



Empire Life webinar - Leveraging our 2022 success for 2023 Transcript of the webinar held on January 24, 2023

PARTICIPANTS

Rob Popazzi

Vice President, Retail Distribution

Paul Holba

Senior Vice-President and Chief Investment Officer

Ashley Misquitta

Senior Portfolio Manager, U.S. and Global Equities

Jennifer Law

Senior Portfolio Manager, Canadian Equities

Greg Chan

Portfolio Manager, Canadian Equities

PRESENTATION

Rob Popazzi

Vice President, Retail Distribution

Good morning and good afternoon, everyone. My name is Rob Popazzi. I'm the Vice President of Retail Distribution at Empire Life, and I'll be your host for today. On behalf of my sales team's colleagues, I want to welcome you to our webinar, Leveraging Our 2022 Success For 2023. Today's date is January 24th, 2023, and we're excited to talk to you today about some key factors that affected the markets in 2022 and how we're using them to set up for success in 2023. We have managers from some of our most successful funds, the Empire Life Asset Allocation Fund, Empire Life Elite Equity Fund and Empire Life American Value Fund.

But first, a few updates. January marks Empire Life's 100th anniversary. And from its humble beginnings in Toronto to our position today as one of Canada's top 10 insurance organizations. On behalf of all of us at Empire Life, I want to say thank you so very much for your support and confidence over the years.

We're excited to have returned to face-to-face meetings last year in a more fulsome way, and I personally am looking forward to meeting with as many of you as possible in the near future. However, given the rapid shift in consumer preferences, we understand

that some customers will prefer to meet virtually, and this is why all of our segregated fund products are available for non-face-to-face sales and through our Fast & Full application, which offers integrated screen sharing video conferencing to make the experience for meeting your client virtually simple, fast and easy to complete the applications and the fund accounts.

We're also excited to announce that we are continuing our GIF Growth Commission Bonus for 2023. And if you'd like more details on that, please connect with one of the members of our sales team.

I want to take this opportunity to thank our investment team for all their hard work last year. As of December 31st, 2022, we have over 80% of our funds in the top two quartiles and ten funds that have achieved a 4-Star Morningstar Rating with Empire Life's Emblem Global Conservative Portfolio and the Empire Life Short Term High Income GIF, having earned a 5-Star overall Morningstar Rating. These are fantastic results.

Before we move on, I need to remind everyone that this presentation reflects the views of Empire Life as of the date published and is subject to change without notice. The information in the presentation is for general information purposes only. It is not to be construed as providing legal, tax, financial, or professional advice. The Empire Life Insurance Company and its affiliates assume no responsibility for any reliance on or misuse or omissions of the information contained in this presentation and document. Information obtained from and based on third-party sources are believed to be reliable, but accuracy cannot be guaranteed. Please seek professional advice before making any decisions.

Now that the legal disclaimer is out of the way, let's start by introducing our panel and get to some fun questions. Let's bring everyone in and we'll start with Paul Holba, our Senior Vice President and Chief Investment Officer. Ashley Misquitta, Senior Portfolio Manager, lead manager for the American Value Fund. Jennifer Law, Senior Portfolio Manager and lead manager for the Elite Equity Fund. And Greg Chan, Portfolio Manager and manager for the Asset Allocation Fund.

They're going to discuss the challenges of 2022 and how that's helped set them up for success in 2023. We've reached out for questions in advance, and we'll address them directly with each member of the panel. If you have additional questions, please put them into the Q&A, and we'll address them as time permits. If we run tight on time, we'll ensure someone responds to you after the webinar. Before we dive into our questions, Paul, I understand you've got some news to share about the Empire Life investment team. What are the plans for the team in 2023?

Paul Holba

Senior Vice-President and Chief Investment Officer

Hi Rob. Thank you. I'm very excited to share that Ashley Misquitta has been appointed as Investment Strategist for Empire Life Investments. This is in addition to the other duties he has as Senior Portfolio Manager for several of our funds. With this expanded role, Ashley will conduct research and provide insight to the rest of the team, which will add a whole other level of information so that we can make investment decisions wisely. Ashley's going to use those insights in various mediums to help inform and educate you, both our advisors and investors, about major events and changes happening within global markets.

In addition, effective immediately, Jennifer Law will take over as lead portfolio manager for Empire Life Elite Equity. This is in addition to her management responsibility for several other of our funds. Jennifer's been a critical member of the investment team on Elite Equity for some time and has certainly demonstrated her investment expertise and leadership, helping the fund deliver above-average returns now for several years.

Over the coming months, we're looking to take the opportunity to grow the team strategically as well. So, we're planning to increase our bench strength by adding several analysts to increase our market coverage across several different sectors, regions, industries and strategies. We're looking to make additional portfolio management appointments into key roles within the team to broaden our expertise and develop a greater diversity of insight among the team. So, keep an eye on Empire Life Investments as we grow to serve you better. Back to you, Rob.

