Eagle Insight

EAGLE Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

Equity Income

Third 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

The broad U.S. equity market (as measured by the S&P 500 Index) delivered a total return of 7.7 percent during the third quarter. This brings total year-to-date performance to 10.6 percent. As strong as the market has been, the strength has been limited to U.S. stocks. Corporate profits remain strong with consensus estimates for third-quarter earnings per share up 21 percent year-over-year. The labor market remains tight as unemployment stayed just below 4 percent and the surveys of consumer and business confidence levels continue to show economic health. While trade is still a potential risk, it appears the market has discounted the effects from any significant escalation.

Portfolio Review[1,2]

The Equity Income portfolios outperformed (on a gross and net basis) the benchmark S&P 500 Index during the third quarter. The dividend yield headwind subsided during the quarter, with dividend-paying stocks (up 7.8 percent) performing relatively in-line with their non-paying counterparts (up 7.3 percent).

During the quarter, the Global Industry Classification Standard (GICS) was updated to broaden/rename the Telecommunication Services to Communication Services. Seeing as the change occurred during the quarter, we will discuss the portfolio in the context of both classifications. Beginning in the fourth quarter, we will begin using only the new standard.

Historical GICS classification –
Stock selection in information technology, industrials and health care contributed positively to outperformance. Our average weighting of approximately 3.1 percent cash was our largest detractor. Stock selection in utilities and an overweight position in energy also hurt performance.

New GICS classification –
The newly expanded Communication Services sector led performance due to both strong stock selection and an underweight position. Stock selection in industrials and health care also contributed positively to performance. Our average weighting of approximately 3.1 percent cash was our largest detractor. Stock selection in utilities and an overweight position in energy also hurt performance.

Apple stock traded higher after the company announced better-than-expected revenues and earnings. Management also raised revenue guidance and noted they expected better margins. The company continues to boast strong growth in its Services segment, while still garnering higher average sales prices on iPhones. Microsoft continued to climb. The company is rapidly expanding its cloud business, while expanding margins and earning impressive revenue growth.

Pfizer reported solid second-quarter results with upside to sales and earnings forecasts. Management also provided bullish commentary around the company's long-term growth prospects, expressing comfort with the Trump administration's efforts to reshape the country's drug pricing and reimbursement landscape. We believe the stock also benefitted from a sector rotation into healthcare, with favorable fund flows into the pharmaceutical industry in particular.

Investors have been pleased with the corporate actions announced at Honeywell. The company has been in the process of spinning off several business units, resulting in a company that is a more streamlined, higher growth entity.

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Lockheed Martin announced higher-than-expected earnings and revenue, along with increasing guidance for the year. Recently, there has been rising confidence around defense spending, specifically as it pertains to the level of spending vs. the amount authorized.

Wells Fargo faced continued regulatory overhang. Management continues to aggressively reduce cost in an effort to bolster profitability.

Chevron continued to trade lower following the announcement of some weakness in its refining and marketing operations, as well as higher than expected corporate expenses. All 5 LNG trains are now operating and the company is back in a free cash flow position and has re-instituted its share buyback program.

Occidental announced earnings that came in slightly below guidance, caused by one-time issues in Oman and midstream operations. Investors were more frustrated with the increase announced in capital expenditures to grow production. Exploration and production (E&P) investors have been fearful of too many companies growing production since the crash in oil prices.

DowDuPont traded lower as investors continued assessing corporate actions. The company is expected to split into three units next year. We view the split as a positive and believe the market has yet to price the change into the stock.

Sempra stock traded relatively flat following a bump at the end of second quarter. A large activist investor has taken a stake in the company and other investors are awaiting the outcome of their review.

Outlook

Ever since the current bull market and economic recovery began back in 2009, our generally positive view of the outlook has been informed by three basic factors: (1) the economic recovery, once begun, would continue until interrupted by policy mistakes or a major, unexpected exogenous event, (2) no bear market was likely until the economy showed signs of entering a recession, and (3) the valuation of the U S market was attractive, especially compared to fixed-income alternatives.

