

Epoch's Quarterly Capital Markets Outlook

Lower for Longer: A World of Yield Starvation



WILLIAM W. PRIEST, CFA
*Chief Executive Officer
and Co-CIO*



KEVIN HEBNER, PHD
*Global Investment
Strategist*



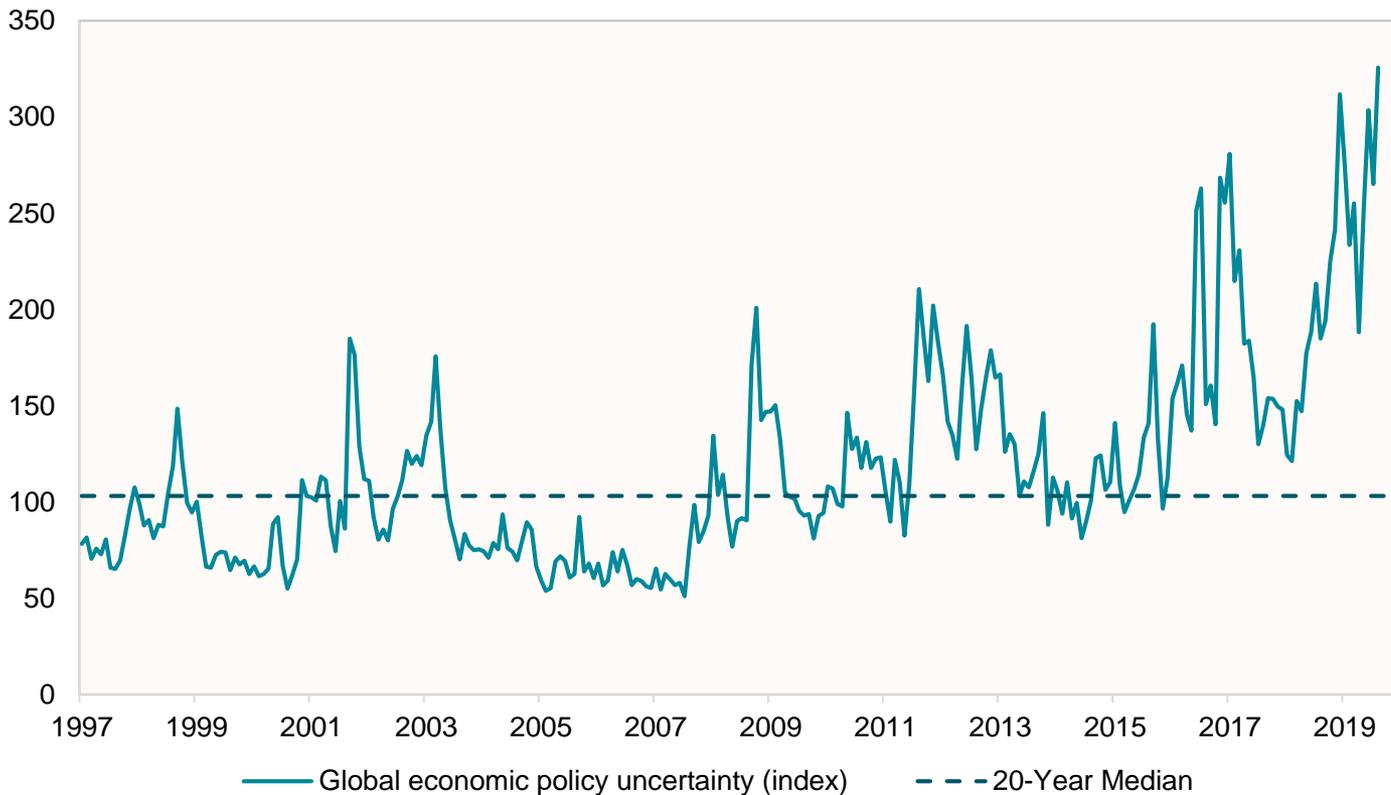
JOHN TOBIN, PHD, CFA
*Managing Director,
Portfolio Manager*

Thursday, October 10, 2019 | The webinar replay is available on our website: www.eipny.com

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Global Policy Uncertainty: At a Record High

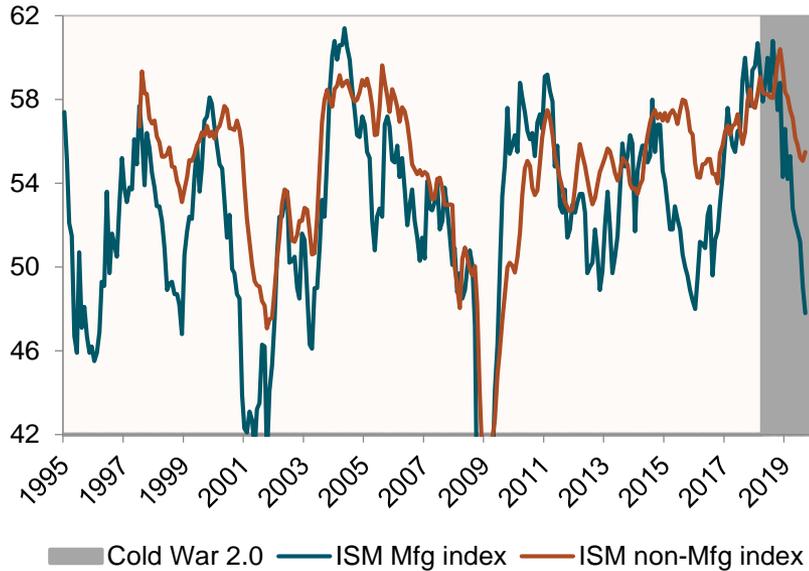
Global Economic Policy Uncertainty Index: Reflecting Cold War 2.0, Brexit, HK, Iran, German recession, hyper-active central banks, fiscal profligacy ...



