EAGLE GLOBAL ADVISORS

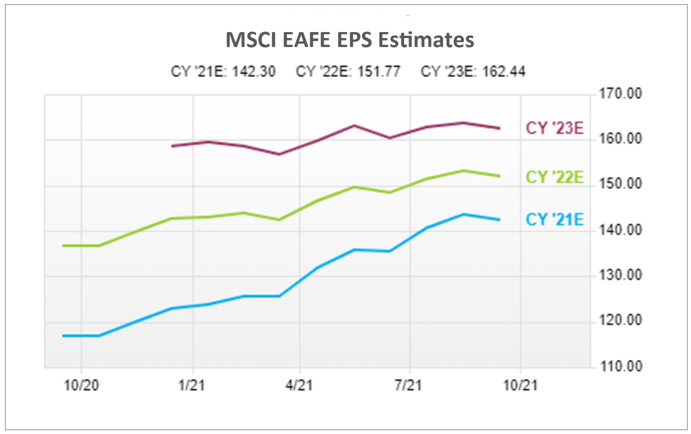
Quarterly Commentary 3Q 2021

EGA International Equity ADR

From the EGA Portfolio Management Team

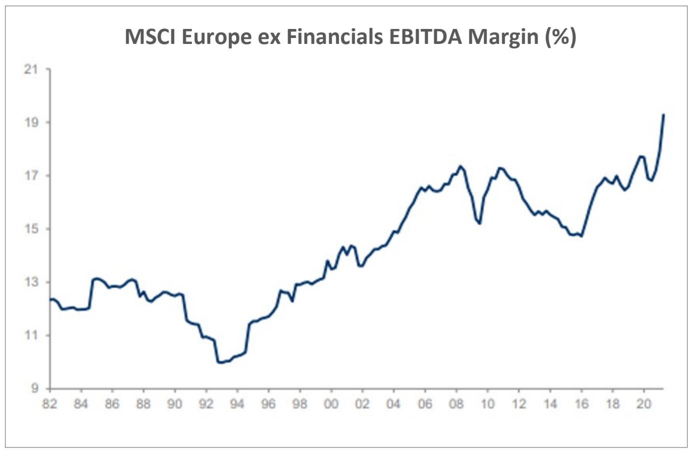
Uncertainty Hovers Over Markets

After a strong first half of 2021, market volatility spiked during the third quarter as worries surfaced initially over the Covid-19 delta variant and its effect on the economic recovery, then over Federal Reserve tapering of bond purchases, to finally illusions of a "Lehman moment" for China with the news of Evergrande's looming demise. After ending the second half on a one year low, the CBOE Market Volatility Index (VIX) spiked several times during the quarter and ended the quarter more than 30% higher, marking increased concerns from investors.



Source: Factset

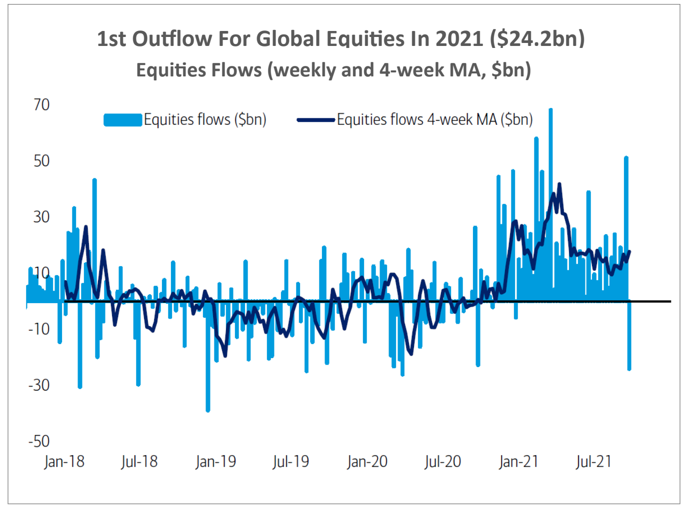
Despite this wall of worries, the markets were flat for the quarter and Eagle International portfolios performed well on a relative basis. Equity markets continued to be supported by rising EPS estimates and strong margins, although the most recent month saw a small downtick in EPS estimates for both the S&P 500 and MSCI EAFE. According to FactSet, MSCI EAFE estimates for calendar year 2021 EPS rose from 135.36 on June 30th to 142.30 at the end of September, a positive change of 5% during this time period. The margin trajectory for European companies (ex. Financials) has also been a tailwind for equities in the region as evidenced in the accompanying chart, showing the highest EBITDA margins for European companies over the last three decades.



