolitical tapestry has introduced the type of byzantine uncertainty that we believe reflects the "true" risk of investing. The periodic emergence of such uncertainty is among the reason First Eagle's Global Value team prioritizes diversification across economic sectors and geographies and holds portfolio ballast in assets like gold.

1. Source: FactSet; data as of March 31, 2022.

KEY TAKEAWAYS

- The supply-chain disruptions resulting from the war and the sanctions placed on Russia are far-reaching and have had rapid inflationary consequences in a world already struggling to contain price pressures. The longer the conflict persists, the greater the range of potential outcomes.
- While China contemplates stimulus in the face of a slowing economy, Western policymakers are heading in the opposite direction. The Fed's 25 basis point hike in March appears likely to be the first of many in 2022.
- Inflation and the threat of slowing growth represent a risk to corporate earnings, and businesses that experienced rapid growth during the pandemic may be particularly vulnerable.
- In an uncertain world, First Eagle's Global Value team believes it's important to view investments simultaneously for opportunity and for ballast.

Views expressed are as of April 11, 2022.

Outbreak of War Exacerbates Inflationary Pressures

Late February saw the outbreak of armed conflict in Ukraine, as Russia invaded its neighbor to the west. In response, unprecedented sanctions were imposed on Russia by countries representing more than half of the global economy, which—while likely to have a substantial negative impact on the Russian economy—have not been without blowback. The supply-chain disruptions resulting from the sanctions and the war itself are far-reaching and have had rapid inflationary consequences in a world already struggling to contain price pressures. Surging prices—particularly in commodities—threaten to dampen consumer spending and business confidence and ultimately weigh on economic growth, increasing the potential for stagflationary conditions to emerge.

With Ukraine refusing to fold to its aggressor, the war wages on, extending the uncertainty surrounding the situation and expanding the range of potential outcomes. For example, while a Russian victory in Ukraine could cement Putin's ambitions and encourage other leaders of similar inclinations, a Russian defeat could be preceded by untold escalation and followed by the emergence of a totally new regime of indeterminate political leanings. There's also a scenario in which diplomacy prevails and sanctions are eased, an outcome that would blunt some of the more severe global macroeconomic and financial market consequences. However, evidence of the horrific violence visited upon Ukrainian noncombatants suggests that Russian sanctions may persist even beyond the end of armed hostilities, independent of outcome. Further, the conflict appears to have crystallized existing alliances and drawn a sharp line between the world's autocracies and its democracies—a structural challenge that will likely have serious long-term ramifications for global supply chains.

Meanwhile, a Covid-19 outbreak in China is having a more short-term impact on supply chains and represents an additional headwind to a Chinese economy that already had begun to scuffle. Beijing recently reintroduced lockdowns affecting tens of millions of people in and around Shanghai, a major industrial and financial hub and the world's busiest container port.[2] Economists have lowered expectations for the country's GDP growth, and the government's target of "around 5.5%" appears to be in jeopardy even as it signals that fiscal and monetary stimulus is forthcoming.[3]

> The longer the conflict in Ukraine persists, the greater the range of potential outcomes.

Policymakers in the West are heading in the opposite direction, as inflation remains uncomfortably high. Consumer prices in the US accelerated to rates not seen in four decades, which—combined with strong domestic growth and low unemployment—prompted the US Federal Reserve to introduce its first policy rate hike in more than three years. Following its March meeting, the Fed raised the federal funds rate target by 25 basis points and signaled that six more hikes of that magnitude were likely over the balance of the year, which would bring fed funds rate to near 2%. The minutes from the latest Fed meeting suggest that even more aggressive action is possible, and futures markets are pricing in an additional 225 basis points of tightening this year. The Fed also is finalizing a plan to pare back its $9 trillion balance sheet through a monthly run-off of maturing securities of up to $95 billion.[4]

Searching for Resilience in an Uncertain Environment

In our view, war is among the conditions that moves us out of the comfort zone of quantifiable risk and into the domain of uncertainty. In his fifth century BC book *The History of the Peloponnesian War*, Thucydides noted that "For war of all things proceeds least upon definite rules." It is wisdom such as this that reinforces our belief in the fundamental role of humility in investing and drives us to build resilient portfolios.

In an uncertain world, we believe it's important to view investments simultaneously for opportunity and for ballast. The confluence of geopolitical aggravation and potentially stagflationary forces suggest the environment may not be particularly nurturing of risk assets, but we feel good about our portfolio from the bottom up, and we have diversified exposure to what we see as constructive tailwinds across a range of industries and geographies.

2. Source: *The Wall Street Journal*; as of April 7, 2022.
3. Source: Bloomberg; as of March 26, 2022.
4. Source: *The Wall Street Journal*; as of April 6, 2022.

That said, inflation and the potential threat of slowing growth represent a risk to corporate earnings in general. The US exited the worst of the Covid restrictions with pretty sound economic momentum, and, as such, consensus expectations call for earnings growth just shy of 10% in 2022.[5] Businesses in certain sub-sectors of the market that experienced rapid growth during the pandemic may be particularly vulnerable, as many of these companies had especially elevated sales-growth assumptions built into their consensus earnings forecast. Now, however, they face a wall of headwinds related to policy, labor and commodity supply, and have seen pretty substantial derating as a result—and the potential for more should a more structural deceleration in growth rates emerge.

> Inflation and the potential threat of slowing growth represent a risk to corporate earnings in general.

Further, it's possible that Ukraine/Russia conflict may represent a tipping point for the US dollar as the global reserve currency, especially if a favorable resolution remains elusive. The freeze on Russia's ample foreign currency reserves must have other central banks questioning the value of holding their reserves in financial assets to which access can be blocked when needed most—and perhaps have them considering greater diversification of their reserve assets, including more substantial allocations to real assets like gold.

We hold gold in many of our portfolios for two primary reasons: to mitigate the short-term impacts of extreme events, such as war, and to serve as a long-term potential hedge against monetary debasement, inflation and other currency issues. Thus far in the current crisis, gold's reputation has been validated on both fronts.

5. Source: FactSet; data as of April 11, 2022.

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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.

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