Epoch's Quarterly Capital Markets Outlook

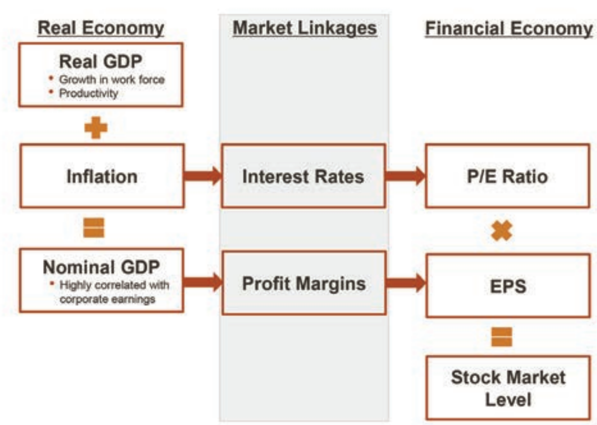


EDITED TRANSCRIPT — APRIL 19, 2017

Each quarter, Epoch Investment Partners' co-CIOs Bill Priest and David Pearl and Investment Strategist Kevin Hebner discuss the macroeconomic themes that are 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 2

Financial Economy linked to the Real Economy



Bill Priest:

Note that real GDP is driven by two factors: growth in the workforce and growth in productivity. Adding in inflation determines nominal GDP which, over a long period of time, is highly correlated with earnings growth. This relationship is not perfect, since the composition of the economy and equity market differ, and there is also some variation in profit margins. Further, lower inflation, ceteris paribus, means lower interest rates which, crucially, are inversely correlated with P/E multiples. Finally, if we take the P/E level and multiple it by earnings, we have the stock market level. This is a good model for understanding the linkages and, as we go through the remainder of this presentation, we will address each of these points in some detail.

Source: Crestmont Research; Epoch Investment Partners

SLIDE 3

Equity Return Drivers: Back to Normal

Cumulative returns over 5-year period (S&P 500, 2012-2016)

P/E Expansion	67.6
EPS Growth	17.0
Dividends	13.6
Total	98.2

Cumulative returns over 5-year period (MSCI World, 2012-2016)

P/E Expansion	73.9
EPS Growth	(1.8)
Dividends	15.4
Total	87.4

Average annual returns over 90-year period (S&P 500, 1926-2016)

P/E Expansion	0.8
EPS Growth	5.0
Dividends	4.0
Total	9.9

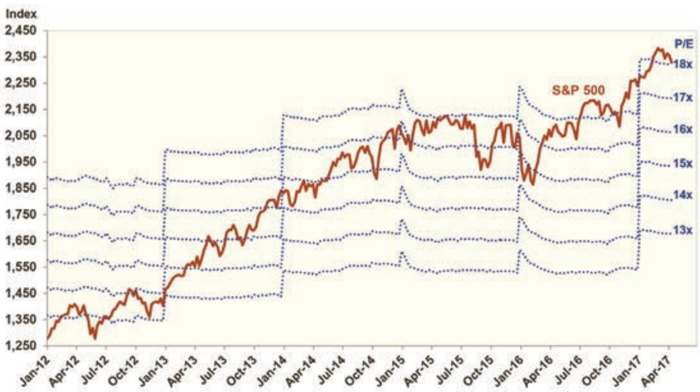
This demonstrates how unusual equity return drivers have been. From 2012 through 2016 the total return on the S&P was an impressive 98%. But the bulk of that return came from P/E expansion, reflecting QE policies and lower interest rates. Relatively little of the return came from EPS growth and dividends. For the MSCI World index, this was even more extreme, as EPS growth was negative over the period. This abnormality is emphasized by the figure on the right which shows the drivers of return from a longer-term perspective. Typically P/E expansion accounts for little (less than 10%), while EPS growth and dividends are the key drivers (contributing roughly 50% and 40%, respectively). With QE now over, at least in the U.S., and widespread signs of gradual reflation, we should return to this more normal distribution.