Source: MSCI, Factset, Morgan Stanley Research

Yet, investors worry that the economic damage from the delta variant, rising inflationary pressures, supply chain disruptions, and looming Fed and ECB tapering are creating headwinds in the near-term that may place pressure on this positive EPS momentum and margin trend. The bullish argument hinges on the continued easy financial conditions, policy stimulus, reopening momentum, pent-up demand, inventory rebuilding, earnings, and equity inflows. The bearish narrative revolves around the delta variant, vaccine efficacy concerns, peak growth and peak policy, near-term benefits cliff, looming Fed and ECB tapering, and company margin headwinds from supply chain constraints and input price pressures.

Thus far investors have voted with their wallets as we have witnessed a remarkable trend in flows into equity funds over the last twelve months (see chart below) although according to Bank of America Merrill Lynch (BAML) data from Emerging Portfolio Fund Research (EPFR), the third week of September witnessed the first outflow from global equities in 2021 and the largest since March of 2020. All this to say that although equities remain well supported by good EPS momentum and economic momentum from re-opening, investors are starting to closely monitor economic and financial conditions after a strong performance for the markets during 2021.



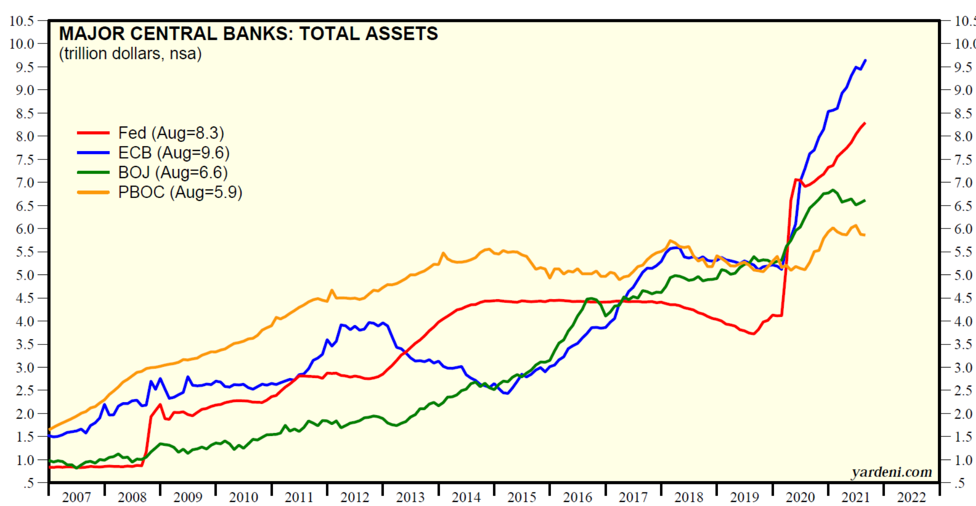
Source: BofA Global Investment Strategy, EPFR

How Quickly Will They Take The Punch Bowl Away?

A major concern of equity markets is the degree to which global central banks, specifically the Fed and the ECB, will start tapering their bond purchases and begin a new interest rate hiking cycle. The latest commentary from both central banks suggest tapering is around the corner and most expect the Fed to begin to reduce its bond purchases from the end of this year while the ECB may not be far behind possibly beginning its tapering early in 2022.

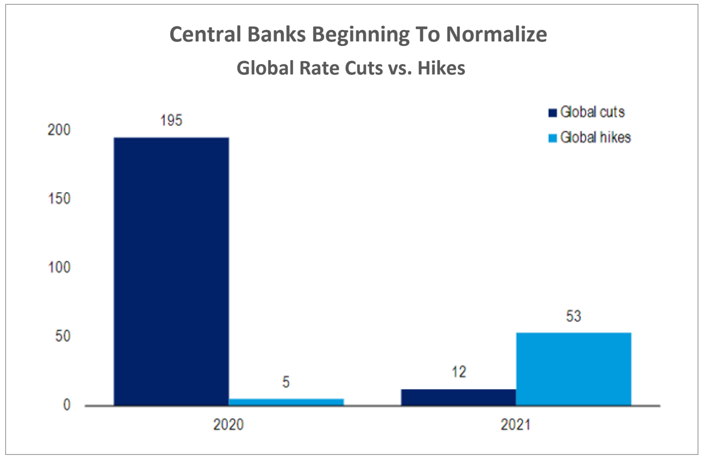
Global central bank balance sheets have ballooned in size during the pandemic and even as tapering is occurring, the balance sheets will continue to grow for some time. It will be a long time before the Fed and ECB balance sheets begin to decline and even then, will likely be a moderate slope downward.

According to Haver Analytics and Yardeni Research, Inc. (see chart below), the balance sheets of some of the world's major central banks has expanded by 50% to over $30 Trillion during the pandemic, led by the ECB and the Fed, from around $20 Trillion prior to the pandemic. Many analysts and market pundits argue that all the added liquidity in the global financial system is one of the reasons equity prices have done so well over this time period, hence the nervousness about reversing this trend.



