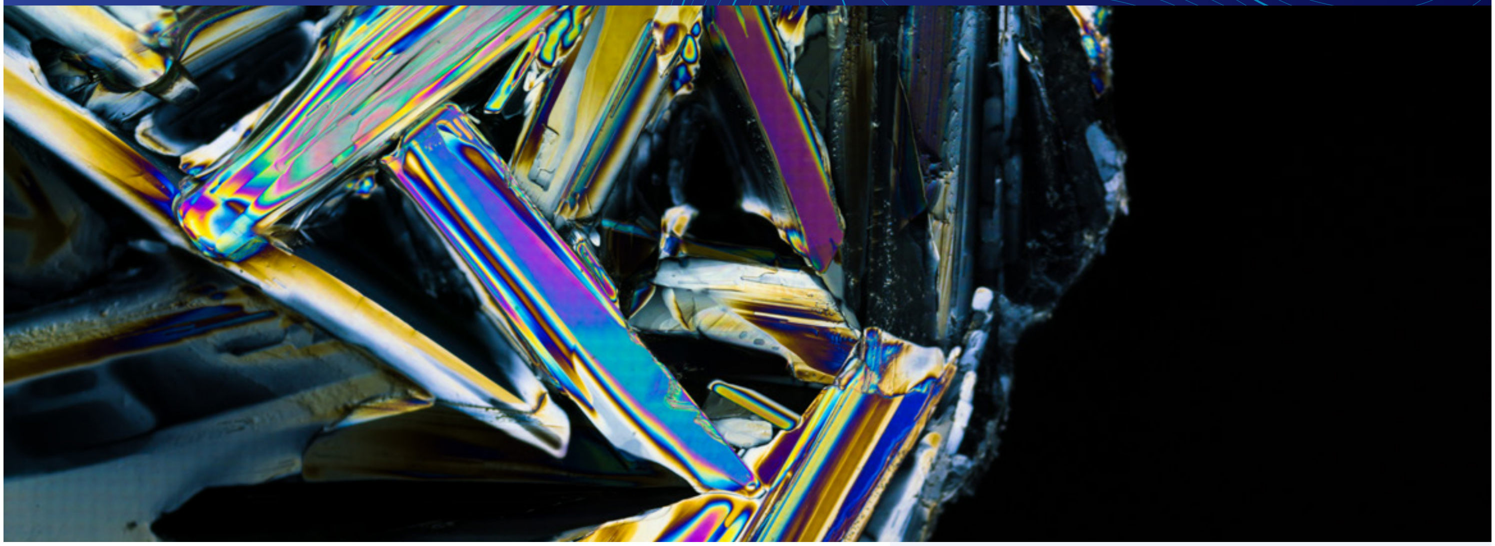

1Q23 Market Overview: My Ever-Changing Moods

Fluctuating readings on the potential trajectory of central bank policy and acute signs of strain in the banking sector whipsawed investor sentiment throughout the first quarter.

Despite the volatility and persistent uncertainty that gripped markets, investment assets in general continued to rebound from what was a very challenging 2022. The shifting dynamics during the quarter also prompted a change in style leadership. After outperforming by more than 2,100 basis points in 2022, the Russell 1000 Value Index lagged the Russell 1000 Growth Index by 1,340 basis points in the first quarter, as interest in these stocks appeared to reignite with the leveling off of interest rates and an uptick in liquidity. A rebound in beleaguered technology stocks helped fuel the style reversal, as the NYSE FANG+ Index returned nearly 40% over the first three months of the year. A similar trend could be seen in equity markets outside the US, which lagged domestic markets on the whole.[1]

KEY TAKEAWAYS

- Market sentiment has fluctuated wildly in recent months as participants try to discern the path of central bank policy.
- We believe the midsized bank failures in the US underscored the pronounced vulnerabilities inherent in today's financial system and the potential for unintended consequences as policymakers attempt to unwind years of highly accommodative policy.
- With government issuance the locus of global indebtedness, it's possible that the recent banking crisis in the US is merely the opening act of a sovereign credibility crisis.
- All in all, the Global Value team is comfortable maintaining a "healthy paranoia" in this environment, focusing as always on avoiding the permanent impairment of client capital by seeking resilience in our portfolios from the bottom up.

1. Source: FactSet; data as of March 31, 2023.

Bank Failures Rooted in Covid-Era Stimulus

Oscillating market sentiment thus far in 2023 seems to suggest participants are struggling to develop a consensus view on the direction of interest rates and economic growth as the Federal Reserve and other major central banks continue to wring liquidity from the system. January's risk rally, fueled by hopes that the US rate-hike cycle was nearing its end, faded in February as a hawkish string of data releases depicted resilience in the economy, labor market and prices. While markets seemed to coalesce around the "higher for longer" narrative by early March, subsequent tumult in the banking sector raised new uncertainties about the Fed's path forward and renewed old concerns about systemic fragility.

