EMPIRE LIFE ASSET ALLOCATION GIF COMMENTARY

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An update on positioning and rationale for the overweight Canadian equities

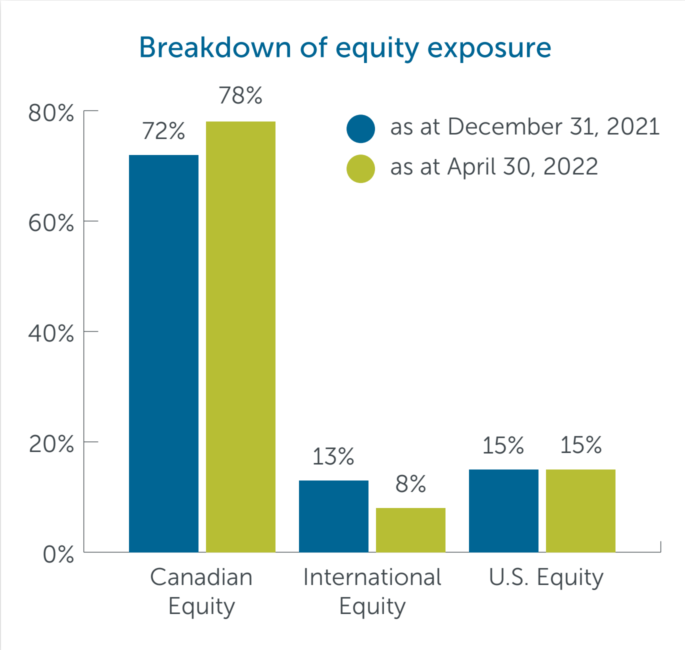
A lot has changed since the beginning of the year including:

- The Russian invasion of Ukraine
- Continued elevated inflation and the significant rise in interest rates
- China's zero-COVID policy and lockdowns in Beijing and Shanghai
- And more recently fears that aggressive tightening by the U.S. Federal Reserve will cause a global slowdown and potential recession.

As of April 30th, 2022, the fund had ~56% of assets in equity, 36% in fixed income and ~8% in cash.

Fund positioning during the turmoil

First off, we would like to express our deepest sympathy for the Ukrainian people, and we hope for a peaceful resolution as soon as possible. We continue to have a more conservative stance today on equities, leaning towards the lower end of the fund's typical range of 55% to 65%. We have been overweight Canadian equities for well over a year and as news broke out of the Russian invasion of Ukraine, we further increased our Canadian equity exposure and reduced our international equity exposure since the start of the year.



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Headwinds affecting global markets and how Canada is positioned to face them

Canada is a commodity-driven country:

We believe the Russian invasion of Ukraine will likely have the largest negative impact on Europe and is a key reason we tactically lowered our international equity exposure. Russia has long dominated Europe's energy market, supplying the continent with 40% of its natural gas and 25% of its oil. Russia is a commodity superpower and due to the recently imposed sanctions, some of the commodities it historically exported are no longer available to global markets.

This has caused a sharp rise in the price of many commodities including oil which is up more than 15% since the start of the invasion. The Canadian market has significant exposure to commodity-driven markets including energy and materials. Together these two sectors represent ~31% of the TSX Composite Index (Energy ~18% and Materials ~13%). High commodity prices should be a tailwind to many sectors of the Canadian economy.

Financials represent the largest sector of the TSX Composite Index at ~31%, dominated by banks and life insurance companies that benefit from higher interest rates:

Concerns around elevated inflation and supply chain issues have been exacerbated by the Russian invasion of Ukraine and more recently China's zero-COVID policy and subsequent lockdowns in Beijing and Shanghai. As investors anticipate a Central Bank response, the US 10-year Treasury Note increased from 1.5% as of Dec 31, 2021, to 2.93% as of April 30, 2022. Banks experience a tailwind from higher rates because of an expansion in the spread between the bank's deposit and lending rates (mortgages in particular).

