

Inflation risk remains in the near-term as bonds offer historically attractive yields after the worst drawdown in history

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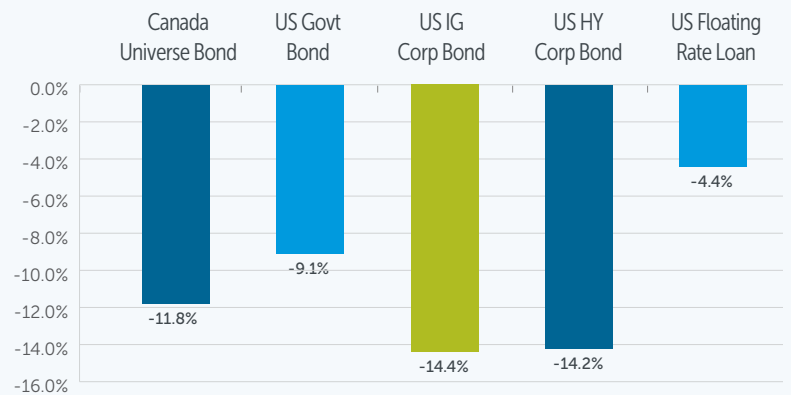
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Although bond markets have had the worst drawdown in more than 40 years, Empire fixed income funds outperformed and we believe remain well positioned for the long term.

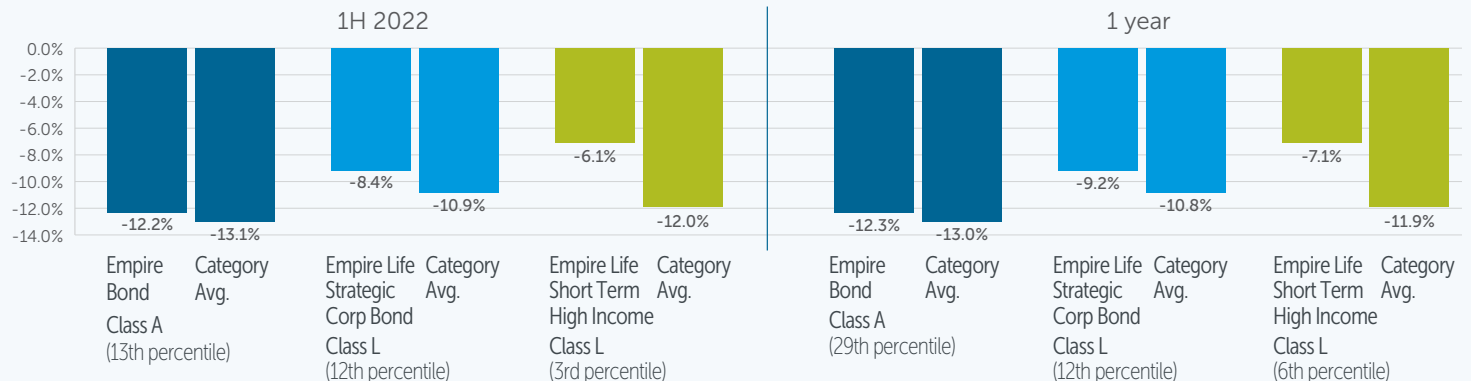
Bond markets sold off sharply in the first half of the year as central banks around the world aggressively raised interest rates to combat the highest inflation since the 1980s and bond yields increased across the curve. Although our fixed-income mandates could not avoid losses in this challenging market environment, our positioning helped us preserve capital, compared with our peers and we delivered performance that was either first-quartile or just shy of first-quartile for the first half of 2022 and on a trailing one-year basis. As we have highlighted in the past,¹ keeping duration relatively short and diversifying with a combination of floating rate instruments, preferred shares and real return bonds benefited our funds over the last year.

H1 2022 Returns by Fixed Income Sectors



Source: Bloomberg, as at June 30, 2022. Canada Universe Bond is represented by the FTSE Canada Universe Index; US Govt Bond is represented by the Bloomberg US Treasury TR Index; US IG Corp Bond is represented by the Bloomberg US Corporate TR Index; US HY Corp Bond is represented by the Bloomberg US Corp HY TR Index; US Floating Rate Loan is represented by the Credit Suisse Leveraged Loan TR Index.

