

Reinventing Globalization Part II:

Unlearning Lessons
Taken to Heart
Since the 1980s



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- In Reinventing Globalization Part I, we demonstrated that global supply chains are being overhauled to reduce vulnerabilities and to restrict Chinese imports of “dual-use” products. This is especially affecting energy and tech (particularly semiconductors). As globalization retreats, we expect Chinese equities to underperform. Many U.S. multinational corporations (MNCs) will also take a hit as exports to China have frequently accounted for 40% of their sales growth over the last decade.
- Part II of the series shows that deglobalization implies a regime change, with trend increases in capex and the labor share, as well as a higher cost of capital, lower potential growth and greater government involvement in the economy. This constitutes a secular headwind for margins and free cash flow (FCF), especially for tech and manufacturing.
- We are not returning to the low inflation, zero real interest rate 2010s. Further, with the end of the “Great Moderation,” we expect higher macro volatility (of GDP, inflation, interest rates and FX).
- With companies facing a higher weighted average cost of capital (WACC), we expect lower average multiples. This will prove especially challenging for longer duration assets, such as venture capital and speculative tech companies that are years away from generating FCF on a sustainable basis.

The great problems we have – energy, climate change, defense, inequality, our dependence on production from China – will all be solved by massive investment. This capex boom could last for a long time.

— Russell Napier,
October 2022

Trend Increase in Capex: The Tangible Twenties

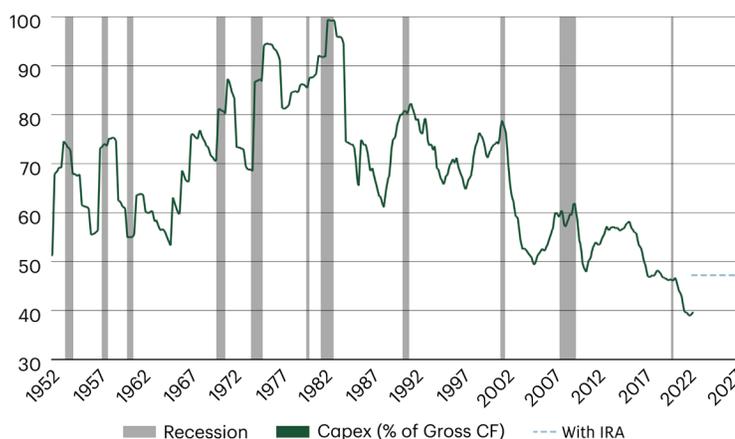
After the intangible 2010s, when tech was the dominant theme, the U.S. economy is becoming somewhat less “capital-lite.” We expect a secular rebound in investment spending reflecting deglobalization and reshoring, as well as decarbonization and demographics (implying a tighter labor market).¹ Further, the government recently passed two major pieces of legislation supporting domestic investment and capex is low relative to history, appearing well overdue for a rebound (**Figure 1**). Overall, this suggests a greater share of corporate cash will be spent on domestic investment.

While capex’s declining share of corporate cash flow is striking, what is even more startling is the changing composition of investment spending (**Figure 2**). The overall share of U.S. GDP that is accounted for by corporate investment is close to its 50-year mean (roughly 13.5%). However, the share of investment spending that is directed toward intellectual property (IP), which includes R&D and software, has soared (to 360% of its share in 1960), while that on manufacturing structures (12%) and mining structures (10%) has plummeted. We expect IP investment to remain strong, but reshoring should prove especially positive for both types of structures.

¹ See our March 2022 paper, “Greenflation: The Energy Transition Will Prove Inflationary”

Figure 1: S&P 500 Capex (% Share of Cash Flow) is at a Record Low

An investment rebound is expected, reflecting the Inflation Reduction Act (energy), Chips Act (semiconductors), reshoring and an extended period of underinvestment in the real economy

