EAGLE GLOBAL ADVISORS

Quarterly Commentary 2Q 2023

EGA International Equity ADR

From the EGA Portfolio Management Team

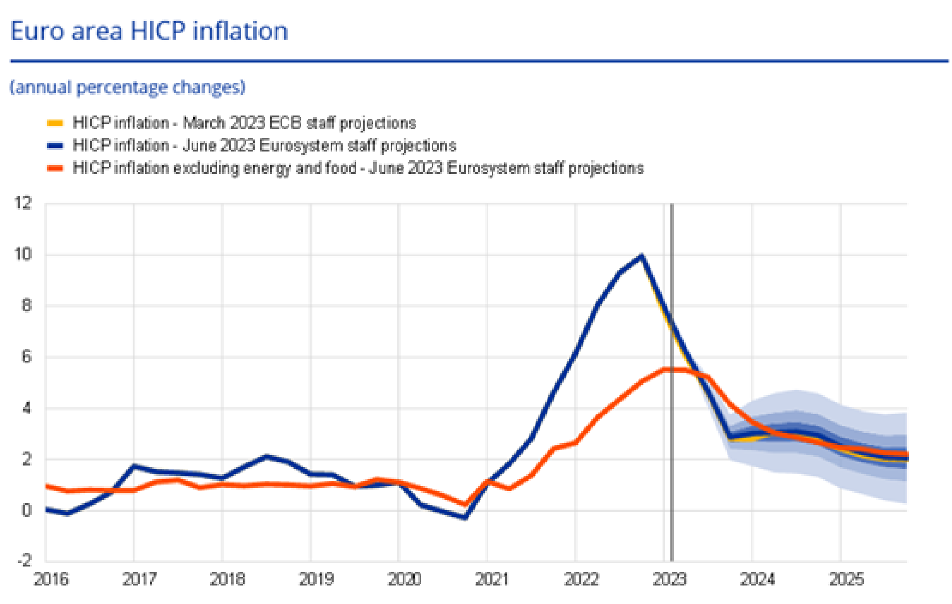
Steady Progress

Global equities rose for the second quarter of 2023 as inflation pressures continued to moderate in several regions and as economic prospects appeared to suggest slowing growth but not an imminent recession. The MSCI EAFE Index rose 2.95% for the quarter while the S&P 500 rallied by a stronger 8.74%.

The Federal Reserve (Fed) paused its rate hiking cycle in June, although the Fed and analysts suggest more rate hikes are possible in the third quarter. The European Central Bank (ECB) continued to raise rates in the quarter and suggested it would remain on a rate hike path although it could be getting close to the end. Even if only 50 bps more of hikes are in the cards as the ECB futures suggest, one comment from ECB president Lagarde is that she expects for rates to remain higher for longer.

Central banks have made steady progress in bringing inflation and inflation expectations down from their peak in 2022 and early 2023. Euro area inflation fell to 6.1% in May, down from 7.0% in April. While inflation has been a little stickier in the larger countries in the Euro area, especially Germany, the latest readings suggest Spain's inflation rose by only 1.6% in June and figures suggest France and Italy saw lower inflation in June than prior months. This is good news for markets concerned that central banks could hike rates more than needed and negatively affect economic growth in the process.

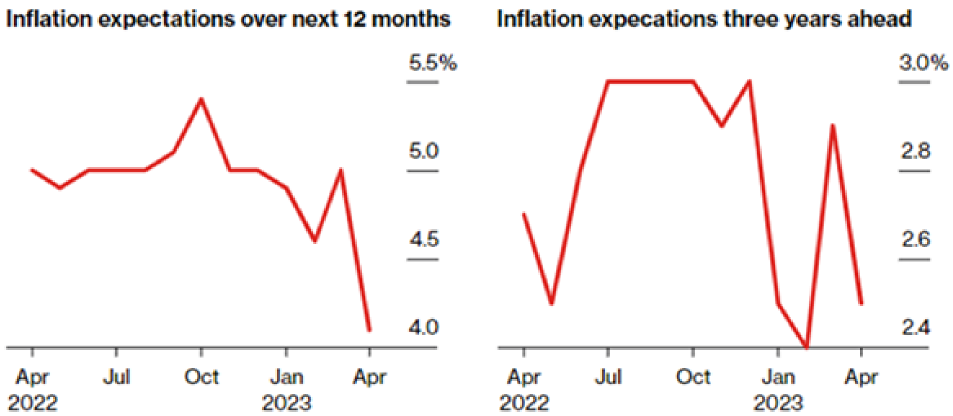
As noted in the inflation chart from the ECB below, the central bank expects Euro area inflation to moderate over time and fall closer to its 2.0% target rate in 2024 as the effects of rate hikes kick in and as base effects moderate. Energy inflation has been front and center in Europe as well and in 2022, natural gas prices rose significantly due to supply concerns with Russia's gas limitations in the continent. However, European consumers were able to reduce demand, the area experienced favorable winter weather, and LNG cargos increased gas inventories, all of which facilitated to bring down natural gas prices significantly in 2023.



