Quality Never Goes Out of Style

The ample liquidity that predominated in the years following the global financial crisis fueled a prolonged period of growth stock outperformance at the expense of value names. However, changing macroeconomic dynamics in 2022 ushered in the more volatile investment environment that persists today.

These novel conditions contributed to a pronounced shift in favor of value stocks in 2022, but we've long been wary of extrapolating market trends. Indeed, growth stocks have outperformed their value counterparts handily year-to-date 2023, as easing financial conditions and moderating inflation pressures have helped markets look past a range of potentially destabilizing factors, including the recent strains in the banking sector.[1] But just as we didn't expect 2022's results to represent the beginning of a durable value renaissance, we don't expect early 2023's results to mark a renewal of extended growth supremacy. In fact, given ongoing uncertainties and elevated market volatility, we believe the stark growth/value binary that has been so prominent in recent years is likely to be replaced by something more idiosyncratic.

In our view, the most important factor that may influence stock returns could be the ability of individual companies to execute in a challenging operating environment rife with tail risk. That is to say, after many years during which success was determined by the vicissitudes of investor preferences around sectors, styles and geographies, we believe the quality of a company—as reflected by a range of tangible and intangible measures—ultimately will determine its performance.

KEY TAKEAWAYS

- As central banks grapple with still-high levels of inflation and softening economic growth, changes in financial system liquidity have been met with market volatility.
- Today's macroeconomic backdrop—characterized by high benchmark yields, a shrinking Federal Reserve balance sheet and a declining money supply—appears to be closer in spirit to the mid-2000s than the bull-market years preceding the current Fed tightening cycle.
- Recent strains in the banking sector underscored the pronounced vulnerabilities inherent in today's financial system and the potential for unintended consequences as authorities attempt to unwind years of highly accommodative monetary policy.
- We believe investment success will be predicated less on exposures to particular styles or geographies and more on identifying quality companies globally whose tangible and intangible attributes position them to navigate a complicated environment.

The go-anywhere, benchmark-agnostic approach of First Eagle's Global Value team allows us to seek out what we believe to be quality businesses across global equity markets—even in parts not traditionally associated with the value investing that is our heritage. When purchased at what we believe to be a "margin of safety" to our estimate of intrinsic value[2] and assembled in thoughtfully diversified portfolios, stocks that reflect our quality bias may help clients avoid the permanent impairment of capital with the goal of generating long-term real returns across market cycles.

1. Source: FactSet; data as of May 15, 2023.
2. "Margin of safety" is defined by First Eagle as the difference between a company's market value and our estimate of its intrinsic value, which is based on a judgment of what a prudent and rational business buyer would pay in cash for all of a company in normal markets. An investment made with a "margin of safety" is no guarantee against loss.

That Was Then...

In response to the global financial crisis and the tepid economic growth that followed it, central banks globally spent many years maintaining policy rates at or near the lower bound while providing massive liquidity through large-scale quantitative easing programs. The repressed interest rates that resulted beget low discount rates, heightening the appeal of the future cash flows of long-duration growth stocks versus the here-and-now cash generation of value names. Discounted cash flow analysis sounds complicated, but we believe the math is fairly straightforward: When the risk-free rate is 0%, a $100 payout 10 years from now is worth $100 today; at 4.5%, this same $100 is worth only $55 today.