Rob Popazzi

Vice President, Retail Distribution

Thanks, Paul. Wonderful. And thanks for that update on the team. It's exciting times, and we're looking forward to the work that you and your team are doing in 2023. With so many other industries shrinking to meet today's challenges, we're leaning in on growth to help us achieve our goals. And so, what I'd like to do now is get right into some of the first questions and start our conversation with our PMs. Let's kick things off with our

first question. Being Canadian investors, our audience is always interested in what's happening in Canada. And so love to know what are some of the key concerns for 2023 and how that's shaping your outlook for Canadian equities in 2023. Jen, let's start with you if we could, please.

Jennifer Law

Senior Portfolio Manager, Canadian Equities

Sure. Thanks, Rob. Great timing for this call. Coming into this year, the consensus was that the first half of 2023 was going to be tough, and in the second half, things will get better, and the Fed will cut rates. Surprisingly, the market is off to a really strong start. The TSX is up 6.4% as of close yesterday, and we still have a week to go in January. 2023 is supposed to be the lag year, meaning the impact of all the aggressive rate hikes last year are supposed to be felt in our economies this year. That's the typical lag between monetary policy and the actual economy. This is the most anticipated recession. Frankly, at this point, we just want to get it over with, so we can look forward to recovery and growing again.

We care about the timing of a recession because, you know what, markets typically don't bottom until we're partway through a recession. So that's why we just want to get started, so we can look forward again if that is the case. If we haven't hit a bottom, the most recent low was mid-October. So, if we give up all those recent gains and go back to that level, that means for the TSX, we'll see a correction of 13% from yesterday's close. That is the key question on investors' minds, is this a bear market rally? What's happening? Why is the market so strong year to date?

Another key question and concern on top of investors' minds are, "Are we going to have a soft landing, or are we going to have a hard landing?" And how long would this recession last? The main difference between hard and soft landing really comes down to jobs. How many jobs will be lost? And what's that number, what number that will propel central banks to start cutting rates and reset the cycle? So, let's look at the U.S. Current unemployment rate is at a historical low, 3.5%, and there are still 1.7 job openings for anyone that's looking. And here in Canada, at 5.0%, we're at a 30-year low. Compare that to the long-term average of 8.1%.

So, the market is expecting rate cuts to start towards the end of this year. Robust equity returns over the last three months are based on the notion that inflation has peaked and central banks will cut rates in the second half. Then, global economies were reset and positioned for growth. I agree that inflation has peaked and is coming down, but what happens if inflation doesn't get down to 2% this year? The unemployment rate will go up, but not so bad, not bad enough to force the Fed to cut rates. Could consensus be wrong? In that scenario,

we could see another market sell-off, especially after the recent runup. All these moving parts, interest rate, inflation, unemployment rate, and GDP growth, promise 2023 to be another volatile year for investors. How we are positioned heading into softer economic data, negative earnings revisions, how we're positioning anticipated timing of rate cuts, timing of the emergence of growth, that would be some of the trickiest decisions this year.

Rob Popazzi

Vice President, Retail Distribution

Wonderful. Thank you, Jen. And one of the things I do want to ask is if you anticipate Canadian equities to outperform the U.S. again in 2023?

Jennifer Law

Senior Portfolio Manager, Canadian Equities

Great question, because we saw a little bit of that in 2022. Let me answer it this way. Canada has the world's fourth largest natural resource base and given how little investment has gone to energy, mining, and basically hard rocks over the last decade, that supply shortage or tightness should lead to higher commodity prices going forward and propel the Canadian market to outperform the U.S. That's a long-term view. I think in decades in that kind of cycle, that's typically two business cycles.

Let's revisit history. History tends to repeat itself and we as investors must respect cycles, especially for the Canadian market where we have a more cyclical economy. So, when I look at the chart of S&P/TSX versus S&P 500, what I saw was a period of 20 years of outperformance by Canada from 1960 to early 1980s, that had the OPEC embargo and we saw a big run up in oil prices during that period of time. And then that was followed by 15 years of under-performance from late 1982 to 1997.

So, I started my career around that time in '97 on Bay Street. If you think about it from late 1999... From 1998 to '99 to 2010, I would say, so over the next 12 years, we had the super commodity cycle driven by Chinese demand to a certain extent. That's the last time the TSX outperformed the S&P 500 in a dramatic fashion. Then at the peak around 2010, we spent the last 12 years underperforming the U.S. where technology dominated market leadership. I really think last year was the start of a new outperformance cycle and they tend to last much longer than just a few years. Good question.

Rob Popazzi

Vice President, Retail Distribution

Wonderful. Thank you, Jen, for your comments. Very insightful, particularly on those cycles. I did want to note before we shift to our next question that we do

have a Q&A box going and we do have some questions coming in. Please continue to do so. We believe these will be addressed in the next set of questions, but again, if we don't, we'll make sure that we do get the responses back to you after the session.

Now, sticking with Canada here and something of concern for many investors with the rise in mortgage rates in recent months is how do you see the Canadian housing market faring in 2023? Let's start with you Greg and get your thoughts.