Empire Life Fixed Income GIFs Versus Category Average



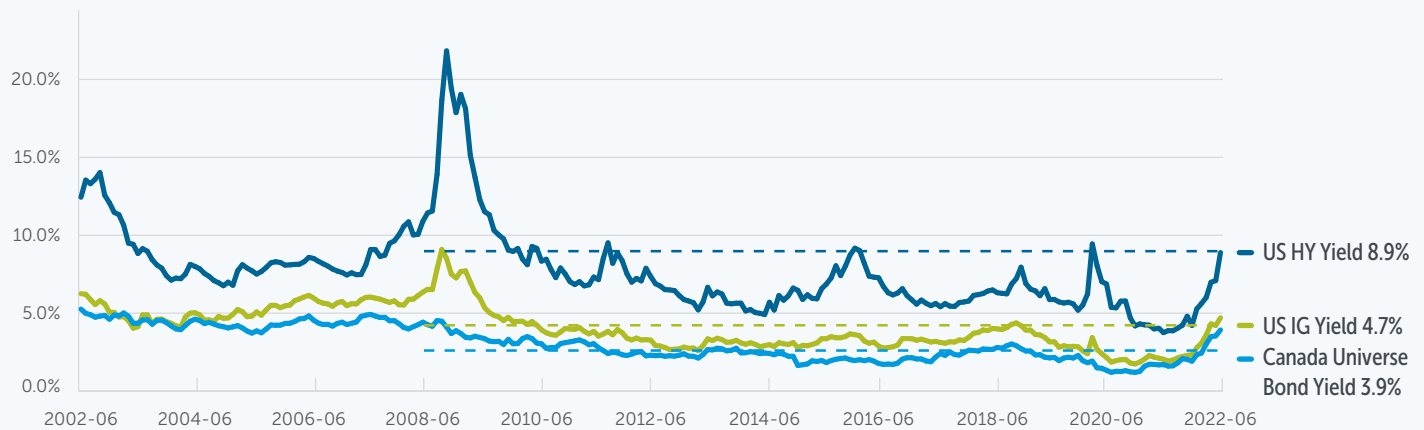
Source: Morningstar Research Inc., as at June 30, 2022.

¹ "A Dynamic Fixed-Income Asset Allocation Strategy for the Post-COVID Era" (January 2022) and "Fixed-Income Update: Navigating a Sea of Volatility in Fixed Income" (April 2022).

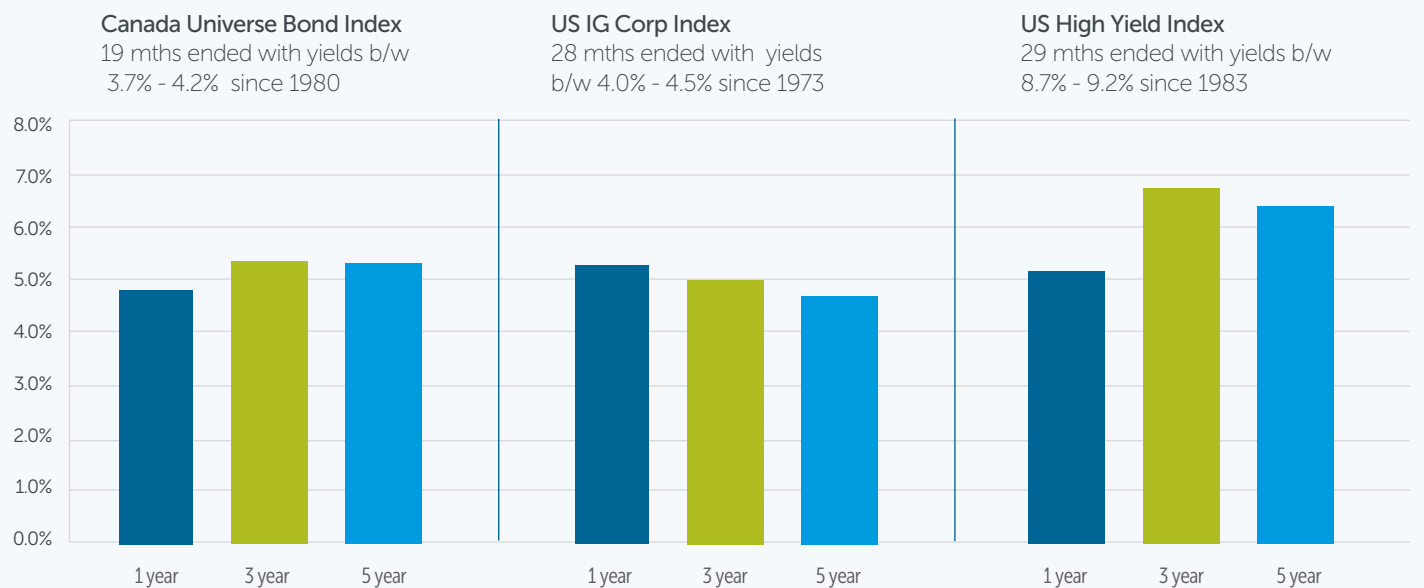
Today, bond yields are at some of the highest levels since the great financial crisis and are at levels that have historically been an attractive entry point for long-term investors – but inflation remains the biggest headwind for fixed-income returns in the short term.

