FIRST EAGLE
INVESTMENT MANAGEMENT

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.

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 government borrowing costs, however, some governments could use fiscal policy more actively to support their economy and respond to the next recession.

Views expressed are as of July 2019.

1. Source: National Bureau of Economic Research.

Potential Triggers for the Cycle's End

The US economy entered the record 121st month of its post-global financial crisis expansion in July,[2] and the cycle's advanced age naturally calls into question its time remaining.

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. For example, profit margins—the heart of the business cycle—may have already hit cyclical peaks, and ongoing capacity expansion in conjunction with expectations for decelerating nominal economic output and limited money supply growth suggest they will remain under pressure. And while risk markets appear complacent, the inverted Treasury yield curve[3] suggests traders of government debt have concerns about the US economy's prospects going forward.

That said, a business cycle's tipping point often is triggered by the emergence of one or more destabilizing factors. 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

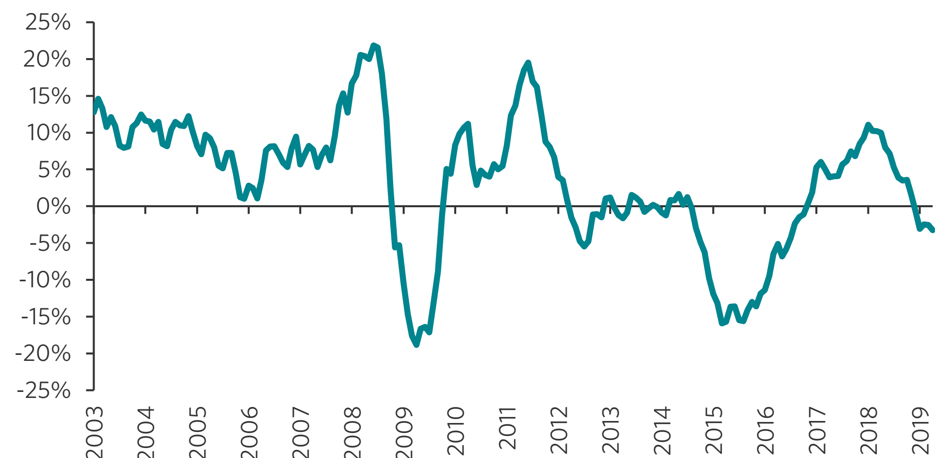
Global Trade Wars

- 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.[4] These trading partners retaliated by raising tariffs on imports from the US, and the initial impact of this tit-for-tat can be seen in Exhibit 1.[5] Additional tariffs threatened by the US would drive the effective tariff rate to levels that prevailed in the late 1930s and likely have a devastating impact on the global economy.[6]

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

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.

2. Source: National Bureau of Economic Research.
3. Source: Federal Reserve Bank of St. Louis.
4. Source: Reuters.
5. Please see our May 2019 paper "US/China Trade Tensions Escalate" for more detail on this topic.
6. Source: Haver Analytics, World Bank, International Monetary Fund, US International Trade Commission, JP Morgan, Global Financial Data, Federico-Tena World Trade Historical Trade, First Eagle Investment Management.

- Estimating the broad economic impact of tariffs is difficult, as the costs will be borne by some combination of producers, importers and end consumers. In addition, so-called "second-order" effects—including tariff-related uncertainty that may stifle business investment and consumer spending and weigh on global economic growth and productivity for years to come—can be just as powerful if not more consequential over the long term.