Source: European Central Bank

This is mostly good news for the ECB. It has been on a hawkish path to raise rates aggressively to stem any entrenchment of inflation expectations by consumers. The ECB has thus far raised rates by 400 bps since mid-2022 and ECB President Lagarde remains focused on finishing the job. She still believes inflation is too high and is likely to remain elevated for too long. Her statements suggest the ECB will raise rates again in 2023 as they are not ready to declare victory yet.

That said, the ECB continued to get good news on inflation expectations as the latest survey of Euro area consumers inflation expectations dropped in April for both the next 12 months and three years expectations. As noted on the chart below, expectations for the next twelve months fell to 4.1% from 5.0% while expectations for the three years ahead fell to 2.5% from 2.9%.



Source: European Central Bank
Note: Chart shows median

Japan Bucks The Trend

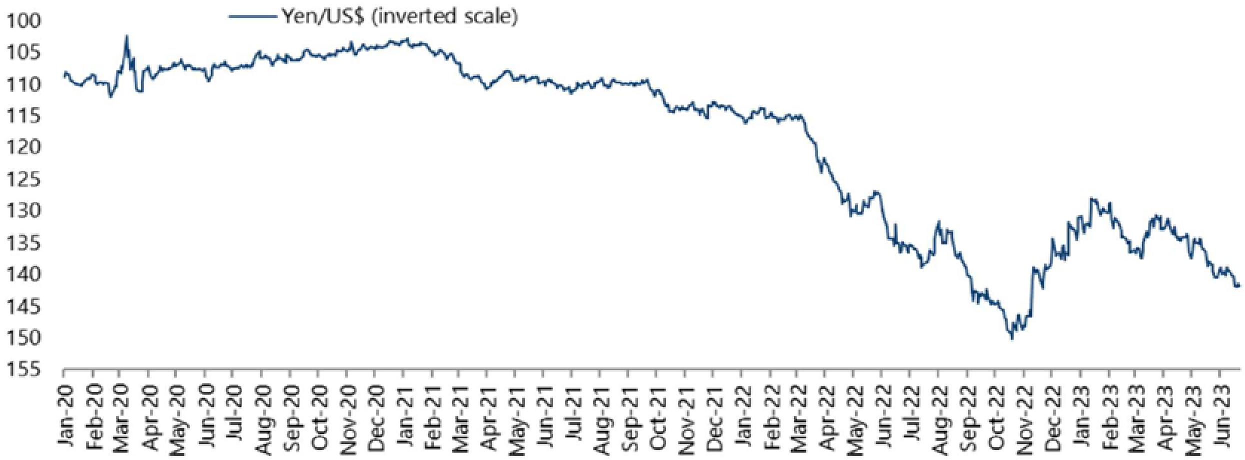
Japanese equities are making a believer of more unbelievers these days as the market begins to take notice of the corporate governance move being made by corporate Japan. A recent foray into Japan by Warren Buffett has also highlighted that market's attraction. While Abenomics called on Japanese companies to reform their corporate governance structures, many have resisted this reform over the years. Activists have made some headway, mainly in small caps, by forcing some companies to take action. There are plenty of Japanese companies trading at below book value and some with significant unproductive cash on their balance sheets keeping returns on capital at low levels.

