Eagle Insight

EAGLE | Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

All Cap Equity

First Quarter | 2018

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Value investing is based on the potential for a company's stock price to rise based upon anticipated changes in the market or within the company itself. Value stocks have historically been sensitive to economic cycles and investor sentiment that can affect volatility and risk.

Market Overview

After gaining 7 percent to start the year, the broad U.S. equity market (as measured by the Russell 3000® Index[1]) traded lower (-0.8 percent) in the first quarter for the first quarterly loss since 2015. A spike in volatility triggered the selling, followed by fears over potential regulation of many of the market's best-performing technology stocks. The selling intensified as news from Washington centered on new tariffs against China, sparking fears over a potential trade war endangering a $600 billion relationship. This quarter also featured new Federal Reserve Chairman Jerome Powell leading his first increase in the Federal Funds rate; Congress passing a spending bill; and oil prices trading higher, further increasing inflation concerns.

Portfolio Review[2,3]

Eagle All Cap Equity portfolios underperformed the benchmark Russell 3000® Index during the first quarter. The growth-over-value trade intensified with the Russell 3000® Growth Index (up 1.5 percent) outperforming the Russell 3000® Value Index (down -2.8 percent).

We had poor stock selection in the consumer discretionary, energy and healthcare sectors. On the other hand, an underweight in utilities continued to benefit the strategy.

Cisco Systems returned to revenue growth after facing headwinds during its transition to a recurring-revenue model. The company also announced it would bring back all foreign cash ($65 billion) and return it to shareholders. Cisco increased its dividend 14 percent and added $25 billion to its share-buyback program.

Microsoft announced impressive quarterly revenue growth, particularly in the cloud business. Margins also continued to grow impressively.

Total System Services also announced strong earnings on accelerating growth. The company said it should be a beneficiary of the new U.S. corporate-tax package.

AMETEK announced strong quarterly results as earnings continued to accelerate. The company said orders are up at a double-digit rate. The company continues to look attractive to us on a free-cash-flow basis.

Results were better-than-expected at BB&T. The company continues to progress on the operating-leverage front, leading to a solid earnings outlook.

Devon Energy announced lower-than-expected earnings; however, it said the miss was due to a change to a more conservative accounting measure. Positively, the company announced a new three-year operation plan, including selling more than $3 billion of non-core assets while increasing production by 25 percent. Devon plans to reduce leverage with excess cash-flow while returning the rest to shareholders.

Procter & Gamble reported in-line earnings but traded lower due to sluggish sales growth. However, the company raised the upper end of its earnings outlook and increased its range of buybacks.

Weaker-than-expected margins hurt the share price of Tupperware, which said it was hurt by a devaluation of Venezuelan currency. Earnings were better than expected and the company said it is progressing nicely on its re-engineering program.

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Citigroup underperformed due to a lower degree of perceived asset-sensitivity in a rising-rate environment. Banks' balance sheets can change with fluctuations in interest rates and those that are perceived to have their assets reprice more slowly underperformed.

Occidental Petroleum traded lower with its energy-sector peers. The sector was hit hard during the February, trading down 10.8 percent. Occidental, however, is ahead of schedule in its plan to become cash-flow breakeven at $50/barrel. Occidental also has several non-core operations for sale.

Outlook[2]

The U.S. stock market entered 2018 looking a lot like 2017: low volatility, a broad advance led by large technology stocks and investors optimistic (if not complacent). But something changed around mid-January. Volatility resurfaced with a vengeance. The proximate cause of the early downdraft in stocks was growing concerns about inflation and interest rates. But as the quarter unfolded, volatility continued, new concerns arose about a trade war with China and there was real questioning of some large-cap tech companies' business models added to the mix. Consequently, the U.S. market recorded its first quarterly decline since 2015.

The volatility and concerns continue as we enter the second quarter. But stepping back from the day-to-day ups and downs of the market, we continue to believe that the underlying fundamentals are sound. None of the normal, historical precursors of recession and bear markets are present. Economic growth is solid almost anywhere one looks around the world. In the United States, we expect gross domestic product (GDP) growth to improve from the approximately 2 percent annual rate it has been stuck at since the financial crisis now nearly 10 years in the past. After years of under-investment, domestic capital spending is poised for acceleration. Led by surging employment growth and abetted by somewhat better wages and lower taxes, household incomes are growing again. Housing construction activity, which historically has been a key driver of U.S. economic growth, is set to accelerate based on demographics and underinvestment since the crisis in 2007-2008. Earnings growth this year should approach 20 percent, boosted by the recently enacted tax bill and faster GDP growth.