Source: Haver Analytics

In addition to the tapering talk around Wall Street and global central banks, investors have also begun to focus on when central banks will begin to raise interest rates. Of the major central banks, most expect the Bank of England to increase rates soon with the Federal Reserve next and the ECB following the Fed. But even if the Fed and ECB are a year or more away from hiking rates, other countries have already begun a new global rate hike cycle. The chart to the right shows the pendulum shift from massive global rate cuts in 2020 to the beginning of a moderate increase in rates around the world. We would not be surprised to see a continued creep up in global interest rates over the coming months. This is likely to continue to lead to volatility in equity markets as interest-sensitive sectors give way to less interest-rate sensitive styles and sectors.

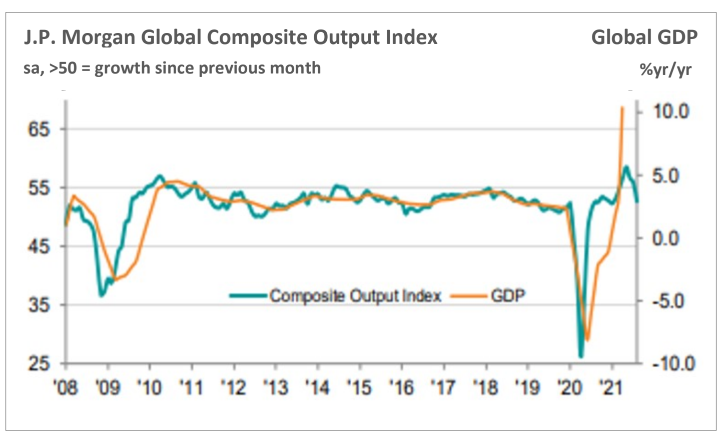


Source: BofA Global Investment Strategy, Bloomberg, IMF

This is evermore in investor's minds as inflationary pressures remain quite elevated. While it could be argued that some of these pressures will be temporary due to supply shortages, consensus appears to be shifting towards believing that inflation may stay higher for longer this time around given wage pressures, supply constraints, labor shortages, and increasing demand as economies fully re-open. While Fed and ECB officials argue that inflation is transitory, it is hard to ignore the fact that many companies are beginning to be affected either positively or negatively from these price pressures. We will be closely monitoring third quarter results from portfolio companies and others to gauge the degree of these pressures. There is plenty of anecdotal evidence that higher price pressures are affecting consumers and companies alike. One such ongoing event is the sharp rise in natural gas prices in Europe and Asia which are affecting heating and power prices. Some observers suggest that the below normal levels of natural gas storage will not be solved until after the winter and hence we should expect high prices in the coming months. This would translate to higher inflation in the near-term, particularly in Europe. It will be interesting to observe how or if this affects discussions at the upcoming U.N. Climate Change Conference (COP26) in Glasgow in November.

Global Macro Deceleration

The decision to taper and to begin hiking rates is ever more important and difficult as indicators suggest that global macro conditions are decelerating. While part of this is to be expected given the sharp bounce back from the pandemic lows, it is also the case that the new delta variant has led to additional lockdowns, especially in Asia where at the beginning of the quarter vaccination levels were low. The JPMorgan Global Composite Output Index hit a 7-month low in August, declining to 52.6 from 55.8 the prior month.



Source: J.P.Morgan, IHS Markit

A level below 50 indicates a contraction. This deceleration of economic conditions was due both to the manufacturing and services industries. Although the U.S. and Europe were weaker, the sharper declines came from Asia, where Japan and China fell into contraction. Supply chain disruptions and labor shortages contributed to the slowdown. While the PMI's do show a slowing trend, other indicators such as activity trackers show consumers in Europe are getting out more to shops, restaurants, and other establishments after a long time in isolation and lockdown.

An Ever Grande Headache

A major debate for global investors recently has been whether China is seeing its "Lehman moment" with the looming demise of its largest and most indebted property developer China Evergrande Group. This is not a new development. Roughly one year ago, the Chinese government implemented its "three red lines" for the property developers to bring their financials into more sustainable levels. China Evergrande has been unsuccessful in this endeavor. Hence, we are in a reckoning moment where the company has missed bond payments and its restructuring or bankruptcy is upon us, but we do not believe this is a "Lehman moment" for China.

We believe that President Xi Jinping will not allow for a disorderly unravelling of this company or the sector. First, as one commentator stated, property investments are the lifeblood of the Chinese economy and the main investments of its people. A sharp decline in property prices and the trust in property investments would have a serious impact on the Chinese economy. Moreover, Xi Jinping is focused on getting reappointed party head and president in next year's twice-a-decade party congress. Any event that leads to severe economic pain, rising unemployment, and demonstrations, would be detrimental to his long-term plans to remain in power.

