FIRST EAGLE INVESTMENT MANAGEMENT

Amundi ASSET MANAGEMENT

Insights | July 2019

Exercising Prudence in a Mature Business Cycle

As the calendar turned to July, the US entered the longest economic expansion in its history.[1] While we won't attempt to predict the long-lived cycle's eventual end date, certain market and economic dynamics—corporate profit margins among them—suggest that the best part of the current expansion is already behind us. That said, cycles don't die merely of old age; typically, some sort of shock or unsustainable financial imbalance is needed to trigger their demise. Currently, we see a number of risk factors that could serve as this trigger.

While economic transitions historically have been accompanied by increased market volatility, the waning days of a business cycle should not be cause for panic. We believe investments able to demonstrate resilience in the face of cyclical adversity—notably, companies that exhibit scarcity in their business models and thus have the potential for persistent earnings power through an economic downturn—should be well positioned for the more challenging environment that may lie ahead. Further, the reemergence of more normal levels of volatility could provide active, long-term investors with opportunities to build on or acquire positions in such investments at attractive valuations.

1. Source: National Bureau of Economic Research.

Key Takeaways

- Though the current business cycle—the longest in US history—is showing signs of age, the potential timing of and impetus for its end remain uncertain.
- Global trade wars, mounting challenges in China, multiple geopolitical flash points and excessive leverage in the US corporate sector are all potential triggers for the next downturn. However, we are humble in recognizing that we cannot predict the cause of the next recession.
- Monetary policy tools previously thought to be exceptional crisis-response measures now appear to be part of central banks' standard toolkit. Concerns remain that central banks have limited policy ammunition to prevent—and/or respond to—the next recession.
- Global sovereign debt has reached peaks not seen since the two world wars, raising questions about the fiscal space available to policymakers. With persistently low interest rates suppressing borrowing costs, however, some governments could use fiscal policy more actively.
- At First Eagle, our conviction that the future is uncertain leads us to build what we consider resilience in our portfolios from the bottom up, in part by investing in companies and assets that demonstrate scarcity and are thus well suited to help protect against the permanent impairment of capital.

Views expressed are as of July 2019.

Emerging Signs of a Mature Cycle

The US economy entered the record 121st month of its post-global financial crisis expansion in July.[2] While expansions of this duration and longer have not been uncommon in other countries, the cycle's advanced age naturally calls into question its time remaining.

The expansion's relative weakness may be one reason for its length; with average annual GDP growth of just 2.25%, the current expansion has been the slowest on record.[3] The evolving structure of the US economy may be another factor, as the service sector, which historically has been more stable than agriculture and manufacturing, now accounts for more than 70% of total output.[4] That said, a variety of signals—including weak non-US bank prices, slowing growth in monetary aggregates, flattening yield curves and sluggish inflation expectations—suggest the global economy already has begun to slow, and there are reasons to believe US momentum may fade alongside it.

Corporate profit margins in many ways are the heart of the business cycle; as companies struggle to maintain margins in less supportive operating environments, business capex and hiring often fall victim and ultimately weigh on overall employment, consumer spending and economic growth. Signs that US profit margins may have already hit cyclical peaks, therefore, is a troubling indicator for the future of the current expansion. And conditions suggest that profit margins are likely to remain under pressure; the US unemployment rate stands near 50-year lows[5], implying that business capex and "capacity creep" are broadly positive despite expectations for decelerating nominal economic output and limited money supply growth. In fact, it is possible that we may be entering a world in which natural disinflationary forces meet normal corporate capacity expansion to pressure margins and earnings without the usual inflationary impulse or the policy tightening in response to it. While this may be unfamiliar territory for US investors—only one US recession since World War II was not preceded by a runup in inflation[6]—Japan over the past 25 years has provided a several examples of how such economic disruption may come to pass.

The Treasury bond market also appears to be flashing concerns about the US economy's prospects going forward, as the yield curve—as represented by the difference between the yields of 10-year and three-month Treasuries—has been consistently inverted since late May.[7] Risk markets remain complacent, however, with equity indexes high, credit spreads tight and volatility low.

Potential Triggers for the Cycle's End

A business cycle's tipping point often is triggered by the emergence of one or more destabilizing factors. Some expansions, for example, have ended due to an external supply shock, such as the 1990 oil price spike. In other cases, the downturn came about because of tighter monetary policy, such as the 20% federal funds rate that was adopted in the early 1980s to tame double-digit inflation. More recent recessions were driven by financial imbalances, such as the dot-com bubble in 2000 or the credit/housing-market boom in the mid-2000s.

