

Empire Life Fixed Income Funds Update

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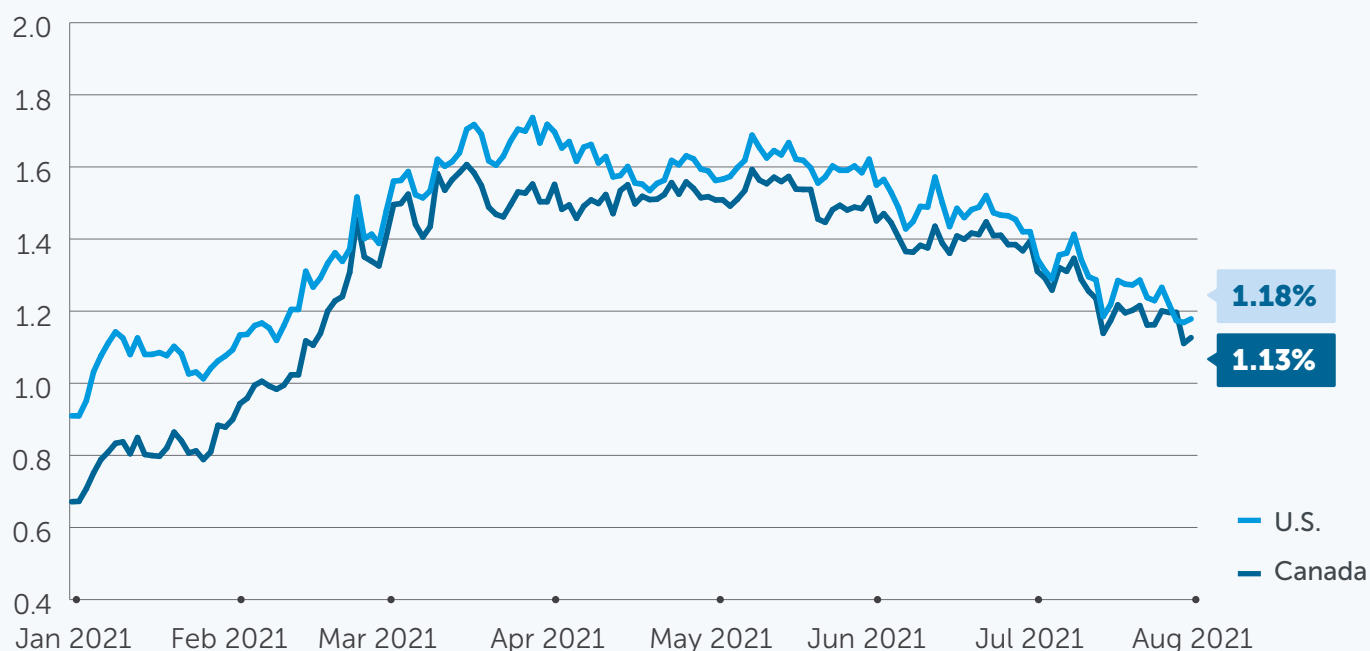
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Market update and outlook on yields

Government bond yields have increased off their pandemic lows, but have been volatile. The increase in bond yields was fast and furious at the start of the year due to a combination of optimism around the economy reopening and fears of high inflation. Despite a strong increase in all inflation measures. The U.S. ten-year government bond yield has fallen sharply from a high of 1.75% in the spring to a low of 1.16% in early August, retracting almost two-thirds of the increase earlier in the year.

10 year Government Bond Yield (%)



Source: Bloomberg as at Aug.4, 2021

Some of the move may be explained by investor positioning and thin summer trading conditions, but the primary driver seems to be that the market's anxiety about inflation has begun to subside. The spread of the Delta variant in the U.S. and globally, particularly in countries that have had slower progress in vaccinating their population, is concerning, and will likely hamper growth expectations. Softer economic data from the U.S. contributes to this viewpoint, with continuing jobless claims remaining elevated, causing yields to decline, and reflecting investors' worries about slowing growth, a weaker economic recovery and a return to lockdowns.

