# ASK ME ANYTHING
## with the Empire Life Investments team

**Transcript: Ask me anything webinar on June 21, 2022, with Sara Shahram, Portfolio Manager, Canadian Equities**

Good day, everyone. I am Paul Holba, Vice President of Retail Distribution at Empire Life, and I'm your host again for today. Once again, on behalf of all of my sales colleagues, want to welcome you to this, the third installment, of our June, Ask Me Anything webinar series. The first one was two weeks ago. We had Ashley Misquitta, who joined us, who's focus was on U.S. equities. Last week was Ian Fung, who discussed the fixed income market. And just a reminder, both of those webcasts are available on our website empire.ca/askmeanything. Now today, Sara Shahram is joining me to talk about the Canadian equity market. So, a whole different market to look at today, Sara. Just a little background, Sara joined Empire Life Investments in 2019, and she's the lead manager of our Empire Life Balanced GIF and co-manager of Empire Life Elite Equity GIF. So, Sara, welcome. And thank you so much for joining us today.

### What are your thoughts on rising interest rates and the impact on the housing market?

- Obviously that is a very topical question today. I'm just going to take a few minutes to talk about where we are right now. So, if you look at the yield for the five-year Canada bond, it has gone from about 50 basis points, in 2020, to just over 3.5% today. And more importantly, it's up about 2% on a year-to-date basis. So, that really just speaks to the speed and the magnitude of that yield increase. I always joke that we have yet to see a more efficient process than banks increasing mortgage rates following a Bank of Canada rate increase announcement. So, mortgage rates have also increased to just over 5% for a five-year fixed. I can tell you that anecdotally, we were looking to purchase a house late last year, and we had a five-year fixed-rate approval for 1.8%. And that was just in December.

- So, obviously, a big increase and clearly this will put pressure on the monthly expenses of households. Now, some economists estimate that monthly mortgage payments can increase $400 to $700 a month. But the bulk of that in my opinion has yet to be felt. So, any house sales that we're seeing today, more than likely, had their mortgages locked in three or four months ago. And on top of that, we're starting to see, actually, a lot more variable rates than fixed rates. And that's because the spread between variable and fixed is actually quite attractive at this point. But as the Bank of Canada continues to rate rates, I think that variable rates will move up a lot faster than fixed and that gap will close. So, you know, we have seen some pullback in terms of the volume and price of housing, but I do suspect that we're going to see a bigger pullback moving forward.

- The other factor that, you know, we should consider is just on renewals. You know, renewals were a tailwind for the past two years or so, but now they're starting to be a headwind, because as you're renewing your mortgage, more than likely it's going to be at a higher rate than what it was before. So, homeowners are having to get a little bit more creative by re-extending the amortization of their mortgage potentially, or paying down some of their mortgage to the extent possible. There are some positives that offset the negatives we're seeing. Strong employment has a very decent correlation with housing. We are seeing strong immigration policy continue. And structurally, we are short housing in some of the key cities in Canada. And, we've been reading that some of the higher cost inflations that we've been seeing are halting some condo projects, which will extend this structural tightness. It is something that we're watching. But as of now, I would say that I'm a bit concerned about the impact of higher rates on housing.

## What do you think the impact will be on banks?

- Yeah. The obvious follow up. Again, if I was to just step back and look at some of the positives and some of the areas of concern for the banks. On the positives, very attractive valuations right now, 10, 10 and a half times earnings, dividend yields are strong at about four times. I would say capital ratios are extremely strong. I think that this is going to be providing downside protection, especially for names like BMO, Royal and TD that have capital ratios of about 12% or so. The key area of concern for me is the impact of rates. On the one hand, you have higher rates, which are generally positive for NIMS. NIMS, are Net Interest Margins. And these are essentially the net income that a bank receives from lending out money through their loan books, through their mortgage book.

- These are typically longer dated in nature. So, five years or so, minus the net interest expense. And these are monies that they pay you and I on our savings account, on our GIC's. As rates go up, typically, NIMS could go up as well. On the other side, as we just discussed, housing is a big driver of GDP, and I'm a bit concerned about the impact of higher rates on housing. And on top of that, we can't really understate the fact that the wealth effect from the robust housing market has caused some spending in the Canadian economy. So what I would say, and what my concern is, that with this housing market issue is that we could see a slow down in economic activity.