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Though we won't hazard a guess at the catalyst that will turn the current cycle, a number of candidates already have emerged, including:

- Global trade wars
- Mounting challenges in China
- Geopolitical tensions
- US corporate debt vulnerabilities

2. Source: National Bureau of Economic Research.
3, 4. Source: Bureau of Economic Analysis.
5. Source: Bureau of Labor Statistics.
6. Source: Congressional Research Service.
7. Source: Federal Reserve Bank of St. Louis.

Global Trade Wars

- Since the beginning of 2018 the US has imposed 25% tariffs on $250 billion of Chinese imports along with duties targeting the import of washing machines, solar panels, and steel and aluminum from most other countries.[8] Trading partners retaliated by raising tariffs on imports from the US, and the impact this tit-for-tat already is having on global trade activity can be seen in Exhibit 1.[9]

Exhibit 1
Tariffs Are Weighing on Global Trade

Year-over-Year % Change in World Export Values, through April 30, 2019

Source: Haver Analytics, Bureau for Economic Policy Analysis (Netherlands), First Eagle Investment Management. Data as of July 2019.

The uncertainty that has resulted from tariffs may weigh on global economic growth and productivity for years to come.

- Through its aggressive trade policy the US has raised its effective tariff rate to nearly 5%, a level not seen since the early 1970s when the world economy was much less integrated and open to trade; exports today account for roughly 23% of global GDP compared to just 10% in the 1970s. Additional tariffs threatened by the US—on Mexican imports, global auto and auto parts imports, and the Chinese goods not already subject to levies—would drive the effective tariff rate to nearly 13%, a rate that prevailed in the late 1930s and one that likely would have a devastating impact on the global economy.[10]
- Estimating the economic impact of tariffs is difficult, as the costs will be borne by some combination of producers, importers and end consumers linked by complex supply and distribution chains across multiple countries and companies. In addition, so-called "second-order" effects can be just as powerful if not more consequential. For example, the uncertainty that has resulted from tariffs—both those in effect as well as the potential for future duties—may cause businesses worldwide to restrain investment and consumers to become more cautious with their spending, potentially weighing on global economic growth and productivity for years to come.
- Already fraught trade negotiations with China were further complicated in May, as the US Commerce Department placed Huawei, one of China's leading companies and the world's seventh-largest tech enterprise, on its "entity list" of firms that need special permission to buy components and technologies from US companies, citing Iran sanctions violations. Restricting Huawei's access to American technology not only threatens the company's

8. Source: Reuters.
9. Please see our May 2019 paper "US/China Trade Tensions Escalate" for more detail on this topic.
10. Source: Haver Analytics, World Bank, International Monetary Fund, US International Trade Commission, JP Morgan, Global Financial Data, Federico-Tena World Trade Historical Database, First Eagle Investment Management.

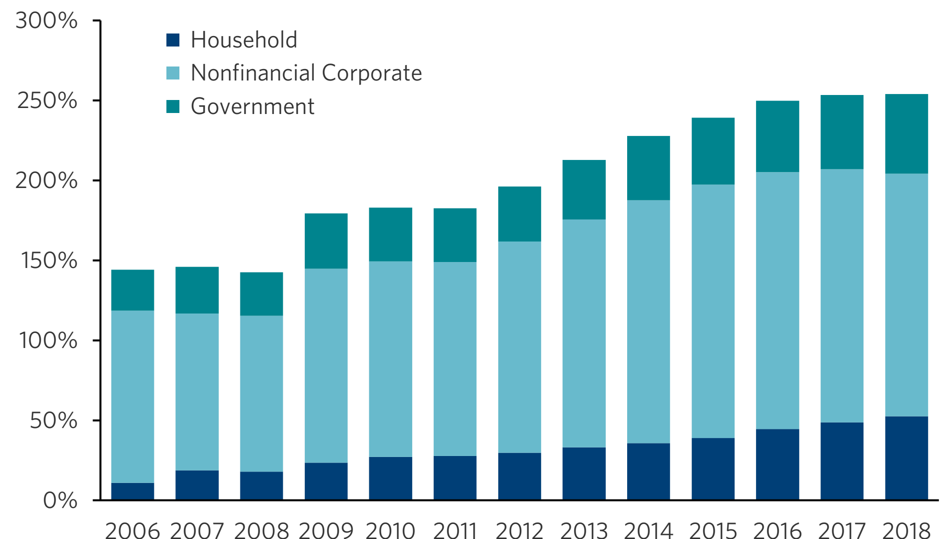
future but also gives credence to views in China that US trade actions are intended to contain China's development rather than solve long-standing trade complaints. In a truce struck at the late-June G20 Summit, the US postponed potential tariffs on additional Chinese goods and appeared to soften its stance against Huawei; subsequent comments from White House officials, however, indicated that dealings with Huawei would continue to be highly scrutinized. While the door to further trade talks between the US and China seems to be open for now, a deal likely is some ways off and an escalation of tensions remains possible.

