INVESTMENT INSIGHTS

with **ASHLEY MISQUITTA, CFA**

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Rob:

Thank you, and good day, everyone. I'm Rob Popazzi, Vice-President of Retail Distribution at Empire Life and your host for today. On behalf of my sales team colleagues, I want to welcome you to our first inaugural Investment Insights webinar. We will host several of these webinars in 2023 to help you better understand how policy and market changes can impact your clients investments. Today's date is May 8, 2023 and excited to be joined by Ashley Misquitta, Senior Portfolio Manager and Investment Strategist. Welcome, Ashley!

Before we get to Ashley's comments, let's begin with a few updates.

We will be announcing some very exciting changes to our GIF contracts in the coming weeks, these will include a new tier in our preferred pricing program, several new portfolios that will leverage the investment expertise of our investment team and select managers from Canoe Financial, and a new client name F-Class/Fee for Service series to help you create value in your business and for your clients. Keep an eye on your inbox for more details or contact a member of sales team and they'll be happy to walk you through the changes we're planning.

I want to take this opportunity to thank and congratulate our Investment Team for their hard work last year. In the recent Investment Executive article [*Stock picking supports segs in 2022*],* Empire Life ranked 2nd in the industry based on overall segregated fund performance in 2022. As of December 31, 2022, we had over 84% of our assets under administration in the top 2 quartiles. This comes on the heels of Empire Life Asset Allocation GIF and Empire Life Short Term High Income GIF being awarded a FundGrade A+ award.[1] As of March 31, 2023 Empire Life has over 9 funds achieving a 4-star Morningstar rating or higher.[2] Great job team!

Before we move on, I need to remind everybody that this presentation reflects the views of Empire Life as of the date published and is subject to change without notice. The information in this presentation is for general information purposes only and 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 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 Let's get our webinar underway…

There are many factors affecting markets around the world; economic and monetary policy shift, continued global tensions, inflation, banking instability and fears of a growing recession are just to name a few.

We've been getting several questions from you our advisors and we've prepared Ashley in advance to help address them. If you have any additional questions, please put them into the chat or reach out to a member of the sales team. We'll ensure have someone responds to you following this webinar.

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* Source: Investment Executive, 2023, *Stock Picking Supports Segs in 2022*, accessed April 13, 2023, <https://www.investmentexecutive.com/newspaper_/news-newspaper/stock-picking-supports-segs-in-2022/ >

Empire Life Investments

With that, let me introduce Ashley Misquitta, Sr. Portfolio Manager and Investment Strategist; welcome and thank you for joining us today, Ashley…

Rob:

1) **What questions are you asking yourself right now? Even if you don't have an answer, what are you currently trying to figure out?**

Ashley:

I'd say in the short term. There are 2 main questions I'm trying to answer and longer-term; there's one big one at the moment.

So in the short term. The 1st question is how profound the lagged effects of interest rate hikes will ultimately prove to be. So we saw the 1st rate hike in March 2022, which was over a year ago. What we generally understand is that it takes something like 9 to 18 months in order for changes in interest-rate policy to be felt in the economy.

The wildcard here is that it feels with every economic cycle, things seem to move faster, and things seem to get incorporated faster. Some of this is because of the Internet and the dissemination of information. Some of this is just because there are so many more market participants, and we have so much more computing power analyzing everything that information is discovered and discounted into the market much quicker than it used to be.

So does that means that the failure of Silicon Valley Bank and Signature Bank, the decline in tech valuations that we've seen over the past 16 or so months represent the worst downstream effects of the interest rate hike impacts or just a taste of what's to come.

The 2nd question I'm trying to answer is sort of related but it's a matter of how impactful the increase in interest rates is gonna prove to be for the regional banking system in the United States.

1 of the key factors that drove the demise of Silicon Valley Bank was the deposit flight where people moved their deposits very rapidly, as we saw with modern technology, enabling people to open and move their account within minutes from one bank to another.