The natural by-product of the first-half sell-off is that bond markets are now offering yields that are either at cyclical highs or the highest since the financial crisis, depending on the fixed-income sector. Historically, when bond yields have been within a 25 basis points (bps) range of current levels, future returns have been strong. For instance, in its 42-year history, when the FTSE Canada Universe Bond Index ended the month with a yield between 3.7% and 4.2% (+/- 25 bps of current levels), annualized returns for the following one, three and five years have averaged 4.8%, 5.3% and 5.3%, respectively. Investment-grade corporates and high-yield bonds in the U.S. have also historically generated strong returns when market yields have been within 25 bps of today's levels.

Historical Bond Index Yield %



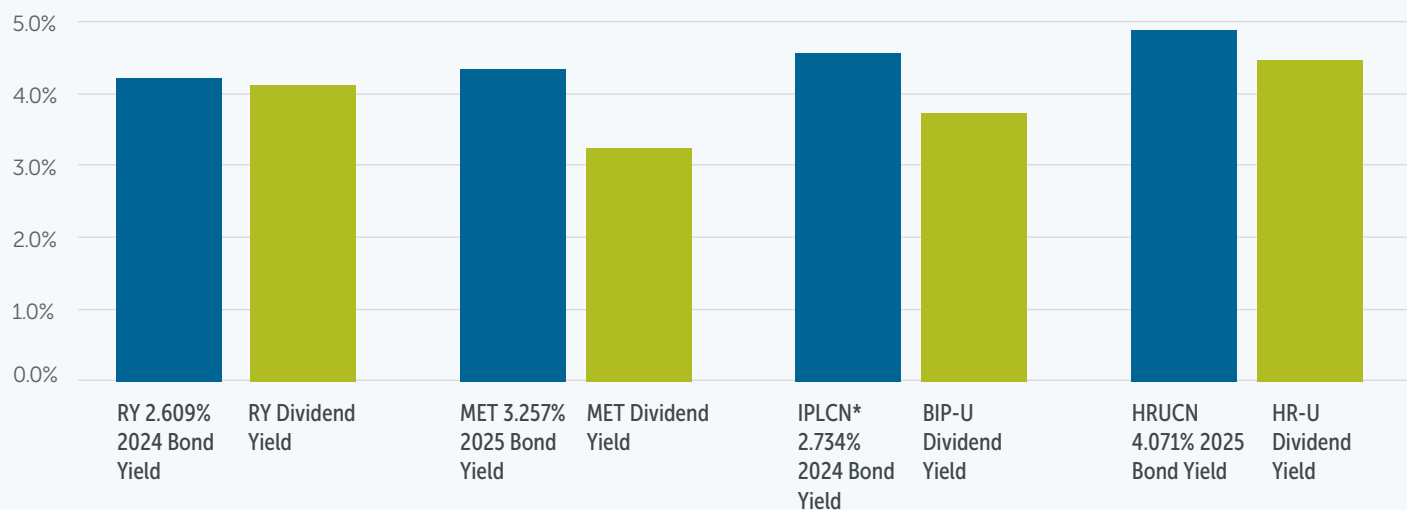
Forward Returns – Average annualized forward returns when historical yields have been within +/- 25 bps of today's



Source of both graphs: Bloomberg, as at June 30, 2022. Canada Universe Bond is represented by the FTSE Canada Universe Index, US IG is represented by the Bloomberg US Corporate TR Index and US HY is represented by the Bloomberg US Corporate High Yield TR Index.

In addition to representing a historically attractive entry point for bonds, today's bond yields make both government and corporate bonds more attractive to income investors who have relied on dividend-paying equities. In the low-interest-rate environment experienced since the Great Financial Crisis, many income-oriented investors have been looking to dividend-paying stocks for income, given relatively higher dividend yields as compared with paltry bond yields. However, in an increasing number of cases, short-dated corporate bonds are offering a higher yield than the dividend yield on the issuing company's stock. Examples include Royal Bank of Canada, MetLife Inc., Brookfield Infrastructure Partners and H&R REIT. We believe bonds that offer higher yields, lower volatility and higher certainty of capital preservation, relative to a company's common equity, provide an attractive alternative to dividend-paying stocks for income-oriented investors.