Source: Bloomberg, Epoch Investment Partners

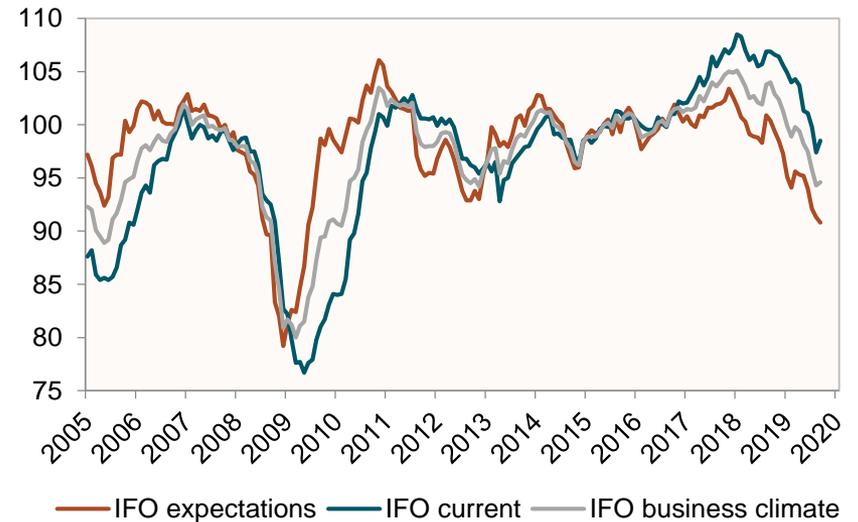
Global Manufacturing Recession: From Optim-ISM to Pessim-ISM

Rolling over with the onset of Cold War 2.0



Source: Epoch Investment Partners, Bloomberg

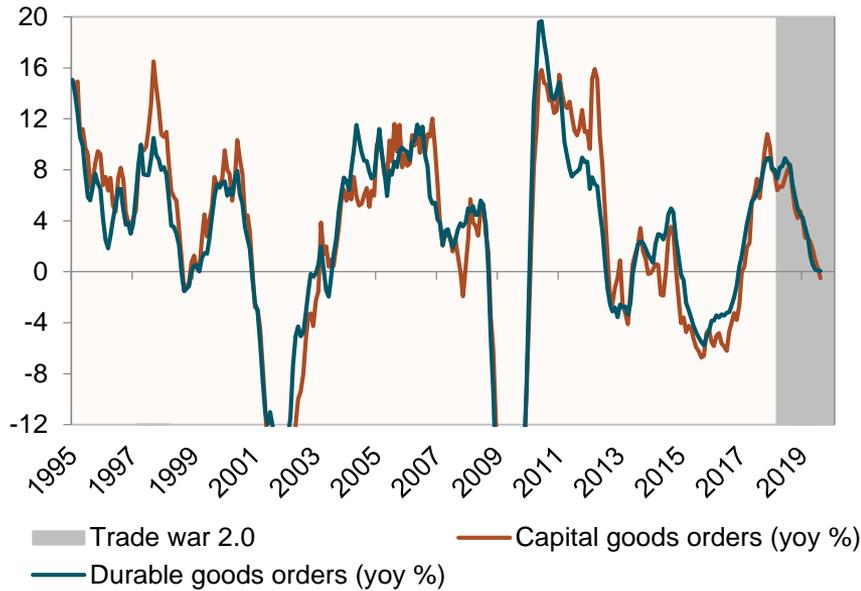
Germany, the manufacturing powerhouse, appears headed for recession



Source: Epoch Investment Partners, Bloomberg

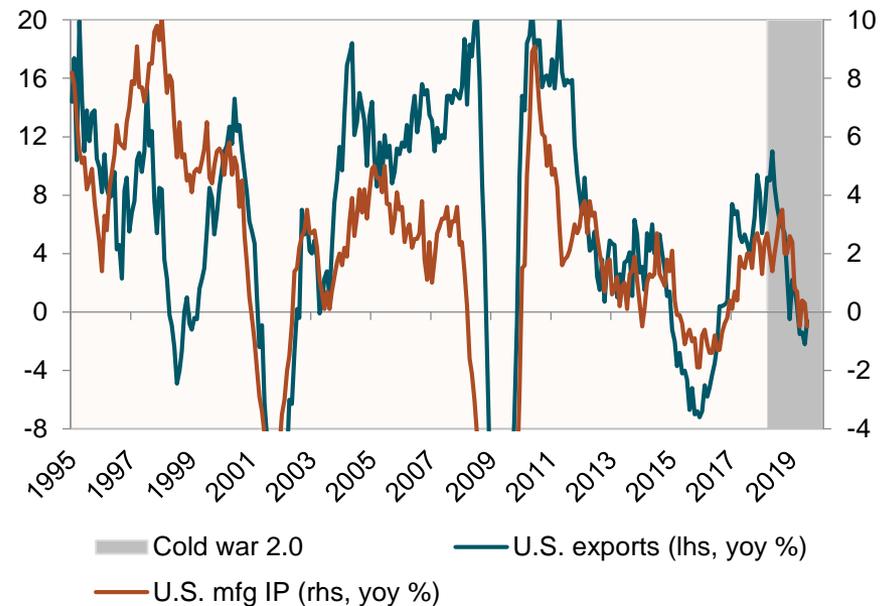
Late-Cycle Worries: Capex and Trade Rolled Over with Cold War 2.0

Capex recession: Globally, not just in the U.S.



