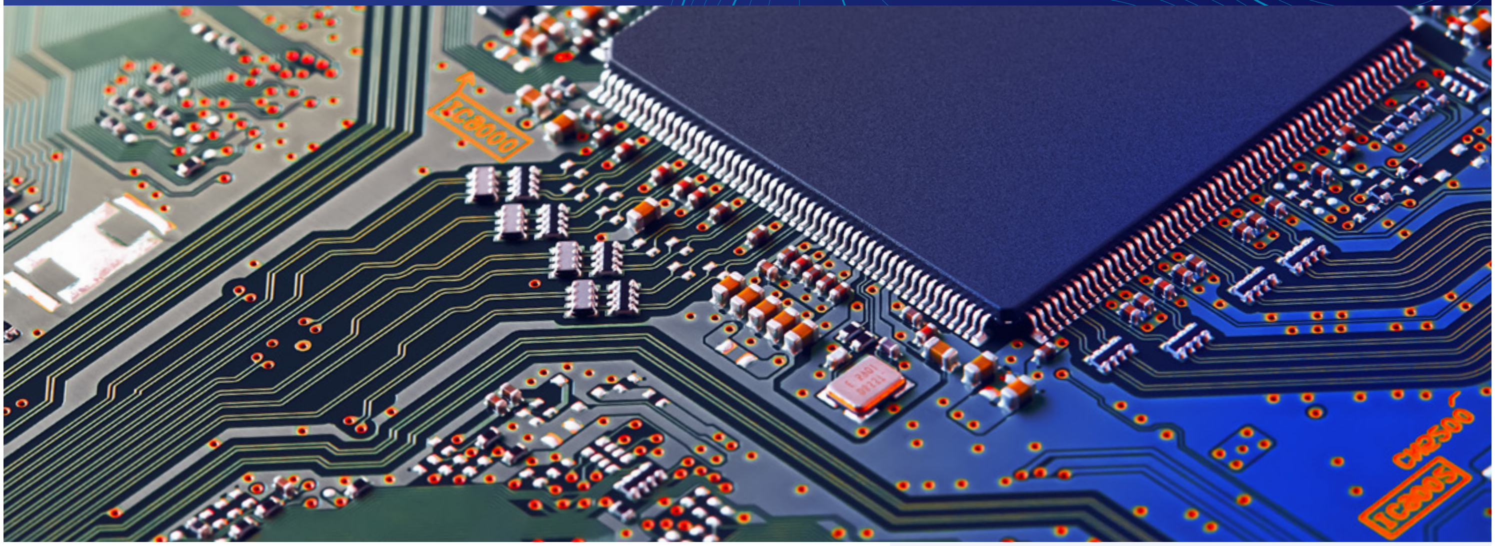

2Q23 Market Overview: OK Computer

The rebound of beleaguered technology stocks—which were among the hardest hit during last year's equity market selloff—continued to make headlines during second quarter 2023.

Enamored with the potential of generative artificial intelligence (AI), investors focused their buying attention primarily on a narrow cohort of megacap growth companies with some connection to the burgeoning technology. Most broad indexes came along for the ride; for example, the S&P 500 Index and MSCI World Index posted their third consecutive quarters of gains, returning 8.7% and 6.8%, respectively.[1]

While the MSCI World Growth Index continued to outperform the MSCI World Value Index during the second quarter, the spread between the two styles was far less extreme than it was in the first, as markets slowly began to accept the Federal Reserve's longstanding contention that policy rates likely would to be higher for longer.

KEY TAKEAWAYS

- Equity markets continued to move higher in the second quarter, driven by a narrow cohort of very large tech-related companies.
- Equity and fixed income markets appear to have fallen out of sync. While rising valuations and lower volatility suggest equity markets are pricing in a soft landing, bond-market turbulence is a warning sign.
- The risk of stagflation is likely to increase as the fiscal impulse that has supported economic growth in the face of tighter monetary policy continues to fade. Our last bout with stagflation, in the 1970s, was bad for growth stocks, bad for US versus international equities, and bad for financial assets compared to real assets like gold and oil.[2]
- Asynchronous equity performance across regions and sectors, in some cases amplified by shifting currency valuations, may create opportunities for go-anywhere, benchmark-agnostic investors like First Eagle, and we consider any opportunities that may emerge with an eye toward resilience.

1. Source: FactSet; data as of June 30, 2023.
2. Source: FactSet; data as of June 30, 2023.

Equity and Fixed Income Markets in Conflict

While the excitement around the AI narrative helped boost US equity markets to varying degrees, a paradox seemed to emerge under the upbeat sheen. Even though the Fed has raised rates considerably over the past year-plus, financial conditions haven't actually tightened all that much thanks to ongoing fiscal expansion, and equity and fixed income markets seem to have fallen out of sync as a result.