Mounting Challenges in China

- Headwinds have been building in China as the government wrestles with a massive credit boom, a rapidly aging population and its ongoing transition to an open, market economy. Coping with these challenges, on top of the trade tensions with the US, makes China—and thus the world economy dependent on Chinese growth—vulnerable to a policy misstep.
- The rapid increase in China's private-sector debt has drawn comparisons to the buildup in US debt that ultimately helped instigate the global financial crisis. As illustrated in Exhibit 2, nonfinancial corporate debt has risen to about 150% of GDP, while household debt stands at more than 50% of GDP; in local-currency terms, these represent increases of 416% and 830%, respectively, from end-2007 levels. On the corporate side, a large portion of the new debt has gone to finance real estate, infrastructure and relatively inefficient investments in state-owned enterprises (SOEs). Debt outstanding among Chinese households as a share of GDP—the majority in mortgages but increasingly in credit cards and other personal loans—is now on par with other developed economies such as Germany and near levels in Japan and France.[11]

The rapid increase in China's private-sector debt has drawn comparisons to the buildup in US debt that ultimately helped instigate the global financial crisis.

Exhibit 2
China Has Levered Up Across Its Economy
Debt Stock as a % of GDP



Source: Haver Analytics, Bank for International Settlements, First Eagle Investment Management. Data as of June 2019.

11. Source: Bank for International Settlements.

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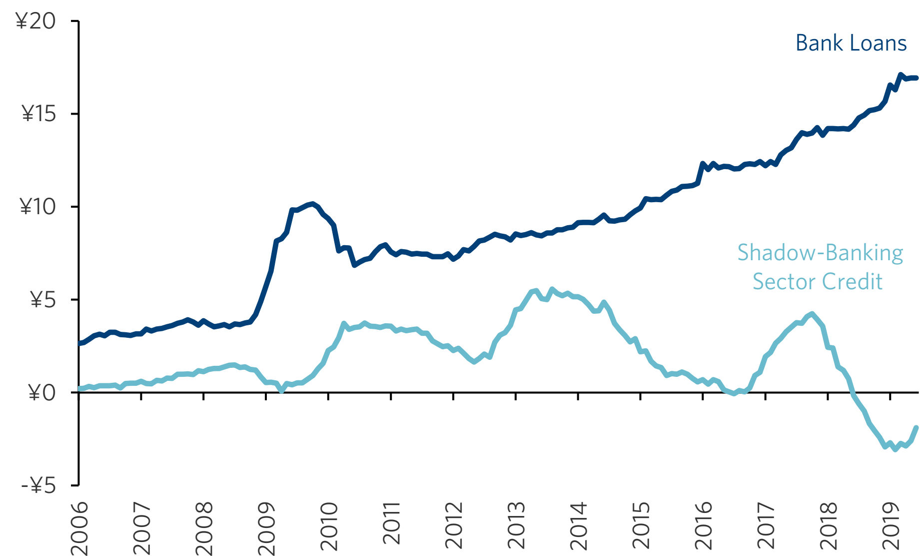
- Recognizing the risks inherent in such a massive credit boom, Chinese policymakers have taken steps to crack down on the worst abuses in the financial system—particularly in the shadow-banking sector (as depicted in Exhibit 3). As China's economy has slowed in 2018 – 19, policymakers are once again encouraging credit creation to stimulate growth. To date, however, financial stability concerns have caused the government to be more restrained in driving credit stimulus compared to its efforts in 2008 – 09 and 2015 – 16; as a result, even if the stimulus is sufficient to put a floor under China's growth, it may not boost the global economy to the extent that it has in the past.

Exhibit 3
Chinese Policymakers Have Curbed the Shadow-Banking Sector

Credit to the Private Sector in Billions of Renminbi on a 12-Month Rolling Basis, through June 30, 2019



Source: Haver Analytics, People's Bank of China, First Eagle Investment Management. Data as of July 2019.