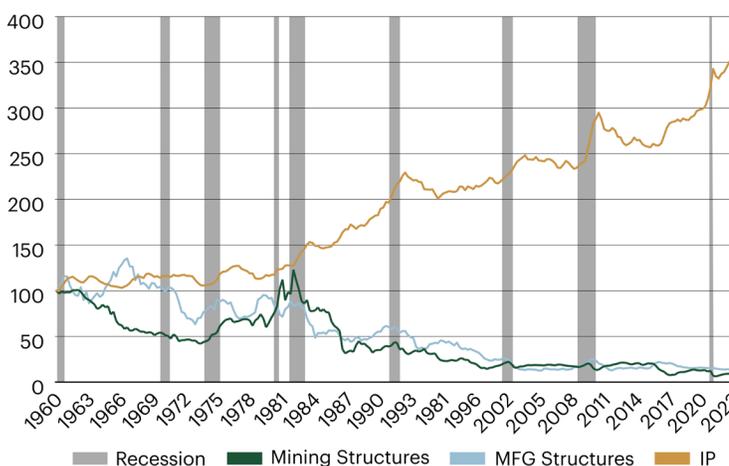


Source: Empirical Research Partners

Note: For Large-Cap Stocks

Figure 2: Composition of Investment Spending (index, 1960 = 100)

The relative share of investment spending on IP has soared, while that on structures has collapsed, although we believe it is set for a rebound



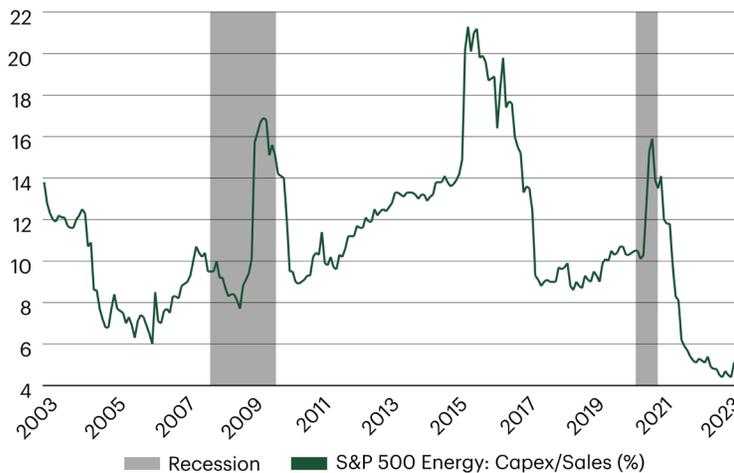
Source: Bloomberg, Our World in Data, Fouquin and Hugot (2016), Epoch Investment Partners

Regarding sectors, the outlook for investment is especially positive for energy, as well as materials and industrials. They all possess relatively low levels of capex, with energy being the standout (**Figure 3**). The energy sector also exhibits a strong return on capital and is trading on a record high relative free cash flow yield. Moreover, the Inflation Reduction Act (IRA) aims to boost energy investment.² Finally, there will be plenty of demand for fossil fuels for decades to come, as energy transitions are much slower than the consensus optimistically assumes.³

Spurred on by the Chips Act, investment in semiconductor fabrication in the U.S. is set to accelerate, despite costs that are 30-55% higher than in Taiwan or South Korea. More broadly, we expect government support for the domestic production of Advanced Technological Products, all of which can be used for both commercial and military purposes, to increase significantly this decade. Note that government investment averaged over 3% of GDP in the '50s and '60s, during the height of Cold War I, but has since declined to 1.5% (**Figure 4**). Even if this increases to just 2%, back to where it was in the mid-90s, that would represent \$100 bn in additional annual investment. This finishes our discussion of why we expect domestic capex to increase significantly, and we now turn to the rising labor share.

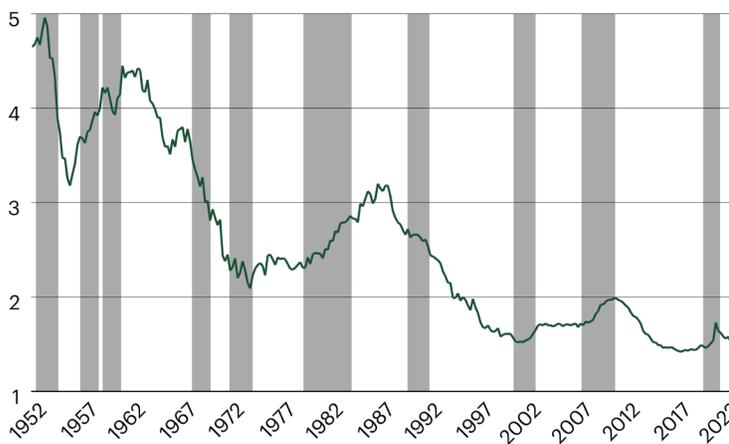
Figure 3: Energy Sector Capex (% of Sales) is Close to a Record Low

Energy majors are often criticized for being terrible capital allocators, but they have behaved in a much more disciplined manner this cycle



Source: Bloomberg

Figure 4: U.S. Gross Federal Government Investment (% GDP) Set to increase above 2% over the coming decade, but will remain smaller than it was during Cold War I



Source: Bloomberg, Federal Reserve

²See Figure 5 in Part I.

