EAGLE GLOBAL ADVISORS

# Market Review and Outlook

## Q1 2017

# EGA International Equity ADR

From the EGA Portfolio Management Team

### Market Overview

Global markets started 2017 higher propelled by rising confidence and improving growth prospects with the recent modest decline in the U.S. Dollar helping international equity returns. The MSCI EAFE Index rose 7.3% in U.S. Dollar terms in the first quarter, (4.7% in local currency terms), as compared to the United States, where the S&P 500 Index rose 6.1%.

## The Global Economy

### Global Summary

Global growth prospects are on track for continuing acceleration of global GDP growth into 2017 and 2018. While 2016 growth at around 3.0% may end up being the slowest global growth since the financial crisis, brighter days are expected in 2017. The OECD's Composite Leading Indicators (CLIs) which are designed to capture turning points in economic activity relative to trend 6 to 9 months out, continue to "point to growth gaining momentum in several advanced economies". The CLIs highlight the United States, Canada, Japan, Germany and France as those expecting to see a pick-up in growth this year. Among major emerging economies, China, Brazil, and Russia should see better growth while India may ease its growth momentum.

Consumer and business confidence in most major economies have improved in recent months. While Q1 activity may prove choppy in some areas of the world, most analysts expect accelerating growth through 2017. The JP Morgan Global Manufacturing PMI shows the global manufacturing sector continued to expand at a solid pace in March. Commenting on the latest survey, JP Morgan said "The global manufacturing sector recorded its fastest rate of quarterly expansion for almost six years over the first quarter as a whole." The increased confidence and industrial activity has led to job gains and increasing inflation pressures across major economies. Headline CPI has risen quickly in the past few months following higher oil and commodity prices while core CPI has also risen, albeit not as quickly as headline inflation.

Rising confidence, inflation, and employment have some advanced economy central banks tilting to a more hawkish tone. The improved economic prospects led to steepening yield curves across most advanced economies while the Federal Reserve increased interest rates in March for the third time in this interest rate cycle. While there may be a slight tilt to more hawkishness, the signals thus far from central banks have been quite moderate. The European Central Bank (ECB), the Bank of England (BoE), and the Bank of Japan (BoJ) remain full throttle ahead in ultra-accommodative mode even though the ECB may begin scaling back its monthly asset purchases sometime in 2017.

### Japan / Asia

According to CLSA estimates, over the last 15 years, Japanese growth has been 86% correlated with world trade growth. It is important to note that in recent months the recovery in world trade growth has become more visible. While we have written repeatedly in the past few years about the stop-start nature of a trade recovery, today's signals are the most positive we have had during this period that point to a potential recovery in world trade starting in 2017. Export growth has accelerated mostly because of recovering volume growth/demand in emerging markets. Yet, it is too early to be overly optimistic about a prolonged recovery in world trade. The trade surge in some commodities has contributed to the improving trade numbers and that could plateau in the next quarters. The better than expected trade data should lead to better Japanese growth if the last 15-year correlation proves correct.

Recent signs suggest that Japan will grow at a higher rate in 2017 than 2016 with a moderate pick up in exports and faster growth in business investment likely leading the way. The Bank of Japan's Tankan Survey of large manufacturers hit a one and a half year high in March as companies remained upbeat about their capex plans. Service sector sentiment also improved for the first time in six quarters to hit a one-year high on brightening business prospects in the service economy. While the latest PMI survey showed a marginal dip in the data, underlying results remain strong for job growth, exports, and overall demand. IHS Markit commented on the latest PMI survey saying that "…exports are rising at an underlying rate of close to 3.0%...Latest PMI data pointed to a seventh successive month of job growth…". With inflation still hovering close to zero, we expect the Bank of Japan to remain very accommodative in its monetary policy for the foreseeable future.

## Europe

January figures from Eurostat confirmed a 1.8% rise in annual Eurozone CPI compared to last year. It was also the first time in over four years that every member nation experienced rising prices. The main reason for the increased prices appears to be the fading effect of falling energy prices and hence, could be a temporary rise. With the ECB celebrating its 2-year anniversary of unprecedented stimulus which has seen it purchase close to 1.6 trillion euros of Eurozone assets, there is some relief by policymakers but no rest yet. The ECB sees the recent positive effect on inflation to be somewhat transitory and hence, remains quite vigilant in its approach to sustainable growth and pricing power. While ECB President Mario Draghi has declared victory on deflation, stimulus measures remain in place and monetary hawks in Germany are increasing their pressure to lay off the monetary policy accelerator.

