First Eagle Investments

AUGUST 2024
Insights

Summertime Observations

First Eagle over time has deliberately sought to nurture an investment-led culture supported by a set of core investment tenets that encourages philosophical autonomy among our portfolio management teams in pursuit of client goals. While our five investment teams operate independently, we strongly believe each can benefit from the disciplined, unconventional thinking the others bring to bear in their areas of expertise. To share such insights broadly across the organization, we periodically assemble the senior members of our investment teams; below is an overview of some of the key issues raised at our mid-July gathering.

Matt McLennan
Co-Head of Global Value Team

Risk appetites continued to fuel financial markets in the first half of 2024. Credit spreads have narrowed as implied volatility has declined and equity multiples have increased. Styles factors have largely remained unchanged as large-cap US growth stocks—fueled by the "narrative economics" surrounding developments like artificial intelligence and GLP-1 agonists—accounted for most of the gains, while value names and non-US markets lagged. More recently, easing inflation and a softening labor market have rekindled expectations for interest rate cuts, albeit with a greater sense of urgency. Are current conditions pointing toward the much anticipated soft landing of the economy? Or are strong financial markets just a mirage that has obscured the true risks and uncertainties of the environment?

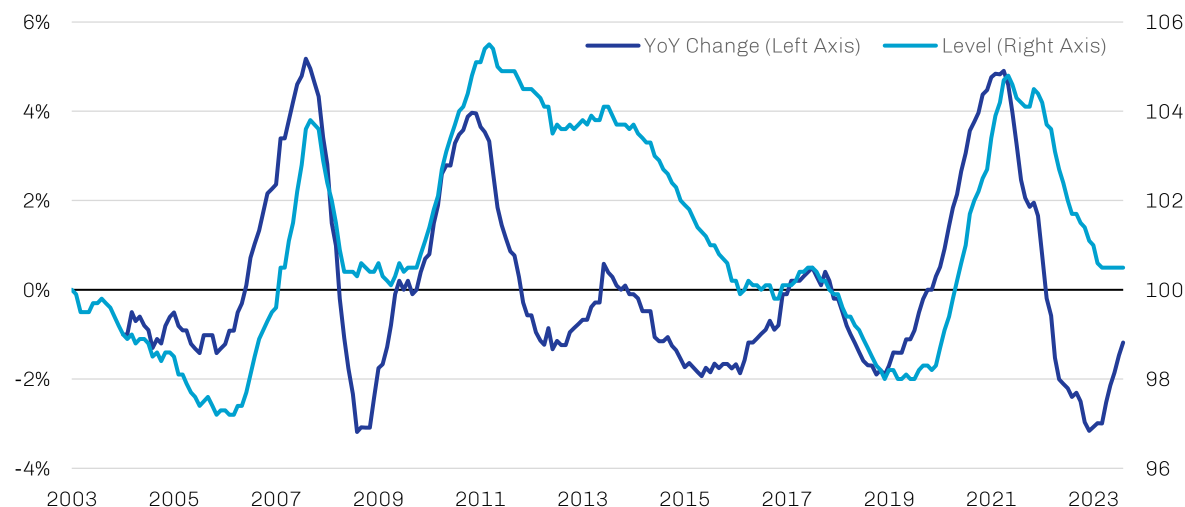
The personal consumer expenditures (PCE) price index has inched closer to the Federal Reserve's target goal of 2.0%.[1] But we think it's worth noting that one of the primary drivers of disinflation has been something originating from outside of the US: deflationary forces from Chinese manufacturers. As shown in Exhibit 1, the price of Chinese exports peaked in 2022 and began to experience year-over-year declines in 2023 as post-Covid

1. Source: US Bureau of Economic Analysis; data as of July 26, 2024.

inflationary pressures eased. We believe the impact of this tailwind will eventually abate as the prices of US imports from China have already plateaued. Without this benefit, inflation may remain stubbornly mired just above the Fed's target; should export prices begin to tick up, inflation may follow suit.