Geopolitical Tensions

- The geopolitical equilibrium has grown more unsteady in recent years, and the escalation of hostilities in any number of areas—from an unpredictable North Korea and increasingly assertive Russia to China's territorial ambitions in the South China Sea and seemingly intractable conflicts in the Middle East—could cause an economic shock. The most notable potential flash point of late has been the persistent ratcheting up of US/Iran tensions, which poses meaningful risk of war even if both sides want to avoid it. Should Iran follow through on its threat to disrupt the flow of crude through the Strait of Hormuz, the likely spike in oil prices could trigger a global recession.
- More broadly, the traditional world order is being upset by the emergence of populist—and sometimes autocratic—politicians and parties across the ideological spectrum, from the Americas (left-wing Andrés Manuel López Obrador in Mexico and right-wing Jair Bolsonaro in Brazil) to southeast Asia (right-wing Rodrigo Duterte in the Philippines) and even Africa (the far-left Economic Freedom Fighters party in South Africa).

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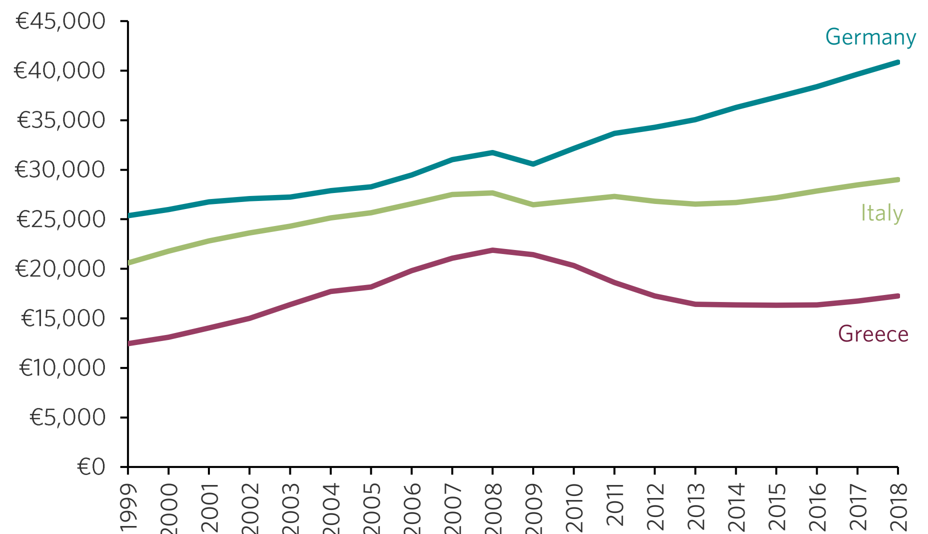
- The changing political winds are being felt keenly in Europe and threatening the future of the single market. The EU's vulnerability to antiestablishment sentiment likely is linked to the persistent income and wealth disparities among EU (and euro area) members. As shown in Exhibit 4, these disparities have only gotten worse since the financial crisis, encouraging an increasing number of voters to abandon traditional political parties for leaders—on both the left and the right—promising radical solutions. While EU Parliament elections in May failed to produce the Continent-wide shift toward Euroskepticism that some had forecast, they did showcase the influence populist parties are having in countries like Italy, Hungary and Poland. Meanwhile, as the October 31 deadline for Brexit approaches with no credible plan currently in place, risks remain that an already-vulnerable UK may be facing a damaging no-deal "crash-out" departure from the EU.[12]

Exhibit 4
Widening Inequality in the EU May Be Fueling Antiestablishment Sentiment

GDP per Capita in Euros, through December 31, 2018



Source: Haver Analytics, International Monetary Fund, First Eagle Investment Management. Data as of June 2019.

US Corporate Debt Vulnerabilities

Companies across the ratings ladder loaded up on debt to take advantage of very low interest rates and of investors reaching for yield.

