EAGLE GLOBAL ADVISORS

# Market Review and Outlook
## Q4 2016

# EGA International Equity ADR

From the EGA Portfolio Management Team

### Market Overview

Global markets recovered post the U.S. election but the strong U.S. Dollar muted international returns for USD investors. During the third quarter, the MSCI EAFE Index fell -0.71% in U.S. Dollar terms bringing its 2016 performance to a slim positive +1% while in the U.S., the S&P 500 Index rose +3.82% for the quarter cementing a strong return of +11.96% for 2016.

## The Global Economy

### Global Summary

Global growth expectations ended 2016 on a bright note with PMI indices and OECD's leading economic indicators pointing towards stronger near-term growth in the first half of 2017. The OCED's leading economic indicators paint a picture of steady growth for the developed economies with improving prospects for developing nations. The OECD data suggests global economic growth may be set to pick up in the early months of 2017. Supporting this assessment is the JP Morgan Global Manufacturing PMI index which registered a 34-month high in December. PMI surveyors commented on this PMI survey that "…With rates of expansion in production and new order volumes having gathered pace during the latter part of 2016, the sector will start 2017 on a solid footing with positive momentum building and job creation accelerating". The survey also indicated the pace of expansion in international trade volumes hit a 27-month high confirming that prospects for global trade in 2017, irrespective of the current trade protectionism rhetoric, appear to be improving.

Increasing manufacturing prospects is also leading to cost pressures globally that together with higher oil and commodity prices is placing upward pressure on inflation across most developed economies. Rising inflationary pressures and near full employment prompted the U.S. Federal Reserve to increase rates in its December meeting for the second time in this rate cycle. OPEC's decision to cut oil production for the first time since 2008 led to a rally in energy prices for the quarter. WTI oil prices ended the year about 100% above the low of $26 reached in February 2016. Rising price pressures, Trump's election, and prospects for more interest rate hikes in the U.S. led to a significant rise in the U.S. Dollar in the quarter placing pressure on the U.S. export sector.

In addition, yield curves steepened and overall interest rates rose across the developed world as growth projections improved.

### Japan / Asia

Manufacturing in Japan appears to be undergoing a gradual cyclical recovery. Higher global growth and global trade prospects are supportive for the export-oriented Japanese economy. The strength of the U.S. Dollar versus the Japanese Yen during the quarter has also improved prospects for economic growth amid improved corporate sentiment. The yen depreciated from 102 to the U.S. Dollar to end the quarter near 117. The Nikkei Japan Manufacturing PMI Index hit a 12-month high in December helped by stronger growth in both production and new orders. This optimism has continued to support the labor market as the rate of job creation picked up to a 32-month high while the unemployment rate sits at a two decade low. The frustrating part of these labor statistics is that it has not led to meaningful wage growth and hence, has not helped out the central bank's inflation targets.

Confirming this positive near-term trend was December's Tankan survey of large manufacturers. This sentiment index improved for the first time in six quarters and hit a one-year high. Yet, thus far capex expectations remain somewhat muted and the lack of any inflationary support has kept companies from increasing investment at a sustained pace. The Bank of Japan's monetary policy remains highly accommodative while the government's fiscal stimulus package passed in August should also help 2017 growth prospects.

## Europe

The growth recovery in the Eurozone is set to continue in the first half of 2017. The Markit Eurozone Composite PMI ended the year at the highest level since May 2011 supported by strong manufacturing. Output growth accelerated to a 67-month high while pricing pressures continued to mount. While political concerns remain for the Eurozone in 2017, thus far companies appear to be focused on the improved prospects. Economists at Markit commented regarding the PMI that "…business activity rose at the fastest rate for over five and a half years…benefitting from the weaker euro…For the moment, however, companies are brushing off political worries, with optimism among service sector companies…reviving to one of the highest levels seen for over five years".

Rising commodity and energy prices as well as increasing demand pressures have begun to show up in inflation for the Eurozone. Inflation reached 1.1% in December with core inflation at 0.9%, both still well below the European Central Bank (ECB) targets of "close to 2%". The output gap in the Eurozone remains wide with Eurozone unemployment at a stubbornly high 9.8%. As a result, the ECB extended its bond buying program to the end of 2017 but announced a reduction in the amount of bond purchases from 80 billion euros a month to 60 billion euros a month starting in April 2017. In addition, the ECB also relaxed the rules around the bonds it will buy, now including those bonds with maturities between 1-2 years and bonds with yields below -0.4%.

In the U.K., the manufacturing PMI reached a 30-month high in December. A weak British Pound following Brexit fears has created a boon for the country's export sector. Input costs are under pressure in the U.K. as the rate of cost inflation stood at one of the highest in the PMI survey's 25-year history. With the prospects that U.K. Prime Minister Theresa May will trigger Article 50 EU exit procedures by the end of March, the GBP may remain under pressure given the high uncertainty around Brexit. Yet, supportive of more stability, Mark Carney, governor of the Bank of England announced he would stay an extra year to the middle of 2019 to provide stability in monetary policy until the U.K. leaves the EU.