Exhibit 1. Falling Chinese Export Prices Have Been a Deflationary Force

Prices of US Imports from China, January 2003 through July 2024



Source: Federal Reserve Bank of St. Louis, US Bureau of Labor Statistics, First Eagle Investments; data as of August 15, 2024.

On the other hand, labor markets have largely absorbed the structural changes brought on by the pandemic, and we are seeing a return to normalized labor dynamics even as wage inflation remains above levels supportive of 2% inflation.[2] Wage growth has declined below nominal interest rates, a phenomenon that historically has occurred at the end of economic growth cycles. This puts pressure on households, whose borrowing rates are now meaningfully higher than their wage growth, and the decline of the personal savings rate to levels well below Covid-era highs adds to the readings that hint at a weakening consumer.[3]

The disappointing July jobs report prompted market prognosticators to speculate whether the Fed has waited too long to cut interest rates and sparked a violent market response. The unemployment rate has increased from its trough of 3.4% to 4.3%, though we have seen an increase in labor-force participation.[4] Reviewing most US recessions since World War II, we've noticed that the unemployment rate has tended to inch higher early into the slowdown before accelerating sharply into recession. It remains to be seen if we are on the cusp of a recession, but with PCE and wage inflation still above target rates, there is a risk that the much-anticipated Fed rate cuts may trigger an unwelcome asymmetric inflationary response.

With inflation still above target rates, there is a risk that rate cuts may trigger an unwelcome asymmetric inflationary response.

2. Source: US Bureau of Labor Statistics; data as of July 31, 2024.
3. Source: US Bureau of Economic Analysis; data as of July 26, 2024.
4. Source: US Bureau of Labor Statistics; data as of August 2, 2024.

More troubling are fiscal conditions in many developed economies, including the US. The swell of public debt outstanding in advanced economies combined with a general lack of fiscal discipline has made sovereign paper an increasingly risky proposition as interest expenses increase as lower-yielding bonds mature and are refinanced with bonds at current rates. Deficits also work against central bank efforts to cool an overheated economy. Worryingly, fiscal discipline is not a concept associated with either major US political party today, and the prospects for improvement in the foreseeable future are dim regardless of the result of November's elections.

Increased concerns about the potential for currency debasement given massive government debt levels worldwide has been supportive of gold, whose price reached new nominal record highs in 2024 even as interest rates increased.[5] Global central banks have been a key source of support for the metal's price in the face of traditional headwinds. Net purchases of gold by central banks in 2022 and 2023 were the highest on record by far, and 2024 has gotten off to a good start.[6] Gold's history as a perceived "safe haven" often attracts buyers of all stripes during periods when perceived risks are high, and it's perhaps not surprising that global central banks have sought to diversify their reserves through additional gold holdings.

Jon Dorfman

Chief Investment Officer, Napier Park Global Capital

In the years following the global financial crisis, highly accommodative monetary policy rewarded businesses and individuals for taking on a significant amount of debt. Two years into a monetary regime with positive real interest rates, we have begun to see visible signs of economic fade as well as greater risk to credit investing. The US services sector—which comprises more than 70% of the economy—has been alternating between expansion and contraction for the past few months, while manufacturing in July posted its weakest level of activity in 2024.[7] Consumer spending has also begun to wane, and the disappointing July employment report underscored the flagging momentum.[8]

