Market Review and Outlook
Q1 2018

EGA International Equity ADR

From the EGA Portfolio Management Team

Market Overview

During the quarter, volatility came back to the markets and equity prices suffered. The MSCI EAFE Index declined -1.5% in U.S. Dollar terms and fell -4.4% in local currency terms compared to the U.S. where the S&P 500 Index fell a modest -0.76% for the first quarter of 2018.

The Global Economy

Global Summary

Global growth remains robust and broad-based, underpinned by strong industrial activity and investment. While inflation remains subdued in most advanced economies, monetary policy is in a global tightening cycle. The majority of advanced economies are expected to raise their policy rates in 2018, with the U.S. Federal Reserve leading the way with three interest rate increases. In spite of the tighter policy framework, global growth momentum remains positive. In its World Economic Outlook in January, the International Monetary Fund (IMF) revised up its expectations for global growth for both 2018 and 2019 after a strong finish to 2017. The new U.S. tax bill is partly responsible for the brighter prospects for investment spending while Europe and Japan's economy also supported a higher growth expectation. The IMF calls the current cycle "the broadest synchronized global growth upsurge since 2010."

In spite of the bullish expectations on economic growth from the IMF, economic momentum in the quarter appeared to have moderated. The J.P. Morgan Global Manufacturing PMI composite index registered a rate of expansion at a five month low in March. According to the PMI report, companies reported slower growth of output, new orders, and employment during the last month of the quarter. Recent weakness in some European manufacturing data also points to a moderation of growth in the near-term. While manufacturing production may be slowing from its accelerated pace, overall absolute data suggests economic growth remains well supported albeit slower expansion than at the beginning of the year. Price pressures appeared to ease in March as well as providing room for continued accommodative monetary policy across the globe. The European Central Bank has begun signaling tighter policy while the Bank of Japan is yet to announce any plans of reduced monetary stimulus.

The U.S. Dollar continued its recent depreciation trend during the quarter even though U.S. bond yields have risen against foreign counterparts. The main culprit appeared to be comments from U.S. Treasury Secretary Steven Mnuchin at the World Economic Forum in Davos, Switzerland. Mnuchin said that "a weaker dollar is good for trade" while also going on to emphasize that longer term "…a stronger dollar is a reflection of the strength of the U.S. economy". Foreign exchange markets interpreted these statements as supportive of a weaker dollar policy and sent the ICE U.S. Dollar Index, which measures the U.S. Dollar against the Euro, Japanese Yen, British Pound, Canadian Dollar, Swedish Krona, and Swiss Franc, falling below 90 for the first time since December 2014. The dollar was unable to recover its early quarter losses.

Japan / Asia

2017 appears to have been the strongest year of GDP growth for Japan since 2013. This was one of the reasons Bank of Japan (BoJ) Governor Haruhiko Kuroda was reappointed to a second five year term by Prime Minister Shinzo Abe. The move indicates that monetary policy is likely to remain ultra-loose for the foreseeable future. Another indicator supporting Kuroda's new term is Japan's jobless rate which declined to a quarter century low in January to 2.4%, the lowest since April 1993. The hope had been that a much tighter labor market would lead to companies raising wages leading to higher inflation. Thus far it does not appear companies have taken that cue and a recent corruption scandal in the Abe administration has lowered the chances of his reform agenda being implemented which includes incentives and penalties for companies related to wage increases.

While BoJ's Kuroda has been mostly consistent on his insistence of not exiting stimulus any time soon, some indications in March suggest that conversations may have begun internally at the BoJ on when to begin exiting ultra-loose monetary policies. Kuroda has publicly said that he would not begin to remove its aggressive monetary easing program before inflation reaches its goal of 2%. Consumer prices in Japan have risen but remain well below target levels. Ex-food and energy, inflation is picking up but remains at only 0.3%. In addition, recent economic measures suggest a possible moderation of economic growth with both the PMI and BoJ Tankan surveys moderating in March. The Tankan Survey of large manufacturers weakened for the first time in two years during the first quarter as businesses grew cautious about the stronger Japanese Yen and global trade tensions. At the same time the Nikkei Japan Manufacturing PMI softened slightly in March and the Services PMI grew at the slowest rate in 17 months.