So we saw bank runs on Signature Bank and Silicon Valley Bank, but there's very likely been a "bank walk" (a slow withdrawal of deposits by retail bank customers) since then. We see some early indications of this as companies are reporting quarterly results. This is happening for 2 main reasons. The 1st is that many banks are refusing to pay up for deposits and so the gap between what somebody could earn in a depository account or a checking account with a financial institution and what they could earn on a 6-month Treasury Bill or money market fund or something like that. As rates rise, the gap becomes bigger. People are more and more likely to take that money and move to that higher interest rate but guaranteed investment.

The other reason people might be inclined to move is that FDIC insurance only covers a bank balance up to $250,000 at a single financial institution. Depositors at Silicon Valley Bank and Signature Bank were protected by the FDIC because those banks were deemed systemically important. There's no assurance that if a smaller bank fails as a result of this bank walk, depositors with funds over 250,000 in a bank account will be protected. However, if the test is of systemic importance, we know that there's a whole bunch of banks that are to be designated as systematically important. So if I'm a depositor with more than $250,000, it would make sense for me to at least consider moving to 1 of the systemically important banks. The question really is 1 of the broader implications of this and how much is going to affect the reduction of credit availability and thereby slow the economy.

From a longer-term perspective, 1 of the questions I'm trying to answer is what are to be the long-term drivers this decade. If you think back to the 1990s, if I'd only told you about the industrialization of the Internet, you'd have done quite well. In the 2000s, meanwhile, if I had told you about the rise of China and then finally, the last decade or so, If I told you about the very easy Fed policy, you've made a lot of money.

The question really is what are to be 1 or 2 main themes that will enable us to do really well this decade.

Rob:

2) **You've talked before about secular tailwinds. What are some of the most impactful that you see out there?**

Ashley:

Yeah, I love this question. I think it's interesting and really important.

So there are 6 major secular tailwinds that I think are really important. Some are sort of mixed in terms of headwinds or tailwinds, depending on what geography or country, but I'll get into that.

So the 1st big one is innovation, and this is, to be fair, principally a tailwind for the US. If you run through the exercise of asking yourself over the last 30 years, what are the 10 most important developments in medicine and science, technology, energy production, or any sort of highly innovative thing. Once you've done that, ask yourself where each development came from, and I think we'll most often it came from the US.

I'd argue there is a pretty good likelihood that that's going to continue, which makes the US a structurally very attractive place to invest.

The 2nd big tailwind is demographics. This is kind of a mixed one, as I alluded to earlier. For countries like the US, India, Argentina and Canada, this is something of a tailwind.

For countries like China, however, this can be quite a headwind, and in fact, last year was the 1st year where China's population actually shrank. I believe I read recently that India has now surpassed China in total population. The bottom line is that the US, India and a couple of others have a growing working-age population.

That's the population between 15 and 64 years old. It's people in that age cohort who are more doing things that drive the economy. They're buying things; they're buying homes, they're having children and buying things for their kids and so forth. They're also contributors to the tax base and are overall net contributors rather than recipients. Contrast that with countries like China that her aging very quickly, largely as a result of their one-child policy.

3rd big tailwind is the energy renaissance that we're seeing in the United States, Canada and a few other places. There's been an absolute bounty of energy reserves that were unknown and inaccessible prior to the development and usage of hydraulic fracturing and horizontal drilling. These 2 techniques unlocked his vast stores of oil and gas. This turned the US (and Canada if we wanted) into global energy superpowers.

The 4th tailwind I'd highlight is re-shoring, and this one is particular to the US. Prior to COVID, there was a set of industries which were deemed essential to national security and therefore had to either be made within the US or a very proximal by the ally.

As we discovered during COVID, things like personal protection equipment for physicians, active pharmaceutical ingredients for important medicines and many other items actually fit within that national security category as well. We just didn't realize it at the time.

Combine this with tensions growing with China and the need for a semiconductor supply chain that is not potentially going to be attacked by China, and we see a lot of spending in the US and some in Europe on bringing these industries back home. And this is leading to a degree of de-globalization.

