EAGLE GLOBAL ADVISORS

Market Review and Outlook
Q4 2018

EGA International Equity ADR

From the EGA Portfolio Management Team

Market Overview

Global equity markets plummeted in the 4th quarter as investor confidence plunged. The MSCI EAFE index fell -12.54% in the quarter bringing its year to date return to -13.79%. In the U.S., the S&P 500 also fell by -13.52% bringing its year to date return to -4.38%.

The Global Economy

Global Summary

The International Monetary Fund (IMF) warned early in the 4th quarter that growth may have peaked in some major economies around the globe. Little did they know that this particular subject of future economic growth would rattle markets over the coming 3 months. The IMF also stated that "downside risks to global growth have risen in the past six months and the potential for upside surprises has receded". The often-followed Citigroup Economic Surprise Index also showed a weakening trend in the 4th quarter. The JP Morgan Global Manufacturing PMI supported this backdrop as it hit its lowest level since September 2016. The PMI survey suggested that "The December PMI surveys signaled that the global manufacturing sector ended 2018 on a subdued footing…The outlook also remains relatively lackluster, as business confidence dropped to its lowest level in the series history".

If this was not enough, the significant volatility in markets in the quarter and waning business confidence worried C-Suites of major global corporations. The Duke University CFO survey showed confidence collapsing to levels below early 2016 and similar to the depressed levels from 2011/2012. But a major concern was whether this was a late cycle deceleration or signs of a looming global recession in 2019. With global median unemployment at the lowest levels since 1980, wages actually rising, and inflation under control, it is hard to envision that a recession is imminent. Global growth will decelerate in 2019, and perhaps down to trend levels after two years of above trend growth, but there is not enough evidence of an imminent global recession.

The US-China trade war thawed a bit as Presidents Trump and Xi met at the G-20 during the quarter and agreed to continue trade talks. In the meantime the US postponed plans to raise tariffs in the new year from 10% to 25% and China agreed to scale back some tariffs it had recently raised. There are hopes that the two countries can come to a resolution sometime in 2019 even though the softer issues like intellectual property rights and cyber espionage will complicate a quick path to resolve their differences. The UK's Brexit continued to provide significant uncertainty for Europe while Italy appeared to be closer to a deal with Europe on a budget.

Japan / Asia

The Bank of Japan's (BoJ) Tankan survey of large manufactures was steady in December after 3 quarters of declining business confidence. While the sentiment on the outlook deteriorated, corporates also projected healthy capex plans for the coming year. The BoJ is expected to remain on the sidelines in 2019 as inflation is far from its targets. While labor markets remain very tight, wage growth has failed to accelerate significantly in recent quarters. With growth somewhat weaker than expected, the BoJ has little ammunition in case of any downturn in growth expectations.

The single biggest issue facing the country over 2019 is the upcoming consumption tax hike that is scheduled to rise in October of 2019 by 2% to 10%. Some analysts project a significant front loading of consumption up to October of 2019 and then a significant retrenchment post the tax hike that will lead to higher economic growth in the first part of this year and then contraction in the 4th quarter. The government has promised fiscal expansion to mitigate the effects of the tax hike.

Europe

Economic growth in the Eurozone took a turn for the worse in the second half of the year. Germany's economy contracted in the third quarter for the first time in 3½ years and the worst showing since early 2013. In addition, French growth disappointed as well with the "yellow shirts" protests adding to the near-term weakness. Italy also ground to a halt as uncertainty over its new budget and negotiations with Europe dented confidence. The IHS Markit Eurozone PMI surveys fell in December to their lowest levels since February 2016. The survey stated that "a disappointing December rounds off a year in which a manufacturing boom faded away to near stagnation…The last three months of 2018 saw manufacturers report the worst quarterly performance in terms of production since the second quarter of 2013".

The weakness caused the European Central Bank (ECB) to cut its growth forecast for the Eurozone for 2018-2020 while ECB president Mario Draghi stated that "it's a climate of great uncertainty". Even with the uncertainty, the ECB stayed on course to end its quantitative easing in December by halting bond purchases at the end of 2018. While most analysts expect the ECB to begin an interest rate increase cycle in the 4th quarter of 2019, recent weakness in the economy does place greater uncertainty on that timing.

The direction of European policy may shift somewhat this year with major events including UK's Brexit and European parliamentary elections in May 2019. While the UK is scheduled to exit the European Union at the end of March, there continues to be a huge degree of uncertainty of what the final Brexit outcome will look like. The uncertainty in Brexit actually has helped the UK economy in the near term as shown by the UK Manufacturing PMI which hit a 6-month high of 54.2 in December. The survey suggests that it is a one-time bump with "clients purchasing to build up safety stocks to mitigate potential Brexit disruption". If a Brexit plan is agreed on and passed by the UK parliament, this soft Brexit scenario would likely allow the Bank of England to continue on its rate raising path over the medium term as inflation hovers above bank targets.

