EAGLE GLOBAL ADVISORS

Quarterly Commentary Q4 2019

EGA International Equity ADR

From the EGA Portfolio Management Team

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Market Overview

Global equity markets rallied into year-end as optimism over a cyclical rebound in 2020 as well as a Phase One trade agreement between the U.S. and China cheered investors. The MSCI EAFE Index gained 8.2% in the quarter bringing its year-to-date return to 22%. While in the U.S., the S&P 500 rose 9.1% for the quarter increasing its year-to-date return to 31.5%.

The Global Economy

Global Summary

Global economic growth appears to have bottomed out in recent months providing some optimism that the global manufacturing recession could come to an end sometime in the first half of 2020. The Organization for Economic Co-Operation and Development's (OECD) leading indicator of economic activity shows a bottoming out process that could lead to better growth ahead. Recent PMI's also support this view, with the JP Morgan Global PMI Composite Index rising to an 8-month high in December. They comment that the "uptick is underpinned by stronger inflows of new work, rising employment, and improved business optimism…reinforcing a view that activity will improve in the coming quarters". In spite of the renewed optimism of a growth rebound, the OECD projects that 2020 global growth will remain below potential, albeit slightly higher than 2019.

Three of the world's major central banks, the Bank of Japan (BoJ), the Federal Reserve, and the European Central Bank (ECB) are all simultaneously expanding their balance sheets providing additional stimulus to the world's economies. Global short rates remain very low but longer bond yields have begun to increase on higher optimism leading to a slight steepening of global yield curves. While central banks are supportive, the debate rages on as to its limited marginal effect while fiscal policy stimulus rhetoric increases. The OECD argues that the fiscal and monetary policy mix in the world's economies is unbalanced and calls for additional fiscal expansion to compensate for this.

Inflation remains well under control in the advanced economies allowing central banks ample room to remain on the sidelines for an extended period of time. While oil prices rose recently due to heightened geopolitical risks in the Middle East, their effect on inflationary expectations remain muted. The renewed hopes of a Phase One deal between the U.S. and China should be supportive of global trade in 2020 and lead to marginal gains in trade volumes, supporting global export-oriented economies.

Japan

The mood in Japan has soured over the last three months in spite of a U.S.-China Phase One deal. The latest Bank of Japan Tankan Survey of large manufacturers declined to zero in December from plus five in September while non-manufacturers sentiment remained stable. The recent consumption tax hike in October will likely affect consumption going forward though as consumers front loaded some expenditures prior to the hike and as the recent history of tax hikes suggests. GDP growth is likely to remain below potential in Japan for 2020 as the tax hike weighs on domestic demand despite some fiscal relief. The latest Jibun Bank Japan Manufacturing PMI continued to show a weak manufacturing sector in a downturn, commenting that "Japan's manufacturing sector ended 2019 where it started, stuck in contraction with little hope of an imminent turnaround".

If the signing of the U.S.-China Phase One deal leads to better global trade, momentum could return to Japan at some point in 2020 as its economy is geared to exports. In addition, the Tokyo Olympics in the summer of 2020 will provide a short-term boost to tourism revenues. In spite of the tax hike and tight employment levels, inflation is likely to stay below 1% in 2020 leading the Bank of Japan to remain on an accommodative path of monetary policy for the coming year.

Europe

Manufacturing remains weak in the Eurozone but appears to have started to bottom in late 2019. The IHS Markit Eurozone Composite PMI improved slightly at the end of 2019 with services at a 4-month high while manufacturing stabilized at a low level. The most pronounced improvements were seen in Ireland, Spain, France, and Germany. Consumer spending in the region is holding up well. Business optimism has improved steadily over the last couple of months with one example being in the Eurozone's largest economy, Germany, which makes up 29% of the region's GDP. The German Ifo Business Climate Index rose in December providing some hope that the yearlong manufacturing recession in Germany may be ending soon.

The European Central Bank (ECB) welcomed a new head in Christine Lagarde but the path of monetary policy remained unchanged. The ECB repeated its same message from prior meetings that it would not raise rates "until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics". Lagarde is a big proponent of structural reforms and growth supportive fiscal expansion and thus we expect more noise around this in the region during her tenure. With Eurozone inflation hovering around 1% recently, it appears the central bank will keep its accommodative policy for an extended period of time. One monetary experiment that ended was in Sweden, where the Riksbank, the world's central bank pioneer in negative interest rates, ended that experiment by raising rates back to zero.

