Quarterly Commentary
Q4 2020

EGA International Equity ADR

From the EGA Portfolio Management Team

Good Riddance 2020, Welcome 2021

2020 was a momentous year never to be forgotten. TIME magazine put it best on a recent magazine cover: "2020: The Worst Year Ever." It was a tough period on all fronts as the global coronavirus pandemic took the lives of hundreds of thousands and triggered a global recession. Few corners of the global economy were spared from the energy sector, to consumer behavior, to the travel and hospitality industries and even the educational system had to quickly adapt to remote learning. In the final weeks of the year, sentiment improved with light at the end of a dark tunnel appearing with vaccine approvals in the U.K. and the U.S. and delivery trucks on the move to begin the vaccination process.

While 2020 was a bear market for humans, global equities rallied sharply, particularly during the fourth quarter as visions of vaccine stocking stuffers danced in investors' heads. Many regions including Europe saw relative returns in November versus the MSCI World Index in USD terms not seen since April 2003. Even Japanese equities hit their highest level in 31 years. Investors with investments outside the U.S. were again rewarded for being diversified as growthier "Work from Home" stocks lost ground in favor of value-oriented stocks levered to the eventual reopening of economies. Returns across regions were also positively impacted by the strength of local currencies and the decline of the U.S. Dollar.

For 4Q 2020, MSCI EAFE gained 16.1%, while in the U.S., the S&P 500 gained 12.2%. MSCI regional and country specific indexes including Europe, Japan and the Emerging Markets gained 15.6%, 15.3% and 19.7%, respectively. Year-to-date, MSCI EAFE gained 8.3%, the S&P 500 18.4%, Europe 5.4%, Japan 14.5% and the Emerging Markets 18.3%.

On The News Stand: Brexit At Last, Recovery Fund Clinched And The U.S. Election

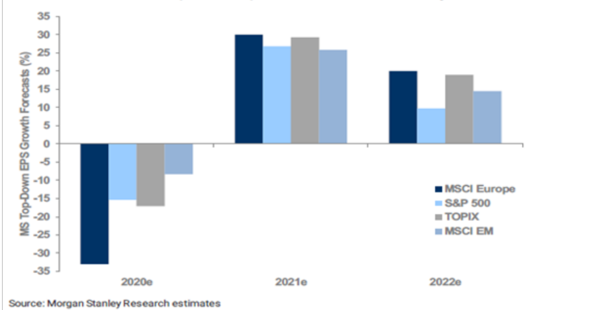
After nine months of contentious negotiations, the U.K. and the EU finally reached a last-minute trade agreement on Christmas Eve. Beginning January 1, 2021, the U.K. will become a "third country" outside the EU's single market and customs union. The economic partnership will govern bilateral trade worth more than £650 billion. The deal covers technical aspects for key sectors including autos, chemicals, pharmaceuticals and professional services. It also provides a governance mechanism to resolve disputes. The playing field will now be leveled with respect to standards and state aid. The U.K. is now free to set its own standards with respect to the environment and labor laws, but they also take on the risk of having access to the European market restricted if they stray too far. Companies in the EU will have the ability to challenge state aid awarded to U.K. rivals in Britain's national courts if they feel the aid violates common principles outlined in the trade deal. U.K. companies will have equivalent rights in the EU. On the contentious fishing rights front, EU fleets will have a five and a half-year transition period with guaranteed access to U.K. waters with annual negotiations thereafter. During the transition, fishing rights currently worth about €650m per year will be reduced by one quarter, with U.K. quotas increased by the same amount. This shift will increase the U.K.'s current share in British waters from about half to two-thirds. Unfortunately, the wrangling between the U.K and the EU is not likely to end anytime soon as there was little mention of the future of financial services in the Brexit accord of over 1,200 pages. The City, London's financial district, which was once considered a dominant hub in international finance, must now wait until later to learn the fate of its firms' future market access in the EU.

