FIRST EAGLE
INVESTMENT MANAGEMENT

December 2015 | The PM's Perspective

Navigating the Current Rate Environment

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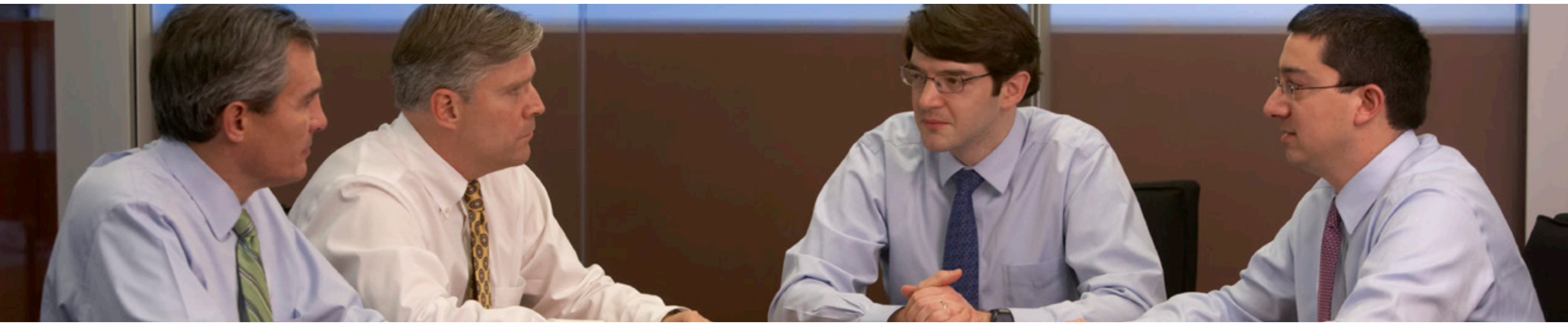

Low interest rates globally have been an important driver of asset price returns over the past few years and are very much on investors' minds today. In our conversations with financial advisers, many questions come up: How long can we expect the low-rate environment to continue? What has led rates to be so low in the first place? What are the consequences of global central banks' quantitative easing ("QE") policies? Have we definitively slain the specter of inflation?

Giorgio Caputo, one of the portfolio managers of the First Eagle Global Income Builder Fund, shares his thoughts on today's low-interest-rate environment and how it's impacting asset prices and the search for value and income.

Q: How do the upcoming Federal Reserve meeting and the possibility that US short-term interest rates may finally lift off from zero affect your outlook?

At the risk of some hyperbole, this may very well be the most discussed potential 25 basis point move in the history of money. At First Eagle, we respect the view of the Austrian School of economics that bad things can happen when money is free. When we invest in risk assets, we try to look across business cycles to discern what we believe is the reasonable, mid-cycle intrinsic value of an asset. As a result, we haven't lowered our underwriting criteria in response to the current low-rate environment.

By keeping rates at zero for so long, the Fed, in our view, has attempted to dampen the business cycle and has potentially distorted pricing within certain asset classes (particularly those that are rate sensitive). This has made it harder for investors to generate income with a "margin of safety."[1] The Fed's efforts may even have been counterproductive. In the case of aging economies, there is some evidence that low rates can actually reduce consumption, as retirees and near-retirees feel the need to save even more to compensate for low yields on existing savings. For these and other reasons, we would welcome a normalization of money rates.

With that said, there remain a number of deflationary pressures throughout the world, such as the strength of the US dollar and the "collapse" of commodity prices. One of the largest deflationary forces may stem from remarkable developments in China, as it attempts to transition its economy from its current fixed-asset-intensive phase to a more consumption-oriented model. However, in the process of growing by fixed-asset investment, China has built up vast industrial capacity for everything from steel and copper production to automobiles, machinery, etc. The output of these businesses, some of which continue to be subsidized in various ways by the state, has to find a home and, as a result, is depressing prices globally. In assessing whether or how fast to raise rates in the future, the Federal Reserve will certainly need to consider the deflation stemming from China and other sources.

Q: What has caused interest rates to be so low for so long?

There are always a broad number of factors that impact interest rates, but in recent years it seems primarily that the combination of quantitative easing and the fear of deflation, coupled with lower potential economic growth, have led both central banks and investors to generally drive up bond prices. Even with the QE taper complete in the United States, sovereign purchases by other central banks feed back into US bond yields as investors scour the world for income. Similarly, the strong performance of the US dollar may likely lead to increased flows into the United States, which often end up in the Treasury curve because of the depth and liquidity of that market. Additionally, a flight to perceived safety prompted by geopolitical concerns further enhances inflows to US assets. Lastly, it is important to point out that global debt levels have *not* fallen materially. The modest declines in financial leverage seen in the US have been largely offset by increases in debt levels in China and other geographies. These high debt levels can amplify the deflationary pressures and fears described above.

