FIRST EAGLE
INVESTMENT MANAGEMENT

Year-End 2018

First Eagle Global Value Team
Annual Letter

We cannot predict what will happen next in economies or markets, but 2018 had the feel of a transitional year. Volatility, which in our view, had been muted for an unexpectedly long period of time, returned in force during the year—first in February and then again in the fourth quarter. The turmoil and uncertainty drove some investors out of the equity market. This was an understandable reaction to pain, but selling into a falling market often erodes a portfolio's long-term value. We have an all-season investment approach that sees a purpose in all phases of the market cycle: Down markets are a time for planting seeds by buying shares, and up markets are a time for harvest.

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Economic Overview

Many world economies continued to grow in 2018—some quite strongly—but there were clear signs that the decade-old recovery from the global financial crisis had reached a late stage. Profits were at peak levels, and slack in the world economy, as measured by unemployment rates, was low. We interpret these trends to mean that a lot of the cyclical recovery is behind us.

During the year, the Fed raised interest rates four times, and the European Central Bank and Bank of England began to unwind years of quantitative easing. Along with the trade dispute between the United States and China and other geopolitical strains, the tightening trend contributed to an upsurge in market volatility. At various points during the year, the MSCI EAFE index and the S&P 500 index were down approximately 20% and Chinese stocks fell 32%.[1]

At the close of 2018, unemployment rates in the major economies of the world—the United States, the UK, Germany, China, Japan—were below where they had been in 2007. We think unemployment rates reflect the level of economic confidence in the immediately preceding period. Late 2017 was a time of very high confidence relative to history. In 2018, we did not see tighter financial conditions translate through to particularly deep recessions. It was only in the most extremely impacted areas like Turkey and Argentina that we saw economic activity decline. But there were other troubling signs: During the year, bank stocks in most large jurisdictions outside the United States—Japan, Europe, China—generally traded below book value. Given that this occurred at the peak of the economic cycle, it raises questions about the health of the world's financial architecture.

We may think of stock indexes as generally grinding higher over time, but this is not always the case. Recent volatility notwithstanding, the S&P 500 index ended 2018 well above its level 20 years earlier but outside the United States, the picture is quite different. The MSCI EAFE index moved sideways for 20 years—with volatility. At year-end, it was at virtually the same level as in 2013 and 2007.

United States

The US economy was buoyant in 2018, lifted by high levels of confidence and late-cycle stimulus from the tax cut. Interest rates rose from a low level, and the Fed tightened policy in each quarter of the year. With the European Central Bank and the Bank of Japan keeping interest rates close to zero, the resulting interest-rate differential raised the value of the dollar. Unemployment fell to 3.7%, a generational low.

1. Source: FactSet.

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Risk-awareness, which had been scarce in the American investment markets in 2017, made its presence felt in 2018; volatility, as measured by the CBOE's VIX index, spiked in February and climbed again in the fourth quarter. Investors were concerned about rising interest rates, the flattening of the yield curve, both rising and falling oil prices, the killing of a Saudi journalist, and the evolving trade dispute with China, among other developments. At one point, about 75% of the companies listed on the New York Stock Exchange were trading below their 200-day moving averages.[2] Although the economy was still hitting on all cylinders, investors were clearly less confident that the recovery would continue in the years ahead.

China

The Chinese economy entered a more complicated phase in the last 18 months, as the government tried to reduce the country's burden of debt. China first reined in bank lending and then began to curb its shadow-banking system. As a result, monetary growth in China was cut nearly in half from 15% to about 8% over the last 18 months.[3]

In the short term, taking on debt can provide strong economic stimulus—as evidenced by recent levels of GDP growth in China. Imagine that you need a 2,000 square foot home but you borrow money and build a 10,000 square foot house instead. In the short term, that's going to be great for growth in the local community, and it may be great for your confidence. But once the mega-mansion is complete, it has to be maintained, and the debt you took on to build it has to be serviced. Your future growth is going to be more constrained because you can only grow through your savings. This could be a shock to the local community, which depended on the jobs you created.

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Think of all the infrastructure China has built. Much of it has certainly been helpful, but some of it, arguably, has been built ahead of the country's needs and now has to be maintained. This diverts capital that could be more productively deployed elsewhere. Apparently, China's immediate response to this challenge has been to ease fiscal policy, but there is now so much debt in China's economy that it may not be able to turn this spigot back on. IMF statistics suggest that fiscal deficits in China have nearly doubled. At a macro level, we think China is reaching a stage where it needs to live with a more modest pace of debt growth.

