EAGLE GLOBAL ADVISORS

Quarterly Commentary
3Q 2021

EGA U.S. Equity

From the EGA Portfolio Management Team

U.S. equities continued their rally in Q3 with the S&P 500 putting up its sixth straight quarterly gain of 0.6%, bringing its year-to-date gain to 15.9%. Growth equities outperformed value stocks in the quarter on concerns about the impact of the latest wave of Covid-19 infections. The economic recovery appears to be still on track, fueled by supportive monetary policy, resilient corporate earnings, and the potential for more fiscal stimulus. Rates increased from rock bottom levels in the quarter which negatively impacted fixed income returns.

We believe the economy has entered a new expansion phase that should last at least a couple of years. While U.S. equity valuations are elevated relative to history, when considered versus interest rates, we believe valuations are supported. While our expectations for the absolute returns to be had from equities is below recent history, in the mid-to-high single digit range, that should offer a sufficient premium to the currently very low fixed income prospective returns to warrant the risk of holding equities.

The primary risks to our outlook relate to 1) a mutation of the Covid-19 virus that would precipitate a return to the pandemic lockdowns, 2) whether the inflation currently seen is temporary and related just to current supply difficulties or more permanent, and 3) rising energy prices and the impacts that might have if they prove to be more than temporary.

Economy: Continued recovery, with supply bottlenecks

If history is a guide, the U.S. economy has recently entered into a multi-year expansion. Historically, these expansions have also corresponded to positive returns for U.S. equities. The graph to the right shows the level of GDP for the U.S. since the early 1970s with recession periods shaded. Between the shaded regions shows the growth of the S&P 500 during the times of expansions.

Source: Evercore ISI Economics

The first thing to take away from the graph is that the lengths of economic expansions in this period average 8 years (ignoring the double dip recession in the early Reagan years). At the right end of the graph is the recent Covid recession, very short but very deep relative to the prior downturns. So, if recent U.S. history is a guide, we are only a little more than a year into a new economic expansion that has lasted as short as 5 years and as long as 11 years in the past. The second takeaway from this graph is that the S&P 500 has enjoyed positive returns in all of these previous expansions. Some expansions have seen stronger returns than others, but still the point remains that major bear markets typically take place in recessionary times and that economic expansions have historically seen good returns for equities.

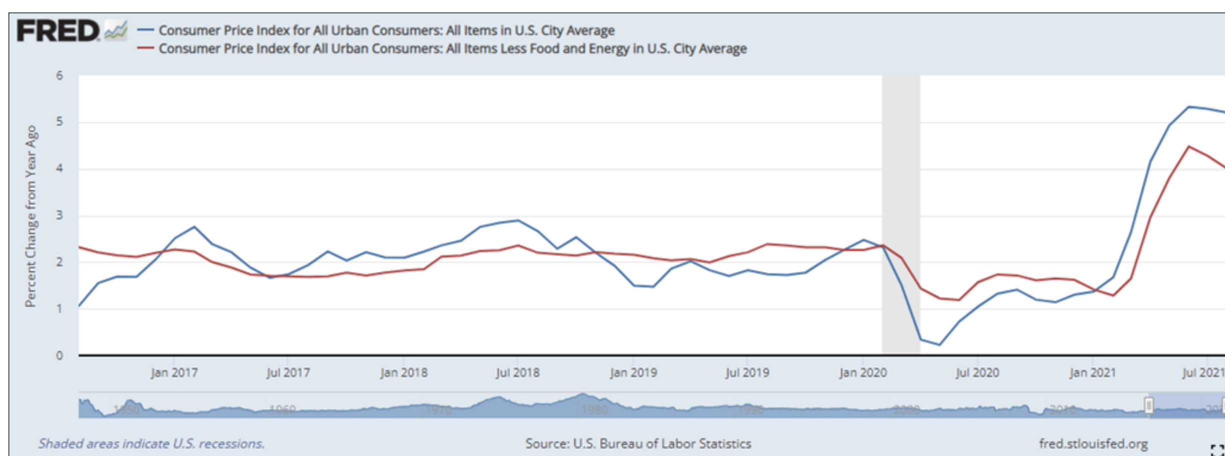
Why might this be? Rudi Dornbush, a well-known MIT economist, famously said "none of the postwar expansions died of natural causes - they were all murdered by the Fed over the issue of inflation." His argument was that the ends of postwar expansions coincided with interest rate tightening cycles engineered by the Federal Reserve in response to fears about rising inflation. This is the reason why the issue of inflation is the key risk factor in our market today. Right now, the thinking is that inflation, which is running from 4.0% to 5.0% depending on what gauge you look at, is due primarily to temporary factors like high commodity prices, clogged supply chains, and backlogs in refilling inventories. But if the Fed begins to believe that inflation is becoming embedded in our economy at a higher rate, they might start to engineer a new tightening cycle which would pose risks for equity prices. We fall into the camp that the currently high inflation is temporary, but we are watching closely.