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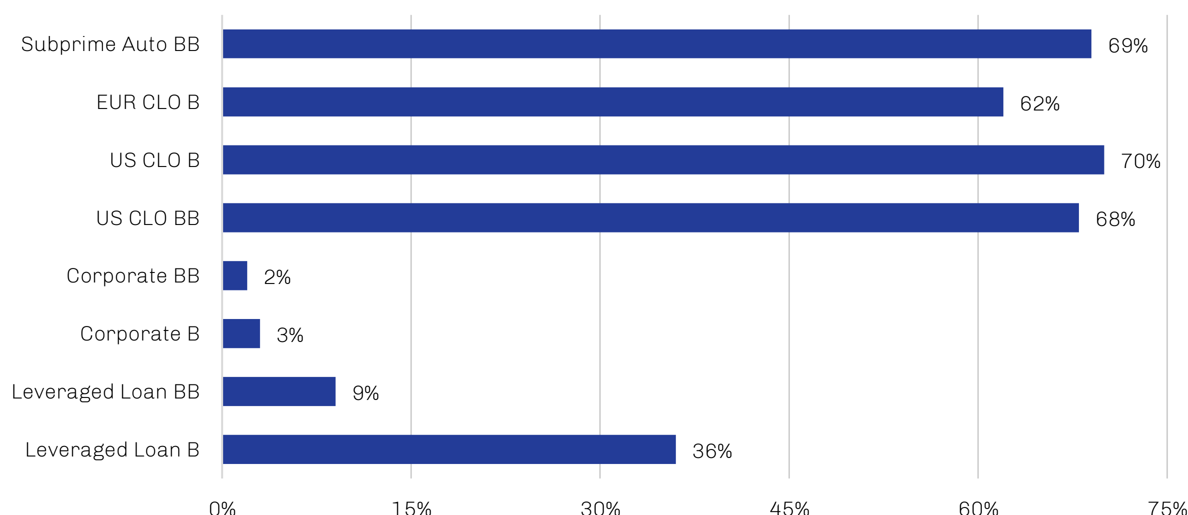
The impact of this softness can be seen on consumers and businesses at the bottom of the credit market. Credit card delinquencies have begun to increase, with the largest increase among consumers in the lowest income bracket.[9] While issues with household balance sheets don't appear serious enough to be systemic at this stage, the weakness is likely to result in greater delinquencies and defaults. We are also seeing weakness in corporate fundamentals, particularly among highly leveraged businesses who have experienced declines in interest coverage, as well as an increase in distressed exchange volumes.[10] As with previous late-cycle stages, defaults likely will remain elevated until all of the weakest players get shaken out.

Despite the slowing economy being only one of a range of risks facing investors, credit spreads in traditional non-investment grade markets remain tight. We attribute some of this behavior to investors targeting gross yields rather than spreads; the potential for falling interest rates may create some stress in the spread markets. More complex structured credit assets, however, currently offer meaningfully wider spreads than high yield bonds and loans, as shown in Exhibit 2. Combined with relatively high base rates, we believe yields on certain structured credit instruments appear enticing.[11]

5. Source: Bloomberg; data as of July 31, 2024.
6. Source: World Gold Council; data as of July 30, 2024.
7. Source: Institute for Supply Management; data as of July 3, 2024.
8. Source: US Census Bureau; data as of July 16, 2024.
9. Source: Federal Reserve Bank of New York; data as of May 14, 2024.
10. Source: Bank of America, JP Morgan, Pitchbook; data as of June 30, 2024.
11. Source: JPMorgan; data as of June 10, 2024.

Exhibit 2. Structured Credit Assets Historically Have Offered Wider Spreads than Traditional Fixed Income
Comparison of Percentile Rank of Spreads, July 2014 through July 2024



Source: JPMorgan; data as of July 29, 2024.

> Structured credit instruments historically have offered an attractive yield pickup relative to traditional fixed income investments.

Though the yield differential between structured and traditional credit currently is wider than typical, the existence of such a gap is far from novel; structured credit instruments historically have offered an attractive yield pickup relative to traditional fixed income investments.[12] This premium also tends to persist over the cycle, during periods of both calm and volatility such as we are experiencing as we write this in early August. While there are a number of valid reasons for the structured credit yield premium—including greater complexity, reduced liquidity and pronounced price volatility—greater credit risk is not one of them, in our view. In fact, certain structured products historically have realized significantly lower defaults than their like-rated traditional counterparts—including, in many cases, no defaults at all.[13]

For investors, structured credit offers the potential for enhanced returns, portfolio diversification and tailored credit-risk exposure. Success in these specialty credit segments has historically featured a higher barrier to entry in terms of experience, expertise and technology, however. Further, we believe the flexibility to actively allocate among the disparate opportunities across credit—both public and private, and both single name and structured—best supports efforts to generate meaningful incremental yield with manageable incremental risk while promoting potential diversification benefits in multi-asset portfolios.

