EAGLE GLOBAL ADVISORS

Market Review and Outlook
Q2 2019

EGA International Equity ADR
From the EGA Portfolio Management Team

Market Overview

After a slow start to the quarter, global equity markets recovered strongly in June. The MSCI EAFE Index rose 3.7% during the quarter bringing its year-to-date return to 14.0%. In the U.S., the S&P 500 Index rose 4.3% for the quarter increasing its year-to-date return to 18.5%.

The Global Economy

Global Summary

The manufacturing slump that started in the second half of 2018 has continued into the new year as global manufacturing is hurt by a slowdown in China, Brexit uncertainty, and looming trade wars all conspiring to increase corporate investment uncertainty. The J.P. Morgan Global Manufacturing PMI continued to fall in June, which at 49.4 is the lowest level for this indicator since the second half of 2012. Of the 30 nations for which a June PMI reading was available, 18 of them signaled a contraction, including China, Japan, Germany, the U.K., Taiwan, South Korea, Italy, and Russia.

Given the slowdown in global trade and manufacturing, the International Monetary Fund (IMF), the OECD and the World Bank have all recently warned about a downside risk to global growth. The IMF projects a decline in the rate of growth for 70% of the global economy in 2019 versus the prior year and has reduced its global growth forecast to 3.3% in 2019. This compares with global growth rates of 4.0% in 2017 and 3.6% in 2018. While the IMF sees "considerable uncertainties in the short-term", it also expects a slight pick-up in activity in the second half of this year. The OECD in turn warns that current fragile global growth may remain over the coming two years. Moreover, the World Bank also lowered its global growth expectations with World Bank President David Malpass stating, "there's been a tumble in business confidence, a deepening slowdown in global trade, and sluggish investment in emerging and developing economies".

Inflation has also disappointed to the downside across most developed economies. A combination of lowered global growth expectations and subdued inflationary expectations has led major central banks to pivot toward more monetary easing in the coming year. The Federal Reserve, the European Central Bank, the Swiss Bank, and the Bank of Japan have all provided rhetoric that supports additional rate cuts and/or additional monetary easing conditions in the near-term. This has led to global bond yields tumbling with the U.S. 10-year bond going form a high of 2.78% earlier this year to a low of 1.99% late in the quarter. European bond yields also tumbled with the French 10-year bond hitting negative levels for the first time ever and the German 10-year bond digging deeper into negative territory closing the quarter at -0.32%.

Japan / Asia

The Bank of Japan's Tankan survey of large manufacturers slipped in the latest quarter to +7 from +12 in the prior quarter, the lowest level in three years due to the slowdown of the Chinese economy and the U.S.-China trade war. Manufacturers sentiment took the biggest hit while big non-manufacturers exceeded market expectations by seeing a rise in business sentiment in the latest quarter. The Jibun Bank Japan Manufacturing PMI from June concurs with the soft Tankan confidence at 49.3, it shows a marginal deterioration from the prior month and points to contractionary conditions at Japanese manufacturers.

While manufacturing is weak, services appear to be holding up well leading most economists to estimate that Prime Minster Shinzo Abe will go ahead with the plan to increase the consumption tax from 8 to 10 percent on October 1st. Though much speculation surrounds this decision given weaker economic growth and with Upper House elections scheduled for July 21, Abe still appears determined to go ahead with raising the tax.

Bank of Japan Governor Haruhiko Kuroda remains very supportive of ultra-low unorthodox monetary easing and pressed on the accelerator in his last meeting by announcing that the central bank will likely continue its ultra-easy monetary policy for well over another year as it remains far from his inflation goal of 2%. Japanese inflation remains below 1% and most analysts do not believe Kuroda can achieve his 2% goal.

Europe

Germany's ZEW indicator of economic sentiment disappointed expectations by falling to minus 21.1 in June, dropping 19 points from May and well below expectations of minus 5.9. The survey commented the drop was due to "…an increased uncertainty regarding the future development of the global economy and substantially worsened figures for the German economy at the beginning of the second quarter". Germany's export economy has been hard hit from the slowdown in China.

