2016 Year-End 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 January 24, 2017.

The year 2016 was a year of the unexpected, with events ranging from wildfires in Alberta to Brexit to the U.S. presidential election results. The rise of populism and protectionism, highlighted by Brexit and the election of Donald Trump as president of the U.S., represented a major shift of economic, social, political and ecological dynamics that seems to reverse a multi-decade trend toward economic integration and globalization. The Trump win was clearly a surprise to the market, and it amplified the market's expectation of economic growth and long-term inflation, which had a profound impact on the performance of and outlook for all asset classes.

Market and Economic Developments

- For the bond market, 2016 was a mixed year. In the first half of the year, bond yields declined around the world. The main drivers were lower oil prices, relatively weak economic data, the Brexit vote and easy monetary policies from major central banks around the world, especially the European Central Bank and the Bank of Japan. The U.S. 10-year yield started to move up at the beginning of July. First it was a rather gradual rise, but the trend accelerated after the U.S. election. In December, the U.S. Federal Reserve (the Fed) raised the benchmark rate for only the second time in a decade, and forecast a faster pace of tightening in 2017 due to the prospect of fiscal stimulus in the form of tax cuts and infrastructure spending. In Canada, although the Bank of Canada didn't follow the Fed, and isn't expected to raise rates in 2017, Canadian bond yields still rose in sympathy with the U.S. They actually rose quite sharply, from 0.95% to 1.72% in the last quarter of the year. The recovery of oil prices and the rally in equity markets have supported the credit part of the bond market. Credit spreads tightened, and high-yield corporate bonds outperformed significantly.

- Canadian equities demonstrated remarkable resilience last year. The first month and a half of 2016 saw the S&P/TSX Composite Index tumbling as much as 10% over troubling news about China's economic growth, the slump in commodity demand and oil prices. Volatility in Canadian equities has since subsided. The S&P/TSX Composite Index started to rise, slowly but surely, when it turned out that fears of a slowing Chinese economy were excessive. In the first half of the year, the bull run was driven by a rally in base metal prices. Gold prices peaked in July before fading into year-end. The

market then turned to energy stocks, which were supported by a recovering oil price. OPEC pledged to cut production, Russia and other oil-producing countries outside OPEC also signed on to reduce crude supply, and high-cost production has gone offline. All this has pushed the oil price from a mid-January low of US$26 to US$55. Oil and gas stocks have rallied accordingly. The positive development in the Energy sector has had a secondary impact on other industries, with the Materials, Energy, Financials and Industrials sectors posting 20% to 40% gains for the year. The S&P/TSX Composite Total Return Index rose more than 20% in 2016, the biggest increase since 2009, and was the best-performing index in the developed markets.

- Priced in Canadian dollars, the U.S. market posted negative returns throughout the first half of the year and remained pretty much flat till the eve of the U.S. election in early November. The initial shock of Donald Trump's election win rapidly gave way to optimism. The markets seemed to anticipate greater upside in growth and inflation, fuelled by Trump's proposals for tax cuts, fiscal spending and deregulation. The market focus quickly shifted to the potential for better economic growth and expectations of higher inflation. The reflation trade swept across global markets, driving equities and base metals higher and bond prices sharply lower, and pushing a surge for the US dollar. At year-end, in U.S. dollar terms, the S&P 500 Total Return index jumped 12% (8.6% in Canadian dollar terms). Sector performances were all positive, except for Health Care, with Energy in the lead.

- The sentiment in Europe was poor at the beginning of the year amid concerns about deflation, weak oil prices, sluggish growth and the health of the banking sector. The Brexit vote prompted equity markets to over-correct to the downside at the end of June, and then the market quickly bounced back. The European economy has recently withstood the impact of a series of geopolitical shocks, including Brexit, terrorist attacks in France and Germany and Italy's failed referendum on constitutional reform. Recent surveys show business and consumer sentiment is running near six-year highs. Unemployment came down to its lowest level since July 2009, and the PMI rose to its highest level since May 2011, suggesting growth is expanding at its fastest pace in almost six years. European equities' rally accelerated with the outcome of the U.S. presidential election, recouping all the earlier losses and ending the year at the highest level. The depreciation of the euro (about 6% against the Canadian dollar) wiped out the gain for Canadian investors. The Euro Stoxx GR Index fell 1.5% for the year in Canadian dollar terms.

