EAGLE GLOBAL ADVISORS

Quarterly Commentary Q3 2019

EGA International Equity ADR

From the EGA Portfolio Management Team

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Market Overview

Global equity markets were volatile during the third quarter, but U.S. markets rose while U.S. Dollar returns of international equities were hurt from the U.S. dollar strength in the quarter. The MSCI EAFE Index fell -1.1% bringing its year-to-date return to 12.8%. While in the U.S., the S&P 500 rose 1.7% for the quarter increasing its year-to-date return to 20.6%.

The Global Economy

Global Summary

A global growth slowdown, Brexit, and trade disputes continued to consume investor's attention during the quarter. Although Britain was ruled by a different Prime Minister during the third quarter, the Brexit saga continued to unfold as major uncertainty exists going into the late October extended deadline. The uncertainty of the outcome has caused an investment pause in the U.K. as well as with its trading partners in Europe. The International Monetary Fund (IMF), in its latest World Economic Outlook cited Brexit and the fallout from trade tensions globally as reasons for cutting its global GDP forecast for 2019.

Following suit, the Organization for Economic Co-Operation and Development (OECD) also cut its global growth forecasts for 2019 to 2.9% and 2020 to 3%. The OECD warned of low growth ahead as "the global outlook has become increasingly fragile and uncertain". It also pointed to escalating trade policy tensions taking a toll on confidence and investment as one of the reasons for the downward revisions to growth estimates. Yet, thus far the growth slowdown is mostly seen in the manufacturing sector globally and not in the service sector. Consumer demand remains solid for the most part.

Inflation remains mostly subdued across advanced economies leading to a trend of multiple central banks doubling down on more accommodative monetary policies. Major central banks such as the Federal Reserve and European Central Bank lowered interest rates during the quarter. Central banks in developed and emerging markets have followed suit as inflation has mostly subsided allowing central banks to be more aggressive. One near-term shock to inflation could be the recent spike in oil prices as attacks (presumed to be from Iran) on Saudi oil facilities temporarily knocked out 5.7m bpd of production capacity in the country. This constitutes 6% of global consumption and is the single biggest oil disruption ever. Middle East tensions have bubbled up in recent months and this is the latest example of the precarious environment in the region.

Japan

Japan's economy continued to moderate in the quarter. The latest Bank of Japan Tankan survey of large manufacturers showed a deterioration in economic conditions as it again fell to +5 in September, the lowest level in six years, although better than consensus expectations.

The OECD lowered its projections for GDP growth in Japan to 1% in 2019 and 0.6% in 2020 as export growth has weakened from the global trade slowdown and the country's trade dispute with South Korea. The latest Jibun Bank Japan Manufacturing PMI finished at a seven-month low following weaker export expectations to China, the U.S., and Europe. Output and new orders were the main culprits for the additional pressure on the manufacturing economy in September.

Even though manufacturing economic conditions have weakened, the government has gone ahead with the latest VAT consumption tax hike on October 1st from 8% to 10%. While inflation is hovering well below the central bank's goal, the tax hike will push up inflation over the coming 12 months temporarily. The Bank of Japan has mostly maxed out its monetary policy with bond yields remaining negative, but at this point not as negative as Europe's bond yields.

Europe

Economic conditions across the Eurozone deteriorated over the third quarter with Germany leading the way. The latest IHS Markit Eurozone Manufacturing PMI fell to its lowest level since October 2012, dropping to 45.7, led down by output, new orders, and purchasing. The weakest links this year are Germany, Austria and Spain, all registering deteriorating and contractionary conditions while France and the Netherlands remained just above expansionary levels. IHS Markit commented that "the health of the Eurozone manufacturing sector went from bad to worse in September, with the PMI survey indicating its steepest downturn for nearly seven years and sending increasingly grim signals for the fourth quarter".

The Eurozone's largest economy, Germany, is likely in a technical recession having contracted in the second quarter and most signs pointing to a contraction in the third quarter. The Zew indicators of economic sentiment, the Bundesbank latest projections, industrial production data, the IFO business climate survey of German executives, and the latest PMI all point to a recession in Germany. The IHS Markit/BME Germany Manufacturing PMI plummeted in September to 41.7, its lowest reading since June 2009. The country is being weighed down by turmoil in the auto industry, Brexit uncertainty, and a global trade slowdown. The deteriorating conditions sent the entire German yield curve, out to 30 years, into negative yield territory, an unprecedented occurrence.