Europe

While Eurozone economic activity appeared to be hitting on all cylinders as 2017 wound down, the most recent indicators have disappointed the economic bulls. The ZEW Indicator of Economic Sentiment in Germany declined sharply in March compared to the previous month. ZEW commented that "concerns over a U.S. led global trade conflict have made the experts more cautious in their prognoses. The strong Euro is also hampering the economic outlook for Germany, a nation reliant on exports…" The Trump administration's announcement about tariffs on global steel and aluminum products sent jitters around the global trade export economies of a potential looming trade war. This, in combination with the recent strength of the Euro, has dented business confidence slightly in the Eurozone.

Industrial production for Germany, France, and Spain also disappointed expectations in January. German industrial production contracted 0.1% month-over-month versus estimates of a rise while French industrial production also fell by 2% month-over-month versus expectations of a more moderate 0.4% fall. The slowdown in manufacturing in January appears to have remained in the Eurozone as the March IHS Markit Eurozone Manufacturing PMI indicates some continued softness. The latest PMI fell to an eight month low amid what IHS Markit characterizes as a "broad-based growth slowdown." While the absolute level of the PMI remains elevated and supportive of continuing strong growth, momentum has moderated. IHS Markit states that although "we should not be too worried by the fall in the PMI as some moderation" from the high level should be expected. Moreover, they continued with "the fact that business optimism about the current year has slipped to a 15-month low suggests there are other factors that are now hitting factory order books. The survey suggests export growth has declined significantly since last year with the strong Euro and higher prices largely to blame." All in all, while growth is likely to remain elevated in the Eurozone we are starting to see signs of slowing economic momentum in the near-term.

The European Central Bank (ECB) tightened its message in their March meeting by removing the pledge to buy more bonds if needed. Retreating from this "easing bias" message has been expected by the markets. The ECB has already begun to buy less bonds as of January 2018 and market expectations are that they will talk about an ultimate exit later this year. Most do not expect the ECB to raise rates in 2018, especially given that inflation remains below the 2% target level. However, the ECB staff remains optimistic with its recent upward revision for Eurozone GDP growth for 2018 to 2.4%. They expect inflation to reach 1.4% this year.

Emerging Markets

Final figures confirmed China's economy grew at a 6.9% pace in 2017, the first growth acceleration in seven years. Although growth accelerated to end the year, the Chinese government and most analysts expect softer economic growth closer to 6.5% in 2018. The official PMI index rose in March driving speculation of better than expected growth during the first quarter. Yet, the competing Caixin China General Manufacturing PMI showed softer results with manufacturing activity dipping to a 4-month low. Moreover, the Service PMI Index also moderated in the last month of the quarter with manufacturers and service providers in both surveys noting slower upturns in new order volumes during March.

Politics

Italy's anti-establishment parties made big gains in the national elections during the first quarter. Italian voters delivered sweeping gains for populist and Eurosceptic parties in the general election raising the risk of an anti-EU coalition. With no one party gaining enough votes to govern, the election results pointed to a hung parliament that has yet to be resolved as of this writing.

The governing center-left Democratic Party suffered a significant defeat while the Five Star Movement, led by 31-year old Luigi Di Maio, was the biggest winner of the election.

Corruption allegations and investigations cost the jobs of two presidents in the developing markets with South African President Jacob Zuma and Peruvian President Pedro Pablo Kuczynski both forced to resign during the quarter. Japanese Prime Minister Shinzo Abe is also ensnared in a corruption scandal affecting a land sale. Abe's popularity rating has declined in recent months from this scandal and although it is not expected to cost him his job, analysts worry that it will cause momentum in his aforementioned reform agenda to slow down in the coming year.

President Vladimir Putin secured another 6-year term after winning Russia's presidential election, following 18 years in power either as president or prime minister. In China, President Xi Jinping is set to rule indefinitely after the National People's Congress voted in favor of abolishing presidential term limits. Xi Jinping has now become the most powerful ruler in China since Mao Zedong.

Stock and Portfolio Highlights

Equity markets began the quarter where they ended 2017 with strong positive momentum. January proved to be more of the same from the strong markets of the prior year. However, volatility was just around the corner. Bond yields rose across the globe during the month on expectations of monetary tightening that were confirmed by the stronger than anticipated wage data out of the U.S. Faster than expected wage growth in the United States led to a significant selloff in the equity markets globally as markets began forecasting faster than anticipated monetary tightening amid the possibility of accelerating inflation. The CBOE Volatility Index surged by more than 100% as this "fear gauge" pointed to trouble ahead.