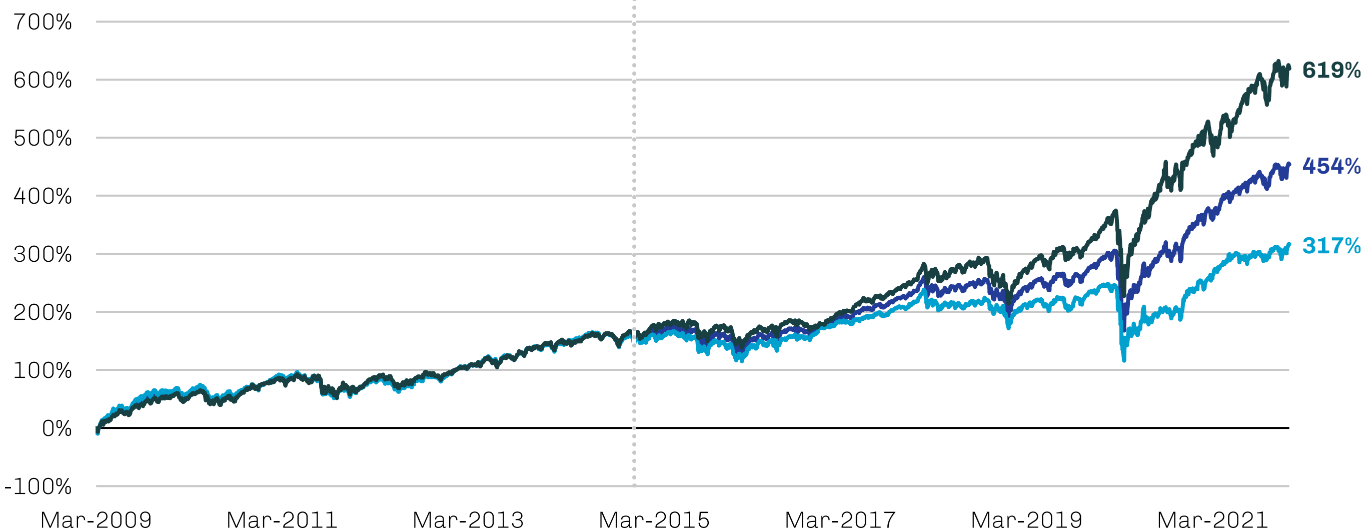
As shown in Exhibit 1, the equity bull market that began in early 2009 initially benefitted stocks equitably across styles before discount rate dynamics ultimately won out in mid-2014 to fuel the significant outperformance of growth stocks through the end of 2021. The technology sector was the focus of attention among market participants bidding up the prices of stocks with longer-term cash flows, providing an outsized benefit to the growth indexes in which most resided. As shown in Exhibit 1, the MSCI World Growth Index—which attributes more than 36% of its market cap to the tech sector—had a cumulative return of 164% over the seven-year-plus period compared to 34% for its value analog—which has a tech exposure of only 9%. Performance in the US was even more pronounced in favor of growth and tech.[3]

> The equity bull market that began in early 2009 initially benefited stocks equitably across styles.

Exhibit 1. Tech Stocks Drove the Growth Outperformance that Began in Mid-2014

Net Returns, March 2009 through December 2021

	March 1, 2009, to June 30, 2014	July 1, 2014, to December 31, 2021
MSCI World Index	161%	293%
MSCI World Value Index	162%	155%
MSCI World Growth Index	160%	459%



Source: FactSet; data as of April 30, 2023.

Past performance does not guarantee future results.

3. Source: MSCI; data as of April 30, 2023.

...But This Is Now

With inflation showing no signs of letting up of its own volition, the Fed was forced to take action to cool the economy in early 2022. Consider the impacts of the Fed's efforts to engineer a "soft landing" that gets inflation under control without tipping the economy into recession:

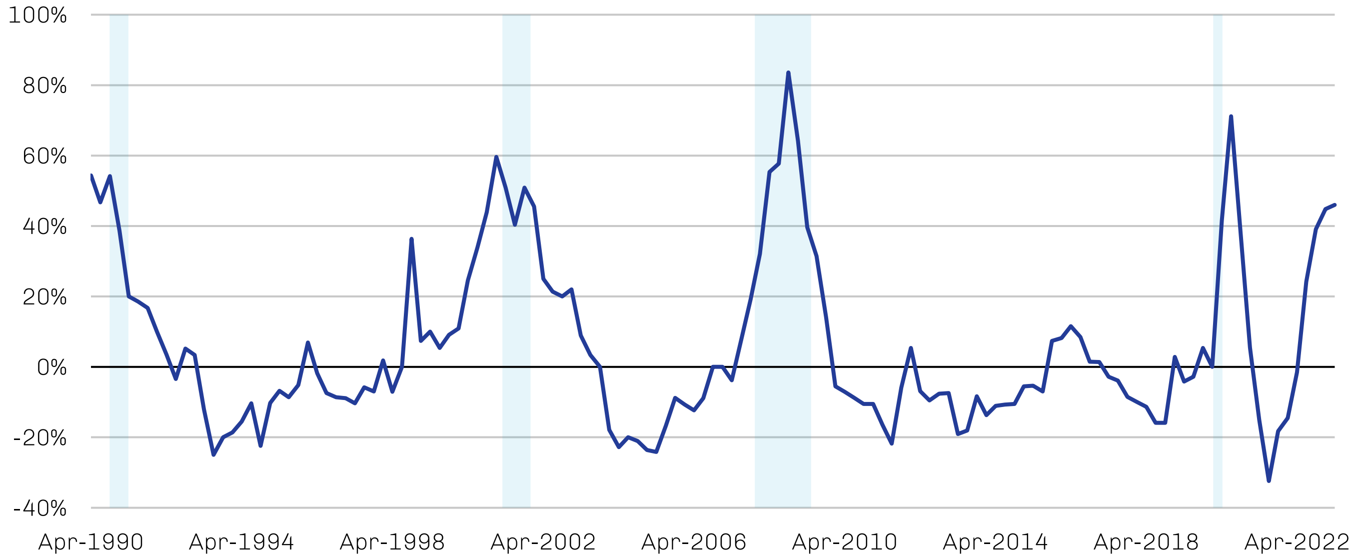
Interest rates. Since the current hiking cycle began in March 2022, the federal funds rate has been raised 500 basis points; with an upper limit of 5.25%, the policy target is at its highest level since 2007. In conjunction with the tightening, real and nominal Treasury yields across the curve spiked to levels not seen since before the global financial crisis.[4]

