Epoch's Quarterly Capital Markets Outlook



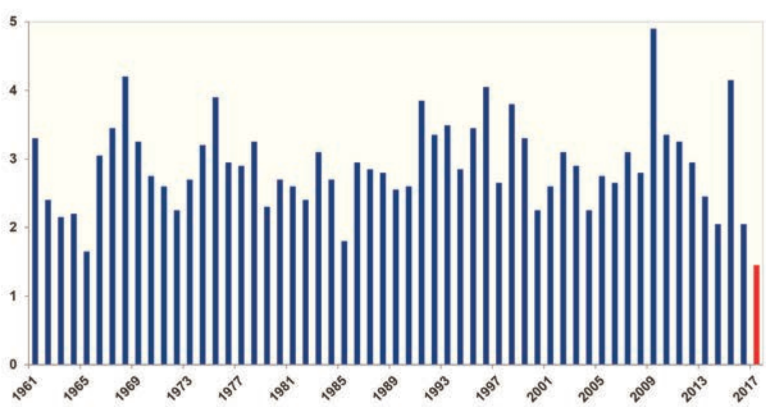
EDITED TRANSCRIPT — OCTOBER 19, 2017

Each quarter, Epoch Investment Partners' co-CIOs and investment professionals discuss the themes affecting global capital markets. This document contains the summarized transcript of the presentation. A full replay of the webinar is available on our website, www.eipny.com.

SLIDE 1

Synchronized Global Recovery

Variability in GDP growth across countries is at its lowest in 50+ years



Bill Priest

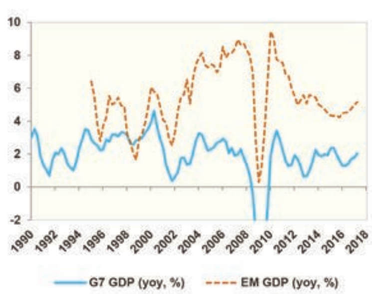
The lower the standard deviation, the more consistent and widespread global growth is. If all 45 countries grew at the same rate, the standard deviation would be zero. What is quite remarkable is that the current standard deviation is the lowest since at least 1961. We are in the midst of a recovery in global growth; a recovery that is happening almost everywhere.

Source: BAML
Note: graph shows standard deviation in annual GDP growth across 45 major countries.

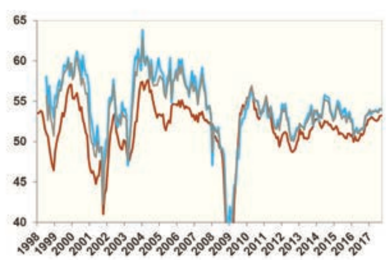
SLIDE 2

Global Growth Upswing

GDP growth is rebounding impressively in both G7 and EM countries



Global manufacturing and service PMIs are solidly into expansionary territory



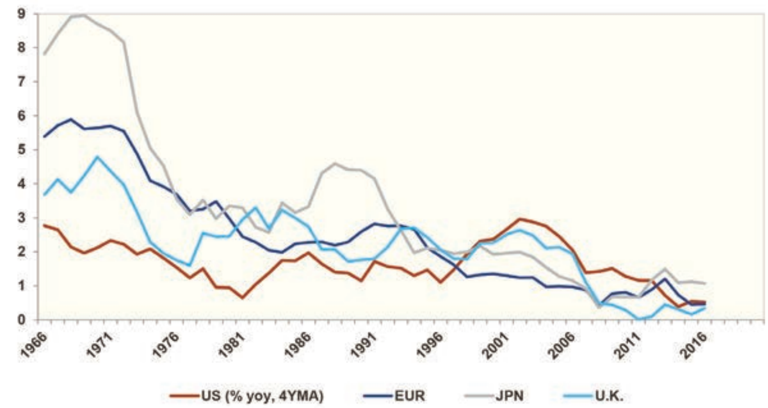
The left chart shows an improving growth trajectory for both G7 countries and emerging market economies. Note that the line for the G7 is lower, reflecting the two key drivers of GDP growth: productivity and growth in the workforce. EMs possess better demographics and are also benefiting from some productivity catchup. Growth in the workforce in most developed countries is modest, particularly for Japan and Europe. Turning to the chart on the lower right, the global manufacturing and service PMIs are both above 50, suggesting economies are expanding. These numbers have been rising for over a year.