Source: Bloomberg, Epoch Investment Partners; December 2016. Totals may not sum due to rounding and compounding effects.
1. Local currency

SLIDE 4

Playing the Movie Backwards: Equity Multiples Expanded on QE. With Reflation, We Expect a Gradual Contraction of Multiples

S&P 500 and Forward Earnings Multiples



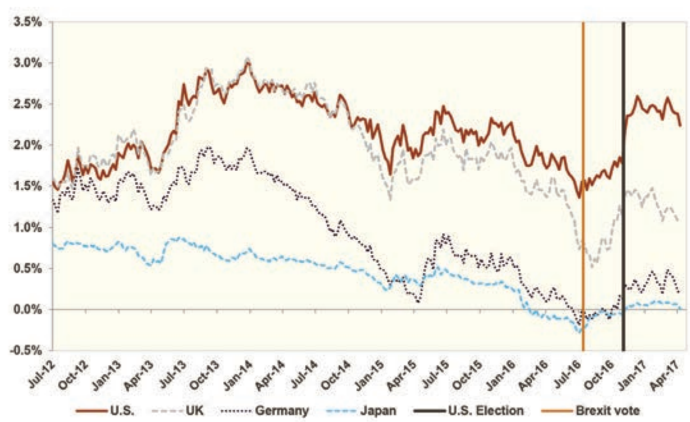
The main point of the previous slide is that, although multiple expansion explains the bulk of returns over the last five years, this is likely to change. This chart makes a complementary point by showing how the forward P/E multiple has increased from less than 13x in early 2012 to just over 18x currently. With interest rates likely to increase moderately over coming years, we expect a gradual decline in the S&P 500's multiple. For the overall equity market to rise, we'll need to see EPS growth win the tug-of-war against gradual multiple contraction.

1. Please see our White Paper dated May 29, 2014: The Power Of Zero + The Power Of The Word
Source: Epoch Investment Partners, Bloomberg; April 14, 2017

SLIDE 5

From Deflation to Reflation: Financials Would Benefit From a Global Upturn in Yields and Less Regulation in the U.S.

Global 10-year bond yields



We expect a moderate increase in nominal bond yields. Ten-year yields in the G4 bottomed right around the Brexit vote last June. As we move from deflation into a more reflationary environment, there will be a number of beneficiaries, of which financials are a clear example. In fact, we expect financials to benefit not only from the global upturn in nominal bond yields, but also from expectations of less regulation in the U.S. (as discussed on slide 11).

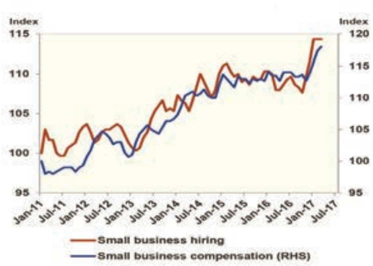
Source: Bloomberg; April 14, 2017

SLIDE 6

We Expect the Ongoing Strength in the U.S. Labor Market to Drive a Moderate Acceleration in Wages

Tightening shadow labor implies higher wage growth

Small businesses tell surveys they plan to increase hiring and compensation



David Pearl:

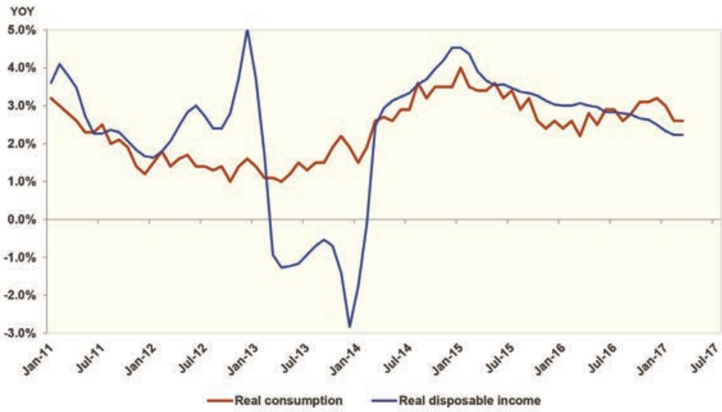
The next few slides examine the key components of the U.S. economy. GDP growth is mainly driven by consumers and what matters most to them are jobs and wages. The left hand chart shows that there has been a significant tightening in the labor market, with unemployment declining markedly, which typically leads to higher wage growth. The right hand chart looks at the plans of small businesses, which is where most of U.S. job growth has been over the last 20 years. Post-election, small businesses are feeling more optimistic (on hopes of deregulation, tax reform and more robust economic growth) and plan to increase hiring and compensation.