1 Benjamin Graham, the father of value investing, used this term to describe the difference between the intrinsic value of a security, as estimated by the investor, and its current price.

What is clear is that those investing in long-term debt at the current low yields are making the assumption that it will be very difficult for rates to return to normal levels for a number of years. Based on interest-rate forward markets, one has to go almost 10 years into the future before 10-year US bond yields cross 3%.[2]

Q: How have low rates impacted asset prices and investment?

The impact on asset prices has been pronounced, with rate-sensitive asset classes being among the best performers in recent years. Beyond this—and perhaps more importantly—the level of rates sets the discount rate at which investors convert future cash flows to present values. In this fashion, low rates can potentially drive higher asset values across all capital markets. Put differently, since all assets have to compete for capital, when a large asset class such as developed market sovereign debt yields so little, this competition for capital becomes much easier, leading investors to pay up for riskier alternatives (which is the point of the QE programs).

One of the negative consequences of artificially suppressed interest rates is the risk of mal-investment. Following a binge of credit issuance, master limited partnership (MLP) structures and yield-linked derivatives, it is hard to argue that some mal-investment hasn't taken place. These financial maneuvers are linked to the real economy, as capital has been expended to create and sell the income properties, transportation infrastructure, pipelines and energy production through these financial vehicles. Somewhat less directly, high asset prices improve confidence and collateral values, and perhaps drive some undesirable consumption as people feel wealthier.

While many investors view low rates as a rationale for high equity valuations, at First Eagle we ask ourselves if the opposite might not be true. If rates are forced to be low (even negative!) due to the fragility of the global economy, should this not be viewed as sign of vulnerability and perhaps a reason why multiples should be *lower* than historical norms?

Q: Is inflation dead?

We certainly don't think so, but inflation has had a long period of hibernation. To some extent, the US Fed has continued to live off the inflation-fighting credibility it gained during the Volcker chairmanship and the early portions of Greenspan's tenure. It has been central bank orthodoxy since then that inflation must be kept under control. The European Central Bank and Bank of Japan,

2 Source: Bloomberg. Based on implied future 10-year interest rates.

which don't have the same historical credibility, have faced greater challenges meeting inflation targets.

Milton Friedman famously stated, "Inflation is everywhere and anywhere a monetary phenomenon."[3] The risk we see potentially unfolding over the next decade is that central banks, in their inability to combat deflation, resort to printing ever increasing amounts of currency and that markets begin to lose faith in the effectiveness of central banks (and potentially even in the value of the currency). The relentless growth of a monetary base is hard to overcome in the long run. Historically, even gold-standard economies witnessed inflation when the supply of gold increased rapidly. These abrupt discontinuities can be a while in the making before the paradigm suddenly shifts and inflation expectations become unhinged. In order to understand Friedman's assertion of the true power of monetary intervention, one need only refer back to the thought experiment conducted in 2002[4] by then (aptly named) "Helicopter Ben" Bernanke, that money could effectively be handed out to the populace, *in extremis,* to combat deflation.

Q: Japan is potentially stuck in a liquidity trap with rates mired near zero. Is the US going to follow this course?

Japan has some significant structural and societal challenges, including an aging demographic and a rigid workforce. The United States boasts one of the more flexible and adaptive economies. Fed Vice-Chairman Stanley Fischer has stated that zero is not a normal interest rate for the US economy.[5] This commentary is important because Fischer is considered by many to be a centrist. For him to assert that zero is an unacceptable rate might imply that there would need to be serious adverse and strongly deflationary developments for the US economy to continue to justify low interest rates.

St. Louis Fed President James Bullard elaborated on this concept by arguing that a policy rate near zero limits central bankers' flexibility to respond to economic crises in the future.[6] He spoke further about the risks that employment levels might fall below "NAIRU" (the non-accelerating inflation rate of unemployment), at which point we might begin to see wage inflation rise. Job openings surveys indicate some pressures along this front.

However, there are powerful conflicting forces at play. Any nascent US inflationary pulse will have to compete with some powerful global deflationary trends in the form of lower foreign currency rates, sharp declines in the

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3 Friedman, Milton, and Anna Jacobson Schwartz, *A Monetary History of the United States, 1867–1960,* Princeton University Press, 1971

4 http://www.federalreserve.gov/boardDocs/speeches/2002/20021121/default.htm

5 http://blogs.wsj.com/economics/2014/12/01/fischer-feds-current-concern-is-how-when-best-to-raise-interest-rates/

6 https://www.stlouisfed.org/from-the-president/video-appearances

commodity complex (including oil, coal, copper and iron ore), weaker growth, excess supply in China and geopolitical tensions, as well. Additionally, there will be effects from the continued drumbeat of technological innovation and step-function productivity increases like factory automation and self-learning algorithms.