³This is true, unfortunately, as emphasized by Vaclav Smil in “Energy Transitions.” Even the IEA expects renewables to account for only 28% of global energy in 2050 (up moderately from 16% in 2020).

The 3Ds and the Rising Labor Share

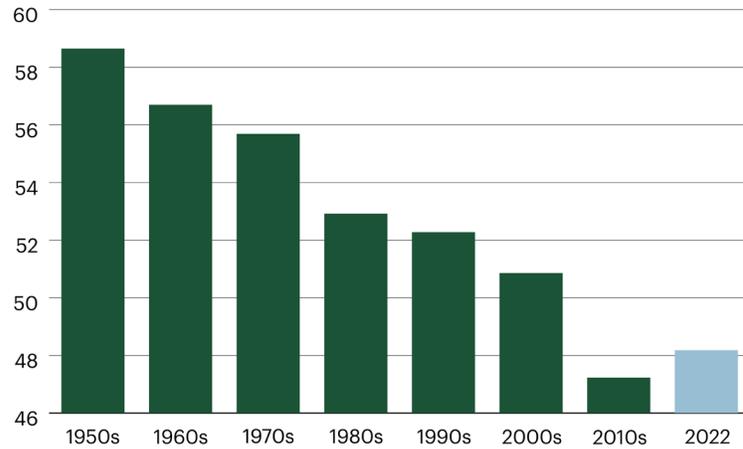
The labor share of both GDP and corporate gross value added hit an all-time low in the 2010s (**Figure 5**). However, deglobalization, as well as decarbonization and demographics, strongly suggests this share will rise toward its level in the 1990s and 2000s. With the reshoring of relatively high wage jobs, we are partially reversing the period from 1990 that led to a four-fold increase in the effective global labor force (according to the IMF). To illustrate the attraction to MNCs, average wages in China are now seven times higher than they were in 2000 but are still only 28% of U.S. levels.

Regardless of China's lower wages, U.S. corporates are increasingly discussing reshoring (**Figures 6 and 7**). The primary reason cited for reshoring is rising concern over dependency on China, with the main sectors affected including electrical equipment (e.g., EV batteries), chemicals (pharmaceuticals, hydrogen), transportation equipment (mostly cars) and electronic products (solar panels, robotics, drones, semiconductors), as well as medical equipment and supplies.

Some commentators claim reshoring means America is heading for a "Manufacturing Renaissance" and is about to regain the 5 million manufacturing jobs it lost after China joined the World Trade Organization (WTO). We believe this overstates the case, but it is noteworthy that the number of manufacturing jobs in the U.S. bottomed in 2010 and has since risen by about 1.5 million. Without reshoring, the number of such jobs would have been roughly flat over the last decade, so it is already making a sizable difference. That concludes our discussion of labor and capex, and we now move on to examine what all this means for inflation and interest rates.

Figure 5: U.S. Wages and Salaries (% of Gross Value Added of Domestic Corporate Businesses)

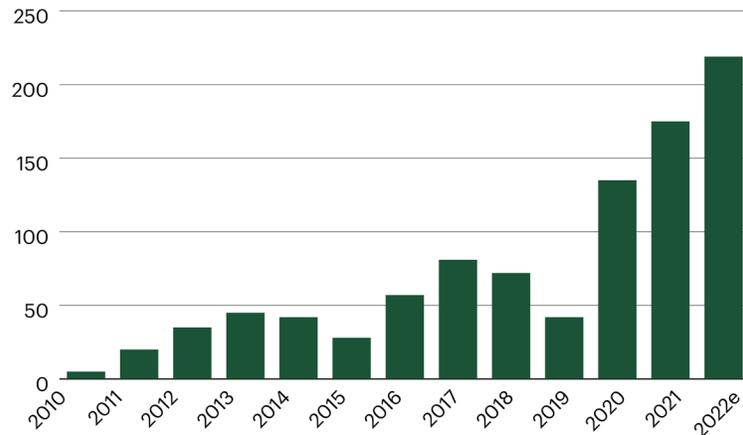
The U.S. labor share bottomed in the 2010s, but is set to rise above 50% by the late-2020s



