EAGLE GLOBAL ADVISORS

Quarterly Commentary Q3 2020

EGA U.S. Equity

From the EGA Portfolio Management Team

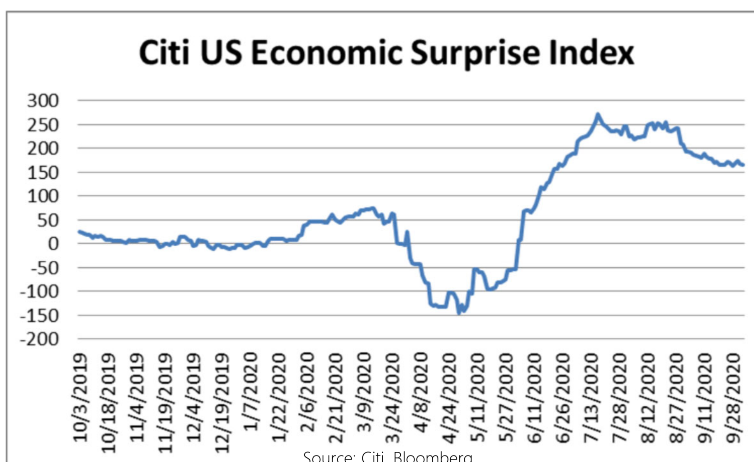
U.S. equities rallied sharply for the second straight quarter during Q3. The S&P and Nasdaq hit a string of new record highs with the S&P 500 finishing the quarter up 8.9%. Growth continued to outperform value following its outsized leverage to the central bank liquidity tailwind and secular growth and disruption themes.

The usual suspects were credited with the Q3 rally. The biggest tailwind for stocks still seemed to be the massive monetary and fiscal stimulus in response to the Covid-19 pandemic, which some analysts have pegged at over $20T. Expectations for a near-term vaccine breakthrough remained supportive. At the end of the quarter, there were four vaccine candidates in late-stage trials in the U.S. and public health officials continued to discuss the potential for the FDA to grant emergency use authorization as early as November.

Although the market was able to push higher in the third quarter, a number of headwinds received increased attention in September when stocks suffered their first monthly decline since March. One of the biggest issues revolved around increased call option activity in crowded big technology companies. Additionally, the quarter ended without a deal on a fifth coronavirus relief bill that had originally been widely expected as Democrats and Republicans remained far apart on the size and scope of the package. Finally, risks related to a second wave of Covid-19 infections in winter and potential delays in announcement of November election results (due to increased use of mail-in ballots) have resulted in increased market volatility.

Economy: Showing signs of fading momentum

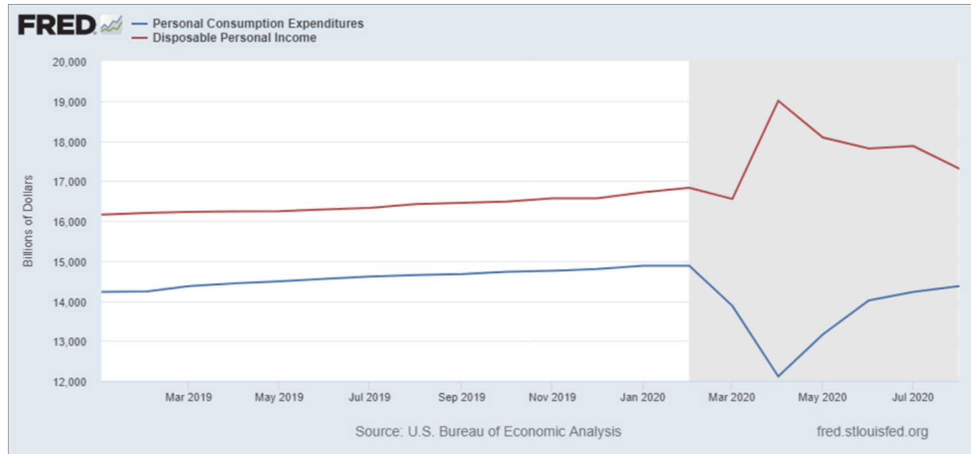
A sharp decline in U.S. GDP was largely expected for Q2. The pandemic recession and the widespread U.S. business closures it spawned, weighed on nearly all industries, as restaurants, hotels and entertainment businesses fared the worst. U.S. gross domestic product shrank at a 31.4% annualized rate in the second quarter. Stimulus skepticism led economists to cut Q4 GDP forecasts and press reports discussed how a number of high-frequency indicators suggest the economic recovery may be stalling out.