Greg Chan

Portfolio Manager, Canadian Equities

Sure. Thanks, Rob, for the question. Home prices fell 12% last year according to the Canadian Real Estate Association and just in December alone, home sales fell by more than 39% year over year. So, there's no doubt the market is slowing down as interest rates have sharply increased. Right now the 5-year fixed-rate mortgage is around 5%, and really since the financial crisis, so over the past 10 years we've seen that rate comfortably in that two to 3% range.

We're thinking who does this impact? First, first-time home buyers, they're getting squeezed out of the market. Second, people with variable rate mortgages, they've already seen that impact with many of them hitting that trigger rate with higher monthly payments. And then third, people who have renewed over the last six to 12 months or really are planning to renew over the next, say, 12 to 18 months, there's going to be a big sticker shock when their monthly payments are 20 to 30% higher.

One concern out there is how does this housing slump impact the Canadian economy? The Canadian banks, all which have large mortgage exposure, recently we heard from many of the CEOs of Big Six banks and they tried to quantify their at-risk customers. So, these are customers with lower FICO Scores, higher loan-to-value ratios, and they indicated that this customer base represented about low single digits of their entire mortgage bulk. Even in a worst-case scenario, it was very manageable.

So, like Jen talked about earlier, I think a key area to focus on is the unemployment rate. Canadians have a history of paying off their mortgage as long as they have a job, they'll cut expenses elsewhere. Right now, as Jen said, unemployment rates are still very low at around 5% and just last month we created 104,000 jobs. I'd say just overall we think the housing market will continue to show tepid growth in 2023, but we're not expecting a housing crisis or any large-scale problems for our Canadian banks.

Rob Popazzi

Vice President, Retail Distribution

Okay, great. Thank you, Greg. Let's move on to positioning and asset allocation. Maybe what we'll do is we'll also bring Jen in for some of her thoughts here. You both manage geographically diverse portfolios, so I'm wondering if you could share your thoughts on the fund's current allocation and specifically what kind of key drivers of performance you're looking for. Jen, why don't we start with you on this one?

Jennifer Law

Senior Portfolio Manager, Canadian Equities

Okay, thank you. I just want to remind everybody; Elite Equity Fund is an equity-only fund. We currently hold 52% in Canada, 34% in U.S., 6.3% in international equities, and 7.6% in cash. We do believe having cash in a volatile market is important to take advantage of opportunities and market dislocations. Let's look at last year. I think David Mann made a really good, timely call. We were underweight international equity relative to our peers for the front part of 2022 and added to our weighting in international equities throughout Q4 when EAFE outperformed both U.S. and Canada in Canadian dollar terms. I think the euro being a stronger currency recovering from the bottom really helped that performance.

Relative to our peers, Elite Equity is currently overweight U.S. I believe Ashley's investment style is well suited to today's market. When you look beyond the handful of mega tech names, and for that, I look at the performance of the equal weighted S&P 500, it has outperformed the market cap weight itself. What that says to me is there are exciting stock picking opportunities out there in the rest of the market and that plays to Ashley and his team's strength. There's a great article in the Financial Times today arguing for switching out of passive funds into active management. So, for the Star Wars fans out there, I think what we had the last few decades was Episode V, Empire Strikes Back with low fees. Maybe this is the start of Episode VI, Return of the stock picker.

Anyhow, with respect to position we're currently overweight energy, overweight staples, underweight discretionary and in materials, slightly underweight, very marginally around one percent in financial and industrials. Our expectation is that earnings and guidance for 2023 will be adjusted down this earning season and next quarter. For now, we're staying tilted to value sectors such as energy and financials, defensive sectors such as consumer staples and looking for the right inflection point to layer in growth in industrials and maybe some good old high free cashflow technology, once expectations have been reset. Thanks. I'll pass it on to Greg.

Rob Popazzi

Vice President, Retail Distribution

Yes, Greg, love to get your thoughts on this.

Greg Chan

Portfolio Manager, Canadian Equities

Sure. Within the Asset Allocation Fund right now we have about 57% in equities, 37% in bonds and 6% cash. And within the equities we're overweight Canada. So, we have... Canadian equities represent 69% total equities, U.S. is 24% and international is 7%. I think the way you can think about this on the equity front is we'll typically be in that 55 to 65% range. So, if we're at the low end of the range, it just means we're a bit more bearish on the equity markets. If we're at the high end, we're more bullish on the equity markets. And this is where it's been over the past, say, five to 10 years.

And just to give you an example of how it shifted over the last several years, back in the beginning of the COVID pandemic, so think March, April 2020, the market sold off pretty aggressively. We put a lot of money to work into high quality companies that were trading at a large discount to our fair value. So our equity rate actually is topped out around 66% in 2022... Sorry, 2020. So that was a bit higher than our top end of our target range. And then the back half of 2020 was strong. 2021 was also a strong market.

So, as we entered 2022, we took a more cautious approach to the equity markets. In 2022 alone, we were around the 55 to 58% range all year. And then similarly to 2022, we're taking a bit more of a cautious approach. And like I mentioned earlier, we're about 57%. So, at that low end of that 55 to 65% target range. Like I mentioned just earlier, we favor Canadian equities right now, which represents 69% of total equity. Jen talked about the supercycle, I won't get further into that, but just also attractive valuations as well within the TSX.

