# EGA U.S. Equity

From the EGA Portfolio Management Team

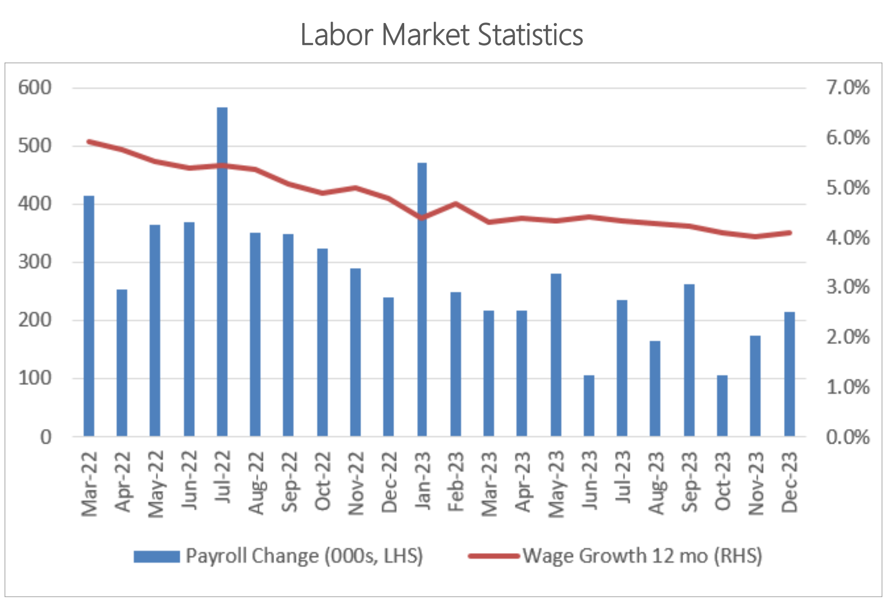
Equity and bond markets ended the year on a strong note as investors concluded that we are in the final innings of battling inflation and that we've seen the last increase in interest rates from the Federal Reserve. U.S. stocks posted a strong 11.7% return for the quarter, bringing their total return for the year to 26.3%, as measured by the S&P 500. The Fed did not change its policy rates in the quarter; in response, longer-term interest rates fell markedly, especially at the end of the year. As a result, the returns to intermediate and longer-term fixed income securities were positive during the quarter.

## Fundamentals

### Economy: Final innings of inflation fight in sight

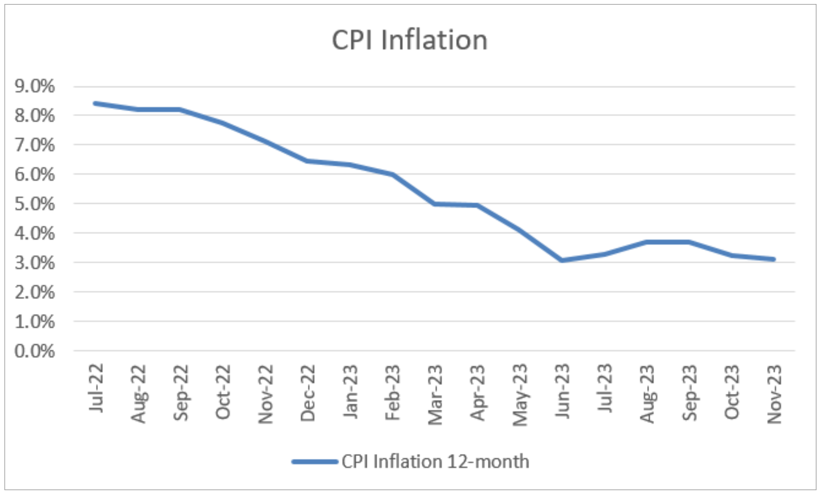
While the contractionary monetary policy that the Fed adopted nearly two years ago is having its intended effect of slowing economic activity, the strength in the economy in the face of higher rates has surprised economic analysts, many of whom forecasted a recession that never materialized in 2023. In its most recent economic projections from December, the Fed raised its forecast for real 2023 GDP growth for the third time this year while lowering its forecast for inflation this year and next. While manufacturing and technology have slowed markedly and layoffs in those sectors have made headlines, the majority of economic activity is still in the services sector. Industries like health care, education, and leisure are showing robust demand. For now, the economic growth appears intact.

The most recent employment report for December showed an increase of 216,000 new jobs (blue line below). Average monthly new jobs in the fourth quarter was 165,000 over the last 3 months, down from the 221,000 pace of the prior quarter. Unemployment remained unchanged at 3.7%. This job growth in the face of higher interest rates supports the view that the economy is stronger than many had assumed. Wages are now running ahead of inflation. Wage growth for the prior 12 months came in at 4.1% (the red line in the graph below), slower than it has been, but ahead of goods inflation statistics.