Jim Fellows

Co-President and Chief Investment Officer, First Eagle Alternative Credit

Robust demand and limited new supply continue to dominate the narrative in leveraged credit, and spreads in broadly syndicated loans and private credit remain very tight. Though we believe investors remain inadequately compensated for credit risk, we expect to see continued demand for floating-rate credit, from both fixed income investors and potentially from equity investors seeking equity-like returns that have the potential for reduced risk.

New-loan issuance surged to record levels in the first half of 2024, but continued to be dominated by repricings and refinancings; net loan supply remained elusive, as higher-for-longer rates and a murky economic outlook

12. Source: JPMorgan, Bloomberg; data as of June 26, 2024.
13. Source: BofA Global Research, Moody's Investors Services; data as of June 30, 2024.

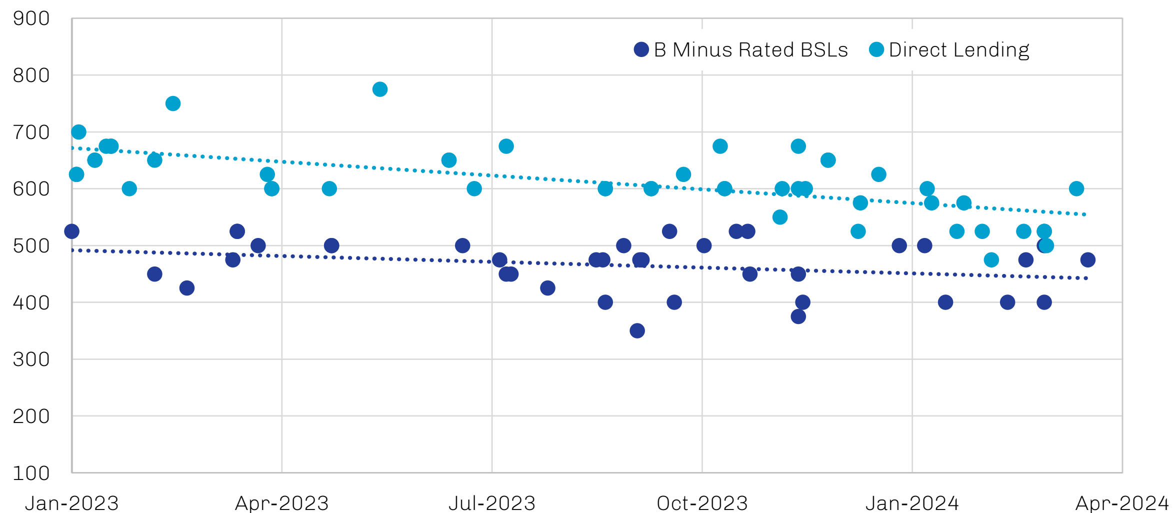
continued to weigh on mergers and acquisition (M&A) activity. Demand, meanwhile, is trending very strongly—especially from collateralized loan obligation (CLO) creation, which accounts for the vast majority of loan demand. In the secondary market, higher-risk issuers, particularly those with negative headline exposure, have been under pressure of late; the risk-off posturing was especially notable among CLOs, given their limited risk budgets and ratings sensitivity.

Spreads across leveraged credit have narrowed in general in response to supply and demand dynamics, but the imbalance appears particularly acute in private credit. As a result, pricing in direct lending appears to be slowly converging with that of broadly syndicated loans. For example, as shown in Exhibit 3, the 200 basis point premium new-issue private credit offered over broadly syndicated loans in early 2023 has been cut in almost half. That said, the lower middle market—which is our focus—appears to have a more balanced supply/demand dynamic overall, as rising private company valuations over the years prompted private equity sponsors to look toward the smaller end of the middle market for more cost-effective platform opportunities.

The lower middle market appears to have a more balanced supply/demand dynamic overall.

