Eagle Global Advisors

Quarterly Commentary Q1 2020

EGA U.S. Equity

From the EGA Portfolio Management Team

After a big selloff in February, stocks came under further pressure in March as the Coronavirus outbreak gained traction in the U.S. Event cancellations, school and university closures, work-from-home mandates, travel restrictions and limitations on public gatherings dominated the headlines in the early part of the month. As the month progressed, there was a seemingly nonstop flurry of announcements regarding business closures (particularly retail and restaurants) and production shutdowns. By the end of March, about three out of four Americans were either under or about to be under some form of lockdown as public health experts stressed the importance of "social distancing" in trying to "flatten the curve".

There was an aggressive policy response to the outbreak from both a monetary and fiscal perspective. The Federal Reserve slashed rates to the zero lower bound, announced unlimited and expanded Quantitative Easing, and unveiled seven facilities to boost market liquidity. Congress passed a third economic support package late in the month worth more than $2 trillion.

While the markets found some stability at the end of March, the S&P 500 Index finished the first quarter down -19.6%. More stimulus will be needed to support the economy in this evolving health crisis. We expect markets to find some stability by the end of April as the extended lockdowns and expanded testing capability starts to show results in the form of plateauing the total number of confirmed coronavirus cases in the U.S. Once we break the current epidemic, Americans can gradually leave their homes, return to work, attend school and congregate. However, experts believe the Coronavirus will become dormant, but not go away. Eventually, we would either have to develop herd immunity against the virus or come out with a vaccine to stop the spread. Both options are 1-2 years away. Until then, the exposure to the virus would need to be managed using mitigation efforts and a more robust toolkit from federal, state and local governments to avoid another outbreak.

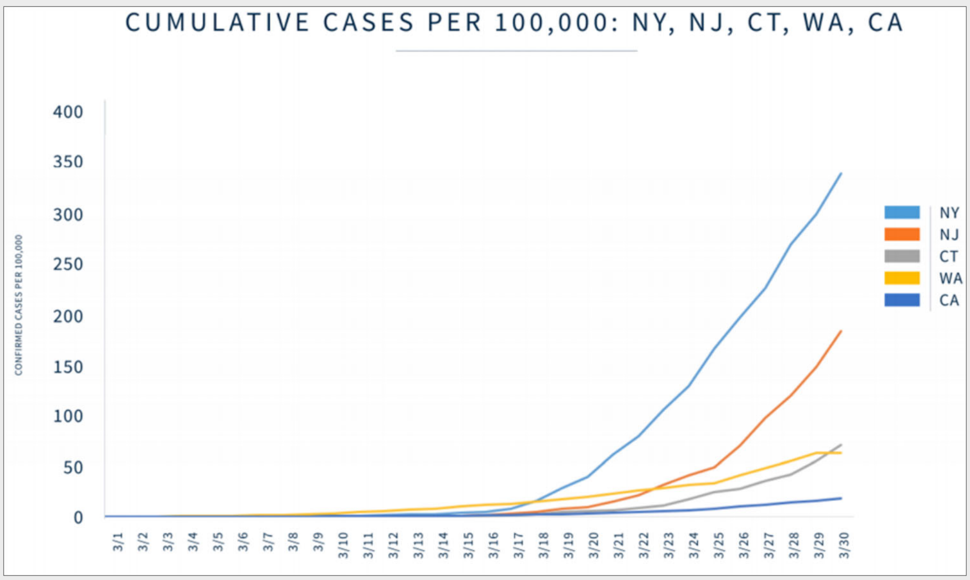
Economy: A steep decline in Q2 GDP followed by gradual but steady recovery starting in Q3

With various forms of lockdowns expanding globally almost concurrently or close together, the economic damage caused by Coronavirus is going to be massive. That is not to say that lockdown measures are the cause behind this damage. Without a lockdown, there would have been a bigger health crisis, arguably a worse economic crisis and most certainly a crisis of confidence.