The U.K. Pound appreciated during the quarter on hopes of a Brexit resolution amid signs of a conservative win in the December election which did pan out. While much vagueness remains as to deadlines to negotiate trade deals, the certainty of a Brexit should remove some investment hesitation. There continues to be expectations of a Bank of England interest rate cut in 2020 as inflation remains subdued and GDP growth remains below potential.

Emerging Markets

China's manufacturing economy continues to be hurt by the U.S.-China trade war and slowing GDP growth but is showing some signs of life as the Caixin China General Manufacturing PMI rose again in December. While China continues its rebalancing process towards more consumption and services, the manufacturing sector still plays an important role in the economy and jobs. Phase One of the U.S.-China trade deal appears to be in the bag, including removing some tariffs that could provide a tailwind to the economy. In spite of this, analysts still project a continued downward path to GDP growth in China with the OECD expecting growth to edge down to 5.5% by 2021.

The People's Bank of China (PBoC) remains diligent in providing ample liquidity and adequate sustainable stimulus to the Chinese economy. Its latest measure includes a reduction of 50bps in the reserve requirement ratio for banks which will be implemented in early January. Even though inflation spiked due to higher food prices following pork prices spiking, inflation overall remains under control giving the central bank continued space to provide a backstop as needed.

Politics

Boris Johnson secured a crushing U.K. election victory, with the Conservatives winning their biggest majority since the days of Margaret Thatcher. The British election was a clear referendum on the future of Brexit and a Conservative win secured that Brexit moves forward and the prime minister is emboldened to negotiate further with the European Union given his strong mandate.

Protests continued to erupt in Hong Kong affecting everyday life and hurting economic prospects for the island. Pro-democracy candidates crushed the China supported candidates in the district council elections giving the protesters an additional boost to continue. Income inequalities or proposed reforms in several regions led to protests in several countries including Chile, Colombia, India, and France.

Other election outcomes included the re-election of Justin Trudeau for another term to lead a minority government in Canada, but he did lose seats in the House of Commons. In Argentina, President Macri was ousted and his Peronist rival Alberto Fernandez won the national election, putting back into power the populist anti-business Peronist government. In Spain, political gridlock remains as the Socialists' fell short of a majority in Parliament and its opposition far-right parties won seats.

Stock and Portfolio Highlights

With global central banks providing ample liquidity, some talk of fiscal stimulus in certain regions, a potential cyclical rebound and better trade deal news, equity markets responded well. Global equity markets cheered news of a potential Phase One trade deal between the U.S. and China which led to significant gains in equities over the quarter. In addition, hopes that the U.S. and global economy may have thwarted a recession in the coming year led to increased optimism by investors. Recent economic data suggests a global cyclical rebound may be upon us as recessionary level manufacturing conditions bottom out and as consumption remains at strong levels. While geopolitical risks appear to be increasing, especially in the Middle East, markets thus far have focused on the positives.

After a tough year of muted earnings growth, 2020 shows promise of better corporate earnings performance. FactSet estimates suggest S&P 500 EPS growth of 9.5% in 2020 while MSCI EAFE is estimated at 6.7% and MSCI Emerging Markets at 15%. This places 2020 P/E ratios at 18x for the S&P 500, 14.8x for MSCI EAFE, and 12.9x for MSCI EM. Recent 2020 estimate revisions for MSCI EAFE and MSCI EM have been positive as analysts had been too bearish in prior quarters for the new year.

EAFE large caps underperformed small and mid-caps for the quarter and year while Growth outperformed Value for the quarter and year-to-date periods. The best performing MSCI EAFE countries for the quarter were Ireland, New Zealand, and Sweden while the worst performing MSCI EAFE countries for the quarter were Belgium, Finland, and Australia. The best performing emerging markets for the quarter were Hungary, Taiwan, and Russia while the worst for the quarter were Chile, UAE and Thailand.

Outperformers: Eagle portfolios continued their outperformance during the quarter cementing a strong outperformance versus the MSCI EAFE benchmark for both the quarter and full year. Superior stock selection continued to be the driver of the outperformance with strong selection in Industrials, Communications Services, Financials and Consumer Discretionary leading the way in the fourth quarter. Standout names included Atlas Copco (Sweden), Techtronic (HK) and Alibaba (China). From a country perspective strong selection in Hong Kong, Japan and the Netherlands were standouts in the quarter.

Disappointments: Sector allocation was slightly negative for the quarter mostly driven by having any cash in the portfolio during a strong quarterly performance. From a stock selection standpoint, most sectors performed well on a relative basis except for Health Care which was dragged down by poor performance from Alcon. From a country standpoint, Switzerland and the U.K. disappointed. Nestle (Switzerland) and Treasury Wine (Australia) were also disappointing for the quarter.