Examples Where Bond Yield is Larger Than Dividend Yield



Source: Bloomberg as at July 6, 2022. *Note: Inter Pipeline (IPLCN) was acquired by Brookfield Infrastructure Partners (BIP).

Inflation remains a persistent risk for fixed income returns

While bonds offer attractive yields in the market today, the biggest risk for fixed income returns in the near term, as we have previously noted, is inflation. We have discussed our views on inflation recently² but to summarize, we do not believe high inflation will be permanent. Monetary and fiscal stimulus have been and will continue to be, reduced, while demand for durable and consumer goods will continue to fall as consumers shift consumption to services and ultimately, high prices will result in reduced consumer confidence and demand destruction. Inventories have been building, both because of a shift away from just-in-time inventory to just-in-case inventory due to supply chain logjams and the shift in consumer spending away from goods to services, which will result in lower prices.

Although we believe that inflation is not permanent, it has remained stubbornly persistent and broad based. As a result, central banks around the world continue to maintain hawkish stances and are tightening monetary policy to combat inflation, even as economies continue to show signs of slowing down. Consumer sentiment surveys have been inflecting downwards, with the University of Michigan Survey of Consumer Sentiment at its lowest reading since the series started in 1978. Surveys of businesses and manufacturing activity are pointing to greater uncertainty and to a slowdown in activity. Economic data on housing and retail sales and employment figures are also beginning to show signs of slowing. Taking all of this into account, we are beginning to position for a potential slowdown in the economy – a scenario that could lead the central banks to ease off on aggressive interest rate hikes sooner than expected.

² "Fixed-Income Update: Navigating a Sea of Volatility in Fixed Income" (April 2022).

Empire Life fixed-income funds provide yields commensurate with the major indexes highlighted above, without taking undue risk and remain positioned to take advantage of future opportunities.

Because of the positioning and managed risk profile of our fixed-income mandates, Empire funds provide attractive yields, as well as relatively conservative interest rate risk (duration) and credit risk exposure. In addition, a significant percentage of the portfolios will mature or will be redeemed into cash within the next two years and that will enable us to deploy cash into whatever opportunities present themselves in the market.

Fixed Income Fund Details Versus Index

	Yield (%)	Duration (Yrs)	Average Credit Rating	% Maturing or expected to be redeemed within two years
Empire Life Bond GIF	4.4	6.6	A	24%
Canada Universe Bond Index	3.8	7.2	AA	18%
Empire Life Strategic Corporate Bond GIF	5.9	3.5	BBB-	27%
U.S. Investment Grade Corporate Bond Index	4.7	7.5	BBB+	10%
Empire Life Short Term High Income GIF	6.3	2.3	BB+	41%
U.S. High Yield Corporate Bond Index	8.9	4.6	B+	5%

Source: FTSE, Bloomberg and Empire Life, as at June 30, 2022.

From a duration perspective, our relatively shorter duration positioning has insulated and will continue to insulate, the portfolios from the potential risk of a prolonged period of high inflation and higher interest rates.

Volatility in fixed-income markets is likely to persist, so for the most part, we will continue to deploy capital into a mix of higher-quality investment-grade and BB-rated short-term corporate bonds, floating rate notes and preferred shares, to dampen volatility and pick up yield. Short-term corporate bonds are particularly attractive now, as they are at some of the highest yields in over a decade. Given how flat yield curves are, there is less incentive for us to extend and buy into longer-dated corporate bonds.

Despite our relatively low-duration positioning overall, we want to remain diversified, given the softer economic outlook. So, when government bond yields increased and became more attractive in recent months, we began to make opportunistic additions of longer-duration government bonds, which typically outperform in a risk-off or a recessionary environment.

From a credit risk perspective, spreads have become wider and valuations have become cheaper but we are aware of the worsening economic conditions and have been shifting our allocations to higher-grade issues in the portfolios and moving higher up the credit quality spectrum. Longer-term, we remain confident in the overall credit quality and ultimate recovery value of our longer-dated holdings. If and when spreads widen – and valuations become even cheaper – we will seek to opportunistically deploy more capital into credit (lower-rated corporates and/or longer-dated corporates). In the meantime, however, we can still earn attractive yields by investing in higher-quality corporates that are rated BB or higher.

The Empire Life investment team is always ready to position the portfolios for any economic scenario, helping investors to see through market volatility and focus on their long-term financial objectives.

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