Investment Team COVID-19 Update – May 19, 2020

The investment team at Empire would like to provide an update on how we are navigating headwinds related to COVID-19, including our views on equity and corporate bond markets.

While we remain constructive on equity and corporate bond markets longer term, we are increasingly cautious short term considering the recent strong rally in the markets. At today's levels, investors appear to be looking past risks of a second COVID-19 outbreak and/or productivity issues from social distancing restrictions as economies gradually re-open. As a result, while we have deployed a material amount of cash across the funds around the market lows in February and March, cash levels across most funds have moved higher over the past couple of weeks.

The rally in equity and corporate bond markets since the end of March appears at odds with the global economic contraction likely to occur this year as a result of the global lockdown and social distancing restrictions related to COVID-19. The magnitude and pace of decline in global economic activity during April was unprecedented. According to Bloomberg, economists, on average, expect global GDP growth to decline by ~2.8% in 2020, nearly twice the decline in 2009 due to the great financial crisis. Despite this, the S&P500, S&P/TSX Composite and MSCI World Index rallied ~31%, ~33%, and ~29%, respectively, from market lows on March 23, 2020 to date. From the peak in equity markets on February 20, 2020 to today, the S&P500, S&P/TSX and MSCI World Index is down only ~13%, ~16%, and ~14%, respectively (note that in Canadian dollars the S&P500 and MSCI World Index is down only ~9% and ~10%, respectively). Similarly, in corporate bond markets, the U.S. investment grade and high yield corporate indices have returned 13% and 15% respectively, from March's market lows and are only down -5% and -9% from the February highs.

In our view, there are a number of factors driving both equity and corporate bond markets higher. First, governments and central banks were very quick to unleash a substantial amount of monetary and fiscal stimulus, well above levels during the great financial crisis. Second, investors are treating COVID-19 as a one-time occurrence and therefore looking past expected short term headwinds in 2020 and 2021 with an expectation that daily new COVID-19 cases continue to decline and

economies successfully re-open. Similarly, there is an expectation that corporate earnings recover in the back half of 2020 and 2021. Third, U.S. Treasury yields are at record lows so the market is beginning to move further out the risk spectrum looking to corporate bonds and equities for additional yield. Fourth, a significant portion of the equity market's rally – at least in the U.S. – has been driven by the strong share price performance of a handful of technology companies (Microsoft, Apple, Amazon, Facebook, Alphabet) which, together, comprise ~20% of the S&P500. Finally, corporate bond markets have benefited from the announcement of central bank programs to purchase corporate bonds in the open market.

There remains considerable risk related to the possibility of a second COVID-19 outbreak and/or productivity issues as economies open up in a social distancing world. Arguably, these aforementioned risks are not factored into economist's GDP growth forecasts that, for the most part, assume a sharp recovery in economic activity during the latter half of 2020. Also, over the past few weeks there has been a steady increase in tension between the U.S. and China related to the race for control over the global roll-out of 5G technology. Moreover, U.S. President Trump is taking a more critical stance against China for the handling of COVID-19, partly in an effort to deflect criticism of how his own administration has responded to the outbreak ahead of the U.S. election in October. The bottom line is that progress towards a U.S./China trade deal made prior to the COVID-19 outbreak seems increasingly at risk.

Moreover, valuations of major equity market indices have nearly recovered to pre-COVID-19 levels. For example, on a trailing twelve-month basis, the price to earnings valuation multiple on the S&P500 has expanded from nearly 15x at the end of March to ~20x today; similarly, the S&P/TSX has expanded from ~11.5x to ~17.5x and the MSCI World Index has expanded from ~13x to ~18.5x. More importantly, when reviewing the individual names across our portfolios and watchlists, we are finding much less value compared to market lows approximately two months ago.

Through the market sell-off, we have remained disciplined in our approach, focusing on attractively valued high quality companies. The sell-off in February and March has allowed us to further bolster our positions in high quality companies at valuation levels we have not seen in years. With first quarter earnings mostly behind us, the vast majority of our companies have weathered the storm very well; they have leveraged their strong competitive and financial positioning, attributes, which from our perspective, will allow them to disproportionately benefit from an eventual economic recovery.

Taking a longer term view, we believe that economic activity will fully recover, however, there remains uncertainty related to the pace of recovery. Also, there will likely be some structural changes in society and the economy as a result of COVID-19, which we are incorporating in our due diligence process. While there is a path to the global economy recovering, likely aided by a combination of anti-viral treatment and/or a vaccine, we believe that much of this has been priced into equity markets. More importantly, considering the valuations of our holdings and watchlist names, we are not finding the same margin of safety through valuation that we did in February and March. As a result, guided by our disciplined approach to valuation, cash levels have for the most part moved higher across the portfolios over the past couple of weeks.

Our team has been very active staying on top of our existing holdings and watchlist names by keeping in touch with management teams, industry experts and sell side analysts as well as maintaining ongoing communication and collaboration among our team members. These efforts, coupled with healthy cash levels across the funds, will allow us to take advantage of any potential market weakness just as we did earlier this year in February and March.

As always, thank you for your continued support, and please stay healthy and safe.

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