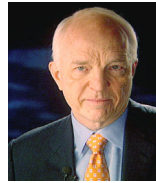


Equity Market Insights

With



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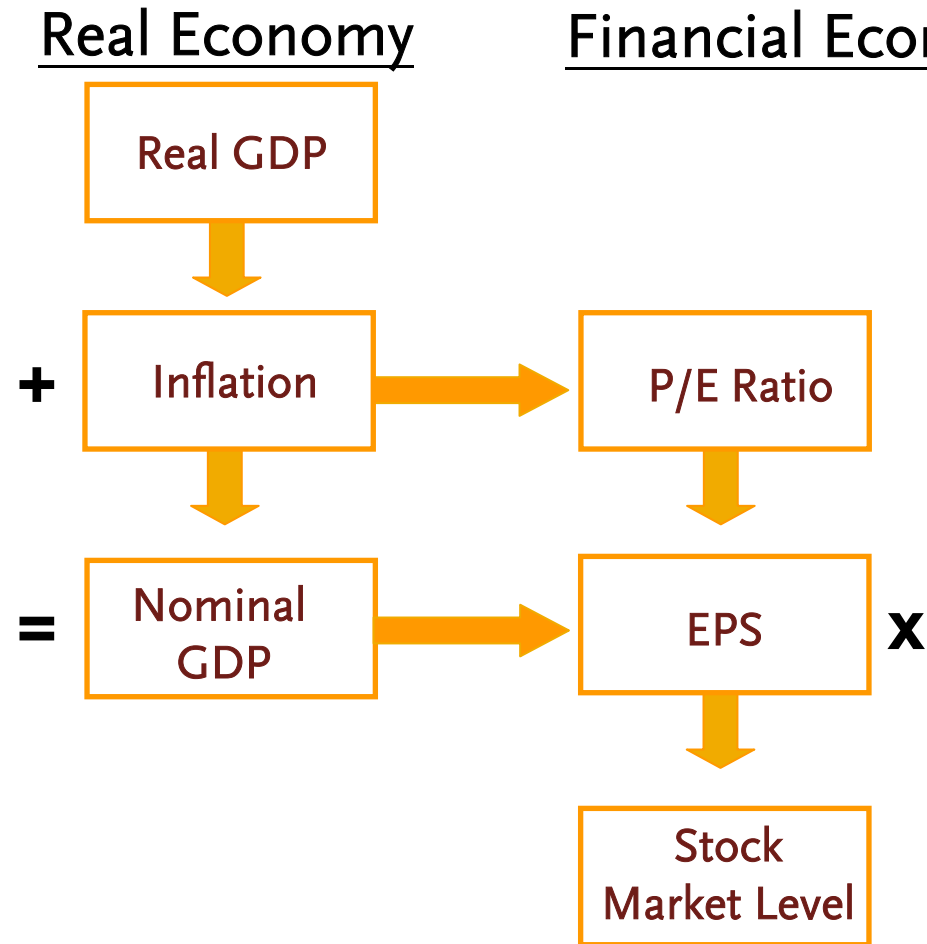
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Experience. Insight. Performance.

What the Stock Market has Not Discounted. . . .

“A Profits Slowdown”

Real Economy and the Linkage to the Financial Economy



Factors Turbo Charging Corporate Profits in Recent Years

- 1) Consumption > Disposable Personal Income
- 2) Residential Real Estate Spending
- 3) Expansion of Budget Deficit
- 4) The Drag? – The Trade Deficit

The Tie-in - GDP & Corporate Profits

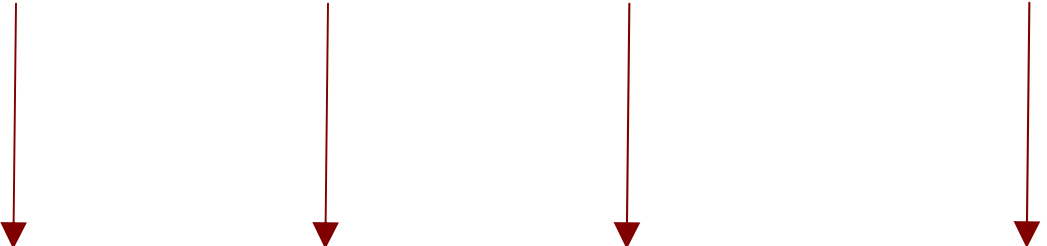
- $Y = C + I + G + (X - M)$
- Changes in the four variables drive profits as well as determine GDP.

Corporate Profit Drivers

- **C – PI =** Where C is consumption and PI is personal income. When consumption exceeds personal income, it is an additional driver for profits. As our net savings rate in the U.S. fell below zero over the past four years, this decrement became additive to profits. The opposite is true as well. When net savings becomes positive again, as it will, profits will be negatively impacted.
- **I =** I represents investment spending by businesses (structures and equipment) and residential investment. When business spending (BI) is increasing, as it is now, profits are helped. The same concept applies to residential investment spending (RI).
- **G – T =** Government Spending – Tax Receipts. Government Spending net of tax receipts (the fiscal deficit) has soared under the Bush administration and has significantly helped profits.
- **X – M =** Exports minus Imports have risen substantially and represent a real drag on profits. Should this change through a falling dollar, for example, profits will benefit. Should the trade deficit worsen, the opposite is true.