Source: Epoch Investment Partners, Bloomberg

Weak export growth almost everywhere



Source: Epoch Investment Partners, Bloomberg

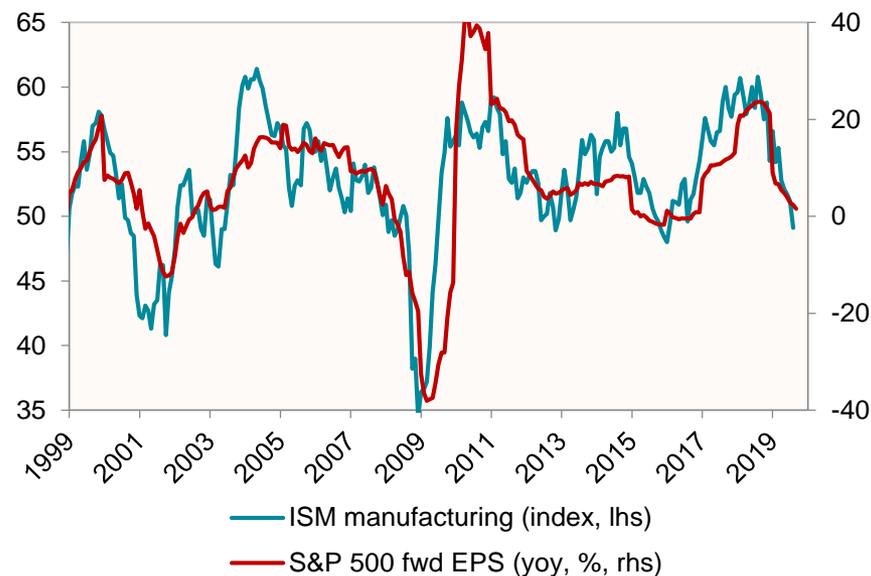
Slowdown \neq Recession: But Still, Headwinds for Earnings Growth

Macro slowdown: Headwind for equities



Source: Epoch Investment Partners, Bloomberg

Earnings growth declining: We expect S&P 500 EPS growth of about 2% in 2019 and 5% in 2020



Source: Epoch Investment Partners, Bloomberg

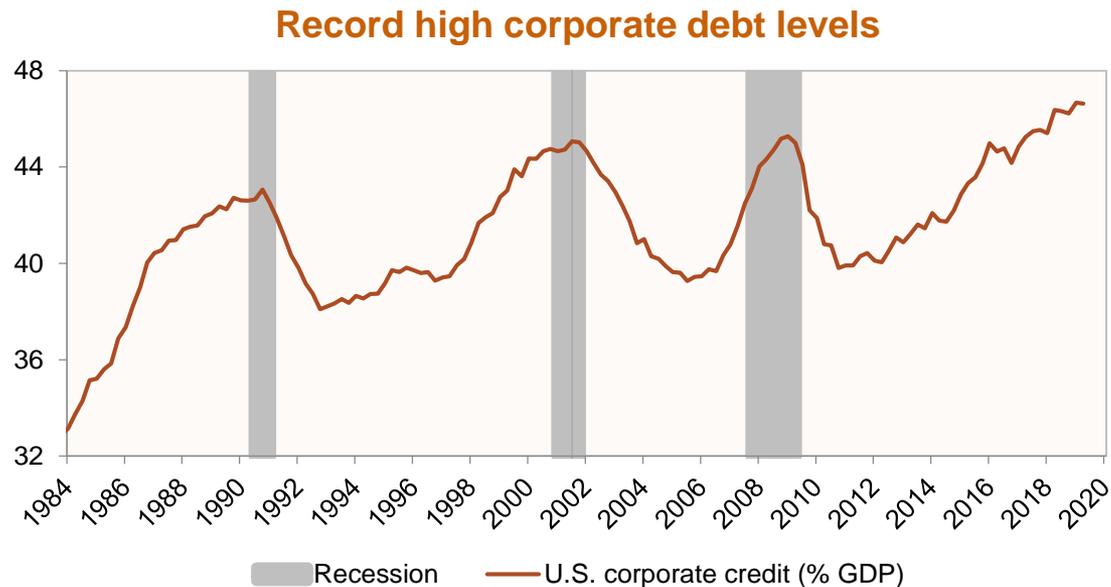
The Next Recession: Corporate Debt Will be the Epicenter

Recession will be exacerbated by

- Corporate spreads widening dramatically
- Avalanche of fallen angels (overwhelming HY market)

Fed toolbox

- Policy rates: Little room to cut
- QE has little support: And will likely prove ineffective
- MMT remains controversial: And the budget deficit is already huge



Source: Epoch Investment Partners, Bloomberg

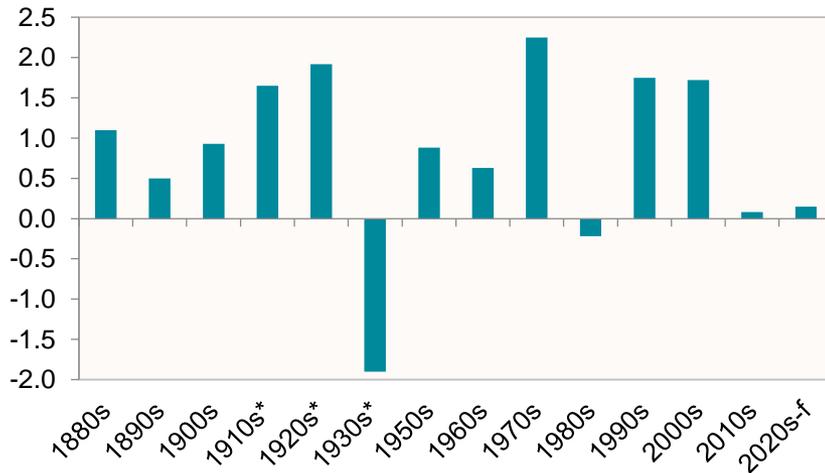
Slowbalization: Globalization has Faltered

Emerging pattern of trade: More regional (Asian) and more focused on services and global supply chains

- Large and sustained increases in the cross-border flow of goods, money, ideas and people have been the most important factor in world affairs for the past three decades.
- But now, most measures of global integration (trade, FDI, MNCs) are in retreat or stagnating.

Negative for overall economic efficiency and growth, as well as corporate margins

Change in openness 1880-2023 (average annual % change in world trade to world production ratio)



Source: World Bank, IMF, Vox EU (van Bergeijk)
 * Limited data available for these decades, as well as for the 1940s.
 Note: 2020s represents IMF forecast to 2023

World trade: Stagnant since 2011



Source: Epoch Investment Partners, Bloomberg

Geopolitical Risk: Challenging the Liberal Order

- Davos vs. Rest of the World
- Income Inequality and Populism
- Globalization vs. Sovereignty
- Trade tensions, Brexit, HK ...
- China, Russia, Turkey, Hungary, Iran, Brazil ...