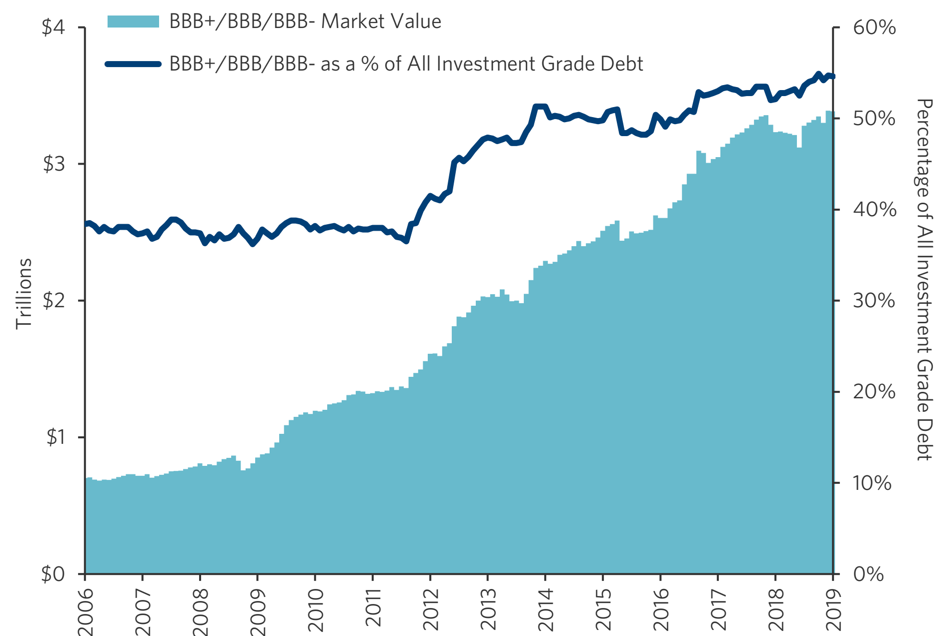
- The US corporate sector has levered up significantly in recent years, as companies across the ratings ladder loaded up on debt to take advantage of very low interest rates and of investors reaching for yield further down the quality spectrum and in less liquid securities. The Federal Reserve reports that total outstanding debt of US nonfinancial companies—primarily in the form of investment grade and high yield bonds and non-investment grade broadly syndicated loans—approached 75% of GDP at the end of 2018, a record high, with issuance increasingly concentrated among riskier borrowers.[13] This boom was accompanied by deteriorating underwriting standards, resulting in a corporate debt market characterized by lower credit quality, higher leverage and weaker investor protections even as spreads remain tight.

12. Please see our April 2019 paper "Brexit Update: Breaking Up Is Hard to Do" for more information.
13. "Financial Stability Report," May 2019, Federal Reserve Board.

- Perhaps most worrying has been the extraordinary increase in BBB rated bond issuance—the lowest tier within the investment grade universe. Typically comprising 30 – 40% of the US investment grade market, BBB rated bonds now account for more than half, as shown in Exhibit 5. Many BBB issuers used the proceeds of their bonds to finance activities like stock buybacks or mergers and acquisitions, resulting in higher leverage ratios. It's worth noting that excessive issuance in a particular asset class or sector during the expansion phase of a credit cycle typically serves as the focal point of the market's eventual repricing once that cycle turns, though this usually isn't widely recognized until after the fact; housing-related structured credit during the financial crisis is a good recent example.

Exhibit 5
More than Half of the Investment Grade Market Is Now Rated BBB

Through December 31, 2018



Source: S&P Global. Data as of January 2019.

- As the economic backdrop weakens and begins to challenge corporate cash flows, the equity cushion for many of these highly leveraged BBB issuers will erode, leading to broad spread widening as investors reprice credit risk across the ratings spectrum. It also could motivate ratings agencies to strip certain issues of their investment grade status, and the high yield market may have difficulty absorbing all of these fallen angels given the volume involved and the tenor/duration typical of investment grade debt. While banks and brokerage houses typically have acted as shock absorbers during such periods of market dislocation, post-crisis regulatory capital requirements now limit their ability to do so. Ultimately, a credit crunch may ensue as lenders begin to limit financing to all but the largest and best-known borrowers, further weighing on already-slowing economic activity.

A credit rating, as represented here, is an assessment provided by a nationally recognized statistical rating organization (NRSRO) on the creditworthiness 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. For more information on the Standard & Poor's rating methodology, please visit standardandpoors.com and select "Understanding Ratings" under Rating Resources.

Policy Flexibility Appears Limited

To respond to the global financial crisis and the subsequent slow economic recovery, policymakers worldwide employed substantial—and sometimes novel—monetary and fiscal stimulus measures. With many of these policies or their financial impacts still largely in place, the extent to which policymakers will be able to deploy additional stimulus to prolong the current expansion and respond to the next recession remains to be seen.

Also remaining to be seen is the impact any such stimulus would have on investors' faith in fiat money. Debt is a promissory asset; too much of it, by definition, erodes the value of that promise. In a world awash with debt, continued accommodative policy—particularly any potential policy measures that are even more aggressive and less conventional than those introduced post-crisis—ultimately may lead investors to lose confidence in paper money as a store of value, which would have widespread implications for financial markets.