Then came the Tokyo Stock Exchange earlier this year. The exchange appeared to draw a red line for companies trading below book value and not actively trying to rectify their low returns. The exchange has threatened companies of delisting in 2025 if they are not making progress on corporate governance reform. In a "culture where shame has always been a more compelling motivating factor that guilt", Jefferies strategist Chris Wood argues that the exchange's threat of delisting is likely to prompt Japanese management teams to be more proactive in reforms in order to avoid the shame of possible delisting.

Japanese equities outperformed global equities in local terms during the quarter as equities there caught a serious bid. A market that has historically been very underweighted by global investors is now getting a second look. Foreign investors are buying. The Nikkei Index has risen to levels not seen in decades. Stocks, in local currency terms, closed at their highest levels in more than 33 years during the quarter as buying beget more buying from foreigners. This trend could continue in the medium-term as global investors remain underweight Japan.

Economic prospects have also brightened for the island country with analysts expecting growth of 1.0% this year. The country's inflation has also risen above 3.0% for a sustained period which is helping the country exit its deflationary spiral. Despite the higher inflation, new Bank of Japan (BoJ) Governor Kazuo Ueda is yet to raise rates or make significant changes to the banks yield curve control (YCC) monetary experiment. While prospects for the yen in late 2022 and early 2023 suggested some expected a change in monetary policy to lead to yen appreciation, the lack of changes to policy has again led to yen weakness. The chart below shows the yen appreciating late last year and coming into 2023 on prospects of potential changes but has again reverted to depreciating late in the quarter.

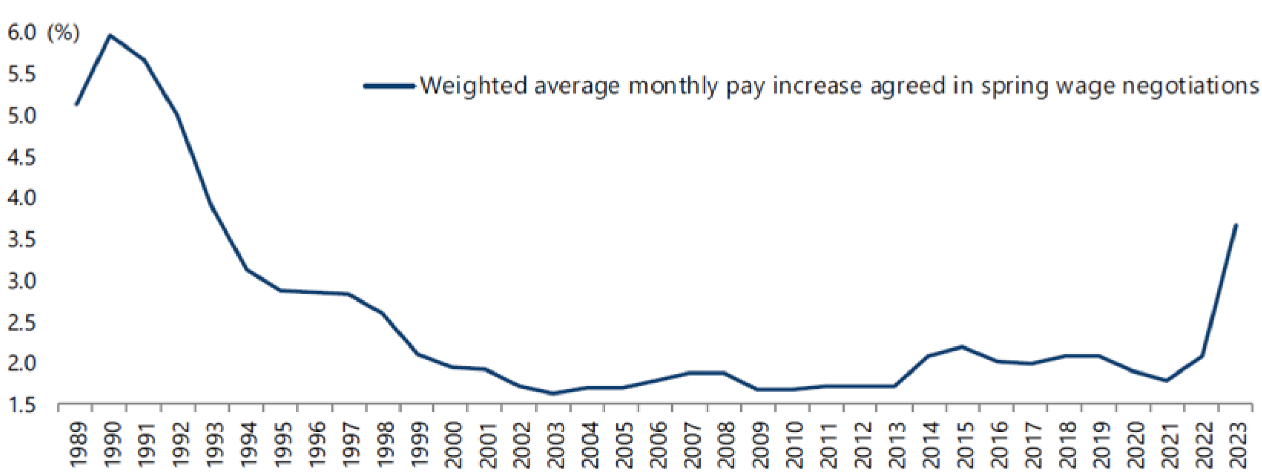
Yen/US$ (inverted scale)



Source: Bloomberg

The depreciation of the Japanese Yen hurt equity returns in USD terms, but the market still outperformed the MSCI EAFE benchmark for the quarter. While inflation has risen to above 3.0% the BoJ remains on the sidelines for now as some expect it wants inflationary expectations to get more entrenched in the economy going forward after decades of deflationary pressures. One major difference this year also helping the positive argument is the labor market and wages. The Japanese Trade Union Confederation published a preliminary report suggesting companies had concluded their annual wage negotiations with an average wage hike of 3.66%, the largest increase since 1993, as can be seen in the below chart.