The IHS Markit Eurozone Manufacturing PMI deteriorated for a fifth consecutive month ending at 47.6 in June. Consumer goods companies are holding up well in the survey, but intermediate and investment goods producers recorded contractions, which are a familiar tone. The survey mentioned that "eurozone manufacturing remained stuck firmly in a steep downturn in June…feeding through to lower inflationary pressures…" Inflation slipped further from the European Central Bank's (ECB) target going down to 1.2% in May.

The slower growth in economic activity and subdued inflation led ECB president Mario Draghi to extend guidance for rate hikes out another 6 months into 2020 while announcing that interest rates are to "remain at their present levels at least through the first half of 2020, and in any case for as long as necessary…" The central bank also announced a new round of generous terms for fresh long-term loans to banks to begin again in September. With its current benchmark rate of -0.4%, the market is now also expecting the ECB to hint in its July meeting of a possible rate cut as early as September. With a more dovish ECB and Federal Reserve, interest rates in Europe continued to decline further into negative territory with the French 10-year bond hitting negative levels for the first time and the German and Swiss 10-year bonds moving further negative. With a benchmark rate of -0.75%, even the Swiss Bank hinted at continued easing as it announced that "we still have room to maneuver so that we can go to an even more expansionary monetary policy."

Emerging Markets

China's manufacturing sector has weakened from its cyclical slowdown and the effects of the trade war with the U.S. The International Monetary Fund cut its 2019 economic growth forecast for China citing renewed trade risks and stated that China's growth "is expected to moderate to 6.2% and 6.0% in 2019 and 2020, respectively." The Caixin China General Manufacturing PMI agrees with the moderating expectations and in its latest survey fell back to contraction at 49.4 in June with Chinese manufacturers continuing to shed jobs in June.

The renewed trade tensions in the quarter led to the U.S. increasing its tariffs on US$200bn worth of goods from 10% to 25% while also increasing pressure on Chinese tech darling Huawei. The Chinese retaliated with increased tariffs of their own while recent discussions in late June at the G-20 appears to provide some hope that the parties are coming back to the table to continue negotiations.

The slowing growth has prompted the Chinese government to continue its path of fiscal and monetary easing. The government announced some loosening of restrictions in property investment while the People's Bank of China (PBoC) announced cuts to reserve requirements for medium and small banks as China's financial system feels the effects of a slowing manufacturing sector. Baoshong Bank was forced to go under state control as this rural bank's capital was insufficient to cover its risky loans. The government's campaign to reign in leverage in the system led to record bond defaults in 2018 and thus far this year, through the first four months of 2019, bond defaults have been three times the levels of last year.

Politics

Britain remains in uncharted waters with no Brexit agreement approved by Parliament leading to the resignation of PM Theresa May. She will resign once the Conservative Tory party nominates a new leader. After a few rounds of party voting, Boris Johnson and Jeremy Hunt are the finalists for leadership that will be decided in July. While Britain and the European Union kicked the Brexit deal can down the road to October, much uncertainty remains as to the final outcome.

European Parliament elections were held in May leading to the rise of Eurosceptic and Green parties in the parliament while pro-EU parties will remain in the majority but with a much more fragmented majority leading to a more challenging leadership of the region. Japan's Upper House election will be held in late July with polls suggesting PM Abe's ruling coalition is likely to retain majority control.

India's Prime Minister Norendra Modi claimed a landslide victory in the national elections cementing his leadership with his ruling BJP party likely to continue on the reform path. In Australia, a surprise victory for the conservatives as Prime Minister Scott Morrison's Liberal-National coalition won a narrow majority in the latest national election. In Turkey, President Erdogan's AKP Party was dealt a significant blow as the re-do of the Istanbul mayoral elections proved a major defeat for his party and autocratic rule. In Hong Kong, protesters flooded the streets on the anniversary of the handover of the island from the U.K. to China and as a controversial extradition law moved through the Hong Kong government.