This year the U.S. economy continues to exhibit a strong recovery from the depths of the pandemic, with the main difficulty being supply chain issues. Numerous stories about the lack of container ships, grid-locked ports, lack of semiconductors, and difficulties in restarting the machinery of the economy has led to shortages of autos, homes, appliances, and numerous other goods. Some businesses are having difficulty hiring labor at their previous wages and have had to increase compensation to fill positions.

U.S. job gains in August were modest compared with the prior strong months with non-farm payrolls increasing by only 235,000 jobs. Still, the unemployment rate has fallen to 5.2% from over 14.0% last year. The summer surge in Covid-19 infections, which has already curbed consumer activity and disrupted in-person schooling and return-to-office plans, may have led businesses to grow more cautious about hiring and dissuaded some workers from pursuing high contact employment opportunities. Due to the approval of booster shots, an uptick in vaccinations, and new therapies, we believe the effects of the Covid-19 delta variant will be transitory.

Inflation: Still hot

Inflation indexes continue to run high relative to recently history. The August Consumer Price Index showed an increase of 5.2% while the "core" CPI (without the effects of volatile food and energy prices) increased 4.0% over the prior year. The report also flagged pockets of upward pressure from supply chain disruptions (a theme that continues to dominate the headlines) and labor shortages, along with expectations for a further pickup in stickier categories like shelter.



Corporate Profits: Extending the strong rebound

For Q3 2021, the estimated earnings growth rate for the S&P 500 is 27.6%. On June 30th, the estimated earnings growth rate for Q3 2021 was 24.2%. Since June 30th, earnings growth rates of six sectors have been revised higher. The forward 12-month P/E ratio for the S&P 500 is 20.8. This P/E ratio is above the 5-year average (18.3) and the 10-year average (16.4). An alternative way to look at stocks is the "earnings yield", which is their net income as a percent of equity value; on this metric, U.S. stocks are trading at a prospective yield of about 5.0%. Compared with the 0% yields on Treasury bills, this "yield difference" between stocks and bonds is much closer to its historic level and supports the view that stocks are well valued relative to fixed income today.

Interest Rates: Reduction in monetary stimulus to come

During the September FOMC meeting the Fed indicated that a reduction in its monthly purchases of bonds might be warranted (the famous "taper" as commentators have dubbed it), assuming the economy continues to improve. Fed Chairman Powell said there was broad agreement among policymakers for a gradual tapering process that would conclude mid-2022, and that this decision could be made as soon as the FOMC's November meeting. Right now, the Fed is projecting that its first increase in the Fed Funds rate will not be until 2023.

Fixed Income: Interest rates fall, then rise sharply

Interest rates fell in the first part of the quarter as concerns that the Covid-19 delta variant would undercut the economic recovery, but as the delta wave of infections waned and concerns that inflation would make the Fed remove their monetary stimulus sooner than previously expected led a strong uptick in rates at the end of the quarter above where they were at the end of June, all across the yield curve. Corporate spreads remain tight but are consistent with their levels in other economic recoveries.

Stock and Portfolio Highlights

Eagle portfolios performed generally in line with the S&P 500 Index in the third quarter. Consistent with growth outperforming value in the quarter, Information Technology and Communication Services performed well while more old economy sectors like Industrials, Energy and Consumer Discretionary stocks lagged.

Purchases / Additions In The Quarter

Union Pacific Corp (UNP): UNP has demonstrated significant success in the implementation of Precision Scheduled Railroading (PSR). A continuation of this success should allow UNP to reduce its Operating Ratio (OR) to 55% or better through 2023, driving additional margin expansion and profit growth. Railroading is an oligopolistic industry with significant barriers to entry. As a result, UNP consistently delivers above-industry profitability and can make incremental investments at very attractive returns. We expect this high level of profitability, coupled with UNP's growth in operating cash flows, to result in increased cash returns to shareholders through both dividends and buybacks. Over the longer-term, we expect UNP to continue to take market share from long haul trucking as rails are able to provide transportation in a more efficient fashion that is favored by ESG-focused investors..

Sells / Trims In The Quarter

AT&T Corp (T): While AT&T's subscriber growth plan for its streaming asset was starting to bear fruit, they suddenly reversed course the decision to simultaneously release films in theaters and their streaming platform, starting in 2022. We believe this eliminates a key differentiation of AT&T's streaming asset versus the two larger competitors. In addition, AT&T also announced a deal with Discovery Inc. to combine their Warner film assets with Discovery's unscripted programming and reality shows. We believe AT&T monetized their media asset too quickly and may have not found the best partner. With the deal expected to take about a year to go through, AT&T may sit on its hands and lose subscriber momentum until the deal is finalized and a new strategy commenced. We would have preferred to see AT&T grow the subscriber base internally with its differentiated original programming.

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