Exhibit 3. Private Credit Spreads Have Compressed on Strong Demand and Limited New Supply

New Issue Spreads on Acquisition-Related Transactions by Private Equity Companies, January 2023 through April 2024



Source: Pitchbook | LCD; data as of April 15, 2024

Default rates are running above the historical average, but not significantly so thanks to still-strong corporate fundamentals. While revenue and earnings growth have normalized following strong post-Covid levels, margins have remained healthy, enabling issuers to reduce leverage and borrowing costs. Beyond fundamentals, while the great wave of M&A activity many are anticipating has yet to materialize, direct lending volumes to finance buyouts in 2024 remain higher than they were during the period of Fed rate hikes. The relatively benign maturity schedule and open access to capital via both the syndicated and private credit markets should also help keep defaults in check, barring a major breakdown in the economy. This is particularly true in the sponsor-backed middle market segment, in our view, given these borrowers' more conservative capital structures. However, we continue to monitor stress factors in the system.

It's worth noting that despite an only moderate default rate, we are seeing lower recovery rates on defaults, especially in the broadly syndicated loan market. This may reflect the absence of covenants, which basically have been stripped from broadly syndicated loans over the years. Covenants both enforce and encourage communication between borrower and lender, especially in periods of distress, and can help dampen defaults and enhance recoveries. Unfortunately, there is a similar erosion of structural protections happening in the upper end of private credit as these two financing options converge. Though they sometimes include covenants per se, larger direct deals already are falling prey to financial engineering and aggressive restructurings—including liability-management exercises (LME)—in which distressed borrowers exploit ultra-loose covenants at the expense of certain lenders.

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Despite ever-changing dynamics and a still cloudy economic outlook, we remain constructive on the long-term outlook for credit, though selectivity, perhaps now more than ever, is key. With increased risk aversion and risk premia already fairly tight—and covenants sometimes "lite" at best—we remain focused on better-quality issuers with limited appetite for higher-stress situations. Should the market exert what seems to us unwarranted pressure on highly levered issuers, however, buying opportunities could emerge.

More broadly, we value our flexibility to migrate between public and private markets in pursuit of attractive risk-adjusted returns. Within direct lending, we currently find sponsored, lower/middle-market transactions a sweet spot, providing reasonable debt levels, structure and information flow. Across markets—both broadly syndicated and direct—we have found specific opportunities within healthcare, as labor-cost pressures continue to abate, and in technology, especially as interest rates decline.