## Emerging Markets

China's economy maintained a steady pace in 2016 with expectations that growth will end up in the fourth quarter somewhere between 6.5% and 7% bringing its 2016 growth to around 6.7%. We expect slightly lower growth in 2017, closer to 6.5%. While real GDP growth remains on a steady pace downward into the end of the decade, nominal growth has been accelerating as of late providing support for corporate top line growth. China's producer price index (PPI) rose in the fourth quarter for the first time in 54 months providing a positive backdrop for corporate sales growth in 2017. The Caixin China General Manufacturing PMI also showed improvement with the index reporting the strongest upturn in operating conditions for manufacturers since January 2013.

With property prices overheating in some areas of the country, the Chinese government did begin targeted tightening measures in some cities to try and calm pricing increases in property markets. The government also remains committed to a more market-oriented currency pricing and the RMB continued its depreciating trend in the quarter. With U.S. President-elect Trump's anti-China rhetoric, uncertainty remains as to his trade and currency policies towards the world's second largest economy.

In other areas of the world, commodity export countries in the emerging economies are benefiting from rising commodity prices and their currencies have been supported year-to-date. While the recent sharp increase in developed market interest rates and the U.S. Dollar placed a temporary headwind for emerging asset prices and currencies, economic prospects appear to be brighter in the emerging economies going into 2017.

## Politics

The populist backlash that led to the election of Donald Trump in the U.S. concerns many observers as we enter some pivotal elections in Europe in 2017. The Netherlands, France, and Germany all go to the polls in a year that is seen as pivotal for the continuation of a united Europe. A key event is the French presidential election where anti-Europe candidate Marine Le Pen remains in second place on a runoff vote in the polls.

Nervousness around the accuracy of polls, after miscalculations in the Brexit and U.S. elections vote, leaves many uneasy as the French election nears in the second quarter of this year.

Populists also won a victory in Italy as constitutional reforms put forth by the Italian government were handily rejected by voters, prompting the resignation of Prime Minister Matteo Renzi. New parliamentary elections may also be a possibility in Italy in 2017. Yet, euro sceptics were not handed a victory in Austria as voters there elected Alexander Van der Bellen, a Green politician who ran as an independent against his far-right opponent and euro sceptic Norbert Hofer. Turkey's President Erdogan extended his emergency powers after the latest terrorist attack in the country, prompting concern about his desire to overhaul the constitution to increase his presidential powers.

In the Far East, South Korea's president was formally impeached amid a corruption scandal where President Park Geun-hye was accused of leaking confidential presidential documents and helping friends extract money from major corporations. In Thailand, the world's longest serving monarch, King Bhumibol Adulyadej passed away leading to a yearlong mourning in the country and a possible bout of instability while the country remains under military rule.

## Stock and Portfolio Highlights

Improving global growth prospects and the election of Donald Trump quickly injected life into the equity markets for the last 2 months of the year. Interest rates and expectations for higher rates quickly rose prompting a significant backlash for interest rate sensitive sectors in the market including Utilities and REITs. These "bond proxies" suffered amid rising rates. Conversely, the Financials sector benefitted from rising yield curves and the prospects of higher interest rates in 2017. U.S. and international equity markets rallied in the final quarter of the year but a sharp rally in the U.S. Dollar dented international equity returns in USD. The MSCI EAFE Index rose 7% in local currency terms in the fourth quarter but posted a negative return in dollars as the USD rallied versus major currencies.

OPEC's decision to cut oil production for the first time since 2008 led to increased confidence in oil markets with oil prices rising quickly during the quarter and Brent and WTI prices ending the year close to 100% above their February lows. This led to the Energy sector being the best performing sector for the quarter.

Improving growth prospects as seen in global PMI indices paints a positive picture for the beginning of 2017. Inflation expectations have risen in the developed world which could mean an end to the ultra-accomodative monetary policies adopted by major central banks since the financial crisis. The Federal Reserve has signaled the potential for more rate increases in 2017 while the European Central Bank and Bank of Japan remain committed to ultra-low rates and asset purchases.

The main risks to rising international equity prices in 2017 remain the ever important major elections in Europe that could tip the balance of the EU and the euro into uncertainty, as well as potential prospects for interest rates to rise too quickly. While China is likely to remain in the headlines given its economic importance and Trump's presidency, we believe that China is less of a risk for equity markets in 2017. If current projections do pan out and global trade volumes finally begin to improve in 2017, export-oriented economies will benefit including most of emerging Asia and Japan. The evolution of Brexit discussions also creates uncertainty for equity markets there, but given the massive correction of the GBP to date, we believe the majority of that uncertainty has been priced in by the markets.