Eurozone unemployment declined in the latest month to its lowest level in eight years but remains stubbornly high at 9.5%. Unemployment has been decreasing steadily since it peaked at more than 12% in 2013 as the ECB deployed unprecedented stimulus. Manufacturing activity has clearly improved as well with the latest PMI surveys for the region showing positive results for Germany, France, and Italy in March with new export business also improving for all countries. This is the fastest growth of manufacturing production and new orders in the Eurozone since April 2011. IHS Markit commented on the latest Eurozone PMI figures stating that "All key business activity gauges—output, new order flows, exports, backlogs of work and employment – are close to six year highs".

## Emerging Markets

Economic activity across emerging markets as a whole has been improving with better trends in global growth and trade as well as the deep recessions in Russia and Brazil abating over recent months. Industrial production growth in Brazil and Russia has bounced back albeit still only marginally positive for Russia and stronger for Brazil, coming off very low levels. Inflation trends across the emerging economies have also subsided as the inflation pressure from currency depreciation has lessened for most except for Turkey and Mexico who saw significant currency volatility in the second half of 2016. Inflation has fallen significantly in Russia and Brazil as currency depreciation in 2015 turned into appreciation that supported downward pressure on inflation. Both currencies have continued to appreciate versus the U.S. Dollar in 2017.

China's GDP grew 6.8% year-over-year in the fourth quarter of 2016 taking full year GDP to 6.7%. The government appears to be anchoring their 2017 GDP growth expectations around 6.5% and recent economic data is supportive of this sustainable growth. Although the real GDP number remains steady at this mid-6% range, it does mask a large improvement in nominal GDP which grew at 9.8% in the fourth quarter, the fastest pace of nominal growth in several years. China's producer prices, as measured by PPI inflation, accelerated in the last half of 2016 and into the first half of 2017 with the latest jump to 7.8% year-over-year in February. Yet, consumer inflation remains in check for now. Industrial production has slowed a bit in recent months along with housing sales and starts as the government took measures to slow down house price inflation. In its latest move, the People's Bank of China (PBoC) raised interest rates on repos, the rates it charges commercial banks. The recent depreciation of the dollar together with a slightly tighter monetary policy from the PBoC has meant a more stable and stronger yuan in 2017.

## Politics

The two main political events that kept markets busy guessing over the course of the first quarter was the French presidential election and the U.K.'s Brexit plans. The French presidential election polls suggest Marianne Le Pen of the National Front Party which supports pulling out of the European monetary union and EU membership could win the first round of the election to be held April 23rd. But, polls suggest she would lose by a wide margin in the second and final round to be held on May 7th to more business friendly Emmanuel Macron of the centre-left party, En Marche! Given the surprising results of the Brexit referendum and the U.S. presidential election in 2016, market participants have been closely watching polls which suggest a much wider margin of victory and hence little chance of a surprise Le Pen victory.

In the U.K., Brexit has officially begun, as Prime Minister Theresa May officially triggered the Article 50 exit clause of the EU Constitution. Thus starts the two year countdown to the U.K.'s exit from the European Union. While growth expectations for the U.K. have improved in the last few months, there is much uncertainty what the effect the beginning of Brexit will have on corporate investment plans. The next two years are sure to be filled with significant rhetoric from both sides, some surprises, as well as the potential for stronger EU members to instill some pain in the U.K. to discourage others from even considering such a move to leave the union. Nicola Sturgeon, Scotland's first minister also announced that her government would want to seek a second referendum vote for independence from the U.K. to hold a vote prior to the spring of 2019, throwing cold water on the notion of a united U.K. in the next two years.

## Stock and Portfolio Highlights

Optimistic consumer and business confidence helped underpin a strong start to the year in global equities. While confidence remains in the potential economic implications of the new Trump administration, some of the optimism around a new infrastructure stimulus plan and worries of protectionism somewhat subsided in the quarter. Currencies, mainly in emerging markets, which rebounded after depreciating in knee-jerk reaction immediately after Trump's election. This led to a strong start for emerging market equities in the new year. Moreover, the strong dollar trade compared to major currencies also lost some of its luster late in the quarter as the U.S. Dollar gave up some of its previous gains post the election, contributing to international equity returns for U.S. Dollar investors.