Source: Bloomberg

Figure 6: U.S. Announcements to Reshore Manufacturing Jobs ('000)

What started as a trickle has become a torrent: One million jobs have been brought home since 2010



Source: ReshoreNow.org

Note: The data comes from the Reshoring Initiative's Reshoring Library of over 8,000 published articles, privately submitted Reshoring Case Studies, and some other privately documented cases.

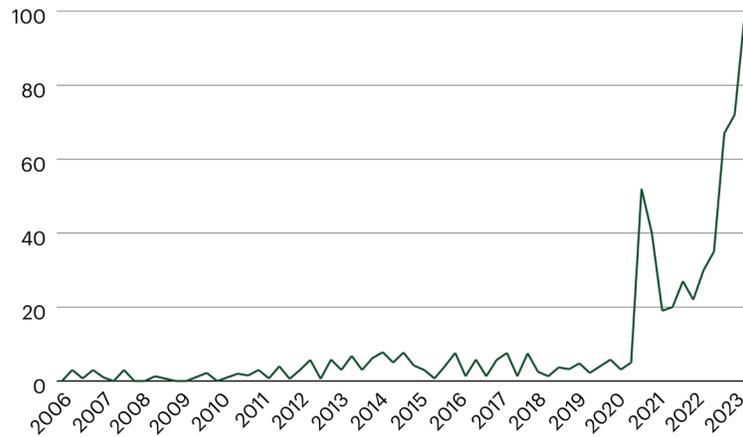
We Are Not Returning to the Low Inflation, Zero Interest Rate 2010s

There is no avoiding the inflationary impact of a deglobalizing world. We expect higher trend inflation and real interest rates, especially relative to the last two decades.⁴ Additionally, as monetary policy normalizes from the extremely loose stance maintained after the Global Financial Crisis (GFC), we expect the cost of money to be higher across the curve. Here we show the 10-year yield (Figure 8), but the same pattern is seen at many maturities, including for the 30-year mortgage rate.

The same conclusion also applies to real yields (Figure 9). To illustrate, the real 10-year yield averaged only 70 bps during the 2010s, a full 180 bps below the previous decade's mean and 350 bps below the 1990s average. Historically, the real 10-year yield has not been a mean reverting or stationary series, which means it is challenging to forecast with any confidence. That said, we believe it will be significantly higher than it was last decade. Our point estimate of 1.8% for 2030 is based on the Congressional Budget Office's mean GDP growth forecast for the remainder of the decade.

Figure 7: Mentions of Re-/Near-/On-shoring by U.S. Corporates (index, 100 = max)

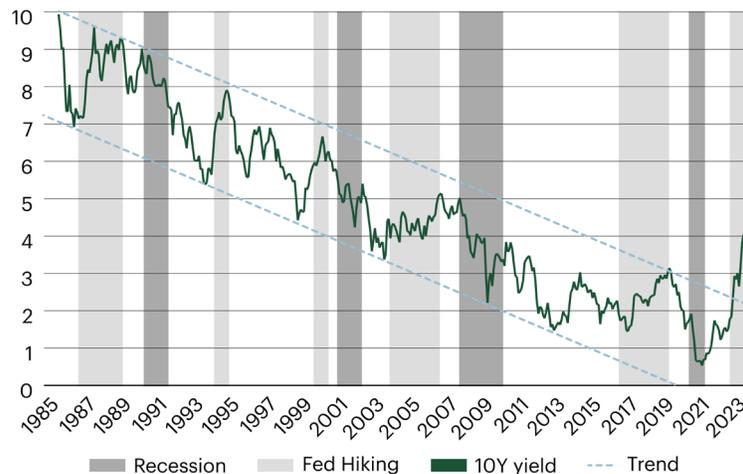
Management discussions of onshoring first soared with COVID, but have skyrocketed this year as tensions with China have escalated