In early December, European leaders struck a landmark deal on a massive €1.82 trillion long-term budget and the EU Recovery Fund to help economies recover from the impact of the coronavirus. Critics said the agreement lets Hungary and Poland off the hook for abusing the rule of law as they agreed to the deal in July and then vetoed it fearing the new "rule of law mechanism" might target them for breaches of Europe's democratic standards. As the pandemic continued to pose serious risks to public health, the ECB also escalated efforts to shield the Eurozone from a possible double-dip recession with another burst of monetary stimulus. The additional round of €500 billion in stimulus coupled with emergency bond buying extended until March 2022 was approved; however ECB President Christine Lagarde made it clear the stimulus "need not be used in full."

On the other side of the pond, the U.S. election produced the largest voter turnout in U.S. election history resulting in a Biden victory over Trump. During his campaign, Biden said he believes in "fair trade" and signaled a return to a more rules-based, pro-trade environment. Time will tell how relations with China materialize over the coming years. Biden's tone appears different than Trump's, but his policy goals may likely be very similar evidenced by the fact he stopped short of saying he would repeal tariffs or how his administration would remove concessions for issues such as subsidies, intellectual property and support for state-owned industries.

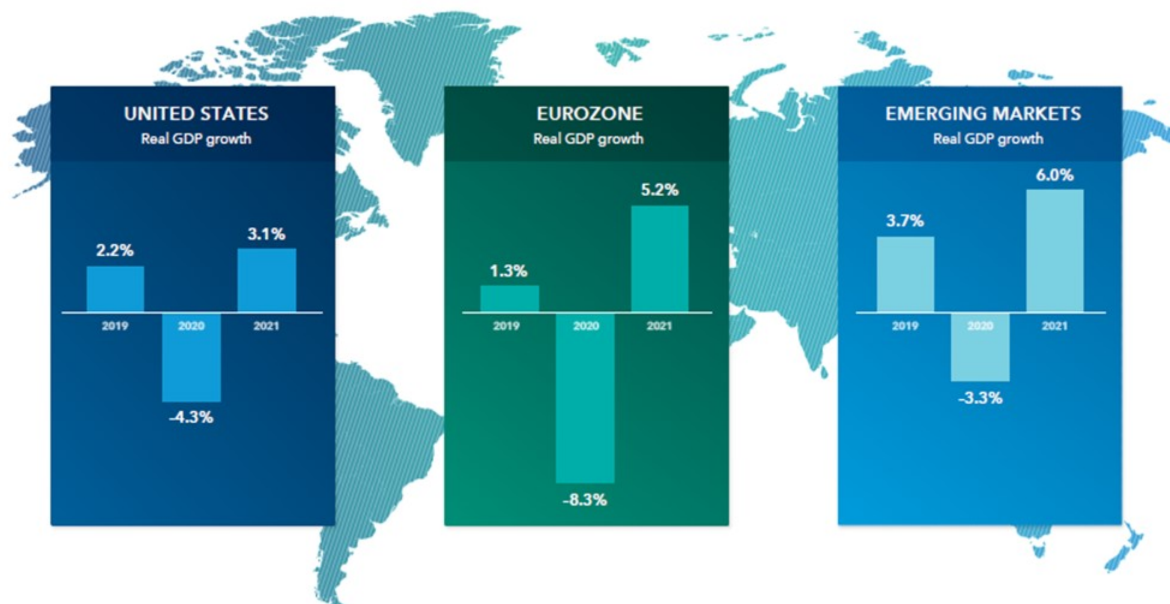
Can European Equities Benefit With A Rising Euro?

The relationship between the Euro/U.S. Dollar rose sharply during the final two months of 2020 reaching a 2.5 year high, which begs the question about the outlook for European equities given record setting poor relative performance this year. It appears the recent currency moves between the Euro and the U.S. Dollar have more to do with Dollar weakness than Euro strength. As shown in Exhibit 5, this is due to the trade weighted Euro being more important when evaluating European corporate profits, where the near-term bounce has been more modest. Dollar weakness also appears reflationary with higher bond yields, steeper yield curves and higher inflation. In a global context, Europe is a relative reflation beneficiary. With respect to earnings and valuation, Europe remains a relative bargain at a P/E multiple of 17.4x given the earnings decline in 2020 and expected rebound on an absolute and relative basis to other regions over the next two years as shown in Exhibit 3. Stimulus provided by the EU Recovery Fund also provides a longer-term foundation for equity prices. At this point, risks to a rapidly appreciating Dollar appear low and in fact according to a recent Financial Times article, "Wall Street analysts expect the currency could fall 20% if the coronavirus jab in the arm leads to economic rebound." While the Dollar has the reputation of being a safe haven in times of stress, investors may be willing to take more risk in search of higher returns.



