2017 Mid-Year Economic and Market Outlook Conference Call

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The following is a summary of the views expressed by Empire Life Investments Inc. during a conference call on July 19, 2017.

Global equity markets continue to do well in the first half of 2017, supported by the positive macroeconomic environment. China has stabilized, Europe is recovering, and corporate earnings in the U.S. are rising. The end of June saw a global coordination among major central banks to bring monetary policies back to a more normal level. The Federal Reserve (the Fed) raised rates, and the European Central Bank (ECB) removed the easing bias on interest rates from its forward guidance. A sudden shift in the policy stance of the Bank of Canada (BOC) showcased the central bank's resolve to join the U.S. in a tightening cycle.

Market and Economic Developments

- The Fed raised rates in March and June. Its projection points to another rate hike later this year and three more in 2018. The Fed is also planning on reducing its balance sheet as early as September. These pressures pushed yields at the short end of the curve gradually higher. At the longer end, the benchmark U.S. ten-year Treasury yield picked up to 2.63% by mid-March, and then retreated again, primarily because of a lack of inflation, delays to the Trump administration's fiscal stimulus and the continued hunt for yield. In the last trading days of June, the prospect of central banks tightening triggered a sell-off in government bonds around the world. In Canada, the benchmark ten-year government bond yield jumped by 25% within two weeks, after the odds of the BOC raising interest rates at least once this year increased to about 95% at the end of June, from almost zero odds at the beginning of the year. The FTSE TMX Canadian Universe Bond Index gave back some early gains and finished the first half of the year with a return of 2.4%.

- The Canadian economy has been robust, as evidenced by GDP data, job growth, household spending, business investment and manufacturing activities. But investor sentiment has been somewhat bearish, with a focus on the downside risks from declining commodity prices, elevated housing prices, growing consumer debt, NAFTA renegotiations and the resulting uncertainties in international trade. After a brief surge, oil prices have sagged this year, as U.S. energy companies have more than doubled the number of active drilling rigs from a year ago, raising their production levels. Oversupply remains an issue. Global crude inventories remain stubbornly high. In addition, speculators, including some hedge funds, that had amassed a record bet on an oil price recovery at the start of the year have recently been dumping these positions, pushing oil prices down by more than 20%. The fallout from Home Capital Group, Moody's downgrade of the big Canadian banks and the falling bond yields during the second quarter created strong headwinds for the Financials sector. Canadian equities lagged other asset classes for the quarter, with a slight gain of 0.7% for the S&P/TSX Composite TR Index.

- There have been signs of synchronized global economic expansion since the second half of last year. The election of Donald Trump was a positive catalyst for financial markets. Corporate earnings in the U.S. are rising. Solid consumer spending and a recovery in investment continue to underpin the growth of the U.S. economy. Inflation is benign, and the easier financial conditions are intensifying the positive feedback loop between the real economy and asset prices. Driven by a combination of earnings growth and multiple expansions, the S&P 500 TR Index increased by 3.1% (0.5% in Canadian dollar terms) over the quarter, accompanied by subdued market volatility. At the end of June, the VIX index, which tracks the implied volatility of the S&P 500 over the next 30 days, reached its lowest level since 1993.

- Political drama played out in Europe, first with the French presidential election and then a snap British election. The outcomes of those events seemed to calm investors. Regardless of these outcomes, the European economy appears to have stabilized and continued to recover to a point where the ECB may begin unwinding its bond purchase program later this year. Monetary policies may not be at the peak of stimulus, but they remain very accommodative in Europe and Japan.

Outlook and Fund Positioning

- With GDP growth of around 2%, unemployment at its current level and inflation edging towards 2%, the Fed funds rate would be, in a normal cycle, heading a lot higher by now. But in today's market, there remains skepticism, which opens up a divergence between where the markets and the Fed see policy heading in the coming year. We consider the recent rate hikes a positive development for a number of reasons: 1) They are a sign of the Fed's confidence in the financial system and economic development; 2) They provide dry powder for the central bank in case of economic downturns; 3) They enhance central banks' credibility and policy transparency, by providing financial markets with a clear rate-hike path; 4) Government may need to pay higher borrowing costs, resulting a higher level of government spending, which might be a stimulus to the economy; 5) They help yields move back to a bit more normal level, which may improve large financial institutions' fundamentals and create a much-needed cushion in monetary policy. In the bond portfolio, duration is slightly short, with an overweight position in corporate bonds. The high-yield position was trimmed further, to around 4%.

- OPEC's decision to extend its production cuts into 2018 has not lifted sentiment. Clearing inventories of this size is a messy process, but we believe the market sentiment on oil has turned too bearish, leaving room for a rebound from current low US$40 level. Most oil producers are not profitable at the current price level; this should eventually slow drilling activity by both U.S. shale and conventional oil producers. OPEC and Russia remain determined to do "whatever it takes to reduce global oil inventories." They are serious about draining the market surplus. If required, more could be done. For the most part, global economic growth has been robust, and demand for oil is likely to remain strong. We believe demand growth would lead supply, with a larger inventory drawdown taking place later this year. Oil prices may be volatile in the short term, but over the medium term, we remain positive. We have positioned the energy portfolio conservatively by being selective among low-cost energy producers with strong balance sheets. The energy portfolio is also constructed to include pipeline companies, energy royalty companies and energy distribution companies whose cash flows are more predictable and less influenced by fluctuating oil prices.

- Suppressed by the weak oil price, the Canadian dollar was fairly weak for most of the first six months of 2017. It then had an abrupt turn in June, after the BOC signalled it may raise rates for the first time since 2010. The rise in the loonie has also coincided with the U.S. dollar index falling to its lowest level since last year's presidential election. The Canadian dollar gained more than 4% in June. The Canadian dollar is likely to be driven by the combined effect of oil prices and central bank policies. We expect the Canadian dollar will likely remain range-bound around mid-70 to low-80 U.S. cents.

- Recent policy initiatives to slow down an overheated Canadian housing market are beginning to have some impact. A gradual increase in interest rates is considered positive for Canadian banks and insurance companies, and will provide support for all companies that offer defined benefit retirement plans. We expect these positive developments to improve sentiment regarding the broad Canadian equity market, about which we remain cautiously optimistic.

- A U.S. recession is unlikely in the foreseeable future. U.S. consumer spending rebounded nicely in March and April, supported by rising income, wealth and credit. The best job prospects in 16 years have lifted consumer confidence. Monetary policies became more restrictive than at the peak of the stimulus, but they remain accommodative. The market is likely not yet at the point at which monetary policy becomes a headwind. The recent historical low volatility encouraged complacency, and that might lead to a risk of investors mispricing risk. Despite having strong confidence in U.S. equities' long-term outlook, we have become more cautious on short-term prospects, primarily due to uncertainties about fiscal policies and a divergence between hard and soft economic data. Market valuations also appear somewhat stretched, as U.S. equity multiples were trading at the high end of historical averages.