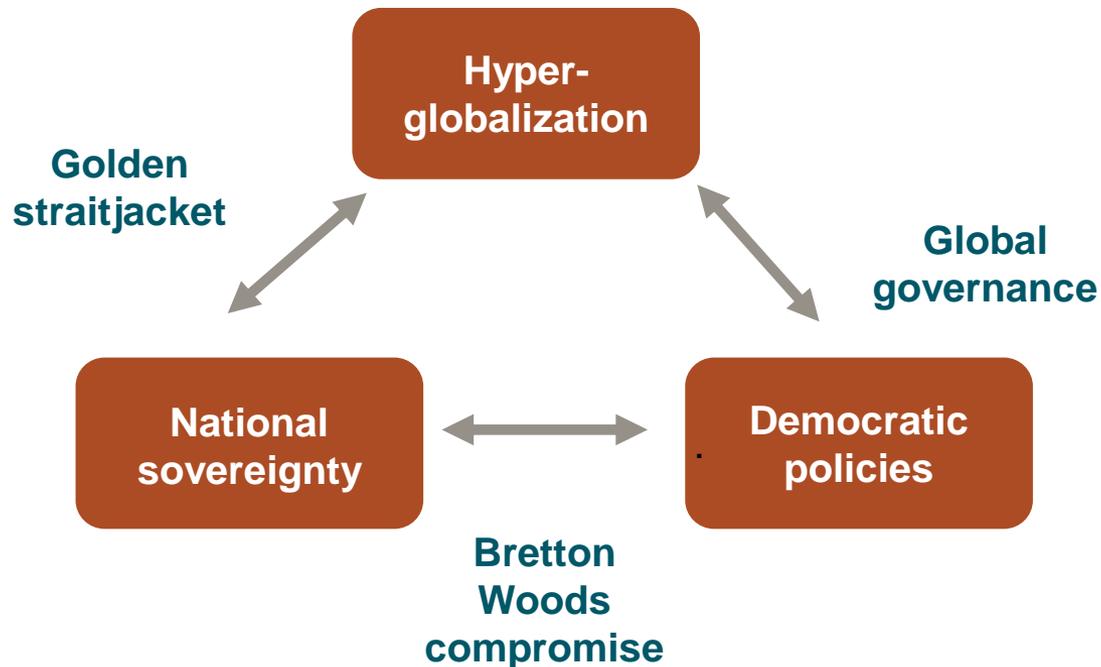
"The global liberal order is coming apart. When you simultaneously challenge social norms and many of the values that anchor people – a sense of home, job security, and the prospects for growth – and amp it up with social media networks, you get serious blowback, as we are seeing in France and Britain with Brexit."

Bill Priest, *Barron's*, Jan. 2019



Globalization and Sovereignty: The "Impossible Trinity"

- Democracy, national sovereignty and global economic integration are mutually incompatible.
- One can combine any two of three, but never all three simultaneously.



Source: *The Globalization Paradox*. Dani Rodrik, 2011

Cold War 2.0: Trade is the Battle, Tech is the War, Values are the Stakes

The platform, the players, and the stakes

- A new cold war has begun: No shots will likely be fired, but the stakes are still extremely high.
- Two superpowers with vastly different economic systems, values, and visions for the global economy.



Free Market Capitalism

- Emphasis on private property, freedom of speech, and the rule of law.
- More than half a century of market dominance.



Autocratic Structures

- Emphasis on command and control.
- Tension has been building for the past 30 years and the new cold war that may last generations.

A trade deal: Will represent, at best, a temporary truce

- Three key issues: Market access, IP protection, opaque industrial subsidies (China 2025).
- Chinese government fears containment and has stressed it will not compromise its values.
- Rising risk of a currency war, that could include restrictions on investment and capital flows.

Trade War Consequences: The End of Margin Expansion

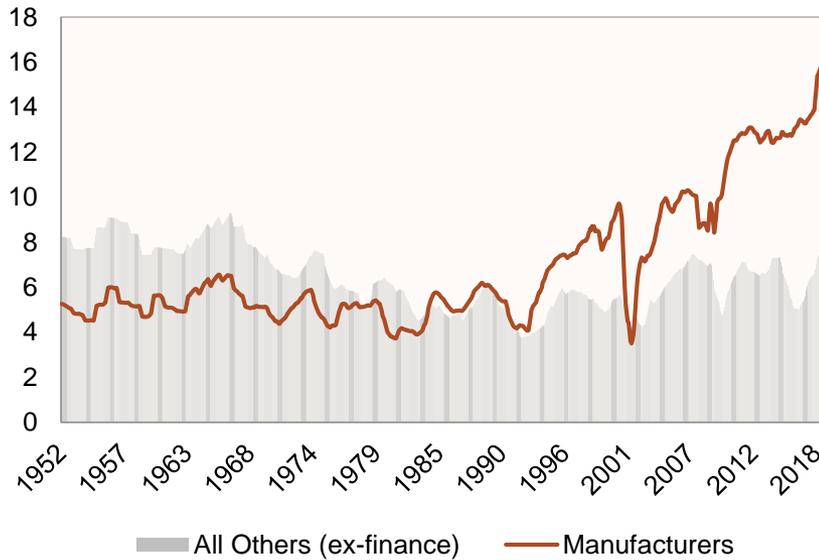
Globalization has faltered: Negative for economic growth, top-line revenues and corporate margins

Emerging pattern of trade: More regional (Asian) and more focused on services and global supply chains

- Large and sustained increases in the cross-border flow of goods, services, capital, ideas and people have been the most important factor in world affairs for the three decades following 1989
- But now, most measures of global integration (trade, FDI, MNCs) are in retreat or stagnating

S&P 500, net profit margins (%)