Profit Equation

$$\Pi (\text{Profits}) = (C - PI) + I + (G - T) + (X - M)$$



Δ in Savings Δ in Investments Δ in Budget Deficit Δ in Trade Balance

Σ of Business Investment and Residential Investment (BI + RI)

Recent “Proof” of Profit’s Equation

Corporate Profits 2002 through 2005 — \$540 Billion

(C – PI)	=	\$140 Billion	
I	=	440 Billion	(\$290B from BI and \$150B from RI)
(G – T)	=	380 Billion	
(X – M)	=	<u>(410) Billion</u>	
		\$550 Billion	

* Federal Reserve Flow of Funds Table

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The Housing Bust – Soft or Hard Landing?

Recent Facts

- Nearly one third of new mortgages and home equity loans in 2005 were interest-only, compared to 0.6% in 2000. For California, 60% of all loans were interest-only or payment option ARMs in 2005.
- 43% of first time home buyers in 2005 put no money down, and the median down payment was 2%.
- More than 15% of 2005 home buyers owe at least 10% more than their homes are worth.
- 10% of all home owners with mortgages have no equity in their home.
- More than \$2.7 trillion in mortgage loans will adjust to higher rates in 2006 and 2007.

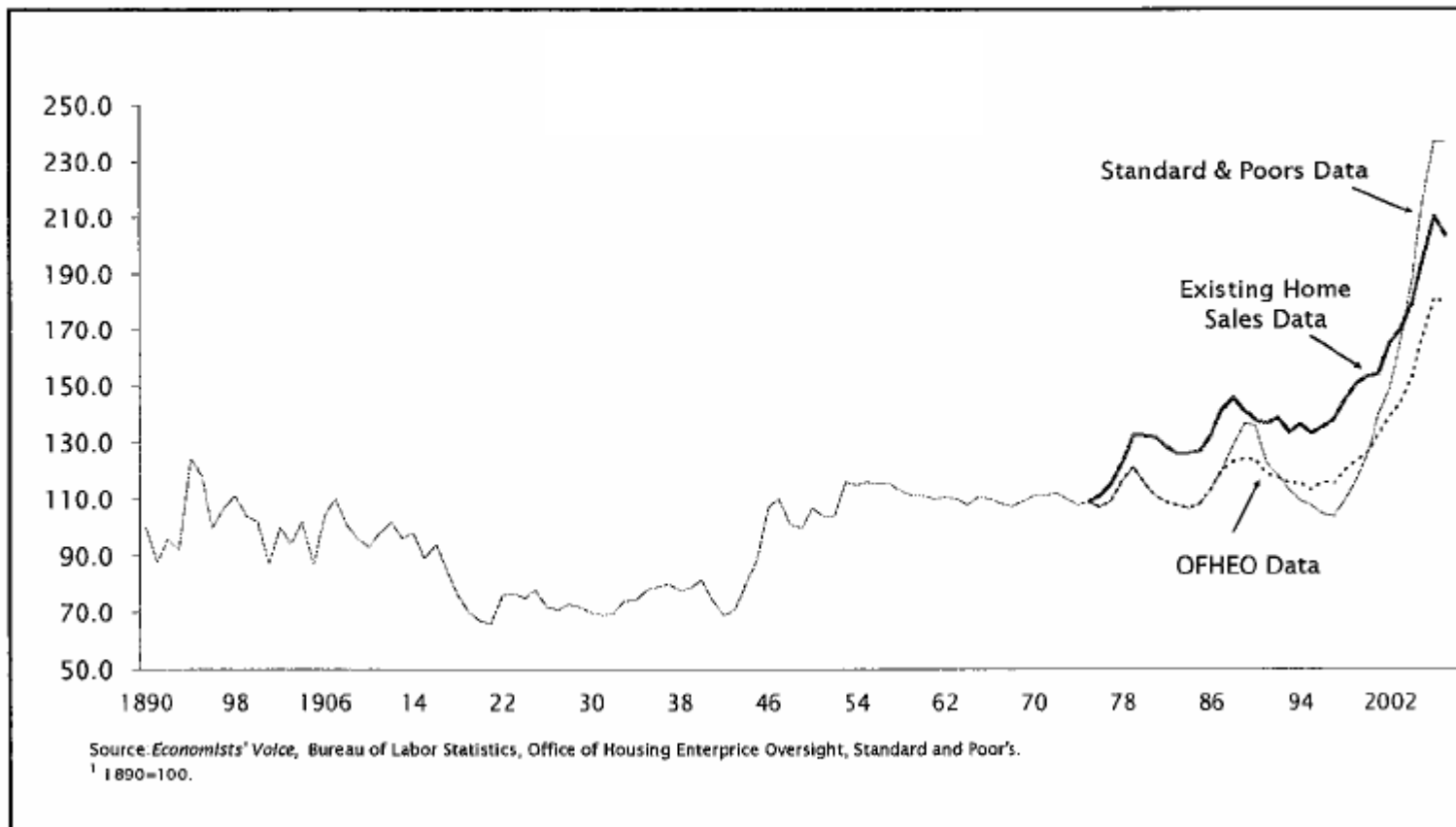
Homeowner Example

- \$250,000 three year i/o with 2% annual rate hike cap.
 - Monthly payment now\$1,123
 - with 1st adjustment.....\$1,429
 - with 2nd adjustment.....\$1,748

- Equal to \$7,500 per annum rise in mortgage costs for the same mortgage.

