Market Review and Outlook

Q2 2018

EGA International Equity ADR

From the EGA Portfolio Management Team

Market Overview

Global equity markets rebounded during the quarter but the strong U.S. Dollar (USD) dented international equity returns in USD terms. The MSCI EAFE Index fell -1.24% in dollar terms while increasing 3.6% in local currency terms for the quarter. In the U.S., the S&P 500 Index recovered nicely, tallying a 3.4% return for the second quarter.

The Global Economy

Global Summary

While global growth is estimated to remain above trend in 2018 and into 2019, much of the latest economic data signals moderation in the rate of growth and momentum. The narrative of a broad-based synchronized global economic recovery appears to be fading slowly. The J.P. Morgan Global Manufacturing PMI hit an 11-month low in June, albeit still signaling strong growth. Price pressures continued to increase as the survey showed both input and output prices rising at faster rates than expected. Although risks beyond the next several quarters lean to the downside, the International Monetary Fund still increased its growth outlook for the world, mainly due to a sizable fiscal expansion in the U.S. Yet, the IMF warned that the positive momentum would eventually slow, leaving most advanced economies with a challenging economic outlook given their aging populations and lackluster productivity.

With higher inflation expectations and rising employment, global central banks are more aligned towards tightening monetary conditions in the coming year. While the major banks appear to have diverging paths, most pronounced the Federal Reserve, the European Central Bank, and the Bank of Japan, Citi estimates suggest that 32 central banks of the 60 they follow have already planned or plan to increase policy rates in 2018. Four of these banks are in advanced economies while the rest are in the developing world. Some central banks are tightening because of good economic performance and rising price pressures (the U.S., Canada, Russia, and Norway) while others are responding to currency depreciations and crisis of confidence (Argentina, Turkey, the Philippines, Mexico, Indonesia, and India). While the world appears to have shifted from a quantitative easing bias to a quantitative tightening bias, world currency and bond markets have taken the shift poorly. The gap between the U.S. 10-year rate and the German 10-year rate rose to its highest level in almost three decades as the Federal Reserve continues to raise rates and the European Central Bank remains far behind in monetary tightening.

The U.S. Dollar appreciated during the quarter as trade jitters, rising U.S. bond yields, Eurozone politics, and volatile emerging markets led to a flight to quality and the U.S. Dollar regaining lost ground. The U.S. 10-year rose above the 3% mark during the quarter for the first time since 2014, although it was unable to stay above those levels given volatile global markets that saw flows back to the U.S. Trade tensions rose during the quarter as the U.S. placed tariffs on aluminum and steel products from several trade partners while subsequently placing tariffs on $50 billion worth of Chinese goods. All tariffs were met with stiff resistance and tit-for-tat countermeasures from trading partners. President Trump threatened additional Chinese tariffs given his perception of unfair trade and intellectual property practices from the Chinese.

Japan / Asia

Inflation in Japan, excluding the volatile food and energy prices, remains close to zero prompting most to expect the Bank of Japan (BoJ) to remain on the sidelines for longer. Most economists expect no change from the BoJ policy anytime this year and little change, if any, in 2019. Labor does remain tight but there is no evidence to suggest that it is leading to higher wages. Economic momentum has moderated in Japan with GDP continuing to disappoint in 2018. The latest Tankan Survey of Large Manufacturers remains elevated but dropped below expectations for the second straight quarter. In contrast, the Nikkei Japan Manufacturing PLMI index increased to 53 in June. The survey suggested continuing strength in output growth while new order growth and export sales disappointed. In addition, input price inflation jumped to a 3.5 year high leading to concern of margin pressures as Japanese manufacturers are forced to absorb higher raw materials prices.

Europe

Although slowing, Eurozone GDP growth remains well above what the OECD considers "trend" growth for the Eurozone of 1.1%. First quarter GDP growth came in at 2.5%, below the 2.8% level of 2017, but well above trend. The European Central Bank lowered its GDP growth forecast for 2018 from 2.4% to 2.1%. Consumption is holding up well in the Eurozone as employment growth remains strong while net exports no longer appear to be contributing to growth. Business confidence is starting to moderate, albeit from high levels. The German IFO Index of business confidence fell again in the most recent month while the Eurozone Manufacturing PMI fell to an 18-month low in June. The lower confidence and PMIs are following very elevated levels and still remain in expansionary territory. A positive sign of current economic activity is seen in the latest bank lending data that shows that lending to non-financial corporates picked up to 3.6% year-over-year in May, the highest growth rate since May 2009.