Source: (left) Bloomberg, Epoch Investment Partners, April 2017
Source: (right) Bloomberg, March 2017

SLIDE 7

The Consumption Outlook Appears Robust, Reflecting Solid Employment and Wage Gains

Real income growing a respectable 2.2%, with real consumption at 2.6%



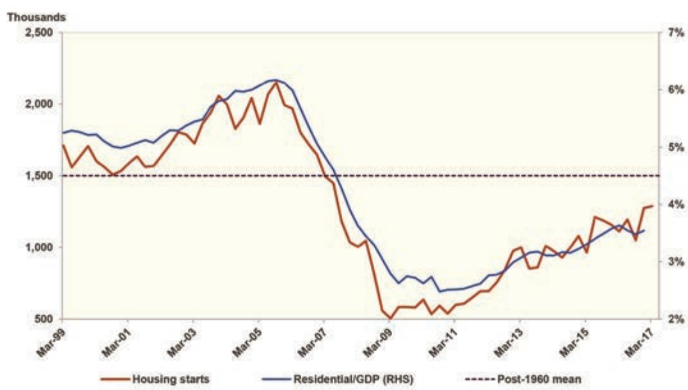
Consumers continue to benefit from the improving labor market outlook and solid earnings growth. This chart demonstrates that income has been growing by over 2% and consumption is even stronger, growing at 2.6%. We see this trend continuing over the next few years, which raises the question of what they are likely to spend on. Homeownership is a big focus, partially because it has lagged since the Global Financial Crisis.

Source: Bloomberg, March 2017

SLIDE 8

Building Permits are Close to a 10-Year High, Mortgage Rates Remain Low, Home Prices are up 6% YOY and Mortgage Applications are Strong

Housing starts are still below trend, suggesting further upside



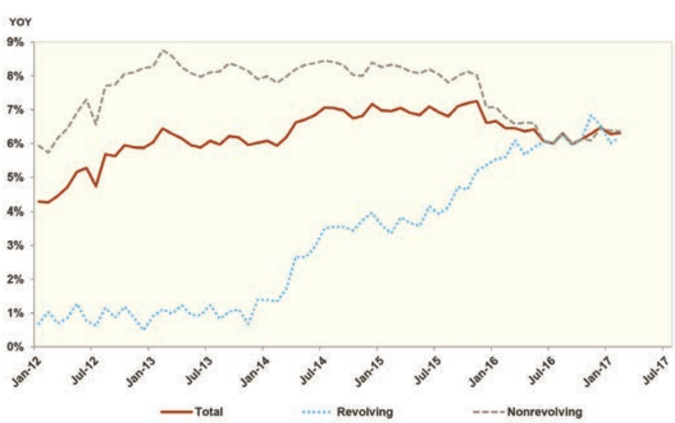
Many young people who graduated from college after the financial crisis could not get jobs. This resulted in a decline in the rate of household formation or family creation, which for a few years constituted a headwind for the housing industry. However, they are now obtaining jobs, forming families and buying homes. As a consequence we have seen building permits, housing starts and mortgage applications for purchases move decidedly higher.

Source: Bloomberg, Epoch Investment Partners, March 2017

SLIDE 9

Broad Consumer Lending Appears Solid, Allowing Household Spending to Outpace Income Gains

Consumer credit growth is a strong 6.3%



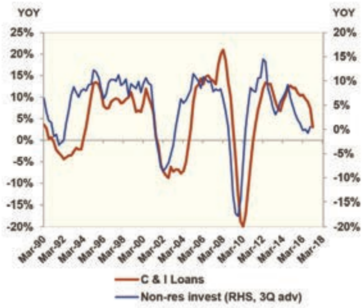
U.S. consumers have already borrowed to buy things like houses and cars. The previous slide discussed our optimistic view on the former. Regarding the latter, auto sales have probably peaked, and are likely to plateau from here. However, the growth of revolving debt (e.g., credit cards) has increased and, remarkably the quality of the credit has remained high. So we're nowhere near a crisis level. Overall, the level of consumer credit growth is stimulative for the economic machine.

Source: Bloomberg, February 2017

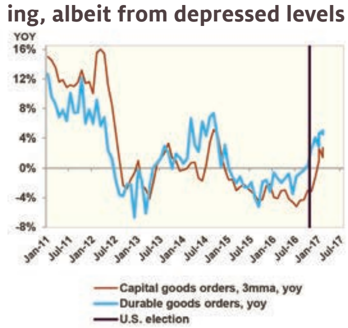
SLIDE 10

Manufacturing PMIs, IP and Exports Have All Improved. We Expect Moderate Gains in C&I Loans and Capex to Follow

Will C&I loans rebound with capex?