Figure 1

U.S. Real Home Price Index 1890 Through Q3 2006E



Figures 2-5

Figure 2: U.S. Existing Houses for Sale: Sept. 3.24

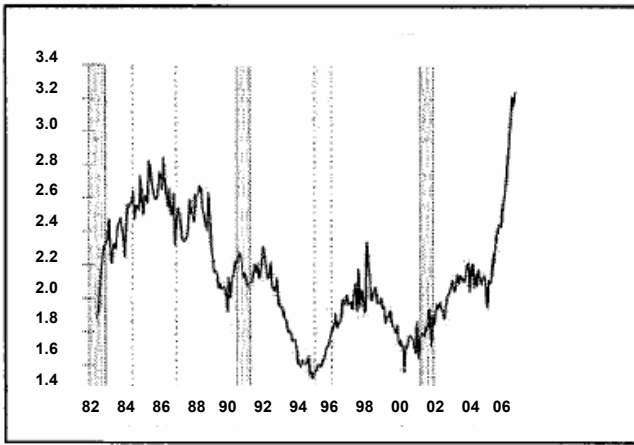
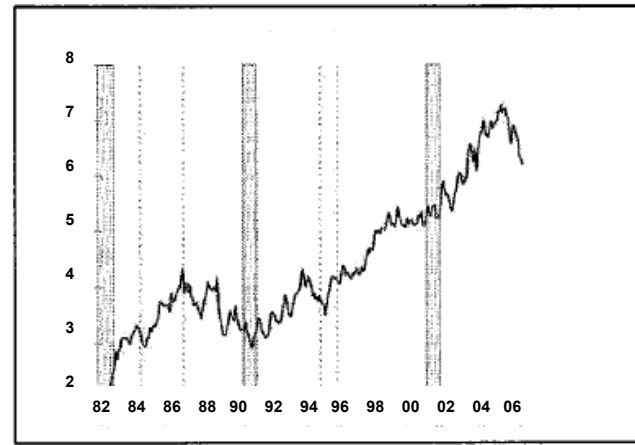
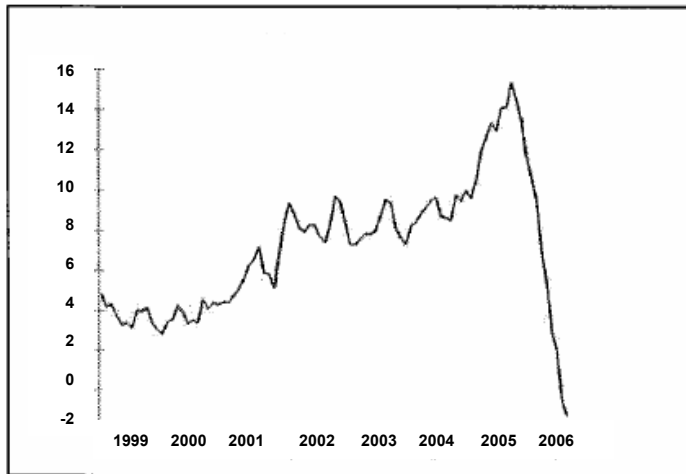


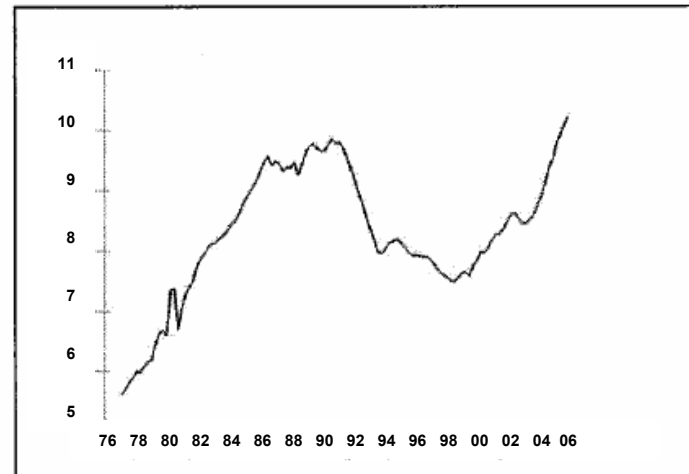
Figure 3: U.S. Existing Houses for Sale: 6.18



**Figure 4: U.S. Existing House Sale Prices
S.A. by ISI 3 Mo. Avg. Y/Y Sept -1.3%**



**Figure 5: U.S. Mortgage Interest Payments
Wages & Salaries 2006: 3Q 10.2%**



Source: ISI Group

Figure 6

**U.S. Housing Affordability Index
Two-Year Rate of Change - 1982 Through June 2006**