The 5th tailwind I would highlight is the energy transition. We are going to need to spend a gargantuan amount of money to transition from a fossil fuel-based economy to a renewable-based economy. It's going to take an enormous amount of commodities, labour and government commitment to build all of the electric vehicles we'll need, and renewable energy production we'll need in the grid storage in infrastructure will need. There will be ebbs and flows. But we're likely to find points in time where selling copper and lithium will be like being the only person selling water in the desert.

The final tailwind I would highlight is the emergence of India. As I mentioned, India is now the largest country in the world by population. India has an average population age of 29 years old, and India's GDP is already 5th largest in the world and growing very quickly.

Boston Consulting Group did a study that suggests every Indian born post-2000 will spend $240,000 in their lifetime. Multiply that by about 1.6 billion people, and it gives a pretty attractive market. Finally, what worked wonders for the Soviet Union, what worked wonders for China and what worked wonders for the United States and for England before their industrialization will likely work here as well. People are moving from rural villages to cities rapidly in India, and those people are all going to need housing, infrastructure, education, water, and so much more. That is a lot of economic development.

I heard a stat recently, and I was amazed by it. India turns 100 years old in 2047. That's the hundred-year anniversary of independence from Britain and the separation of India and Pakistan. At that point, approximately 21% of the world's workforce will be in India, at about 20% of the middle class. That's less than 25 years from now.

Some people might advocate having your kids learn Mandarin. For my money, they may be better served learning Hindi.

Rob:

3) Are there any tailwinds that you think are underappreciated?

Ashley:

We can chat about energy separately, which I also think a sort of underappreciated but one that I would really like to highlight is demographics. Demographic trends will rarely make the front page of the paper or be highlighted on the news.

But turns out that they are so important. The demographic tailwind of women entering the workforce in North America in the 60s and 70s was a huge productivity boom. As I mentioned elsewhere, the transition from an agricultural economy to an industrial economy is an incredibly potent force.

Having a demographic tailwind in your overall population or working-age population, as in India and the United States, respectively, is enormously helpful. The real challenge China is going to face from here is that it has become old before becoming wealthy on a per capita basis. This is a different situation than Japan, where per capita wealth is very high. Even though the population is older, this permits them basically to spend and automate their way through this.

Rob:

4) Which markets are you most excited about over the next few years?

Ashley:

Once we get on the other side of whatever recession is coming, I'm actually very optimistic on Canada. Given the amount of commodities and natural resources that are going to be required to support the energy transition, as well as the demands from the emergence of India, Canada seems very well positioned.

The other market that seems to represent quite an attractive opportunity is Japan. As I may have mentioned earlier, Japan is a leader in automation. This is, to some extent, not that surprising, given the technological strength in Japan, coupled with their demographic challenges. However, that puts them in an interesting position.

Meanwhile, the United States is seeking to bring manufacturing back onshore. This manufacturing is almost certainly to be paired with high levels of automation because of the cost of labour. 2nd major tailwind and highlight for Japan is that they've been behind in digital investment, and that will represent a tailwind for them potentially going forward. And finally, the deflationary pressures that Japan's face for many years appears to be abating.

David Mann, who manages our international portfolio and the ex-North American part of our global portfolios, is quite optimistic on Japan and is overweight that geography in funds he manages. He shares several insights from his recent trip to Tokyo, in a recent piece that can be found in the handouts section of this webinar.

Rob:

5) **What are the biggest risks you see right now?**

Ashley:

Well, how much time do you have?

I would say the biggest risk I see is that we are in a bigger bubble than we realize. If that's the case, then what looks like it'll be a bumpy ride for the next little while may actually prove to be a very, very difficult situation.

A key part of why we have recessions is to work off excesses that built up in the previous upcycle. There's no question the valuations have come in on the NASDAQ and other broad market indices. However, there are still many instances of froth in the market ranging from Bitcoin to Tesla's valuation to the size of the Fed's balance sheet, the country's outstanding debt and finally, housing.

