Eagle Insight

EAGLE Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

Equity Income

First Quarter | 2018

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The risks associated with Equity Income investing are based upon the identification of companies that possess both moderate growth rates as well as higher-than-average and consistent dividend distributions. There are risks associated with dividend investing, including that dividend-issuing companies may choose not to pay a dividend, may not have the ability to pay or the dividend may be less than what is anticipated. Dividend-issuing companies are subject to interest-rate risk and high dividends can sometimes signal that a company is in distress. Historically, dividend yields have been relatively constant and therefore have created a cushion for investors when stock prices have declined. However, as with all equity investing, there is the risk that a company will not achieve its expected earnings results, or that an unexpected change in the market or within the company will occur, both of which may adversely affect investment results. The biggest risk of equity investing is that returns can fluctuate and investors can lose money.

Market Overview

After gaining 7 percent to start the year, the broad U.S. equity market (as measured by the S&P 500 Index) 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[1,2]

Eagle Equity Income portfolios underperformed the benchmark S&P 500 Index during the first quarter. The quarter began with many of the same themes from 2017 but was followed by two sell-offs. The first was technical in nature and the wide breadth caused all stocks to trade lower. The second sell-off was more classic and our portfolio behaved the way it was designed. That is, we captured about 70 percent of the downside during this second sell-off. Overall, our strategy has captured less downside than many of our dividend-oriented peers since the market peaked Jan. 26. The dividend-payer headwind continued during the quarter with above-median dividend-paying stocks underperforming their non-dividend paying counterparts by 8.24 percentage points.

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 (USD 65 billion) and return it to shareholders. Cisco increased its dividend 14 percent and added USD 25 billion to its share-buyback program.

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

Lockheed Martin produced stronger-then-expected revenue and earnings on an increase in F-35 deliveries. Its helicopter segment was also particularly strong. The company also increased guidance mostly tied to the new U.S. tax package. Visibility on growth in defense spending also became clearer.

PNC Financial announced positive quarterly earnings. The company is expected to benefit from U.S. corporate-tax reform and will now have a 17 percent tax rate. A higher 10-year Treasury also benefited the company because it is highly asset-sensitive.

Total continued to perform well with higher oil prices. The company announced higher-than-expected earnings. The company has completed a large capital-expenditure investment cycle and is now reaping the benefits of those investments.

Wells Fargo stock underperformed primarily as a result of the Fed's announcement that it is placing an asset cap on the bank, thereby preventing it from growing beyond 2017 levels. The cap is expected to reduce earnings 1 percent-3 percent, which we believe is a modest headwind, and we are hopeful that it is lifted by year-end 2018. Finally, we note that the Fed didn't identify any new issues.

Altria continued to trade lower on news that the U.S. government was planning to pursue restrictions on the amount of nicotine allowed in cigarettes. However, lower nicotine levels in each cigarette may simply lead to smokers consuming more cigarettes. The stock traded lower with all consumer staples, the quarter's worst-performing sector.

Occidental Petroleum traded lower with the entire energy sector. The sector was hit hard during February, trading down 10.8 percent. The company, however, is ahead of schedule in its plan to become cash-flow breakeven at $50/barrel, expecting to cover both drilling and completion capital expenditures as well as the dividend. Occidental also has several non-core operations for sale.

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.

Johnson & Johnson underperformed despite reporting solid earnings and initial 2018 guidance while also obtaining early federal approval for a new prostate-cancer drug. The stock's weakness can be attributed to a modest slowdown in the company's projected revenue-growth profile.

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 underinvestment, 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.

Top 10 Holdings

Microsoft
JPMorgan Chase
PNC Financial Services
Apple
Lockheed Martin
Honeywell
Carnival
Home Depot
Pfizer
Johnson & Johnson

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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Equity Income	Top Securities	Average Weight (%)	Security Contribution to Portfolio Return
	Cisco Systems	3.09	0.34
	Microsoft	4.65	0.30
	Lockheed Martin	3.60	0.19
	PNC	4.26	0.18
	Total	2.66	0.15

Bottom Securities	Average Weight (%)	Security Contribution to Portfolio Return
Wells Fargo	2.79	-0.38
Altria Group	2.45	-0.30
Occidental Petroleum	2.51	-0.28
Procter & Gamble	2.09	-0.28
Johnson & Johnson	3.39	-0.26

* 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.

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. 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.

Consequently, we view our strategy of investing in high-quality, financially strong companies that pay above-market dividends and have cash resources to increase dividends regularly as well-positioned to benefit from this trend.

[1] 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.

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[2] Source: FactSet