We believe he will allow for Evergrande to go under, but in an orderly manner. This issue did not come out of left field, the government has been aware of Evergrande's situation and partly helped accelerate this eventual outcome since instituting its "three red lines" policy. The most likely outcome is a restructuring of Evergrande with assets sold off and some pain but not enough to cause an economic or financial meltdown of historic proportions. But whatever the outcome, it is possible to create some unintended consequences that authorities will have to deal with in due time.

An orderly restructuring is ever more important now as the Chinese economy has been slowing for a couple of months and most recently due to strict lockdowns from cases of the delta variant in various provinces. In addition, power shortages have also caused some industries to slow production or shut temporarily, which is affecting industrial production. This is noted in the latest government official manufacturing PMI which fell into contractionary levels in the month of September.

Portfolio and Stock Highlights

MSCI EAFE large caps slightly outperformed mid-caps but underperformed small caps for the quarter, while growth slightly outperformed value for the quarter but still trails value for the year-to-date period. The best performing MSCI EAFE markets for the quarter were Austria, Norway, and Japan while the worst were Hong Kong, Belgium, and Germany. The best performing MSCI EAFE sectors for the quarter were Technology and Energy while the worst performing were Materials and Utilities.

Eagle International portfolios outperformed the MSCI EAFE benchmark for the quarter as both sector allocation and stock selection provided positive alpha for the portfolio. The portfolio remains ahead of the benchmark MSCI EAFE Index for the year-to-date, last twelve months, and three-year periods. As seen late in the quarter, we expect a continued battle between growth and value styles and work from home versus re-opening focused stocks as the markets digest economic, political, and financial conditions data. The portfolio remains positioned to benefit from secular growth themes and we will use this added volatility to be opportunistic for our clients.

Outperformers: Eagle portfolios performed well relative to the MSCI EAFE Index for the quarter as both sector allocation and stock selection helped. From a sector standpoint, being underweight underperforming Materials and Consumer Staples and overweight outperforming Information Technology and Energy was additive to the portfolios. From an individual stock selection perspective, selection in Health Care and Industrials was best. In Health Care, strong performance from Hoya Corp (Japan), Novo Nordisk (Denmark), and Lonza Group (Switzerland) led the group. In Industrials, Recruit Holdings (Japan) and Techtronic Industries (Hong Kong) were the standouts. From a country basis, stock selection in Hong Kong, Japan, and France provided positive alpha for the portfolio.

Disappointments: An overweight to an underperforming Communications Services sector was detrimental to performance in addition to poor stock selection in that sector for the quarter. Stock selection was also challenging in the Utilities and Consumer Discretionary sectors. Poor performance in the Consumer Discretionary sector included Alibaba (China) and Magna International (Canada) while negative selection in Communication Services was led by poor performance from Tencent (China) and Softbank (Japan). From a country perspective, our allocation to China and Canada were detrimental as both countries underperformed for the quarter.

Purchases / Additions The Quarter

ADIDAS AG ADR (ADDYY) SECTOR: Consumer Discretionary, COUNTRY: Germany. Adidas' Q2 results showed continued healthy improvement, particularly in North America. Importantly, the company is seeing significant recovery to above pre-pandemic levels in China, a major turnaround since the backlash against Western brands peaked in April. We are encouraged with the ongoing demand rebound in China, which demonstrates that the Western-brand backlash in April is likely temporary and will not alter the strong structural growth associated with this key demand engine for the athletic sector. While near-term catalysts are centered on Adidas' 2H-weighted product pipeline this year, the long-term story revolves around the company's transformation to a more direct-to-consumer (DTC) driven business and expanding operating margins to 12-14%, 200-300 bps above the prior peak.

AMADEUS IT GROUP (AMADY) SECTOR: Information Technology, COUNTRY: Spain. Amadeus benefits from a recovery in travel as both consumers and corporates move towards more normal travel trends given higher vaccination rates across developed markets. We have seen better than expected EBITDA in 2Q21 driven by improved volumes and the company's cost savings plan. Consensus expects traffic to fully recover in 2024 while we believe it could be sooner. We took this opportunity after some softness in the shares to add to our position.

SUNCOR ENERGY (SU) SECTOR: Energy, COUNTRY: Canada. Short-term operational issues as well as mid-quarter underperformance of the energy sector gave us an opportunity to add to our position in Suncor. We believe Suncor has a strong capital allocation program as well as a proven long-term operational track record despite recent delays at its Fort Hills facility. The company has low geological risk and generates high free cash flow. We believe oil prices are constructive in the near-term given the capital discipline in the industry and re-opening demand and Suncor offers above average oil-price leverage.

Sells/Trims This Quarter

TENCENT HOLDINGS (TCEHY) SECTOR: EM-Communication Services, COUNTRY: China. We trimmed our position in Tencent to reduce our direct exposure to China given the regulatory risks and the uncertain impact across the company's various business lines. Tencent also has a slower growth outlook than expected.

Disclosures

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