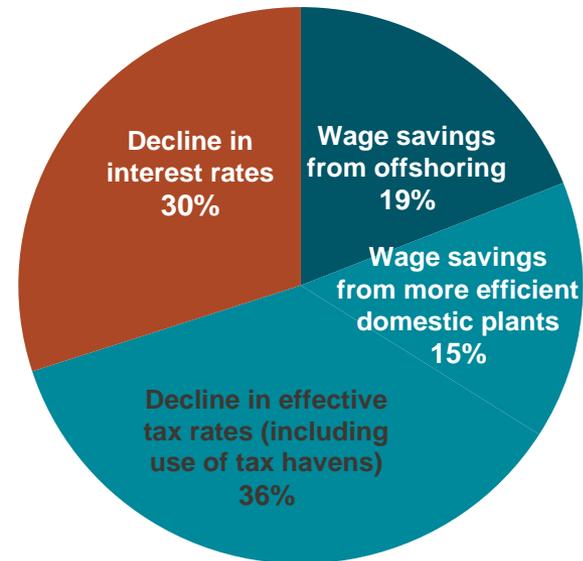
Manufacturers Have Enjoyed Tremendous Margin Gains during the Last 30 Years



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

S&P 500 Manufacturers Margin: 2018 vs 2000

The Margin Expansion Can Be Attributed to Four Factors

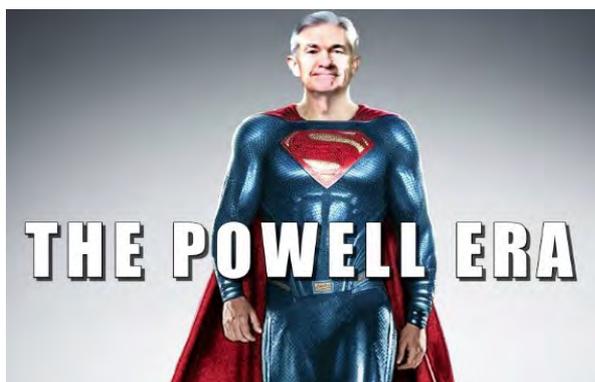


Source: Empirical Research Partners

Trade War Consequences: Central Bankers to the Rescue



Or do they just make things worse by multiplying excesses, ignoring the law of unintended consequences and postponing the inevitable?



How central bankers see themselves



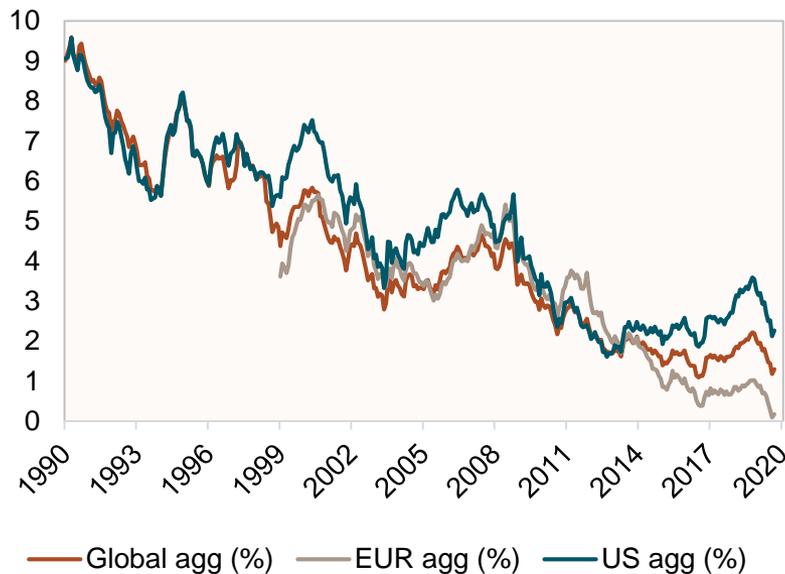
Bild, Germany's most popular newspaper, portrayed Mr. Draghi as a vampire sucking the blood out of the country's savers, after the ECB unveiled its latest stimulus package on Sept. 12

Cold War 2.0 and Bond Yields: The Disappearance of Price Discovery

Why?

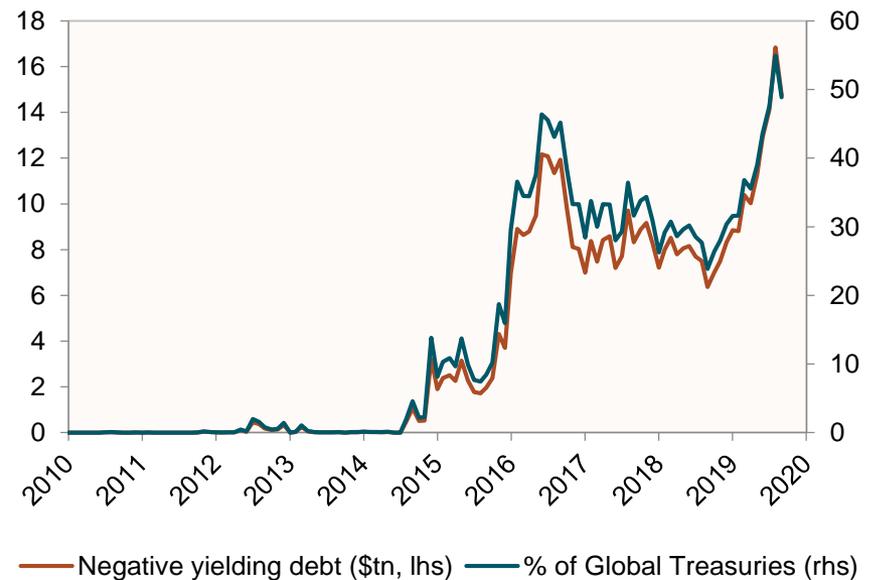
- Demographics: Especially in Japan and Europe
- Tech is the new macro: Transition from atoms to bits is deflationary
- Hyper-active central banks: Pre-emptive global easing cycle