Emerging Markets

The Chinese economy is witnessing a marked deterioration. The most recent official government PMI and the private Caixin/Markit Manufacturing PMI both slowed to levels below 50, signaling a contraction in manufacturing activity. It was the first time the Caixin PMI fell to contraction level in 19 months while the government PMI was at its lowest since February 2016. It was not that much of a surprise as recent industrial production data had disappointed. While retail sales have also disappointed, worrying some about the consumer side of the economy, the slowing is mainly caused by weak auto sales. With the US-China trade war still ongoing, even though recent negotiations have resumed, the Chinese government appears now to be shifting to protecting growth over financial stability and managing a soft landing of its economy.

President Xi passed new tax cuts for individuals in October and is expected to announce additional stimulus with a VAT tax cut and corporate tax cuts in the 1st half of 2019. The government has also sent signals to the banking sector that it would like banks to support small and medium sized enterprises with higher loan growth. The government has announced aggressive reserve ratio requirements for banks and most analysts expect more RRR cuts to be a possibility in 2019.

The new year will be a tough one to navigate for the Chinese government as the US-China trade war continues and as policy tools narrow given the increasing amounts of debt in the country. This led S&P Global to warn that China could be facing a "debt iceberg with titanic credit risks" following a boom in infrastructure projects financed by off-balance sheet local government financing vehicles.

Politics

Chancellor Angela Merkel's popularity reached a low in recent elections as her immigration policies have backfired with voters. Local elections in Bavaria and Hesse dealt significant blows to her Christian Democratic Union (CDU) party and her coalition parties. Anti-immigration and nationalist parties gained significant support leading Ms. Merkel to announce she would not run for CDU leadership and would step away from politics when her term is done after nearly two decades at the helm of Germany's biggest party. Some have speculated that early elections may be called in Germany over the next 12 months.

While Merkel suffered defeats, her French counterpart Emmanuel Macron dealt with major backlashes to his reform agenda. A proposed gasoline tax hike was the final straw that sent protesters to the streets. The "gilet jaune" ("yellow shirts") protests gripped the country for over a month and slowed economic activity. Protesters called for Macron's ouster as a man out of touch with the French people. Macron reversed some of his more unpopular reforms and taxes leading to a softening of tensions, but the situation remains tenuous in France.

UK Prime Minster Theresa May struggled to get her Brexit deal passed in the UK Parliament and there is significant uncertainty as to the final outcome in the UK. Brazil's conservatives won the runoff presidential election and markets cheered as Jair Bolsonaro pledged a new era of "order and progress" for Brazil. European Parliamentary elections in May will be a focus for European markets in the first half while Asia will be focused on India's general elections in the second quarter.

Stock and Portfolio Highlights

Global equity markets took it on the chin in the 4th quarter. Uncertainty over Federal Reserve monetary policy, US-China trade war, Brexit, Italy, and just overall concerns of global economic growth over the coming twelve months sent markets in a tailspin that resulted in a significant correction of risk assets. Investor confidence plummeted as fear gauges reached oversold levels and volatility spiked. The Federal Reserve Chairman's remarks aided the equity rout as his flip flopping comments on whether interest rates were far from neutral or just below neutral confused equity and bond markets alike. The yield curve flattened significantly as a result giving way to concerns over an imminent inversion of the yield curve which could signal a looming recession on the horizon.

While all seemed to view the markets on a "glass half empty" basis, the large correction in the equity market is pricing in a significant slowdown in earnings growth already. Earnings estimates have been revised downward across the globe while MSCI EAFE EPS growth in 2019 still expected to be in the mid-single digits. Valuations have fallen to much more attractive levels and provide a much better risk reward opportunity for investors. The MSCI EAFE index is now trading at less than 12x 2019 expected earnings, one standard deviation below the long-term average, and close to a 4% dividend yield.

Oil prices plummeted in the quarter leading to a rout for oil stocks on both supply and demand concerns. On the supply side, less stringent than expected Iran sanctions together with Saudi pumping more oil in anticipation of less Iran barrels plus higher than expected US shale oil production sent jitters through the markets. Moreover, global growth concerns gave way to lowered demand growth expectations and the combination of higher supply and lower demand expectations rattled oil markets.