While the European Central Bank (ECB) failed to normalize interest rates over the last few years, it now finds itself in a conundrum and with very few policy tools left. The ECB reduced the policy rate another 10bps to -0.5% and announced a restart to net asset purchases at a monthly rate of 20bn euros. It also maintained its current reinvestment rate and offered ever more generous TLTRO lending facilities to banks. The ECB warns that "risks are tilted to the downside" and encouraged European governments to focus more on fiscal consolidation in the Eurozone and fiscal stimulus. The disappointing economic data in Germany has begun an internal debate about providing a fiscal stimulus shot for the country. This is likely to be a focus of incoming ECB head Christine Lagarde who takes over Mario Draghi's job on November 1st.

While the U.K. also joined the contraction party as its economy shrank in the second quarter for the first time in almost seven years following Brexit uncertainty, France remained one of the few bright areas in the region. French PMI remains slightly above expansionary levels and reform momentum appears to be back. President Maron announced a package of tax cuts for both individual and corporate taxpayers as he continues his reform agenda.

Emerging Markets

While China's economy has been slowing, with second quarter GDP growth registering the slowest growth since 1992, the monetary and fiscal stimulus the government started more than one year ago may be starting to work its way through the system. Targeted stimulus continues, with the latest example of additional reserve requirement ratio cuts, but we are unlikely to see any major stimulus from China. The latest private Caixin Manufacturing PMI and the government official PMI both surprised on the upside in September, showing some signs of hope that the worst may be over for the manufacturing sector.

GDP growth is likely to continue to decline over the coming years as the economy maintains its shift towards consumption and away from manufacturing. The U.S.-China trade war has taken its toll on manufacturers and employment and there are plenty of examples of global companies reevaluating their supply chain away from China toward places like Vietnam, Southeast Asia, and India. The renminbi fell in the quarter as some analysts accused China of weaponizing its currency as it fell past the psychological 7 level versus the U.S. Dollar. This led the U.S. government to label China as a currency manipulator.

India's economy has slowed recently, and Prime Minister Modi took the opportunity to continue his reform agenda by announcing a Trump-style corporate tax cut. The surprise massive corporate tax cut from 34.3% to 21.2% is focused on spurring economic growth, jobs, and encouraging foreign investment in the country.

Politics

The British politics saga continued as the controversial Boris Johnson won the Tory contest for head of the party and became the United Kingdom's newest Prime Minister to succeed Theresa May who resigned amid pressures over her Brexit negotiations. Brexit outcome is a complete mess. While Johnson pushes for a snap election, parliament has focused on taking some powers away from the new Prime Minister in regards to Brexit negotiations. PM Johnson has said he will abide by the October 31 Brexit deadline even if it means a hard Brexit. The outcome is very uncertain at this juncture but negotiations with the EU in October could provide some concessions from both parties in order to avoid a hard Brexit outcome.

Hong Kong suffered from major protests against an extradition bill that spurred hundreds of thousands of people to protest as they see Chinese influence increasing more and more. Protestors blocked city streets, disrupted transportation, including the city's main airport, and demanded significant government reform. While the HK government finally gave in to demands to pull the extradition bill, this did not appear to allay their concerns. Tourism into Hong Kong is feeling the brunt of these clashes.

Japan's ruling coalition retained its majority in the upper house elections in July all but likely cementing Shinzo Abe's legacy as the nation's longest serving leader. In Italy, the ruling coalition of far left and far right collapsed as Far-right League leader Matteo Salvini took a risk of being able to increase his power in a new government. That did not prove to be the case as a new coalition formed without the Far-right League party. Most observers do not expect the latest coalition to last long. In Argentina, a surprising primary election loss for business-friendly President Macri led to a crash in the stock market and currency there as surprise expectations now are that a populist will win the presidential election in October.

Stock and Portfolio Highlights

Global equity markets gave up some of their gains during the quarter as concerns over a global economic slowdown and trade disputes remained elevated. The Trump administration announced additional tariffs on a final list of consumer goods early in the quarter as negotiations with the Chinese appeared to stall, only to reverse course a few weeks later on renewed negotiations momentum. U.S.-China trade negotiators are hard at work with important talks in October as tariffs have been delayed until December on certain goods and as China has shown willingness to start buying some agricultural goods from the U.S. once again. The stop-start uncertainty of trade relations with the U.S. is likely to keep markets on edge.

