Each quarter, Epoch Investment Partners’ co-CIOs Bill Priest and David Pearl discuss the macroeconomic themes that are affecting global capital markets. This quarter, one of our senior research analysts, Barney Rosen, MD, joined the discussion to provide insights on the health care sector. This document contains the summarized transcript of the presentation. A full replay of the webinar is available on our website, www.eipny.com.

Bill Priest:

From 2012 through 2015 multiple expansion has been the driver of returns globally and, to a slightly lesser extent, domestically due to the effects of quantitative easing. Going forward, stocks will no longer have the benefit of the broad-based valuation expansion that propelled markets as central banks began to ramp up their QE programs.

QE’s effect was enormous and affected most financial assets across the globe in a very favorable way. Here we see the effect of QE on earnings multiples, which are up approximately 40% from 2012.

Source: Standard & Poor’s; MSCI; Epoch Investment Partners; December 2015
China is in the midst of rebalancing their economy and the sectors such as construction and industry that once contributed significantly to growth have slowed considerably as they move toward a more service-based economy.

China’s rebalancing will play out over the next few decades and during the transition, industrial production and capex are likely to continue to decline. The expectation is that consumption will represent approximately 50% of GDP by 2020–2030.

Real GDP is simply the sum of two economic variables, growth in the workforce and productivity. Given this backdrop, we believe that 2% growth is a lot more likely than the recent 4% average for mature economies due to the slowdown in demand.

The specter of deflation is hanging over the developed world and restraining policy makers. Of the 34 countries in the OECD, roughly 31 of those have inflation under 2%, 27 countries with inflation under 1% and 10 are actually negative.
Technology is having a large impact on capital productivity. The substitution of capital for labor through technology is what we believe will allow margins to exceed expectations.

The list of economies with negative interest rate policies (NIRPs) continues to grow. Hungary, Japan, Europe, Sweden, Denmark and Switzerland all have negative rates. We will be producing a white paper on the NIRP phenomenon and its potential implications.

The list of countries with NIRPs continues to grow.
Technology is the new macro and will have a significant impact on returns. If you think of return on equity in the form of three variables, profit margins, scale (or asset utilization) and leverage, technology affects all three. Profit margins are helped by technology in the aforementioned capital-light world, as is scale, as you are able to produce more revenues with fewer assets. Finally, in a low-interest-rate world, you can actually take on more leverage if you’re confident of your final demand outlook. So technology works its way through and produces a positive effect on every component of return on equity.

David Pearl:
The U.S. economy is still growing at a little over 2%, but corporate earnings have been impacted by the strength of the dollar. As a result, companies that derive the majority of their sales outside of the U.S. have seen revenues decline due to the currency effect, which has, in turn, affected earnings.
Companies have been underestimating the strong dollar’s impact on earnings, but the dollar has finally started to stabilize. This could potentially result in companies exceeding guidance for the first time in several quarters.

Oil supply is beginning to decrease in response to lower oil prices. Drilling and capital spending on oil rigs have declined dramatically due to the low cost of oil, and as a result, production and supply have begun to roll-over from their peaks.

Recent economic data in both the U.S. and Europe has been surprising on the upside, indicating that both economies are gaining traction over the last several months.
Manufacturing, which has long been either stagnant or in decline, has begun to pick up. This is important because it means manufacturing has become a relative contributor to our economy recently, instead of detracting from growth.

The plight of the American consumer has been improving. While wage growth has not been significant, disposable income growth has been outpacing GDP because of the increase in purchasing power due to inexpensive oil and the strength of the dollar.

The tide has turned in favor of workers at the expense of corporate profits as it becomes more difficult to continue to achieve productivity increases, particularly from cutting the cost of labor.
The first quarter of 2016 was truly a tale of two halves with a 10% peak-to-trough move. This was the result of macroeconomic factors more so than fundamentals and dramatically affected market leadership over the quarter.

Since the third quarter of 2014, there has been a significant difference in the performance of cyclical and defensive stocks. Defensive stocks have been the clear leaders, widening the gap between cycicals during the periods of heightened uncertainty.

Here we see the quarter broken into two halves with the defensive sectors performing well in the first half of the quarter. The trend reversed in the second half of the quarter with economically sensitive sectors leading the way, but defensive still in positive territory. This highlights the importance of yield in both market environments.
Expectations for health care earnings have been pretty strong and have in fact compressed during the first quarter.

<table>
<thead>
<tr>
<th>Sector</th>
<th>December 31, 2015</th>
<th>March 31, 2016</th>
<th>Percent Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>16.10</td>
<td>16.61</td>
<td>3.2%</td>
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<tr>
<td>Health Care</td>
<td>16.00</td>
<td>14.90</td>
<td>-8.9%</td>
</tr>
<tr>
<td>Financials</td>
<td>12.66</td>
<td>12.60</td>
<td>-2.1%</td>
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<tr>
<td>Consumer Discretionary</td>
<td>18.14</td>
<td>18.09</td>
<td>-0.3%</td>
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<tr>
<td>Information Technology</td>
<td>15.97</td>
<td>16.33</td>
<td>2.2%</td>
</tr>
<tr>
<td>Industrials</td>
<td>15.52</td>
<td>16.02</td>
<td>3.2%</td>
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<tr>
<td>Consumer Staples</td>
<td>19.89</td>
<td>20.98</td>
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<tr>
<td>Materials</td>
<td>15.34</td>
<td>17.16</td>
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<tr>
<td>Telecom Services</td>
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<td>13.93</td>
<td>13.2%</td>
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<tr>
<td>Utilities</td>
<td>15.44</td>
<td>17.71</td>
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<tr>
<td>Energy</td>
<td>28.04</td>
<td>82.84</td>
<td>124.1%</td>
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</tbody>
</table>

Source: Standard & Poor’s, Epoch Investment Partners; April 2016

Barney Rosen:
The S&P Health Care Index has underperformed the S&P 500 Index significantly over the last several months, particularly following Hillary Clinton’s tweet on price gouging on September 21, 2015.

The underlying business fundamentals for health care companies remains solid based on expectations for future cash flow and earnings. Here we see the underlying growth rates on the left for earnings and then we see the earnings revisions on the right of the major sectors and health care screened quite well on both of these.

Bill Priest:

We are entering a period where returns from financial securities are likely to be less than what we've enjoyed historically. Here we see the substantial difference in the yields between regional benchmark indices and 10-year sovereign bond yields.

We believe that successful investing is linked to prudent capital allocation. The key here is: can you earn something above your cost of capital? Those companies that can do that are involved in capital spending and acquisitions. On the other hand, if you can't exceed your cost of capital, you should give the money back to investors in the form of cash dividends, buybacks and debt reductions, which we call shareholder yield.

Buybacks and dividends will continue probably at a lower rate than what we've seen recently, but still at elevated levels historically. We expect buybacks and dividends to continue as a favored use of cash, in part because there's less capital required to generate a dollar of sales in an increasingly capital-light world.
While M&A activity hit a record in 2015, it is conceivable that there could potentially be an aggregate decline in M&A activity because of fears of a unilateral action by the Treasury without any change in congressional law.

Source: Strategas Research Partners; December 2015

Summary

- Low growth reflecting demographics, productivity and slow down in China have made 2% the new normal for real GDP growth.
- Technology is the new macro: enhancing productivity, sustaining profit margins and reconfiguring capital allocation choices.
- Dividend payers and free cash flow generators should drive relative equity returns.
- The diminishing impact of monetary policy (QE) on valuation metrics will foster greater interest in active management.