Mounting Challenges in China

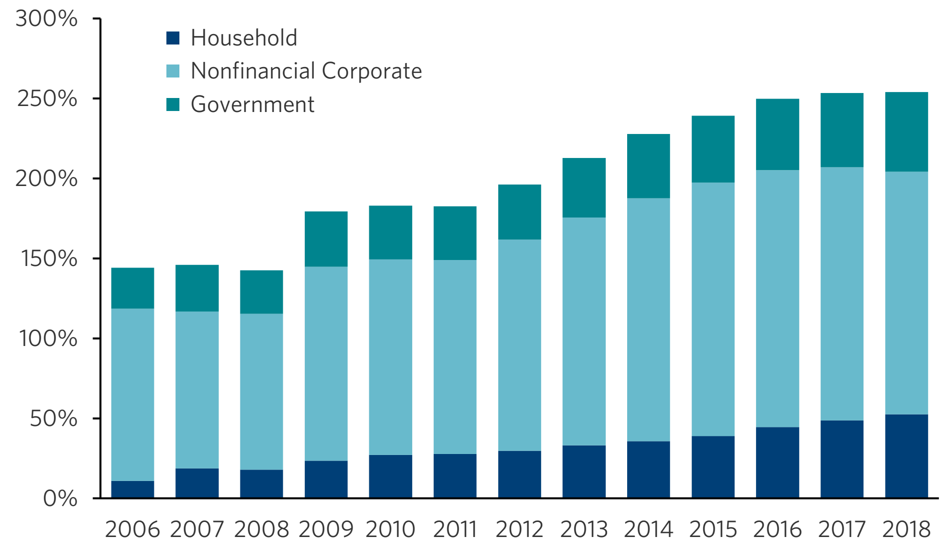
- Headwinds have been building in China as the government wrestles with a massive credit boom, a rapidly aging population and its ongoing transition to an open, market economy. Coping with these challenges, on top of the trade tensions with the US, makes China—and thus the world economy dependent on 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.

- The rapid increase in China's private sector debt since the financial crisis, as illustrated in Exhibit 2, has drawn comparisons to the buildup in US debt that ultimately helped instigate the global financial crisis. Nonfinancial corporate debt has risen to about 150% of GDP, and Chinese household debt as a share of GDP is now on par with other developed economies such as Germany and near levels in Japan and France.[7]

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.

- Recognizing the risks inherent in such a massive credit boom, China has taken steps to crack down on the worst abuses in the financial system—particularly in the shadow-banking sector. Though the encouragement of credit creation has resumed of late, financial stability concerns have prompted restraint from policymakers, suggesting Chinese stimulus may not boost the global economy to the extent that it has in the past.

7. Source: Bank for International Settlements.

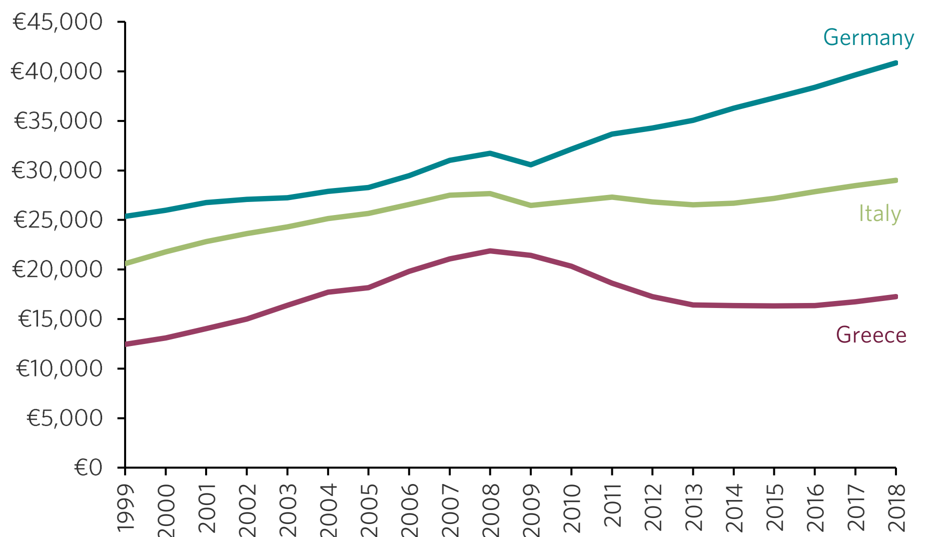
The traditional world order is being upset by the emergence of populist—and sometimes autocratic—politicians and parties across the ideological spectrum.

