FIRST EAGLE
INVESTMENT MANAGEMENT

1Q20: Reflections on an Unfolding Crisis

Investors initially downplayed news of the novel coronavirus outbreak in China, and equity indexes continued to press higher for the first weeks of 2020 as they did for much of 2019, led by growth-oriented stocks in general and the popular "new economy" names in particular. Sentiment shifted violently midway through the first quarter, however, as it became evident the virus initially written off as a regional concern in fact represented an emerging global health crisis, one that ultimately would bring an end to the longest bull market in US history and more than likely propel the global economy into recession.

Key Takeaways

- Though stocks broadly participated in the first quarter selloff, industries typically associated with value investing—like energy and financials—bore the brunt of it given their exposure to sensitive and immediately observable factors like oil prices and bond yields.
- Policymaker response has been swift and aggressive, but the global economic impact of the coronavirus shutdown is likely to be massive and to potentially result in a permanent loss of output and lower growth potential in the future.
- The coronavirus struck at a particularly vulnerable time, with mature parts of the market already in a stall zone and risk assets seemingly priced for perfection. As such, it's not hard to believe that we may be in only the early stages of a broad market re-rating, with the first quarter selloff merely scraping off the most pronounced valuation excesses that have built up over the years.
- Recent events underscore a key precept of First Eagle's investment philosophy: to seek resilience in portfolios from the bottom up. We build resiliency into our portfolios by allocating capital to what we view to be well-positioned, well-capitalized, well-managed businesses with the potential for persistent earnings power over time, combined with holdings in gold as a potential hedge and in cash and cash equivalents as deferred purchasing power.

Views expressed are as of April 9, 2020.

An Abrupt End to Decade-Plus US Equity Bull Market

The first quarter market rout began as a typical flight to safety, with risk assets declining sharply while traditional safe havens rallied on concerns that the impact of the coronavirus (Covid-19) outbreak would be more widespread than originally thought. By mid-March, however, financial markets appeared on the verge of breaking down, with pockets of illiquidity emerging across asset classes as a burgeoning oil-price war added a supply shock to the growing demand shock emanating from what now was officially a global pandemic; investors had nowhere to hide as cross-asset correlations and intra-stock volatility rose to historic levels. As global monetary and fiscal policy responses to the crisis began to take shape toward the end of the quarter, markets were able to recover some of their deepest losses. Once the dust had settled, only the "safest" asset classes provided a diversification benefit during the period, but even for these perceived havens—such as long-dated sovereign bonds, the US dollar and gold—the ride was anything but smooth.

The parts of the equity market whose fortunes rest on the most readily observable impacts of the economic shutdown—including the traditional "old economy" industries often associated with value investing—bore the brunt of the first quarter selloff. This included energy, which was forced to contend with not only the pandemic-inspired cratering of demand but also a supply shock courtesy of an oil-price war that emerged between OPEC+ members Saudi Arabia and Russia. The price of West Texas Intermediate—the US benchmark for crude oil—stood near $20/barrel at the end of the quarter, an 18-year low and a 65% decline from its 2020 starting point.[1] With oil prices below the production costs of many marginal producers, some drillers will fall by the wayside, destroying supply in the process; the longer prices remain low, the more supply that will be destroyed. This dynamic could make the global economy vulnerable to an energy price spike should oil demand recover, to the potential benefit of higher-quality operators able to demonstrate resilience and take share from those producers unable to survive the current downturn.

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Banks, too, struggled, particularly those in Europe and Japan that never really fully recovered after the financial crisis. Traditional deposit-based bank models aren't built for a world of zero interest rates and flat yield curves, and the coronavirus-related impact on business borrowers likely will translate into higher credit losses for lenders. Moreover, banks soon may need to negotiate the degree to which they allow their operations to be co-opted by government authorities for use as a policy transmission mechanism, actions that may not be to the benefit of long-term shareholders. Already, we've seen a number of the UK's largest banks agree to suspend dividends and share buybacks at the urging of their regulator.

In contrast, certain corners of the stock market held up relatively well—including not only defensive sectors like utilities and healthcare, but also technology—though in some cases this is likely due to the relative lack of observable data that surrounded them. Though revisions throughout the quarter have brought the consensus estimate for 2020 MSCI World Index earnings growth down to -1.3% as of March 31 (from 8.7% to start the year), even this figure represents an improvement from 2019's final growth rate of -2.0%—hard to fathom given that the global economy remains more or less on pause with no definitive end in sight.[2] Further revisions are likely as analysts and investors process news from the upcoming earnings season, and it's quite possible that some sectors and companies may reprice sharply. Cash-flow-negative businesses whose market valuations are based on an extrapolation of future growth rates may have particularly large downside risk going forward as these expectations fail to materialize in a prolonged economic slump.

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1. Source: Bloomberg, as of April 8, 2020.
2. Source: FactSet, as of March 31, 2020.

Despite Forceful Policymaker Response, Permanent Economic Impairment May Be Unavoidable

Data suggest the demand shock of social distancing and other measures intended to stop the spread of the coronavirus have metastasized into the business cycle.