- And as you know, banks are very much linked to economic activities. The one pushback that I get when I make that comment is, "Yes, but consumer balance sheets are very strong." We've all seen either dollar amounts or percentages in terms of how much the Canadian consumer has added to its balance sheet. And I don't disagree with that statement. The one thing I would say, is that the propensity to spend from income is much higher than the propensity to spend from savings. So, while I do think that some of that money will make it back into the economy, I'm a little bit hesitant to assume that we will see this aggressive buying continue as the consumers bring down their balance sheet. The last area of concern is, it's something that we're watching and that is provision for credit losses.

- When the banks reported the last quarter, we saw better than expected provisions. And the provisions continue to be below trend. The CEOs did state that they do expect to see some normalization, but I do think that this is one area that warrants watching because there could be some downside risk. So, you put it all together and, what does that mean for us? We continue to have a pretty decent position in the banks at about 18%. We have been reducing our weight since the beginning of the year. We're now under the benchmark, but this is, again, something that we are continuing to watch in the portfolio.

## Is the energy sector undervalued or not?

- Yeah. So, maybe I'll touch on the allocation question first, and then get into the energy part. I would say we're bottom up stock pickers, but we obviously do monitor the top down macro events. And when it comes to the allocation part, we use both of those. Before I actually get into that, I just want to, again, remind everyone that we are in very unusually volatile and fast moving markets today. So, what we want to make sure we are right now, is nimble. We want to make sure that we have the ability to react to known unknowns and any unknown unknowns that seem to be creeping up more frequently. So, right now, we're ensuring that our investment in both fixed income and on the equity side is liquid. As Paul stated earlier, the fund that I manage is the neutral balance fund [Empire Life Balanced GIF], which means that the fund has to be invested 40 to 60% in each of equity and fixed income.

- This is versus our asset allocation fund [Empire Life Asset Allocation GIF], which has more flexibility in terms of that asset allocation. And really the fund is meant to deliver stable long term cash flow. And, there's a focus on capital preservation. As I've noted in the past, I would say the asset allocation part of the fund is really a team effort. We have informal daily meetings and then more formal monthly presentations. And really the purpose of all of this is to hear the experts of the different regions, the different asset classes, talk about what they're seeing, talk about the trends that they're witnessing. And then we debate all of those

topics. And I'll put all of that together to come up with the asset allocation call. As I mentioned earlier, we have been concerned about inflation for a while now.

- Our bond limit has been sort of closer to the bottom end of that 40% limit, and our duration has been below market. We can increase our exposure to rates by either increasing our weighting in bonds or by extending our duration. Hopefully everyone had a chance to listen to Ian Fung's discussion last week, but we are starting to get increasingly more constructive on duration right now. So, what we want to do, we want to make sure that as the equity markets go through a potential pull back, that we balance the safety feature of bonds with the rate sensitivity.

- On the regional side, I would say, no significant changes. Continue to be overweight Canada because of its commodity exposure, which has generally been positive in terms of inflation hedge. At the end of the day, the U.S. continues to offer the best long term potential. So, we're always looking for opportunities in the U.S. And just recall that we get our U.S. exposure through the American Value Fund, which is managed by Ashley Misquitta. We have reduced our international exposure. Europe, unfortunately is going to be feeling the brunt of what's been happening between Russia and Ukraine. And we have strategically been selling down and trimming some positions and building our cash position. We're ready. We want to make sure that we have some dry powder, should we see opportunities come up.

- I'm just going to focus on the Canadian allocation for this part. So, as I mentioned earlier, we are underweight the banks. We continue to be underweight technology. We have even bigger underweight in super growthy technology names with no earnings. Again, all of this in line with our expectation of rising rates. Although I would say that we are starting to see select opportunities on the technology side, we are being diligent in terms of putting some of capital to work in that region, but we are seeing some opportunities.

- I'm also overweight the high quality industrials. I think everyone's heard me speak about true pricing power. Again, this is a company's ability to increase pricing without significantly impacting volumes. And I think that the industrial names that we have in our portfolio, not only have this pricing power, but they also have another feature, one of my favorite metrics, which is free cash flow per share growth. I would say that unfortunately, these names trade at higher near term multiples. So, year to date, they haven't quite performed as expected. They have been slightly disappointing, but we continue to like them. So now, I'll touch on energy here to make sure that I covered that part of it. It's an area that we were overweight, and we continue to be overweight.