Stock and Portfolio Highlights

Global equity markets went on a wild ride in the second quarter with equities rising in April, taking a plunge in May and then rebounding strongly in June to end the quarter on a strong footing. Hopes of accommodative central bank action early in the quarter led to equities continuing their first quarter rally but was interrupted abruptly by a falling out of the U.S.-China trade talks. An announcement that the U.S. would be ending talks and increasing tariffs on $200bn sent the markets on a tailspin as the goldilocks market environment was questioned.

Central banks around the world appeared to double down on their commitment for further monetary easing and markets began to price in rate cuts in 2019, a major change versus earlier in the year where rate hike expectations had been delayed but not expectations for rate cuts. The "central bank put" is back with the Federal Reserve, European Central Bank, Swiss Bank, and the Bank of Japan all appearing to sound the same trumpet of "whatever it takes" mentality to support economic growth and confidence over the coming year. Excess central bank liquidity has helped financial assets since the Global Financial Crisis and central banks appear to be turning on the taps once more. Global bond yields plummeted during the quarter hurting the Financials sector but helping support growth equities. Recessionary concerns continued to surface as the 3m-10y U.S. bond yield spread remained in negative territory and the New York Fed Probability of U.S. Recession measure reached over 29%, the highest reading since 2007.

In spite of rising tensions in the Middle East, oil prices fell during the quarter as increasing production from the U.S. Permian Basin combined with higher than expected global inventories and concerns over demand given weakening economic outlook led oil prices lower from their April highs. The U.S. Dollar softened a bit given increasing expectations for rate declines in the U.S. but remained elevated versus most currencies.

Large caps outperformed small and mid-caps for the quarter and year while Growth has significantly outperformed Value for the quarter and year-to-date periods. The best performing MSCI EAFE countries for the quarter were Switzerland, Australia, and Germany while the worst performing MSCI EAFE countries for the quarter were Israel, Finland, and Austria. The best performing emerging markets for the quarter were Argentina, Russia, and Greece while the worst for the quarter were Pakistan, Chile, and Hungary.

Outperformers: Eagle portfolios slightly outperformed the performance of the MSCI EAFE Index, maintaining their large lead over the index for the year-to-date period. Stock selection in the Industrials and Consumer Staples sectors was beneficial with core holdings Techtronic Industries, Canadian Pacific, and Nestle all providing positive alpha for the quarter. From a country standpoint, underweights to the U.K. and Japan provided positive allocation and selection benefits for the quarter.

Disappointments: Disappointments for the quarter included holding any cash, an allocation to underperforming China and an underweight to outperforming Australia. From a sector standpoint, the Consumer Discretionary and Communications Services sectors disappointed mainly due to exposures in China in both sectors with Melco and Alibaba hurting in Consumer Discretionary and SINA and Tencent hurting in Communications Services.

Purchases / Additions in the Quarter

Alcon Inc (ALC): SECTOR: Health Care; COUNTRY: Switzerland: Alcon is the leading vision care company in the world and has been owned by Novartis since 2010. Within Novartis, Alcon struggled due to lack of focus and underinvestment in new products. In 2016, Novartis started a plan to turnaround the company and the results have been positive with the last four quarters having top line growth above 4% after many quarters of negative to flat growth. In April, Novartis spun out Alcon. Now that Alcon is independent, they should be able to continue the 2016 turnaround and actually accelerate revenue in 2021 and onward driven by new products and mega trends with an ageing population and growing middle class putting them in the sweet spot. We believe Alcon can improve margins annually over at least the next 5 years while also tripling free cash flow as recent investments come down along with better profitability which should lead to increased payouts to shareholders through increased dividends and share buybacks.

RELX PLC (RELX): SECTOR: Industrials; COUNTRY: United Kingdom: RELX (formerly known as Reed Elsevier) provides information, data, and analytics across multiple industries. Over the last several years, RELX has transformed itself from a print-based, advertising-dependent information provider into a subscription and transaction-based provider of digitally delivered content that leverages on RELX's access to and analysis of big data. RELX has produced excellent operational results which should continue to be driven by (1) market-leading positions in several high barrier-to-entry businesses; (2) visible and low-variability revenues supported by a high rate of subscription revenue coupled with a relatively demand-inelastic customer base; and (3) new growth opportunities within the R&BA and Exhibitions businesses.