Central banks are beginning to put most of their chips on the table as the global economy slows, and inflation remains under control. With major central banks such as the Federal Reserve and the European Central Bank on a monetary policy easing path, many advanced economy and emerging economy central banks have cut rates or announced further stimulus measures in the past quarter. Central banks easing and interest rate declines are positive for global growth in the next 6-12 months. The added stimulus led to plunging bond yields across the globe with pronounced falls in Europe and the U.S. European yields were led down by German yields which reached a point in the quarter where the whole German yield curve sat at negative yields. Estimates suggest that 20% of the global economy has negative 10-year bond yields with more than $17 trillion of global bonds trading in negative yield territory while 25% of the world's central banks have negative policy rates. This led to bonds outgaining equities in the quarter in most regions.

MSCI EAFE large caps underperformed small and mid caps for the quarter while Growth outperformed Value for the quarter and year-to-date periods. The best performing MSCI EAFE countries for the quarter were Belgium, Japan, and the Netherlands while the worst performing for the quarter were Hong Kong, Singapore, and Sweden. The best performing emerging markets for the quarter were Turkey, Egypt, and Taiwan while the worst for the quarter were Argentina, South Africa, and Poland.

Outperformers: An underweight to the Materials sector was beneficial for the quarter in addition to good stock selection in Consumer Discretionary, Consumer Staples, and Energy. Good stock selection in Italy, Australia, and Switzerland was positive to performance. In particular focus, utility Enel in Italy, Swiss food company Nestle, and Australian wine company Treasury Wine Estates outperformed for the quarter.

Disappointments: Eagle portfolios slightly underperformed the MSCI EAFE Index for the quarter as stock selection in Communication Services, Financials, Health Care, and Industrials hurt performance. The Hong Kong protests hurt Hong Kong stocks and the portfolio's overweight to the country was detrimental with names such as AIA Group (Financials), BOC Hong Kong (Financials), and Techtronic (Industrials) all down for the quarter. An underweight to Japan also hurt performance as it outperformed MSCI EAFE for the quarter.

Purchases / Additions In The Quarter

ASML Holding NV ADR (ASML): SECTOR: Technology; COUNTRY: Netherlands: ASML is the dominant semiconductor lithography supplier in the world. The company's extreme ultraviolet lithography (EUV) has reached an inflection point in foundry adoption for leading technology nodes. This makes it resistant to a semiconductor down cycle because foundries are less likely to cut spending on tools that are strategic to the next generation technology roadmap. If memory fundamentals start improving in 2020, ASML will start benefitting from a cyclical rebound in deep ultraviolet (DUV) tools in 2021.

Enel SPA (ENLAY): SECTOR: Utilities; COUNTRY: Italy: We added to our position in Enel as the company executes on its strategy. Its 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.

Fanuc Corp (FANUY): SECTOR: Industrials; COUNTRY: Japan: Fanuc is well-positioned for long-term, secular growth in the factory automation and robotics segment, as the world's largest computer numerical control (CNC) and industrial robotics manufacturer with over 50% market share. The growth of the industrial robotics industry is being underpinned by secular trends like decreasing labor force from aging populations as well as increasing wage levels in key markets like China. With the rise of AI, Fanuc is making robots easier to train therefore making automation more accessible to a wider range of industries outside of automotive and electronics industries such as the pharmaceuticals and food industries. Fanuc has been preparing for these secular trends with large investments in both product development and manufacturing capacity. This has sacrificed short-term profitability and depressed the stock price as well but should pay off in the future by generating both top line growth and margin expansion as well as ancillary revenue streams such as the Field system which is an open, cloud-based platform that allows Fanuc to collect global manufacturing data in real time on a previously unimaginable scale and use it to self-teach robots, connect robots to existing machinery in the factory, and provide remote monitoring and preventive maintenance to further reduce downtime. With the secular trends in place and the investments largely behind them, we opportunistically started a position in Fanuc.

