Brexit Update: Breaking Up Is Hard to Do

In June 2016 citizens of the United Kingdom voted to leave the European Union. Proponents of the split had promised a smooth exit that would return to the UK greater control of its laws, budget and borders. But nearly three years after the referendum, UK and EU officials are still struggling to agree on the terms of the divorce.

With a March 29, 2019, deadline looming and negotiations at an impasse, the UK faced a worst-case scenario—crashing out of the EU’s single market into a state of uncertainty. A last-minute reprieve from the EU postponed the separation date to at least April 12, but difficult questions remain regarding how to break the deadlock and whether Brexit will even happen at all. What appears clear is that the negotiation process is far from over, and the nature of the UK’s future relationship with the EU could remain undecided for some time.

If and when the UK does leave the EU, both sides are likely to face negative economic consequences, with most estimates suggesting that the UK will bear the brunt of the blow. Still, the departure of its second-largest economy will exacerbate the EU’s current economic weakness and further test the seams of a union already straining against increased Euroscepticism. Further, Brexit stands as a testament to the ongoing embrace of anti-establishment doctrine worldwide, with consequences for the stability of the traditional global order and the capital markets.

Key Takeaways

• The Brexit referendum in 2016 was a high-profile entry in what has become a long list of populist movements that emerged following the financial crisis.
• After nearly two years of negotiations failed to produce a mutually acceptable compromise, the UK and EU agreed to postpone the original March 29 Brexit separation date to at least April 12.
• The new deadline offers little time to resolve serious disagreements between the UK and EU as well as within the UK Parliament itself. The situation is fluid, and several outcomes—including crashing out, general elections, a second referendum or no Brexit at all—are still in play.
• The timing and conditions of Brexit remain unclear, but most estimates suggest that both the UK and EU economies will suffer as frictions are introduced into their economic connection. The magnitude of the costs likely will depend on the relative closeness of the future UK/EU relationship.
• We think companies with strong balance sheets, sustainable earnings and conservative managements are most likely to weather the impact of Brexit regardless of its outcome, to the potential benefit of their investors. In fact, near-term market volatility may provide opportunities to build on or to acquire positions in such companies at attractive valuations.

Views expressed are as of April 3, 2019.
We believe we have transitioned to a more uncertain socioeconomic equilibrium in which unexpected political outcomes—such as Brexit—can dominate the ordinary vicissitudes of the business cycle.

Brexit Is Part of a Broader, Disruptive Trend Toward Populism

Populist movements worldwide have continued to attract supporters disillusioned by the weak economic growth and rising inequality that followed the global financial crisis. Despite historical levels of intervention by governments and major central banks, the post-crisis recovery has been uneven, and voters of many nations continue to struggle with the losses and dislocations that manufacturing automation and globalized labor markets have fostered.

Brexit has been discussed in the UK as early as the 1970s. Anti-EU sentiment reached a fever pitch after the financial crisis, however, as frustration with these losses—perceived to be driven by the trade and immigration requirements of the EU alliance—pushed more UK voters to reject the status quo. In addition to the June 2016 Brexit referendum, we have seen populist, anti-establishment change across a number of advanced and developing economies. In the US, Donald Trump ascended to the presidency. To the south, left-wing Andrés Manuel López Obrador was elected in Mexico while right-wing Jair Bolsonaro was elected in Brazil, each defeating the traditional political parties with campaigns focused on reducing corruption and improving security. In the euro area, Emmanuel Macron overthrew the French political establishment only to be confronted by ongoing populist discontent embodied in the “yellow vest” movement, while an anti-establishment coalition of the far-left Five Star Movement and the right-wing League took control in Italy. Prime Minister Viktor Orbán in Hungary, in power since elected in 2010, implemented popular spending programs financed by taxes on foreign companies and served as an inspiration for leader Jarosław Kaczyński in neighboring Poland. The list goes on.

This swell of political left-tail events has us questioning society’s bandwidth to absorb structural economic change and the unorthodox fiscal and monetary policies employed to address it. As such, we believe we have transitioned to a more uncertain socioeconomic equilibrium in which unexpected political outcomes—such as Brexit—can dominate the ordinary vicissitudes of the business cycle. This vulnerability is exacerbated by the growth in debt, which renders the global economy more sensitive to changes in risk perception. To the extent that the Brexit referendum was a high-profile example of this trend, we think it’s worth reviewing the situation as the UK and EU sit at the intersection of a number of uncertain paths.