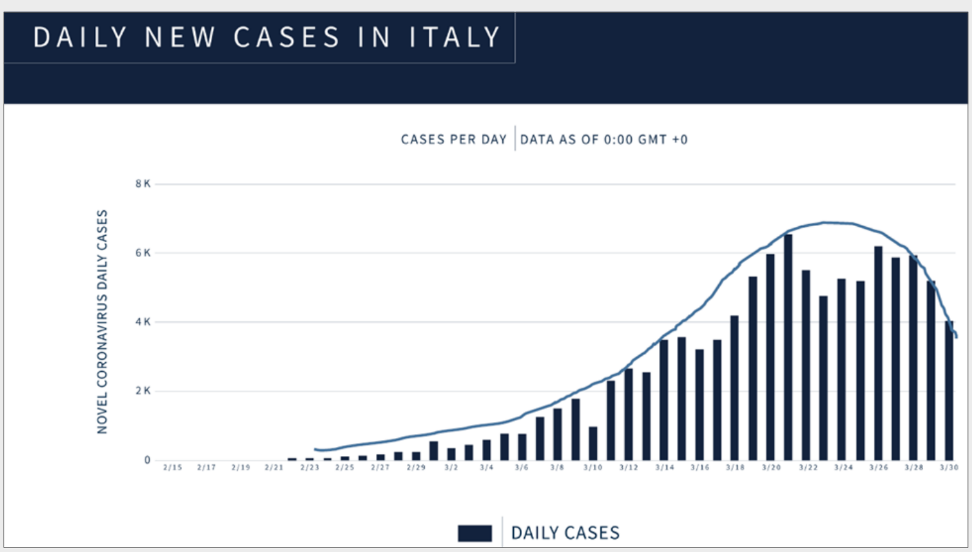
Unemployment, just 3.5% in February, could top 10.0% in coming months, higher than its peak in the 2008-09 recession. Some see it surpassing 20.0% soon, levels unseen since the Great Depression. But it isn't a foregone conclusion that this must wreak as much damage as the great recession, much less the depression. That would depend not just on how high unemployment goes in the next month or two, but how long it stays there. That, in turn, depends on two things: how long it takes health officials to stop the Coronavirus pandemic, and whether businesses and workers, with the aid of government, can stay afloat in the meantime. This isn't like other recessions, in which businesses and consumers are unwilling to spend. This time they are unable to spend. It resembles a natural disaster such as a hurricane that closes an entire affected region, except in this case the hurricane has hit the entire planet around the same time. Businesses and employees typically treat a natural disaster as transitory and pick up afterward where they left off. The difference is that this one is shutting down most of the country, potentially for months. The longer it drags on the more businesses will fail and the more temporary layoffs become permanent, with knock-on effects on spending and employment that become difficult to reverse.

For the economy to recover, a number of things need to happen. First, the spread from this virus needs to slow and eventually stop. Second, the businesses that drive the economy and create employment need to be supported to get past this epidemic. Third, Americans need to be convinced that public-health measures have halted the spread of the virus to encourage them to resume a more normal lifestyle. Finally, a vaccine needs to be developed to prevent a future outbreak. Progress is being made on most of these fronts.

During mid-March, the Trump administration published nationwide guidelines to slow the spread of the virus. Efforts have been made to significantly ramp up testing. We now know from experiences in California and Washington that aggressive testing and mitigation methods can slow the spread. Additionally, Italy has now entered the fourth week of full mitigation and it has seen a decline in total number of new cases.