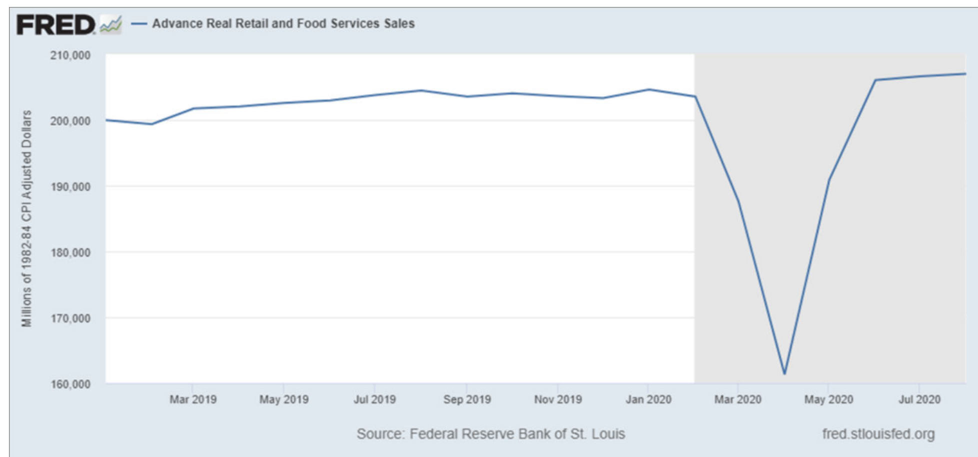
Source: Citi, Bloomberg

Economic surprise momentum remained elevated throughout the quarter, but U.S. job gains slowed in September as many Americans quit looking for work, suggesting the economic recovery is downshifting as the country struggles without a Covid-19 vaccine or fresh government aid. Nonfarm payrolls increased by 661,000 compared to a 1.49 million advance in August and median consensus estimate of 859,000. The unemployment rate fell by more than forecast, dropping 0.5 percentage points to 7.9%, though the labor force participation rate declined by 0.3 points to 61.4%. The employment report reflects a sizable decline in local education jobs, while gains in retail and temporary workers slowed. Persistently high jobless claims, along with recent high profile layoff announcements indicate continued and widespread economic pain.

Americans' incomes fell in August by the most in three months after the government's supplemental unemployment benefits expired, threatening to temper consumer spending that increased during the month. The 2.7% decrease in personal income was a sharp reversal from the 0.5% gain in July and missed consensus expectations of a 2.5% drop. A deceleration in personal spending accompanied this decline.



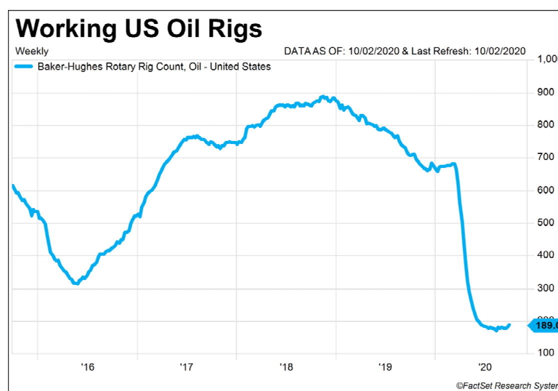
The rebound in U.S. retail sales slowed by more than expected in August as federal relief for jobless consumers and small businesses dried up and the pandemic continued to weigh on economic activity. August retail sales increased 0.6% compared to a 0.9% increase in July and the median economist estimate of 1.0%. So-called control group sales, which exclude food services, car dealers, building materials stores and gasoline stations, fell 0.1%, also missing forecasts. This measure is often considered more reflective of underlying consumer demand. With many more stores and restaurants now open, the initial boost in spending driven by re-openings appears to be moderating. At the same time, the expiration of the supplemental $600 weekly payments at the end of July as well as slowdowns in back to school spending likely weighed on retail activity during the month.



The housing market remained a bright spot. The U.S. Home Builders' Confidence Index in September rose to 83 versus 78 in the prior month. This was the highest reading in records going back to 1985. Sales of new homes in the U.S. advanced higher than expected for a fourth consecutive month in August, reaching the highest level in almost 14 years as record low mortgage rates continued to entice buyers into a market with ever shrinking supply. Builder backlogs - the number of properties sold for which construction hasn't yet started – jumped to 342,000 in August, also the highest since 2006 and a sign builders will be busy for months to come. Similarly, U.S. pending home sales rose more than expected in August, the fourth straight monthly gain for the index, which is now at the highest level in records dating back to 2001.