Equity markets appear to be pricing in a soft landing. The year-to-date rally in the S&P 500 Index brought its price-to-earnings (P/E) ratio back up to around 20x, while implied volatility receded to pre-Covid levels. In contrast, fixed income markets are flashing warning signs. The yield on two-year Treasuries backed up to the 5% level that preceded March's bank failures, further inverting the yield curve, while measures of interest rate volatility remained elevated.[3] At the same time, capital is being rationed within certain parts of the economy; leveraged credit new issuance continues to be muted, and bank-lending standards have tightened to levels that we believe are consistent with recession.[4]

While fixed income markets generally had seemed to coalesce around the "higher for longer" narrative toward the end of the first quarter, mid-March's bank failures called into question the Fed's willingness to follow through on this strategy amid such systemic fragility, pulling rates lower across the curve. While this notion dominated market action for the next several weeks, rate sentiment began to shift with the Fed's May 2–3 policy meeting. Though the 25 basis point increase, which brought the federal funds rate target to 5–5.25%, was dubbed by some as a "dovish hike" given the messaging that accompanied it, rhetoric from Fed officials in the days and weeks that followed made it clear there was still work to be done in the fight against inflation.

This was amplified at the central bank's mid-June meeting; though the fed funds rate was left untouched, many considered this a "hawkish pause" in light of Powell's comments and the release of a new dot plot showing rates peaking at 5.6% later this year. Indeed, minutes released a few weeks later revealed that a "strong majority…expect that it will be appropriate to raise interest rates two or more times by the end of the year," per Chair Powell. Additional hikes would not come as a surprise; while headline inflation has improved markedly on the back of falling energy and food costs, core inflation remains sticky, reflecting resilient economic activity and a still-strong labor market.

> While equity markets are pricing in a soft landing, bond markets are flashing warning signs.

While we've seen continued gradual disinflation from last year's pricing peaks without the emergence of recession, the fiscal largesse that has eased this transition appears likely to fade. Combined, these factors may increase the risk of stagflation, which for those who do not remember the 1970s was bad for growth stocks, bad for US versus international equities, and bad for financial assets compared to real assets like gold and oil. Furthermore, by the end of the 1970s, equity multiples were about half of their current levels while fixed income yields were about double. While we make no attempt to forecast the future and are mindful that past performance does not guarantee future results, if a similar trajectory were to emerge in the 2020's, we could be in for a long period of adjustment.[5]

Shifting International Dynamics May Reveal Opportunities

Though perhaps not as seductive as AI, a number of global developments during the quarter caught our attention. In Asia, the currencies of China and Japan have been notably weak, as central banks in both countries—for similar but nuanced reasons—are pursuing accommodative monetary policy as much of the rest of the world tightens. While a disappointing post-Covid recovery in China has forced the People's Bank of China to

3. Source: FactSet; data as of June 30, 2023.
4. Source: Federal Reserve; data as of June 30, 2023.
5. Source: FactSet, data as of June 30, 2023

intervene, the Bank of Japan remains committed to yield-curve control despite signs that Japan's economy may be breaking out of its multidecade malaise. This nuance likely explains why Japan's Nikkei 225 Index outpaced China's Shanghai Shenzhen CSI 300 Index by more than 2,000 basis points in the second quarter.[6]

In China, aging demographics, massive private-sector and local-government debt, property-market woes and slowing productivity growth have continued to weigh on the economy, while an emergent slump in exports—which account for about one-fifth of economic activity—is a more recent headwind. After spiking with the government's loosening of Covid restrictions in late 2022, activity in the services sector has cooled as well.[7] Though policymakers have introduced small stimulus measures in recent months, large fiscal deficits limit their ability to respond forcefully to the economic doldrums. The country's GDP growth target for 2023 is 5%, the lowest bogey in more than three decades; the Chinese economy expanded only 3% in 2022 amid its extended zero-Covid strategy.[8] On a positive note, recent rhetoric suggests that the contentious relationship between China's regulators and its tech industry—a feud that is estimated to have resulted in the loss of more than $1 trillion in market value since it began two years ago[9] —may be on the mend, providing greater clarity for these businesses.

> In Japan, we continue to see an uptick in the adoption of corporate governance best practices.