Nearly ten years later, with the S&P 500 up nearly 400 per cent from the lows of March 2009, our view remains the same. The economic recovery is showing signs of acceleration as the benefits of lower taxes and deregulation continue. Only a slight uptick in inflation and a flattening (but not inverted) yield curve are giving any warning signals at all. Employment, credit, manufacturing, earnings and housing all point to continuing growth. The Atlanta Federal Reserve is pointing to a 4.1 percent real GDP growth rate (one of the major forecasters of the economic outlook) for the third quarter of 2018. We think a growth rate in the 4 percent area for the fourth quarter is likely, and the odds of a bear market in stocks anytime soon are low.

Valuations remain supportive of the market with the price/earnings (P/E) ratio on the S&P 500's estimated 2019 earnings standing at just over sixteen times (16x), only slightly above the long-term average for this indicator. And as we have continually noted, compared to yields available in the fixed income markets, the valuation of equities remains quite attractive on an historical basis.

Investor concerns over interest rates and trade policy are worth addressing. It has been our position that increases in interest rates occa-

Top 10 Holdings

Microsoft Corporation
Apple
JPMorgan Chase
Honeywell International
Cinemark Holdings
PNC Financial Services Group
Lockheed Martin Corporation
Union Pacific Corporation
Cisco Systems
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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	Top Securities	Average Weight (%)	Security Contribution to Portfolio Return	Bottom Securities	Average Weight (%)	Security Contribution to Portfolio Return
Equity Income	Apple	4.49	0.93	Wells Fargo	3.10	-0.11
	Microsoft	4.83	0.76	Chevron	2.87	-0.09
	Pfizer	3.53	0.75	Occidental Petroleum	2.82	-0.04
	Honeywell	3.70	0.57	DowDuPont	2.21	-0.03
	Lockheed Martin	3.30	0.56	Sempra Energy	2.10	-0.03

* as of Sept. 28. 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.

sioned by stronger economic growth would not be detrimental to stock prices. We believe the stock market and 10-year Treasury rates both making new highs at the same time recently lends credence to this point of view. Remember: an investor buying a Treasury bond at a yield of 3 percent is paying 33 times earnings for a stable non-growing stream of payments over the life of that bond. An alternative of investing in the S&P 500 at an "earnings yield" of more than 6 percent (the reciprocal of a 16x P/E) with some growth seems attractive to us. (We should point out that we are not constrained to buying the averages. We spend our time searching for individual equities with valuation and growth characteristics more attractive than the average stock.)

As for trade, the Trump administration has embarked on a policy never before seen by investors or modern day policy makers, for that matter. Instead of embracing large, one-size-fits-all multilateral trade deals, the administration is focusing on a country-by-country approach. The "carrot and stick" philosophy is on full display; despite some scary headlines and some possibly ill-advised tweets, it seems to be working. The old NAFTA agreement which the Trump administration had abandoned has now been reworked with palpable benefits to the United States. European agreements are in the works. A new agreement with South Korea has been struck with Japan next in line. China remains difficult but we doubt that a full-on trade war is likely, since each side has too much to lose. With the U.S. market roughly ten times as important to China as the Chinese market is to the United States, we would not be surprised to see some kind of a "deal" by year end. It is likely that the markets will applaud even more than they did for the U.S./Mexico/Canada accord, which was agreed to on the last day of the third quarter.

The more or less steady climb in stock prices over the past ten years has been occasionally interrupted by brief bouts of panic selling. We estimate there have been over thirty of these incidents, with the causes ranging from European credit concerns, to changing Federal Reserve policy, to Brexit, to a brief U.S. government shutdown. Each of these "crises" has worked to keep investors nervous and – most importantly – underinvested. Investors should be prepared for more of these unstable periods from time to time; however, we believe continuing earnings growth, reasonable valuations and the United States' attractiveness as an investment venue will prevent periodic dislocations from becoming more substantial.

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.