Capex-related orders are improving, albeit from depressed levels



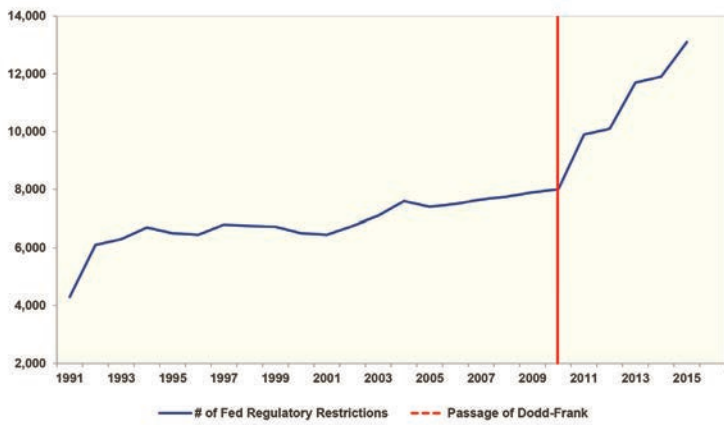
Having already looked at consumption and housing, we now examine the next GDP component: capex. Commercial and industrial loans made by U.S. banks have been weak but we expect them to rebound along with corporate investment (which tends to lead by three quarters). The chart on the right shows two leading indicators for capex and they have both improved markedly. Catalysts for this include government policy, with the energy sector being a good example (so expect firms to build new pipelines and construct more oil-drilling equipment), as well as repatriation of cash held overseas (most will be paid out in dividends and buybacks, but some will wind up as brick and mortar investment). We believe the U.S. is coming out of a trough in capex, which should provide a tailwind to overall growth.

Source: (left) Bloomberg, Epoch Investment Partners, Wolfe Research LLC, March 2017
Source: (right) Bloomberg, Epoch Investment Partners, March 2017

SLIDE 11

Well-Crafted Deregulation Would Especially Benefit Finance

The number of regulatory restrictions from the Federal Reserve increased dramatically with the passage of Dodd-Frank



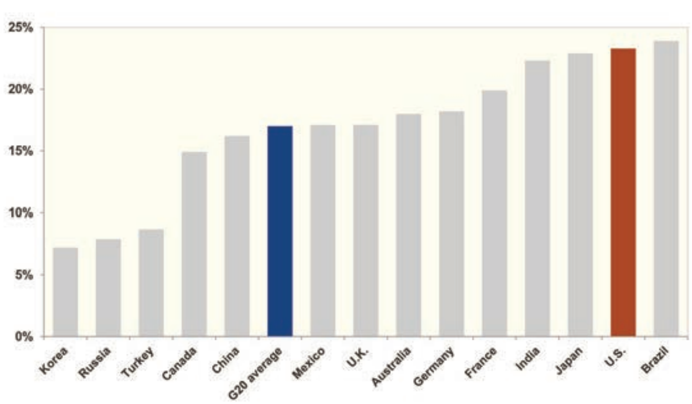
The Trump administration's promise to lighten the regulatory load should prove to be a major positive factor for small businesses, as well as the energy and financial sectors. To illustrate why this is important, this chart shows a dramatic increase in the number of regulatory restrictions affecting the financial sector since 2010. Under the new administration, this is highly likely to be reversed. Banks have reported very good numbers for Q1, which partially reflects their having been given a little more flexibility and are making more loans.

Source: Wolfe Research LLC, Federal Reserve

SLIDE 12

Effective Marginal Corporate Tax Rate

A five percentage point reduction could add $8-$10 to S&P 500 EPS



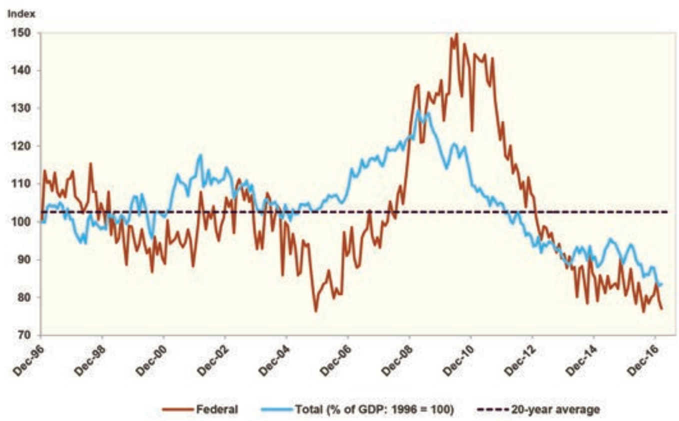
Congress and the White House have promised to lower tax rates. This slide shows effective marginal corporate tax rates for the G20 countries. The U.S. clearly has not been competitive with its large country peers (although this comparison isn't quite apples-to-apples as it doesn't take into account the effect of VAT taxes and such). This structure has created incentives for U.S. companies to invert and move to countries where tax treatment is more favorable. The good news is that tax reform or relief is a key priority for Congress and we believe it is likely to happen during the next nine to twelve months. This should prove a major positive for companies' bottom-lines. Finally, repatriation issues will likely be addressed as well, which should especially help companies in the technology and health care sectors.

