EAGLE GLOBAL ADVISORS

Market Review and Outlook

Q1 2019

EGA International Equity ADR

From the EGA Portfolio Management Team

Market Overview

Global equity markets rallied in the first quarter of 2019 after oversold conditions in the prior quarter. The MSCI EAFE Index rose 10.0% during the quarter and year-to-date period. While in the U.S., the S&P 500 Index rose 13.7% for the quarter and year-to-date period.

The Global Economy

Global Summary

Economic prospects and earnings estimates were downgraded away during the quarter as a deceleration in economic activity occurred. The International Monetary Fund (IMF) began in January with its World Economic Outlook noting that "the global expansion has weakened". It lowered global growth forecasts for 2019 down to 3.5% as softer momentum from the second half of 2018 appeared to have carried over into the new year. The IMF blamed weakness in Germany, Italy and a deeper contraction in Turkey for a vast reason for the downgrade while noting that "risks to global growth tilt to the downside". In addition, the IMF called out "countries" to quickly resolve their trade disagreements which it said were hurting global trade.

The World Bank followed in January with its Global Economic Prospects report "Darkening Skies". The bank stated that "the outlook for the global economy has darkened" amidst tighter global financial conditions, moderating industrial production, and elevated trade tensions. In its assessment of global economic conditions, the OECD stated that "the global expansion continues to lose momentum" and revised lower its economic growth estimates for almost all G20 economies. The OECD noted softness in the Eurozone, high policy uncertainty, ongoing trade tensions, and further erosion of business and consumer confidence all contributing to the slowdown. While the OECD's global composite leading indicators (CLIs) continued to show easing growth momentum, it did note signs of stabilizing growth momentum in France and China in its March report. It appears all three organizations are seeing the world through the same lenses.

The common thread among these downgrades appears to be a manufacturing slump. The JPM Global Manufacturing PMI confirms this stating "growth of manufacturing production remained weak in March" with a global PMI barely above expansionary level. While March saw a modest improvement in business optimism, manufacturing remains a drag on global GDP. Services is a different story. The JP Morgan Global Services PMI gained further in March, posting its highest reading since November of last year. Commenting on the survey, JPM stated that "the global PMI indicates that the upturn in the global service sector gathered pace in March, with rates of expansion in output and new business both accelerating". In summary, while industrial activity has been on a decelerating trend globally, services activity has held up better and kept the global economy from slipping into a recession.

Japan / Asia

The IMF projects 1.1% growth in Japan in 2019, higher than its previous estimate in October of 2018 as it reflects additional stimulus measures to mitigate the effects of the planned consumption tax hike. This hike goes into effect in October of this year, where consumption taxes are set to rise to 10% from 8% currently. The IMF estimates a deceleration in 2020 as stimulus measures dissipate and the effects of the consumption tax are felt. The Japanese government approved an $18+ billion stimulus package to encourage consumption in its latest budget to mitigate the effects of the rise in the consumption tax.

Despite this, industrial activity in the country remains lackluster. The latest Bank of Japan Tankan Survey of large manufacturers business confidence slumped to a +12 reading from a +19 reading, the biggest decline in the survey since the December 2012 survey. The Nikkei Japan Manufacturing PMI survey agrees with this decline as it pointed to “the worst quarterly performance in the sector since Q2 2016”. While manufacturing slowed, services were a bright spot with the Nikkei Japan Services PMI survey continuing to expand and showing a solid start to the services sector in Japan.

The Bank of Japan (BoJ) remains on the sidelines with the weaker manufacturing data while reducing its forecast for inflation. The BoJ lowered its forecast for CPI ex. food to 0.9% for the fiscal year ending March 2020 from its previous forecast of 1.4%. Governor Haruhiko Kuroda stated that the BoJ’s goal of 2% inflation “…is likely to take some more time to achieve”. Given the tight labor markets in Japan, wages did provide a positive stimulus to support consumption with the growth of wages in 2018 almost twice that of the prior year.