SAP SE (SAP): SECTOR: Technology; COUNTRY: Germany: This leading German software company is benefitting from accelerating top line growth by new product cycles for the cloud and HANA software. Activist involvement has led management to focus more on margin expansion in its new medium-term targets as well as capital returns, while a much higher base of recurring revenue stream leads to a much more stable revenue and earnings base than in past cycles.

Takeda Pharmaceutical Co (TAK): SECTOR: Health Care; COUNTRY: Japan: Confusion over medium-term targets provided an opportunity to increase our position in Takeda as the company embarks on integration of its Shire acquisition with increasing cost synergy benefits as well as significant debt paydown with its large free cash flow generation. The company is also moving quickly to sell assets to help pay for the debt of its Shire acquisition and is focused on expertise in a core number of therapeutic disciplines going forward with promising futures.

Treasury Wine Estates (TSRYY): SECTOR: Consumer Staples; COUNTRY: Australia: This major global wine producer based in Australia is seeing significant growth prospects in the Asia region, particularly China, given the rise of wine consumption there. In addition, its new distribution abilities in China create additional margin opportunities. The company is also making changes to its go-to market strategy in the U.S., leading to significant changes in distribution and closeness to customers. With some major brands such as Penfolds, Sterling, BV, 19 Crimes, Stag's Leap, Beringer, and Rawson's Retreat, the company has streamlined its portfolio to focus on brand building.

WPP PLC (WPP): SECTOR: Consumer Discretionary; COUNTRY: United Kingdom: WPP is undergoing a restructuring of its operations with its new CEO as the company undergoes the sell of a major division, Kantar. After some customer losses in the prior year, WPP appears to be stabilizing its business and focusing on improvement of the business in 2019 with our expectation that the worst is behind them. Valuation is very attractive, and confirmation of the turnaround should provide ample room for the equity given its 10% FCF yield and 6%+ dividend yield.

Sells / Trims in the Quarter

Aercap Holdings NV (AER): SECTOR: Industrials; COUNTRY: Netherlands: Aercap is the global leader in aircraft leasing serving close to 200 airlines in over 80 countries mostly geared toward emerging markets. With the increased global macro risks and volatility in the global leasing market stemming from some distress within emerging market carriers, foreign currency swings, interest rate fluctuations, trade war back drop and some weakness in lease rates, we decided to trim our position in Aercap after a nice recovery from the December lows. Aercap continues to execute on what they can control and are growing book value while buying back shares annually, but we felt the risk reward was more balanced and decided to redeploy some of the position to other opportunities.

Ashtead Group PLC (ASHTY): SECTOR: Industrials; COUNTRY: United Kingdom: Ashtead, which is primarily comprised of its U.S. subsidiary Sunbelt, has significant leverage to the U.S. economy. Through Sunbelt, Ashtead is specifically geared to the U.S. construction cycle. We chose to trim Ashtead as a means to reduce overall U.S. economic risk in the portfolio.

BT Group PLC (BT): SECTOR: Communications Services; COUNTRY: United Kingdom: Increased regulatory scrutiny and uncertainty led us to exit this position as regulatory and economic pressure on the business led to added uncertainty as to the sustainability of the current dividend.

ING Groep NV (ING): SECTOR: Financials; COUNTRY: Netherlands: We trimmed this position in order to reduce the portfolio's weight to European financials at a time where net interest margins are being squeezed by lower interest rates, economic activity has slowed, and particular to ING is their exposure to Turkey.

Melco Resorts & Entertainment (MLCO): SECTOR: Consumer Discretionary; COUNTRY: Hong Kong: Although mass market visitations continue to increase, overall gaming revenues have slowed in Macau due to slower economic activity in China and added scrutiny on the VIP segment. China's macro slowdown is likely here for some time leading to continued pressures on gaming revenues while longer-term gaming license renewal remains an uncertainty.