Source: Oxford University Center for Business Taxation, 2015

SLIDE 13

While We Expect a Moderate Increase in Defense Outlays, the Outlook for Infrastructure Spending is Much More Uncertain

Public construction spending is well below its 20-year mean



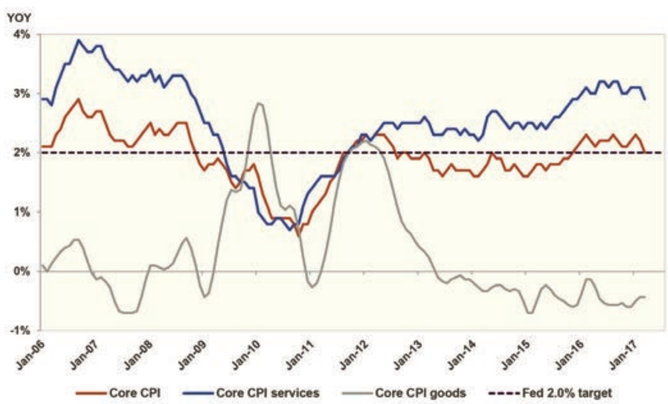
Turning to the next component of GDP, government activity, public construction spending has been low for the last few years. Further, defense spending is also at historically low levels, so that's another area of likely stimulus, and one that the GOP strongly favors. The previous few slides have provided a constructive view on most components of GDP (consumption, housing, capex and government). Although we don't expect the economy to rocket ahead, incrementally, all of the directions are positive.

Source: Bloomberg, Epoch Investment Partners, February 2017

SLIDE 14

We Expect a Moderate Increase in Inflation, but Goods Prices Have Been in Deflationary Territory for Four Years

Core goods inflation remains in negative territory, while core services inflation is just below 3%



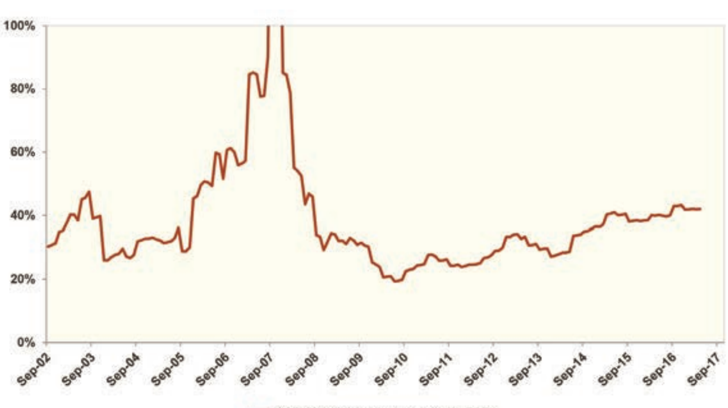
Turning to our view on reflation, the core CPI print has been steady at around 2% over the last five years or so. However, when you disaggregate the CPI between goods and services, you can see that goods have been in deflation for quite a while (partially due to technology), but core services inflation has definitely moved higher. This reflects the tightened labor market, which has led to modest wage growth. Overall, we expect wages to continue trending higher, meaning we are in a moderately reflationary environment. This implies short- and long-term interest rates are likely headed up, although only gradually.

Source: Bloomberg, Epoch Investment Partners, April 2017

SLIDE 15

With Moderate Cash Flow Growth, and Still Tepid Capex, U.S. Companies Should Continue to Offer an Attractive Dividend Yield

Dividend yields are sustainable at 42% of free cash flow



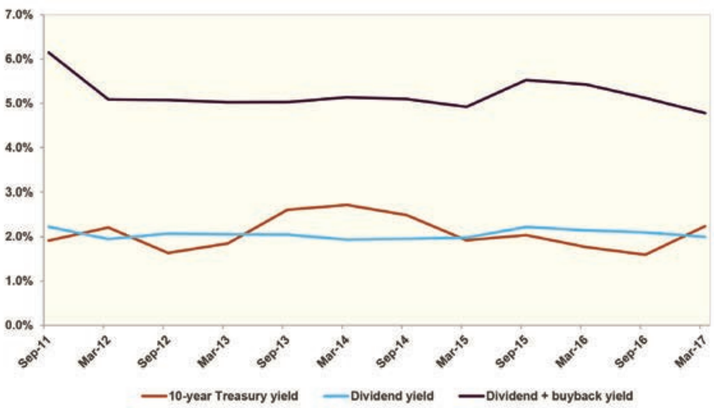
Turning to shareholder yield, in aggregate S&P 500 companies are cash rich. This means dividend yields are sustainable, especially given that dividends currently account for only 42% of free cash flow. In fact, not only are they sustainable, but there is plenty of room to raise dividends. Further, we have the likelihood of repatriation, which would be another positive factor for the corporate return of capital.