Inflation has begun to creep up in the Eurozone with headline inflation rising to 1.9% in May although core inflation, excluding volatile food and energy prices, only rose 1.1%. The European Central Bank (ECB) has raised its headline inflation expectations for 2018 and 2019 to 1.7%. Yet, core CPI levels are likely to remain below that given much of the recent increase is due to lag effects of rising oil and other commodity prices. In its most recent meeting, the ECB announced that it would be ending its quantitative easing at the end of this year. Starting in September 2018, monthly bond purchases will decline from 30 billion euros to 15 billion euros and will end completely in December. The ECB also announced that it would not increase its policy interest rate any time before the summer of 2019. ECB president Mario Draghi's 8-year term is scheduled to end in November 2019 and his successor will be a key figure in the next phase of monetary policy in the Eurozone.

Emerging Markets

Emerging markets had a busy quarter of turbulent markets as confidence suffered. Rising trade tensions, growth losing steam, removal of stimulus from advanced economy central banks, and renewed anxiety over China led to significant currency weakness. A trucker's strike in Brazil to protest rising energy prices sent the Brazilian market on a tailspin and hurt economic activity in the country. Emerging market economies have accounted for two-thirds of global growth over the last seven years according to a recent Bank of International Settlements (BIS) report. The same report warned that the international financial system is vulnerable to a jump in borrowing costs. In particular, it singled out emerging market dollar debt which stands at $7.6 Trillion, double the level from 2007.

China fought back with two cuts in bank reserve requirements as the most recent data suggests China's economy is slowing. The Chinese government has allowed recent bankruptcies and is more focused on quality over quantity as it tries to smooth a soft landing of its economy. Environmental concerns will remain a key pillar to China's growth model going forward. In addition, the "Made in China 2025" strategic plan has spurred significant concern from developed countries as China aims to move up the value chain in many industries to compete on a global basis. The Chinese Yuan reversed course and depreciated during the quarter as U.S. Dollar strength resumed.

Politics

Italy was finally able to agree on a coalition government that brings a far left and a far right party together to form a new government. Italy's anti-establishment 5-Star Movement and the right wing League parties formed a populist Eurosceptic coalition that is sure to provide the EU some headaches. The coalition will be headed by Prime Minister Giuseppe Conte, a political rookie while 5-Star leader Luigi Di Maio and the League's Matteo Salvini will be deputy prime ministers. Most observers point to Salvini as the one gaining more power as his party continues to gain popularity in the polls.

Another historic election occurred in Mexico as leftist Andres Manuel Lopez Obrador (AMLO) was elected president of Mexico in a landslide victory. AMLO's victory was historic in many ways. It is the first time since the 1920's that a leftist party will head Mexico's government. In addition, his margin of victory of more than 30% above his closest rival was the largest margin of victory in four decades. The long-term ruling PRI Party was decimated in this election following major corruption charges across the country. AMLO's Morena Party coalition was also handed victory in both houses of congress. AMLO has promised to root out corruption in the government and his populist rhetoric is likely to test the markets.

Across the Atlantic, Turkey's election handed Recep Tayyip Erdogan unprecedented new powers as he won the presidential election. The election comes with new executive powers as reforms passed last year basically merged the powers of the prime minister and president and allows the new president significant room to rule by decree and appoint government figures with little approval process. There is much concern that the independence of the central bank there will be compromised and Erdogan has been using the excuse of the failed coup from 2016 to fire thousands of government workers not aligned with his party. Thus far since 2016, more than 160,000 public servants have been dismissed and more than 50,000 people have been jailed under emergency powers. Turkey's future appears to be in the hands of an elected dictatorship that is rooting out any opposition efforts.