We remain constructive on Canadian banks over the medium to long term for the following reasons:

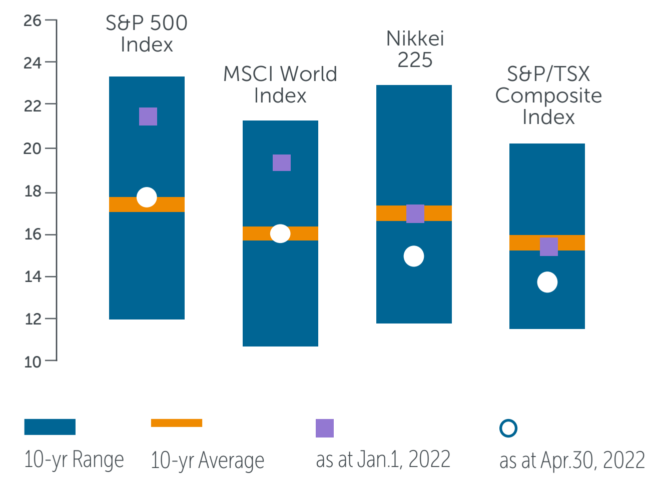
- Rising interest rates are a tailwind to earnings
- Strong ROE's the banks have exhibited through various economic cycles
- Record high capital levels
- Strong capacity for capital returns to shareholders and
- Canada's relatively strong economic outlook because of a commodity supply shock caused by Russia's invasion of Ukraine.

In the near term, we are watching closely for a potential slowdown in loans as rates rise (we are beginning to see this in the housing market) and the negative impact on consumer confidence. Also, fears are increasing that an aggressive Fed tightening will cause a global slowdown and potential recession. Recently, we marginally lowered our Canadian bank weight, but as long-term fundamentals remain constructive, we still have a healthy exposure of ~14% of total equity.

The Canadian equity market continues to trade at an attractive valuation:

The TSX Composite Index has outperformed most major markets year to date and as of April 30, 2022, was down ~1.3% vs the MSCI World Index down ~12.9%. Despite the recent outperformance, Canadian equity valuations are still very reasonable at 12.8x forward twelve-month P/E, which compares to the S&P 500 Index at 17.5x, MSCI World Index at 16x, and Nikkei 225 Index at 14.7x. We believe the attractive relative valuation of the Canadian market provides a margin of safety which is consistent with our investment philosophy of focusing on downside protection.

Forward 12-month price to earnings for select markets



Source: Bloomberg as at April 30, 2022

Fixed Income Overview

Consistent with our view that there is upside risk to interest rates, the fixed income allocation has maintained a duration of under four years. The lower duration has helped shelter the portfolio from the impact of rising rates, which equate to lower mark-to-market bond prices. The fixed income allocation is skewed to corporate bonds where we are seeing attractive value — as of April 30, 2022, corporate bonds made up 83% of the fund's bond exposure with a weighted average yield of 4.2%.

Though rising interest rates have generally been negative for bonds, the silver lining is that we are seeing higher all-in yields on bonds and are able to capture higher yields when we deploy new capital or proceeds from maturing positions into new opportunities. We are seeing some of the highest historical yields on short-term high-quality corporate bonds since the financial crisis, which was ~3% yield for investment-grade corporates and ~5% for BB-rated corporates during that period.

To address elevated inflation levels, central banks have increased interest rates and communicated their willingness to continue raising rates to bring inflation lower. In the short term, we are likely to see interest rates continue to move higher. However, we are assessing the right time to increase the duration of the portfolio, as we continue to keep a close eye on economic data and the yield curve for indications of a slowing economy, a situation where interest rates may begin to decline.

Conclusion

In summary, we feel very good about how the Empire Life Asset Allocation GIF is positioned. We continue to be overweight Canadian equities as we feel that the current market environment of high commodity prices and rising interest rates are supportive of the Energy, Materials and Financials sectors, which collectively make up just north of 60% of the TSX Composite Index, in comparison the same sectors make up ~19% of the S&P 500 Index. Additionally, the relative valuation of the Canadian market continues to look favourable compared to other major markets around the world. We continue to closely monitor economic data and our positioning in equities and fixed income.

Contact us to find out more about the Empire Life Asset Allocation GIF!

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