*Source: U.S. Bureau of Labor Statistics*

The good news is that inflation has slowed since the first half of 2022. The Consumer Price Index (CPI) has slowed to a 3.1% annual rate, and when looked at over a shorter period (3 or 6 months) is advancing at even slower rates. Energy prices have recently been soft, with gasoline averaging $3.00 a gallon according to the EIA, equal to its lowest levels in the past two years. Also, measures of housing costs and apartment rents are showing prices slowing or even falling in some markets, which should be reflected in lower inflation statistics in the months to come.




*Source: U.S. Bureau of Labor Statistics*

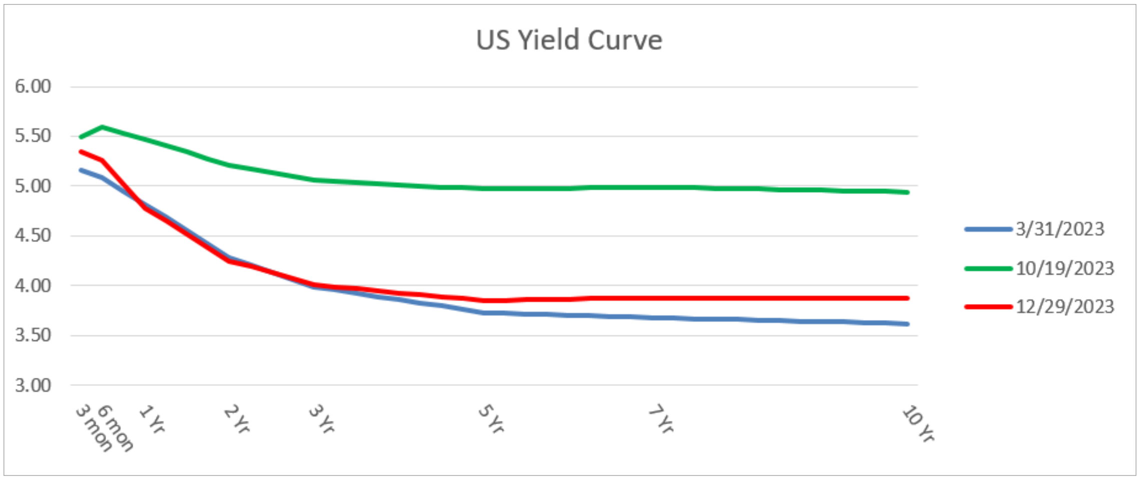
The Federal Reserve lowered its expectation of inflation to 2.4% in 2024 in its December forecast, which is close to its long-term target of 2.0%. Progress on inflation will be the key to how fast or even whether the Fed lowers its policy interest rates, so their actions will continue to be a focus of investors in 2024.

## Federal Reserve: Pivot to an easier regime?

The fourth quarter saw the Fed put a halt to its program of increasing interest rates and raised speculation that the Fed will shift to lowering its policy rates in the new year. At their meetings in October and December, they maintained the target zone for the Federal Funds rate at 5.25% - 5.50% and continued their policy of reducing their security holdings. Most significantly, in their projections of economic statistics which they release quarterly, the Fed pivoted from projecting an increase in the Fed funds rate in 2024, which they had done in prior projections, to forecasting a decrease in the Fed Funds to 4.6% at the end of 2024. While the Fed is therefore anticipating three rates decreases of 25 basis points, the market, as measured by Fed Funds futures, is forecasting approximately six rates cuts of that magnitude.

While less a focus of analysts than interest rates, the Fed guided that it will continue to reduce the size of its balance sheet. To date, the Fed has reduced its holdings of securities by about $1.2 Trillion from its peak. This has led to a reduction in measures of the monetary supply, which many observers think of as key to inflation and market liquidity. At the press conference in December Fed Chairman Powell guided that this policy would continue unless the economy suffered a negative shock like it experienced this past spring with the banking crisis.

The pause in Fed rate increases and speculation of a Fed pivot caused a dramatic turnaround in interest rates in the fourth quarter. Three months ago, all the talk about the Fed was that its policy on interest rates was “higher for longer” and as a result longer-term interest rates like the 10-year Treasury increased from about 3.6% at the end of March to 5.0% in early October. The pause in rate increases in the fourth quarter prompted an almost complete reversal of the prior interest rate increases in the last three months of the year and the 10-year Treasury ended the year at 3.9%. (See graph p. 3)




*Source: Factset*

## Corporate Profits: Analysts making larger cuts than average to Q4 EPS estimates

We expect corporate profits for the fourth quarter to be up year-over-year modestly. The S&P 500 is expected to report annual earnings growth of 2.4% for Q4 according to FactSet. While this will mark the second consecutive quarter of year-over-year earnings growth for the index, earnings growth is expected to be below the 4.9% growth seen during the third quarter. Six of eleven sectors are expected to record positive earnings growth, led by the Communications Services, Utilities, and Consumer Discretionary sectors. Only Energy, Materials, and Health Care sectors are expected to record negative year-over-year earnings growth this quarter.