And then within our fixed-income portfolio, our duration rate now is 5.7 years. We continue to maintain our overweight position in corporate bonds relative to government bonds. And more recently we've been focusing on higher quality corporate issues, so we've been upgrading our credit quality.

Rob Popazzi

Vice President, Retail Distribution

Okay. Wonderful. Thanks. Now Greg, I wonder if we could do a bit of a follow-up question for you...

Greg Chan

Portfolio Manager, Canadian Equities

Sure.

Rob Popazzi

Vice President, Retail Distribution

With Asset Allocation being a more tactical fund, can you share any of the large tactical moves made in the fund over the past 12 months?

Greg Chan

Portfolio Manager, Canadian Equities

Sure. Yes, definitely it is a tactical fund. So, we have done a few broader tactical moves in 2022, and I'll share a few of them. Firstly, this was back in February or March 2022, we cut our international equity exposure in half. So, we went from 8% of total assets to 4% and this was after the invasion of Ukraine. Russia, as we all know, is a top exporter of oil to Europe. And just the close proximity of the war made it a bit more bearish on Europe. We deployed those assets into Canadian equity. We just thought our resource-based countries, such as Canada, would be a positive beneficiary. So that was our first move on the equity side.

I'd say our second bigger move was on the fixed-income side. So, we entered 2022 with short duration, which was a positive relative contributor to performance. We then started to add to our duration over the last six months as the outlook for government bonds had improved. And as we enter 2023 right now, like I mentioned, our bond duration is 5.7 years, which compares to 3.9 years as of June 30th, 2022.

And then I'd say our third bigger tactical move we did last year was on the equity side. This happened on two separate occasions. It was back in the summer in July and August we moved about 6% of total assets, Canadian equity to U.S. equity. Like I mentioned earlier, we're still overweight Canadian equity, we still favor this market. But we did this for several reasons. I'll just name a few. Firstly, the TSX had outperformed. So just naturally our weight in Canadian equity got a bit higher than we were comfortable with, so we took some profits off the table. Second, we took advantage of the U.S. sell-off, especially the NASDAQ. We own some very high-quality large cap companies in the Allocation Fund. Companies such as Microsoft, Google, Amazon, which were all down close to 30% last year.

But then lastly, and just probably most importantly, we're beginning to see more data points that inflation has peaked, interest rates are getting closer to terminal rates. And as the Fed does pivot, this should favor growth stocks, which in support of the U.S. market, in particular technology stocks. Those are the three larger moves we did over the last 12 months. And as we enter 2023, we continue to monitor the macro data as well as individual company fundamentals and we'll continue to make necessary adjustments as we see fit.

Rob Popazzi

Vice President, Retail Distribution

Wonderful. Thanks, Greg, for the update on your fund and appreciate the insights this morning.

Leaving Canada for now, are there any structural or policy changes in the global markets that you're watching, and how might they impact your portfolios? That was a question that came in and I'd like to start with the other side of the globe and China seems to be in the news quite a bit. So, I'm wondering, Jen, if you'd care to comment on that as well and start us off with this question if you could.

Jennifer Law

Senior Portfolio Manager, Canadian Equities

Okay, thanks Rob. Let's talk about China. And you've got to talk about China reopening at this point. The speed and timing of the reopen was not expected. It's definitely more aggressive than I thought. All eyes were on China in mid-October because they just had this People's Congress and appointed Xi to his third term and there was no indication that he was going to abandon the COVID policy. And so nobody thought it was going to happen this quickly, but I think some of the movement we saw in the market was like, "Okay, finally People's Congress is done, it will reopen. We don't know when." And there was definitely some preposition. You can see it in the movement of copper.

But to me it just didn't seem... The timing, it was still surprising because I never thought it would be before Chinese New Year, which started this past Sunday. This is a country where we're going to see 2 billion trips for 1.4 billion people. To open before Chinese New Year definitely surprised me. And it didn't seem well planned because if you think about what percentage of the elderly was fully vaxxed with three shots, it is still shockingly low.

But without a doubt China reopened, is a material economic event for 2023, especially when rest of the world's heading into a recession. Remember what happened in 2009 and 2010 because the rest of the world was into a great financial crisis and China was rebuilding, finishing Olympics and going to other major events it was hosting? And it drove a lot of that demand when rest of the world was weak. But the key question for '23 is how fast can China ramp up economic activity? The rest of the world has just gone through this. We saw how COVID impacted that labor availability and absenteeism was common. We had companies that had 30% absenteeism in plants. So how smooth is this ramp up? That is a key question.

In the meantime, commodity stocks have rebounded strongly since October 2022. Copper is up 21% in the last three months. I do feel like it's a bit ahead of itself. We would like to give a bit more time and be patient. Longer term our confidence is a lot higher. China's leadership in energy transition and drive to energy independence will be key to demanding commodities. I

mean, they are after all 50% of global demand in copper. Think about lithium for EV cars and its storage and iron ore. They're 70% of seaborne market, which you use for steel making. Those are key commodities that we care about and we think we will benefit from owning.