Europe

Economic activity remains sluggish in Europe. The European Commission’s Economic Sentiment Indicator (ESI) continued to decline in the quarter, reaching a more than 26 month low, but still above its long-term average. Industrial activity is the main culprit for the weakness, but consumption has slowed in certain countries as well. The ESI index saw its sharpest declines in Germany and the Netherlands, while rising in Spain and remaining broadly unchanged in the last month in France and Italy. Germany has been the biggest disappointment in the region with the European Commission slashing its forecast for growth due in part to the sharp decline in factory output in Germany. In addition, the latest German Ifo Institute Business Climate Index fell to a 4-year low in February.

It is a similar story in this region with manufacturing slumping while services keep economic data from collapsing. The IHS Markit Eurozone Manufacturing PMI signaled the greatest contraction of the manufacturing sector for nearly 6 years in March while the Composite PMI held up better following services activity rising to the strongest rate since November. The Eurozone Composite PMI did rise in February, the first sign of some possible improvement. The OECD also noted in its commentary with the leading composite indicators that there were some signs of stabilizing in growth momentum in France. It is too early to say whether this is the start of some green shoots in the Eurozone.

Both the IMF and the OECD noted the Eurozone as weak areas of economic growth while the European Central Bank (ECB) noted “risks surrounding the euro area growth outlook have moved to the downside”. This was a shift from its previous opinion of a “broadly balanced” view. This shift prompted the ECB to reverse course and announce new stimulus only 3 months after ending its bond buying program. The ECB stated it would not raise rates until at least through year-end and it would begin another batch of cheap long-term loan programs for banks in September. This led the German 10-year bond yield to dip back below zero for the first time since 2016.

Emerging Markets

In its latest World Economic Outlook, the IMF expects emerging markets growth to dip slightly this year as China’s economy slows due to financial regulatory tightening and trade tensions while India is poised to pick up in 2019. The OECD projects China’s GDP growth to moderate gradually to 6% by 2020 with new policy measures offsetting weak trade developments. This appears to be in step with the Chinese government’s targets that forecast GDP growth between 6-6.5% in 2019, in line with analyst expectations. China’s GDP grew 6.6% in 2018, the slowest since 1990, but within analyst estimates. China continues to provide targeted stimulus measures to offset the decelerating growth.

China’s government announced a slew of targeted measures including a reduction in some income taxes as well as a reduction in the VAT tax rate from 16% to 13%. The government also announced a blueprint for a Greater Bay Area (GBA) initiative focused on science and technology with Hong Kong, Macau, Guangzhou, and Shenzhen at the center of the initiative. In the blueprint, Hong Kong is identified as the financial and trade center, Macau as the tourist center, while vague on the other two cities. While this is another program from a centrally planned economy, the effects are more long-term in nature. In the short-term, focus remains on economic activity. The most recent news was positive with both the Caixin China Manufacturing PMI and Service PMI coming in better than expected and showing an improvement at the quickest pace in nine months.

In other regions, Turkey’s economy remains mired in a significant slowdown, with rising inflationary pressures, a weak currency, and lower foreign exchange reserves. Investors are very concerned about the economic prospects of Turkey. In Latin America, Mexico has slowed as business investment has decelerated due to the uncertainty around the new leftist administration. In Brazil, economic activity is rebounding after a prolonged slowdown.

Politics

Brexit negotiations are consuming the headlines with a daily barrage of news on all the possible outcomes given that the British Parliament has defeated every Brexit recommendation from Prime Minister May's government. The Parliament went as far as voting to take over the process only to find out in all subsequent votes that it cannot agree on anything itself. There is little consensus in the Parliament to overcome a hurdle on the vote and the latest news suggests Prime Minister May is looking to negotiate with the opposition Labour party to see if she could garner enough votes for any type of Brexit resolution.

If that were not enough for Europe, the European Union Parliament elections are to be held in May, the first time since 2014. Europe has changed since then, and the immigration policies of the last five years have given rise to nationalist and populist parties across many countries. The new EU Parliament is likely to have a much larger representation from Eurosceptic parties and lead to more dissent. In Spain, Prime Minister Pedro Sanchez called for early elections to be held on April 28th as its parliament rejected his government's budget.

