Quarterly Commentary
2Q 2023

EGA U.S. Equity

From the EGA Portfolio Management Team

Markets continued their strong advance in the second quarter, with U.S. stocks posting an 8.7% return for the quarter, bringing their total return for the first half of the year to 16.8%, as measured by the S&P 500. The Fed continued to increase its short-term policy rates; longer-term market interest rates increased also due to increased signs of strength in the economy and receding fears about instability in the banking sector. As a result, the returns to intermediate and longer-term fixed income securities were negative in the quarter.

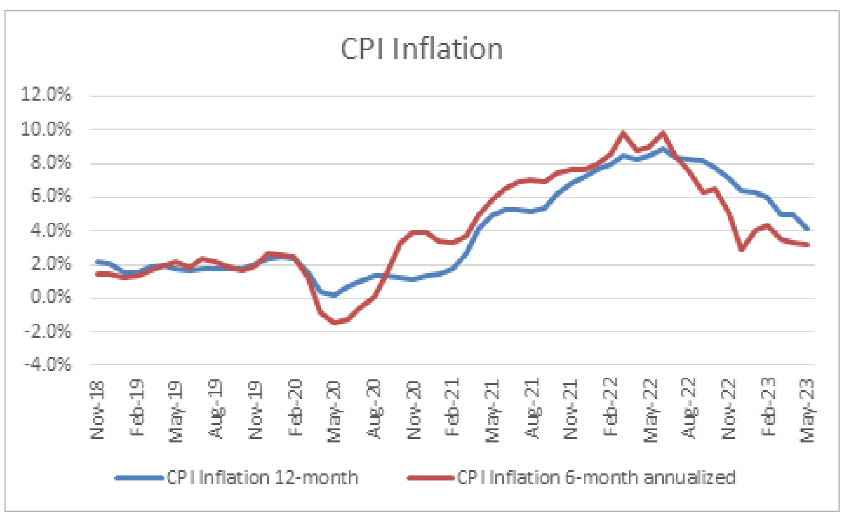
The economy surprised many observers with its strength as unemployment hit 50-year lows while measures of inflation continued to decrease. Excitement about the potential for artificial intelligence to positively impact many sectors of the economy fueled a boom in enterprises connected to its development. Meanwhile, sectors of the market outside of technology and artificial intelligence showed muted performance as concerns about an economic "hard landing" persisted, fueled by fears the Fed may continue its tight policy too far.

Fundamentals

Economy: Strong employment, cooling inflation

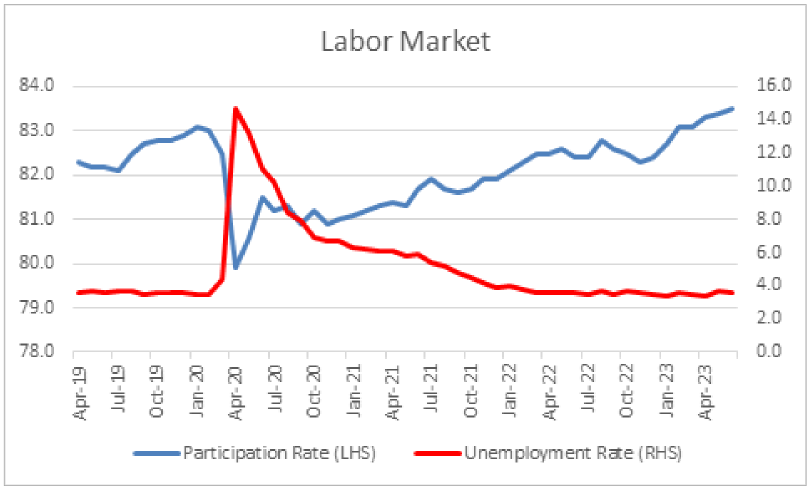
While the contractionary monetary policy that the Fed adopted in March of last year is having its intended effect of slowing economic activity, the strength in the economy in the face of higher rates has surprised economic analysts, many of whom forecasted a recession that has yet to materialize in 2023. In its most recent economic projections from June, the Fed raised its forecast for real GDP growth this year to 1.0%. While manufacturing and technology have slowed markedly and layoffs in those sectors have made headlines, the majority of economic activity is still in the services sector. Industries like travel, restaurants, and entertainment are showing robust demand. For now, the economy appears to be growing, but the outlook is particularly hazy.