Personally, I think this is a potential to be a more robust commodity cycle than I previously experienced. The entire world's going through an energy transition at the same time. The amount of government subsidies and grants are at record highs. On the ground, the West is duplicating what China has in order not to rely on them for critical materials and battery-making, EV battery-making capabilities. And at the same time, Chinese manufacturing companies are duplicating footprints in North America so they can keep supplying the Western customers. All these political tensions, they're like, "We're not going to wait for that to happen." So, there are plants in Mexico, it's full of Chinese companies basically setting up satellite manufacturing footprints.

So, the whole world is all building. These are great for commodities, great for industrial companies. But at the same time, in the meantime, producers of critical materials are way more disciplined and balanced between production growth, increasing dividends, maintaining a strong balance sheet and returning cash to shareholders. This time I think that's the difference between the last cycle we went through. Companies are way more disciplined; shareholders are demanding more cash back to them. So that tightness of supply plus increasing demand on a global basis, that is the definition of a supercycle. I am really excited by [how to take advantage of the economic situation] on a risk-adjusted basis in 2023. That's the key question. So, thanks Rob. I'll pass it back to you.

Rob Popazzi

Vice President, Retail Distribution

Thank you. Thank you. Fantastic answer and very detailed. So thank you for that insight.

Ashley, we haven't heard from you yet and so I'm wondering if you'd like to add anything to this question from a U.S. perspective? We're just going to have to get you off mute though.

Ashley Misquitta

Senior Portfolio Manager, U.S. and Global Equities

Yeah, sorry about that. You'd think I'd have learned by this point, right? Thanks for the question. I'm completely in accord with Jen on her views on commodities and I think that there's going to be a very interesting opportunity there. It's something we're thinking a lot about and paying attention to as well. So, one of the things I've talked about in the U.S. for years now is there's a series of three structural tailwinds that I

think are very important. And I think they continue to assert themselves. And now I think we can add a fourth, actually. We've wanted to, based on some hand waving and discussions and insights. Let me get right into them and it'll make more sense maybe when I do that.

The first one is the difference and uniqueness about the U.S. in terms of innovation. And so, do this exercise sometime when you have a moment and you're bored or whatever, ask yourself, where have been the most important innovations in science and technology, in medicine more recently, in energy production? What have been the most important developments in the past 30 years? And then when you make that mental list, ask yourself where those came from. I think you'll find the overwhelming majority of them have come from the U.S. and that's a huge asset.

One, from a growth perspective. Because I think it was in the 1850s, 1870s economist Joseph Schumpeter talked about the idea of creative destruction. In the natural course of an economy, some industries will be destroyed and be replaced by newer ones. And it's so important to be the economy where those new industries are created, not just where the ones are destroyed. The U.S. is a great example of that. We saw very recently back in December where OpenAI introduced their chat implementation of GPT-3 called ChatGPT, and it exploded. It had, in popularity and in usage, a million users I think within a week. I've played around with it extensively. The applications of it are extensive, but the innovation and the advancement that that represents and how it will be implemented, how it will help us, is really amazing. We're barely scratching the surface with it.

And that's just a great example I think of the innovation because of course that came from the U.S. And so that is just one of the three tailwinds that I talk about and I think is going to be very important not only from an economy, a growth, a jobs perspective, but also from the perspective of investors. So, we have a continually replenishing supply of really interesting businesses that are being created that give us the opportunity to invest in when we find that time is right. So that's the first one.

The second one is demographics. And I think this is so important and I'm always amazed at how little attention this is given in the popular press. And when people talk about these things, it's actually one of the most important things. People probably don't talk about it so much because it's a factor that impacts things over time. It's not today the market is up or down because of demographics, but rather it's something that affects things over time. Here's one for you. The Chinese population is smaller today than it was a year ago. Let that sink in for a second. This monstrously large economy, very, very large economy has grown so

rapidly and now is in potentially structural decline in terms of the total population size.

So why is that? Well, because of the one-child policy, China has an inverted pyramid almost. It's a little too stark a description because it's not quite so pointed on the bottom. But normally what you'd have is a pyramid shape where you have a large number of younger people and a gradually declined number of elderly people. China is inverted a little bit. And the problem with that is that it results in, based on the development they've seen, an economy that on a per capita basis has become elderly before it became rich.

Japan, on the other hand, which also has a declining population, has become wealthy on a per capita basis prior to becoming elderly. But regardless, both are concerns. So, the Japanese prime minister just gave a speech recently about his concerns about the solvency, if you will, as a civilization and as a society with the very low birth rate they're experiencing. Europe is a little bit better off because they're seeing a lot of immigration. Russia is an absolute basket case because not only did they have a terrible and very difficult demographic to start, but they also have lost a lot of people in the war. The U.S. is in really interesting shape this way, not the best in the world, but because of the immigration policies and the desire for people to move there, it's a positive for them. India is actually probably in the best shape overall. They don't start hitting the top of that population curve until 2060, 2070 or so.