Source: (left chart) Bloomberg
Source: (right chart) JP Morgan

SLIDE 3

Upside to G4 Growth is Limited Unless Productivity Rebounds

Productivity growth has decelerated in developed markets during the last five decades



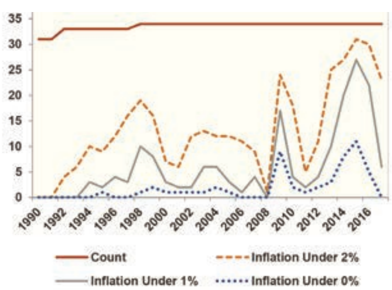
Part of the secular decline in productivity reflects the nature of national accounts and official statistics, which understate true productivity growth and the revolutionary impact on companies of several technological innovations. We've written a number of papers on our "Tech is the New Macro" theme. We encourage you to go to our website and take a look at those papers. Among other things they explain why we believe productivity growth is stronger than what is being reported in the official statistics.

Source: OECD, Epoch Investment Partners

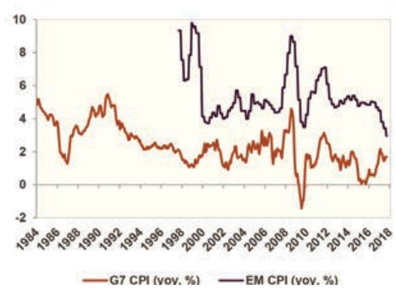
SLIDE 4

Inflation Remains Very Low Across Both DM And EM Countries

A majority of OECD countries have inflation below the 2% threshold



Inflation remains sub-2% overall in the G7 and continues to decline in EMs



Partially because of technology, inflation remains low. OECD countries still have very low rates of inflation, but this is changing. The number of countries with inflation under 1% has declined from about 27 two years ago to fewer than 10 now. Similarly, the number of economies with inflation under zero has fallen and as a result, deflation worries are largely gone. While this is not great news for bonds, it is good news for equities. The view that deflation worries are behind us explains why quantitative easing is morphing into quantitative tightening. Still, there is no rush. As the lower right chart shows, inflation remains below 2% in the G7 and continues to decline in emerging markets. With the convergence of inflation toward 2%, neither runaway inflation nor deflation looks likely.

Source (left chart): Bloomberg, OECD, Epoch Investment Partners
Source (right chart): Bloomberg

SLIDE 5

Global Macro Backdrop is Constructive for the Earnings Outlook

Leading Indicators suggest solid earnings growth

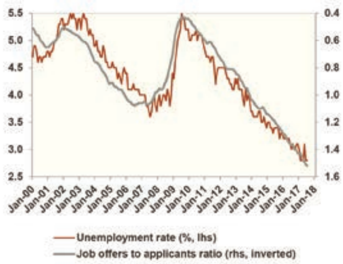
The global macro backdrop we have described is constructive for earnings outlooks. The correlation between the G7 leading indicator versus earnings growth for the MSCI World Index is high. You can see that the OECD leading indicator bottomed in 2016, which has set the stage for MSCI earnings to take off. These earnings numbers were initially distorted by energy and, to some extent, materials. However, the backdrop now suggests that earnings are going to continue to grow.

Source: OECD, MSCI, Bloomberg, Epoch Investment Partners

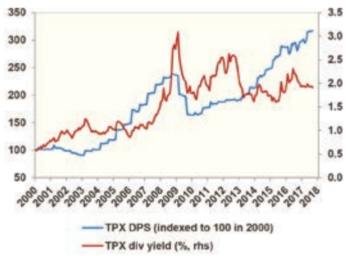
SLIDE 6

Is Japan Investable Through a Cash-Flow Prism?

