Market Review and Outlook

Q4 2017

EGA International Equity ADR

From the EGA Portfolio Management Team

Market Overview

Rising confidence across the globe continued to support positive momentum in equity prices. The MSCI EAFE Index rose 4.2% in U.S. Dollar terms in the fourth quarter bringing its year-to-date return to 25% as compared to the U.S. where the S&P 500 rose 6.6% for the final quarter and 21.8% for the whole of 2017.

The Global Economy

Global Summary

The global economy remains underpinned in a "goldilocks" scenario of near synchronized global growth, the first time since the financial crisis almost a decade ago. Strong economic growth, low inflation, and benign central bank policies provide ample amounts of liquidity to the world's economic system. The latest International Monetary Fund World Economic Outlook from October 2017 agrees. IMF economists claim that the "global upswing in economic activity is strengthening" and expect continued strong growth. The IMF raised its forecasts for global GDP growth to 3.6% in 2017 and 3.7% in 2018 from a base of 3.2% in 2016. Even with the stronger GDP data the IMF states that "the recovery is not complete…growth remains weak in many countries…and inflation is below target in most advanced economies".

The latest JP Morgan Global All-Industry Output Index, a global composite PMI measure, appears to support the strength in economic activity after expanding for 63 successive months in December. According to the survey, output growth accelerated in both the manufacturing and services sectors with the Eurozone remaining the strongest performing region. The survey also shows employment rising at the fastest pace globally in the last 7 years. Strong consumer and business confidence is seen in many parts of the world with rising household consumption and strong PMI indices across most of Europe. Most emerging markets are also participating in the stronger economic activity as global trade has improved and external demand remains robust.

In spite of the strong economic growth and rising employment, inflation in most advanced economies remains muted. While there are pockets of wage growth picking up in some countries, overall wage growth is weak in spite of job gains and lower unemployment in many countries. The lack of current inflationary pressure means central banks are likely to remain very accommodative. The U.K. has joined the U.S. in raising rates given higher inflationary pressures in the U.K., but other major central banks, including the Bank of Japan and the European Central Bank, have yet to signal rate increases any time soon. Inflation will be important to monitor in the coming year to gauge any changes in monetary policies across the globe.

Japan / Asia

Positive momentum remains in the Japanese economy. The latest Nikkei Japan Manufacturing PMI is at a 46-month high while the latest Bank of Japan Tankan survey of business confidence among Japan's large manufacturers moved to an 11-year high in December. The better economic data helped Prime Minister Shinzo Abe make gains in the latest general election providing him ample room for his reform agenda in the coming year. While labor conditions remain extremely tight with the ratio of applicants to open jobs at its highest since 1974, wage growth overall is weak. Even though unemployment reached a 24-year low of 2.7% in November, inflationary pressures are subdued.

The Bank of Japan (BoJ) continues to maintain a very aggressive monetary accommodation stance with its most recent anchoring of the 10-year yield at close to zero with its asset purchases. While there is talk of a slight anchoring to shift at some point this year, the BoJ is likely to remain very accommodative in the foreseeable future. Bank of Japan Governor Kuroda's term expires in March of 2018 and consensus indicates that PM Abe will reappoint Kuroda to another term to maintain stability in monetary policy. Kuroda's 2% inflation target does seem unattainable in the near-term, although according to the most recent PMI survey, the current run of inflation at 12 months is the longest since a 15-month stint ending in November, 2008.

Europe

The Eurozone appears to be firing on all cylinders. Whether or not you agree with the unorthodox monetary policies of the European Central Bank, the ample liquidity conditions have improved consumer, business, and investor confidence. The latest IHS Markit Eurozone Composite PMI points to economic growth at the highest since early 2011 with momentum expected to continue. IHS Markit states that "a stellar end to 2017 for the Eurozone rounded off the best year for over a decade…with no sign of momentum being lost as we move into 2018". Household consumption has led the way with better labor conditions amid employment gains, and recent data suggests that public and private expenditures are also improving.

Following very strong economic data, the European Central Bank (ECB) announced in its October 2017 meeting that it would reduce the rate at which it purchases government bonds from EUR 60 billion per month to EUR 30 billion per month starting in January 2018. Yet, it did extend the buying to at least September of 2018 while leaving open the possibility of further extensions to Quantitative Easing (QE). ECB President Mario Draghi stressed at the press conference following the meeting that continued monetary stimulus is needed to get inflation to the central bank's target of 2%. Core inflation in the Eurozone is hovering around 1% leading most to expect a very gradual normalization of monetary policy in the region during the next two years.

