Empire Life Investments

Investment Team Update: COVID-19

March 20, 2020

While the world is still in the early stages of managing unprecedented economic headwinds caused by COVID-19, taking a longer term view we are positive on equity and corporate bond markets. More importantly, we remain disciplined in our investment style which we believe positions Empire Life's funds very well in the current environment and when markets recover.

We believe social distancing will be a material headwind on global economic growth and corporate earnings, likely more severe than what occurred during the 2009 financial crisis. China, who is about one month ahead of the United States in fighting COVID-19, reported a 13.5% drop in industrial production and a 20.5% drop in retail sales in the first two months of 2020. The effects of COVID-19 have also surfaced in US economic numbers with initial claims for unemployment spiking by 33% in the latest week, one of the biggest one-week increases in history.

The good news is that unlike the 2009 financial crisis there are no "bad actors" with COVID-19. This is a global health crisis which gives governments around the world the ability to intervene quickly and with as much monetary and fiscal stimulus as needed. To date, actions by governments have been reassuring and recent weak economic data will only further motivate governments to act aggressively. The United States Federal Reserve cut short term rates to virtually zero and committed to buying at least $700 billion worth of Treasuries and mortgage backed securities. In addition, the US government has approved a $1.3 trillion fiscal stimulus package with discussions of an additional $1 trillion. The European Central Bank approved a €750 billion monetary stimulus package and the Eurozone's largest economy, Germany, has committed to a stimulus package of up to €550 billion for companies hit by COVID-19. These are big numbers and the list goes on.

Here in Canada the federal government has announced an $82 billion stimulus package. The Canadian government has also committed to purchase up to $50 billion worth of insured mortgage pools through Canada Mortgage and Housing Corporation to provide funding to Canadian banks and mortgage lenders; and OSFI lowered the domestic stability buffer which effectively allows the Canadian banks to inject $300 billion of additional lending into the economy. Finally, the Bank of Canada slashed interest rates on March 13th by 50 basis points to 0.75% and left the door open for additional cuts.

Once the spread of COVID-19 is contained and social distancing ends, we believe the unprecedented level of monetary and fiscal stimulus will be a major boost to global economic activity. When the recovery occurs, capital will likely flow into corporate bonds and equities given that spreads for corporate bonds and equities are at levels not seen in decades. Within corporate bond markets, the spread (or the incremental yield over government bonds) of the investment grade corporate index is 3.6% while the spread on the US high yield index is 10.1%.

While in equity markets, the dividend yield on the S&P 500 Index ("S&P 500") is ~2.6% versus ~0.9% for the ten year US government bond. In Germany, the spread is even wider with the dividend yield on Germany's DAX Index at ~4.5% versus the ten year German government bond which currently yields negative ~0.3%. The timing of a recovery in markets is uncertain but it will probably start well before economic activity normalizes, possibly when countries in Europe such as Italy start to report a decline in new cases or significant development towards developing a vaccine is announced. Bonds with sustainable balance sheets and stocks of companies that possess attractive and highly visible growth prospects with the capacity to increase dividends over time will likely benefit disproportionately more in this environment.

We have remained disciplined in our approach to investing which focuses on high quality and attractively valued companies. The majority of companies that populate Empire Life's funds share a number of attributes including healthy balance sheets; attractive (and highly visible) growth prospects supported by a sustainable competitive advantage and structurally growing end markets; and, high quality management teams. We believe these are the types of companies that will weather the downturn relatively better and that will be better positioned to take advantage of an economic recovery. However, in times like these all stocks will decline and the downdraft in markets will take no prisoners. The one month correlation of equities within the S&P 500 are at a 25 year high[1]. We must continue to ensure the companies in our portfolios have the balance sheet and business model to withstand all scenarios.

In a very short period of time a lot of bad news has been priced into markets as a result of algorithmic trading and passive mandates. In only one month as of Friday March 20, 2020, the U.S. investment grade corporate and high yield indices are down ~13% and ~19% respectively. In the recent sell-off, the spread on the U.S. investment grade corporate index has widened from 1% to 3.6%, while the spread on the U.S. high yield index has widened from 3.3% to 10.1%. While in equity markets, the S&P 500and S&P/TSX Composite Index ("S&P/TSX") are down an astonishing ~32% and ~34% respectively. Prior to the COVID-19related equity market sell-off the S&P 500 and S&P/TSX was trading at ~19x and ~16x forward earnings. As of Friday March 20, 2020 valuations are much lower at ~13x and ~11x for the S&P 500 and S&P/TSX respectively. These markets could move lower from here but a lot of damage has already been done.

This is undoubtedly an uncertain time. However there are some positives. Governments around the world are moving quickly to implement and enforce social distancing which we believe will slow the virus and allow health care to better respond to the outbreak. Moreover, pharmaceutical companies are working very hard to find a vaccine which experts say could be available in as early as a year. On the negative side, the modern world has never gone through a global pandemic so the timing of a recovery from COVID-19is highly uncertain. However, through all of this the Empire Life investment team is working closely together to ensure our existing holdings can withstand this environment and prosper when the recovery comes. We

[1] Source: Evercore ISI (Bridging the Gap To Peak Cases Most Important Short Term Question)
(all other data sourced from Bloomberg)

have proactively reached out to a number of companies to get a better sense of how management teams are dealing with this very difficult time. Also we are selectively adding new companies to the portfolios as all funds held cash coming into the New Year. Finally, in unprecedented times like this, we can assure you that we will keep true to our investment style and process which we believe positions Empire's funds well to generate strong returns over the long run.

Thank you for your support, and stay safe.