To be sure, there are concerns on the horizon … but there always are. The Federal Reserve likely will continue to normalize interest rates this year. There is a grand debate about how many times the Fed will raise rates. Our position is informed by the straightforward observation that gradually rising interest rates – from a low level, impelled by stronger economic growth – historically have not been an impediment to higher stock prices. We believe there is still enough slack in the global markets for goods, commodities and labor to keep inflation at or below most central banks' 2 percent target.

It is possible to paint a dire picture based on a spreading trade war with China and that possibility cannot be ruled out completely. But, in our experience, it is wiser to position portfolios for the most likely outcome and not for a high-risk-but-low-odds result. We believe that, in spite of some real economic concerns and grievances, the impending "trade war" is mostly political posturing and neither side would benefit from a significant escalation.

Top 10 Holdings

Darling Ingredients
Microsoft
AMETEK
Intercontinental Exchange
Procter & Gamble
Citigroup
Delta
AT&T
Apple
Carnival

The information provided above should not be construed as a recommendation to buy, sell or hold any particular security. The data is shown for informational purposes only and is not indicative of future portfolio characteristics or returns. Portfolio holdings are not stagnant and may change over time without prior notice. Past performance does not guarantee future results. Please note that the holdings identified do not represent all of the securities purchased, sold or recommended for the composite. They are provided for informational purposes only. Eagle, its affiliates or their respective employees may have a position in the securities listed. Please contact your financial advisor to obtain the calculation's methodology and/or a list showing every holding's contribution to the overall composite's performance during the measurement period.

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	Top Securities	Average Weight (%)	Security Contribution to Portfolio Return	Bottom Securities	Average Weight (%)	Security Contribution to Portfolio Return
All Cap Equity	Cisco Systems	2.90	0.31	Devon Energy	2.08	-0.53
	Microsoft	4.71	0.30	Procter & Gamble	3.74	-0.49
	Total System Services	2.95	0.22	Tupperware Brands	2.06	-0.47
	AMETEK	3.71	0.15	Citigroup	3.77	-0.35
	BB&T	2.35	0.10	Occidental Petroleum	1.91	-0.28

* as of March 31. The information provided above should not be construed as a recommendation to buy, sell or hold any particular security. The data are shown for informational purposes only and are not indicative of future portfolio characteristics or returns. Portfolio holdings are not stagnant and may change over time without prior notice. Past performance does not guarantee future results. Please note that the holdings identified do not represent all of the securities purchased, sold or recommended for the composite. They are provided for informational purposes only. Eagle, its affiliates or their respective employees may have a position in the securities listed. Please contact your financial advisor to obtain the calculation's methodology and/or a list showing every holding's contribution to the overall composite's performance during the measurement period.

That said, we have to acknowledge leaders make irrational mistakes and, until the air clears, this concern likely will weigh on stocks. Further, it may prevent stronger earnings growth from being fully translated into higher stock prices.

Market corrections such as the ongoing one often have ushered in a change in market leadership. We believe it is quite likely that the technology sector – and especially social-media companies – may struggle for a while. Business models are being questioned if not attacked outright, valuations seem extreme and the sector is approaching the same share of the market's capitalization that it held during the "internet bubble" that disastrously ended in 2000. A commonly referred to grouping of the most popular technology stocks (a social-media stock, the world's largest online retailer, an online entertainment company and the world's largest search-engine company) sell at 133 times current earnings and 73 times 2018 estimates. That compares to about 17 times earnings for the S&P 500. These four stocks also comprise nearly 8 percent of the S&P 500's market capitalization.

We expect, on the other side of this correction, a much more "democratic" market with many more stocks and sectors showing good performance on the basis of earnings and attractive valuations. We believe a reversal of the dominance of growth stocks compared to value stocks may well be under way. Also, we would expect an attraction to companies with growing dividend streams to re-emerge in a still-low interest-rate environment.

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[2] References to specific securities are intended to illustrate the types of securities Eagle may hold in this portfolio. They are not intended as representations of specific investment recommendations that would have been profitable to an investor. Past performance is not a guarantee of future results. Opinions and estimates offered constitute Eagle's judgment and are subject to change without notice as are statements of financial-market trends, which are based on current market conditions. Investing involves risk, including the possible loss of principle.

[3] Source: FactSet