While the Eurozone is hitting on all cylinders, the U.K. has not had the fortune of positive economic momentum like its neighbors. Even though home price inflation and overall growth is moderating, the Bank of England decided to raise rates for the first time in a decade due to inflation above its target levels. Inflation in the U.K. has risen to 3.1%, above the BoE's 2% target. The U.K. Markit PMI survey suggests that Brexit is partly to blame for the lack of growth momentum in the economy as it comments that "service providers noted that Brexit-related uncertainty continued to hold back clients willingness to spend".

Emerging Markets

The accommodative global financial environment and recovery in advanced economies is supportive to emerging market growth prospects. A number of economies that slipped into recession in 2016, including Russia and Brazil, are now in recovery mode as commodities have rebounded and external demand has improved. This improvement in emerging market growth should remain well balanced into the new year. The latest Nikkei India Manufacturing PMI shows the strongest improvement in manufacturing conditions in India since 2012. This strong backdrop as well as success in the reform agenda led Moody's to upgrade India's sovereign rating for the first time in 13 years.

China's growth in 2017 surprised to the upside in spite of continued efforts to reign in property prices and local debt financing schemes. While some analysts remained pessimistic as to China's prospects, the economy is likely to have grown at a higher than expected 6.8% pace in 2017. Most believe that growth will slow in 2018 with expectations that the National's People's Congress in March will set a target of mid 6% growth for 2018. Caixin's China General Manufacturing PMI showed some improvement toward the end of 2017 with stronger increases seen in output and new orders while confidence remained weak. It does however point out that "…we should not underestimate downward pressure on growth next year (2018) due to tightening monetary policy and strengthening oversight on local government financing". We expect a continued gradual decline in China's growth rate to the end of this decade as the government's goal moves from quantity to quality.

Politics

China's Xi Jinping emerged from the 19th Communist Party Congress unopposed and with greater powers. The Congress also voted to include "Xi Jinping Thought" into the country's constitution, a sign of his increasing power base. We expect a continuation of his policies for the foreseeable future. His adding the word "beautiful" to one of China's goals stresses the importance of the current attention on environmental concerns in the country.

In Europe, Austria elected the world's youngest leader in Sebastian Kurz, whose primary rhetoric revolved around anti-immigration policies. Catalonians voted for independence in Spain, but while Catalonia's parliament voted to declare the region independent, the national government threatened significant legal action against Catalonia for a vote it sees as illegal. Tensions flared in the country and all is not well in Spain as we enter 2018. Italy will be holding elections this March 4th after the president dissolved parliament. Elections there will be closely watched for any resurgence of anti-EU parties.

Brexit concerns waxed and waned during the last quarter of the year with phase one negotiations stalling on several fronts only to have both parties, Britain and the EU, reach agreement on exit terms in early December. The historic deal will open the way for phase two of the negotiations that will include tough trade talks. In Germany, Angela Merkel is yet to form a new coalition government after elections were held in September. Coalition talks previously failed during the quarter and she has shifted her attention to a different grand coalition. Talks will restart in January and markets will be waiting for a resolution to the unanswered question of governance in Germany. An inability to form a working government would be a negative surprise.

Stock and Portfolio Highlights

Equity markets continued to climb higher in the fourth quarter as investor optimism boosted share prices. Strong global economic conditions and accelerating economic momentum helped earnings growth for the year. 2017 will be the first year of double digit EPS growth for the MSCI EAFE Index since 2010 and only the third year of positive EPS growth in the last 8 years according to FactSet estimates. FactSet bottom-up estimates suggest EPS growth of more than 20% in 2017 for the MSCI EAFE Index boosted by strong sales growth and margin improvements. Estimates suggest earnings growth will continue in 2018 underpinned by strong economic conditions leading to consumer buying, private and public investment, and export growth. Animal spirits have been awakened in Europe.

The dollar depreciated for most of 2017 leading to a nice tailwind for international equity returns for U.S. Dollar investors. Most developed and emerging market currencies appreciated versus the dollar with the euro and the Danish Krone leading the way in developed markets while the Czech Koruna and the Polish Zloty were the firmest versus the dollar in the emerging markets. Significant euro strength from here could dent GDP growth in the region as exports would be impacted by a strong currency. Central banks in Europe and Japan remain highly accommodative and should continue to provide significant amounts of liquidity. Financial assets are benefiting from this ample liquidity and strong economic backdrop. While the Federal Reserve has increased interest rates and begun to scale back its balance sheet, the ECB is only now scaling back its QE purchases and the BoJ has not given any hints about its next move.