Stock and Portfolio Highlights

Monetary policy normalization in the U.S. and Trump's trade war led to significant volatility for equity markets during the quarter. The U.S. 10-year bond yield crossed over the psychological 3% barrier during the quarter before falling back below that level as risk aversion took hold. The yield curve continued to flatten in the U.S. and some became concerned that the Federal Reserve's continued hike cycle over the coming 12 months could lead to an inverted yield curve causing much concern. The U.S. Dollar bounced back strongly during the quarter as trade tensions and monetary policy normalization reduced investor confidence in emerging markets. The U.S. Dollar Index rose by 5% versus major currencies for the quarter. Currencies in the emerging markets declined significantly with the Brazilian Real, the South African Rand and the Turkish Lira all falling more than 13% versus the dollar during the quarter. The Argentine Peso also went into a tailspin, prompting the central bank there to raise interest rates by more than 1000 bps and ultimately asking the IMF for support.

President Trump's trade war took hold as he initiated tariffs on aluminum and steel products from various countries. In addition, a 25% tariff was placed on $50bn worth of goods from China as the U.S. government fights back against intellectual property theft and China's perceived unfair trade practices. This significant development led to equity price volatility around the world as the uncertainty of the trade war may lead to inflation pressures and delayed investment plans. The trade disputes are likely to continue while Trump presses ahead with announcements of additional tariffs on Chinese goods. Thus far the Chinese have announced tit-for-tat tariffs and have threatened quantitative and qualitative retributions. Oil prices continued their ascent in the quarter as the Trump administration pulled the U.S. out of the Iran nuclear pact that could lead to curtailed oil volumes from the country. Prices rose despite Russia and OPEC's decision to increase production, mostly to balance the markets from anticipated lost Iranian volumes and as the oil markets had become more balanced since their initial cut.

Mid caps slightly outperformed small and large caps for the quarter while growth continued to outperform value. The best performing MSCI EAFE countries for the quarter were Israel, New Zealand, and Australia while the worst performing were Austria, Singapore, and Italy. For the year-to-date period, the best in MSCI EAFE thus far are Finland, Israel, and Norway while the worst are Austria, Denmark, and Germany. The best performing emerging market countries for the quarter were Colombia, Qatar, and India while the worst performing were Brazil, Turkey, and Pakistan.

Outperformers: Overweights to the outperforming Energy and Information Technology sectors were helpful for the quarter. Stock selection was also positive in the Telecom Services sector as the portfolio's Japanese telecom holdings outperformed European peers. From a country standpoint, the portfolio's absolute weight to Canada was positive as stocks there outperformed. Stock selection was also positive in Switzerland and Spain.

Disappointments: Eagle portfolios struggled for the quarter and underperformed the MSCI EAFE Index. Stock selection in the Consumer Discretionary, Utilities, and Consumer Staples sectors hurt performance the most. Exposure to European auto parts in Consumer Discretionary, a Brazilian water utility in Utilities, and a European tobacco and a Brazilian beer company in Consumer Staples were the main culprits. Exposure to emerging markets was detrimental for the quarter as two-thirds of the underperformance was related to EM exposure.

Purchases / Additions in the Quarter

AIA Group Limited ADR (AAGIY): SECTOR: Financials; COUNTRY: Hong Kong: We added to our position in this major Asian insurer. Strong growth potential from low insurance penetration across the region, especially China, gave us continued confidence in the long-term story at AIA. The company has high visibility of cash flows, a strong balance sheet, and an attractive valuation underpinned by secular growth prospects.

Ambev ADR (ABEV): SECTOR: Emerging Markets-Consumer Staples; COUNTRY: Brazil: Ambev is the largest brewer in Latin America, a region with higher than average volume growth and higher profitability per hectoliter. Demographics in Ambev's target markets are favorable as well as the company holds the leading position in a concentrated market. The potential for a sustained cyclical recovery in Brazil also provided prospects of a growth cycle.

Ashtead Group PLC (ASHTY): SECTOR: Industrials; COUNTRY: United Kingdom: Based out of Britain, Ashtead is the second largest equipment rental company in the U.S. with its Sunbelt brand. Non-residential construction in the U.S. is rebounding and the company is benefitting from cyclical trends. Ashtead continues to gain market share with the industry's youngest fleet.