Japan's labor market is improving – unemployment at a 23-year low



Dividends per share keeps improving, with dividend yield close to 2.0%



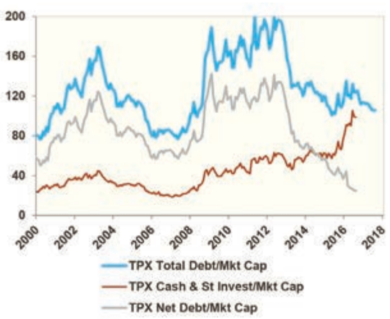
In Japan, you would think hitting a 23-year low in the unemployment rate would result in some wage inflation, but so far that has not been the case. Dividends per share keeps improving, with the overall dividend yield in Japan now just under 2%, roughly the same as the S&P 500. This is interesting because we believe Japanese corporations have the capacity to dramatically increase payouts to shareholders. Our biggest issue with Japanese managements is how they answer the question, "How do you allocate capital?" Unfortunately, many place too much emphasis on stakeholders and vested interests, rather than the efficiency of capital allocation. So, while there are signs of improvement in Japan, capital allocation is still a concern of ours.

Source: Bloomberg

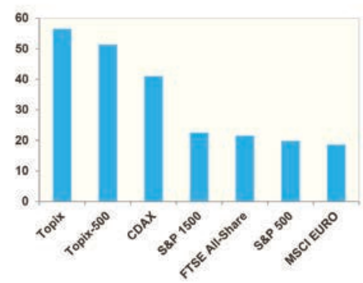
SLIDE 7

Japanese Corporations Have the Capacity to Dramatically Increase Payouts to Shareholders

The overall Topix has very little net debt



56% of Topix companies are net cash



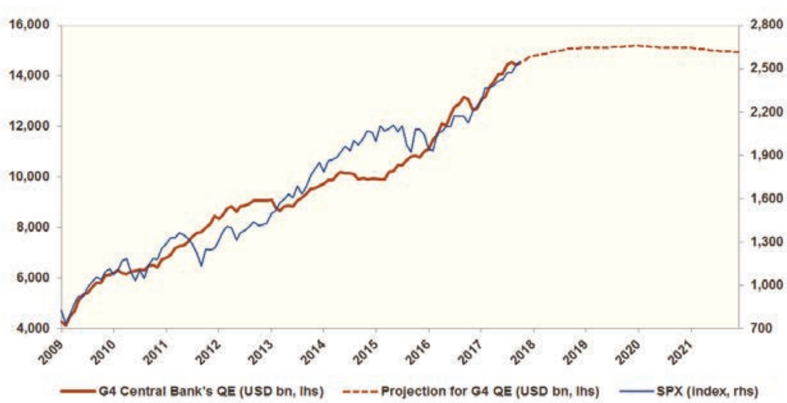
The TOPIX has very little net debt, and over half of the TOPIX companies have net cash. The key here is getting that cash to work either through dividends or share buybacks. However, one oddity is that when Japanese companies buy back shares, they often do not cancel the stock. It just sits on the balance sheet. This is an oddity, and we'd like to see those shares canceled. Regardless, the problem is that the velocity associated with the cash on balance sheets is close to zero. This is clearly suboptimal. A majority of Japanese corporations have the ability to increase payouts to shareholders and perhaps re-engage in capital spending. We'll just have to see if they follow through.

Source (left chart): Bloomberg
Source (right chart): Bloomberg, CLSA

SLIDE 8

From QE to QT

QE: Gently rolling over



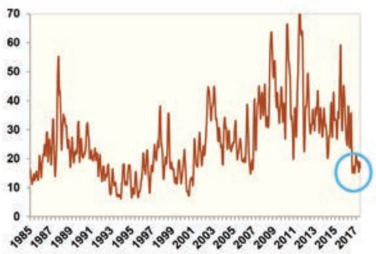
Turning to monetary policy, we are seeing a slow, gradual shift from quantitative easing to quantitative tightening. We know that we're done with QE in the U.S. and U.K., with tapering about to begin in Europe. Only the Bank of Japan is suggesting that QE is likely to be ongoing. Regardless, the shift from QE to QT raises the following uncomfortable question: If QE did such wonderful things for markets, what is the impact of QT likely to be, even if it's well-telegraphed and implemented extremely slowly and gradually? We'll be releasing a white paper on this topic soon. It is hard to imagine going from QE to QT without disruption, likely manifesting itself in lower correlations and, more worrisome, higher volatility.