While the wage data and inflation scare subsided after data from March did not confirm a trend, the damage was done and volatility was back in equity markets. This scare, coupled with the Trump administration's newly found trade battle, sent equity markets on another volatile ride in the last two months of the quarter. The Trump administration announced new tariffs on steel and aluminum products while exempting some nations from the order. It appears the main target is China with the Chinese also announcing tit-for-tat tariffs on some U.S. produced goods including wine, pork, and steel pipes. If that was not enough, the Trump administration continued on this road and announced the potential for close to US $50 billion worth of new tariffs on Chinese goods. In summary, trade tremors around the world led to weakness in equity markets due to fears that an all-out trade war had begun. The technology sector, which had been the market leader, also saw some increased volatility following the Facebook scandal affecting the private data of over 50 million of its users.

Small caps outperformed large caps for the quarter while growth outperformed value. The best performing MSCI EAFE markets for the quarter were Finland, Italy, and Portugal while the worst for the quarter were Australia and Ireland. The best performing Emerging Markets for the quarter were Brazil, Egypt, and Peru while the worst performing were the Philippines, Poland, and Indonesia.

Outperformers: Overall sector allocation proved positive for Eagle portfolios during the quarter with overweights to Information Technology and Consumer Discretionary and an underweight to Materials helping returns for the quarter. Good stock selection in Information Technology, Financials, and Materials sectors were additive to the portfolio's relative performance to the benchmark. Exposure to Emerging Markets was also additive in the quarter with Russia and China leading the way. On the developed side, good selection in Singapore was additive while an underweight to underperforming Australia and the United Kingdom was positive.

Disappointments: Eagle portfolios underperformed for the quarter mainly due to stock selection in the Consumer Discretionary and Health Care sectors. Our stake in a French auto parts company was negative as the company reported lower results for the quarter while exposure to a Hong Kong power tools company was hurt by the U.S.-China trade battle. Stock selection in the United Kingdom, Japan, and Switzerland was negative during the quarter while underweights to outperforming Japan and Italy were also detrimental to relative performance.

Purchases / Additions in the Quarter

AerCap Holdings NV (AER): SECTOR: Financials; COUNTRY: Netherlands: The company continues to execute and buy back shares (bought back 25% of market cap the last two years) while valuation is compelling, trading under book value (BV). Aercap continues to sell older airplane assets at above book value justifying a higher valuation. In addition, book value should grow at a double digit rate for the foreseeable future as Aercap returns to asset growth. The combination of book value growth and a potential for a rerating provided an opportunity for us to add to this position.

Arcos Dorados Holdings SA (ARCO): SECTOR: Emerging Markets-Consumer Discretionary; COUNTRY: Argentina: Arcos Dorados is the world's largest McDonald's franchisee, accounting for 5% of global McDonald's sales. Its geographic footprint covers 20 countries and territories across Latin America. An investment in Arcos Dorados offers access to emerging market consumers via a well-established, proven and simple operating model with world-wide brand recognition. We added to the position at a more attractive valuation than the original investment following our increased conviction in the consumption recovery trend in Brazil and Argentina, which produced a significant part of the company's EBITDA.

AXA SA ADR (AXAHY): SECTOR: Financials; COUNTRY: France: The plan to spin off the company's U.S. unit which correlates well with high interest rates could garner good investor interest as interest rates rise in the U.S. Similar spinoffs were positive for Metlife and ING in the recent past. AXA stub has the potential to re-rate as the leftover business is a higher quality business and is not reflected in today's valuation giving us an opportunity to add to this position.

Canadian Pacific (CP): SECTOR: Industrials; COUNTRY: Canada: CP is well positioned to exceed management's 2018 guidance of low double digit EPS growth driven by better-than-expected crude by rail volumes, potential market share gains from their main competitor's network congestion, a better demand environment as well as strong pricing gains. As North America's best run railroad that is trading at a discount to peers, combined with strong free cash flow generation used to increase the dividend and repurchase shares, we decided to add to our position.

ING Groep NV (ING): SECTOR: Financials; COUNTRY: Netherlands: ING has a high cash distribution potential, good quality balance sheet and solid earnings with positive momentum supported by healthy volume growth. We believe ING will be a multi-year capital return story so we decided to add to our position. On our estimates, its dividend payout should increase to 55% and dividend yield to 5.5% over the next three years.

