

EGA International Equity ADR

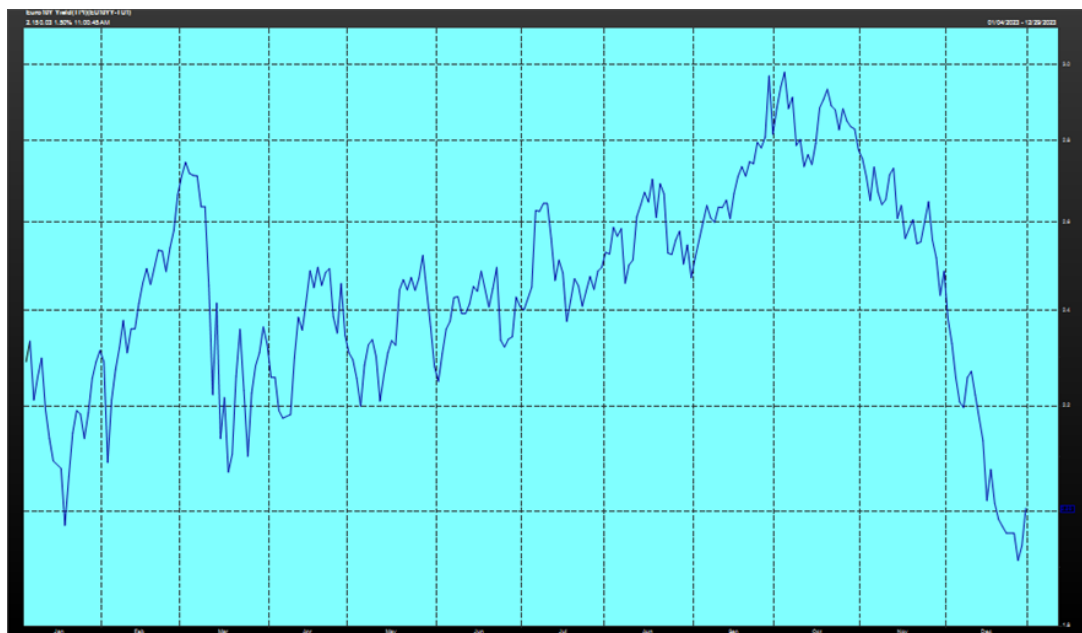
From the EGA Portfolio Management Team

Markets Rally as Central Banks Pivot

Global markets rallied in the last quarter of the year after a weak third quarter. Indications that major global central banks are done hiking and will begin cutting interest rates in 2024 gave the market narrative of a soft landing a boost. The MSCI EAFE Index rallied by 10.4% during the fourth quarter nearing the return of 11.7% for the S&P 500.

Growth style came back some in the quarter beating value for the three month period but was not enough as value beat growth for the year in international equities, as measured by MSCI EAFE style indices. With inflation expectations declining, central banks began to focus on a potential pivot in the interest rate cycle. This led to a sharp drop in bond yields in developed countries which supported equity prices. As can be seen in the last twelve months chart below, blended European 10-year bond yields declined about 90bps in the quarter from a peak of around 2.9% to end the quarter at 2.0%. The U.S. 10-year bond yield declined slightly more in the quarter from a mid-October peak of about 5.0% to end the quarter just below 4.0%.

