EAGLE GLOBAL ADVISORS

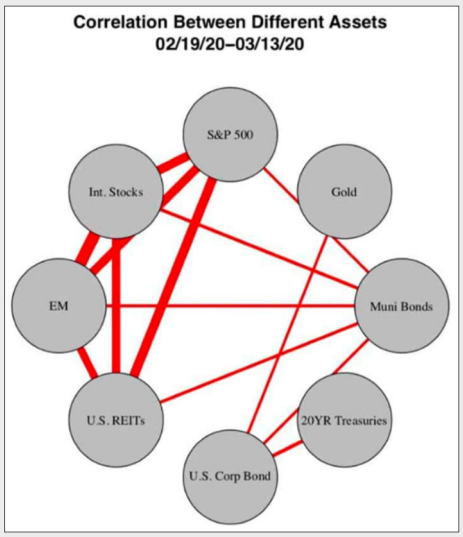
Quarterly Commentary Q1 2020

EGA International Equity ADR

From the EGA Portfolio Management Team

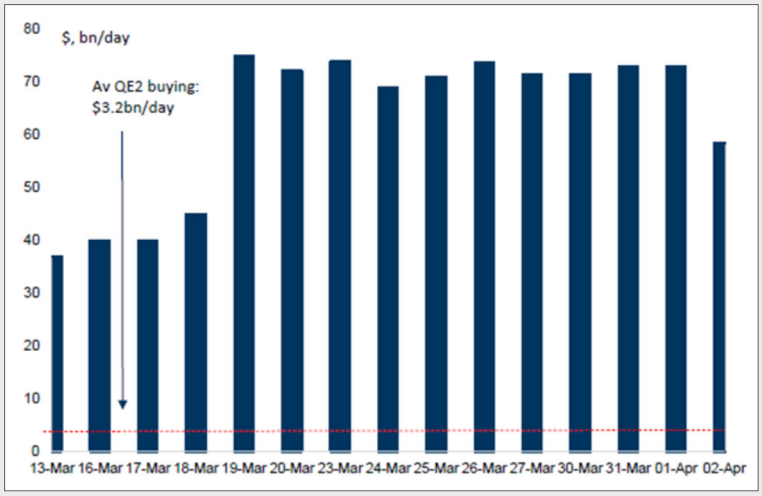
These Are Unprecedented Times

The onset of the Covid-19 virus coupled with a potential oil supply surge due to an unexpected conflict between Saudi Arabia and Russia resulted in global equity declines for 1Q 2020 on par with those seen in 1987. Similar to the 2008 global financial crisis, correlations went to one (as indicated by the thick red lines in chart to the right) and indications of fear as noted by global equity volatility indexes reached extreme levels. Cash was king and one of the only safe havens for investors. In sharp contrast to 2019 performance, the MSCI EAFE Index lost -24.3% during the first quarter of 2020, while in the U.S., the S&P 500 lost -19.6%. Regional and country specific indexes including Europe, Japan and the Emerging Markets declined -24.3%, -17.7% and -23.6%, respectively.



Source: YCharts (OfDollarsAndData.com)
Note: Correlations between –0.5 and 0.5 have been excluded. Red lines correspond to positive correlations. Thicker lines correspond to larger correlations.

By quarter-end, equity markets showed some sign of stabilization as massive levels of fiscal and monetary stimulus were pumped into the global economy. During February and March alone, there were 253 fiscal and monetary stimulus measures announced around the world. Most recent was the passage of the $2.2T Coronavirus Aid, Relief and Economic Security (CARES) Act in the U.S. Additionally, the U.S. Federal Reserve cut interest rates to zero and launched a $700B Quantitative Easing program. To put this into perspective, the chart below shows current Fed purchases are enough to complete QE1, which occurred in 2008 during the global financial crisis, every ten days.