Fed balance sheet. After more than doubling from March 2020 to March 2022 to surpass $9 trillion, the Fed's balance sheet is currently shrinking as the central bank allows maturing securities to roll off its books. A recent Fed study estimated that a $2.5 trillion reduction in the balance sheet over the next several years would have an economic impact similar to a 50 basis point increase in the policy rate.[5]

Money supply. As a result of the Fed's policy actions, the M2 money supply has been in contraction on a year-over-year basis for the past four months; it previously had never contracted for even a single month. The shrinking supply of money should have a slowing effect on economic activity—the less money in the system, the less there is for banks to lend and for businesses and consumers to borrow and spend—though likely with a lag. As shown in Exhibit 2, sharply tightening lending standards typically have preceded or coincided with recessionary periods going back to 1990.[6]

Exhibit 2. Tightening Lending Standards Warn of Potential Recession

Net Percentage of US Banks Tightening Standards for Commercial and Industrial Loans to Large and Middle Market Firms, April 1990 through April 2023



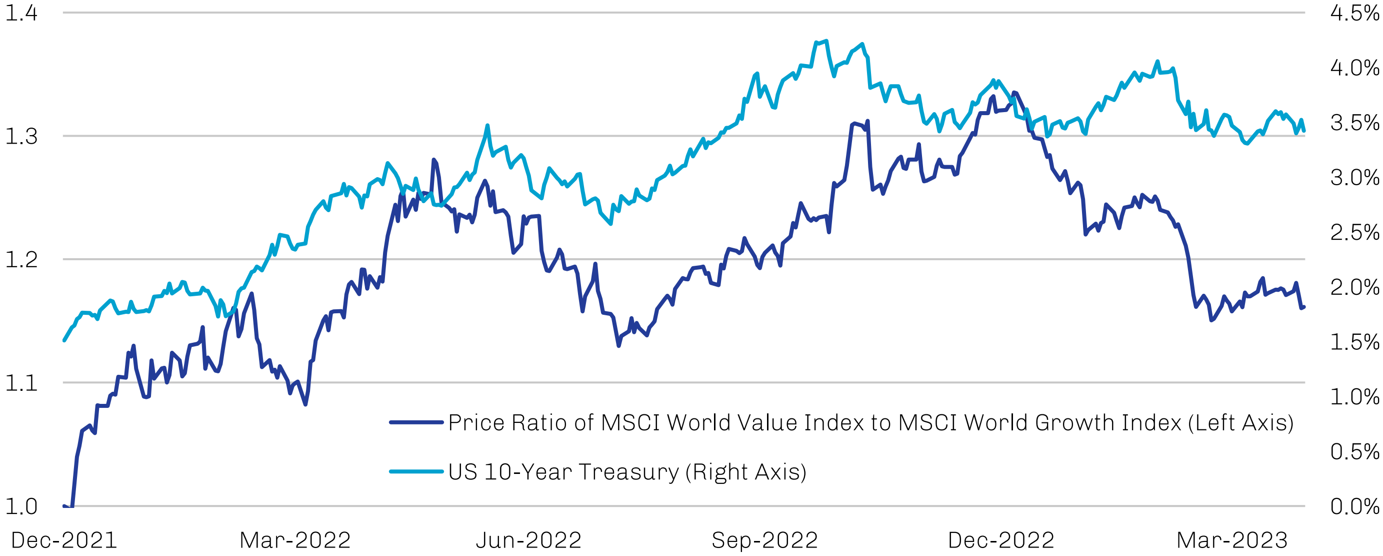
Source: Federal Reserve; data as of May 8, 2023.