Any 1 of these categories of problems could prove bad if they burst, but it could be quite a bit worse if they all burst together.

This is what leads me to conclude that the right approach is to have a defensively position portfolio, which is what you see with portfolios I'm associated with.

Rob:

6) **What about the other way? What are some of the biggest opportunities you see out there?**

Ashley:

From an opportunity perspective. How about getting 5% of the 6-month treasury bill?

I'm only partly kidding really. The US 2 years pay 4.23% and even our own Empire Life Money Market GIF is paying out 4.8% before fees.

And that may be the right answer in the very immediate term, but when I think longer term and I've touched on this elsewhere. I think there could be enormous opportunities potentially in certain commodities. Not all of them mind you but certain ones.

Let me highlight here a framework that I am applying to determine the relative attractiveness of various commodities. I'm going to apply it to energy. I'm also applying it more broadly. It's a four-part framework.

Part one is related to demand. The idea is that demand is either going to be strong going forward or meaningfully better than what is probably thought to be the case. When it comes to energy. I have not seen a model that I believe is credible that forecasts peak demand for oil before the end of this decade. That means that global daily demand for oil will be higher towards the end of this decade that it is today. I don't think that's a broad consensus view of the market, so it fits part 1 of my framework.

Part 2 is related to supply and that has to be constrained for some reason. The more robust the reason the better. In the case of energy we see example after example of ESG-related pressure on the producers and funders of energy production.

The biggest pension fund in Europe for example, told the banks that it owns that they should be reducing their funding of energy companies. Not too long after, BNP Paribas announced that they would be reducing their energy funding by 80% through the end of the decade.

Meanwhile, Columbia's new president talks about the need to leave fossil fuels in the ground. These are just 2 of many examples.

To top it all off, Pres. Biden talked about shutting down drilling, essentially as a campaign promise.

If you were on the board of a fossil fuel company and had to make decisions on capital allocation for the next 10 to 15 years, would you be inclined to approve projects that require 5 to 7 years of investment before the 1st dollar comes back to you? Most likely not.

This will likely pressure supply. Supply pressure matters particularly when it comes to energy because there is this concept called the decline rate. With that means is each year a given oilfield will produce less oil than they did a year before. That makes sense, right, you have less oil remaining in the field, and so there's gonna be less pressure pushing that oil upwards so you need to invest in pumps and in other forms of well stimulation and of course drill new wells in order to just stay flat. This decline rate is in the range of 5 to 7% per year. Depending on who you ask, we need to spend $375-$450 billion a year just stay flat and to stem this decline rate, forget about growing as we'll need to do through the end of the decade.

The bottom line here is that we are likely to be undersupplied as we look to the future.

But that's only part 2 of the framework part 3 is that the stocks have to be ridiculously cheap because investors either don't want to touch them or a substantial number of investors are prevented by mandate from owning them. As a result, one would expect the stocks to be very, very cheap and we see many oil companies, particularly Canadian ones trading at absurdly low valuations. So check for point, #3 in the framework.

Finally, there has to be a way for the value to be realized. There is this notion in investing that markets will ultimately revalue undervalued businesses. I generally subscribe to that argument. However, in the case of these energy companies where investors may never warm to them again, I need to see them return their massive free cash flow in the form of dividends and share buybacks. There are plenty of instances where these companies can almost buy themselves back in a short number of years just from free cash flow and oil prices near where we are now.

So this four-part framework applies to energy and certainly works there, but it can up also be applied to other commodities and we're working through some of that as we go. But more to come on that.

Rob:

7) **What are your views on inflation, interest rates and the risk of recession?**

Ashley:

I am concerned that inflation proves to be more structural and more sticky than policymakers would like it to be the case. There are several different reasons, but let me highlight a couple of them. 1st we've heard about a labour shortage since pre-Covid. However, at that point, it was limited mostly to skilled trades.

Post Covid the breath of labour insufficiency was far wider. As a result, we saw meaningful wage growth. However, this wage growth did not even keep pace with inflation, resulting in negative real wage growth.