Source: Bloomberg, Epoch Investment Partners

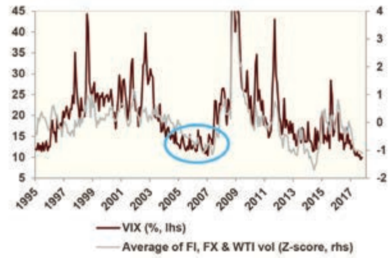
SLIDE 9

With QT, Expect Correlations to Decline and Volatility to Rise

SPX correlation at 10-year low: good news for active managers



The Volatility Paradox: close to post-1995 low



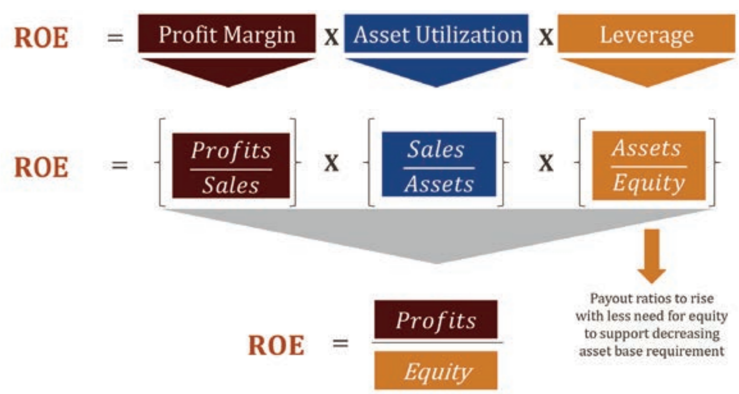
Continuing on the QT theme, the left chart shows that the SPX correlation is at a 10-year low, which is good news for active managers. When such correlations are high, like they were during the QE period, there is essentially one factor driving everything, creating a challenge for stock pickers. As we've discussed previously, the major driver of gains in the S&P 500 was multiple expansion, rather than earnings growth and dividends. Turning to volatility, the VIX is at a level that most of us consider unsustainably low. This is where the argument regarding QE and QT bump into one another. If QE promoted low vol, will QT promote high vol? Our expectation is that volatility is not going to stay low, although we don't have confidence in forecasting exactly how high it is likely to go.

Source: Epoch Investment Partners

SLIDE 10

Technology Continues to Drive Profitability Higher

Return on Equity Components



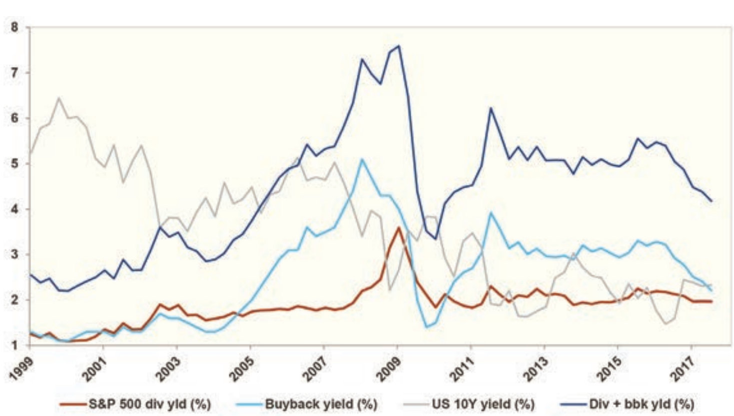
Technology will improve all three components

Another theme we've emphasized (and written about in our white papers) concerns the impact of technology on ROE and its three components. As the business models of firms increasingly emphasize bits rather than atoms, their cost curves change dramatically. Profit margins should increase (as firms substitute technology for labor), as should asset utilization (with companies substituting technology for assets). Leverage should decrease (as firms need less equity). If I do not need the same level of fixed assets relative to revenues going forward, I can reduce the equity base required to run my business. I can pull equity out of my business by increasing my cash dividend or pursuing share buybacks. In other words, I can increase my dividend payout ratio. This environment should be particularly constructive for our Global Equity Shareholder Yield strategy.

SLIDE 11

Outlook for Equity Income Stream Well Above that of Bonds

The combined dividend + buyback yield is almost 200bps above the 10-year yield



Continuing on the topic of shareholder yield, while we believe the outlook for bonds is challenging, the prospects for dividends and buybacks are quite promising. This chart shows that the combined dividend plus buyback yield is almost 200 basis points above the 10-year Treasury yield. If you're interested in yield, you want an absolute level that's good, and you want it to grow. Further, so long as you have global growth, then you can start off with almost twice the yield of a bond. Given that it also has a growth rate, an equity yield strategy makes an enormous amount of sense.