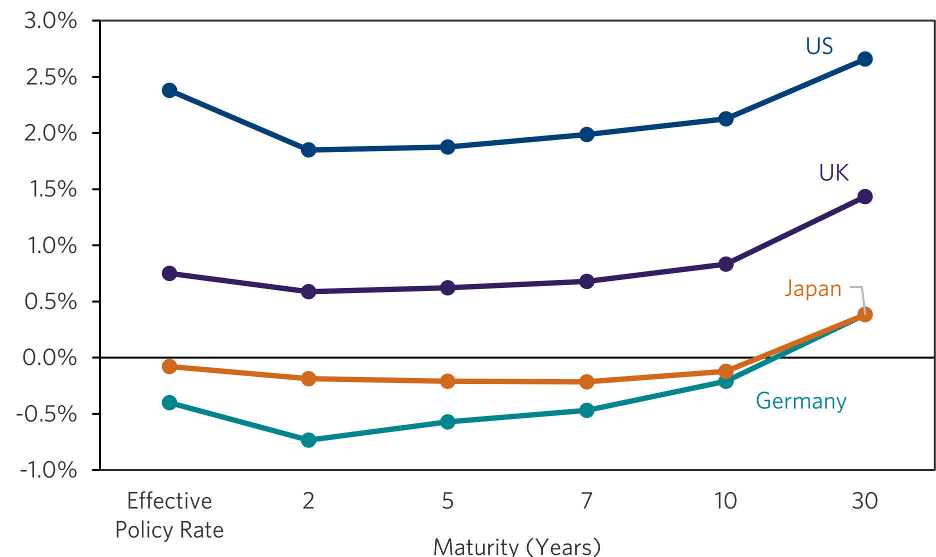
Potential monetary and fiscal stimulus measures may be constrained by the lingering impacts of post-crisis policy.

Monetary Policy

- Central banks in advanced economies could find their ability to respond to the next economic downturn constrained relative to previous recessions. As a result, we expect central banks in general will continue to employ complex and relatively untested policies to achieve their employment and inflation objectives, with the potential for unintended consequences.
- Interest rates across the yield curve remain low in the US and near zero elsewhere (see Exhibit 6). In battling the seven recessions that have occurred since 1960 the Fed cut its short-term policy rate by an average of five percentage points,[14] a degree of flexibility not currently available with a federal funds rate target of 2.25 – 2.50%[15] at the time of writing.

Exhibit 6
Interest Rates Remain Low Across the Curve Worldwide

Government Debt Yield Curves, as of July 13, 2019



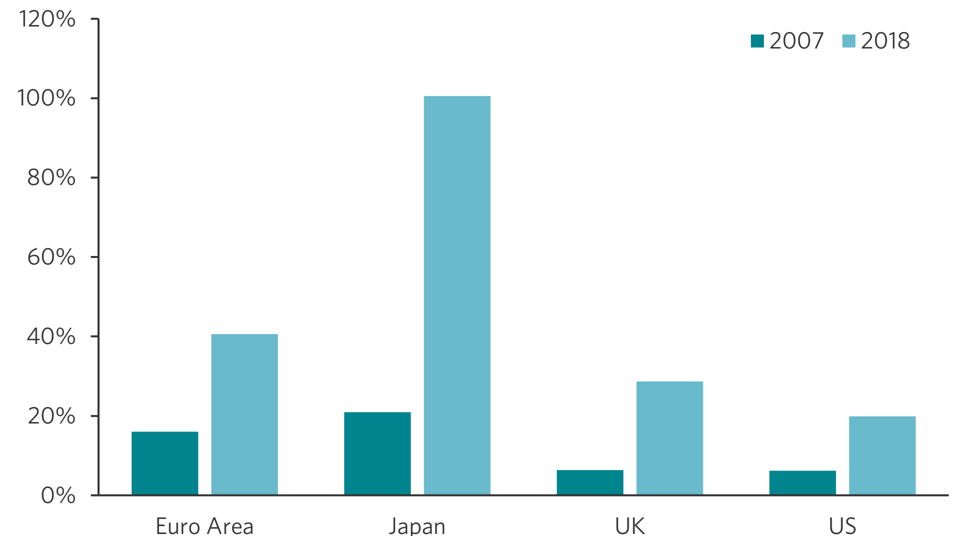
Source: Bloomberg, First Eagle Investment Management.