Lower for longer interest rates



Source: Bloomberg, Epoch Investment Partners

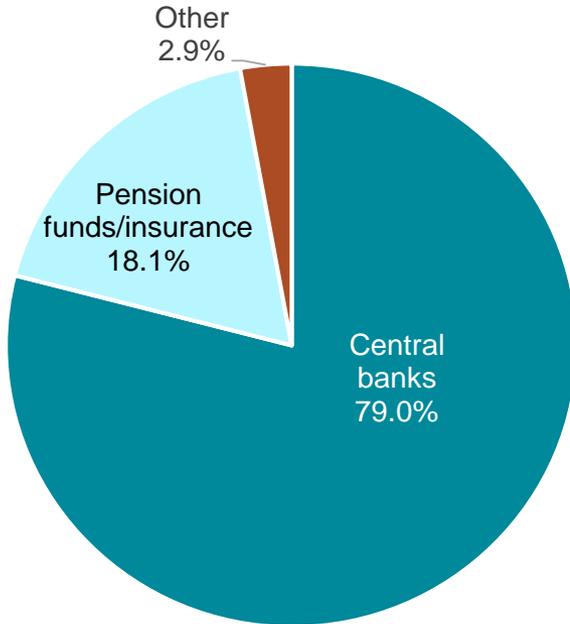
More than 50% of global treasuries trade at negative interest rates



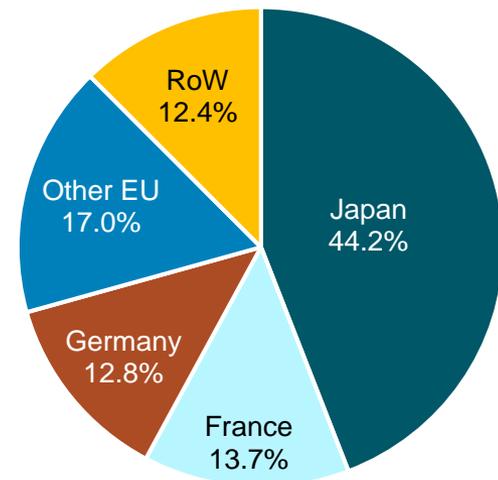
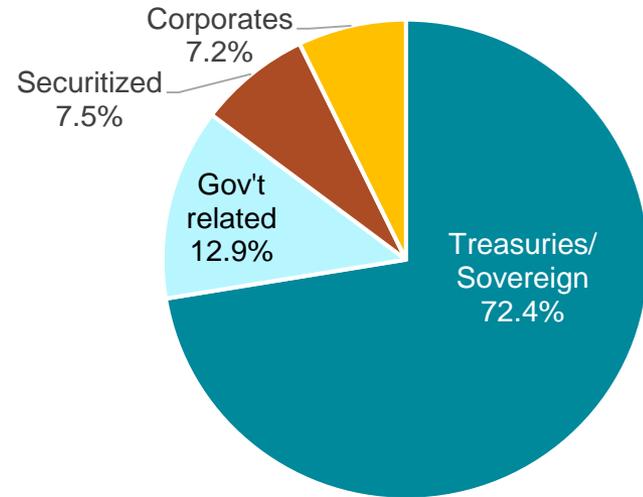
Source: Bloomberg, Epoch Investment Partners