Some Global Value team members recently traveled to Japan for company visits, and management sentiment there appeared to be the most constructive it has been for quite some time. In general, we continue to see an uptick in the adoption of corporate governance best practices, including stock buybacks, higher dividends, the appointment of independent directors and enactment of meaningful return-on-equity targets. While some of these improvements can be attributed to reforms imposed by the Tokyo Stock Exchange, we are encouraged that a constructive groupthink on the issue seems to have emerged within corporate Japan. We remain vigilant, however; policy settings in Japan are still a long way from normal, both in terms of its fiscal deficit and eventual need to unwind yield curve control, and changes here could be disruptive to equity markets.

In contrast with Asia, Latin American currencies have appreciated sharply; the region is home to five of the world's eight best performing currencies during first half 2023. Latin American central banks acted early and decisively to raise interest rates in early 2021 in the face of inflationary pressures, and the resulting positive nominal and real rate carry attracted foreign capital.[10] In addition, concerns that the leftward political shift in the region over the past few years—which engulfed its top six economies among a few others—would bring about a populist overhaul have abated as the most-feared policy outcomes of this "new pink tide" failed to come to fruition.[11] Certain countries also have been outsized beneficiaries of the re-domiciling of manufacturing capacity alongside the rise of protectionism and pandemic-era disruptions to supply chains. Mexico, for example, recently became the US's top trading partner, accounting for 15.4% of bilateral trade for the first four months of 2023; in contrast, China's share fell to 12% after reaching an all-time high of 17.5% in fourth quarter 2019.[12] This vibrancy combined with what had been very cheap valuations propelled the MSCI EM Latin America Index to a 14.3% return in US dollar terms during the second quarter.[13]

Europe, meanwhile, has been a paradox. Despite a wide range of concerns gripping the region—not only the war in Ukraine and its impact on food and energy costs, but also riots in France, a rightward swing in Sweden and a various other local and geopolitical issues—the euro has been firm. We think this is a good reminder of the push-pull dynamic between prices and prospects that can sometimes emerge. In our view, the euro had become

6. Source: Bloomberg; June 30, 2023.
7. Source: Financial Times; data as of July 13, 2023.
8. Source: FactSet, data as of June 30, 2023
9. Source: Reuters; data as of July 12, 2023.
10. Source: Bloomberg; June 23, 2023.
11. Source: Wilson Center; January 6, 2023.
12. Source: Federal Reserve Bank of Dallas; July 11, 2023.
13. Source: FactSet; data as of June 30, 2023.

very cheap relative to its fundamentals prior to Russia's invasion and became cheaper still as it sold off in the months that followed. Though its fundamentals have weakened as a result of the war's impacts, the currency has trended steadily higher since bottoming off multi-decade lows in September 2022.

Going Anywhere Resilience Can Be Found

Equity markets have been quite asynchronous among regions and sectors, and currency effects in some cases have amplified these divergences. As go-anywhere, benchmark-agnostic investors, we believe these types of disparities can create opportunities—whether to sharpen our pricing in an old-economy stock typical of value investing, or to find an entry point into a less traditional name whose temporary valuation displacement belies a quality operation with still-unrealized potential.

As always, we 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 what we believe is a "margin of safety."[14]

14. 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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Risk Disclosures

All investments involve the risk of loss of principal.

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.

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.

Federal funds rate is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis.

Implied volatility is the market forecast of future fluctuations and movements in a security’s price.

Price-to-earnings ratio (P/E ratio) is a valuation ratio of a company’s current share price compared to the earnings per share. Generally, a high P/E ratio means that investors are anticipating higher growth in the future.

Two-Year Treasury Rate is the yield received for investing in a US government issued treasury security that has a maturity of two years. The two-year treasury yield is included on the shorter end of the yield curve and is important when looking at the overall US economy.

Volatility is a statistical measure of the degree to which an individual portfolio return tends to vary from the mean, based on the entire population. The greater degree of dispersion, the greater degree of risk.

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

MSCI Emerging Markets Latin America Index measures the performance of large and midcap stocks across emerging market countries in Latin America.

MSCI World Index measures the performance of large and midcap securities across 23 developed markets countries around the world.

MSCI World Growth Index measures the performance of large and midcap securities exhibiting growth style characteristics across 23 developed markets countries. 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, long-term historical EPS growth trend, and long-term historical sales per share growth trend.

MSCI World Value Index measures the performance of large and midcap securities exhibiting growth style characteristics across 23 developed markets countries. 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.

Nikkei 225 Index is an unmanaged price-weighted equity index, which consists of 225 stocks in the first section of the Tokyo Stock Exchange.

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.

Shanghai Shenzhen CSI 300 Index measures the performance of 300 A-share stocks listed on the Shanghai and Shenzhen Stock Exchanges.

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