This transition from an investment environment characterized by a generationally low cost of capital to one in which money once again has a price inspired a broad selloff in equities and a pronounced shift in style leadership, with the MSCI World Value Index outperforming its growth analog by about 2,100 basis points in 2022. However, we entered the new year wary of extrapolating these trends, and, in fact, growth stocks have outperformed significantly thus far in 2023. This perhaps should not come as a total surprise; though the change in style leadership during 2022 was stark, relative performance over the year was not monotonic. As shown in Exhibit 3, sentiment oscillated as marginally improved inflation data and/or weakening economic growth fueled speculation that the Fed could moderate the pace of rate hikes or even pivot toward rate cuts, pulling down the yield on the 10-year Treasury and narrowing the spread between growth and value.

4. Source: Federal Reserve, Treasury Department; data as of May 3, 2023.
5. Source: Federal Reserve Bank of Richmond; data as of September 30, 2022 (most recent data available).
6. Source: Federal Reserve; data as of April 30, 2023.

Exhibit 3. Relative Equity Performance Has Been Buffeted by Movements in Treasury Yields

January 2022 through April 2023



Source: Bloomberg; data as of April 30, 2023.

Past performance does not guarantee future results.

Today's Environment Is a Novel One for Many

As summarized in Exhibit 4, today's macroeconomic backdrop appears to have more in common with the mid-2000s than the bull market years preceding the current Fed tightening cycle. While the direction of these metrics going forward is uncertain, it's hard to believe a return to the highly accommodative conditions that fueled the outperformance of growth stocks is imminent given inflation well above target levels, robust wage growth and very low unemployment. Instead, it seems more than likely that investors will be tasked with navigating a more complicated macroeconomic landscape whose parameters are dissimilar to anything seen in more than a decade and a half.

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Exhibit 4. One of These Things Is Not Like the Other

	April 30, 2023	December 31, 2021	December 31, 2006
Federal Funds Effective Rate	4.83%	0.08%	5.17%
10-Year US Treasury Nominal Yield	3.44%	1.51%	4.39%
10-Year US Treasury Real Yield	1.26%	-1.10%	2.06%
Fed Balance Sheet: YOY Change	-4.22%	18.93%	2.60%
M2 Money Supply: YOY Change	-1.10%	12.30%	4.10%

Source: Federal Reserve, Treasury Department; data as of April 30, 2023.

Of course, no two investment environments are exactly alike; each comes with its own set of unique complications. One such complication today is the stresses that have emerged in the banking sector. Just as markets were seeming to coalesce around the narrative that interest rates were likely to be "higher for longer," the US bank failures in early March raised new uncertainties about the Fed's path forward and renewed old concerns about systemic fragility.

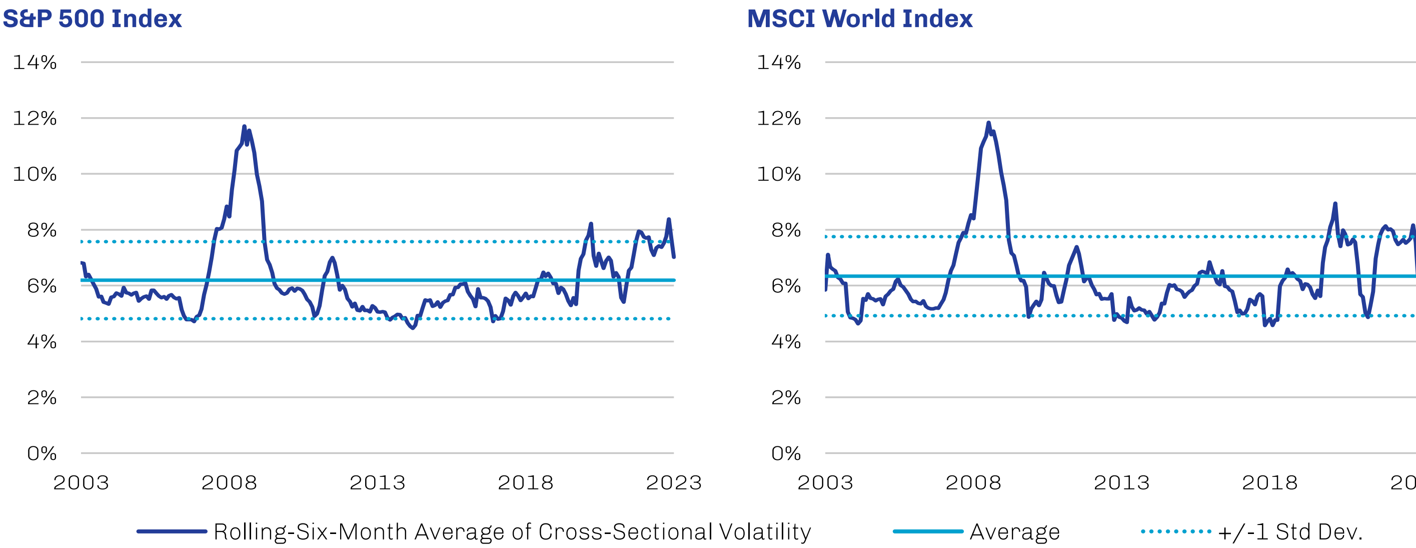
We've long been concerned about the potential for some sort of financial accident, and the shuttering of midsized Silicon Valley