Source: Goldman Sachs Global Investment Research, Haver Analytics

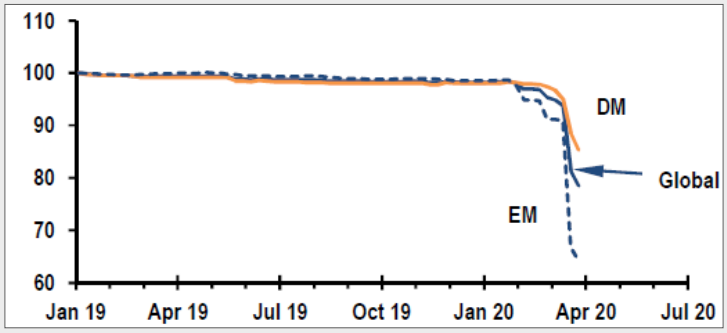
Outside the U.S., $6T of stimulus was announced including a €750B Quantitative Easing program by the European Central Bank (ECB). The U.K. also ramped up bond purchases and cut interest rates to near zero or the equivalent of 300 basis points (3%), while Japan agreed to inject $526B into their economy. Emerging market central banks in Thailand, India, Mexico and Pakistan also eased interest rates to boost their markets, while China (RMB 1.3T), India ($50B), Malaysia ($58B) and Singapore ($33B) announced fiscal support for their economies. As shown in the chart to the right, global short rates are now below 1.0% and have fallen further than they did in 2008. The black dot represents the point in 2008 when the S&P 500 began its recovery.

Source: Evercore ISI

Where Does Global Growth Go From Here?

As shown to the right, global GDP growth will be meaningfully impacted for at least the first quarter in response to the demand shutdown. Economists have slashed their 1Q 2020 forecasts to -10.0% for the U.S., -15.0% for the Eurozone, -4.0% for Japan and -21.0% for the emerging markets. However, expectations are for a stronger second half of 2020 with global GDP levels ending the year approximately 2.5% below pre-Covid-19 levels. On the earnings front, we began 2020 with expectations of improving results; however, it is no surprise earnings forecasts have also been adjusted downward. The extent to which growth is permanently impaired will be determined by five key factors: (1) the longevity of the shutdown; (2) whether or not business models need to adapt because of changed behaviors; (3) the extent of bankruptcies, particularly in the leisure-related and travel industries; (4) the loss of corporate and consumer confidence; and (5) the ongoing fiscal and monetary response, particularly outside the U.S.