Now, it appears that for a number of reasons, the pool of workers (semi?) permanently declined post-Covid, and we see that extraordinarily large number of job openings as yet unfilled. This is likely that result in continued wage pressure.

The 2nd dynamic is that the energy transition is going to be inflationary. Each new copper mine we find is likely to be of a lower grade than previous ones, more expensive to extract than previous ones and further from infrastructure than previous ones. All of this leads to a structurally higher cost. The same idea applies to other critical metals and minerals like lithium, cobalt and others. When you then get up to the level of electric vehicles, there appears to be a structurally higher cost. I can go on with this, but I think you get the general idea that a lot of the aspects of this energy transition are going to be more expensive for society than the world we currently live in.

The final point I'd highlight about inflation structurally is that this whole movement towards onshoring, "friend-shoring," or whatever you'd like to call it, is likely to have an inflationary impact as well. Having the overwhelming majority of advanced semiconductor fabrication taking place in Taiwan was to a meaningful extent because that was the most efficient way to create that supply chain. It's inevitable that with export limitations on semiconductor fabrication equipment to China, we're going to see new supply chains built up in the US and in Europe that are structurally more expensive but potentially very necessary for national security reasons in case China ever does invade Taiwan. Remember, semiconductors go into everything in our lives almost at this point, but most importantly, from a national defence perspective, into our national security equipment and apparatus.

Put all this together, and it suggests that inflation may prove to be more difficult to resolve than it seems at 1st blush.

And how would you resolve it? You resolve it with higher interest rates to slow the economy.

Now there are some who might argue that you don't need to worry about that. Just let inflation run a little hot. The problem with that argument is that inflation is a highly regressive tax, and what that means is that it hits everybody. Everybody who buys gasoline; everybody who buys food; everybody who buys clothes for their kids; and Everybody feels that; and as a result, it is politically toxic. If it is viewed as sustaining, then over time, inflation expectations among the public will change. And then you run the risk of a wage-price spiral where workers demand higher pay because they expect they're going to be paying out more for day-to-day living.

So all of this makes for a considerably more complicated next few years when it comes to inflation, interest rates and recessions.

Rob:

8) **What's your most unconventional view that may be really impactful if you're right?**

Ashley:

My view that's different than the crowd is related to energy – that four-part framework that really drives my thinking there. That interplay of longer-term demand strength combined with suppression of supply growth, stocks that people absolutely hate and, as a result, are deeply undervalued and then finally, the capital allocation policy, which aggressively returns capital to shareholders. I had a lot of pretty robust debates about this with people over the past couple of years and remain of the view that while we may have a temporary lull if we have a recession, the interplay of those 4 factors may lead to some extremely attractive opportunities. I can pretty easily sketch out ways that things go better from the supply/demand perspective than I'm contemplating, which would only represent further upside.

What I've found in my investing career is that there's a real upside to be had in situations where the overwhelming majority of the market believes one thing while you have a different view and data points have emerged that are supportive of your view but the market has yet to adequately or correctly interpret.

I think there's a good chance this is 1 of those situations.

Rob:

9) US election season is approaching (does it ever leave us?). Where are we in the process, and what is your impression of sentiment among voters?

Ashley:

We're still quite early in the process, although it doesn't feel that way, given some of what's happened already.

Normally at this point, candidates are testing the waters, giving speeches in early primary states and assessing whether they have enough support to even come to the starting line.

It's been a little different, in this instance, because Donald Trump announced so early that he was running again. So far Nikki Haley, former governor of South Carolina has also announced her candidacy. You may recognize her from the Trump administration, where she was ambassador to the United Nations. There's been at least one other lesser-known candidate who've announced that I'm aware of and a couple of big names who already announced that they won't be running for the nomination.

The next big event everyone is waiting for in order for things to really start in earnest is Florida Gov. Ron DeSantis announcing his candidacy.