Europe 10-Year Bond Yields

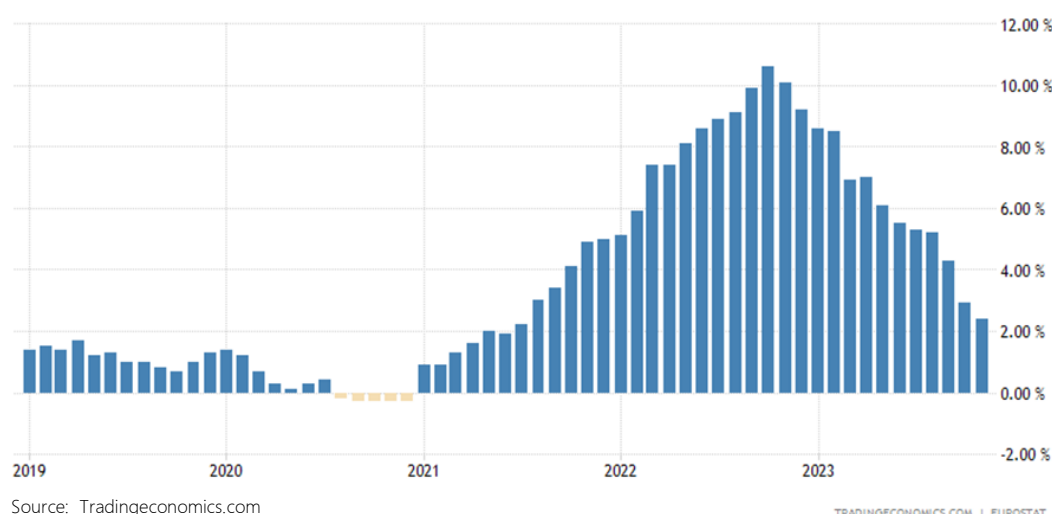


Source: Factset

The Federal Reserve held rates steady again in its December meeting, the third meeting in a row of no action from the Fed. It also signaled the end of its aggressive rate hikes as its dot plot now forecasts three rate cuts in 2024. Fed fund futures are forecasting a more aggressive rate cut campaign in 2024 with five to six rate cuts priced in by the futures market. Expectations differ whether the first rate cut will be in the first or second quarter. That aside, the narrative has changed and now focuses on the ability of central banks to successfully soft land their economies and how quickly they will lower rates starting in 2024.

ECB President Christine Lagarde pushed back on the market's expectation that the ECB may begin cutting rates as early as March of 2024 by stating in the latest ECB rate decision press conference that "we don't think that it's time to lower our guard". Euro area inflation has fallen significantly in recent months with the annual inflation rate at 2.4% in November. Annual core inflation in the euro area fell to 3.6%, the lowest level since April 2022. ECB President Lagarde mentioned in her comments as well that the ECB expects inflation to bounce back some in December due to base effects for the cost of energy. Moreover, the ECB also expects inflation to moderate more slowly in 2024 as further base effects take hold. But in a dovish pivot, the ECB in December dropped a previous statement that stated "inflation is expected to remain too high for too long."

Euro Area Headline Inflation

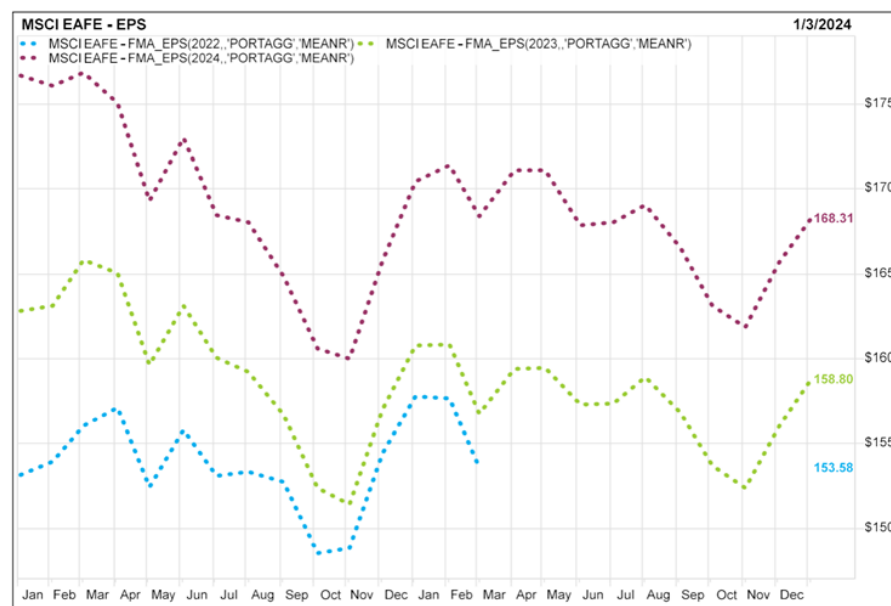
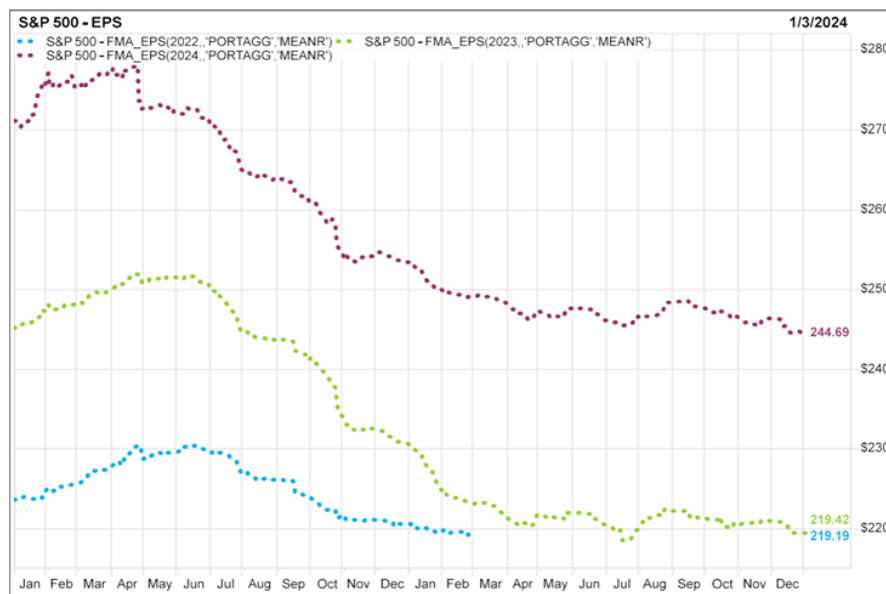