Large caps outperformed small and mid-caps for the quarter and year to date periods. Value performed better in the quarter while growth did better for the year. The best performing EAFE countries for the quarter were Hong Kong, New Zealand, and Singapore while for the year were Finland, New Zealand, and Israel. The worst performing EAFE countries for the quarter were Austria, Belgium, and Norway, while the worst for the year were Austria, Belgium, and Ireland. The best performing emerging markets for the quarter were Brazil, Indonesia and Qatar while the worst for the quarter were Pakistan, Colombia, and Mexico.

Outperformers: Stock selection in Health Care and selection in Germany and Switzerland were helpful to the portfolio. An underweight to Materials and overweight to Communications Services also helped the portfolio in this difficult quarter.

Disappointments: Eagle portfolios struggled for the quarter due to their cyclical and China exposure at a time of cyclical and China concerns. Leading the disappointments was stock selection in Industrials and Consumer Discretionary. When the markets were worried about global growth, cyclical stocks in these two sectors were battered significantly. Stock selection was also challenging in France, the Netherlands, and Hong Kong.

Purchases / Additions in the Quarter

BT Group PLC (BT): SECTOR: Communication Services; COUNTRY: United Kingdom: After a few years of negative momentum and regulatory hurdles, the company has begun to show positive earnings momentum and improving regulatory clarity. Cost cutting is also supporting a less robust fiber backdrop. The stock looks attractive on an earnings rebound, valuation and a 6% dividend yield.

Intesa Sanpaolo SpA (ISNPY): SECTOR: Financials; COUNTRY: Italy: Intesa is among the #1 banks in Italy with over 20% market share in all business areas due to its network of 6,100 branches across the country. We see Intesa as a bank with good earnings visibility, a strong balance sheet and a solid capital position with a commitment to pay cash dividends for the next three years trading at an attractive valuation. It is attractive compared to other European Banks at an 8.6x 2019 P/E and 0.7x P/B for an 8% ROE and 10% dividend yield (2018e).

Suncor Energy (SU): SECTOR: Energy; COUNTRY: Canada: Suncor is benefitting from very strong operational execution of its downstream and upstream operations. While the oil backdrop is less positive today, we believe the company is on course for significant free cash flow generation that they can redeploy for share buybacks and dividend increases.

Sells / Trims in the Quarter

Aegon NV (AEG): SECTOR: Financials; COUNTRY: Netherlands: Aegon is a globally diversified insurance group operating across U.S. and international markets. Over the past three to four years, low interest rates have weighed on the group's profitability as it has a high earning sensitivity to changes in long-term interest rates. In addition, US Long Term Care costs continue to pose significant risks for Aegon as they remain relatively aggressive with assumptions, creating the risk of further negative surprises vs expectations. With the increase in balance sheet risk and interest rate outlook cloudy across the globe, we decided to sell and redeploy the proceeds.

AGC Inc (ASGLY): SECTOR: Industrials; COUNTRY: Japan: Concern over falling chlor-alkali prices, which had buoyed performance, as well as the company's exposure to auto glass at a time of global auto sales under pressure led to our sale of the position.

Japan Airlines (JAPSY): SECTOR: Industrials; COUNTRY: Japan: JAL came out of bankruptcy in 2015 in superior financial shape with legacy costs and debt erased allowing them to earn high returns on capital. Although we did see increased shareholder returns, Japan airlines never earned a valuation premium as spikes in oil, bumpy operational execution, China slow down fears, and tepid growth all contributed to the stock being mostly dead money through the investment period. With the government restrictions now ending allowing Japan airlines to acquire assets with no restrictions at a time when their eps growth is flat for the next 3 years, we decided the risk has increased and our thesis has now played out, therefore, we have exited the position.

Kingfisher PLC (KGFHY): SECTOR: Consumer Discretionary; COUNTRY: United Kingdom: While progress was made on the ONE Kingfisher plan, "Business as Usual" continues to be too strong a headwind to overcome. French protests have reduced prospects for Kingfisher's already-challenged Castorama business and Brexit uncertainty in the UK led to a new wave of concern for B&Q's like-for-likes.

Magna Intl (MGA): SECTOR: Consumer Discretionary; COUNTRY: Canada: Magna is one of the largest tier 1 auto suppliers in the world. With recent vehicle sale declines in both China and Europe and the threat of US sales peaking, we decided to take advantage of the premium valuation ahead of Magna's earnings release and trimmed the position. Although we like their long-term positioning in ADAS, advanced seating and vehicle assembly, out year expectations now appear too lofty and need to be reset down and that the risk reward is more neutral to unfavorable.