Neither higher rates nor deflation would be particularly good for equity prices. In the deflationary scenario, US dollar earnings will be pressured by lower foreign subsidiary cash flows or price competition from overseas-based substitutes. Rising rates, on the other hand will reduce the value today of future earnings and should make traditional fixed income a more competitive alternative.

Q: In light of this, how are you positioned today and why?

We continue to be very concerned about taking on duration exposure. Holding a low-duration portfolio was helpful during the taper tantrum of 2013 when 10-year rates spiked to almost 3%[7] but has proven a (modest) headwind since then. After an over-30-year bull market in bonds, global long rates in many geographies have hovered near and even below zero. While in any given year it may be a good trade to take on duration exposure, looking a bit further out, we fear this may prove to be risky for investors who don't reverse the position at precisely the right time.

Lower commodity prices mean that oil exporters, such as Saudi Arabia, which have been an active source of demand for US Treasuries, may have less cash to send our way as they dip into their sovereign wealth funds to support their domestic social programs while state revenues are depressed. A pivot toward a more consumption-oriented economy in China might reduce the need to soft-peg their currency to the dollar, further reducing demand for our paper. These forces may however be masked for some time as the strength of the USD may beget ever more flows from private investors.

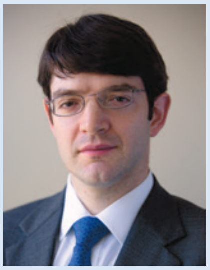
During episodic pullbacks in credit markets, we have often found value in the higher-quality echelons of that asset class. While lower-quality high yield could decline more and could possibly show higher returns in a robust economic environment, we worry about the fate of some more stressed issuers, should the deflationary scenario play out. In light of these deflationary risks and what we believe are the fair-to-full valuations in US equity markets, we have on balance found more value in international markets. Finally, the decline in many currencies versus the dollar makes holding some non-dollar fixed-income assets more appealing as a means of diversifying our cash and cash equivalents.

7 Source: Bloomberg

Q: How is First Eagle's income approach different?

At First Eagle, we are keenly aware of our limitations in being able to predict the future. Events can quickly unfold that may render perfectly reasonable financial assumptions hopelessly obsolete. As a result we try to build resilient portfolios across a broad range of outcomes. We don't invest in "yieldy" investments just for yield's sake. When we put capital to work, we insist on what we feel is an appropriate discount to our estimate of intrinsic value—a discount that is commensurate with the risk we are underwriting. In addition, we hold cash for deferred purchasing power, and we hold gold and dividend-paying gold miners as a potential hedge against more extreme events.

In managing the Global Income Builder Fund, we, like many of our income-oriented clients, struggle with low-rate environments. Still, we are guided by the primary goal of seeking to preserve purchasing power in the long term. We maintain broad flexibility in an effort to avoid certain asset classes should their valuations not make long-term sense, such as, in some environments, traditional, longer-duration fixed income. While seeking to make the best of the current environment, we look forward to the eventual return of a more normalized environment where investors are adequately compensated for the risk of investing in longer-duration debt instruments.



Giorgio Caputo

Giorgio joined First Eagle Investment Management in 2009 as a research analyst on the Global Value Team. Since 2012, Giorgio has served as portfolio manager of the First Eagle Global Income Builder Fund. In addition, he currently follows investments within the energy, distribution, paper and packaging, building products and restaurant sectors, as well as certain special-situations investments.

Giorgio began his career in 1996 as a quantitative analyst in the Equity Derivatives Group at Lehman Brothers. In 2002, he joined the investment banking division of Credit Suisse First Boston, where he worked as part of the M&A Takeover Defense Team. In 2004, Giorgio became a managing director and industry generalist at JANA Partners, LLC, where he pursued a value-oriented strategy across the capital structure.

Giorgio received a Bachelor of Science in engineering from Princeton University and an MBA from Columbia Business School.

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.

Funds that invest in bonds are subject to interest-rate risk and can lose principal value when interest rates rise. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner, or that negative perception of the issuer's ability to make such payments may cause the price of that bond to decline.

The Fund invests in high yield securities (commonly known as "junk bonds") which are generally considered speculative because they may be subject to greater levels of interest rate, credit (including issuer default) and liquidity risk than investment grade securities and may be subject to greater volatility. High yield securities are rated lower than investment grade securities because there is a greater possibility that the issuer may be unable to make interest and principal payments on those securities.

Bank loans are often less liquid than other types of debt instruments. There is no assurance that the liquidation of any collateral from a secured bank loan would satisfy the borrower's obligation, or that such collateral could be liquidated.

Income generation is not guaranteed. If dividend paying stocks in the Fund's portfolio stop paying or reduce dividends, the fund's ability to generate income will be adversely affected.

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.

The commentary represents the opinion of Giorgio Caputo as of December 2015 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 purposes 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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