Small and mid-caps continued to outperform this quarter, widening their leads versus large-caps for the year. Growth outperformed value for the quarter improving its outperformance for 2017. The best performing MSCI EAFE markets for the quarter were Singapore, Japan, and Australia, while the worst for the quarter were Sweden, Finland, and Italy. The best performing emerging markets for the quarter were South Africa, Greece, and India, while the worst performing were Mexico, UAE, and Egypt.

Outperformers: Eagle portfolios performed well for the quarter matching the strong performance of the MSCI EAFE Index. Strong stock selection in the Consumer Discretionary, Financials, and Health Care sectors helped performance. Exposures to the banking industry in Singapore, a global leading power tools supplier from Hong Kong, and a casino operator in Macau were important to the strong performance in the fourth quarter. Country selection was best in Singapore, Hong Kong, and Spain while an allocation to Canada also helped.

Disappointments: Country selection in Japan and an allocation to China and Mexico were detrimental to performance for the quarter. From a sector standpoint, security selection in the Materials, Information Technology (IT), and Energy sectors hurt. An underweight to the Materials sector was also detrimental as that sector outperformed for the quarter. China IT gave back some of its gains during the quarter while Mexican cement unperformed due to disruptions from Hurricane Harvey and complexities of NAFTA renegotiations.

Purchases / Additions in the Quarter

AIA Group Limited ADR: SECTOR: Financials; COUNTRY: Hong Kong: AIA is the leading insurer in the Asia Pacific region. The company has solid ROE, best in class execution, and secular growth prospects from continued insurance penetration in the region. Prospects are bright for this insurer, driven by continued secular gains in China and recoveries in Singapore and Thailand.

Arcos Dorados Holdings SA (ARCO): SECTOR: Emerging Markets-Consumer Discretionary; COUNTRY: Argentina: Arcos is the largest McDonald's franchisee running over 2,100 restaurants in Latin America and accounting for 4.5% of MCD's global sales. Macroeconomic recovery in key Latin American markets should set the company up for a long growth runway of increasing sales.

British American Tobacco (BTI): SECTOR: Consumer Staples; COUNTRY: United Kingdom: BAT is one of the leading global tobacco companies. Its recent closure of the acquisition of Reynolds America provides opportunities for positive surprises on synergies. Worries about FDA regulation of nicotine provided a buying opportunity to add to this position. We are also encouraged by the progress of Glo (the company's heat, not burn product) in Japan. We believe BAT's FCF yield of 5%, dividend yield of 3.9% and projected 2018 EPS growth of 8% are attractive.

Melco Resorts Entertainment (MLCO): SECTOR: Consumer Discretionary; COUNTRY: Hong Kong: Melco is one of the leading operators in the gaming industry in Macau. After two years of industry pressures from regulators, Macau gaming appears to be entering a period of sustained upcycle and has begun to outpace expectations. Melco's premium mass exposure positions the company well in the ongoing gaming market recovery.

Tencent Holdings ADR (TCEHY): SECTOR: Emerging Markets-Information 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-Information Technology; COUNTRY: Russia: Yandex 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

Iberdrola SA ADR (IBDRY): SECTOR: Utilities; COUNTRY: Spain: After a significant rise in the share price of Iberdrola, the share price had reached a level that provided little expected upside. This, at a time of significant uncertainty for Spain with the Catalonia independence vote, led us to sell and redeploy to more attractive areas.

National Grid (NGG): SECTOR: Utilities; COUNTRY: United Kingdom: Major headwinds abound for the company's U.K. business, while the U.S. subsidiary performs well. In the U.K., weaker economic growth is likely to lead to lower growth prospects and pressure from the regulator could force much lower allowed returns for this utility for years to come.

Orange SA (ORAN): SECTOR: Telecom Services; COUNTRY: France: Competition in France remains challenging for Orange. The regulator is also focused on additional fiber investment that may hurt Orange in the medium-term. The chances for industry consolidation are uncertain while the Orange Bank initiative is likely to create headwinds to operations.

Prosieben Media SE ADR (PBSFY): SECTOR: Consumer Discretionary; COUNTRY: Germany: Prosieben provides free-to-air and pay TV broadcasting services in Germany, Austria, and the German speaking part of Switzerland. The cash cow nature of the broadcast TV business and the growth optionality offered by digital businesses were the key tenets of our investment thesis. However, a recent decline in broadcast TV advertising revenue and subpar growth in the streaming video service has changed our opinion on the health of the business.

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.

Siemens AG ADR (SIEGY): SECTOR: Industrials; COUNTRY: Germany: We trimmed our position as power industry fundamentals have deteriorated causing a headwind for operational results for Siemens. The addition of the Gamesa wind into its renewables business is causing integration problems at a time of weaker industry pricing. While restructuring still continues to bear fruit, we believe the announcement of its health care spinout is mostly in the price.