Bill Hench

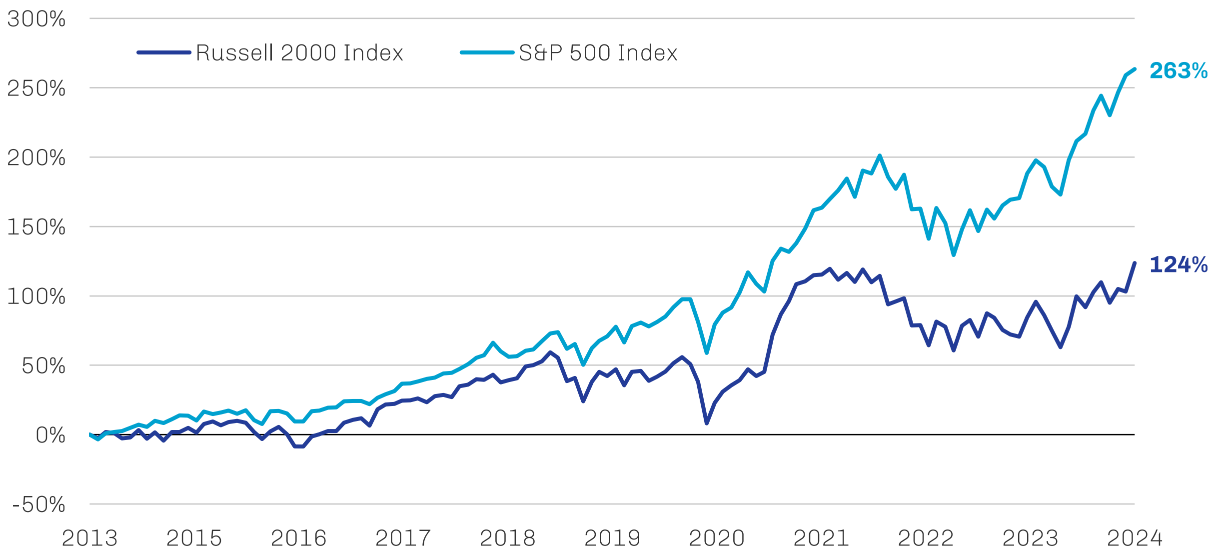
Head of Small Cap Team

While we're in the midst of the longest period of small cap underperformance I can recall in my 24 years of investing in this space, shorter chunks of time have been similarly disappointing. Higher interest rates have hurt, but relatively slower earnings growth may be a stronger constraint, at least at the index level. Good companies with strong businesses and solid earnings have languished alongside weaker operations. But, as we have seen from time to time, market perceptions of value can change quickly.

July proved to be one of those times, as investors appeared to shift focus away from recessionary concerns and toward the prospect of Federal Reserve rate cuts. As a result, small caps broke free from the protracted run of underperformance illustrated in Exhibit 4, and the Russell 2000 outperformed the S&P 500 Index 10.2% to 1.2%.[14] While potentially only a mini-burst within a long slog of relative weakness, this 9,000 basis point bump in relative performance is a good reminder of how decisively markets can respond once investor perceptions—for whatever reason—finally shift. Surges of this magnitude sometimes reflect nothing more than short covering or even a cessation in selling. In the final analysis, though, consistent buying interest among market participants perceiving the same bargain pricing we do is needed for opportunities to be fully realized.

14. Source: FactSet; data as of July 31, 2024.

Exhibit 4. Small Caps Have Lagged Large Caps Considerably for the Past 10 Years
Trailing Returns, January 2014 through July 2024



Source: Bloomberg: data as of July 31, 2024
Past performance does not guarantee future results.

Higher interest rates arguably have restrained durable outperformance for small caps.

Higher interest rates arguably have restrained durable outperformance for small caps. And yes, small caps—which tend to have higher debt levels and greater exposure to floating-rate debt—are more vulnerable to higher rates than large cap companies. But lower interest rates may be less of a linchpin than generally perceived. In our experience, investors will look beyond interest-rate levels so long as a company grows its earnings. But earnings growth is key. And, quite simply, small caps—at least at the index level—have not grown earnings as quickly overall as large caps. This slower aggregate growth reflects, at least partially, the proliferation of companies within the Russell 2000 that aren't currently and perhaps never will be profitable; non-earners comprised more than 40% of the index at the end of the second quarter.[15]

On the other hand, we think that small cap "pick and shovel" suppliers to the artificial intelligence behemoths of tomorrow appear poised to deliver compelling earnings growth, just as small cap providers to future internet giants like Google, Amazon and Facebook/Meta did in the early 2000s. Following the dot-com implosion that troughed in 2002, small companies with robust end markets grew rapidly and performed well; abundant capital fueled vigorous initial public offering (IPO) activity, and small caps outperformed large by more than 7,000 basis points over the next ten years.[16]

M&A can also aid in price discovery. Distorted valuations historically have been arbitraged away by M&A activity by sophisticated market participants like private equity sponsors and strategic buyers. Strategic buyers, in particular, tend to target companies that have rationalized their cost structures, survived difficult times and may be well positioned for the future, with sound business models and responsible balance sheets. Strategic buyers often pay attractive premiums for these companies, beyond which they expect to generate additional solid returns.

Perhaps validating the conclusions of our own wide-ranging proprietary research, we have observed an uptick in takeout activity within the small cap universe during 2024, and we are hopeful that persistent interest from sophisticated buyers may call greater attention to the latent value we see in this market. In the meantime, we

15. Source: FactSet, data as of July 31, 2024.
16. Source: FactSet; data as of July 31, 2024.

remain focused on what we as investors can control: namely, the stocks we invest in and the price we pay for them.