Markets Appear Calm for Now, but Volatility May Emerge

UK markets were surprisingly resilient in the months leading up to the original March 29 Brexit separation date, as parliamentary developments dampening the outlook for a deal were seemingly offset by signals that an extension would forestall a no-deal “crash-out.” The pound, though about 12% weaker than its pre-referendum level, has appreciated modestly against both the US dollar and the euro since the end of 2018, by roughly 5%. UK stocks (as represented by the FTSE 100) also have rebounded from the global equity declines observed in December 2018, though to a lesser degree than US and European indexes. The yield on 10-year gilts has bounced around a bit, though mostly in line with other sovereigns.²

While a Brexit deal’s impact on equities is not straightforward, some generalizations can be made. For example, export-focused companies that produce significant revenue outside the UK—which includes much of the large-cap FTSE 100—have benefited significantly from the pound’s post-referendum weakness. These names would enjoy

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1. Apart from the UK, the EU single market covers 27 countries: the 19 nations using the euro currency (the “euro area”) and eight others that do not (Sweden, Denmark, Bulgaria, Croatia, Hungary, Poland, Czech Republic and Romania).
2. All data Bloomberg as of March 29, 2019.
unchanged trading rules during the Brexit transition period, but their foreign earnings may take a bit of a hit from a stronger pound due both to currency translation effects as well as some loss of relative price competitiveness in international markets. In contrast, more domestically focused companies—which tend to populate the FTSE 250 and FTSE SmallCap indexes—may find that a less-downbeat near-term economic outlook encourages more spending by their customers, though now-cheaper imported goods may compete for those incremental pounds.

Should a deal before the April 12 deadline remain elusive and the UK be forced to request an extended Brexit delay, the market implications are harder to gauge; while it raises the probability of no Brexit at all, it does so at the cost of a protracted period of uncertainty. In the less likely but worst-case scenario of a no-deal/crash-out Brexit, the potential market impact seems unambiguously negative. We would expect risk aversion to take hold worldwide, as a crash-out would disrupt not only what previously was intra-EU trade but also other trade agreements the UK was party to as a member of the EU, including its trade with the US. The reaction of markets to the results of the Brexit referendum may provide a good framework for what to expect. After the surprising victory of “Leave” in June 2016, the exchange rate on the British pound plunged 11% against the dollar almost overnight, global equity markets fell sharply, and investors flocked to historical safe havens like US Treasuries, German Bunds, Swiss francs, Japanese yen and gold.

A Brexit deal or an extended delay would appear preferable to a crash-out from an investment perspective, but they do little to provide long-term certainty to businesses or investors. The UK and EU will need to return to the negotiating table to establish terms of their future relationship. It’s likely that headline risk around the progress of these negotiations could combine with other fears facing the global economy—slowing global growth, trade battles, growing isolationism/protectionism—to create higher levels of volatility across currencies, sovereign yields, credit and equities, accompanied by bouts of risk-off investor sentiment.

Though such pronounced market gyrations can be disconcerting, we believe companies with strong balance sheets, sustainable earnings and conservative managements are more likely to weather the impact of Brexit no matter the outcome, to the potential benefit of their current investors. In fact, near-term market volatility may provide opportunities to build on or to acquire positions in such companies at attractive valuations, especially for patient investors with cash on hand. Currency-risk hedges, meanwhile, may help mitigate return volatility during periods of tumult, as may other traditional hedges like gold.

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3. To bridge the gap between the UK’s formal exit from the EU and the establishment of a new UK/EU trade partnership, the PM May/EU Brexit agreement included a transition period during which EU law, including the current trade and regulatory relationship and the free movement of people, would continue to apply in the UK as if it were still a member state. The transition was intended to run until December 2020, with the possibility of extension for up to two years (to be triggered by July 1, 2020). We expect a similar transition plan likely would be part of any Brexit deal.

4. The UK has signed continuity agreements with some of these markets that will take effect in the event of a no-deal Brexit, though negotiations are ongoing with some of its larger partners, including Canada and South Korea. A mutual recognition deal signed with the US in February 2019 is not a free-trade deal, but rather an agreement to accept technical standards for certain “telecom equipment, communications, pharmaceutical products and marine equipment.”
A Long and Bumpy Road to Brexit

Through its membership in the EU single market, the UK is able to trade goods and services with all other members without tariffs, quotas or non-tariff barriers. These benefits, however, come in exchange for some loss of independent policymaking power and an acceptance of the “four freedoms” of the EU—the unrestricted movement of goods, services, capital and people within the bloc. For many Leave voters, separation from the EU was not so much an economic imperative as it was an urgent attempt to regain what they characterized as a loss of national sovereignty. (See the timeline that begins below for a condensed history of UK/EU relations over the past 45 years.)