Japan Weighted Average Monthly Pay Increase Agreed In Spring Wage Negotiations



Note: Based on preliminary results reported on 5 June 2023. Source: Japanese Trade Union Confederation (Rengo)

With potentially the largest wage increase amongst large companies in 30 years, Japanese consumption could become a new driver of economic growth in the coming years. With Japanese demographics suffering the same fate as most large developed economies and some developing economies, wage growth appears to have finally taken note of the tight labor conditions. The Bank of Japan's 1Q23 Tankan Survey also shows that Japanese companies five-year inflation expectations have risen from 1.1% in 3Q21 to 2.1% in 1Q23, highlighting the fact that companies now see a more inflationary environment for wages in the coming years.

While in many economies this inflationary pressure could be a negative drag to economic growth, Japan's economy is likely to welcome some wage growth and higher inflation as the country has been stuck in a deflationary spiral for much too long.

The changes in corporate governance, wage growth, and rising prices are likely to provide better opportunities for Japanese companies' equity performance in the future compared to years past. We will continue to monitor these developments looking for investment opportunities and have increased our Japanese weight in the portfolio in recent months.

The Dollar Decline Pauses

The much weaker yen as well as a continued hawkish stance by the ECB led the U.S. Dollar to halt its depreciation started in 2022. As you can see from the 2-year chart of the U.S. Dollar, as measured by the DXY Index, the dollar rose markedly during 2021 and 2022 to more than 20-year highs, only to begin to decline and depreciate in late 2022. That depreciation was expected to continue into 2023 but has paused for now as the dollar has remained in a tight trading band during most of 2023. Any significant change in Japan's monetary policy in the near future or major changes in monetary policy between the U.S. and Europe could lead to material changes in the dollar rate. The dollar remains close to the strongest levels in 20 years, so we are more inclined to expect dollar weakness from here going forward, but perhaps not at the sharp change as we saw in late 2022.

Source: FactSet

Portfolio and Stock Highlights

Eagle international equity portfolios rose slightly better than the MSCI EAFE benchmark for the quarter. The markets are now less convinced of a looming recession and more cyclical areas of the economy performed better in the quarter. While the war in Ukraine continues, hopes have increased in Europe of a de-escalation of the conflict. The latest revelations related to generative artificial intelligence (AI) provides additional revenue and investment opportunities for companies as well as future productivity gains from the use of AI in their own operations. Eagle will continue to look for opportunities for our portfolios to benefit from these and other secular trends.

Concerns about commercial real estate and the disappointing reopening momentum in China point to issues for companies with exposure there. Although, Chinese authorities have begun to provide minimal stimulus, and some suggest they may continue to provide additional stimulus to reinvigorate the stalling economy. Central banks appear to be nearing the end of their hiking cycles but inflation remains well above target levels which could translate to higher rates for longer than the markets are anticipating. Despite these pressures, equity prices rose in the quarter as consumers remained resilient and markets positioned for better than expected economic conditions.

MSCI EAFE large caps outperformed mid and small caps for the quarter. Value came back for the quarter and beat growth for the period. The best performing MSCI EAFE markets for the quarter were Italy, Japan, and Spain while the worst were Finland, New Zealand, and Belgium. The best performing MSCI EAFE sectors for the quarter were Industrials, Technology, and Consumer Discretionary while the worst performing were Communication Services, Materials, and Real Estate.

The U.S. Dollar rose slightly for the quarter, hurting international equity returns for dollar investors. Valuations are well supported for international markets with MSCI EAFE trading below its own average historical valuation as well as trading below the average discount to the U.S. markets.

Outperformers: Eagle portfolios outperformed slightly for the quarter on good sector allocation and neutral stock selection. An overweight to Consumer Discretionary and Industrials and underweight to Materials and Real Estate helped performance for the quarter. Good stock selection in Health Care and Materials also helped the outperformance. From a country standpoint, the portfolio had good stock selection in France, the Netherlands, and Hong Kong. Key positive attributors for the quarter included Amadeus IT (Spain -Technology), ORIX (Japan – Financials), and Ashtead (U.K.-Industrials).

Disappointments: Stock selection in Consumer Discretionary, Financials, and Information Technology was more challenging this quarter. On the country side, an underweight to Japan and overweight to China and Hong Kong was detrimental as those markets moved in opposite direction this quarter. Specific negative attributors this quarter included Alibaba Group (China-Consumer Discretionary), NICE (Israel-Technology), and DBS Group (Singapore-Financials).