14. "Rethinking the Fed's 2 Percent Inflation Target," June 2018, Hutchins Center on Fiscal & Monetary Policy at Brookings.
15. Source: Federal Reserve Board.

- With near-zero policy rates proving insufficient to boost the economy in the wake of the global financial crisis, central banks turned to "unconventional" strategies, the most important of which was quantitative easing (QE)—namely, central bank purchases of financial assets from the private sector to reduce sovereign long-term interest rates to encourage investment in riskier assets. As a result of its QE efforts, the Fed's balance sheet currently stands at 20% of GDP, four times larger than before the crisis.[16] The balance sheets of other major central banks have grown much larger than that, however, suggesting the Fed may still have the capacity to purchase additional assets to combat the next recession. Still, with long-term risk-free interest rates already so low, the ability of additional QE to reduce them further is limited. Major central banks outside the US have employed other unconventional stimulus tools—including negative policy rates, facilities to encourage bank lending and, in Japan, yield-curve control[17]—and we would expect central banks to engage these and other new innovations in response to the next recession.

Exhibit 7
Central Bank Balance Sheets Have Ballooned

Central Bank Assets as a Percentage of GDP



Source: Haver Analytics, national authorities, First Eagle Investment Management. Data as of June 2019.

- Concerns that central banks could be running out of policy ammunition could account for recent declines in inflation expectations and the compensation required for taking on inflation risk.[18] Comments by Fed Chairman Powell[19] and European Central Bank President Draghi[20] in early June pushed back on the narrative that central banks have limited policy space, sparking a global decline in interest rates across the yield curve and boosting prices for risk assets. Should one of the triggers discussed above materialize, however, this easing of financial conditions likely won't be enough to sustain the current expansion.

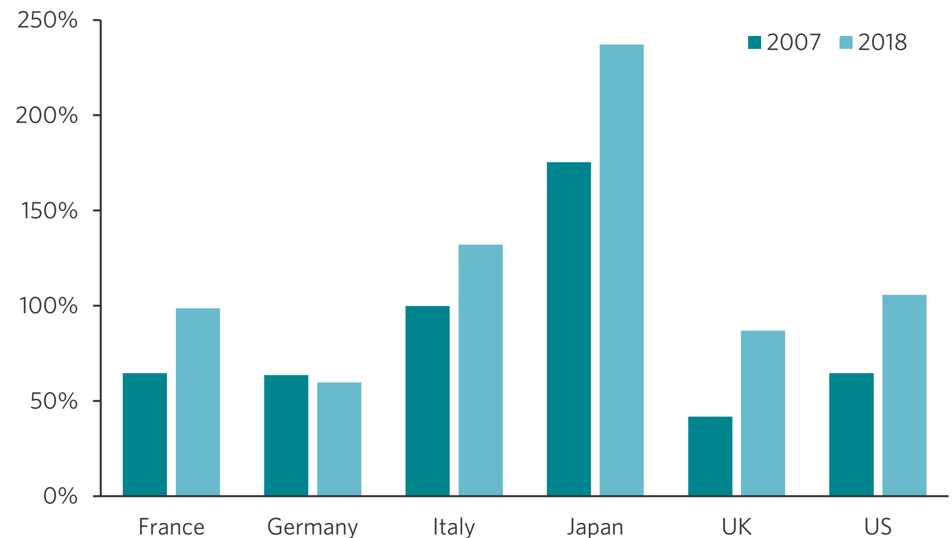
16. Source: Federal Reserve Board.
17. Yield-curve control entailed the Bank of Japan adopting a target interest rate of around 0% for 10-year Japanese government bonds in addition to its negative short-term policy rate.
18. Inflation compensation is typically measured by the five-year, five-year forward inflation swap rate or the difference between nominal bond yields and inflation-linked bonds of comparable maturity.
19. "FOMC Press Conference," June 2019, Jerome Powell.
20. "Twenty Years of the ECB's Monetary Policy," June 2019, Mario Draghi.

Fiscal Policy

- While central banks contend with still-low policy rates and large balance sheets, the availability of additional fiscal stimulus could be constrained by the post-crisis buildup in sovereign debt across advanced economies. Given very low interest rates on this debt, however, governments could have more flexibility than previously assumed.
- As shown in Exhibit 8, sovereign debt as a share of GDP in many advanced economies has expanded since the financial crisis thanks to accommodative fiscal policies, government support to the financial sector and other private companies and reduced recessionary tax receipts. Moreover, aging populations in these economies are likely to pressure health care and pension spending needs in the years ahead, adding to government debt burdens.