Source: Standard and Poor's, Bloomberg, Epoch Investment Partners

SLIDE 12

Global Equity Shareholder Yield

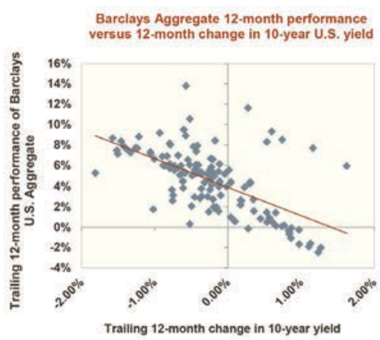
- **How is GESY likely to perform in a rising interest rate environment?**
- **Some investors have seen GESY as a "bond proxy"**
- **The "proxy" characteristics have to do with the ability to generate a steady income stream**
- **But because GESY's underlying holdings are stocks, and not actual bonds, they have the ability to generate a growing income stream.**
- **And because the conditions that lead to rising interest rates also tend to lead to faster growth in that income stream, GESY reacts to rising interest rates differently than bonds do.**

Turning to our Global Equity Shareholder Yield strategy, some investors have suggested it's a bond proxy. Nothing could be further from the truth. This is an equity strategy with a growing income stream. It's powerful, and over a long period of time it will substantially outperform any set of bonds. The reason is because the underlying holdings are stocks, they have the ability to generate a growing income stream. And that really matters. To illustrate, imagine a world where operating cash flow simply grew with nominal GDP. But along the way you find you do not need all of the capital currently retained in the business because you have substituted technology for physical capital — bits for atoms. This substitution effect causes the ratio of operating cash flow per dollar invested in the firm to incease. This allows the dividend payout ratio to rise as long as economic growth continues.

SLIDE 13

Global Equity Shareholder Yield In A Rising Rate World

- **Bonds do worse when interest rates rise.**
- **However, GESY has actually enjoyed better returns in absolute terms when interest rates have risen**



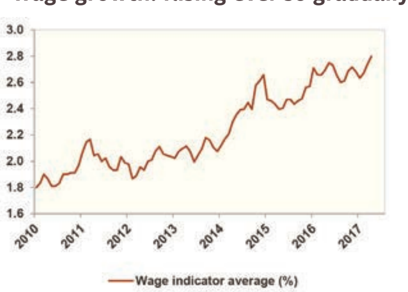
Staying with our Global Equity Shareholder Yield strategy, some people have asked how it is likely to perform in a rising interest rate environment. The Barclays U.S. Aggregate Bond Index typically suffers a substantial decline when interest rates are increasing. By contrast, our Global Equity Shareholder Yield product typically performs well in a rising rate environment. Further, the outlook for shareholder yield in real terms may actually be better now than when we initially implemented the strategy. Originally we were looking for a nominal return of 9% that meant net of inflation (around 3% in those days), a real return close to 6%. Today, with inflation lower than it was previously, the real return from Global Equity Shareholder Yield is actually better than when we implemented the strategy in 2006.

Source: Bloomberg

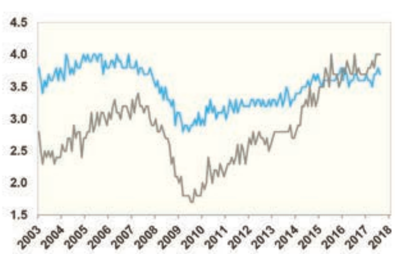
SLIDE 14

U.S. Labor Market: Tight and Getting Tighter

Wage growth: Rising ever so gradually



JOLTS: Openings rate highest since inception (12/2000)



David Pearl

We now turn to the U.S. economic and market outlook. Data from JOLTS (the Job Openings and Labor Turnover Survey), shows that job openings and new hires have clearly recovered. The job openings rate is the highest it's ever been for this survey (which commenced in 2000). The hiring rate has not kept up with new job openings, so we're still in a tight labor market. This tightness is being reflected in continuous, moderate wage growth. This is clearly good news for consumers, although the rate of improvement in wages and personal income is muted relative to prior recoveries.