Purchases / Additions In The Quarter

Fanuc Corp (FANUY): SECTOR: Industrials; COUNTRY: Japan: We first purchased Fanuc in the third quarter and added to the position during the fourth quarter. 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 a 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 the 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. The Field system 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.

Kao Corp (KAOOY): SECTOR: Consumer Staples; COUNTRY: Japan: We first purchased Kao in the third quarter and added to the position in the fourth quarter. 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 between 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 PG in the last 10 years and actually traded in line with them at the beginning of 2018. This gap has widened 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.

Sampo OYJ (SAXPY): SECTOR: Financials; COUNTRY: Finland: Sampo is a financial conglomerate headquartered in Helsinki, Finland. It is the 100% owner of the largest Nordic non-life insurer (If P&C), Mandatum Life and a major shareholder in Nordea (19.9% stake) and Topdanmark (46.7%). We expect a re-rating driven by simplification of the group structure with a shift towards insurance making up a larger part of group profit which could help the valuation gap to Sampo's sum of the parts to narrow. We believe the valuation doesn't reflect the underlying improvement in Sampo's insurance operations. "If" is a premium asset in the Nordic P&C space as it operates in an oligopoly and is the largest operator across the Nordic region, with leading market positions in Sweden, Norway, Finland and the Baltic states. The arrival of new management and the rebasing of the dividend following Nordea's dividend cut removed the funding uncertainty (dividend now covered) and improved the capital position. We expect the group to continue to deliver attractive dividends that will follow earnings more closely. The next catalyst is the announcement of a new strategic plan by the new CEO as well as a new dividend policy in early February.

Takeda Pharmaceutical Co (TAK): SECTOR: Health Care; COUNTRY: Japan: Takeda has been executing on its strategy of successfully integrating the Shire business it acquired earlier in 2019. In an effort to cut its debt load, the company is selling non-core assets. Takeda is also focused on expense management to drive better operating margins in the business. In order to replace revenues from drugs going off patent in future years, the company is focusing its attention on expansion of sales of existing drugs as well as new drug development. We believe the current valuation does not give the company credit for its ongoing execution of asset sales, expense management and drug development.

Unilever PLC (UL): SECTOR: Consumer Staples; COUNTRY: United Kingdom: Unilever is a dominant global player in the Home and Personal Care (HPC) and Food industries, boasting many well-known brands including Dove, Degree, Vaseline, Hellmann's, Lipton and Ben & Jerry's. Unilever generates extremely attractive operating metrics (e.g. mid-teens ROA) and has a product and country mix that should allow for above industry growth. Of specific importance to Unilever's above industry growth is a significant exposure to emerging markets (especially India) and overweight exposures to above average growth categories (e.g. ice cream and skincare).

WPP PLC (WPP): SECTOR: Consumer Discretionary; COUNTRY: United Kingdom: Our constructive stance on WPP is based on improving organic growth trends coupled with confidence in management's strategy to turn around the business by simplifying the structure, investing in talent and focusing on creativity and technology. At 11x PE ratio, the valuation is attractive.

Sells / Trims In The Quarter

Ambev (ABEV): SECTOR: Consumer Staples; COUNTRY: Brazil: We exited the Ambev position following disappointing third quarter results driven by -2.8% volume growth for beer in Brazil. We had hoped that industry consolidation would follow price rationalization, but competitors have continued to push discounts, hurting Ambev's ability to hold its volume after increasing prices.

Anheuser Busch Inbev (BUD): SECTOR: Consumer Staples; COUNTRY: Belgium: The global beer market continues to suffer structural headwinds and we believe the important U.S. market for BUD will continue to remain in structural decline. The company is also losing market share to competitors in other high margin markets like Brazil and Colombia. We took the opportunity to sell out of BUD after a nice rebound after a positive surprise from asset sales.

Sekisui House Ltd (SKHSY): SECTOR: Consumer Discretionary; COUNTRY: Japan: We exited Sekisui house for valuation reasons. The stock no longer looks undervalued following share price gains that reflect strong earnings and prospects for profit growth via downsizing in China, where margins have been low. Additionally, housing demand in Japan is likely to be muted in months following the recent consumption tax rate hike.

Total SA (TOT): SECTOR: Energy; COUNTRY: France: We did a marginal trim of Total to reduce the energy weight in the portfolio. The company continues to do self help and manage its cash flow smartly but macro and structural headwinds to energy stocks could continue to hold back their performance.