Global Current Quarter (Q) FRI
Index, Jan 4, 2019 = 100

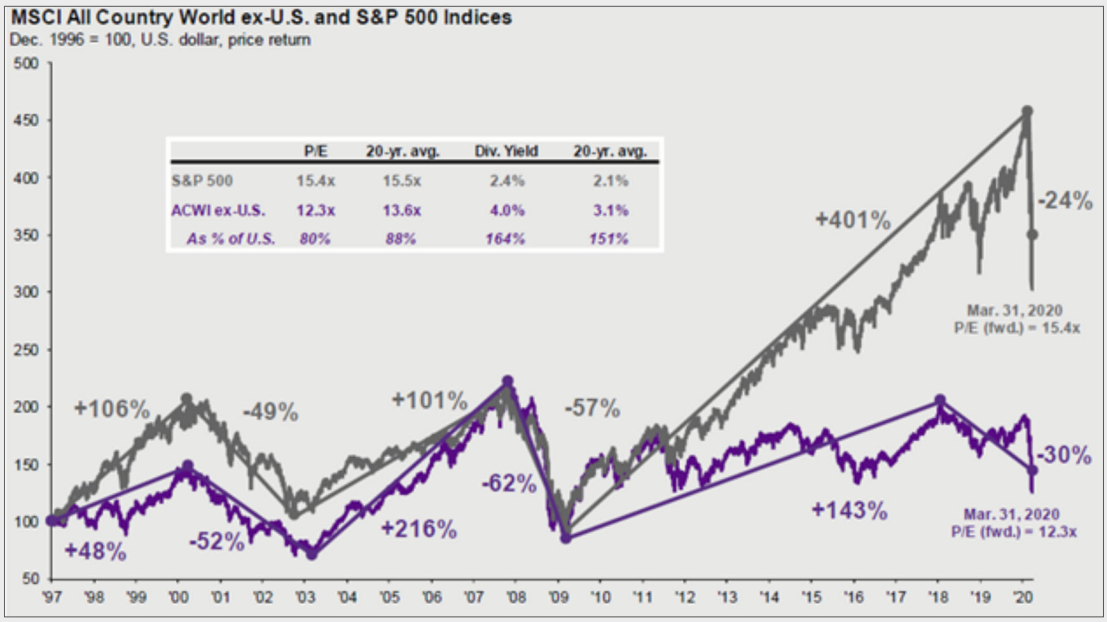


Source: JP Morgan

At this point, a range of outcomes is in play as to the trajectory of growth, earnings and market performance, albeit with extremely fluid data. While governments have provided loose monetary conditions, it remains unknown when the trough in growth will be reached. As a result, the depth of the recession and its duration cannot be determined at this point. Previous health related epidemics like SARS in 2003 indicate the key data points to watch are the timing of peak infection rates followed by a trough in global PMIs. The optimists say time is on our side and infections will peak in May/June with a return to pre-GDP levels by the middle of 2021. The pessimists take the view infection rates will be much slower to peak with the possibility of re-infection, so resulting demand will take much longer to return to pre-pandemic levels.

Equity Valuations: A Tricky Proposition

As we entered 2020, valuations for international and emerging market equities were trading at healthy discounts to their domestic counterparts. As shown below, valuations for equities outside the U.S. have gotten even cheaper. Similar to the exercise of predicting future growth, valuation is also a tricky proposition at this juncture because it is difficult to know just what is and is not priced in current valuations. What we do know is valuation alone will not cause the market to have a sustainable rebound. There must be one or more catalysts of which the most powerful would be the green shoot of a peak then material slowdown in U.S./European Covid-19 infection rates. As previously noted, this outcome appears to be a late May/June phenomenon as U.S. infections are still accelerating and Europe is now rotating from Italy to Germany and the U.K.



Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
Guide to the Markets - U.S. Data as of March 31, 2020.

To put the current market environment into perspective, the following table shows the market decline and rebound during various historical exogenous shocks. The average peak to trough was -22.0% and the average performance over the following three and nine month periods was 16.0% and 21.0%, respectively. The clear message is there is light at the end of the tunnel, it is just a matter of time.

Non-Economic Exogenous Shocks Saw Stocks Rebound Quickly (S&P 500)

Exogonous shocks to financial markets	Event date	Peak to trough decline	Trough date	Length (months)	3m perf	9m perf
European sovereign debt crisis/ US credit rating downgrade	Apr-11	-19%	Oct-11	5.2	14%	24%
September 9/11 terror attacks	Sep-01	-12%	Sep-01	0.3	18%	7%
Russian default and financial crisis	Jul-98	-19%	Aug-98	1.5	25%	36%
1987 Black Monday	Oct-87	-32%	Dec-87	2.0	20%	17%
Pres. Johnson's Great society program	Feb-66	-22%	Oct-66	8.0	11%	24%
Kennedy Slide	Dec-61	-28%	Jun-62	6.5	8%	27%
Suez Crisis 1956	Aug-56	-21%	Oct-57	14.9	6%	17%
Kobe earhquake (Topix)	Jan-95	-22%	Jun-95	3.9	22%	29%
Fukushima earhquake (Topix)	Mar-11	-23%	Nov-11	6.6	17%	8%
Average		-22%			16%	21%

Source: Refinitiv, Credit Suisse research

The Oil Patch Suffers A Double Black Swan

One of the largest pain points for investors was felt in the oil patch with energy being under siege on two fronts. Not only is the sector feeling recessionary demand caused by COVID-19, it also faces a potential supply surge engineered by Saudi Arabia to maximize output. Storage facilities for excess supply are nearing capacity. Jet fuel is one such example as flight cancellations continue to grow. Large price declines and extremely volatile conditions resulted with crude oil declining 66.5% with sub-sector returns losing in concert. It is difficult to predict how low oil prices will go; however, it will likely get worse before it gets better. It is safe to say balance sheet strength and the ability to navigate an uncertain environment will outweigh current valuation in investor decision making. Toward quarter-end, the U.S. did initiate an aggressive asset purchase program to provide support to oil prices. Time will tell how this story unfolds. Wild cards to the oil outlook include how quickly demand returns and whether the OPEC+ response to the current pricing environment is to capitulate or stay the course with their scheduled plan to maximize production. If there was a bright spot for energy during the quarter, it could be found in natural gas prices for future delivery taking a 10% jump near quarter-end in response to producers laying down rigs. The expectation is associated gas volumes will decrease by 2 BcF/d or more, which could be a boon for pure natural gas shale producers next winter if excess supply is burned prior to the upcoming winter season.