The good news is that inflation has continued to slow since the first half of 2022. The year-over-year increase in the Consumer Price Index continues to come down with the most recent year-over-year reading in May at 4.1%, down from 6.0% in February. (See graph to the right.) A blip in prices in February and March has reversed, and recent months have shown slowing inflation. The shorter-term measures of inflation, like the six-month annualized figure (shown in red) continue to be below the longer-term measures, auguring for more decreases in price pressures.



Source: U.S. Bureau of Labor Statistics

However, labor is the most significant portion of costs, and the most recent jobs report shows the labor market is strong but cooling from the torrid pace it set last year. The number of jobs increased only 209,000 in June, well below the rates achieved in 2022 but still impressive. The prime age participation rate (labor force as a portion of the population) hit a new high of 83.5% (blue line in the graph below), exceeding that seen before the pandemic, indicating that many who have been out of the labor force are now seeking or finding employment.

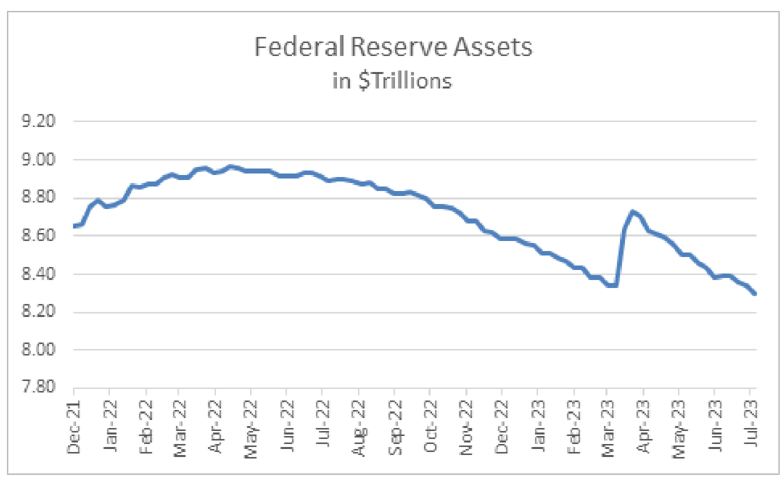


Source: U.S. Bureau of Labor Statistics

The unemployment rate (red line in the above graph) at 3.6% is at multi-decade lows and wage inflation is a concern. Wage gains, especially at the lower levels of the income spectrum, have been robust and indicative of tight labor markets. Robust wage growth raises concerns that inflationary forces in the economy are still an issue and that the job of the Fed is not yet done.

Federal Reserve: Back to the inflation fight

As we commented last quarter, the Fed had to reverse course in February to deal with instability in the banking system, marked by the failure of two large regional banks, and injected liquidity into the economy. This quarter brought evidence that the problems in the banking system have been contained, and the Fed quickly returned to its playbook of the past year; it raised the target zone for the Federal Funds rate by 25 basis points in May to 5.25% - 5.50% and resumed reducing the size of its balance sheet, draining reserves from the banking system. As of the end of the quarter, the Fed has totally reversed the injection of nearly $400 billion of reserves it made in response to the banking crisis and has reduced its assets below the level it maintained in early March before the crisis. (See graph above.)



