2018 Economic and Market Outlook Conference Call

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The following is a summary of the views expressed by Empire Life Investments during a conference call on January 30th, 2018:

2017 resulted in a very strong year for global equities, reasonable performance for Canadian equities, and positive performance for fixed income (despite a rising interest rate environment). Heading into the New Year, equity markets are supported by the effects of U.S. tax reform and improving global economies. Risks are primarily related to elevated equity valuations and investor complacency.

Economic and Market Developments

- Despite three interest rate increases by the Bank of Canada in 2017, the Canadian bond market managed to eke out positive returns for the year. While shorter term bond yields did increase, longer term yields were less affected. This was due mainly to subdued long term inflation expectations, and strong demand for bonds from portfolio rebalancing, and from traditional long term buyers like pension plans and insurance companies. Another reason why the bond market did relatively well was because of the credit market. It was a very strong year for corporate bonds. It was actually a record year in terms of new issuance of corporate bonds in Canada, and demand for them was very high as investors searched for yield. Spreads narrowed as a result, which helped boost returns. Overall, the Canadian bond universe index advanced 2.5%, which is not a huge gain but better than most people expected.
- 2017 is the first so called "perfect" year for U.S. equities since at least 1928 as the S&P 500 delivered positive total returns (including dividends) each and every month. The S&P 500 made 62 closing highs and the Dow Jones Industrial Average recorded 71 fresh closing highs in 2017, a record dating back to 1896. Not only have stock prices soared, volatility and fear seemed to have disappeared from markets. The realized 90-day volatility of the S&P 500 hit its lowest since the 1960s, taking the derivative-based VIX index of expected volatility to its lowest ever reading. Low volatility was a global phenomenon in 2017 as the MSCI World index's volatility hits its lowest level since at least 1972. The S&P 500 Index returned 19.4% in 2017.
- The S&P/TSX Composite returned 9.1% including dividends last year. Although a respectable absolute gain, it fell short of what U.S. and international markets delivered. While U.S. and international equities generally showed consistent performance throughout the year, the S&P/TSX Composite had to overcome a weak first half of the year, where it was up less than 1%. The Energy sector dragged the most on returns due to an over-supplied oil market holding down oil prices. The

second half of the year was much better - all eleven sectors delivered positive results. Financials gained 10.5%, supported by a rising interest rate environment and strong earnings from the banks, and the Energy sector gained 7%, supported by a 50% rebound in WTI crude prices.

Market Outlook and Investment Strategy

- The yield curve flattening has been one of the biggest stories in the bond market lately. Some see it as a harbinger of recession. We view the flattening is simply a return to normal. The yield curve was extremely steep before because short-term rates were so low thanks to ultra-easy monetary policy. But now that short rates are returning to more reasonable levels, the yield curve is simply returning to normal. However, that doesn't mean we're complacent. We are monitoring the yield curve very carefully and would not want to see this flattening trend approach an inversion where long rates fall below short rates. Curve inversions are what tend to foreshadow recessions. But so far, we are a long way from there.
- We are taking precautions to protect the bond portfolios against rising rates, for example, by maintaining a relatively short duration and some cash that we may deploy at higher yield levels in the future. We also remain overweight in corporate bonds which should outperform in a rising yield environment. However, we don't think bond yields are going to move sharply higher. Central banks have been very slow and cautious so far, both in terms of tapering and raising rates, and we think that will continue. The U.S. Federal Reserve is only expected to raise rates 2-3 times this year, and same with the Band of Canada. The bond market is likely to be able to handle that easily.
- We continue to like Canadian Equities. Valuations are not demanding; at the end of December the S&P/TSX Composite was trading under 18x forward earnings. That is somewhat above the 16x average since the turn of the century, but we've seen much higher levels as well.
- The big Canadian banks, for the most part, are attractive businesses and should benefit from a rising interest rate environment. Valuations remain very reasonable; loan growth likely slows down a bit going forward, but not crashing, and the market has already priced in some slowdown. We see the issues that faced Canadian oil stocks last year to be mostly transitory, as new supply eventually is absorbed into the market and pipeline capacity resumes. The short and intermediate term outlook for Canadian integrated oil companies remains strong as a fair oil price combined with strong refining margins will likely lead to robust cash flow. We've taken a conservative approach to the oil sector, where we have a good mix between high quality oil producers, and pipelines and royalty companies.

- Overall the U.S. economic expansion remains broad-based and in good health. The passing of the tax reform bill shows the current administration can pass major legislation and break the gridlock that has challenged past administrations. Lower taxes at both corporate and individual level, and the transition to a territorial tax system will likely result in higher corporate earnings, investment, and consumer spending, which should benefit U.S. equity markets. Equity valuations are up, but they are not at levels that significantly concern us since solid earnings growth should keep valuations in check. In terms of U.S. portfolio positioning, we continue to focus on companies with strong competitive advantages in their business model, generating strong cash flows.