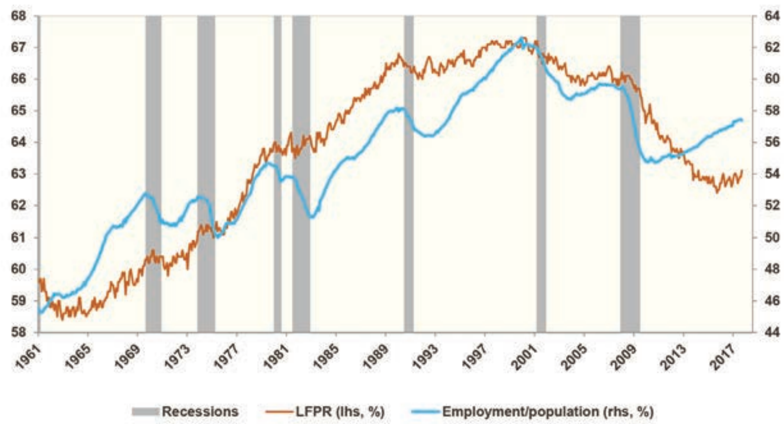
Source (left chart): Bloomberg
Average of four series: Atlanta Fed, NY Fed Median, AHE, ECI

Source (right chart): Bloomberg

SLIDE 15

Although the Participation Rate Suggests Some Slack Remains

Participation has potential to increase significantly



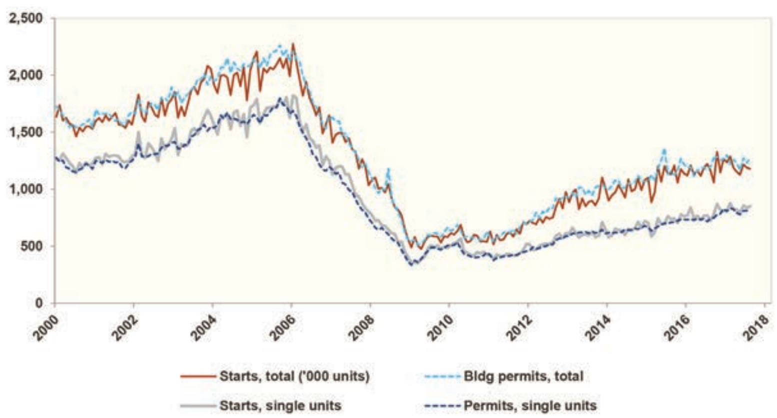
The strong labor market is good for the overall economy, especially given that consumer spending is over 70% of GDP. The participation rate, however, has not fully recovered from the recession. There may still be room for people to re-enter the labor force, a factor that could keep somewhat of a cap on wage growth. But still, it is a tight job market and wages are what ultimately attract people back into the workforce. While we're not predicting as strong a recovery as we've had in past cycles, there is potentially more room for jobs and economic growth to improve.

Source: Bloomberg, Epoch Investment Partners

SLIDE 16

Housing Market: Gradual Recovery

Housing starts and building permits on a gradual upswing, supported by the solid labor market and low mortgage rates



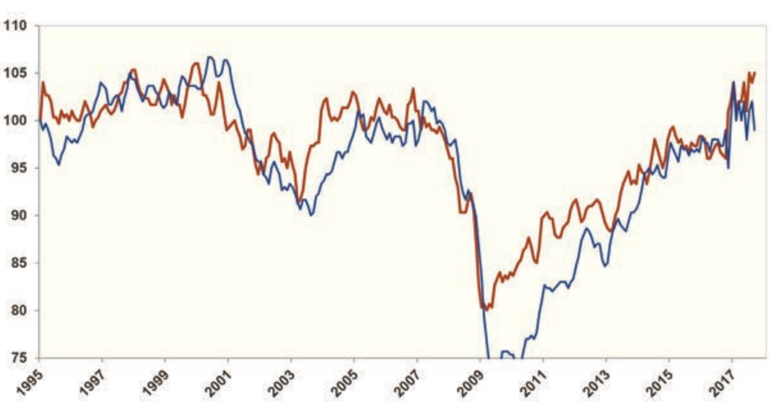
Another factor in the cyclical upswing has been housing, which has been in a gradual recovery since the financial crisis. Part of this reflected the delay of new entrants into the job market post-2008 (because of the severe recession they were delayed both in getting their first jobs and in forming households). However, it is happening now and we're seeing moderate growth in housing. Further, home prices have appreciated more in specific areas of the economy with the most job growth, such as Seattle, San Francisco, and some of the other regions with hotter economies. There's still plenty of room for starter home sales and overall new starts to go up.