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Given the pace of vaccinations in Canada and the U.S., a return to full lockdowns is unlikely but the pandemic is constantly evolving and something we continue to monitor closely. The post-COVID recovery is likely to hinge on the return of the service sector – and with growth in the service sector potentially slowing due to the Delta variant, yields could remain in their lower range in the short term. We believe, however, that the recent fall in yields is more technical in nature, rather than a fundamental reassessment of the growth outlook. Yields could drift upward when economies begin to normalize. Still, as mentioned in our last report, yields are quite low by historical standards, and a normalization and steepening of the yield curve would indicate a healthier economy.

Outlook on inflation and credit spreads

Vaccine-led reopenings, in conjunction with massive fiscal and monetary support, spurred a strong recovery. Economic output has risen close to or above its pre-pandemic level in both Canada and the U.S., where central banks have begun or discussed the timing and the process of reducing the amount of monetary stimulus in the system. The Bank of Canada has initiated the process of tapering off the amount of securities it purchases each month, and the U.S. Federal Reserve is likely to do so as well.

Inflationary pressures are continuing to build, but the durability and sustainability of inflation remains a key debate among market participants. The market remains undecided as to whether inflation will indeed be transitory, as central bank governors believe, or will have some persistence.

Headline inflation measures have continued to tick upwards and show large increases in inflation over the quarter, but so far much of these have been in pandemic-related areas, such as commodities like lumber and copper, and used car prices, which have been exacerbated by a global semi-conductor shortage and the consumer's desire to move away from public methods of transportation. Central banks are currently of the view that upward price pressures should alleviate once the pandemic begins to subside. On the other hand, more persistent sources of inflation are beginning to move higher as well, with more structural areas such as rent and shelter perking up.

Break-even inflation measures in Canada and the U.S. have rolled over from the highs seen in April, with break-even inflation currently hovering around 1.67% in Canada and 2.31% in the U.S., suggesting that the market feels inflation is manageable for now. Central banks have also discussed a willingness to act if inflation does run too hot.

We continue to maintain the view that inflation will be kept in check by disinflationary forces and trends such as high household debt levels, technology developments that allow for automation and reduction of costs, and an aging demographic. However, we continue to monitor inflation carefully.

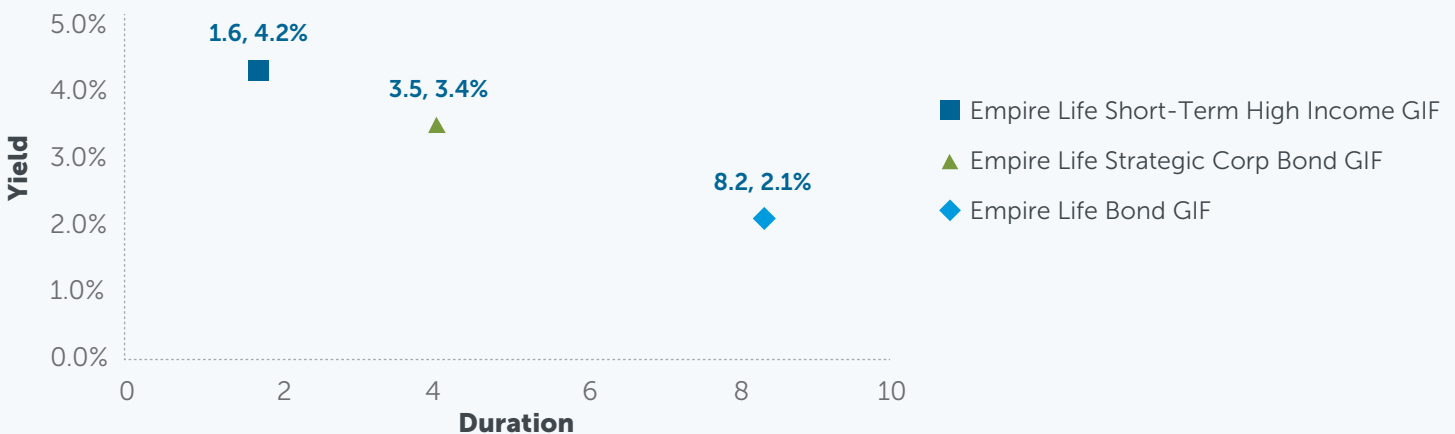
Despite headlines about changes in bond yields, interest rates remain low in absolute terms, and investors continue to look to investment-grade bonds and high-yield bonds for yield. Corporate spreads have contracted from the widening seen at the onset of the COVID-19 pandemic, and are at near cyclical lows. However, there are several factors that should support corporate spreads:

1. Corporate balance sheets have generally improved. Companies have had the opportunity to bolster their balance sheets, and to refinance or pay down their debt.
2. The faster-than-expected rollout of vaccines provides some support to companies, as corporate earnings have been trending positively, and should help spreads tighten.
3. Canada's higher vaccination rate should help support growth, avoid lockdowns and accelerate a return to normalcy, despite the potential spread of the Delta variant. However, the pandemic is ever-evolving and it will be something that we monitor closely.
4. Though a potential headwind in some industries, higher commodity prices are helpful to large portions of the resource - and commodity-driven environment, and should bode well for growth.

Empire Life offers three fixed income strategies to help meet these objectives:

	Empire Life Bond GIF	Empire Life Strategic Corp Bond GIF	Empire Life Short-Term High Income GIF
Objective	<ul style="list-style-type: none"> Income Capital preservation 	<ul style="list-style-type: none"> Higher income Capital preservation 	<ul style="list-style-type: none"> Higher income Capital preservation
Benefits	<ul style="list-style-type: none"> Very limited credit risk 	<ul style="list-style-type: none"> Low credit risk 1.5x the yield of government bonds Less than half of the rate risk of government bonds Geographic diversification 	<ul style="list-style-type: none"> Low volatility as a result of low rate risk and moderate credit 2x the yield of government bonds One-quarter of the rate risk of government bonds Geographic diversification
Category	Cdn Fixed Income	Glbl Corp Fixed Income	High Yield
Asset Class Mix			
Cash	1%	5%	12%
Governments	48%		
Investment Grade Corp Bond	43%	48%	8%
High Yield Corp Bond	4%	32%	62%
Converts & Preferred	4%	15%	18%
Average Rating	AA	BBB	BB
Yield	2.1%	3.4%	4.2%
Duration	8.2	3.5	1.6
Other features	<ul style="list-style-type: none"> Gain exposure to broad Cdn investment grade bonds universe with highest interest rate risk and lowest credit risks among Empire Life fixed income products 	<ul style="list-style-type: none"> Actively managed across various asset classes including govt, investment grade, and high yield bonds, preferreds and convertible with minimum 60% investment grade Offers income with opportunity for capital gains with excess yield over government bonds 	<ul style="list-style-type: none"> Actively managed across various asset classes including govt, investment grade, and high yield bonds, preferreds and convertible Offers income with opportunity for capital gains with excess yield over government bonds

Empire Life Fixed Income Funds interest rate risk and yield profile



Source: Empire Life as at June 30, 2021

Choice of Empire Fixed Income Funds

Given we are likely in the early stages of an economic recovery and in an era of record-low yields and increasing interest rate risk, it is important to build a resilient, diversified and balanced fixed income portfolio. But there is no panacea that will address hedging equity risk, reducing credit risk and interest rate risk and producing high income all at the same time.

Empire offers a variety of fixed income strategies to help meet investors' objectives:

- For investors with significant equity exposure, Empire Life Bond GIF is the best hedge for equities, but has the lowest yield and is the most susceptible to rising rates.
- For investors that have significant exposure to investment grade bonds and are comfortable with additional credit risk, Empire Life Short Term High Income GIF (STHI) offers the highest yield and the lowest interest rate risk, but has the highest credit risk.
- Empire Life Strategic Corporate Bond GIF (ESCB) is positioned in between, with the flexibility to invest in investment-grade corporate bonds, high-yield and convertible bonds and preferred shares.

All these strategies are supplemented with opportunities for capital gains through higher yielding bonds trading at a discount, preferred shares and convertible bonds. The choice between these strategies ultimately comes down to the objective the investor prioritizes the most.

As always, thank you for your continued support.

A description of the key features of the individual variable insurance contract is contained in the Information Folder for the product being considered. **Any amount that is allocated to a Segregated Fund is invested at the risk of the contract owner and may increase or decrease in value.** Please read the information folder, contract and fund facts before investing. Performance histories are not indicative of future performance.

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