Source: Bloomberg, Epoch Investment Partners, April 2017
Note: The series was greater than 100 for three months in H2 of 2007, peaking at 182.6% on 9/2007.

SLIDE 16

Although the U.S. 10-Year Yield is Similar to the S&P 500's Dividend Yield, Buybacks Bring the Total Yield to Almost 5%

The dividend plus buyback yield is currently just below 5%



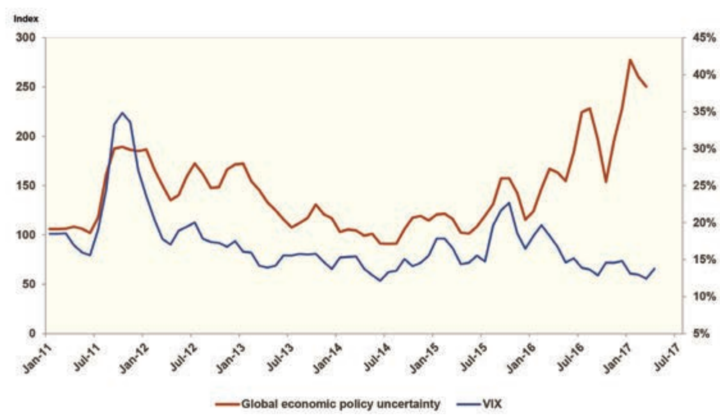
The chart on this page is also pertinent to shareholder yield, and compares the rate on 10-year treasuries with the dividend yield on the S&P 500, as well as the buyback yield. The key point is that equity yields are attractive, especially when you include share buybacks. Companies are returning a lot of capital and this is why income strategies will likely remain popular.

Source: Bloomberg, Epoch Investment Partners, Standard & Poor's, December 2016
Note: Q1 of 2017 buyback yield is an estimate.

SLIDE 17

No One Buys an Umbrella Until it Starts Raining: Global Uncertainty is Elevated, yet Equity Markets Remain Relaxed

Global policy uncertainty is close to a record high, while VIX suggests investors are not terribly worried



Bill Priest:

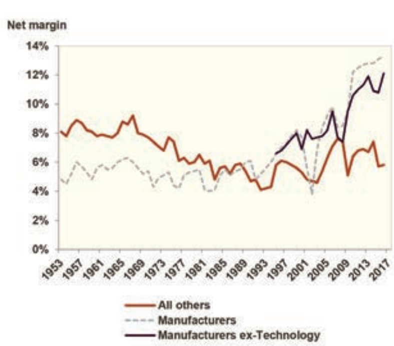
Global economic policy uncertainty is elevated and event risk is high. However, equity market volatility is muted and this disconnect is probably as high as it's ever been. This is partially related to the rise of populism and how it ultimately manifests itself. Will it be friendly to capitalism, or unfriendly? What does it mean for taxes, regulation and state interference? All this creates a lot of uncertainty. To illustrate, one area we are particularly concerned about is protectionism, especially given Trump's ill-advised perspective on trade. In addition, many commentators are anxious about corporate debt levels in China. Regardless, this chart shows a huge amount of uncertainty, while the volatility exhibited by the stock market is relatively benign. This is unlikely to remain the case, either the red line will come down or the blue line will go up.

Source: Bloomberg, April 2017

SLIDE 18

Playing the Movie Backwards: Will Protectionism Shrink Manufacturers' Profit Margins?

Manufacturers have propelled the S&P 500's margin gains during the Bretton-Woods II era



The margin expansion of S&P 500 manufacturers from 2000-2015 can be attributed to four key factors