Source: Bloomberg

SLIDE 17

Small Business: Sentiment and Hiring Have Improved

Small business: Hiring up, but comp still subdued



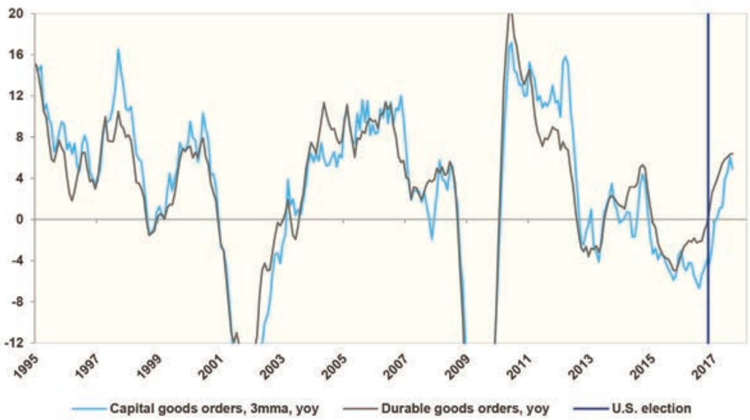
The small business sector, which is usually the primary job creator for the U.S. economy, continues to recover. Hiring is really beginning to pop up, although compensation is a bit more restrained. While wages are lagging, if the strong hiring environment continues, we would expect wage growth in the small business sector to start catching up.

Source: Bloomberg, Epoch Investment Partners

SLIDE 18

Production, Capex and Exports have all Improved

Capex-related orders



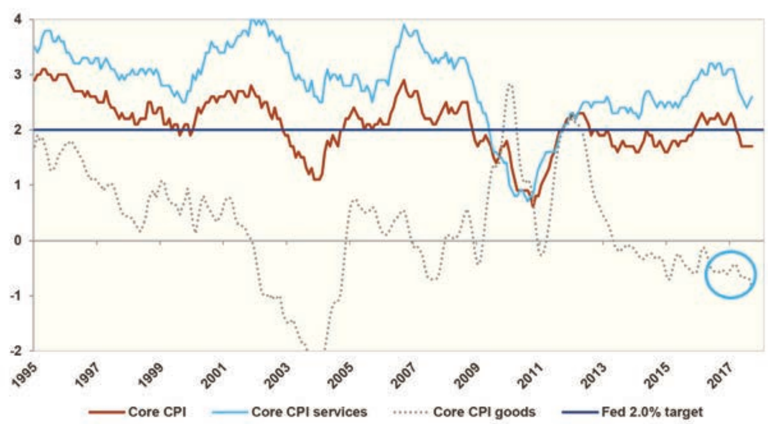
The last leg for the cyclical recovery is business confidence. The natural progression is if consumers are buying, then businesses are feeling better as sales and profits are up, so Capex will grow, and the economy enters a virtuous cycle. However, given our "Tech is the New Macro" theme, it is unlikely that Capex growth will equal that of prior cycles. Although a Capex recovery is occurring, it's going to be modest. Even IT spending is up by less than in the past. One reason is the movement to the cloud; so companies buy IT services which aren't considered Capex. As companies move to a subscription model, they spend less on facilities and computers.