China's trade position is another source of stress. The country's trade surplus has been shrinking for some time, and in the first half of 2018, China reported a trade deficit. The tariff debate with the United States is happening on top of that—yet another concern for China.

2. Source: Indexindicators.com.

3. Source: International Monetary Fund.

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Japan

Despite its high level of sovereign debt and the challenges of an aging population, Japan has had a level of political stability that is quite notable relative to the rest of the world. As we look, bottom-up, at companies in Japan, we've been satisfied to see, on average, an improving trend in corporate governance, with many companies returning more capital to shareholders by raising their dividend-payout ratios. In Japan, we see many companies structuring themselves to be resilient by trying to strengthen their market position and capital structure, and by behaving prudently. We see a similar trend in other regions, too, but it is particularly pronounced in Japan. A lot of Japanese companies have enough net cash on their balance sheets to cover several years of expenses and capital spending. On a macro level, we were not unhappy to see the Japanese government abandon its 2% inflation target, which had eluded it for years.

European Union

The political situation in Europe became more complicated in 2018. After the election of Emmanuel Macron as president of France, there was hope that a new centrist path would be forged in Europe, but people forget that Macron defeated two political parties to get into power. His popularity is now very low and he's having to deal with protests over his economic agenda. In Italy, we've seen the election of a populist coalition that's openly flouting the EU's budgetary rules. We've also seen the attempts to forge a compromise on Brexit end in a messy stalemate that's not particularly attractive for anyone. And we've seen Angela Merkel lose her power base and status in Germany.

Europe as a region, in our view, has needed a degree of financial repression. Its currency is depressed, its current account surplus is very large, and its real interest rates are extremely low. There has been little flexibility regarding the restructuring of bad debts. This issue has been particularly pronounced in countries like Italy, but even the German banks have not been immune.

The European market has defied top-down categorization. The Euro Stoxx 50 index is trading roughly where it was 20 years ago, but we've seen a bifurcation within the market, with some quality businesses grinding higher and trading at full valuations while some banks and other more vulnerable businesses have traded much lower.

Europe has been one geography that, at least theoretically, has had scope for improvements in confidence in the underlying economy. Unemployment rates are a lot higher than they are in the United States. Directly after the global financial crisis, EU policy was less stimulative than US policy, and, as a result, the fiscal position in Europe is, by and large, a little healthier than in the United States. P/E ratios and price-to-book ratios have been lower. These facts have generated a fair amount of enthusiasm for Europe within the investment

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community, but, as bottom-up investors, we have always cautioned against forming a generalized view of any region as a whole. We've also noted that companies of similar quality are similarly priced in Europe and the United States. Finally, a lot of the valuation discounts in Europe have been in the financial sector and in companies that have vulnerable capital structures or could become victims of financial repression.

Conceptually, there are some positives for Europe at a macro level, but we'd reinforce that, bottom up, markets are much more nuanced, and the integration of the European experiment is far from perfect.

Finding Opportunities

In 2018, increased market volatility created opportunities for us to invest, as prices of attractive stocks came down to levels that offered us a "margin of safety" in price. We invested in diverse companies, some that we already owned and others that were new to the portfolio. These included consumer staples companies that sold off because rising Treasury yields made them less appealing as bond proxies, energy stocks that declined with the falling price of oil, European construction-related businesses that lost ground because of expectations that economic fundamentals would weaken, luxury-goods retailers that declined because of fears of falling Chinese demand, and holding-company stocks on several continents that fell because of growing risk aversion.

As we put money to work, our cash level in the Global Fund drifted down from around 20% to approximately 12%. Our gold position came up to the 12% to 13% range during this period of weakness in the gold price. We believe our positioning is still fairly cautious as we think about the decade ahead.[4]

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We don't try to predict what markets will do, but we have a sense of déjà vu because both 1998 and 2007 were also difficult environments for value stocks, and both were precursors to the market starting to discount more structural issues. Based on these past instances, we don't expect a very favorable environment over the next four or five years, but—as in those earlier periods—we stand ready to take advantage of emerging opportunities, one stock at a time.

Cash or Gold?

When investment opportunities become scarce, it's been our practice to sit in cash and cash equivalents. But cash in what currency? We are troubled to see that most of the world's currencies, including the US dollar, are in questionable health. The United States has a large current-account deficit and an increasing

4. Source: First Eagle Investment Management.

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fiscal deficit, and the dollar has been held aloft by interest-rate differentials. Holding dollars or other currencies is not as risk-free as conventional wisdom would indicate. In most countries, the rate of money-supply growth exceeds the interest rate investors can earn from government bonds. Holding these currencies is like owning a stock that pays a 2% annual dividend while shares outstanding grow by 5% per year. Today, sovereign debt-to-GDP ratios are already at generational highs, and when governments have too much debt, they have an incentive to keep interest rates low relative to nominal growth. This means that governments now need prospective financial repression more than ever. Unfortunately, no man-made asset is risk free.