Bank and Signature Bank within days of one another (and First Republic Bank about six weeks later) underscored the pronounced vulnerabilities inherent in today's financial system and the potential for unintended consequences as authorities attempt to unwind years of highly accommodative monetary policy. 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.

We noted in Exhibit 2 how tighter lending conditions historically have preceded economic contractions, and Fed Chair Powell acknowledged the same at his May 3 press conference, commenting that strains in the banking sector "are likely to weigh on economic activity, hiring and inflation."[7] The Fed's need to balance price stability with financial stability seems likely to complicate its policymaking process going forward and promote further volatility in what Exhibit 5 shows are already choppy markets. It's also possible that the recent banking crisis in the US is merely a precursor to broader, more insidious issues around sovereign credibility that would drive investors to demand greater risk premia for bonds issued by national governments.

Exhibit 5. Market Volatility Has Increased in the US and Abroad

Rolling-Six-Month Average of Cross-Sectional Volatility, April 2003 through April 2023



Source: FactSet; data as of April 30, 2023.

Emphasizing Quality over Style

Despite sharp losses across equity markets in 2022, valuations remain elevated compared to long-term trends in the face of mounting headwinds. We believe investment success going forward will be predicated less on exposures to particular styles or geographies and more on identifying quality companies globally whose tangible and intangible attributes position them to navigate what seems likely to be a complicated and volatile environment. Generally speaking, these are businesses that in our view not only appear well-positioned to generate persistent cash flows over the long term but also have the capacity to suffer through short-term challenges—such as a potential credit crunch.

While we are philosophically drawn to low prices, our value-oriented investment approach begins not by screening for the statistically cheapest stocks but rather by identifying business character. By making the quantification of price conditional to our fundamental appraisal of an organization's specific tangible and intangible attributes, "value" becomes a big tent. We even welcome companies traditionally associated with growth portfolios—assuming that growth creates intrinsic value.

Specifically, we look for companies we believe have the potential for persistent earnings power by virtue of possessing a scarce, durable asset—a tangible or intangible factor that in our view

> We believe success going forward will be predicated less on exposures to particular styles or geographies and more on identifying quality companies.

7. Source: Federal Reserve; data as of May 3, 2023.

provides it with a long-term operational advantage and is highly difficult to replicate. Often, these companies have strong, entrenched market positions; scalable business lines with diversified income streams; prudent management teams; and simple, transparent business models. Companies meeting these criteria are not immune from the impact of business cycles, but their persistent free cash flow generation may provide a cushion against economic downturns while also creating opportunities to enhance their competitive position against less-resilient businesses. Once we've identified what we believe to be quality business that is a well-positioned, well-capitalized, well-managed company, we invest in it only when we can do so at a meaningful "margin of safety."

In our view, there never is a wrong time to seek quality. However, a transitioning market searching for direction in a highly uncertain environment may represent particularly rich ground for quality stocks and investment managers that can identify them consistently.

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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.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

Strategies whose investments are concentrated in a specific industry or sector may be subject to a higher degree of risk than strategies whose investments are diversified and may not be suitable for all investors.

Definitions

Bull market is generally defined as a period during which a market experiences a prolonged increase in price.

Discount cash flow analysis (DCF) is a valuation method that estimates the value of an investment based on its future cash flows.

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.

Federal funds effective rate is the volume-weighted median of overnight federal funds transactions using data provided by domestic banks and US branches and agencies of foreign banks.

10-Year US Treasury nominal yield is the coupon rate of a 10-year Treasury note.

10-Year US Treasury real yield is the coupon rate of a 10-year Treasury note minus the rate of inflation.

Standard deviation is a statistical measure of a security's volatility, or variability in expected return.

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.

Benchmark Definitions

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

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.

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.

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