The Brexit referendum was fiercely contested. Though betting markets and pollsters depicted a close race, most observers expected “Remain” to pull out the victory. In hindsight, confidence that reason would prevail seems misplaced. So, too, was the belief that negotiations would be swift and straightforward.

UK and EU leaders have struggled to settle on terms for their separation, with the “red lines” established by each side at the onset of negotiations making mutually satisfactory compromise near impossible. UK Brexiteers were intent on breaking free from the rules and restrictions seen as incompatible with self-determination, but compulsory for membership in the EU customs union and access to its single market. These included

5. In contrast to a free-trade area (FTA)—which minimizes tariffs and quotas on goods traded between countries—or a customs union—which enhances an FTA by adding a common external tariff—the single market goes further by removing non-tariff barriers to goods and services exchanged through the harmonization of regulations.
allowing the free movement of people, paying into the EU budget, regulatory coordination, a prohibition on extra-EU trade arrangements and subjugation to the authority of EU institutions. For the EU, preserving the inseverability of the four freedoms was paramount; the union would not allow the UK to pick the parts of the single market it liked (free movement of capital, goods and services) while scrapping the parts it didn’t (free movement of people and budget contributions). To discourage other EU member states from exiting the EU, Brussels has been keen to limit the benefits the UK might derive from separation.

After two years of difficult talks—along with a number of political miscalculations that compromised her negotiating position—UK Prime Minister May and representatives of the other 27 EU member states agreed in November 2018 on a set of departure terms, including a legally binding withdrawal agreement dictating conditions for the immediate aftermath of the separation. Members of PM May’s pro-Brexit Conservative party viewed the deal—which included a £39 billion divorce payment by the UK and the “Irish backstop” provision (see text box on page 6)—as a betrayal of the Leave mandate, and it was defeated three times in Parliament over the course of several months.

Without a deal in place before the March 29 deadline, the UK faced immediate expulsion from the EU trade and services bloc, giving citizens and businesses no transition period and little certainty about future access. Absent ad hoc continuity agreements, the country’s goods exports worldwide would be subject to the World Trade Organization’s less-accommodating tariff regime. The residency status of EU nationals in the UK (and vice versa) would be unclear, as would the reliability of such cross-border necessities as banking, commercial haulage, passenger transport and the delivery of medicines.

6. The draft agreement can be found here.
With no agreement forthcoming and a crash-out scenario just days away, the EU agreed to postpone the Brexit deadline to at least April 12. The new timeframe is short, and we are skeptical about PM May’s ability to break through the deadlock. If the UK government can manage to approve an acceptable withdrawal agreement by that date, the EU will delay separation until May 22 to allow the UK to pass the legislation required to implement the deal. If not, the UK will have to decide between crashing out after April 12 or seeking a much longer extension. Such an extension would require participation in the May 2019 EU parliamentary elections and open the door to a raft of alternate scenarios including a new general election, a second referendum or no Brexit at all.

Within the grab bag of contentious Brexit issues, Northern Ireland (NI) emerged as the key roadblock. Negotiators struggled to find an acceptable compromise that would preserve NI’s unique position as part of both the United Kingdom and an EU member state (Ireland), while also establishing the customs and regulatory separation between the UK and EU imposed by Brexit. Neither the UK nor the EU wanted to undermine the 1998 Good Friday Agreement with a physical, guarded divide across the island, but a border on NI’s other boundary—the Irish Sea, which stands between it and the rest of the UK—was unacceptable to many in the UK. As a compromise, PM May and the EU agreed to the “Irish backstop,” which dictates that the entirety of the UK—not just NI—would remain in the European customs union should the UK and EU fail to reach a permanent trade and regulatory pact before the end of the transition period. It amounts to an insurance policy preventing NI from becoming a backdoor into the EU single market.

The Price of Independence

If Brexit does eventually happen, the UK and EU will need to settle on a new relationship for the longer term. Among the models discussed for UK/EU affairs going forward are ones similar to those already in place for Norway and Canada, though each has shortcomings that would seem to stand in the way of broad political support.

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The “Norway +” framework envisioned by some UK politicians would combine this single-market access with the add-on of EU customs union membership; this would avoid the need for customs checks between Ireland and Northern Ireland, but at the cost of participation in other free-trade agreements.