Analysts are more positive on earnings in 2024. Next quarter (Q1 2024) analysts are expecting earnings up 6.2% above a year ago, and earnings for the full year 2024 are expected to be up 11.5% over 2023. At current levels of the S&P 500, the forward 12-month P/E is expected to be 19.3, above its 5-year average of 18.8 and above the forward P/E ratio of 17.8 at the end of Q3 2023. It appears analysts are assuming a “soft landing” for the economy, that is, that the Fed will be able to engineer the economy to achieve its 2.0% inflation target without sparking a recession. If the economy does fall into a recession, these earnings estimates will be too optimistic.

## Fixed Income: Rates fall, bond prices rise

As noted above, the fourth quarter saw a dramatic reversal of longer-term interest rate increases seen in the first nine months of the year. Short-term Treasuries rates stayed flat as the Fed halted their increases of policy rates. Falling long-term rates with stable short-term rates led to a more negatively sloped yield curve. Corporate bond yields fell as well, and mortgage interest rates also declined. The Fed has signaled that it will start to reduce policy rates in 2024. For now, credit is strong and corporate spreads are at average levels. We are somewhat concerned that the tight financial conditions will start to create more distressed credits. We continue to maintain high quality portfolios with short to intermediate maturities in this environment.

## Stock and Portfolio Highlights

Eagle portfolios outperformed the S&P 500 Index during the quarter mainly due to good stock selection. Sector allocation was largely neutral as underweights to Consumer Staples and Health Care were undercut by cash in a rising market. Stock selection in Industrials (Uber, Trane Technologies), Consumer Discretionary (Holding Amazon and Home Depot, Not holding Tesla), and Financials (American Express, JP Morgan) were favorable. American Tower, a REIT with cell phone towers, was favorable as well. Energy took a breather in the quarter and Pioneer Natural Resources and Chevron detracted from returns.

## Purchases/Additions In The Quarter

American Tower Corporation (AMT): American Tower Corp. is the largest Cell Tower REIT and provides tower site rental, in-building, and network development services in the United States and several core (Mexico, Brazil, India, Nigeria) and emerging international markets. We like AMT given its stronger growth profile than peers driven by international growth with 4G densification and inflation-based escalators, better domestic growth given solid tower activity from AT&T, T-Mobile and Dish, data center exposure via its Coresite business, highly predictable revenue stream and less impact from Sprint churn since AMT has already processed most of this (while peers will see a step up). AMT still expects to close a sale/JV of its India business near-term as well.

Lear Corporation (LEA): Lear is the most vertically integrated supplier of complete automotive seat systems and has been gaining share and improving margins. Lear is also a world leader in Electrical Distribution Systems which are used across power and signal distribution for both low and high voltage vehicle solutions. Management expects electrification products within this division to continue to drive the company's growth over market. With both divisions performing well and management guiding to record margins and cash flow in the out years, we decided to add to our position while the valuation was still compelling.

NextEra Energy, Inc. (NEE): NextEra is the largest regulated utility traded in the U.S. NextEra consistently delivers best-in-class growth driven by the company’s best-in-class exposure to renewables-based generation growth. A bit more than half of the company’s revenue comes from its Florida-based regulated utility, while the balance is primarily generated by a portfolio of renewables-based assets operating on long-term contracts in competitive jurisdictions. We added to our NEE position in order to maintain our weight in the Utilities sector, which declined due to our sale of Duke Energy.

PayPal Holdings, Inc. (PYPL): We made a buy and sell transaction in PayPal as part of year-end tax loss harvesting. PayPal is navigating growth headwinds due to macroeconomic and competitive forces. Its user and merchant networks remain resilient with increased adoption of the platform within existing users and best in class merchant retention rates. The new executive team is driving a growth strategy that differentiates the value proposition of PayPal, both for users and for merchants, against its competitors, while buying back its stock in large volumes. We believe there is a large growth runway ahead for the company and the market is wrong in assigning it the low valuation of 11 times price to earnings ratio.

## Sells / Trims In The Quarter

Duke Energy Corporation (DUK): Relative to our expectations, Duke was not demonstrating an ability to close a sector-relative growth deficit. Additionally, after falling further behind the sector during the first two fiscal quarters, Duke had not adjusted its growth plan, leaving the company vulnerable to further disappointment.

PayPal Holdings, Inc. (PYPL): Portfolios also showed a sell in the quarter even though we also booked a buy. This was part of year-end tax loss harvesting, where we replaced a high-cost tranche of this name with a lower cost tranche.

Walt Disney Company (DIS): Disney is finally facing the headwinds of the inevitable transition from linear television to streaming. The market had gotten ahead of the fundamentals in assigning Disney's streaming business a Netflix like valuation multiple when Disney's monetization, profitability and growth runway were trailing the category leader. Now, the cash flows from linear TV have deteriorated, while streaming profitability is at least a year away. Having said that, we believe in the quality of the assets the company holds, particularly its intellectual property and its parks business. We believe Disney is down but not out and we will be opportunistic in adding to our position. The recent trim was done to harvest tax losses.

## 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 U.S. Strategy includes buying and selling various U.S. equity companies. Holdings will vary from period to period and U.S. equity companies can have a material impact on the performance.

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