- I would say that for all commodities, I think it's prudent to have a short-term view and a long-term, more structural view. And that's because dislocation in the market in the near term can really hurt the equities on the commodity side. And we just want to make sure that we preserve capital where possible. So, we've been positive energy for a while now. We've been positive net gas for a better part of a year, and continue to maintain that view. Both of these positive views on both oil and net gas have really been predicated initially, on what we saw as tightness on the supply side and increasing demand as we saw reopenings on the back of COVID. The Russia-Ukraine tension, simply intensified that situation. And up until the last Fed meeting a week ago, I would've said that, I was very bullish energy, both on the near term and on the long term perspective.

- From a long term perspective, I would say the oil and gas producers, they continue to show capital discipline in the face of high commodity prices. They're continuing to pay down their debt. They're continuing to return cash to shareholders. Everything that you want to see from a producer. And valuations don't seem that stretched at this point. If you look at where the commodity prices are, north of a hundred dollars, none of these companies from a longer term perspective are pricing anywhere close to that amount. So, we remain positive from a medium term, for sure. Near term, however, during the Fed press conference, Chairman Powell was asked, "What are you targeting? Are you targeting head inflation or are you targeting core inflation?" And his response to that was, "Our mandate is to control inflation, not only core inflation. So, we're targeting headline inflation." And I would say, the reason that comment concerned me is because headline inflation is predominantly the result of higher energy prices and higher food prices.

- And really because of tightness in the supply market. Neither of those, the Fed can control. So his comment, what that said to me is that he's going to at least be a lot more aggressive, try to tame the headline inflation as much as possible. Which really told me that we could potentially see a bit more demand destruction in the near term than what I had expected in the past. Whether or not the Fed is going to be successful in terms of taming inflation remains to be seen, but from a near term perspective, I think the demand side is something that warrants watching. And it's something that we're watching very, very closely at this point.

**Can you further elaborate on Canadian bank earnings and increased revenues as we move through this period of rising rates?**

- Yeah. So, my commentary with respect to the variable mortgage was that, right now, if you were to buy a house and you go under variable mortgage, you're paying about three, three and a half percent or so. As you start to see that number go up, I think what you start to see is a pull back in terms of the buying activity on the housing market. And that's the part that I'm a bit more concerned about. Just general activity in the housing market. And the one thing I would say is that, we can't really underestimate the ripple effects of housing. You buy a house, you paint it, you fix your garden, so there's all these ripple effects through the economy that really have their source in housing. So, that was my concern with respect to the variable mortgage. Hopefully, I answered that question.

**Can expand a little bit on what we learned from large grocers with respect to how they're weathering the storm and what the environment's like for their pricing power.**

- Yeah, absolutely. So, pricing power, it's really one of my favorite qualities of a quality company. So, we're seeing cost inflation everywhere. So, usually what happens when there's cost inflation that happens in such a short period of time with a significant magnitude like we're witnessing today, the companies cannot pass the entirety of that cost inflation onto their end users without impacting volume. But there's certain companies that have a bit more pricing power than others. So, you probably all heard me speak ad nauseum about how much I like the waste management companies or the garbage companies, for that reason. Because I think that fundamentally not only are they positioned favorably, because they are recession resistant, they do have true pricing power. But to your point, Paul, they're not alone. I think the consumer staple space is another one, especially the grocers, again, not immune to inflation at all, but I think that they do have more pricing power than most.

- And I'm going to just use an example here in terms of demonstrating how things work with the grocer. So, you have suppliers, say you have the Saputo's or the Pepsi's of the world that try to push price increases to the grocers. Typically, what grocers and these suppliers do is that they meet once a year, they discuss the price increases. In a world where we have 2% inflation, all is well, every party is happy. You and I won't complain about a 2% increase on our bill. It won't significantly change our buying behavior. The suppliers are able to cover their cost. The grocers are able to cover their cost and maybe even see a few basis points sub-margin expansion. In today's world of high single digit, low double digit inflation, it's very different. The suppliers are still trying to push that price increase onto the grocers. The grocers, having already experienced their own inflation, predominantly in terms of tightness in the labor market and wages, are pushing back as much as they can on that. Because they know that they can't pass the entirety of that onto the end user.