Trajectory For Growth: Emerging From Covid-19's Shadow

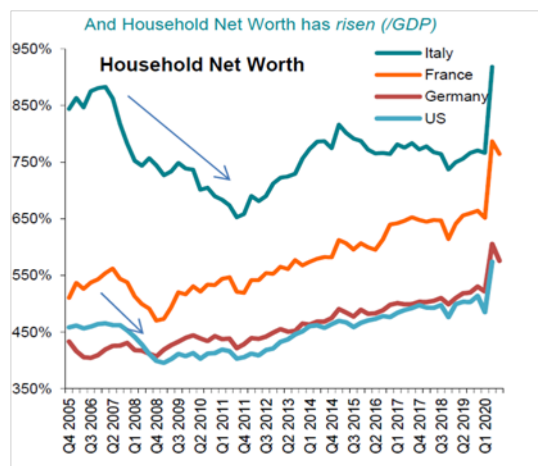
As shown below, expectations for global growth from the International Monetary Fund remain on a positive trajectory as 2020 came to a close; however, given the historic level of collapse in activity, a sustained period of robust economic growth will be necessary to achieve pre-Covid 19 levels. Proactive fiscal and monetary policy actions continue to play a substantial role in the recovery process, particularly as the winter resurgence of infections has led to additional lockdowns and a hit to short-term economic growth. Thankfully, the vaccine approval process had its first victory in the U.K. on December 2nd followed by approvals in the U.S.



Source: International Monetary Fund, World Economic Outlook, October 2020. GDP figures for 2020 and 2021 are projections.

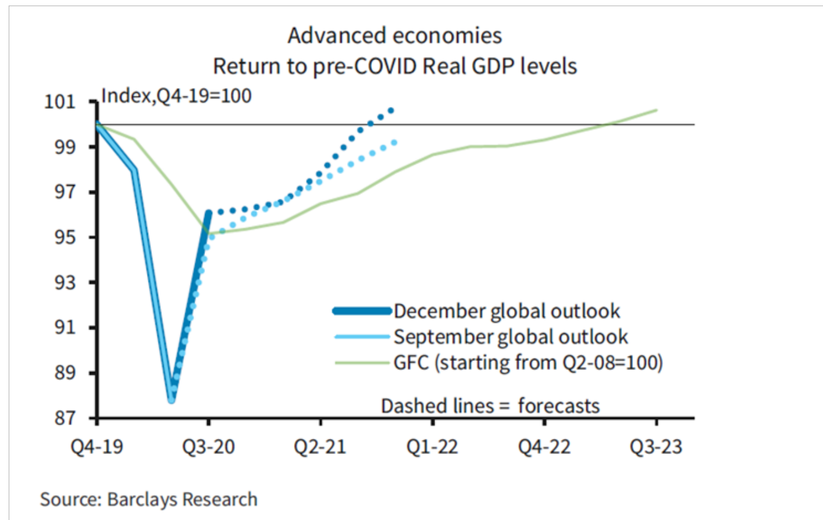
The biggest vaccine campaign in history has now begun. According to a recent Bloomberg tracking report, 4.6 million doses have been administered in 16 countries with the bulk occurring in the U.S., China and the U.K. to date. Delivering billions more will be one of the greatest logistical challenges undertaken. The high efficacy rate of the current and future vaccines should bring a broader recovery assuming a high rate of vaccination.

Despite the near-term challenges to growth, there are several catalysts pointing to light at the end of the tunnel. In addition to vaccines and vaccinations, pent up demand and accumulated excess private saving can add fuel to the growth fire. As shown in the chart to the right, household net worth in a select group of developed economies has risen sharply over the past year. These financial resources should be an enormous boost to future demand as some sense of normalcy returns with a higher percentage of employees returning to the office, business and leisure travel resuming and increased discretionary spending. While household savings have surged since the onset of the pandemic, generous fiscal stimulus has offset some of the income losses from unemployment.



