Eagle Insight

EAGLE Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

Value

Third 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

The broad U.S. equity market (as measured by the Russell 1000® Value Index) delivered a total return of 5.7 percent during the third quarter. To date, this brings total performance to 10.6 percent for the year. As strong as the market has been, the strength has been limited to US stocks, as global indices have not fared as well for the year. Driving US strength continues to be a solid economic backdrop. 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 four percent. Further, the surveys of consumer and business confidence levels continues 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[2,3]

Eagle Value portfolios underperformed the Russell 1000® Value Index during the third quarter.

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 industrials, information technology and real estate contributed positively to performance. An underweight position in health care, as well as poor stock selection, negatively impacted the portfolio. Stock selection in energy and financials also detracted from performance.

New GICS classification –

Stock selection in industrials, information technology as well as consumer discretionary contributed positively to performance. An underweight position in health care, as well as poor stock selection, negatively impacted the portfolio. Stock selection in communication services and energy also detracted from performance.

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 stream-lined, and higher growth entity. Microsoft continued to climb higher. The company is rapidly expanding its cloud business, while expanding margins and earning impressive revenue growth.

Union Pacific announced plan to institute a new initiative called Precision Scheduled Railroading. After several peers enacted PSR, the results appear promising. Margins are expected to be much higher after putting this plan into effect over the next 12-18 months.

Zimmer Biomet posted solid second quarter results including a return to positive organic revenue growth. While the company received an FDA warning letter in August, management assuaged investor concerns by providing favorable commentary around the progress of company's ongoing quality and supply remediation initiatives at various events throughout the quarter.

Total System Services announced a very strong quarter, with both revenues and earnings coming in higher than expected. Each segment accelerated organic revenue growth and the company appears to be the fastest growing merchant acquirer in North America. Management also raised guidance again for the year.

Omnicom announced a disappointing quarter. Advertisers continue to face challenging North American trends as cost cutting persist at many consumer product good companies.

Management at Halliburton reduced third quarter guidance as a result of some disruption in activity in the Permian due to lack of takeaway capacity. While new pipelines are beginning to come online, operators have reduced activity and/or redeployment of rigs to other basins.

General Electric continued to trade lower due to challenges in their power business. The stock has struggled as CEO Flannery attempts to turn around the business.

Devon announced lower-than-expected earnings-per-share, due to disappointing results in its Canadian heavy oil operation. The company made higher government royalty payments along with longer than expected turnaround form scheduled maintenance. Management continues to focus on key shale operations, while divesting non-core assets and returning cash to shareholders.

LyondellBasell traded lower following a surge in ethane prices. As an input product, higher ethane prices serves as a headwind to the business. Output prices tend to be tied to oil, so with a narrower spread, margins will be impacted.

Outlook[1]

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 percent 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 occasioned 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

Top 10 Holdings

JPMorgan Chase
Honeywell International
Microsoft
Union Pacific
PNC Financial Services Group
Prologis
Citigroup
Total System Services
Zimmer Biomet Holdings
BB&T Corporation

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	Top Securities	Average Weight (%)	Security Contribution to Portfolio Return
Value	Honeywell	4.00	0.61
	Microsoft	3.76	0.58
	Union Pacific	3.45	0.51
	Zimmer Biomet	2.72	0.46
	Total System Services	2.84	0.45

Bottom Securities	Average Weight (%)	Security Contribution to Portfolio Return
Omnicom Group	1.86	-0.21
Halliburton	1.63	-0.18
General Electric	0.83	-0.14
Devon Energy	1.42	-0.13
LyondellBasell Industries	2.19	-0.13

* 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.

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.

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3. Source: FactSet.