Across the pond in Europe, investor concerns concentrated mostly around Brexit and the French elections. Theresa May triggered Article 50 to begin Brexit for the U.K. as promised, leading the U.K. to underperform for the quarter as investors remain concerned about the long-term economic effects of the U.K. pulling out of the European Union. In France, the presidential election heated up with scandals surrounding the Fillon candidacy which have for the most part handed over the non-Le Pen vote to Emmanuel Macron. While anything can happen these days in an election, polls have Macron handily beating Le Pen in the second round of the election to be held in early May. While the polls seem certain, CDS spreads and bond yields show some hesitation on the part of investors. The spread between French and German 10-year bonds hit a 5-year high during the quarter as investors demanded to be paid more to hold French paper. Demand for safe-haven German paper was strong, pushing its 2-year yields to the widest gap with the U.S. 2-year Treasury since the start of the euro, underscoring the gap in monetary policies between the U.S. and Europe. In addition, the ECB's bond buying program remains in full force continuing to put downward pressure on European yields.

Not all was rosy during the quarter as oil prices took a bit of a pause on investor concerns of oversupply. While adherence to the OPEC cuts was very strong throughout the quarter, investors became concerned that the prolific unconventional oil fields in the U.S., especially in the Permian Basin, would increase production much more quickly than previously thought, hence reducing expectations for oil markets to rebalance soon. We believe OPEC is likely to remain in compliance with its production cuts in the near future in order to keep oil prices at a healthier level, especially as Saudi Arabia prepares to IPO its national darling Saudi Aramco at a valuation some have placed at near US$1trillion. While oil suffered some losses in the quarter, other commodities fared better with copper, platinum, gold, and corn all positive.

Large caps underperformed small and mid-caps for the quarter while MSCI EAFE growth beat value for the quarter. The best performing MSCI EAFE markets for the quarter were Spain, Singapore, and Hong Kong while the worst for the quarter were Norway, New Zealand, and Ireland. The best performing emerging markets for the quarter were Poland, India, and South Korea while the worst performing were Russia, Greece, and Hungary. We believe valuations remain attractive for international equities in both developed and emerging markets.

**Outperformers:** Eagle portfolios struggled during the quarter compared to the index but had a few bright spots. Stock selection in the Utilities and Industrials sectors were positive. In Utilities, the Brazilian water utility in the portfolio benefited from a stronger currency and better prospects for the year. Stock selection in Germany and Singapore also helped performance while allocations to Brazil and Mexico were positive as well as those markets bounced back in the quarter.

**Disappointments:** Stock selection for the quarter was disappointing with Financials, Telecom Services and Health Care providing headwinds for the portfolio. In Financials, weights to a Japanese leasing company and a brokerage house hurt performance as they underperformed for the quarter. In Telecom Services, the British telecom service provider in the portfolio was hurt by weak results and a cloud of regulatory uncertainty. Stock selection was also negative in Japan, the Netherlands, and the U.K. overall.

## Purchases / Additions in the Quarter

**Aegon NV (AEG):** SECTOR: Financials; COUNTRY: Netherlands: Aegon has suffered a depressed ROE over the last few years due to the low interest rate environment, regulation, and competition. With the Federal Reserve on a clear path to raising rates, Aegon's rate-sensitive U.S. business, which accounts for 60% of earnings, will be a clear beneficiary. In addition, with management undergoing a deep self-help strategy with cost cuts and asset disposals, we believe Aegon's prospects have improved.

**East Japan Railway (EJPRY):** SECTOR: Industrials; COUNTRY: Japan: East Japan Rail is the country's largest passenger railway company by network as well as a major commercial real estate operator and land bank owner around its rail stations. The company is a prime beneficiary of the booming tourism industry in the country as intra-Asia tourism is rising rapidly. This underpins a sustainable growth trend for East Japan that can lead to balance sheet deleveraging and increasing returns to shareholders.

## Sales / Trims in the Quarter

**BT Group PLC (BT):** SECTOR: Telecom Services; COUNTRY: United Kingdom: BT is seeing pressure on its public sector as well as international corporate markets leading to softer earnings guidance for the year. In addition, an investigation into its Italian operations uncovered accounting fraud by its Italian management leading to a large write-down of operations there. With Brexit, pensions, and regulatory uncertainty on top of these announcements, we decided to trim our position.