Source: Exane BNP Paribas estimates

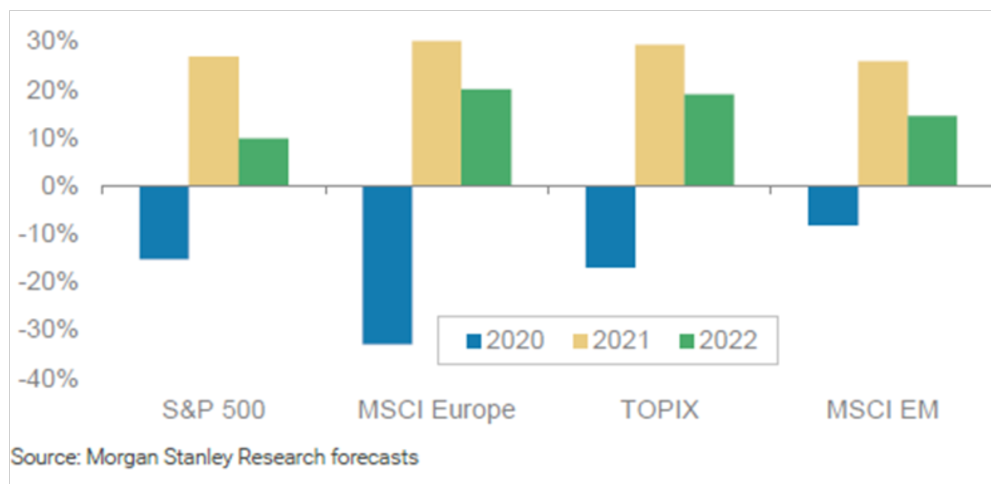
It's interesting to note that relative to the 2008 Global Financial crisis, bank lending to households and corporations held up, driven by a combination of healthier balance sheets, government guarantees, and aggressive monetary policy. As such, the recovery to pre-pandemic levels of growth is expected to be more robust as shown in the chart below:



Source: Barclays Research

From Late-Cycle To Early-Cycle

Looking back twelve months, investors were concerned about a late-cycle economic backdrop with elevated valuations and heightened investor sentiment, which resulted in below consensus EPS expectations and single-digit future returns. Fast forward to today and we find the silver lining of the pandemic is an environment that has transitioned back to early-cycle, an indication of a strong rebound in profits not yet priced into stocks despite the rally over recent weeks. As shown below, a sharp recovery in consensus EPS growth is expected across all regions for the next two years as developed and emerging economies transition out of recessionary conditions. While valuations have continued to re-rate higher with NTM (Next Twelve Month) P/E ratios at 22.4x for the S&P 500, 17.5x for MSCI EAFE, and 15.4x for MSCI EM, sustained policy support should allow for early-cycle elevated equity valuations as central banks leave the "punchbowl" in place with little to no policy tightening even as growth recovers.



Source: Morgan Stanley Research forecasts

Portfolio And Stock Highlights

In the fourth quarter, EAFE small cap outperformed both EAFE large and mid caps, while Value outperformed Growth by over 6.0%. The best performing MSCI EAFE countries for the quarter were Austria, Spain and Australia, while the worst performing MSCI EAFE countries for the quarter were Switzerland, Finland and Germany.

Outperformers: Our portfolio strongly outperformed the MSCI EAFE Benchmark by 11.5% for the year and 0.7% for the quarter. Superior stock selection by sector and country drove the bulk of our outperformance for the quarter. Holdings in Consumer Discretionary, Health Care and Communication Services sectors were among the top performers for the fourth quarter. Standout names included Magna International, Inc. (Canada), Hoya Corporation (Japan) and WPP Plc (United Kingdom). From a country perspective, our stock selection in Japan, U.K. and France were the top contributors. On a year-to-date basis, stock selection was the main driver of performance in the Industrials, Consumer Discretionary, and Communications Services sectors, while from a country perspective a combination of stock selection and allocation decisions led to our strong outperformance.