While central banks have not aggressively waived the victory flag over the highest inflation since the 1970's, it is clear from their recent comments and actions that they perceive the majority of their work is done. We expect central banks to remain vigilant in making sure inflation expectations remain underpinned at low levels while at the same time inflation, labor markets, and economic growth are likely to give them plenty of room to take their foot off of the brake and begin pivoting to rate cuts. While the Federal Reserve has begun discussing timing of rate cuts, President Lagarde said in her comments that ECB policymakers had not discussed interest rate cuts in the December meeting. It is conceivable to expect the Fed to begin cutting first as it hiked first in this cycle and for other central banks such as the ECB to follow suit soon thereafter. In addition, inflation in the U.S., as depicted by one of the Fed's favorite measures, core PCE, is now running at a 2.0% annualized run rate over the last six months.

Markets Expect Earnings Growth in 2024

While analysts and economists may debate the timing of rate cuts to come in 2024 and the following year, the key variable for markets is what this all means for earnings in the coming year. With inflation moderating, revenue growth from price increases is likely to also moderate.

Markets rallied in 2023 despite subdued earnings growth; hence, most of the return in the markets in 2023 was due to rerating in trading multiples rather than earnings. Part of this was an expectation that central banks would win their fight against inflation without causing severe economic pain. Thus far, signs point to a soft landing in 2024 but analysts will be closely watching the data. Consensus earnings expectations, as can be seen from the two charts below, show both U.S. and international markets expect earnings growth in 2024 as can be seen from the difference in the burgundy (2024e earnings) and green (2023e earnings) lines.



Source: Factset

While consensus estimates historically tend to be optimistic for earnings growth at the beginning of the year, we still expect decent earnings growth in 2024. The headwind of high interest rates will soon translate to a tailwind of lower rates for corporates. Those companies with higher refinancing needs will likely see the biggest benefit as well as lengthening of the economic cycle helping more cyclical corporate earnings. Moreover, some secular themes, including AI, robotics, and energy transition should continue to provide opportunities for companies globally. These are some of the areas that will likely support earnings growth in the coming year.

International Equity Relative Valuations at Multi-Year Lows

While both international and U.S. markets rose in 2023, the appeal of international equities remains as their valuations versus the U.S. are at multi-decade lows. The chart below depicts the P/E discount of the MSCI All Country World ex. U.S. Index versus the S&P 500. As can be seen from the chart, the valuation discount is around 34% or two standard deviations below their average discount over the last 20 years.

International: Price-to-Earnings Discount vs. U.S.

MSCI All Country World ex-U.S. vs. S&P 500, next 12 months



Source: Factset, MSCI, S&P, JPAM

While valuation is not by itself a perfect timing mechanism, it is rare to see such a drastic discount of international equities versus their U.S. counterparts. Such a discount could provide an opportunity for longer-term minded investors.

Portfolio and Stock Highlights

International equities rallied in the quarter as optimism over central bank pivots to lowering rates and a soft landing in 2024 provided a boost to equity prices to finish the year strong. The dollar also provided a small tailwind to international equity returns in the quarter as the dollar lost most of its gains from the prior quarter. The U.S. Dollar, measured by the DXY Index, remains at the higher end of its range over the last 30 years, suggesting dollar depreciation is more likely from here in the medium-term. Eagle portfolios participated in the rally nicely during the quarter beating the MSCI EAFE Index by almost 150 bps.

While portfolios performed well for the quarter, they were held back versus the benchmark for the full year due to our exposure to non-Japan Asia and underperforming positions in non-EAFE market Canada. Absolute overweights and underperformance of two specific country exposures, China and Canada, more than made up for the slight underperformance of the portfolio in 2023 to the MSCI EAFE Index.

While optimism ruled the day in the latter part of the quarter, some market participants are concerned equities rose too quickly and perhaps pulled forward some of the gains from early 2024. Either way, equities benefited from cautious positioning early in the quarter as well as central bank policy shift which led to lower discount rates being priced into equity prices. Given the continued optimism for a soft landing, lower quality areas of the market may lead gains in the near-term.