While health authorities struggle to contain a virus about which much remains uncertain, vast swaths of the world remain in lockdown and a global recession appears all but certain. We've yet to see a first quarter GDP print at the time of writing, but a range of higher-frequency economic data suggest the demand shock of social distancing and other measures intended to stop the spread of the coronavirus have metastasized into the business cycle. Service-sector PMIs have collapsed worldwide, and manufacturing PMIs are likely to do the same with a lag. The impact on employment has been perhaps even more stark. In the US, for example, initial jobless claims for the two weeks ended March 28 came in at nearly 10 million, a level that took more than six months to reach in the 2008–09 recession. With nearly half the nation's workforce employed by small businesses, employment data are likely to worsen; about 25% of the country's small businesses had temporarily shut down as of April 3, and 40% of those still open expected to close their doors within two weeks.[3]

Central banks have responded rapidly and forcefully to the dislocations caused by the pandemic, with interest rate cuts, programs to provide liquidity and restore market functioning, quantitative easing and regulatory forbearance. Central bankers clearly want to prevent this temporary pause in household and business activity from turning into a permanent solvency crisis and wave of defaults. For its part, the US Federal Reserve already has gone further in response to the current crisis than it had during the global financial crisis. In addition to restarting all of its global financial crisis-era provisions, including zero interest rates and very large-scale Treasury and agency mortgage-backed security purchases, the Fed has established facilities that enable it to support the primary and secondary investment grade corporate bond markets, lend to small- and medium-sized enterprises and facilitate repo transactions with foreign central banks. By the end of the first quarter, the Fed's balance sheet amounted to nearly $6 trillion—it previously maxed out at around $4.5 trillion—and appears likely to climb higher.[4]

Governments, too, have acted aggressively, adopting fiscal policies to fund healthcare, provide household income support and bolster the corporate sector. The US federal government has passed three fiscal packages and a fourth seems likely; already-high sovereign debt levels will continue to climb as these programs come online, expanding the deficit in the face of falling nominal GDP.

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Despite their magnitude, the abovementioned policy responses may be only partially successful at stemming the damage. The economic impact of the coronavirus shutdown is likely to be massive, causing contractions potentially greater than any we've seen in the post-World War II period. Further, it's likely that the pandemic will result in a large and permanent loss of global economic output and that growth, when it returns, will trend at a lower potential rate than it had prior to the crisis—two scenarios that also came to pass in the aftermath of the global financial crisis. With the current shock hitting global economies simultaneously, however, we aren't likely to see a massive stimulus package from China to buoy demand the way we did in 2008–09.

Current Crisis Bears Similarities to Previous Upheavals—Along with Key Differences

Not only is its salutary effect uncertain, recent fiscal and monetary activity is likely to promote further deterioration in the quality of man-made money and sovereign balance sheets, which we believe underscores the importance we place on gold as

3. Source: US Chamber of Commerce, as of April 8, 2020.
4. Source: Federal Reserve, as of April 8, 2020.

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a potential hedge in portfolios across First Eagle. Movements in the price of gold during first quarter 2020 reminded us of its behavior in fourth quarter 2008, another extremely challenging investment environment during which gold increased its relative purchasing power despite intra-quarter volatility. In both cases, the gold price rose in the early stages of a risk selloff, only to decline as liquidity breakdowns across markets paradoxically pushed real yields higher. The potential hedge value of gold has tended to reassert itself as central bank actions ease liquidity fears, however; we saw this in the recovery of gold's price in late March and even more powerfully in the years following the global financial crisis, as gold ultimately doubled its fourth quarter 2008 levels. We don't have a directional view on gold, but we believe strongly that its value as a potential hedge will remain in place.

While the current crisis bears some of the hallmarks of previous economic challenges, it is far more intense than anything we've seen in our lives, including the dot-com bubble of 2000 and even the global financial crisis of 2008. The concurrent demand shock from the coronavirus pandemic and supply shock from the oil-price war has had an impact unique in its swiftness and ferocity. Furthermore, the current crisis struck financial markets and the global economy at a particularly vulnerable moment. Equity markets entered 2020 priced for perfection after a year of robust gains but little to no growth in corporate profits, while mature parts of the global economy had already entered a stall zone due to such factors as trade wars, fading fiscal stimulus, margin pressures and the competitive threat from new-economy predators. In addition, very low bond yields implied downbeat expectations for nominal economic growth moving forward, likely reflecting a range of concerns, from excessive debt levels and the economic mix shift toward services to lower workforce growth and increased risk of populist policy.

The current crisis struck financial markets and the economy at a particularly vulnerable moment.

At First Eagle, Sailing a Steady Course Through Uncertain Waters

Recent events remind us why we don't presume to forecast market movements at First Eagle; while there was ample evidence that the business cycle had grown mature, no one expected a global pandemic to be the catalyst for its turn. That said, it's not hard to believe that we may be in only the early stages of a broad market re-rating, with the first quarter selloff merely scraping off the most pronounced valuation excesses that have built up over the years.

Though a Covid-19 vaccine by most estimates remains 12–18 months away, policymakers are continually monitoring infection rates and forecasts to weigh the risks to public health against those of ongoing economic impairment. While we're hopeful for a swift return to normalcy—in markets, economies and societies—as investors we must be mindful of the difficulty of this transition and cognizant that the last pandemic of this scale, the Spanish flu in 1918–19, came in three distinct waves over an 18-month period. False dawns are possible.

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While harrowing market moves and persistent uncertainty are unsettling, such environments often present opportunities for the discerning investor. At First Eagle, our cash holdings and our potential hedge in gold provide us with ample liquidity, and in the first quarter we were able to selectively allocate capital, on what we believed to be advantageous terms, to what we view as well-positioned, well-capitalized, well-managed businesses with the potential to demonstrate resilience over the long term. We think this is moment where our patience as investors may be rewarded, and we're sailing a very steady course as the crisis continues to play out.

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