Disappointments: Stock selection in the Consumer Staples and Materials sectors detracted from performance for the quarter due to Nestle S.A. (Switzerland) and Arkema SA (France). From an allocation perspective, our underweight to the Materials sector and our Cash allocation detracted from performance. Finally, our overweight positions to China and Switzerland and lack of exposure to Australia detracted from performance. For the full year, our stock selection in Consumer Staples and Energy as well as an underweight to Materials were the largest detractors. Both stock selection and allocation decisions in Switzerland, Finland and Germany were negative contributors.

Opportunity Set / Portfolio Positioning

Our international strategy generated solid results during the fourth quarter, despite the strong rotation from growth to value stocks as we were well-positioned due to our core bias. We believe our focus on investing in long-term structural growth stories with solid fundamentals trading at attractive valuations serves our clients well during transitional periods. Generally, chasing short-term performance trends leads to disappointing results as sharp moves in style are difficult to predict. From a longer-term perspective, strategy returns for the one, three, five and seven-year annualized periods exceed the MSCI EAFE benchmark on a gross of fees basis.

We continue to monitor opportunities in recovery stories in Japan where exposure to cyclicals is high and thus is a beneficiary of above-trend GDP growth in 2020. The Emerging Markets also offer potential investments in select areas via the rise of the EM consumer, a reversion in GDP and an improving trade relationship with the U.S. Finally, in Europe a combination of improved earnings results, benefit from the EU Recovery Plans extending across economies and attractive valuations should lead to an expanded opportunity set.

So far in 2021, equity markets have seen a choppy, back and forth trend as investors digest valuations and the trajectory for growth with difficult days for the virus looming as well as challenges with vaccine distribution. We expect this trend to likely continue through the first quarter and possibly second quarter as the timing of 60% herd immunity to the virus remains difficult to predict. Investors will have a keen eye on earnings results in 2021 given the expectation for significantly improving results. As such, we are cognizant of maintaining an appropriate level of market risk in our portfolio to balance the risks and rewards.

Purchases / Additions This Quarter

Deutsche Boerse AG (DBOEY) SECTOR: Financials, COUNTRY: Germany. We initiated a new position in Deutsche Boerse, the second largest exchange group in Europe by market cap which operates several diverse businesses positively geared to secular growth. The company's two largest businesses are Eurex, a trading and clearing platform for financial derivatives and Clearstream, which is one of the two major settlement houses for fixed income in Europe. Eurex is benefitting from growing market share in Euro denominated interest rate swaps market, while EEX stands to benefit from market share gains as power trading migrates from OTC bilateral protocols to electronic execution and central clearing. Deutsche Boerse is expected to generate 4-5% secular annual revenue growth and 6-8% earnings growth per annum in the next few years with upside from cyclical effects and M&A; yet trades at an attractive valuation supporting our thesis to purchase the stock.

Recruit Holdings (RCRCY) SECTOR: Industrials, COUNTRY: Japan. Recruit Holdings, which is tied to the global recovery, both through its employment services offerings and other consumer-based services is temporarily constrained due to Covid-19. Relative to expectations, the company has been delivering generally encouraging results, and we believe the longer -term value proposition of the company's offerings remains attractive. While operations have been trending in the right direction, a group of large corporate cross-holders sold shares for their own corporate purposes, creating what we saw as a temporary pricing dislocation and an attractive opportunity to add to our position.

Sells / Trims This Quarter

ING Groep NV ADR (ING) SECTOR: Financials, COUNTRY: Netherlands. We trimmed ING Groep based on a deterioration in operating trends during 3Q 20 and a lack of catalysts to drive the stock price higher. We expect weak net interest income due to continued pressure from negative interest rates, the need for more cost reduction and a strict stance from the ECB on the payout of dividends to investors.

Roche Holding LTD ADR (RHHBY) SECTOR: Health Care, COUNTRY: Switzerland. While we remain constructive on Roche's prospects longer term, we trimmed our position as biosimilar competition pressures appear to be higher than anticipated in 2021. In addition, we took this opportunity to swap into more economically-sensitive companies given the recovery cycle in the economy. Roche's MS drug franchise could also face increasing competitive pressures in the medium term versus prior estimates. That said, the company's drug pipeline remains strong and the company's long history of innovation and reasonable valuation makes this a continued core holding.