So that's a tailwind though for the U.S. Their tailwind is energy production, domestic independence of energy production. That's a huge asset for the U.S. And then finally the new one is reshoring or nearshoring or however you want to think about it. That's a tailwind for the U.S. and that's a challenge for China in particular. There used to be many businesses and industries that were deemed national security critical, that is growing as we've learned over COVID. And this is what I was talking about earlier, we've heard about it for a while, people have talked about it for a while, but it hasn't really manifested.

Now we're seeing dirt being moved, we're seeing buildings being constructed, we're seeing dollars being invested in the U.S., as Jen alluded to in semiconductors. We're seeing tens and hundreds of billions of dollars invested in semiconductor manufacturing in the U.S. to harden global supply chains around this absolutely critical... We could not be doing this webcast without cutting-edge semiconductors. We couldn't drive our cars, we couldn't do national defense, we couldn't have smartphones. All of these things. Our modern life depends on these and countries are going to spend a lot of money to support domestic production or allied production of those things. Battery tech, EVs, all sorts of things. And this is going to be a real tailwind for the

U.S. going forward and these are structural aspects that I think are going to be very, very helpful.

Rob Popazzi

Vice President, Retail Distribution

Wonderful. Thanks, Ashley. This is great content that both you and Jen are sharing with the audience. So thank you very much. I want to shift to the next question and Ashley more for you. You really had some great success managing on the downside in 2022, and I'm wondering what the biggest contributor to that success would be and do you see that positioning changing in 2023?

Ashley Misquitta

Senior Portfolio Manager, U.S. and Global Equities

Yeah, thanks Rob. I appreciate that. Yes, it was a good year. We were able to protect quite substantially on the downside, it's how we geared our portfolio. We came into 2023... Sorry, '22 rather, having very strong views on inflation, on interest rates. We had high conviction inflation was going to be higher than people thought it was. I was mystified in late '21 as the market seemed to just keep ripping and as evidence built that the Fed was going to become far more aggressive in their response. And we saw that. We saw interest rates move with hikes that we haven't historically ever seen. The rate of hikes was also very, very robust. So that was one thing that helped us out a lot.

The second thing that helped us out a lot was... And sorry, and I guess our positioning around that was, we were more defensively postured. We were underweight tech and underweight long duration assets. As interest rates rose, cash flows far into the future were discounted back at higher rates and it reduced the present value of those cash flows. Value of the businesses declined. So, we were underweight those kinds of businesses.

And the other part that helped was we were overweight energy. So, I have over the past four years, or sorry past year or two, built in a mental framework that I'm applying to energy and to all other commodities. And it's a four-part thesis. Part one is you have to have a demand environment that you anticipate in the future that is more robust or at least as robust as it needs to be based on your assessment of the demand supply world. In energy, I have not seen a model that I believe is credible that shows a peak demand in oil prior to 2030. What that means is it's got to be not just stable but higher. We're going to grow based on the model. Every model I've seen that I think is reliable, we're going to grow energy demand through this decade. What that means is we need to be investing and that's the supply side of things, which is part two of the thesis.

You have to have supply that is constrained for artificial or legitimate reasons. Whatever the case may be, you have to have supply constrained. So, what are we seeing in terms of energy supply? A lot of ESG investors have been unwilling to even own energy companies that are moving towards Scope 1 and Scope 2 net zero carbon targets. And so, what ends up happening is you end up with pressure on supply, you end up with situations like... An article I read yesterday that large European pension plans were putting pressure on European banks to not provide capital, not do debt financing, not do equity financings for energy companies to produce oil and gas. You find situations where the mines minister of Columbia has talked about not licensing any more oil and gas production in the country. And all of these things constrain supply. So that's part two. Part three is investors have to really hate the stocks. Evaluations have to be deeply discounted and really on their backs. We see that very much so in the energy companies. Especially we saw that in late '21 coming into '22.

And then the fourth part of it is I've seen situations where it all makes so much sense and you're depending on the market saying, "Hey. You're absolutely right. That is the right answer." And then they re-rate them. And we're not... I'm really as interested in waiting for those situations. Sometimes you have to do that, but for this part of the thesis at least I want the companies returning capital to shareholders. Jen alluded to this in her comments. I do not want these companies aggressively trying to grow at low rates of return and hope everyone says, "Wow, that's great, you're doing the right thing." I want them giving that money back to us and growing at modest rates. And we're seeing that extensively in energy companies and I'm applying that four-part framework to other commodity business. I've never really looked at metals or mining in general, but I am looking at those now.

And those are the two main things. The third thing that helped is that we had a couple of companies get taken out and obviously that's very helpful when that happens. You don't plan for that. But at the same time, when we buy... We have a mental bucket for large caps, mid-caps, smaller caps within American Value and we are more... Or depending on our level of aggressiveness, we may have more or less small caps and we'll flex that up and down. When we buy smaller and mid-cap companies, part of the thesis is if the market doesn't appreciate the value of these businesses, their competitive advantages, their cash flows, the opportunities they represent, somebody else will. And we see that manifest over time. We've had some good luck in our companies' getting taken out over time and I think some of it comes down to that approach and that thinking. So those are the three things that helped us out a lot last year, Rob.