John Miller

Head and Chief Investment Officer of High Yield Municipal Credit Team

In a volatile interest rate environment not terribly supportive of fixed-rate assets, municipal bonds in general comported themselves well year to date while high yield munis have surged thanks to higher base rates and spread tightening.

> New issuance volume in 2024 reflect a return to pre-rate-tightening trends rather a secular break higher.

While fundamentals usually win out over time, performance of the muni bond market can be highly technical in the short run. Demand trends thus far in 2024 have been supportive, with muni fund inflows solidly positive year to date after two years of heavy outflows.[17] On the supply side, relative stability in interest rates was enough to encourage issuers to bring new bonds to the market, and 2024 has gotten off to a robust start after two years of declining net supply.[18] Note that these volumes, while strong, reflect a return to trends in place before the Fed began tightening its policy rate rather than a secular break higher.

That said, we think this issuance trend has the potential to persist. This is especially true if interest rates remain contained; the volatile rate environment that characterized most of 2022 and 2023 was among the disincentives to municipal issuance, along with well-stocked local coffers following years of federal-level support and a post-pandemic tax-revenue windfall. The supply/demand imbalance has helped support muni bond prices in recent years, but we think there is sufficient pent-up demand to absorb any uptick in issuance—particularly with both absolute and tax-equivalent yields at such high levels, as shown in Exhibit 5. Moreover, falling interest rates could inspire greater inflows into munis as the yields on cash-equivalent investments lose their appeal.

Exhibit 5. Muni Yields Are Near Levels Not Seen in Many Years

Bloomberg US Municipal Bond Index Yield to Worst, January 2023 through July 2024

Source: Bloomberg; data as of July 31, 2024.

17. Source: Investment Company Institute; data as of July 31, 2024.
18. Source: JPMorgan; data as of July 2, 2024.

Fundamentally, the municipal market remains robust. Unlike the US federal government, the fiscal positions of state and local governments are strong overall. Total financial assets for state and local governments ended 2023 at an all-time nominal high, and expenditures, while above trend, have begun to moderate.[19] Municipal bond defaults are far less common than defaults by corporate issuers—muni issuers have multiple levers that can be pulled to help service their debt, including tax increases, spending cuts and drawing on reserves—and current fiscal dynamics should support historically low default rates as well as high recovery rates in the event of default. Most of the defaults we have seen this year have been idiosyncratic in nature.

We believe current conditions in the municipal bond market—marked by elevated yields, favorable technicals and healthy fundamentals—support putting money to work in fixed-rate, tax-exempt bonds.[20] Longer-dated issues may be particularly attractive at the moment, offering the opportunity to lock in yields not seen in many years, especially as potential federal funds rate cuts loom.

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While we are constructive on the municipal market as a whole, we believe there are a number of unloved, overlooked or contrarian sectors in which fundamental, research-driven managers can uncover particularly attractive investment opportunities. With about $4 trillion distributed across more than one million distinct municipal bonds and 50,000 issuers, the municipal bond market is large but highly fragmented, which historically has resulted in pricing inefficiencies and opportunities for skilled active investors to add value in certain corners of the market.[21] Currently, we believe this may include healthcare, where issuers continue to rebound from the dislocations of Covid-19 at differing paces; charter schools, where opportunities are emerging as federal funding winds down; and unrated bonds in general, which offer attractive yield premia for greater complexity and information risk.

19. Source: Federal Reserve; data as of December 31, 2023.
20. Source: CME Group; data as of March 20, 2024.
21. Source: Securities Industry and Financial Markets Association; data as of March 30, 2023.

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Past performance is not indicative of future results.

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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.

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.

There are risks associated with investing in securities of foreign countries, such as erratic market conditions, economic and political instability and fluctuations in currency exchange rates. These risks may be more pronounced with respect to investments in emerging markets.