Mitsubishi UFJ Financial (MUFG): SECTOR: Financials; COUNTRY: Japan: MTU is one of the largest banks in Japan and one of the most sensitive to an increase in Japanese interest rates as expectations increase of more normalization in both short and long-term rates. In addition, MTU should benefit from recovering credit demand growth in Asia, improved credit in resource related sectors on higher crude oil prices, and a larger contribution from their stake in Morgan Stanley. MTU also boasts a dividend yield close to 3%, while also buying back shares.

Royal Dutch Shell (RDS.A): SECTOR: Energy; COUNTRY: United Kingdom: Shell is providing a good balance between debt reduction, dividends, capital investments, and share buybacks that should lead to positive shareholder returns in the next few years. This LNG leader is benefiting from better than expected LNG demand and prices which leads to better cash flow for this important division of the company. We expect the company's vast investments in the past are starting to bear fruit leading to brighter prospects not recognized by current valuations, encouraging us to add to this position.

Sony Corporation (SNE): SECTOR: Consumer Discretionary; COUNTRY: Japan: Sony has rebuilt its operating profit (8x growth in 3 years) due to strength in the games, music, and CMOS image sensor business. These businesses continue to grow and outperform street expectations leading to earnings upgrades. We see this path continuing with a bull case operating profit roughly 50% higher than current expectations. We believe the games business has not peaked and there will be continued strong growth in the CMOS business as the number of cameras per phone increases along with a potential automotive opportunity. There could be a potential turnaround of the movies business with a new management team.

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.

Yandex NV (YNDX): SECTOR: Emerging Markets-Technology; COUNTRY: Russia: Yandex is considered the Google and Uber of Russia. It is the leading search engine in Russia and the merger of its car hailing service with Uber Russia creates a near monopoly app in car hailing in Russia. The merger will allow Yandex to build scale and eliminate losses in that business. Secular growth in online advertising will also drive significant revenue growth from their search engine.

Sells / Trims in the Quarter

Cemex (CX): SECTOR: Emerging Markets-Materials; COUNTRY: Mexico: Although CX has been improving it has been mere financial engineering. CX is still heavily indebted at a time where there is a potential negative impact from a continuing weak Mexican Peso, weaker Mexican cement demand from NAFTA renegotiations, and upcoming elections in Mexico where a leftist leader is well ahead in the polls. A negative outcome for one or all of these could hurt profitability and add more pressure to the balance sheet. We decided to sell and redeploy.

Coca-Cola Andina Cl B (AKO.B): SECTOR: Emerging Markets-Consumer Staples; COUNTRY: Chile: The looming termination of the company’s distribution agreement with Heineken in Brazil poses downside risks not priced into current valuation. Competition in its main market of Chile remains fierce and, even though volumes are recovering in Brazil, we believe the current valuation prices in this recovery and decided to sell and redeploy.

NXP Semiconductors NV (NXPI): SECTOR: Technology; COUNTRY: Netherlands: With the stock trading above the Qualcomm offer price and the risk of the deal falling through as Broadcom made an offer for Qualcomm contingent on them giving up pursuit of NXPI, we decided to sell and redeploy elsewhere.

Seven & I Holdings Co Ltd (SVNDY): SECTOR: Consumer Staples; COUNTRY: Japan: Seven and I Holdings is a Japanese retail holding company we originally purchased to gain exposure to the improving prospects of the Japanese consumer and the convenience store brand 7-Eleven. Continued restructuring and increased e-commerce competition has proven difficult for underperforming subsidiaries and masked the better performance of 7-Eleven in Japan and the U.S.

Shire PLC (SHPG): SECTOR: Health Care; COUNTRY: United Kingdom: The company’s Neuroscience division is struggling from few visible growth drivers and its potential spin-off decision has been delayed to the second half of this year. In addition, the important rare disease division is being hampered by increasing competition in hemophilia leading Shire to significantly lower growth and revenue targets. We reduced our position to redeploy.

Swedbank AB (SWDBY): SECTOR: Financials; COUNTRY: Sweden: The Swedish property market has begun cooling off and the company’s significant exposure to mortgages will be affected. This will lead to subpar earnings growth over the next few years and the company’s low leverage to an improving Eurozone economy led us to sell this position.