Source: AlphaSense, Bank of America

Figure 8: U.S. 10-year Nominal Yield (%)

The four-decade disinflationary trend, in place since Volcker helmed the Fed, is unequivocally over

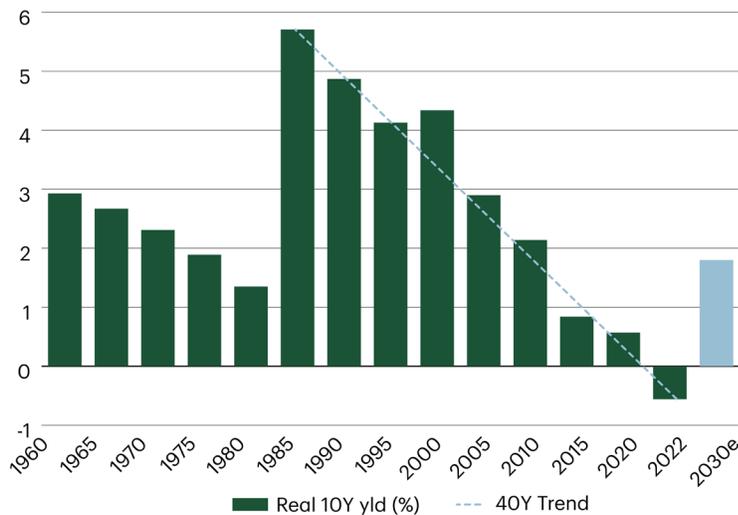


Source: Bloomberg

⁴ Please see our July whitepaper, "Inflation and the 3Ds."

Figure 9: U.S. 10-year Real Yield (%)

The 40-year downtrend in real yields is emphatically over, with 1.8% being our forecast for 2030

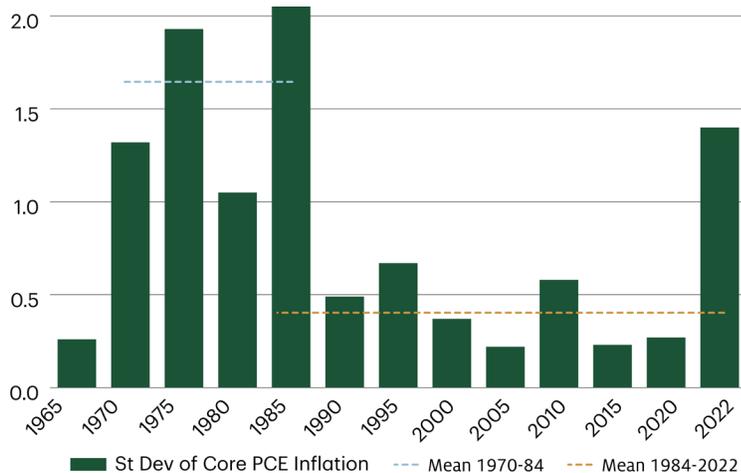


Source: Bloomberg, Congressional Budget Office

Note: Real yield using core PCE inflation (results are similar using break evens, but data only available from 1998). Bars display 5Y average at end of year shown (except for 2022). Our 2030E estimate of 1.8% is based on CBO's mean real GDP growth forecast to 2030

Figure 10: Standard Deviation of U.S. Core PCE yoy Inflation (%)

After 1985, the standard deviation of core inflation declined by 75%. However, volatility will probably trend significantly higher over coming years.



Source: Bloomberg

Note: Bars display 5Y standard deviation at end of year shown (except for 2022)

End of the “Great Moderation”

In addition to elevated inflation and interest rates, we expect higher macro volatility (of growth, inflation, interest rates and FX) with the end of the “Great Moderation.” To illustrate, after a long period of relative calm, inflation is likely to exhibit much higher variation over the next decade due to the 3Ds, as well as the lack of fiscal and monetary policy space (Figure 10). The “Great Moderation” pattern can also be seen with GDP (the standard deviation declined from 4.8% prior to 1985 to 2.1% since), and the USD (volatility declined from 10.0% prior to 1990 to 4.3% during the last 30 years). Elevated macro variability over the next decade will assuredly test policy makers and, regrettably, comes at a time when they have less dry powder to respond. It will also challenge investors who will need to unlearn lessons taken to heart since the 1980s. This includes assumptions about the cost of capital, as we’ll now discuss.