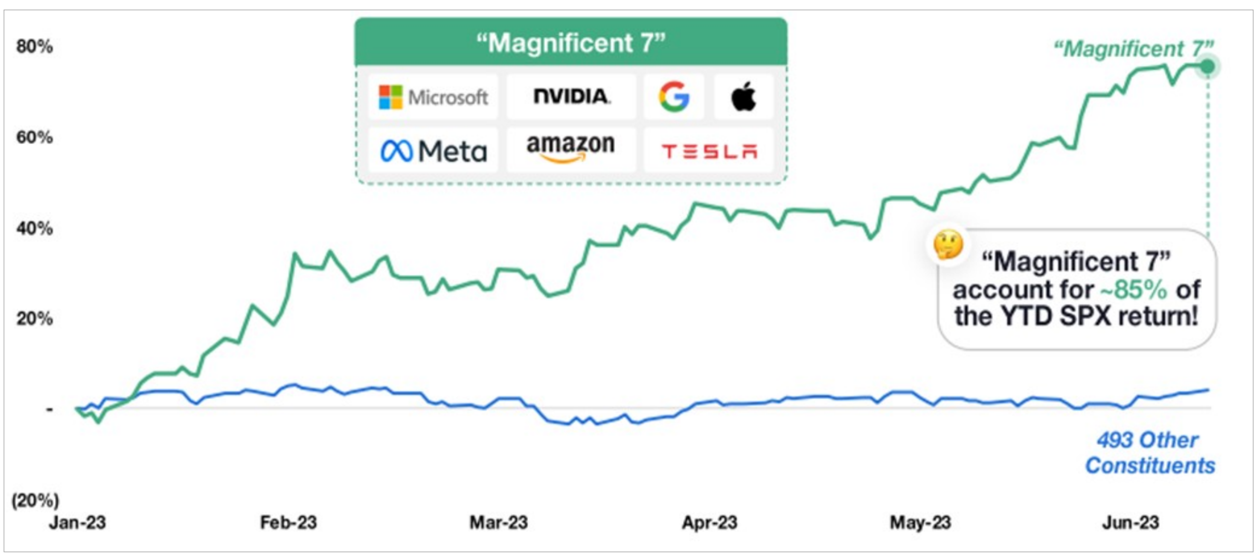
Source: Federal Reserve

Per its stated plans, the Fed should continue to reduce its assets at greater than one trillion dollars in the next 12 months. We expect that the Fed will increase its policy rates by 25 basis points at its July meeting. The Fed continues to guide that it will increase rates at least two more times before the end of the year.

Corporate Profits: Estimates trimmed, but stocks rebounded

First quarter earnings were slightly above estimates. However, analysts have trimmed second quarter estimates which are now expected to decline 6.8% compared to a year ago. This would represent the largest year-over-year decline in earnings since Q2 2020 and mark the third straight quarter of declines. Reasons cited have been slower economic growth, rising interest rates, higher labor costs, and strength in the dollar. S&P 500 companies earn about 40% of their revenues from overseas, and the dollar's sharp increase in 2022 has depressed the earnings posted abroad. Despite this expected slowdown in near-term earnings, the market appears to be looking beyond this year as it has rebounded 23% from last October's low. Earnings for the full year 2023 are expected to be $220, the same level seen last year. Analysts are expecting a 12% increase in earnings in 2024. At 4411, the S&P 500 is trading at 20.0 times expected 2023 earnings, falling to 17.9 times next year's earnings. The 2024 figure is now below the average PE multiple for the past five years (18.5) but above the past ten-years average (17.1) per FactSet. While interest rates are higher, Eagle's estimate of the equity premium is well below its historic average; this means the expected return for holding equities versus bonds is narrower than it has been in a decade.

Investors became enamored with stocks having some connection to artificial intelligence during the quarter, and enterprises perceived to have some exposure to that developing trend soared. Stocks like Microsoft, Google, Apple, Amazon and Meta all emphasized the potential for AI to be applied in their businesses during their earnings calls and saw their stock prices jump. Nvidia, which makes computer chips that are currently the most effective in processing AI applications, forecast that its future earnings would see significant boosts from this trend and its stock price rose. Tesla, which despite seeing its earnings estimates fall as it reduced prices to boost sales, also saw significant gains in its share price. These seven large cap stocks have seen their prices rise on average over 75% in 6 months and have accounted for about 85% of the S&P 500's rise this year, while the remaining 493 other stocks in the index on average are close to flat.