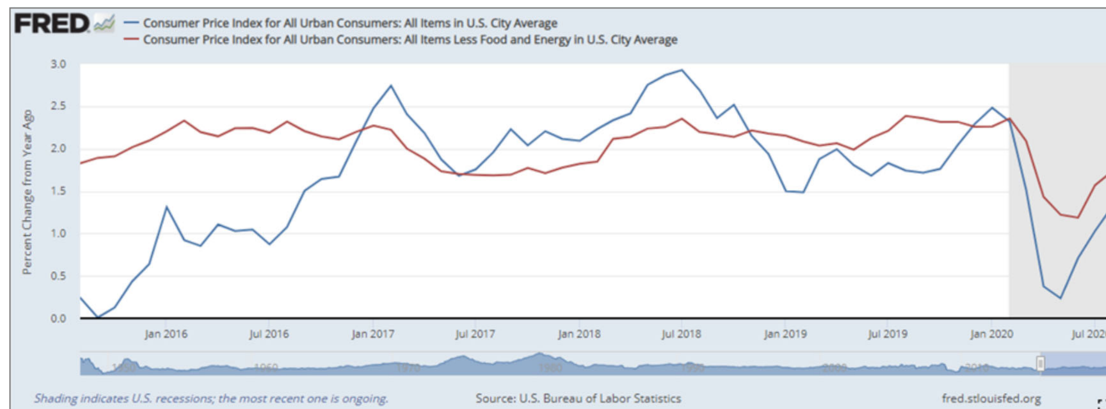
Oil: Price flatlined at $40

While gasoline demand increased steadily during the quarter, jet fuel demand remains severely depressed. Inventories of oil and refined products remain at elevated levels keeping crude-oil prices near $40 a barrel and challenging the global energy industry heading into the final months of the year. Some analysts are wary that surpluses could begin building again as the summer driving season ends. While gasoline demand rebounded sharply in the second quarter, its improvement slowed in the third quarter with U.S. demand 92% of its year earlier level at the end of September. Gasoline demand growth has also slowed in other key oil consuming countries that have been hit hard by the coronavirus, such as India. Additionally, with many flights canceled, consumption of jet fuel around the world remains low.



Inflation: Core inflation rebounds

Core U.S. inflation, which excludes food and fuel costs, increased 1.7% in August vs. the prior year. This follows a 1.6% year-over-year increase seen in July. Core inflation increase was driven by the shelter index, which rose 2.3%, and the medical care index, which increased 4.5%. The gain in consumer prices reflects the steady advance in demand for goods and services since the pandemic-induced lockdowns earlier this year, suggesting inflation is gradually returning to the pre-pandemic pace. August Core PCE inflation growth also accelerated to 1.6% from 1.4% in July. 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: Upward revisions have begun

For the third quarter, the estimated earnings decline for the S&P 500 is -21.0%. On June 30th, the estimated earnings decline for Q3 was -25.3%. Since then, 9 of 11 sectors have seen upward revisions. The EPS estimates for Q3 for all companies in the index increased by 4.1% (from $31.78 to $33.08) from June 30th to September 30th. This begs the question - How significant is a 4.1% increase in the bottom-up EPS estimate during a quarter? During the past five years (20 quarters), on average, quarterly EPS estimates decline by about 5.0% as the quarter progresses. This suggests that analysts had cut estimates too much, which were then revised higher during Q3. For 2020, S&P 500 earnings are projected to decline by 18.0% with revenue declining 3.0%. For 2021, earnings are projected to climb 26.0% with revenue growth of 8.0%. The forward 12-month P/E ratio for the S&P 500 is 21.6. This P/E ratio is above the 5-year average (17.2) and above the 10-year average (15.5), but after adjusting for lower than usual interest rates, the valuation gap relative to historical data may be justified.

Interest Rates: Lower till 2023, at least

September's FOMC meeting featured a change in policy that would allow the Fed to hold down interest rates until inflation has moderately exceeded 2.0% for some time. Previously the Fed was expected to tighten policy when inflation approached 2.0% from below; this policy change implies that inflation can be above 2.0% for some time before the Fed may start to tighten. This framework shift seeks to make up for past inflation shortfalls and allow the labor market to run hotter until inflation has sustainably risen. Chairman Powell's characterization of the Fed's new guidance as "powerful" led analysts to not expect much in the way of changes in the near-term. The shift to average inflation targeting was accompanied by some talk about "peak Fed" given a largely depleted policy arsenal and no signs of urgency to adjust its QE program. Nevertheless, we continue to expect the monetary policy outlook to remain extremely accommodative over the near-to- medium-term.