Geopolitical Tensions

- The geopolitical equilibrium has grown more unsteady in recent years, and the escalation of hostilities in any number of areas could cause an economic shock. Perhaps most notable of late has been the persistent ratcheting up of US-Iran tensions; a threatened Iranian disruption of the flow of crude through the strait of Hormuz would likely result in oil price spike—and potentially 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. In Europe—which is particularly vulnerable to antiestablishment sentiment given the persistent and worsening income and wealth disparities among EU (and euro area) members, as shown in Exhibit 3—these changing political winds are threatening the future of the European single market.[8]

Exhibit 3
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.

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

US Corporate Debt Vulnerabilities

- 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. The Fed 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.[9]
- 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 4. Many BBB issuers used the proceeds of their bonds to finance activities like stock buybacks or mergers and acquisitions, resulting in higher leverage ratios.

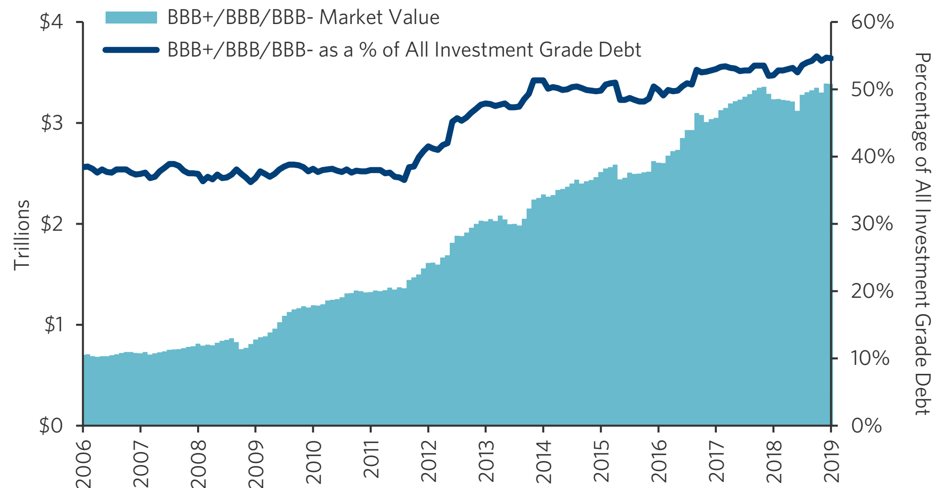
8. Please see our April 2019 paper "Brexit Update: Breaking Up Is Hard to Do" for more information.
9. "Financial Stability Report," May 2019, Board of Governors of the Federal Reserve System.

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.

Exhibit 4

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 and perhaps significant ratings downgrades and a large volume of "fallen angels" into the high yield market. With post-crisis regulatory capital requirements limiting the ability of banks and brokerages to provide liquidity in the event of a market dislocation, a potential credit crunch may further weigh on already-slowing economic activity.

Policy Flexibility Appears Limited

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

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—particularly potential policy measures that are even more aggressive and less conventional than those introduced post-crisis—may have on investors' faith in fiat money.

Monetary Policy

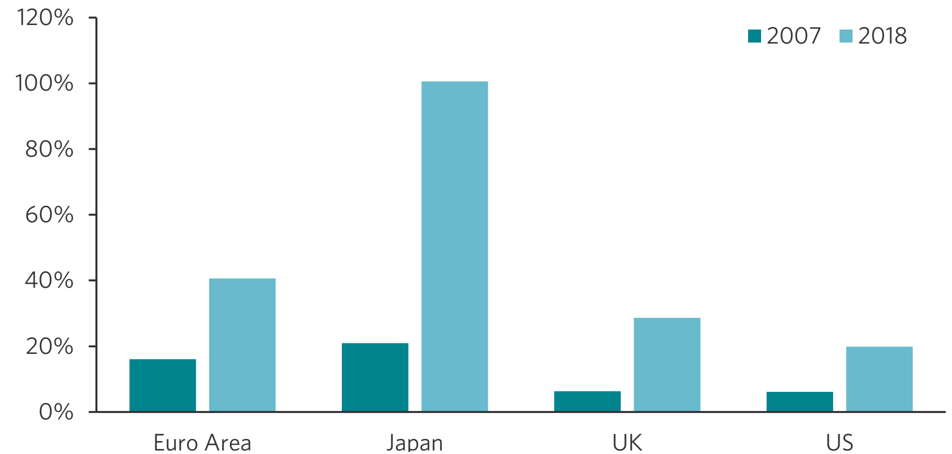
- With interest rates low and balance sheets stretched, central banks in advanced economies could find their ability to respond to the next economic downturn constrained relative to previous recessions. As a result, we expect central banks in general will continue to employ complex and relatively untested 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. In battling the seven recessions that have occurred since 1960 [10] the Federal Reserve cut its short-term policy rate by an average of five percentage points, a degree of policy rate flexibility not currently available with the current federal funds rate target at 2.25 – 2.50%[11] at the time of writing.