Negative Yielding Debt: An Experiment Too Far

Hard to argue this is not being driven by QE



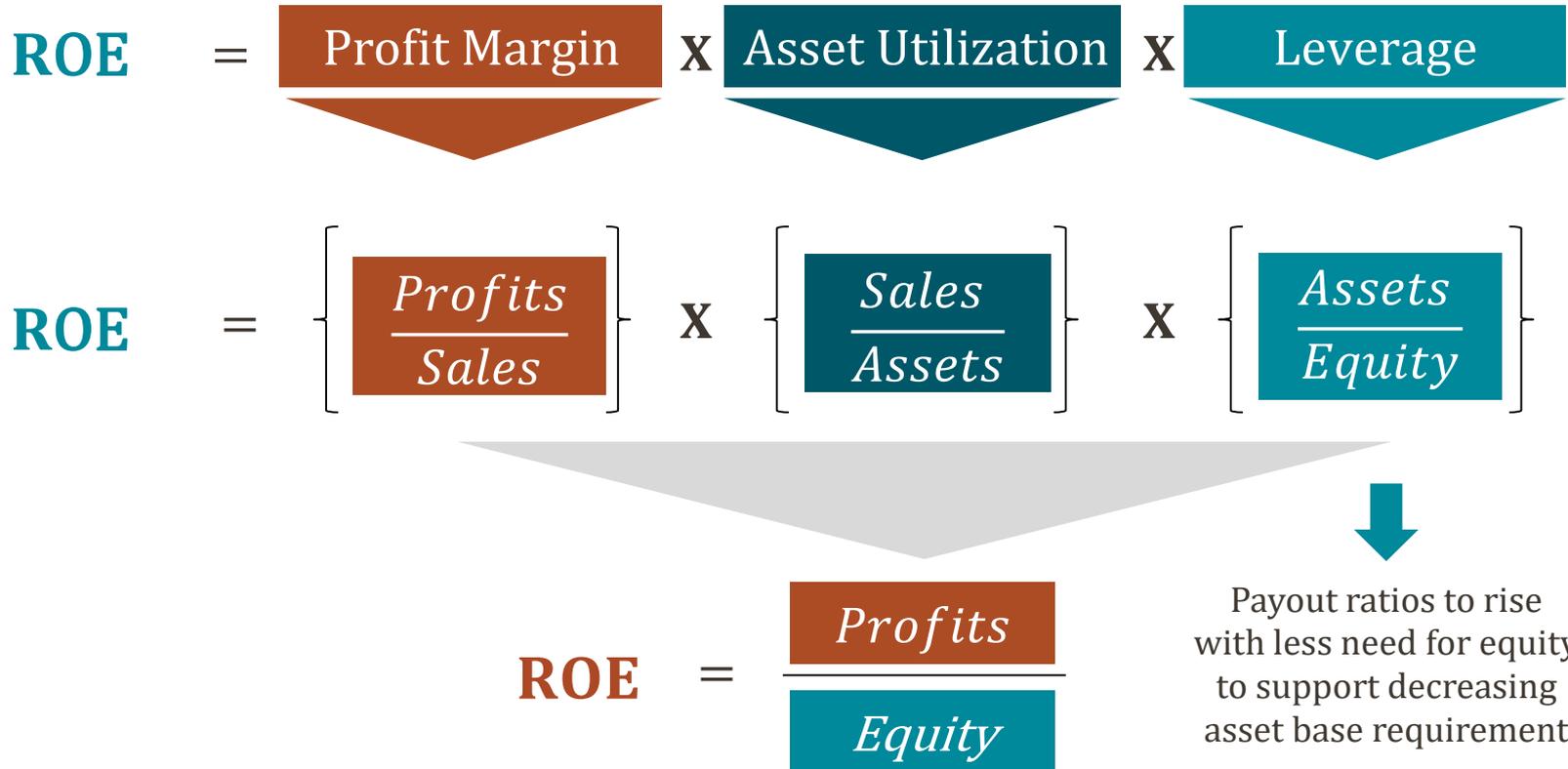
Supply-side of negative yielding debt



Source: Doubleline

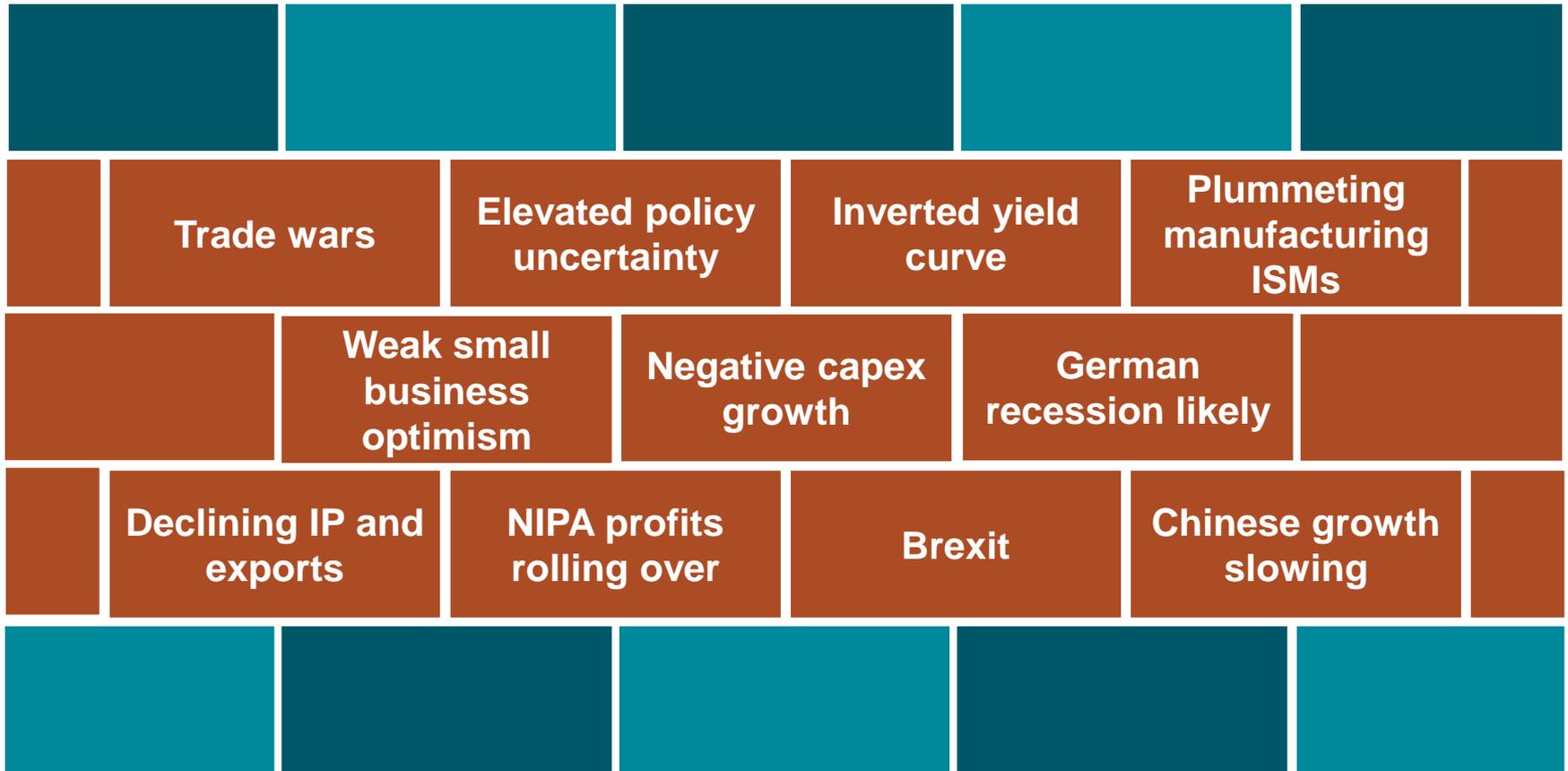
Technology Will Lead to Higher Payout Ratios

Capital Light Models are Great for Dividends (and Buybacks)



Lower labor cost increases margins and profits for distribution. Lower capital needs increase utilization and reduce the amount of debt and equity needed.

Wall of Worry: Recession Coming or Just a Slowdown?