Other upcoming elections of note include those in India where Prime Minister Modi fights for another term, as well as elections in Indonesia and Israel. In Turkey, early results from local elections held at the end of the quarter gave the opposition parties control of the two major cities in Turkey, Ankara and Istanbul, but the ruling AKP party of president Erdogan is contesting the results. The opposition garnered many votes, despite a lack of freedom of the press, freedom of speech and Erdogan's jailing of journalists and dissenters over the last few years.

Stock and Portfolio Highlights

Global equity markets rebounded strongly for the quarter after a major selloff in Q4 2018. While economic and earnings downgrades continued during Q1, equity markets appeared to be focused on a rebound in activity into the second half of the year. Weak first quarter data appeared to have been priced in the selloff of 2018 while an about face from the world's two most important central banks provided a stimulus shot to the market. The Federal Reserve and the European Central Bank both retreated from signs of rising rates this year and both went a long way to fight over who was more dovish coming into the second quarter and second half of the year.

With the possibility of the start of green shoots with some data items in Europe and better China economic data arising, markets continue to need confirmation of improving conditions to maintain its current rally. Another set of possible good news could be in the U.S.-China trade negotiations as negotiators from both countries appear to be getting closer to a deal that would remove a major uncertainty for businesses. Commodities rose with oil prices following slower production in OPEC, Venezuela, and Iran and iron ore prices moving sharply higher on supply cuts in Brazil and Australia.

While the New York Federal Reserve's recession indicator hit a 25% chance of a recession in the U.S., the highest level since the Global Financial Crisis, markets focused on the prospects of looser monetary conditions providing equity markets a boost. The dovish talk from central banks led to a sharp decline in bond yields with the German 10-year bond retreating below zero percent for the first time since 2016 and the U.S. 10-year bond plummeting below 2.5% for the first time since early 2018. The decline in the long bond and lack of a similar move in the front end of the yield curve led to an inverted yield curve at the 3m-10y level which spooked the market. A San Francisco Federal Reserve study from last year indicates an inversion at the 3m-10Y level is the best indicator of a recession one to two years out while other studies suggest the yield curve must remain inverted at least for one quarter for this indicator to work. The markets will be watching this development over the coming months. The lower yields pushed financial sector stocks down, in particular bank stocks, as lower yields and a flatter yield curve makes it much harder for them to earn reasonable rates of returns.

Large caps slightly underperformed small and mid caps for the quarter while Growth outperformed Value for the quarter. The best performing MSCI EAFE countries for the quarter were New Zealand, Belgium, and Hong Kong while the worst performing MSCI EAFE countries were Singapore, Japan, and Germany. The best performing emerging markets for the quarter were Colombia, China, and Egypt while the worst were Qatar, Turkey, and Poland.

Outperformers: Eagle portfolios bounced back strongly far outpacing the MSCI EAFE benchmark for the quarter. Stock selection led the way with selection in every sector outperforming the benchmark sector return. The best selection was in the Communication Services, Financials, Consumer Staples, and Consumer Discretionary sectors. Country allocation and selection was also additive with good allocation to Japan and Canada and strong stock selection in Japan, Hong Kong, and Switzerland.

Disappointments: The main disappointment for the quarter was holding any cash in the portfolios as the markets rose sharply. Sector allocation was negative partly from cash weighting but also due to underweights in outperforming sectors such as Real Estate and Materials. From a country standpoint, stock selection was negative in Italy and an underweight to the U.K. was detrimental given its outperformance versus MSCI EAFE.

Purchases / Additions in the Quarter

Alibaba Group (BABA): SECTOR: Emerging Markets-Consumer Discretionary; COUNTRY: China: Over the past few years, Alibaba has transitioned from a traditional e-commerce company to a big data conglomerate, with transaction data from its marketplaces, financial services and logistics businesses allowing it to move into cloud computing, media & entertainment, and online-to-offline services. Alibaba's internet services affect the vast majority of Chinese internet users based on 70% penetration of Taobao/ Tmall marketplaces. This provides Alibaba with unparalleled source of data that it can use to help merchants and brands develop personalized marketing strategies to bolster return on their marketing investments. Recent pull back in share price offers an attractive entry point into what is expected to be a multi-year growth in penetration of e-commerce and its expansion to offline services.