The Canada Model leans toward a more distant long-term relationship modeled on the Comprehensive Economic and Trade Agreement (CETA) signed between the EU and Canada in 2016. It gave Canada almost tariff-free goods trade with the EU while also allowing it the freedom to participate in trade deals with other countries. Customs controls would remain intact, however, requiring border controls either between Ireland and Northern Ireland or in the Irish Sea. CETA does not provide Canada with preferred status in the trade of services. UK proponents of the Canada model hope to negotiate around this obstacle to arrive at a more accommodating “Canada++” version, meaning Canada + financial services + aviation services + data services, etc. However, the EU is unlikely to accept a “Canada++” model because it could encourage other countries to leave the bloc.

Exhibit 1
The Impact of Potential Brexit Outcomes

<table>
<thead>
<tr>
<th>IMPACTS ON UK</th>
<th>BREXIT SCENARIOS</th>
<th>No-Deal Crash-Out</th>
<th>Hard Brexit (Canada model)</th>
<th>Soft Brexit (Norway Model)</th>
<th>Customs Union</th>
<th>PM May/EU Withdrawal Agreement***</th>
<th>Cancel Brexit (Revoke Article 50)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Extra-EU Trade Agreements</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>X</td>
<td>TBD</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Free Movement of Goods</td>
<td>X</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>TBD</td>
<td>✓</td>
<td></td>
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<tr>
<td>Free Movement of Services</td>
<td>X</td>
<td>X</td>
<td>✓</td>
<td>X</td>
<td>TBD</td>
<td>✓</td>
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<tr>
<td>Free Movement of Capital</td>
<td>X</td>
<td>X</td>
<td>✓</td>
<td>X</td>
<td>TBD</td>
<td>✓</td>
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<tr>
<td>Free Movement of People</td>
<td>X</td>
<td>X</td>
<td>✓</td>
<td>X</td>
<td>X</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Open Irish Border</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>✓</td>
<td>Subject to the Irish backstop</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Contribute to the EU Budget</td>
<td>X</td>
<td>X</td>
<td>Partial*</td>
<td>X</td>
<td>X</td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Subject to EU Laws and Courts</td>
<td>X</td>
<td>X</td>
<td>Partial**</td>
<td>X</td>
<td>X</td>
<td>✓</td>
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</tr>
</tbody>
</table>

Source: First Eagle Investment Management.

* Norway does not pay directly into the EU budget but contributes to the EU cohesion fund, which aims to reduce economic disparities across the bloc.

** Norway is not subject to rulings by the European Court of Justice but is subject to the EFTA court, administered by judges from each of the participating countries. Moreover, the EFTA court oversees the application of EEA laws in EFTA countries, which are themselves largely a copy of EU laws.

*** “TBD” means the impact is to be determined subject to the final negotiation of a future arrangement between the UK and EU during a status-quo transition.

Progress toward any outcome would require enlightened and cohesive political stewardship within the UK, which has been notably lacking. Without such leadership, the country could face a harsh adjustment to its post-EU circumstances, perhaps inspiring a populist response to the original populist impulse. And let us not forget the 1970s, when the tragic combination of a depreciating pound, an uncertain economic path and shaky government forced the UK to take a $3.9 billion bailout from the International Monetary Fund.
Given the unprecedented nature of Brexit—no advanced economy has ever withdrawn from such a complex trade and services agreement before—the economic impact is difficult to predict. Ultimately, the effect likely will depend on the duration of uncertainty and the extent to which the UK is able to preserve close economic ties with the EU. Most published projections—including those from the Bank of England and UK Parliament as well as a variety of private concerns—suggest that the UK’s departure from the EU’s single market will leave it worse off over the long term than if it had remained.

As shown in *Exhibit 2*, forecasts that assume a no-deal Brexit in which the UK faces World Trade Organization tariffs and limited access to the EU service markets produce the most eye-popping negative results. However, even estimates that pencil in a closer post-Brexit economic partnership—such as remaining in the European Economic Area (the Norway model) or establishing a bilateral free-trade agreement with the EU (the Canada model)—point to a weaker UK economy over the long run.

**Exhibit 2**
Forecasts Mostly Paint a Bleak Picture of Brexit’s Impact on UK Economy

<table>
<thead>
<tr>
<th>Forecast Scenario</th>
<th>Rabobank</th>
<th>CEP (Dynamic)</th>
<th>CPB (Dynamic)</th>
<th>HM Treasury</th>
<th>HM Gov’t</th>
<th>CPB (Static)</th>
<th>Rand</th>
<th>NIESR</th>
<th>Oxford Economics</th>
<th>PwC</th>
<th>CEP (Static)</th>
<th>Ciuriak Consulting</th>
<th>Bertelsmann</th>
<th>Open Europe</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>World Trade Organization</strong></td>
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<tr>
<td><strong>Free-Trade Agreement</strong></td>
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<tr>
<td><strong>European Economic Area</strong></td>
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<tr>
<td><strong>Unilateral Free Trade</strong></td>
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</tbody>
</table>

Source: Institute for Government (UK).