Rob Popazzi

Vice President, Retail Distribution

Wonderful. Thank you, Ashley. And I want to be respectful of time. We're about the 45-minute mark and so what I'd like to do now is actually now that we've got this great update on your fund, I want to talk about what's happening in terms of that global slowdown and the risk of a recession. So, I'm going to pivot again here and talk a bit about... And get Greg back onto the scene and, Greg... What are your thoughts? So, we've had some of these questions in the chat as well. What are your thoughts and how do you feel the Canadian banks are positioned about this talk and the risk of a recession?

Greg Chan

Portfolio Manager, Canadian Equities

Okay. Great question Rob. Firstly, I'd just like to say we're pretty constructive on the Canadian banks over the medium to long term. They're well positioned as a true oligopoly. It's demonstrated by the strong ROEs they generate throughout an economic cycle. But having said that, in a recession environment, this is obviously not a positive for the banks. Loan growth begins to slow, credit loss has increased and the banks' capital ratios become more important. So, while we still like the banks here, we're just paying very close attention to many of these macro factors we talked about on the call today that can impact their financial results. I was recently at a bank conference where all the major banks' CEOs presented and I would say just the general tone of the conference was cautiously optimistic.

In terms of loan growth, while it is slowing down, it's still relatively healthy, both in Canada and outside of Canada. Credit, like I mentioned, becomes a big focus with any slowdown. Right now, the banks' impaired loans are still well below pre-pandemic levels, but they are increasing and I think the expectation is that they will normalize over time. So, no big credit issues here yet.

And in terms of capital, right now, the Big Six banks are well capitalized as we head into a potential downturn like we've talked about. BMO recently raised about 3.15 billion in equity. They did this because of the recently increased Domestic Stability Buffer from 2.5% to 3%. So now banks have to hold the 11% CET1 ratio. It was previously at 10.5%. So, BMO's equity rate is more because they recently closed a large U.S. acquisition called Bank of the West. So, this was more of a one-off situation and we don't envision any other banks raising capital in the near term.

If I close this out, just in terms of valuations, the Big Six banks are trading at 9.7 times price earnings multiple. And if we look over a very long time period, they've historically traded around 10 to 12 times earnings. So

just being slightly below that 10 times to us suggests that investors are likely pricing in a mild recession, which we think is appropriate at this moment.

Rob Popazzi

Vice President, Retail Distribution

Okay, great, thank you. What I'd like to do now is to ask you to bring Ashley back in. And really Ashley in your capacity as the Investment Strategist would love to get your take on inflation. Is your expectation we're past the worst of it, we're entering a period of deflation? Really love to get your thoughts here on this one as we wrap up the session.

Ashley Misquitta

Senior Portfolio Manager, U.S. and Global Equities

Yeah, for sure. I think we're likely past the worst of it. In the absence of some sort of exogenous event in the world that causes a major crisis or something like that, we're likely past the peak of inflation. But the really interesting, and the very important question is let's say we go from nine to five, how hard is it to go from five to two? Because there's a few things happening in the world that I think are important to this. My sense is the market is not really appreciating that. And so, I think there's a happy days are here again view in the market around inflation.

And then the corollary to that of course is that what it means for rates. I get the sense in the market that there's an expectation that we're going to get rate cuts this year. We talked about that a little earlier on the call and I think what we're seeing manifest itself in the market in January here is some expectation of that. I'm not quite as certain about that.

And so what I would highlight, one, oil. Just to follow up on what I said before, we need about 375 to 450 billion dollars of capital spent each year just to stay in the same place. Because as you would expect when you drill an oil well, after a year there's less oil down there than there was in the previous year. So, there's something called a natural rate of decline and you have to spend money just to abate that, just to stay in the same place. We're not spending enough in order to do that. And what that means is we're going to see upward pressure on the price of oil, I think. That is going to be a net increment to inflation in my view at least. So that's going to put upward pressure.

We're doing this energy transition thing and we are seeing a huge, huge demand for physical commodities. Like I said, I tend to agree with Jen that I think there's really interesting potential opportunities here around for Canada because of the demand we're going to see for copper, for lithium, for nickel, for all sorts of other physical commodities where Canada is reasonably well positioned for those kind of opportunities. But because of this not-in-my-backyard attitude that seems to exist

in a lot of places and the best characterization I've heard of it is there's a global ESG view, but a local not-so-ESG view. We need to globally, in a macro sense, build more mines, but not around where I am. Not commenting on the merits or lack thereof of that. Set that aside for a moment.

If people are not willing to have mining done proximal or whatever, we're not going to have... We can print money; we can't print copper. And so, I think that's going to be a challenge we're going to face. And even if we were to be able to do all of this in an accelerated timeframe, I'm skeptical that we're going to get that balance between what we need from an incentive price perspective relative to what we're getting in terms of copper. So, I expect that that will provide upward pressure as well.