Purchases / Additions In The Quarter

HDFC BANK LTD (HDB): SECTOR: Emerging Markets - Financials, COUNTRY: India. HDFC Bank, following its merger with HDFC Ltd., will become the tenth largest bank globally with a loan book size of $270 billion with a focus on retail loans, commercial loans, wholesale banking and trade services. Post-merger (closed in July 2023), HDFC Bank remains well positioned against competitors given its large scale, customer centric approach, and ability to gain market share in both loans and deposit books thanks to its product suite and geographical reach which would be superior to those of most private banks. HDFC Bank benefits from the merger as it gets access to a secured and long tenor retail mortgage product as well as large customer base and potential to cater to larger underserved customers.

TOKIO MARINE HOLDINGS (TKOMY): SECTOR: Financials, COUNTRY: Japan. Tokio Marine Holdings is the largest insurance company in Japan with a global footprint. It has established a global managerial structure given that half of its revenue comes from overseas markets (North America 33%) and is most advanced among the domestic insurance companies in terms of business and regional diversification. TKOMY benefits from high profitability and strong growth potential driven by its overseas segment and in its domestic non-life insurance business. In the domestic non-life insurance business, there is potential earnings upside in a better product lineup and expansion of new types of insurance (healthcare, SMEs, cyber insurance), as well as in the fire insurance segment given ongoing price increases. Headwinds from inflation and soaring reinsurance rates are offset by continuing increase in rates and building up reserves at an early stage. Having already improved adjusted ROE to 15.1%, its goal is to continue to improve margins helped by the accelerated disposal of cross shareholdings. Upside from investment income from rising interest rates in Europe and the U.S. are also in prospect.

TOKYO ELECTRON LTD (TOELY): SECTOR: Information Technology, COUNTRY: Japan. Tokyo Electron is the world's fourth largest semiconductor production equipment (SPE) producer. It commands a 90% share of the global market for coater developers. Although there is macro-driven uncertainty to the near-term growth of the wafer fab equipment market, we believe TOELY will outperform the overall market led by etching and deposition systems, which are its core strengths. We believe the near-term earnings will be supported by a steady field solutions business.

UNILEVER PLC (UL): SECTOR: Consumer Staples, COUNTRY: United Kingdom. Unilever shares had pulled back with other Consumer Staples stocks even though Unilever has begun to see underlying volume deterioration stabilize. This pullback offered an attractive opportunity to add to our position in the name. Going forward, we expect that volume stabilization will slowly turn to volume growth, supporting the shares relative to the sector.

Sells/Trims In The Quarter

BRITISH AMERICAN TOBACCO (BTI): SECTOR: Consumer Staples, COUNTRY: United Kingdom. BTI's traditional cigarette business is struggling as volumes continue to deteriorate in the U.S., especially on the back of bans on menthol cigarettes in California and downtrading by consumers. Final rules on the menthol ban and flavored cigarettes are still being worked out, but uncertainty is high. The company's next generation products (NGPs) have not performed as well as expected and hence are not providing enough of a buffer for the volume declines in the traditional business.

MAGNA INTERNATIONAL INC. (MGA): SECTOR: Consumer Discretionary, COUNTRY: Canada. Magna's recent execution has been subpar at a time when they are increasing capex and acquisitions to invest in future growth areas. While the recent acquisition of Veoneer holds promise, the need for further investment and the drag on current profitability clouds the short-term. Magna has also paused their share buyback program as they look to pay down debt to get their debt ratios back to historic averages. We decided to trim our position while the company works through its operating issues and completes its investment phase.

TOTALENERGIES SA (TTE): SECTOR: Energy, COUNTRY: France. We sold our position in TTE to reduce the energy weighting in the portfolio on concerns of slowing economic activity and a mixed demand/supply picture for global oil in the second half of the year. Recent OPEC+ cuts underscore the idea that demand is softer than anticipated and the oil cartel needed to be more reactive to mitigate significant oil price softness in the second half of the year. The lack of industry capex to increase production could be a positive tailwind to oil prices longer-term but there are plenty of headwinds in the near-term that could keep the sector range bound.

Disclosures

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