We see gold, by contrast, as nature's defensive perpetuity. Gold has had its valuation peaks when the system was in distress, such as during the global financial crisis (when our system was in question and the eurozone was on the brink of breaking apart), the early 1980s (after stagflation and two oil shocks), and the Great Depression. Although it may be the least exciting asset while stock markets are roaring (as in the past handful of years, the late 1990s, the late 1960s and the 1920s), gold has, historically, been a store of value when needed most. While most businesses and governments have net debt that compromises the promissory value of their securities, gold is unencumbered. It has no management team, and it is not subject to ill-conceived political experiments at a macro level. Unlike man-made money, gold is scarce and stable in supply. In 2018, we enlarged our position in gold and gold-related securities.

A Time for Active Management

Developments in 2018 reinforced our sense that investment returns are likely to be less robust in the period ahead than they were through most of the last 10 years. In strongly rising markets, many investors choose passive vehicles that allow them to participate in market gains while paying minimal fees. In sideways-moving or slowly rising markets, active managers may become more valuable to the extent that they can distinguish stronger stocks from weaker. In falling markets, active managers who focus on reducing risks may be able to help insulate investors against the full force of the market downturn while potentially taking advantage of opportunities to buy what they believe are attractive stocks at discounted prices.

On First Eagle's Global Value team, we have a long-standing commitment to active investment management. In 2018, when some investors and firms were gravitating toward passive approaches, we made further investments in our team of securities analysts. We wanted to be ready to meet the greater challenges that could lie ahead in the next phase of the market cycle. We deepened our capabilities by adding talented professionals with varied expertise who share our convictions about active value investing.

Many of our clients also share these convictions and, in some cases, have done so for decades. We want to close by thanking you for your continuing support. We look forward to serving as prudent, risk-averse stewards of your capital in the years ahead.

Sincerely,

Matthew McLennan
Head of the Global Value Team
Portfolio Manager
Global, Overseas, U.S. Value
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T.K.R

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There are risks associated with investing in funds that invest 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 Global Value Team defines "margin of safety" as the difference between a company's purchase price and our estimate of its intrinsic value.

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.

The MSCI EAFE Index is an unmanaged total return index, reported in US dollars, based on share prices and reinvested net dividends of approximately 1,100 companies from 21 developed market countries.

The Standard & Poor's 500 Index is a widely recognized unmanaged index including a representative sample of 500 leading companies in leading sectors of the US economy and is not available for purchase. Although the Standard & Poor's 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 Standard & Poor's 500 Index includes dividends reinvested. One cannot invest directly in an index.

The MSCI China Index is constructed based on the integrated China equity universe included in the MSCI Emerging Markets Index, providing a standardized definition of the China equity opportunity set. The index aims to represent the performance of large- and mid-cap segments with H shares, B shares, red chips, P chips and foreign listings (e.g., ADRs) of Chinese stocks. China A shares will be partially included in this index, making it the de facto index for all of China. It can be used as a China benchmark for investors who use the MSCI ACWI Index or MSCI EM Index as their policy benchmark.

The EURO STOXX 50® Index is Europe's leading blue-chip index for the eurozone and provides a blue-chip representation of supersector leaders in the region. The index covers 50 stocks from 11 eurozone countries: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

The VIX Index is an up-to-the-minute market estimate of expected volatility that is calculated by using the midpoints of real-time S&P 500® Index (SPX) option bid/ask quotes. More specifically, the VIX Index is intended to provide an instantaneous measure of how much the market "thinks" the S&P 500 Index will fluctuate in the 30 days following each tick of the VIX Index. No one person or committee determines the level of the VIX Index. Rather, the VIX Index reflects an equilibrium price for risk as reflected in the prices of SPX options, which rise and fall based on the flow of orders from traders around the world.

The commentary represents the opinion of the Global Value Team Portfolio Managers as of December 31, 2018, and is subject to change based on market and other conditions. The opinions expressed are not necessarily those of the entire firm. These materials are provided for informational purpose only. These opinions are not intended to be a forecast of future events, a guarantee of future results, or investment advice. Any statistics contained herein have been obtained from sources believed to be reliable, but the accuracy of this information cannot be guaranteed. The views expressed herein may change at any time subsequent to the date of issue hereof. The information provided is not to be construed as a recommendation or an offer to buy or sell or the solicitation of an offer to buy or sell any fund or security.

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