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

- While the Fed's balance sheet currently stands at 20% of GDP, four times larger than before the crisis, as a result of its quantitative easing (QE) efforts, the balance sheets of other major central banks have grown even larger.[12] Though the Fed may still have the capacity to purchase additional assets to combat the next recession, the ability of additional QE to substantially reduce long-term risk-free interest rates appears limited.

Exhibit 5
Central Bank Balance Sheets Have Ballooned

Central Bank Assets as a Percentage of GDP



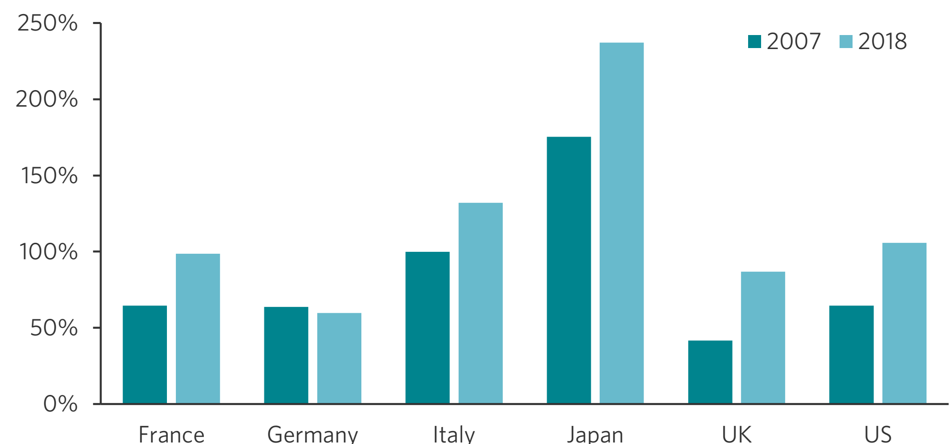
Source: Haver Analytics, national authorities, First Eagle Investment Management. Data as of June 2019.

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, as shown in Exhibit 6. In the US, federal government debt held by the public increased to 78% of GDP from 35% of GDP over 2007 – 18.[13] Due to the large tax cuts and increased spending enacted in 2017, the US federal fiscal deficit remains cyclically large at 3.9% of GDP in FY2018 and absent policy adjustments will increase in the next economic downturn, driving federal debt still higher.[14]

Exhibit 6
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.

12. Source: Federal Reserve Board.
13. Source: Congressional Budget Office. Note that this does not include debts of state and local governments and intragovernmental debt holdings.
14. "Updated Budget Projections: 2019 to 2029," Congressional Budget Office.

- Some governments—such as Japan—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. 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.

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 are likely to 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.

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. Scarcity, in our view, is at the root of resilience, and we look for companies in possession of a scarce asset—a tangible or intangible that provides them with an operational advantage and is highly difficult to replicate—which historically have been less vulnerable to crises and more likely to preserve their earnings power over time. Our ability to maintain consistent investment standards as market dynamics shift is supported by our holdings in cash and cash equivalents, while gold—scarce and stable in supply—serves as a valuable potential hedge in our portfolios.

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.

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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.

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.

The 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.

All investments involve the risk of loss of principal.

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