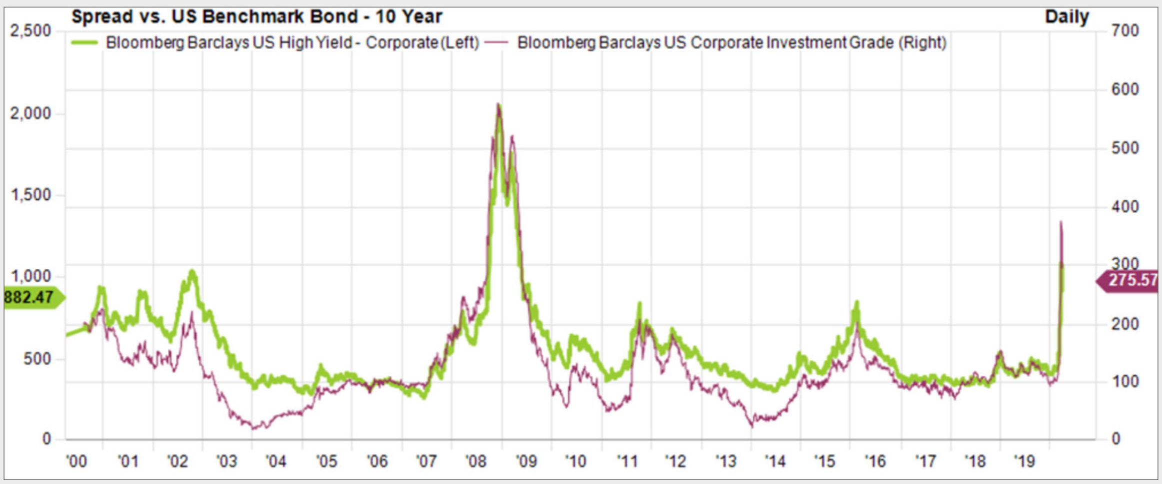


Source: White House Presentation on March 31, 2020



Source: White House Presentation on March 31, 2020

During this period of mitigation, the Federal Reserve and Federal Government are taking unprecedented stimulus measures to backstop the economy. The Federal Reserve moved swiftly by announcing an emergency interest rate cut on March 3rd and is rolling out new efforts almost weekly since, including slashing rates to zero and launching unlimited large-scale asset purchases. These efforts stemmed a credit crisis from erupting to the levels seen in 2008-2009. In the background, Washington was ironing out the kinks of a broader fiscal stimulus plan. The fiscal stimulus passed by lawmakers was designed to help individuals and businesses survive a locked down economy for 2.5 months. It featured $250B in direct payments to Americans, $367B in small business loans that can be forgiven if employment retention metrics are met, a $500B loan and loan guarantee program for industries, cities and states that with the help from the Fed can produce ~$4T in total liquidity, expanded unemployment benefits, $150B for state and local governments, and $130B for the nation's healthcare system. These measures eased some of the stress that had been building in the markets, which had all but shut down even for high quality borrowers. Since then, credit spreads for investment grade and high yield corporate borrowers have improved and the economy has dodged a 2008-2009 style widespread credit crisis.

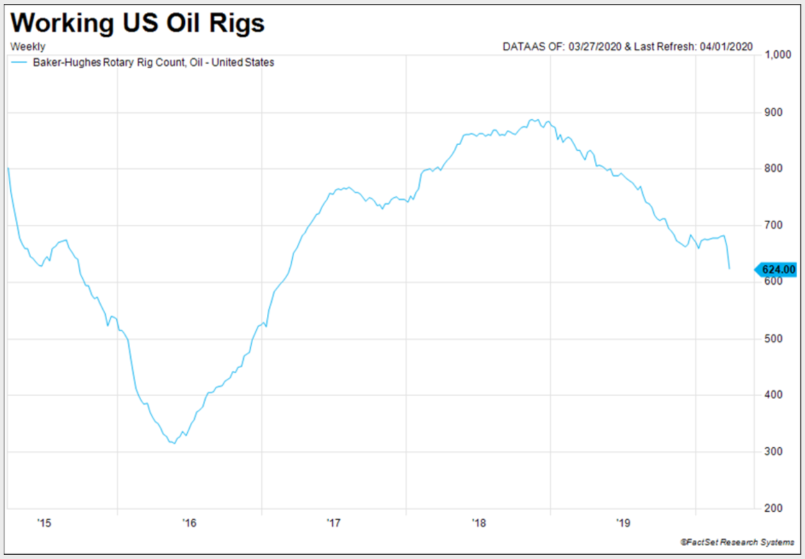


Source: Factset data as of March 31, 2020

According to a recent economic forecast by the economists at Goldman Sachs, U.S. real GDP will decline -9.0% in Q1 and -34.0% in Q2 in quarter-over-quarter annualized terms. The unemployment rate is forecasted to rise to 15.0% by mid-year. After mid-year, GDP is forecasted to grow 19.0% in quarter-over-quarter annualized terms. Overall, the estimates imply that a bit more than half of the near-term output decline will be made up by year end and that real GDP for 2020 will decline -6.2%.