Fixed Income: Interest rates steady

During the quarter, Treasury rates remained steady at the unprecedentedly low levels that have prevailed after the Covid-19 economic crisis hit in the second quarter. The 10-year Treasury began the quarter at 0.65%, dipped to 0.51% in July, before ending the quarter at 0.68%. Corporate spreads compressed a modest amount. Eagle fixed income portfolios continued to maintain shorter than index duration and greater than index exposure to corporates as we believe longer dated bonds could see rates rise as the economy recovers and corporate spreads tighten as investors gain more confidence in credit. In the early days of October, longer Treasuries have spiked in yield up to 0.80% as prospects for an additional fiscal stimulus have increased.

Stock and Portfolio Highlights

Eagle portfolios outperformed the S&P 500 Index in the third quarter due to better stock selection in the Information Technology, Communication Services and Industrials sectors.

Purchases / Additions In The Quarter

SBA Communications Corp. (SBAC): SBA Communications is the third largest U.S. wireless tower company with over 7,800 towers spread across the country. The core business for SBA is leasing antenna space on its towers to various wireless service providers on a long-term basis. It benefits from structural growth driven by 5G investments as wireless carriers invest in 5G coverage and capacity (new mid-band spectrum availability; C-band deployments; T-Mobile 2.5 GHz rollout). We believe it is well positioned to capitalize on industry trends of rising data usage which leads to increased carrier activity and site densification. As more equipment is added to the towers, SBAC collects more in revenue. The industry has an oligopolistic structure with high barriers to entry due to regulatory restrictions on the numbers of towers being built (zoning issue) and with three major tower companies controlling about 80% of the market.

Intercontinental Exchange, Inc. (ICE): ICE is a leading operator of regulated exchanges and clearinghouses. Additionally, ICE offers pricing and analytics, exchange data and desktops and connectivity services. We believe that ICE benefits from a solid outlook for volumes and a stable data revenue growth driven by new initiatives such as fixed income and mortgages. ICE is making a big push into digitization of mortgages, with the acquisition of Ellie Mae which adds to the prior MERS and Simplifile acquisitions to create a $1.1B revenue mortgage technology vertical. The company now has an end-to-end offering and targets a $10B TAM with expected growth from millennial homebuyers and increasing demand for automation.

UnitedHealth Group, Inc. (UNH): UnitedHealth Group engages in the provision of health care coverage, software, and data consultancy services. It operates through the following segments: UnitedHealthcare, OptumHealth, OptumInsight and OptumRx. Reduced utilization rates during Covid-19 helped improve margins for UNH during the second quarter. OptumInsight is UNH's data analytics, technology and consulting business. OptumInsight is a growth driver of sales and margins for UnitedHealth Group. No other company comes close to the promise of bringing together the largest health plan, third largest pharmacy benefit manager (PBM), one of the largest Healthcare IT companies and the largest ambulatory care provider, at scale, nationally.

Walmart, Inc. (WMT): Walmart, Inc. engages in the retail and wholesale business. The company offers an assortment of merchandise and services at "everyday low prices". It operates through the following business segments: Walmart U.S., Walmart International, and Sam's Club. Walmart recently began three additional online initiatives: Walmart+ and the pursuit of TikTok Global and Tata Group super app. Walmart's designation as an essential business during Covid-19 restriction and stay at home pantry stocking also led to improvement in earnings. Attractive relative valuation versus Amazon coupled with Walmart's steps to improve competitive positioning in ecommerce led to our interest in Walmart.

Sells / Trims In The Quarter

Hess Corp. (HESS): We sold Hess due to a district court's ruling to shut down the Dakota Access Pipeline (DAPL). A loss of DAPL, whether temporary or permanent, directly and materially impacts Hess' ability to market crude out of the core Bakken basin. In addition to Hess' potential loss of Bakken volumes, a removal of DAPL's takeaway capacity would likely increase basis spreads for Bakken crude. This would not only negatively impact the price Hess receives on existing Bakken production, but could also reduce the number of economic locations Hess could develop in the future. We will continue to monitor this legal overhang to determine if the risk/reward balance improves for Hess shares.

EOG Resources Inc. (EOG): We chose to monetize our tax-loss position in EOG. With the sale, we reduced our exposure to the secularly-challenged Energy sector.

Ingersoll Rand, Inc. (IR): Prior to the merger with Gardner Denver, Ingersoll Rand Inc. was predominantly an HVAC company with a small industrial segment. In April 2019, Ingersoll announced a merger of their industrial business with Gardner Denver and the simultaneous spinout of the HVAC business. Upon the close of the merger in March 2020, the new industrial merged entity retained the legacy name of Ingersoll Rand while the HVAC business formed a new entity called Trane Technologies. Our original investment thesis hinged on the secular growth trends of the HVAC business, which is still ongoing. We continue to hold Trane Technologies in the portfolio but decided to sell the new Ingersoll Rand entity because we were not bullish on the overall business which is heavily tied to the energy segment.