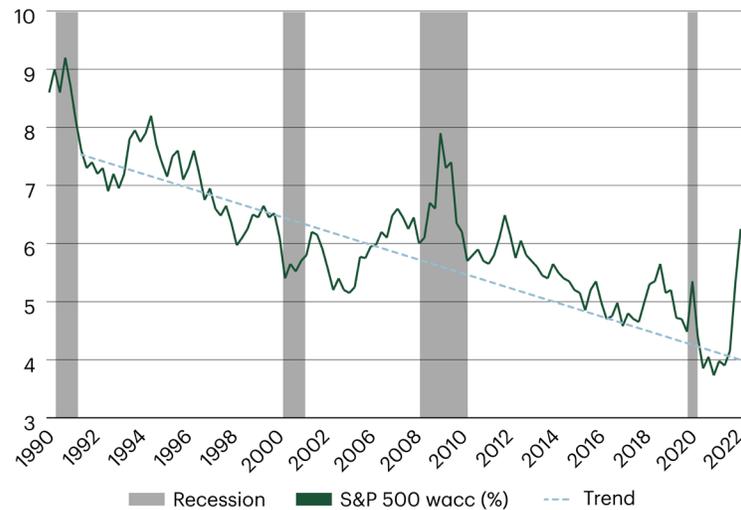
This extra variability in inflation can come through two channels. The first is an increase in the prevalence of supply shocks. ... The second channel is through the global supply curve being less elastic than it has been over the past decade or so.

— “Price Stability, the Supply Side and Prosperity,”
Philip Lowe, RBA Governor, November 2022

Companies to Face a Higher Trend WAAC

A few years ago, an exuberant sell-side analyst wrote, “When capital is free, dreams are reality.” This quote illustrates how the era of zero interest rates encouraged poor capital allocation decisions. However, the secular decline in WAAC is now over (**Figure 11**). U.S. companies are expected to face a significantly higher cost of capital than they did last decade, which suggests lower multiples. This will prove especially challenging for longer duration assets, such as venture capital and speculative tech companies that are years away from generating FCF on a sustainable basis.

Figure 11: S&P 500 WACC (%)
The multi-decade downtrend is over



Source: Bloomberg, Goldman Sachs, Damodaran, Epoch Investment Partners

Reinventing Globalization: Impact on Corporate Margins and FCF

Figure 12: U.S. Import Prices vs Domestic Producer Price Index (PPI) (Index, 2004 = 100)

Since 2004, import prices from China and ASEAN have declined by over 40% relative to the domestic PPI



Source: Bloomberg

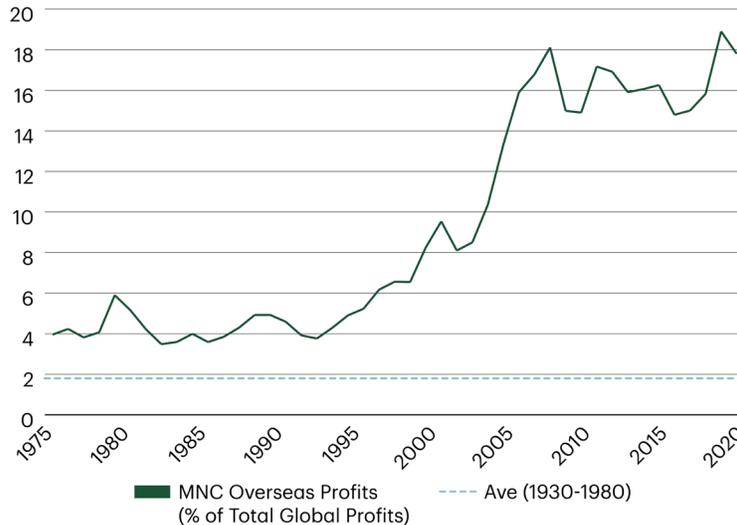
Reshoring production might reduce supply chain vulnerabilities and eliminate some national security risks. However, as we have shown above, it poses challenges for U.S. corporates by raising their capex, labor and capital costs. Companies will also face higher prices for intermediate inputs as they shift to domestic suppliers (**Figure 12**). That is, deglobalization means unwinding comparative advantage and relying more heavily on expensive domestic factories, workers and intermediate inputs.