Portfolio And Stock Highlights

MSCI EAFE large caps outperformed small and mid caps for the quarter and year, while Growth outperformed Value by over 10%. The best performing MSCI EAFE countries for the quarter were Denmark, Switzerland and Portugal, while the worst performing MSCI EAFE countries were Austria, Norway and Australia. The best performing emerging markets for the quarter were China, Qatar and Taiwan, while the worst for the quarter were Brazil, Columbia and Greece. U.S. investor returns versus regional returns outside the U.S. were negatively impacted by a stronger dollar during the quarter, which included a sharp rebound in March as markets became extremely volatile.

Outperformers: Eagle portfolios generated strong relative results during a very challenging market environment due to our quality bias leading us to own companies with consistent earnings, high free cash flow and strong management teams. A combination of strong sector allocation and stock selection drove returns. Superior stock selection continued to be the driver of the outperformance with holdings in the Healthcare, Industrials and Consumer Discretionary sectors. Standout names included Lonza Group Ltd. (Switzerland), Canadian Pacific Railway (Canada) and Pan Pacific International Holdings Corp. (Japan). Our lack of exposure to Real Estate and overweight positions to the Information Technology and Communication Services also added value. From a country perspective, our overweight to Switzerland and China combined with our underweight to Australia contributed to performance. Finally, our cash position provided some cushion to performance in a declining market.

Disappointments: Stock selection in the Information Technology, Communication Services and Energy sectors detracted from performance for the quarter due to poor results from Amadeus IT Group (Technology), WPP Plc (Communication Services) and Suncor Energy (Energy). From an allocation perspective, our overweight to the Energy sector was the largest detractor. Stock selection in the Netherlands and France also detracted from performance due to ING Groep N.V. (Financials) and Valeo SA (Consumer Discretionary).

Opportunity Set / Portfolio Positioning

The market dislocation during the first quarter has given our team the opportunity to evaluate attractive companies in the Consumer Discretionary, Information Technology and Communication Services sectors where long-term structural growth stories with solid fundamentals now have compelling valuations. As described in detail on page 6, Mercadolibre and LVMH are two examples of new purchases fitting this profile. Our team also raised cash for new opportunities through the reductions of two bank holdings Intesa San Paolo and BOC Hong King Holdings given our expectation interest rates will stay lower for longer, keeping net interest margins and thus profitability for banks depressed. Portfolio turnover has been higher than normal during the first quarter due to market conditions evolving so quickly.

The shape of the recovery is difficult to predict at this point. However, if history is any guide to post exogenous stock performance, returns are likely to be very attractive as infection rates peak and decline, communities around the globe resume their normal daily activities and global growth returns to an upward trajectory. We are cognizant of maintaining an appropriate level of market risk in our portfolio to allow for upside participation as the market eventually rebounds.

Purchases / Additions This Quarter

MercadoLibre (MELI): SECTOR: Consumer Discretionary, COUNTRY: Argentina. We initiated a new position in Mercadolibre because we believe the company is poised to benefit from increasing adoption of online and mobile commerce in Latin America. Internet penetration in the region is around 70%, with half of all internet users already actively using MercadoLibre. Marketplace infrastructure, software engineer expertise, and payment settlement capabilities differentiate MercadoLibre from direct rivals. MercadoPago offers meaningful long-term potential through its mobile POS platform, merchant services (processing payments for other online businesses), mobile wallet, asset management, and other credit services.