Komatsu Ltd ADR (KMTUY): SECTOR: Industrials; COUNTRY: Japan: With 50% of earnings before interest and taxes (EBIT) coming from mining and 50% from construction equipment, Komatsu is a play on mining recovery due to equipment operating beyond normal use in the recent downturn and thus should drive service as well as new equipment sales while global infrastructure investment should drive construction equipment sales. Mining equipment is the higher margin business and the gem of the company as they compete head to head with CAT as the only two companies with a full breadth of equipment.

Sina Corp (SINA): SECTOR: Emerging Markets-Technology; COUNTRY: China: We added to our position in Sina as its discount valuation implied by its controlling stake in Weibo had widened making the valuation attractive versus growth. The company had sold off in lockstep with Facebook and other social media firms on concerns of possible new regulation. Chinese internet companies are already highly regulated and the growth potential of the firm more than compensated for the market concerns.

Tencent Holdings ADR (TCEHY): SECTOR: Emerging Markets-Technology; COUNTRY: China: Often called the "Facebook" of China, Tencent has close to 1 billion monthly active users in its WeChat platform. We forecast continued strong growth following solid advertising gains and continued monetization of its platforms. Its solid performance of online gaming, video, and mobile payments will also provide significant room for revenue growth in the future.

Sells / Trims in the Quarter

A.P. Moeller-Maersk (AMKBY): SECTOR: Industrials; COUNTRY: Denmark: Growing concerns over tariffs and a potential trade war led us to eliminate our exposure to Maersk, the largest cargo company in the world. The industry continues to build new capacity, albeit at a slower pace, and the company has had significant disruptions to its operations from an outside hack into its important shipping business. The sale of the company's rig business also seems more remote as interest there from counter-parties is low.

Arcos Dorados Holdings (ARCO): SECTOR: Emerging Markets-Consumer Discretionary; COUNTRY: Argentina: We harvested losses in this position and redeployed to another LATAM oriented consumer stock. While Arcos results have been decent the last couple of quarters, depreciation of the Argentine Peso and the Brazilian Real do affect its expenses.

BMW AG (BMWYY): SECTOR: Consumer Discretionary; COUNTRY: Germany: Earnings growth is expected to be slightly positive over the next couple of years as luxury competition has increased and the company invests more in their vehicles. There is little room for margin expansion as the company continues to invest in a move towards hybrid and pure electric vehicles leading to sub-par profit growth in the medium-term.

Brenntag AG (BNTGY): SECTOR: Industrials; COUNTRY: Germany: The oil and gas industry rebounding from the depths was supposed to be a catalyst for Brenntag's revenue growth and margin at a time when other parts of their chemical distribution business should have seen a tailwind as the global economy continued to improve. While the oil and gas market in the U.S. has certainly improved, poor execution in other parts of the business have disappointed revenue expectations. In addition, higher labor costs and less pricing than anticipated continues to eat away at margin causing estimates to miss and calls into question the credibility of management and their acquisition strategy. It also questions the defensiveness of the business and the ability to expand market share as was expected from being the big player in a fragmented market.

East Japan Railway Co (EJPRY): SECTOR: Industrials; COUNTRY: Japan: EJR's operating metrics have been choppy with passenger declines stemming from fizzling demand of new routes and dissipation of special demand driven by Great East Japan cleanup efforts. The company sees achieving its targets as a very high hurdle and the market has reassessed its profit forecasts. This leads to profit growth about 2% a year for the next three years and low free cash flow going mostly to the dividend as the capital structure will not change much.

Magna International (MGA): SECTOR: Consumer Discretionary; COUNTRY: Canada: After a very strong performance we decided to trim our position and redeploy to more attractive opportunities. Valuation is on the higher end as the auto cycle remains strong even though headline risks have increased from trade tensions, higher gas prices, higher interest rates, and higher raw material costs all having the potential to put a dent into the current auto upcycle.

Mitsubishi UFJ Financial Group (MUFG): SECTOR: Financials; COUNTRY: Japan: MTU is one of the largest banks in Japan and one of the most sensitive to Japanese interest rates. Expectations of more normalization in both short and long-term rates has been pushed out as Japan continues to struggle to generate target inflation. In addition, MTU's recent results were less than stellar and their buyback was cut in half. With a short-term loss in hand, we decided to monetize against the portfolio gain for the year and redeploy in more attractive areas.