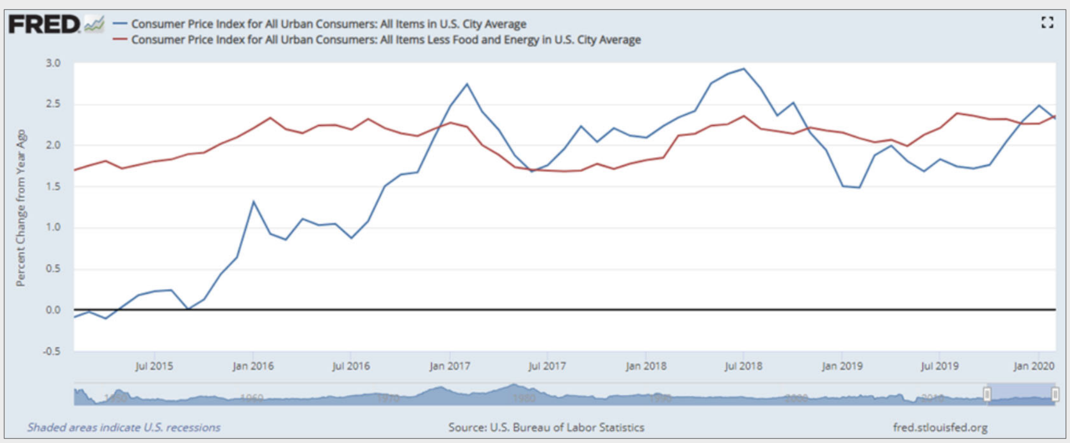
Oil: Price war resumed just before demand collapsed

There were very few developments outside of the Coronavirus that received much attention this month. The biggest was the rout in oil with WTI crude falling 54.2% to end the month at $20.48 a barrel. Supply concerns came into focus following the breakdown of the OPEC+ alliance. Russia balked at the Saudi-led OPEC push for a further 1.5M bpd output cut to stabilize the market, reportedly concerned that such a move would help U.S. shale producers. Saudi Arabia quickly responded by slashing prices and announcing a ramp in output and export capacity. The developments led to a nearly 35.0% decline in the Energy sector and also exacerbated credit concerns given energy companies account for over 11.0% of the U.S. high-yield market. Within days, Coronavirus related lockdowns started getting announced in Western economies. That sent demand lower, further widening the gap between supply and demand. U.S. oil producers have already responded to this new environment by reducing the number of oil rigs.



Inflation: Core inflation remains steady

Core U.S. inflation, which excludes volatile categories such as food and energy, rose 2.4% in February over the prior year. The Core PCE Price Index rose 1.8% y/y, remaining below the Fed's inflation target of 2.0%. Consumers expect minimal price pressure over the long-term. In the near term, many prices are clearly falling in response to the collapse in demand. Longer term, however, we remain concerned that the unprecedented fiscal and monetary stimulus may have a hangover effect in higher prices. How the authorities will deal with mopping up the liquidity after this crisis will have a significant effect on future inflation.



Corporate Profits: Profit estimates revised lower due to Coronavirus

As of February 28 2020, Q1'20 S&P 500 earnings were tracking to rise 1.0%. Since then, earnings expectations have been reset to account for the spread of Coronavirus outside of China. Current estimates call for a –10% decline in Q1'20 earnings. Right now 2020 earnings estimates are totally up in the air, with forecasters estimating declines from 8% to 40% in corporate earnings depending on the course of the pandemic. However most observers expect a vaccine and other measures to return life to normal in 12 to 18 months, and the earnings power of corporations should also return to previously expected levels in most areas of the economy. As near-term earnings represent a fraction of the value of companies, we think the intrinsic value of corporations has not really changed much, and the decline in prices make stocks a better value today than they were at the beginning of the year.

Interest Rates: Dash to zero lower bound with unlimited QE

On January 29, the FOMC left the fed funds rate at its targeted range of 1.5%-1.75%. It stated its satisfaction with rates of economic growth, inflation, and unemployment at that time. On March 3rd, the Fed held a special meeting in response to Coronavirus outbreak. It lowered the fed funds rate by 50bps to a range of 1.0%-1.25%. In less than two weeks, the FOMC held an emergency meeting to lower the rate to a range of 0% and 0.25%. It also revived the Quantitative Easing (QE) program. It would purchase $500 billion in U.S. Treasuries and $200 billion in mortgage-backed securities over the next several months. On March 23rd, the FOMC held an emergency meeting to expand credit. The Fed expanded its QE program to an unlimited amount. It also included purchases of commercial mortgage-backed securities. It expanded its overnight repurchase agreement operations. The Fed has also allowed banks to decrease their capital levels to allow them more funds to lend to those hit hard by the Coronavirus crisis. The Fed also established two funds to support corporate bond lending. The Primary Market Corporate Credit Facility (PMCCF) is for new bonds and the Secondary Market Corporate Credit Facility (SMCCF) is for existing bonds. The Fed revived the Term-Asset Backed Securities Loan Facility (TALF). It supports credit for asset-backed loans such as student and auto loans, credit cards, and Small Business Administration (SBA) loans. It expanded the Money Market Mutual Fund Liquidity Facility (MMLF) to support municipal bonds. The Commercial Paper Funding Facility (CPFF) allows high-quality, tax-exempt commercial paper to be considered eligible securities. The Fed announced it will create a Main Street Business Lending Program (MSBLP) to support lending to eligible small-and-medium-sized businesses, complementing efforts by the SBA.