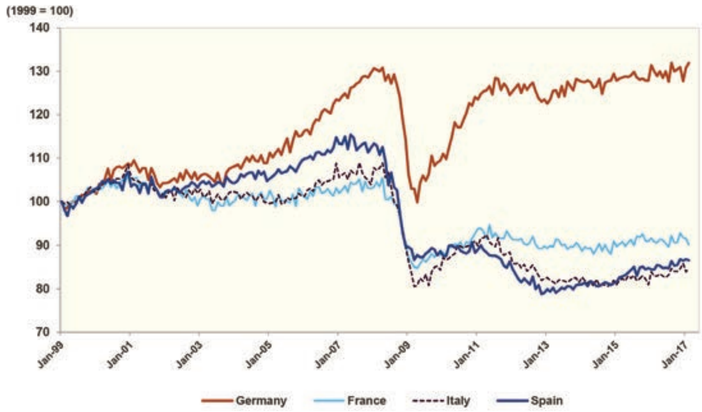
We are also concerned about "playing the movie backwards," that a move toward protectionism could reverse the strong improvement in manufacturers' profit margins witnessed over the last 25 years. The pie chart attributes the margin expansion to four factors. Unfortunately, the top two factors are likely to play in reverse in the coming years (although the bottom two factors could have room to improve). Also note that over the last 20 years, U.S. manufacturing output has increased 87%, even as manufacturing employment declined by one-third. This development reflects advances in automation and technology, with trade being a much smaller factor. This has been an important theme at Epoch, where we believe technology is a positive factor for margins (slide 22).

Source: (left) Empirical Research Partners
Note: Net profit margins for S&P 500 companies, trailing 4 quarters, smoothed.
Source: (right) Empirical Research Partners

SLIDE 19

The German Economy Has Thrived Under the Euro, While Italy, France and Spain Have Struggled

Industrial Production



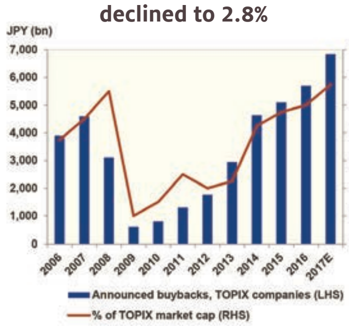
Turning to Europe, this chart shows that German manufacturing has thrived under the euro while most other economies have struggled. This places a great deal of stress on the EU's atrophying institutions and constitutes a potential Achilles' heel. Ultimately, we believe the European Union will bend, but not break during upcoming years. Still, we are worried about the outlook for France and especially Italy.

Source: Bloomberg, Epoch Investment Partners, February 2017

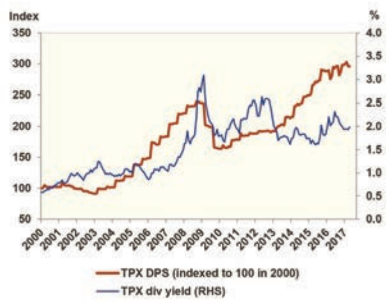
SLIDE 20

Shareholder Yield Beginning to Improve in Japan, but Far from Levels Required

Japanese unemployment rate declined to 2.8%



TOPIX dividends have risen since 2000



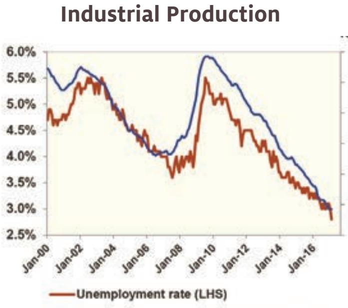
Moving to Japan, shareholder yield and capital allocation is beginning to improve, although it is still insufficient for many of our strategies. The good news is that we expect 2017 to be yet another record year for buybacks. Further, dividends per share for the Topix have risen dramatically since 2000. However, there is still an enormous amount of cash locked up in the balance sheets of Japanese companies that could be deployed more efficiently. There is some movement toward improvement in shareholder yield and capital allocation, but it is far from the levels required.

Source: (both graphs) Bloomberg, CLSA, Goldman Sachs

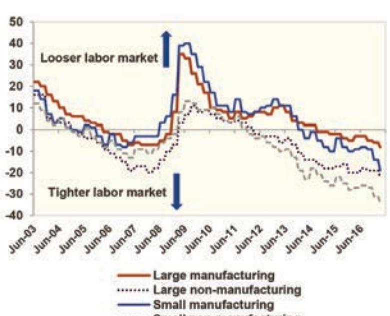
SLIDE 21

Japanese Labor Market Has Tightened Significantly, Suggesting Higher Wages in Coming Quarters