- As you mentioned, Paul, we had a meeting with the CFO of Metro very recently, to discuss all these dynamics. So, he did mention that they are having more frequent conversations with the suppliers in terms of inflation. And they are aggressively pushing back to the extent that they don't think the ask of the supplier is justified. But one of the other comments that he made was that, while we might see margin percentages be impacted because of the inflation that we're experiencing, their focus is really on protecting and growing margin dollars. And that matters to us. Because at the end of the day, we are cash flow per share, and that's what we care about. So, we want to continue to see that cash flow per share growth go up.

- The other positive that I would say from a grocer's perspective is that they're diversified in terms of, they have their conventional stores, they have their discount banners. They obviously have the pharmacy. But as an example, in an inflationary environment, what you might see is some shoppers switching from say, conventional stores to discount banners. So, we would shop at Food Basics versus Metro; shop at No Frills versus Loblaw. All in all, I think that the grocers actually, are fairly well positioned. I think they do offer a decent amount of protection in the rapid inflationary environment that we're seeing today.

**Interesting. So, garbage and grocers.**

- And gas. And energy.

**Gas.**

- Energy. Yes. And resources.

**The other one we had, relates to the "R" word. So, do you think in your view, and the team's view, do you think we'll see a recession? And then how do you position portfolios based on that view?**

- Oh yeah. That R word is making me age, that's for sure. Honestly, I don't know if we're going to see a recession, or not. And I would argue that no one really knows until we've been in it for a while, and by definition two quarters. What I do know, or rather what I do believe, is that the Fed and the Central Bank, with the exception of Japan, that Dave [Mann] will probably touch on next week, is trying to control inflation. So, they're aggressively increasing rates. Before the last CPI print, the market was looking for some sort of peak inflation, which is why it sold up so aggressively after CPI was reported at 8.6%. I think it was about 0.3% or so higher than expectations, because the market was like, "Maybe we're not at that peak inflation."

- Right now, I would say, I know it's only been a couple of weeks, but I would say the conversation is more around, "Okay, we are reaching peak-ish inflation." Unless we see another print that is sharply higher than what we saw the last time, I would say, most people would believe that, we're at peak-ish inflation. The question now, is where will inflation be by the end of the year next year? Will it be at 5% or will it be at 2%? I think that the Fed will do anything, and will be as aggressive as necessary to bring it closer to that 2% than the 5%. And that's really for two reasons, I think. I think that they want to sure that they have tools in their toolbox if we do see another significant leg down. So, i.e., have the ability to cut rates again, if they need to.

- And the second one is that, falling behind on inflation is never good. We hear the term stagflation. Often the Fed would prefer to have a recession rather than stagflation. So, they really want to make sure that they attack that inflation. So, in my opinion, I think we are going to see aggressive tightening from all central banks. Whether or not that will result in an actual recession, I don't know. But I do know that we will see economics slow down and whether or not the Fed can achieve this soft landing, terminology "soft landing", whatever that means. I would say again, I don't know that either, but one thing that I would mention is that it is a big ask. So, the Fed is trying to balance this really very delicate balance between tightening and slowing down the economy just enough. But what it's doing, as it's tightening is that it's looking at backward looking metrics, which increases the risk that they're going to... they're going to go too far and they're going to tighten too much.

- So, I think that if I was to step back and look at it, I would say that the risk of an economic slowdown is to the downside from where I'm sitting today. I would also argue that it's really difficult for the markets to outperform as the economy is continuing to slow down. So, there are some economists that estimate that we won't really see a bottom in the market until sometime next year. And that's predicated on the fact that

they expect to see PMI bottom next year. And PMI is really a measure of economic activity. To be honest, I tend to agree with that assessment.

- So, what does this mean for long only portfolio managers like ourselves? I think that it means that we want to make sure that we preserve capital as much as possible. As I mentioned before, we have increased our cash position in the funds. Today, we're just at under 9% in terms of cash and cash equivalent. We are also ensuring, again, as I mentioned before, liquidity is not an issue. We're also doing sensitivity analysis on some of the names that have a higher leverage. We want to make sure that repayment of debt, repayment of interest is not something else that we have to worry about.
- Again, as I mentioned earlier, the other thing that we're doing is really revisiting our fixed income allocation to make sure that we're balancing that safety aspect of bonds versus the rate sensitivity. I would mention though, on the other side, markets like this do present opportunities. We have very recently added to a position in the consumer discretionary sector, Aritzia, which we were able to enter into at very attractive levels following a leg down on the discretionary front.

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