Municipal bonds are subject to credit risk, interest rate risk, liquidity risk, and call risk. However, the obligations of some municipal issuers may not be enforceable through the exercise of traditional creditors' rights. The reorganization under federal bankruptcy laws of a municipal bond issuer may result in the bonds being cancelled without payment or repaid only in part, or in delays in collecting principal and interest.

The value and liquidity of portfolio holdings may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the United States or abroad. During periods of market volatility, the value of individual securities and other investments at times may decline significantly and rapidly. The securities of small and micro-size companies can be more volatile in price than those of larger companies and may be more difficult or expensive to trade.

The information is not intended to provide and should not be relied on for accounting or tax advice. Any tax information presented is not intended to constitute an analysis of all tax considerations.

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

Alternative investments can be speculative and are not suitable for all investors. Investing in alternative investments is only intended for experienced and sophisticated investors who are willing and able to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks include:

- Loss of all or a substantial portion of the investment;
- Lack of liquidity in that there may be no secondary market or interest in the strategy and none is expected to develop;
- Volatility of returns;
- Interest rate risk;
- Restrictions on transferring interests in a private investment strategy;
- Potential lack of diversification and resulting higher risk due to concentration within one of more sectors, industries, countries or regions;
- Absence of information regarding valuations and pricing;
- Complex tax structures and delays in tax reporting;
- Less regulation and higher fees than mutual funds;
- Use of leverage, which magnifies the potential for gain or loss on amounts invested and is generally considered a speculative investment technique and increases the risks associated with investing in the strategy;
- Carried interest, which may cause the strategy to make more speculative, higher risk investments than would be the case in absence of such arrangements; and
- Below-investment-grade loans, which may default and adversely affect returns.

B credit rating is highly speculative with a material default risk. This is the grade by S&P and Fitch while the respective grade by Moody's scale is B2.

BB credit rating is speculative with an elevated default risk. This is the grade by S&P and Fitch while the respective grade by Moody's scale is Ba2.

Broadly syndicated loans (BSLs) are loans extended by a group of financial institutions (a loan syndicate) to a single borrower. Syndicates often include both banks and nonbank financial institutions, such as collateralized loan obligation structures, insurance companies, pension funds or mutual funds.

Collateralized loan obligations (CLOs) are financial instruments collateralized by a pool of corporate loans.

Credit ratings as represented here are assessments provided by nationally recognized statistical rating organizations (NRSRO) of credit worthiness of an issuer with respect to debt obligations, including specific securities, money market instruments or other bonds. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice. Not Rated (NR) indicates that the debtor was not rated and should not be interpreted as indicating low quality.

Direct lending occurs when non-bank lenders make loans to companies without intermediaries such as an investment bank, broker or private equity firm.

The **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.

A **floating interest rate** is an interest rate that adjusts according to a predetermined formula; it is usually linked to an interest rate index.

A **leveraged loan** is a type of loan that is extended to companies or individuals that already have considerable amounts of debt or poor credit history.

The **personal consumption expenditures (PCE) price index** measures changes in the prices of goods and services purchased by consumers in the US. Core PCE excludes food and energy.

Private credit is debt is issued by a non-bank lender that is not publicly traded.

Subprime refers to borrowers with a poor credit history or none at all. Subprime loans carry higher interest rates to make up for the greater risk that subprime borrowers are assumed to pose.

Yield to worst is a measure of the lowest possible yield that can be received on a bond that operates within the terms of its contract without defaulting.

Bloomberg US Municipal Bond Index (Gross/Total) measures the performance of the US municipal tax-exempt investment grade bond market. It includes general obligation and revenue bonds, which can be pre-refunded years later and get reclassified as such. A total-return index tracks price changes and reinvestment of distribution income.

Russell 2000® Index (Gross/Total) measures the performance of the small cap segment of the US equity universe. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. A total-return index tracks price changes and reinvestment of distribution income.

S&P 500 Index (Gross/Total) 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. The S&P 500 Index includes dividends reinvested. A total-return index tracks price changes and reinvestment of distribution income.

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

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