Notes: CEP = Centre for Economic Performance at the London School of Economics and Political Science; CPB = Netherlands Bureau for Economic Policy Analysis; NIESR = National Institute for Economic and Social Research.

“Static” forecasts reflect one-time impacts to productivity that result from changes to trade barriers, while “dynamic” forecasts reflect ongoing impacts to productivity.

Forecasts are based on the following Brexit scenarios for the UK: 1) “European Economic Area”: The UK remains part of the EEA such that no tariffs are imposed on goods traded with the EU; 2) “Free-Trade Agreement”: The UK enters into goods-only free-trade agreement with the EU that eliminates or substantially reduces tariffs below those applied under WTO rules; 3) “World Trade Organization”: The UK’s goods trade is subject to WTO rates; and 4) “Unilateral Free Trade”: The UK eliminates all barriers to trade into the UK without reciprocal agreements in place with other markets. Note that each organization applied unique and varied assumptions regarding the magnitude of tariff and non-tariff barriers applied under each scenario.

The primary drivers of these downbeat economic forecasts are expectations of higher tariff and non-tariff barriers to trade, as well as hits to investor and consumer confidence. The EU as a bloc is the UK’s largest trading partner, accounting for 48% of the UK’s goods exports and 41% of services exports in 2017, per the Office for National Statistics (Exhibit 3). With nearly one-third of UK GDP attributable to goods and services exports, increased trade friction would exert a significant drag on growth. This is particularly true for the financial sector. “Passporting” rights granted under EU membership allow UK banks, insurers, asset managers and clearing houses to access the single market from London. This access in turn underpins a large portion of the UK’s financial services exports (43% go to the EU) and total service exports overall (9%). Beyond the potential for direct losses vis-à-vis the EU, diminished access to EU markets and customers could make London a less attractive destination as a global financial center.

Exhibit 3
Europe Is the UK’s Top Customer for Goods and Services Exports
As of December 31, 2017

<table>
<thead>
<tr>
<th>Exports of Goods</th>
<th>Exports of Services</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU</td>
<td>US</td>
</tr>
<tr>
<td>48.4%</td>
<td>22.4%</td>
</tr>
<tr>
<td>36.4%</td>
<td>41.2%</td>
</tr>
<tr>
<td>Rest of World</td>
<td></td>
</tr>
</tbody>
</table>

Source: Office for National Statistics (UK).

With net exports from the UK expected to decline, economic activity will be under further pressure from falling investment and consumption. Some companies already are reluctant to spend, and many that are spending reportedly have opted to build capacity in EU cities where conditions for supply chains, regulation and labor capacity are easier to predict. A dip in UK real estate prices and property transaction volumes since the Brexit vote suggests that homebuyers are also holding their powder, while negative net migration indicates that some people are taking their skills and buying power out of the UK market entirely.
Uncertainty May Create Opportunity

While at this point it seems likely that the worst-case, crash-out Brexit scenario will be avoided, we remain watchful that a disappointment in the political process—not an unreasonable expectation given recent history—could shift sentiment on short notice. If the separation date is extended significantly, many of the alternate scenarios being discussed lean toward a softer Brexit; however, an economically disruptive crash-out at some point would remain a real possibility. Also, the uncertainty inherent in an extended delay is an impediment to growth, and volatility in the currency, equity performance and bond yields may be the norm until a long-term resolution can be reached.

That said, Brexit-related headwinds are just one of the factors that lead us to believe equity index returns are likely to be less robust in the period ahead than they were through most of the last 10 years. We think active management is particularly vital in a more complicated market environment such as the one we expect. In sideways-moving or slowly rising markets, active managers may become more valuable to the extent that they can distinguish stronger stocks from weaker ones. In falling markets, active managers that focus on reducing risks may be able to help insulate investors against the full force of a downturn while also potentially taking advantage of opportunities to buy what appear to be attractive stocks at discounted prices.

In many ways, Brexit is a microcosm of a worldwide challenge: While globalization has reduced inequality among countries over the years, it has increased inequality within them. The UK and others have reacted to this condition by abandoning the traditional political route in favor of an untested path, and it will be many years before we know if this was the right decision. In the meantime, rather than try to anticipate the fluctuations of the markets and the global economy, we will continue to focus on building portfolios designed to be resilient in the face of turbulence.

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