MSCI EAFE large caps underperformed mid and small caps for the quarter but outperformed for the full year. Growth came back in the quarter beating value but value beat growth for the full year. The best performing MSCI EAFE markets for the quarter were Sweden, the Netherlands, and Australia while the worst were Norway, Hong Kong, and Singapore. The best performing MSCI EAFE sectors for the quarter were Information Technology, Materials, and Real Estate while the worst performing were Energy, Health Care, and Consumer Staples.

Outperformers: Eagle portfolios performed well on an absolute and relative basis versus the MSCI EAFE benchmark as stock selection was strong for the quarter. Security selection in Industrials, Health Care, and Consumer Discretionary boosted the portfolios for the quarter. Strong stock selection in Japan, Hong Kong, and Germany added to the outperformance. Top attributors for the quarter included Techtronic Industries (Hong Kong-Industrials), Recruit Holdings (Japan-Industrials), and Capgemini (France-Technology).

Disappointments: Sector allocation was slightly negative for the quarter with underweights to outperforming Materials and Real Estate sectors hurting relative returns. Exposure to non-EAFE markets Canada and China was disappointing this quarter and was a headwind to further outperformance. Stock selection in Switzerland also detracted from performance. Main detractors of performance were Suncor Energy (Canada-Energy), Alibaba Group (China-Consumer Discretionary), and Lonza Group (Switzerland-Health Care).

Purchases / Additions In The Quarter

LONDON STOCK EXCHANGE GROUP (LNSTY): SECTOR: Financials, COUNTRY: United Kingdom. LSE Group is a market infrastructure and data company with several diverse businesses in its portfolio, including those from the January 2021 Refinitiv acquisition. We view the revenue mix at LSE Group, with a higher gearing to data revenues (~2/3) and to recurring/subscription revenues (>70%), as appealing in the context of European peers. LSE Group benefits from a number of secular growth drivers including indexing/smart beta/passives/ESG via FTSE Russell and the shift towards the central clearing of OTC derivatives via LCH. These growth assets combine with the migration to Workspace (~50% done), the Microsoft partnership, to yield further pricing and market share gains across the Trading and Banking solutions sub-segment. Moreover, tech re-platforming of FX (Foreign Exchange) and continued index businesses driving further improvement together with cost synergies from the Refinitiv transaction should support earnings growth.

UNICHARM CORPORATION (UNICY): SECTOR: Consumer Staples, COUNTRY: Japan. Unicharm is a leading manufacturer of non-woven fabrics and absorbent materials such as wet wipes, disposable diapers for children and adults, and feminine hygiene products. The company also produces pet care products. Through leadership positions in their primary lines, Unicharm has posted a track record of growth well in excess of most global personal care companies. We expect Unicharm's focus on products that are driven by favorable demographic trends to result in continued growth leadership in the Consumer Staples sector. Specifically, Unicharm focuses on baby diapers in emerging countries and on incontinence products, feminine hygiene, and pet care in developed countries. By matching products to markets with supportive demographics, Unicharm should continue to deliver above sector-average growth.

WPP PLC (WPP): SECTOR: Consumer Discretionary, COUNTRY: United Kingdom. In 2023, WPP faced headwinds from lower discretionary spend by its tech clients. Its valuation continues to look attractive. At current levels, there is arguably a deep value in WPP. But valuation is never the sole pillar in our investment theses. Our recent purchase was encouraged by our tax loss harvesting strategy as well as restructuring potential. We see a near-term catalyst in the upcoming capital markets day as WPP has already announced plans to simplify its media unit, GroupM. That, together with other cost cutting plans could provide the company a needed boost after a disappointing year.

Sells/Trims In The Quarter

SHIMANO INC (SMNNY): SECTOR: Consumer Discretionary, COUNTRY: Japan. Shimano continues to deal with high inventory, customer cancellations and lower growth prospects following the Covid boom in demand. Margins have also deteriorated and could be falling back to pre-Covid levels. We decided to sell and redeploy the proceeds.

UNILEVER (UL): SECTOR: Consumer Staples, COUNTRY: United Kingdom. Headwinds to growth from consumers downtrading out of Unilever's premium products was evidenced by fewer business lines gaining market share. As a result of the poorer growth environment for Unilever, we chose to swap into more attractive opportunities.

Disclosures

The indices shown are for informational purposes only and are not reflective of any investment. They are unmanaged and shown for illustrative purposes only. The volatility of the indices are likely materially different than the strategy depicted. Eagle Global's International Equity ADR strategy includes buying and selling various international equity companies. Holdings will vary from period to period and international equity companies can have a material impact on the performance.

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