Source: Bloomberg, Epoch Investment Partners

SLIDE 19

Core Inflation Still Well Below Target

Core goods price inflation is at a 13-year low



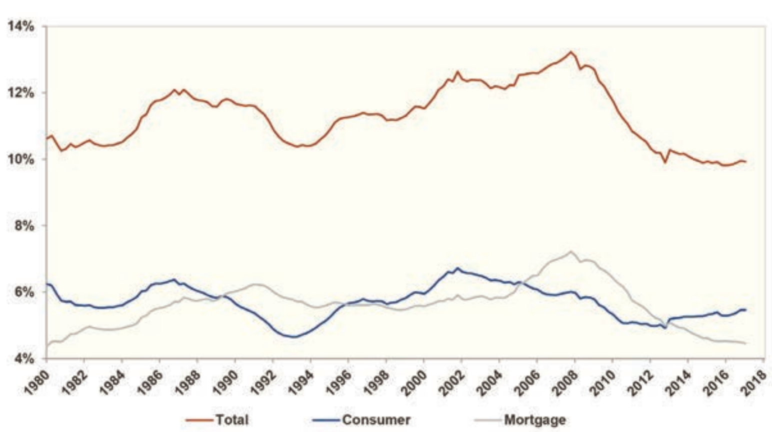
The core services CPI is over 2%, but is showing few signs of acceleration. Services inflation normally runs hotter than goods because it is less affected by deflationary forces such as trade and technology, and is now being affected by slowly increasing wage inflation. On the other hand, core goods inflation is at a 13-year low. To a large extent this reflects the impact of technological change, which continues to make manufactured goods cheaper to produce. Technology is even affecting food prices, as it becomes cheaper to grow and harvest what ends up on your dinner table. Almost every good has seen deflation, which acts to keep overall CPI well below the Fed's 2% target. Regardless, with the shift from QE to QT, there will be pressure for rates to go up. Natural pressure should come from core inflation, however, and we haven't quite seen that yet.

Source: Bloomberg

SLIDE 20

Household, Corporate and Government Debt Levels are Elevated

U.S. household debt service (% of Personal Disposable Income): If yields rise 100bps, debt service will hit historical high



What will be the effect of higher interest rates in the U.S.? Debt service is sensitive to interest rates, which have been at historically low levels, but are likely headed higher over coming quarters and years. For example, if the yield curve were to shift up by 100 bps, household debt service levels would likely rise to a new historic high, in line or higher than the level experienced in 2007. This could cause a marked decline in consumption growth. Further, U.S. federal debt service is already 6% of all federal spending. A rise in rates of 100 bps would increase it toward 10%, causing a much higher deficit and/or squeezing discretionary spending. The bottom line is that if interest rates were to rise by more than 100 bps, it would have difficult consequences for U.S. households and government spending, as well as for highly leveraged corporations.

Source: Bloomberg

SLIDE 21

Summary

1. **Equity multiples unlikely to increase further:** Multiples expanded on QE, but the period of looser monetary policy is now well behind us. Consequently, equity return drivers are likely to shift from broad multiple expansion to earnings growth.
2. **Tech is the new macro:** Technology is positive for all three return on equity (ROE) components — profit margins, asset utilization, and leverage. Among other things, this implies corporate margins can remain high for a prolonged period and don't necessarily need to revert.
3. **Muted wage and price inflation:** Much weaker than in a typical cycle, likely due to technology. Still, given the global cyclical recovery, we expect moderate reflation and slightly higher bond yields.
4. **Robust U.S. outlook:** Regardless of policy (which doesn't appear to be moving the needle, one way or another), domestic demand is solid and the production side of the economy is picking up. This provides a robust backdrop for earnings growth in the coming quarters. Risks include excessive household debt and Fed tightening. Tax cuts in 1Q2018 could provide a short-term boost to growth (and add 6% to EPS).
5. **European growth continues to improve, but political risks loom:** Corporate fundamentals appear solid, earnings growth is picking up and valuations are "fair." Further, election outcomes have been supportive to mixed, but Italy remains a wildcard. Overall, we are focused on bottom-up opportunities within Europe.
6. **The Gathering Storm:** Risks are rising and, as QE is withdrawn, we expect equity market volatility to rise. This is worrisome given historically high debt levels and stretched valuations for many assets. Further, several market developments since 2008 have made severe liquidity disruptions more likely. These developments include the shift from active to passive managers and the increased AUM of systematic strategies that sell on auto pilot. As Richard Bookstaber has argued in The End of Theory, although the last crisis was caused by excessive leverage, liquidity disruptions will play a large role in the next one.
7. **Investment approach:** As a result of the above points, it is ever more important to favor companies with a demonstrated ability to produce free cash flow and allocate that cash flow wisely between return of capital options and reinvestment/acquisition opportunities.

Bill Priest

Several items in our summary haven't changed very much from the last quarter. However, the sixth bullet point, "The Gathering Storm," is new. It is intended to highlight that, as rosy as the near term looks, risks will rise as QE is withdrawn. Further, given historically high debt levels and stretched valuations for many assets, you have the possibility for substantially more volatility. We will soon be publishing a white paper on this topic.

A replay of our quarterly webinar is available on our website

www.eipny.com