Large caps outperformed small and mid-caps for the quarter bringing their year to date performances to similar levels. EAFE value crushed growth for the quarter leading to a significant gap in their performances for the year with value outpacing growth by more than 800bps in 2016. The best performing MSCI EAFE markets for the quarter were Italy, Austria, and France while the best for 2016 were New Zealand, Norway, and Australia. The worst for the quarter were Belgium, Israel, and New Zealand while the worst for the year were Israel, Denmark, and Italy. The best performing emerging markets for the quarter were Russia, Greece, and Hungary while the worst performing were Egypt, Turkey, and the Philippines. We believe valuations remain attractive for international equities in both developed and emerging markets.

**Outperformers:** Eagle portfolios slightly outperformed the MSCI EAFE Index for the quarter. Energy, Materials, and Financials sectors were the best performing sectors in MSCI EAFE for the quarter given higher commodity prices and steepening yield curves. Eagle portfolios benefitted from being void the bond proxy REIT sector while overweights in the outperforming Energy, Financials, and Consumer Discretionary sectors provided positive alpha. Good stock selection in Industrials was also beneficial. Positive stock selection in the Netherlands, Japan, and Hong Kong also helped the portfolio outperform.

**Disappointments:** An underweight to the Materials sector and an overweight to the Telecom Services sector were headwinds to the portfolio in the quarter. Stock selection was negative in the IT, Health Care, and Financials sectors. Country selection in the U.K. and Switzerland were negative contributors to portfolio performance. Bond proxies and over-extended defensive industries underperformed during the quarter as growth prospects improved and cyclicals sectors outperformed.

## Purchases / Additions in the Quarter

**A.P. Moller-Maersk (AMKBY):** SECTOR: Industrials; COUNTRY: Denmark: Consolidation and rationalization in the container shipping industry indicates the early stages of improvement for supply/demand balance. Maersk, the largest and most efficient shipper in the industry is set to benefit from these improving fundamentals. This improving industry dynamic combined with plans to split the company into two divisions could unlock additional value for shareholders.

**Arkema SA (ARKAY):** SECTOR: Materials; COUNTRY: France: Arkema has made significant strides since being spun off from Total SA 10 years ago. Highly cyclical products now account for only 30% of its business versus 65% seven years ago. The company is also more balanced with better exposure to growth markets. We believe the market has not yet given the stock the benefit of this transformation and growth potential.

**Cemex ADR (CX):** SECTOR: Materials; COUNTRY: Mexico: We added to our Cemex position as the company continues to execute on its profitability and debt paydown plans. The company has been divesting assets globally, refinancing debt maturities and using all free cash flow to reduce high debt levels from past acquisitions. Continued positive industry dynamics should allow Cemex to continue generating high amounts of free cash flow.

**Kingfisher PLC (FPAFY):** SECTOR: Consumer Discretionary; COUNTRY: U.K.: Kingfisher is the market leader in the oligopolistic DIY segment in the U.K. and France. The company's ONE Kingfisher program is on track toward delivering significant improvements in operating margins and earnings growth not recognized by current valuations.

**Nippon Telegraph & Telephone (NTT):** SECTOR: Telecom Services; COUNTRY: Japan: We added to our position in NTT, Japan's leading telecom services operator. The company continues to generate strong free cash flow that it is using to increase remuneration to shareholders through dividend growth and share buybacks. We believe the market is not rewarding NTT for its growth prospects and dividend and free cash flow growth potential.

**Petrochina Co Ltd (PTR):** SECTOR: Energy; COUNTRY: China: Petrochina is China's domestically oriented oil major with significant exposure to land-based upstream projects in China and midstream with the largest pipeline network in the country. The stock has not participated as much as oil prices have risen globally and we believe will play catch up. Moreover, the potential for a spinoff or restructuring of its pipeline division could unlock significant value for shareholders while in the near-term, local gas tariff increases are supportive to cash flows.

## Sales / Trims in the Quarter

**Nissan Motor Co Ltd (NSANY):** SECTOR: Consumer Discretionary; COUNTRY: Japan: Concerns about a slowdown in the U.S. new vehicle market are increasing at a time of historically high volumes. Nissan is also highly exposed to trade policy risk as the company's U.S. production is low compared to its sales in the country. We exited this position to redeploy to more attractive companies.

**ONO Pharmaceutical Co Ltd (OPHLY):** SECTOR: Health Care; COUNTRY: Japan: Disappointing top line projections for the company's blockbuster cancer drug Opdivo drove us to revise down our prospects for the stock in the medium-term. With a large price cut for Opdivo in Japan brought forward to 2017 and lowered expectations for the drug's extension into other treatable areas, we exited this position to redeploy to more attractive opportunities.

**Sanofi (SNY):** SECTOR: Health Care; COUNTRY: France: Sanofi continues to encounter sales erosion and pricing pressure to its key drug franchises while little earnings growth is expected until 2018. While we do not think the dividend is at risk, the lack of any earnings visibility in the medium-term and the potential for expensive M&A to compensate for this led us to exit this position.