As of September 30, 2019

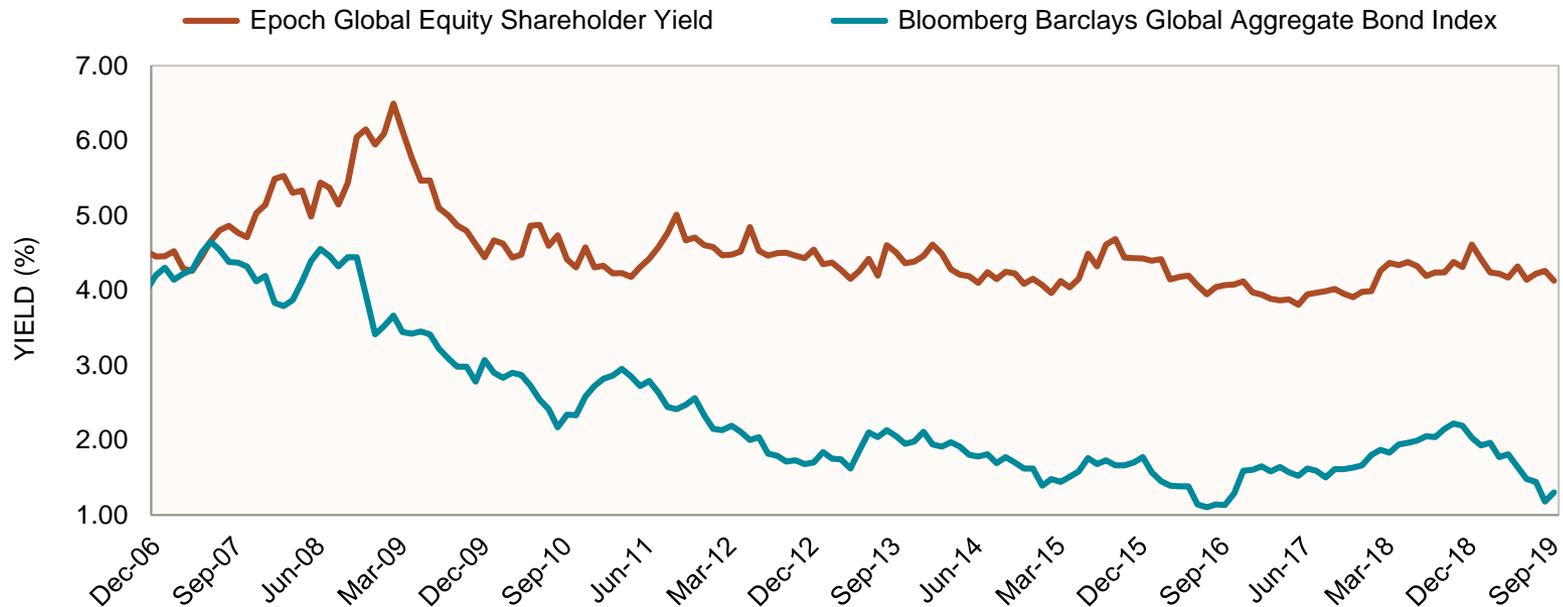
Equity Yield: Far Superior to Bond Yields

- U.S. SPX: Dividend yield of 2.0% + buyback* yield 3.3%
- Europe SXXP: Dividend yield of 3.8% + buyback* yield 1.1%
- Japan TPX: Dividend yield of 2.5% + buyback* yield 1.2%

*Buyback yield = value of shares repurchased divided by market capitalization

Source: Bloomberg, Yardeni, Goldman

Global Equity Shareholder Yield



Source: Bloomberg, FactSet. As of September 30, 2019

The data shown for Global Equity Shareholder Yield is of a representative account and such data may vary for each client in the strategy due to market conditions, client guidelines and diversity of portfolio holdings.

Key Benefits of Global Equity Shareholder Yield

Consistent Income Potential

- Abundant and steady income
- Attractive relative to other income generating strategies

Downside Participation

- Smaller than market drawdowns in most down periods
- Lower drawdowns = less time and return needed for recovery

Lower Volatility

- Below-market volatility a consistent outcome
- Lower volatility generally leads to a higher portfolio end value

Long-Term Capital Appreciation Potential

- An equity strategy focused on companies generating growing cash flow
- Consistent dividends and return compound over the long-term

Investment Implications: Lower for Longer and a World of Yield Starvation

- 1. Late-cycle slowdown:** As the cycle matures, exacerbated by trade tensions, economic and earnings growth are slowing. Earlier this year the hyper-active Fed responded with the "Powell Pivot", which has broadened into a global easing cycle. The resultant loosening of financial conditions has provided a welcome, albeit temporary, tailwind for equities.
- 2. Trade is the battle, tech is the war, values are the stakes:** Trade tensions to remain a source of volatility and we're concerned about the impact on margins of a bifurcation in global supply chains (especially affecting tech hardware). There is also a rising risk of a currency war, that could include restrictions on investment and capital flows.
- 3. Tech is the new macro:** Technology is positive for all three 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. Equally importantly, suggests companies will continue to return a higher proportion of cash to shareholders.
- 4. A World of Yield Starvation:** Bond yields have been driven lower by record high policy uncertainty, the late-cycle slowdown and hyper-aggressive central banks. However, dividends and buybacks remain robust, partially reflecting a capital-lite world. As a result, the yield available from equities can be far superior to that available in fixed income markets.

As a result of the above points, it is ever more important to favor companies with a demonstrated ability to produce FCF and allocate that cash flow wisely between return of capital options and reinvestment/ acquisition opportunities.

Thought Leadership

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Join us each episode as host and Portfolio Manager Steve Bleiberg takes on current topics and issues concerning capital markets, portfolio management and the asset management industry.

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“Blitzscale and Hope: Unicorns, IPOs and the Fear of Repeating the Late 1990s”

Hype about digital platforms, blitzscaling and winner-takes-most markets has fueled a surge in IPO listings and produced stratospheric valuations that are difficult to reconcile with free-cash-flow (FCF) fundamentals. Are we repeating the excesses of the dot-com boom?



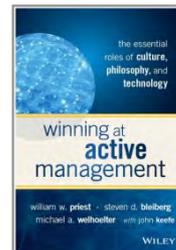
“The P/E Ratio: A User's Manual”

Does a stock's price and its P/E ratio tell you how much a company is worth? Conventional wisdom says yes, but we think otherwise ...



"Trump, Tech and Trade"

China's mercantilist behavior, underscored by its "Made in China 2025 initiative," is in conflict with U.S. demands for greater IP protection, a level playing field and improved market access. Left unresolved, free trade and globalization will be in retreat, with broad economic implications beginning with manufacturers.



Winning at Active Management

Authored by three Epoch portfolio managers, the book examines the issues facing the investment management industry and explores the essential roles of culture, philosophy and technology.