Fixed Income: Bond yields plunge

Government bond prices soared and yields plunged in the wake of the crisis, as investors rushed to safe-haven assets. The U.S. 10-year bond closed the quarter at a 0.68% yield, down from 1.92% at the beginning of the quarter. Corporate bonds were another story. Concerns about liquidity, solvency, and a credit crunch saw corporate bond prices slump and yields rise in the early days of the crisis, with lower rated names suffering the most. But as the Fed announced new and unprecedented steps to buy investment grade corporate and municipals bonds, prices in those areas improved dramatically and yields fell. However, yields on non-investment grade (Junk) bonds have remained elevated as most expect a significant uptick in defaults. While our fixed income portfolios were stable and provided a port in the storm that overwhelmed equities, we underperformed fixed income indices due to our shorter-maturities and higher exposure to corporates than the benchmarks. We maintain our exposures as we expect the Fed’s unprecedented measures to further stabilize the corporate credit market will work, and at some point the extreme financing demands of the government fiscal programs should raise yields on government bonds.

Stock and Portfolio Highlights

Eagle portfolios outperformed the S&P 500 Index in the first quarter due entirely to better stock selection in Industrials, Consumer Discretionary and Financials sectors.

Purchases / Additions In The Quarter

Hess Corp. (HESS): Guyana, which presents the most transformative opportunity in energy, continues to post fantastic results and updates. Last week's update from XOM and HES increased estimated recoverable resources from 6Bboe+ to 8Bboe+. This is potentially the most exciting discovery in the world right now, and it represents an opportunity for Hess to considerably outgrow peers on production through an asset with lower costs and better economic terms than most opportunities in the world. The incremental net production uplift from Guyana in 2020 represents 10.0% of Hess' average Q4/19 TOTAL production. Hess is an investment-grade credit with YTMs similar to high quality names such as PXD and FANG. The vast majority of Hess' debt does not mature until after 2029, with very minor amounts due in 2022, 2024, 2026, and 2027.

Intercontinental Exchange Inc. (ICE): ICE was founded in 2000 as an OTC energy market and has since expanded both organically and through acquisitions across trading, clearing, and data. We view ICE as well positioned, with the strategic benefits of NYSE Euronext transaction, for a pickup in trading volumes (equities, rates and energy). They have a strong mix of data and transactional revenue. As financial markets become increasingly fragmented (including by regulatory changes), data becomes more valuable. IDC has made ICE a more stable business with higher recurring revenues. Data revenues are resilient driven by the need for mission critical pricing and reference data. It is a solid franchise with steady revenue growth around 4.0% to 5.0% a year driven by pricing, data services and new initiatives.

Lockheed Martin Corp. (LMT): Lockheed remains perhaps the highest quality name in the Defense group and the company should trade defensively in a volatile market. While the defensive nature of Lockheed's business helped it to outperform year-to-date, the shares still pulled back materially on an absolute basis, affording us the opportunity to add to our position. Finally, geopolitical tensions may escalate as a result of coronavirus and the ongoing oil price war, an environment that favors the Defense industry.

S&P 500 Index Fund (SPY): We utilized the ETF as a placeholder to add market beta to the portfolio after a precipitous decline in the underlying index.

Sells / Trims In The Quarter

Allegion Plc. (ALLE): Allegion is a high quality manufacturer of security products and solutions mainly throughout North America. They have been a structural winner in the move from mechanical to electronic locks. After a strong third quarter of organic growth, the stock raced ahead to a point where the risk reward was not as compelling to other opportunities so we decided to trim and redeploy capital to more attractive opportunities.

Corteva Inc. (CTVA): Inconsistent and mostly disappointing results led us to exit the position. Wildly variable results driven by unpredictable events (primarily weather) coupled with a concerning PFAS overhang led us to a decision that holding Corteva was not consistent with the framework we rely upon to choose high quality investments.

Select Sector SPDR Utilities Fund (XLU): After recent outperformance during the market correction, we decided to trim our Utility weight and redeploy to other opportunities.