Imperial Brands PLC (IMBBY): SECTOR: Consumer Staples; COUNTRY: United Kingdom: Trading at a very attractive valuation, including a 9%+ dividend yield, this major tobacco company is selling non-core assets and seeing potential growth in NGP products. We expect a possible management change in the company to provide a positive catalyst while some relief from Brexit uncertainty going away sooner rather than later would be welcome. The U.S. FDA is likely to increase NGP product regulation and smaller players are likely to exit the business in the next two years. Traditional firms such as Imperial Brands may have the ability to increase market share going forward.

Kao Corp (KAOOY): SECTOR: Consumer Staples; COUNTRY: Japan: Kao is the largest consumer product manufacturer in Japan, controlling more than 30% of the home detergent and disposable baby diaper market. Close to 90% of revenue comes from its home market, where the segment is highly consolidated, with the top three companies Kao, Procter & Gamble, and Lion possessing a combined market share of over 70% with Kao at over 30% and gaining share. Kao has been on a mission to expand outside of Japan and become a global leader similar to P&G. They have been successful in amassing over 10% share in Thailand, China, and Indonesia while also maintaining a stable operating margin of roughly 20% over the past 10 years. One of the reasons why Kao has been able to expand revenues while maintaining profitability is from its cost advantage and vertical integration. We believe Kao's strong management team will continue to innovate and leverage its cost advantage to continue to not only take share in their home market but grow rapidly in emerging markets where penetration is still low. Their goal is to grow organically by 5% annually and hit operating margins of 15% in 2020 from roughly 13% today. Kao has been closing the gap on an EV/EBITDA basis versus P&G the last 10 years and actually traded in line with them at the beginning of 2018. This gap has widened out again with P&G at 17x and Kao at 13x as P&G has been executing and Kao had a couple of tough quarters. We feel the long-term outlook for Kao has not changed and took advantage of this opportunity.

SAP SE (SAP): SECTOR: Technology; COUNTRY: Germany: We believe SAP has the ability to expand their margins by 500bps to 2023 after multiple years of decline combined with revenue growth driven by the new product cycle (S/4HANA seeing significant early-cycle traction) and their cloud offering. This combined with continued dividend payout and a potential multi-year share repurchase program, demonstrate SAP's commitments to improve shareholder return. The next catalyst should be Investor Day on November 12th in New York City, where details will be provided on SAP's plans to achieve the +500bp of margin by 2023, plus any plans for a share repurchase program. Valuation remains attractive, especially compared to software peers.

Sells / Trims In The Quarter

Orix Corp (IX): SECTOR: Financials; COUNTRY: Japan: We think Orix's valuation reflects a lack of growth. Their mid-term targets seem too ambitious and a meaningful share buyback seems unlikely. Orix may lower its mid-term targets as sustainable profit growth of 4–8% appears difficult for the time being, judging from earnings results in FY2018 and Q1 FY2019. Given that ROE is a balance between equity capital and profit, slower profit growth could lead to a decline in ROE going forward.

Prada ADR (PRDSY): SECTOR: Consumer Discretionary; COUNTRY: Italy: The turnaround in Prada's sales growth hit a stumbling block with macroeconomic weakness in China and Europe. Analyst expectations pointed to a negative like for like sales growth for retail stores (80% of sales). On guidance, due to recent initiative relating to wholesale partner rationalization, wholesale (~20% of sales) guidance was expected to be muted. Because SG&A costs are largely fixed, a decline in revenue will be met by margin pressure. It looks like things will get worse before they get any better. We also wanted to de-risk China exposure in the portfolio.

Shiseido Co Ltd (SSDOY): SECTOR: Consumer Staples; COUNTRY: Japan: Shiseido not only reached our target price but also outperformed Kao by over 20% since we purchased it. We felt the valuation coupled with the high expectations surrounding the stock and outperformance versus Kao provided us an opportunity to move into Kao which we believe has better assets and returns at a more compelling valuation.

SINA Corp (SINA): SECTOR: Emerging Markets-Communication Services; COUNTRY: China: While SINA's user and usage share has remain unchanged, its monetization capacity has been affected by a surge in advertising inventory created by Bytedance properties (primarily Douyin and Toutiao). Douyin's short video app uses artificial intelligence to show 30 second video clips to users. It has become the go-to time killer app in China, hurting SINA. While this hasn't materially affected the time users spend on Weibo (Sina's main property), it has opened up high ROI inventory to advertisers. At the same time, Tencent is adding more ad units to support growth in its ads business, which is also beginning to feel the impact of higher ad inventory being supplied in the market.