Outlook and Fund Positioning

- We believe the current rates rise is cyclical rather than secular. The Fed has hiked twice, and it may hike another two or three times in 2017. However, rates still remain extremely low, and the duration of the current economy up-cycle is getting long by historical standards. We don't expect an economic downturn in the near future, but eventually the cycle will turn over, and rates are going to come back down from an already low level. We would not be surprised to see the Fed funds rate go to zero in the next down cycle. Our base case is that the economy will continue to grow moderately this year. The Fed will raise rates at a gradual pace, but other central banks around the world will remain very accommodative, including the Bank of Canada, which isn't expected to hike at all this year. In our view, as 2017 begins, government bond yields have risen a long way very quickly, to the point where they actually look quite oversold and appear somewhat attractive, at least on a short-term basis. Bonds are currently discounting a lot of good news and high expectations, particularly with regards to Trump. Maybe Trump will succeed, but given the optimism that is already built into the markets, the risk is to the downside. If Trump hits roadblocks, we are likely to see some volatility in the markets, triggering flight-to-safety trading. Overall, there is a fairly positive environment for bonds right now, and we are positioned accordingly. At current yield levels, bonds are considered a good hedge against equities.

- Canadian equities are not cheap, but we don't think the valuations are over-stretched in the current environment, with the Canadian economy still recovering from lower commodity prices and lost exports. The uneven pace of recovery gives the Bank of Canada reason to continue with its dovish stance, while the Fed will likely continue to increase interest rates in 2017. The monetary policy divergence might have an adverse impact on the loonie, while the rising oil price is a positive for the Canadian dollar. We believe the Canadian dollar will be stuck in a range around its current level (US$0.75), which helps Canadian exporters. Led by the U.S., the global economy is poised to accelerate modestly in 2017. Oil prices have gone about 100% higher than last February's low as the price mechanisms gradually balance the market. OPEC's recent decision to cut production added to the momentum, which could provide a tailwind for the Canadian economy and equity markets. In 2017, some of the drivers behind the recent rally – such as a low-interest-rate environment, weaker Canadian currency, demand from a stronger U.S. economy and federal government fiscal plans for infrastructure spending – are likely to remain in place. Other drivers – such as earnings growth, particularly in Materials, Energy, Industrials, Consumer Discretionary and insurance companies – will provide support to the bull market. We are cautiously optimistic about Canadian equities, while remaining alert to macroeconomic and geopolitical risks.

- After almost eight years of a bull market, the market consensus is that further gains in U.S. equities will need to come from earnings growth, not monetary policy. The driver behind the next phase of the bull market needs to be shifted from low interest rates to corporate earnings growth. That is why equity markets have responded so strongly and positively to Trump's election victory, as well as the Republican majorities, which provides an opportunity for fiscal policy to take over from monetary policy. Trump's policy on deregulation and his pro-manufacturing and pro-energy stance are also welcomed by the markets, as they support expansion of the economy, corporate earnings growth and a further run of the bull market. However, commodity price stabilization in 2016 suggests that inflation might edge up in 2017; when fiscal stimulus comes at a time of close-to-full employment, short-term rates may rise faster than expected. There is a risk of the economy running a lot of inflation pressure, which could be a serious problem, forcing the Fed to raise rates more rapidly than it planned. That could be a headwind for equity markets. However, our base-case view is broadly supportive for U.S. equities. We are optimistic about the potential positive impacts of Trump's policy mix, while remaining cautious that the sharp rally might have pulled forward some of 2017 performance.

- The populist revolt is, in large part, a reaction against the free movement of capital and labour that has contributed to the making of previous bull runs. Populism is challenging globalism and creating new tail risks. The shift may pose challenges for some smaller, trade-focused, open economies. Countries with larger domestic economies should be less vulnerable. When the world is becoming less global, investor portfolios will need to become more global.