And then finally, wages. We have seen a structural shift... Well, let me say it differently. We've seen a shift; the question is how structural it is. Around capital and labor. For the past 20 years, post China getting most favored nation trading status with the U.S. and post China's accession to the World Trade Organization, we have seen capital benefit at the expense of labor. Margins have increased and Western labor has not benefited as much because a lot of the work was being moved overseas. As that starts to return and as the demographic profiles are less appealing domestically and less appealing in certain overseas markets, so wages are going up there, we're going to see potentially wages structurally under upward pressure here as well. So, you have those things, you have a few more other near-term dynamics and I'm unconvinced that we're going back at a very rapid rate to 2% inflation or below.

And so really the big question this year that I think is not being well appreciated is getting from five to two, I think that's going to be harder than people think it is.

Rob Popazzi

Vice President, Retail Distribution

Okay. Wonderful. Thank you for your insights, Ashley. Again, we've had a couple of questions come into the Q&A and there's one more that maybe since I've got you on the screen right now, I'll cycle in and get a response if I could, around your thinking around the positioning for 2023 and what are you watching for to shift away from maybe being defensively positioned through your framework to more aggressive positioning?

Ashley Misquitta

Senior Portfolio Manager, U.S. and Global Equities

Yes, I think that's a great question. And the key is to... I think we are probably closer to the end than we are to the beginning right now. So, while I'm not ready to make that leap at this point, I am watching for that

opportunity. Whereas if you talked to me at this point last year, I think I would say "We just have so far to go. It's very hard to see where exactly that endpoint is." Now what we need to see is, as Jen alluded to, there is a natural and normal lag in monetary policy.

So, when we raise rates, there's usually... There's historically at least been a nine to 18-month lag before we start to feel the effects of that. Because it takes time for people's mortgages to come due, it takes time... A business that's in the middle of building something, they're going to keep building it, but the next project is going to incorporate that higher interest cost. And they may say, "Rates are up. This project is not net present value positive, so we're not going to do it." So, it takes... That's why there's a lag. And so, we're just seeing that now and that's going to start hitting EPS, that's going to start hitting earnings.

There are arguments you can make why that might not be the case. I think based on the evidence I've seen and based on our analysis, our conclusion is that we are going to see, or my conclusion certainly is we're going to see some pullback in earnings. And as that starts to get reflected into stock prices, then I'm going to be a little more interested in jumping in and becoming a little more aggressive. We do have our eye to this, I just think we're not quite there yet.

Not to overly simplify, but if we get a big pullback in the market concordant with earnings estimates starting to come down, we're going to start looking for that opportunity. We don't want to wait until earnings estimates turn up because you're going to be too late at that point.

Rob Popazzi

Vice President, Retail Distribution

Right. Okay, that's great. Thank you. That was really helpful, we had time for that piece of the question. So, thank you for taking the time to address it.

As we're getting close to time, I want to be respectful of everyone's end time here at half past. And so what I'd like to do is conclude the webinar and thank Paul and Ashley and Greg and Jen for all their insights today. And thank you for taking the time to join us. The investment team does continue to find investment opportunities in all market cycles as you've heard, and you can stay informed on their activities through the investments blog where we also have our Emblem Portfolios asset allocation update and our recent video message featuring Paul Holba providing his insights on the past year and what lies ahead.

So, if you have any questions on today's webinar and our industry-leading product choices, please contact the sales team. We would love to talk to you. Watch your inbox in the next few days for an email that will blast out including a replay of today's webinar you

could share with your colleagues. You can rewatch it and listen and take your notes and dive deeper into the commentary. We'll also include several resources in support of the Empire Life Asset Allocation Fund, the Empire Life Elite Equity Fund, and we've got a piece featuring the Empire Life American Value Fund. That will be out shortly. This, and many other great resources can be found on the updated advisor website, empire.ca/advisor.

With that, I wish you all a wonderful 2023 if we haven't had a chance to meet yet. I'm looking forward to connecting with everyone and thank you very much for joining us today. And that concludes our session.

© 2023 Morningstar Research Inc. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results.

This article includes forward-looking information that is based on the opinions and views of Empire Life Investments Inc. as of the date stated and is subject to change without notice. This information should not be considered a recommendation to buy or sell nor should they be relied upon as investment, tax or legal advice. Information contained in this report has been obtained from third party sources believed to be reliable, but accuracy cannot be guaranteed. Empire Life Investments Inc. and its affiliates do not warrant or make any representations regarding the use or the results of the information contained herein in terms of its correctness, accuracy, timeliness, reliability, or otherwise, and do not accept any responsibility for any loss or damage that results from its use.

Past performance is no guarantee of future performance.

Empire Life Investments Inc., a wholly owned-subsiidiary of The Empire Life Insurance Company, is the Portfolio Manager of Empire Life Segregated Funds. **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.** A description of the key features of the individual variable insurance contract is contained in the Information Folder for the product being considered. Segregated Fund policies are issued by The Empire Life Insurance Company.

® Registered trademark of **The Empire Life Insurance Company**. Policies are issued by The Empire Life Insurance Company.

The Empire Life Insurance Company

259 King Street East, Kingston, ON K7L 3A8 • 1 877 548-1881 • info@empire.ca • empire.ca