Enel SpA (ENLAY): SECTOR: Utilities; COUNTRY: Italy: Enel's Capital Markets Day in late 2018 highlighted shareholder friendly targets for this integrated utility with minimum dividend floors, a focus on ROIC, and containment of capex. The company confirmed net income targets for the next two years and set a new target for 2021 highlighting the attractiveness of this utility with an 11% net income CAGR from 2018-2021. The company is attractively valued with strong dividend support. In addition, the improved regulatory outlook in Italy gives greater comfort in the company meeting its targets.

Pan Pacific Holdings (DQJCY): SECTOR: Consumer Discretionary; COUNTRY: Japan: As an early entrant to the fringe off-price retail market, Donki (Don Quijote) has built its success on Japan's deflationary economy. Deep discounts offered by a broad array of off-price items lure consumers who trade down on commoditized products and seek bargains. It is poised to take share from the JPY 13 trillion market of general merchandise stores whose sales are on a secular decline as consumers turn to specialty retailers and online channels. Donki's proven track record in turnaround of unprofitable stores, backed by its low cost procurement and lean operations, indicate a strong likelihood that the joint-name stores with Uny will be a success.

Shimano Inc (SMNNY): SECTOR: Consumer Discretionary; COUNTRY: Japan: Shimano manufactures and sells products for cycling, rowing and fishing worldwide. Through innovation and a global presence, they are the market leader in the oligopolistic bicycle components industry which is going through many changes set to benefit Shimano in the immediate future. These include increased penetration of higher margin disc and hydraulic brakes within the racing and mountain bike segments. In addition, penetration of electronic shifters on bikes is also another catalyst that will drive sales and margins as they replace the more traditional mechanical shifters and allow users to connect their group set to a compatible device to view essential data. In addition, Electric bikes which allow you to both pedal for exercise as well as provide pedal assistance when going up difficult terrain are beginning to take off in mountain biking as well as becoming a commuting alternative to autos in congested cities around the world. Within the past 12 months, both Lyft and Uber have made purchases within the E-bike sharing industry as they look to provide mobility options outside of autos. These catalysts are set to drive Shimano's sales in the near future and should drive strong earnings and value creation.

Sells / Trims in the Quarter

Komatsu Ltd (KMTUY): SECTOR: Industrials; COUNTRY: Japan: The thesis on Komatsu of accelerating mining and construction demand did not play out as trade war tensions came to light shortly after purchase which aided in China's slowdown which then impacted the rest of the world. Although we still like Komatsu's mining and construction high margin aftermarket businesses, we decided to reduce the indirect China weight within the portfolio and redeploy to other areas.

Melco Resorts (MLCO): SECTOR: Consumer Discretionary; COUNTRY: Hong Kong: A trim of Melco shares was made to de-risk our China exposure following a strong performance in Melco's stock at the beginning of the year.

Softbank Group (SFTBY): SECTOR: Communication Services; COUNTRY: Japan: We trimmed this position after a sharp rally in the shares in the first quarter. Uncertainty surrounding the Sprint-T-Mobile merger and Japanese domestic telecom competition led us to trim and redeploy. While the announced share buyback led to a significant rally in the shares, uncertainty with some of the investments in the company's Vision Fund could hold the shares back in the near-term.

Techtronic Industries (TTNDY): SECTOR: Consumer Discretionary; COUNTRY: Hong Kong: Techtronic continues to be a core holding as their leading Milwaukee and Ryobi brands drive sales growth through increasing market share, battery powered tools replacing corded tools, and by expanding their product breadth to new verticals which all leads to higher sales of their high margin batteries. With the recent run up in price and still the risk of additional tariffs as the U.S.-China trade tensions have yet to be resolved, we decided to take some profits.