Exhibit 8
Government Debt Stocks Have Increased Substantially

Gross General Government Debt as a Percentage of GDP



Source: Haver Analytics, International Monetary Fund, First Eagle Investment Management. Data as of June 2019. Note: Gross general government debt includes debt of the central, state and local governments and does not subtract out government assets.

- In the US, federal government debt held by the public increased to 78% of GDP from 35% of GDP over 2007 – 18.[21] Meanwhile, despite the record-long expansion and unemployment rates at 50-year lows, the US federal fiscal deficit remains cyclically large at 3.9% of GDP in FY2018[22] due to the large tax cuts and increased spending enacted in 2017. As growth and tax collections slow in the next downturn and spending picks up with automatic stabilizers, the fiscal deficit as a share of GDP will increase absent policy adjustments, driving the federal debt still higher. The Congressional Budget Office forecasts that US federal debt held by the public will reach 92% of GDP by 2029 and could be as high as 105% of GDP if individual income tax cuts do not expire in 2025 and discretionary government spending is not cut in 2020 as scheduled under current laws.[23]
- Some governments may have the flexibility to pursue more expansionary fiscal policies to confront the next recession, as low interest rates have kept debt-servicing costs in check despite high debt stocks. In Japan, for instance, government interest payments on debt totaled 0.3% of GDP in 2018, down from 0.5% in 2007, even as the debt rose to 237% of GDP from 175% of GDP over the same period.[24] Nonetheless, the experiences of Greece and Italy have highlighted that even advanced economies have fiscal limits, though determining those limits ex ante could be difficult.

21. Source: Congressional Budget Office. Note that this does not include debts of state and local governments and intragovernmental debt holdings.
22, 23. "Updated Budget Projections: 2019 to 2029," Congressional Budget Office.
24. Source: International Monetary Fund. Note that at around 1.5% of GDP, US government debt-servicing costs are roughly unchanged from precrisis levels, as the larger debt stock has been offset by lower interest rates.

Ready for the Turn, Whenever It Happens

As the business cycle draws closer to its end point, investors likely will grow more sensitive to the impact of systemic risk on their portfolios, resulting in greater volatility in financial markets. A weaker economic backdrop also suggests that equity index returns may be less robust than they were in the decade-plus since the global financial crisis. A more complicated investment environment shouldn't be cause for alarm, however, and glimmers of the cycle's end on the horizon offer time to thoughtfully prepare for the transition.

The potential return of a market in which companies are differentiated by fundamentals like the quality of business models and the sustainability of cash flows may come as a bit of a shock to investors grown accustomed to US equities that are biased higher by default. While market volatility may be difficult for some to endure, the resurgence of normal equity market dynamics may provide long-term, active investors with opportunities to differentiate stronger stocks from weaker ones and potentially acquire them at a price offering what we believe to be a "margin of safety."[25]

At First Eagle, our conviction that the future is uncertain leads us to seek resilience in our portfolios from the bottom up.

At First Eagle, our conviction that the future is uncertain leads us to seek resilience in our portfolios from the bottom up. We look for companies that exhibit scarcity in their business models and thus have the potential for persistent earnings power. Scarcity, in our view, is at the root of resilience, and companies in possession of a scarce asset—a tangible or intangible that provides them with an operational advantage and is highly difficult to replicate—historically has been less vulnerable to crises and more likely to preserve their earnings power over time.

Our ability to capitalize on higher levels of volatility is supported by our holdings in cash and cash equivalents. Varying over time, our cash position enables us to maintain consistent investment standards as market dynamics shift. Meanwhile, gold—scarce and stable in supply—serves as a valuable potential hedge in our portfolios. Historically, the opportunity cost of holding gold is the real interest rate one could earn on "risk-free" sovereign debt, a low hurdle given real sovereign yields that are now near zero or negative and likely to decline further in the next recession. Together, the resiliency these assets provide has helped us mitigate the impact of market downturns, protecting investors against the permanent impairment of capital, encouraging them to remain in the market and positioning them to potentially participate in the next upturn.

We know that we are unable to predict the future—including the date of the next economic downturn. However, we also know that cyclicality has been a perennial feature of economies and securities markets, which have generally trended upward over time with intervening periods of instability. As active investment managers with a long-term perspective, we seek to take advantage of the entirety of these cycles on behalf of our clients.

25. The First Eagle Global Value Team defines "margin of safety" as the difference between a company's purchase price and our estimate of its intrinsic value.

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