Louis Vuitton Moet Hennessy (LVMH): SECTOR: Consumer Discretionary, COUNTRY: France. LVMH is a leading global luxury brand company with Louis Vuitton and Christian Dior accounting for a major portion of their sales and profitability. LVMH has been a leading force in product innovation and creativities with their brands in the luxury segment as well as in enhancing the quality of their distribution over time. Their brand awareness and image are top in their categories. While the global recession will dent near-term earnings, the lower stock price gave us an opportunity to begin a position in a secular grower with a moat around its brands taking advantage of the elevation of the Asian and emerging market consumer.

Magna International Inc. (MGA): SECTOR: Consumer Discretionary, COUNTRY: Canada. Magna is one of the largest auto suppliers in the world with capabilities in metal-forming, powertrain, and seating. The recent market selloff saw the stock price get cut in half. With high market share, strong balance sheet, plenty of liquidity and no debt maturities until 2022, we feel Magna can come out of this crisis a stronger company either by war of attrition, buying assets at attractive valuations, or continuing to buy their own shares at a discount. After two optimistic trims in 2018, we decided to add back to the position at a compelling valuation.

Alibaba (BABA): SECTOR: Consumer Discretionary, COUNTRY: China. We added to Alibaba after shares pulled back on Covid-19 concerns. Alibaba has been a beneficiary of the outbreak, despite the fact that their offline retail was forced to shut down during the lockdown. The company responded by substituting offline retail for online retail, which resulted in increased online consumption for fresh foods and other daily necessities. Another positive benefit has been the structural change in consumer behavior towards digital consumption.

iShares MSCI EAFE Index (EFA): We utilized the ETF as a short-term holding to reinvest proceeds from the sale of securities where we had concerns. We will look for opportunities to redeploy this holding into individual stocks.

Sells / Trims This Quarter

Intesa San Paolo (ISNPY): SECTOR: Financials, COUNTRY: Italy. Our sale of Intesa San Paolo was well-timed as we avoided most of the impact of weakening economic conditions in Italy due to the impact of Covid-19. We also had concern about the slow-down in demand negatively impacting smaller businesses relative to larger businesses. We expect deteriorating asset quality and provisions for non-performing loans to rise combined with a weaker revenue outlook (lower volumes, revenue rates/margins, lower fees) to impact profitability of the bank.

BOC Hong Kong Holdings (BHKLY): SECTOR: Financials, COUNTRY: Hong Kong. BOC Hong Kong Holdings was sold during the quarter due to the weakening economy in Hong Kong in part due to the geo-political risk caused by ongoing protests and rioting. We believe this will cause revenue growth to slow. At the same time provisions for bad loans have been increasing, so we also expect credit costs to stay elevated versus history.

Aercap Holdings (AER): SECTOR: Industrials, COUNTRY: Netherlands. AerCap is the largest air leasing company in the world. The company has managed through downturns in the past and has emerged in a stronger position. However, Covid-19 provided new challenges for global airline traffic, not just slowing, but essentially grinding to a halt with current travel bans. This in turn had led their airline customers to request deferral of payments to AerCap, which puts pressure on their liquidity and their ability to meet debt obligations. With limited visibility on when demand will resume and even less visibility on a return to normal traffic, we decided to sell the stock and redeploy the proceeds into better opportunities.

Treasury Wine Estates LTD (TSRYF): SECTOR: Consumer Staples, COUNTRY: Australia. A combination of factors led to our exiting this position. The distribution changes in the U.S. are taking longer than expected and leading to an unexpected drop in profitability. In addition, major management changes give us concern as to the sustainability of the long-term strategy of the company. Moreover, the lockdown in China over Covid-19 will lead to a significant short-term pain for the company whose major profitability growth driver is in China.

Pan Pacific International Holdings Corp. (DQJCY): SECTOR: Consumer Discretionary, COUNTRY: Japan. After recent outperformance during the market correction, we decided to trim this position and redeploy into other opportunities.

Total SA (TOT): SECTOR: Energy, COUNTRY: France. We trimmed our position in this oil major to reduce the oil exposure in the portfolio after a significant bounce in the stock. The dual Covid-19 induced demand shock and OPEC+ inability to come to terms with the supply shock has sent oil prices reeling making it harder for the industry overall and for Total to reach its stated targets. This is yet another challenge for the industry already under pressure from anti-fossil fuel ESG investing trends.