Industrial Production



The Bank of Japan's survey also shows a very tight labor market



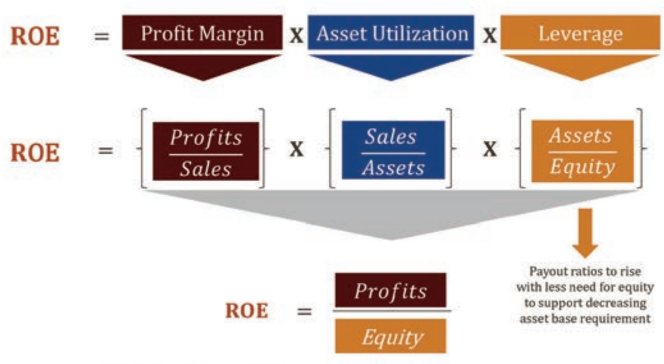
The Japanese labor market has tightened significantly, suggesting higher wages in coming quarters. The unemployment rate has declined to 2.8% and the job offers-to-applicants ratio is now running roughly 1.4 to 1. Further, as shown in the right hand chart, the Bank of Japan's survey also shows a tight labor market. So we keep thinking Japan might be a good place to source investment ideas, but we struggle to find companies that meet our investment criteria.

Source: (right) Bloomberg
Source: (left) Bloomberg, Bank of Japan

SLIDE 22

Technology: Impact On Capital Returns

Return on equity components



Technology will improve all three components

"Technology is the new macro," and it is positive for all three components of ROE. First, new technologies allow for improved profit margins because firms can have lower labor costs per dollar of sales. the retail sector, where internet sales are growing in importance, offers a good example of this. Second, asset utilization improves, as you have higher sales per dollar of physical assets (plant, equipment and inventories), because we are in an asset-light world. Third, leverage increases, as you don't need the same amount of equity for the assets involved. If you don't need as many assets to drive your sales level, you can pull equity out of the business. This means higher payout ratios. In fact, we believe payout ratios are going to rise significantly over the coming years in many sectors. All three of these components point to higher ROE and technology is behind this crucially positive development.

SLIDE 23

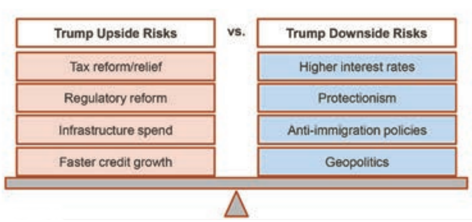
Key Market Risks: The Known Unknowns

Upside risks

- Corporate tax: A five percentage point reduction, even as a one-off, could add $8-$10 to S&P 500 EPS.
- Repatriation: Primarily benefiting technology and health care.
- Deregulation: Finance and energy could receive boosts from well-crafted deregulation.
- Small business: If animal spirits kick-in, this could turbo-charge employment and capex.

Downside risks

- The Big Unwind: Higher bond yields could drive equity multiples lower.
- Protectionism: End of labor arbitrage, supply chain disruption, fewer gains from trade.
- Economic nationalism: Upcoming elections will not resolve the underlying fundamental malaise.
- Geopolitical: Low probability powder kegs like N. Korea don't matter, until they do.



The downside risk we are most concerned about is "the big unwind." Our anticipation is that bond yields are going to rise moderately and there is typically an inverse relationship between bond yields and equity multiples. This headwind can be overcome by strong EPS growth but the point is that as yields rise, there will be downward pressure on multiples.

Source: Wolfe Research LLC

SLIDE 24

Summary

1. Playing the movie backwards: Equity multiples expanded on QE. With moderate reflation, we expect a gradual contraction of multiples and a tug-of-war against EPS growth.
2. Tech is the new macro: Effects include downward pressure on wages and core services inflation, dislocative impact on labor market (e.g., retail sector employment) and increased sector concentration, resulting in higher margins and RoE for many sectors.
3. Is Trumponomics working? Not yet clear, but we are carefully monitoring wages, capex and credit growth. Could be positive for domestic cyclicals, financials and small caps.
4. Robust U.S. consumer: Regardless of policy, after five years of solid employment growth we are more worried about upside than downside risks for the domestic economy.
5. European equities require a risk premium: To reflect a busy political calendar and contagion risks from populist party candidates.
6. Is Japan investable through a cash flow prism? The short answer is yes, as corporate Japan is changing (albeit ever so slowly). However, we have found it difficult to find companies in Japan that meet our investment criteria.
7. Equity return drivers: To shift from broad P/E expansion to firms with prudent capital allocation process – shareholder yield and capital reinvestment opportunities.

SLIDE 25

Conclusion

A replay of our quarterly webinar is available on our website

www.eipny.com

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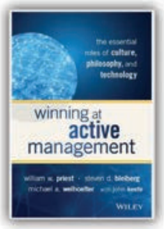

Winning at Active Management

"Trump and Trade: What are the Risks?"

"Vox Populi: In 2017 the Eurozone Will Bend, But Not Break"

"The Big Rewind"

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