Source: Coatue Investments

Stocks in economically sensitive areas like energy, regional banks, retailing, and transportation have not performed well this year, following disappointing earnings and concerns about the future of the economy. It remains to be seen whether the future earnings of the "magnificent seven" justify the soaring prices that they have seen this year.

Fixed Income: Rates rise, bond prices fall

After the stabilization of the banks and the return to austerity by the Fed, market interest rates rose over the course of the second quarter leading to generally negative returns for fixed income. The 10-year government bond started the quarter at 3.5% and rose to 3.8% by June 30th (and has already hit 4.0% in the early days of July). Short-term Treasuries rose more sharply leading to a more negatively sloped yield curve. Corporate bond yields rose as well, but less than Treasuries, with lower rated bonds rates rising more than higher rated bonds. While the Fed is guiding to at least one or two more rate rises this year, futures indicate that market participants are discounting this outcome. This discrepancy between official Fed pronouncements and market expectations promises to produce some surprises and volatility in the markets as this uncertainty is resolved over the next several months. We continue to maintain high quality portfolios with short to intermediate maturities in this environment.

Stock and Portfolio Highlights

Eagle portfolios underperformed the S&P 500 Index during the quarter mainly due to our underweight to the "magnificent seven" stocks. Good stock selection in Financials, Industrials, and Materials were not enough to make up for difficult performances in the Information Technology and Communication Services sectors.

Purchases / Additions In The Quarter

Advanced Micro Devices, Inc. (AMD): AMD designs compute and graphics products for PCs and data centers. AMD's performance lead (on the back of a superior technology process node vis-a-vis Intel) should support share gains in the data center CPU segment. Additionally, due to its GPU and CPU IP, AMD will ship its new accelerating processing unit (APU) later this year in partnership with its hyperscale customers, who are looking to bring down their cost and diversify their accelerated compute chip/systems sourcing for generative AI training and inference applications. The recovery in data center CPU and adoption of its new accelerated compute systems are expected to drive a new growth leg for AMD.

Booking Holdings Inc. (BKNG): BKNG provides global travel and restaurant online reservation and related services. The company benefits from robust leisure travel demand worldwide especially as it is the best positioned in cross-border travel. We believe it can achieve double digit earnings growth given its strategic investments (merchandising, flights, cross-selling) that should support above pre-pandemic growth in terms of room nights, bookings, revenue and EPS as conditions normalize. BKNG's initiative to drive more traffic directly to its site (over 45% of room nights are now via its mobile app) implies the potential for margin expansion. This combined with improving market share and shareholder friendly capital allocation (buyback is 25% of market cap over the next four years) makes it an attractive investment at 16x P/E and 13x EV/EBITDA.

Sells / Trims In The Quarter

Apple Inc. (AAPL): We trimmed our position in Apple due to persistent softness in the products segment, particularly in the developed markets, tough comps and macro headwinds, which are slowing services revenue growth, and uncertainty caused by the impending European regulations (DMA and DSA) early next year. At 29 times next twelve months earnings, Apple's relative valuation is less attractive versus other opportunities in the Information Technology sector.

Keurig Dr Pepper Inc. (KDP): The company displayed deteriorating metrics within our process while we deemed the valuation full. Additionally, growth in coffee is moderating following the post-pandemic highs and competition is increasing. We decided to sell and redeploy the proceeds.

Target Corporation (TGT): Part of the thesis on Target was increased market share gains but recent turmoil in their marketing campaigns has impacted foot traffic. While we believe the impact may be short lived, the impact of boycotts seen at Anheuser Bush have gone on longer than what was expected complicating the matter. With the position slightly underwater, we decided to implement our tax loss strategy and monetize the loss now and reevaluate the situation in the future for possible reinvestment.

Disclosures

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