The two biggest beneficiaries of hyper-globalization have been China and MNCs, and both now face significant headwinds. We've already discussed why we expect Chinese equities to keep underperforming (see Figures 6 and 7 of Part I). Turning to MNCs, their share of profits increased moderately from the early-1990s, then soared from 2002 with China's entry into the WTO, and finally plateaued after the GFC (**Figure 13**). Reflecting the impact of deglobalization, we expect their share to decline by several percentage points by 2030.

The key takeaway from the above analysis is that deglobalization poses five challenges for overall margins and FCF: More capex, higher wages, increased cost of capital, lower potential growth and greater government involvement in the economy. These factors will affect all companies, but especially those in technology and manufacturing, the sectors that have contributed the bulk of the improvement in margins and FCF over the last two decades (**Figure 14**).

Figure 13: Global Multinational Profits (% of Total Global Corporate Profits)

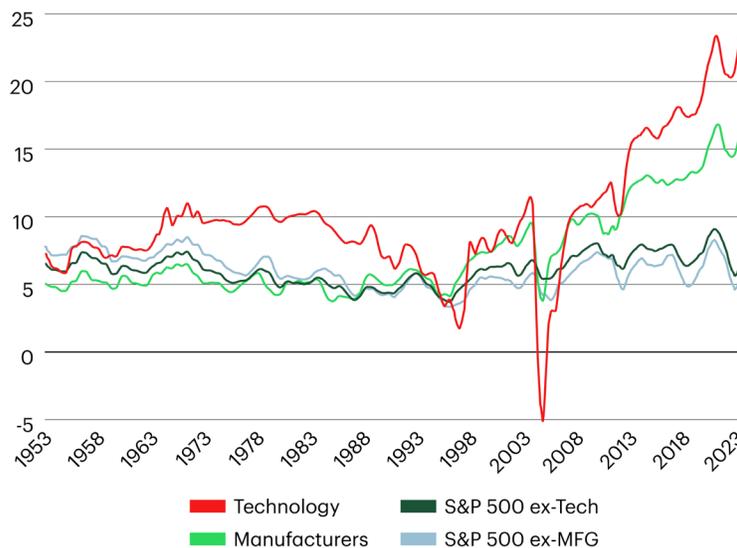
MNCs were one of the biggest beneficiaries of the golden era of globalization, but their share is set to decline over coming years



Source: Bloomberg, Goldman Sachs, Damodaran, Epoch Investment Partners
 Multinational profits: Defined as profits booked by corporations in a country other than their headquarters

Figure 14: S&P 500 Net Profit Margins (%)

The technology and manufacturing sectors benefitted the most from globalization, but will see margins retrace as the process works in reverse



Source: Empirical Research Partners

Implications for Investors: Unlearning Lessons Taken to Heart Since the 1980s

Global supply chains are being overhauled to reduce vulnerabilities and to restrict Chinese imports of “dual-use” products. Sectors such as energy and tech (especially semiconductors) are the most directly affected. With the end of hyper-globalization, we expect Chinese equities to underperform. Many American MNCs will also be challenged as exports to China have frequently accounted for 40% of their revenue growth over the last decade.

While the deflationary impact of tech remains in place, we believe it is being overwhelmed by the 3Ds — Deglobalization, Demographics and Decarbonization — meaning we have entered a secular reflationary environment. That

is, we are not returning to the low inflation, zero real interest rate 2010s. Moreover, we are saying farewell to the “Great Moderation” and opening the door to heightened macro volatility (of GDP growth, inflation, interest rates and FX).

Deglobalization implies a regime change, with trend increases in capex and the labor share, as well as a higher cost of capital, lower potential growth and greater government involvement in the economy. This constitutes a secular headwind for margins and FCF, especially for tech and manufacturing. Further, with companies likely to face a higher WAAC, we expect lower average multiples. This will prove especially challenging for longer duration

assets, such as venture capital and speculative tech companies that are years away from generating FCF on a sustainable basis.

Epoch has always favored companies with effective capital allocation policies, including a demonstrated ability to deliver a return on invested capital above their WACC. Such companies are the most probable winners, especially today as management teams face a future that is likely to look very different from the last two decades.



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