After a long period of relative calm in the US banking system, mid-March saw the midsized Silicon Valley Bank (SVB) and Signature Bank fail within days of one another. SVB was brought down primarily by its investment portfolio of long-duration fixed income securities, a portion of which it was forced to sell at large losses in the face of falling deposit levels. SVB's troubles produced runs at other banks deemed vulnerable in the uncertain environment, causing widespread weakness in bank equity prices and ultimately bringing down crypto-focused Signature Bank and prompting a cohort of the country's largest banks to assemble a rescue package for First Republic Bank.[2] Not long after, Swiss authorities engineered a swift deal for UBS to acquire Credit Suisse—one of 30 systemically important banks globally—as it teetered on the edge of insolvency.[3]

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While the issues in the banking sector have yet to demonstrate the kind of interconnectivity that spawned the global financial crisis in the late 2000s, we think it would be premature to signal all-clear. The US bank failures were idiosyncratic in nature but appeared to grow from a common systemic root: the massive stimulus rolled out in response to the disruptions from Covid-19. M2 money supply in the US, for example, grew by about 40% from March 2020 to its peak in April 2022.[4] The resulting excess demand in the economy and very tight labor markets presaged a step function in inflation levels, necessitating Fed action—albeit with a pause enabled by the average inflation-targeting policy framework adopted by the central bank in 2020. The flexibility of this new framework allowed the Fed to let inflation run hot for a period of time—it's hard to imagine 12 months of unaddressed "transitory" inflation in the old regime—but as a result also required very aggressive tightening once underway.

In addition to promoting inflationary pressures, the expansion in the US money supply also produced a commensurate expansion of deposits in the banking sector. While some of these assets were held on reserve at the central bank, interest rates near zero incentivized banks to put this money to work in more potentially profitable ways. Many sought to scratch out marginal yield from their investment portfolios by increasing exposure to long-dated paper including sovereigns, which generally are assigned favorable risk weights when calculating capital requirements. Despite the limited credit risk posed by these bonds, their long durations left holders quite vulnerable to the sharply rising rates that transpired in 2022.

2. Source: Reuters; data as of March 16, 2023.
3. Source: Reuters; data as of March 20, 2023.
4. Source: Federal Reserve; data as of March 31, 2023.

Sovereign Credibility May Be Next Hot Spot

It's been our observation that crises historically have found fertile ground in areas of the economy where excesses of debt have built up: take, for example, the US corporate sector and the impropriety-driven collapses of Enron, WorldCom and Tyco in the early 2000s, or the household and mortgage debt in the mid-2000s that culminated in the global financial crisis.

Today, the locus of indebtedness is sovereigns, and it's possible that the recent banking crisis in the US—seemingly contained at this stage—is merely the opening act of a sovereign credibility crisis. On top of a massive stock of public debt, the waning demand for long-duration sovereign paper and a lack of fiscal discipline among policymakers suggest a possibility that investors may soon demand increased risk premia for bonds issued by national governments. We may have seen a sneak preview of how these dynamics can play out last fall in the UK, when the government released a highly stimulative—and since-scuttled—budget proposal at odds with the Bank of England's inflation-fighting focus, quickly sending the pound to a record low against the dollar and 10-year gilt yields to levels not seen since 2010.[5]

We've long cautioned that conditions seemed ripe for the emergence of some sort of financial accident. While government intervention quickly soothed jittery markets, the bank failures during the first quarter underscored the pronounced vulnerabilities inherent in today's financial system and the potential for unintended consequences as policymakers attempt to unwind years of highly accommodative policy. It seems likely that the Fed's need to balance price stability with financial stability may further complicate its policymaking going forward and lead to further market volatility.

> It's possible that the recent banking crisis in the US—seemingly contained at this stage—is merely the opening act of a sovereign credibility crisis.

All in all, the Global Value team is comfortable maintaining a "healthy paranoia" in this environment, focusing as always on avoiding the permanent impairment of client capital. We continue to seek resilience in our portfolios from the bottom up, searching for cash-flow-generative companies with strong market positions, healthy balance sheets and prudent management teams, and buying these stocks only when available at a "margin of safety."[6] As a result of this investment discipline, portfolios managed by the Global Value team had no direct exposure to Silicon Valley Bank or Signature Bank, and our exposure within the broader financial sector is biased toward large money center and super-regional banks and financial services companies, alongside niche insurers, insurance brokers, payments networks, and clearing and custody platforms. In addition, many of our portfolios hold gold-related securities as a potential hedge against a range of adverse market developments, including elevated sovereign risk.

5. Source: Barron's; data as of September 26, 2022.
6. First Eagle defines "margin of safety" as the difference between a company's market price and our estimate of its intrinsic value. "Intrinsic value" is based on our judgment of what a prudent and rational business buyer would pay in cash for all of a company in normal markets.

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There are risks associated with investing in foreign investments (including depositary receipts). Foreign investments, which can be denominated in foreign currencies, are susceptible to less politically, economically and socially stable environments, fluctuations in the value of foreign currency and exchange rates, and adverse changes to government regulations.

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

NYSE FANG+ Index measures the performance of 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 2000® Growth Index measures the performance of the small cap growth segment of the US equity universe. It includes those Russell 2000 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).

Russell 1000® Value Index measures the performance of large-cap value segment of the US 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.

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