He was 1 of the few Republican success stories coming out of the 2022 midterm elections, where he won re-election by 19 points and turned traditionally purple Florida deep red. It's likely he will be announcing his candidacy within the next month. There may be a few other people who jump in the race but this is likely to come down to Trump or DeSantis unless something quite unexpected happens. The next step in the process will be the debates probably starting in the summer. Actual voting in Iowa, New Hampshire, South Carolina, and Nevada kicks off in January of next year.

On the Democrat side, it's Joe Biden's spot to lose. He's unlikely to have a serious challenger.

Rob:

10) Before we wrap up, AI and Chat GPT has been front and center since it opened for public beta in December. Things are moving so fast in the AI space, but I'd be curious if you have any thoughts to share on the topic and how it's affecting your investment process.

Ashley:

Yeah, I think this is an important topic. And I don't want to overstate things based on what I see today, but AI and chatGPT may have an impact on the scale of the introduction of the Internet or the iPhone. That big.

It has the potential to massively increase the efficiency of people who embrace it but potentially prove painful for people who try to hide from it.

It's going to affect everyone, from doctors to people who write marketing copy. Realistically, it's moving so fast at this point that we don't even have any idea of the breadth of applications we're yet to see.

People misunderstand things a little bit when it comes to chatGPT I think. It's not a matter of getting it to do your work for you. Rather, the skill to develop is becoming very good at creating the prompts in order to get it to produce a result. In the case of chat GPT the output is textual, while in the case of other AI products like DALL E, the output is visual. But like I said, this is only the beginning.

Rob:

11) I know you read a lot and listen to a lot of podcasts. What's the most interesting book or podcast you've come across lately, and why?

Ashley:

You know me well. I am, indeed, a big fan of audiobooks and podcasts.

I just finished a podcast series from The Economist magazine that was about Pres. Xi of China.

It was a really interesting 8 part series called The Prince. It takes you from his early days as a boy through his ascent to the top of the Chinese Communist Party.

I'd say after listening to it, I came away with a little deeper understanding of how he seems to think about things and view the world.

I would definitely recommend this podcast to anyone interested in understanding that part of the world a little better, geopolitics, the US-China relationship or the potential China-Taiwan conflict.

As for books, one that I listened to not that long ago was written by a guy named Peter Zeihan. It's called The End of The World Is Just The Beginning. It's his 4th book that follows his view of the past 80 years or so of how we got to where we are today and what to expect in the future.

His basic premise is that the US created this global order to combat the Soviet Union post-World War II and the trade they offered was that if you stand with us against the Soviet Union, we'll do a bunch of things for you. For example, we'll

- Open US markets to your goods on favourable terms.
- Guarantee freedom of the seas via the U.S. Navy and prevent piracy.
- Make the US dollar a stable global currency and take the hit to fight inflation by raising interest rates when necessary.

Basically, the US offered to provide all the things that used to require an empire. It allowed countries to specialize to such a degree that they could rely on being able to import goods they needed.

He argues that with the fall of the Soviet Union, one side of this trade went away and there was no longer a need for the US to make the associated sacrifices.

This book is his assessment based on demographics, geography and natural resources, how this all shakes out in the coming years.

It remains to be seen how accurate his analysis proves to be but was definitely food for thought and an enjoyable read.

Rob:

Well, that concludes our webinar today. I would really to thank Ashley for his insights today, they helped put several things in perspective for, and to thank all of you for taking the time to join us.

The investment team does continue to find investment opportunities in all Market Cycles; you can stay informed on the investment team's activities through our investments blog, where, we also have our Emblem portfolios asset allocation update and our recent video message featuring Ashley himself, providing his views on what lies ahead for materials, mining and the energy transition.

If you have any questions on today's webinar or our product choices, please contact your sales team. We would love to talk to you.

Watch your inbox in the next few days for an email blast that will include a replay of today's webinar that you can share with colleagues that missed it. This and many other great fund resources can be found on our newly enhanced and updated advisor site - empire.ca/advisor.

With that, I wish you all a wonderful start to the spring season. Thank you very much for joining us today

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