



Quarterly: **June 30, 2009**

Empire Life Investment

Economic Outlook

State of the Recession: The worst is likely behind us

- The period covering the fourth quarter of 2008 and the first quarter of 2009 is likely to have marked the deepest point of the recession. Various economic indicators suggest that the worst of the recession may be behind us.
- The manufacturing sector is showing clear signs of revival. Rising new orders, production and employment indices are hinting at an improving economy in coming months. For example, the national purchasing manager's index has increased for five consecutive months.
- There are early signs indicating that the global economy is responding to the massive fiscal and monetary stimulus implemented by governments and central banks around the world. These programs work with some lag - it takes time for their positive effects to trickle down through the economy. Given that only a small fraction of the stimulus package has been deployed so far, it should continue to provide support in the second half of 2009 and into 2010.
- A successful re-capitalization of the financial sector, as well as the quick and smooth emergence from bankruptcy of GM and Chrysler, has helped to further improve market psychology.

The Inventory Cycle: Destocking phase coming to an end

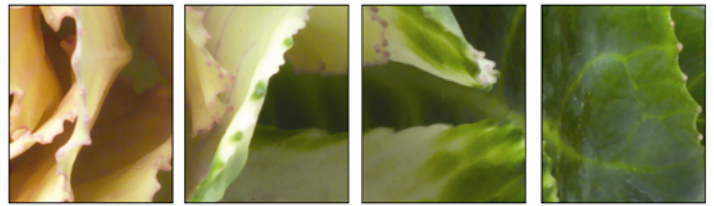
- Economic weakness in the previous two quarters was likely amplified by inventory draw downs as corporations chose to run down stocks to new historical lows rather than replenishing inventories as sales were made. This downward inventory adjustment might still be continuing but should be close to an end as companies cannot continue destocking indefinitely. Inventory levels are generally very low.
- The early stages of a recession are often marked by inventory reductions as corporations adjust to the lower level of activities as well as to uncertainty about the future. Conversely, in the early stage of a recovery, as business activity picks-up and sentiment improves, the inventory rebuilding cycle can serve as a catalyst, at least in part, for renewed economic activity.

The Recovery: Mild economic revival in the cards

- The employment picture is becoming "less bad". This is ultimately a pre-condition for economic stabilization and should be followed by positive job growth. This is likely a few quarters away. Unemployment typically continues to rise in the early stage of a recovery.
- We believe that the first phase of the recovery will be driven by the corporate sector, both in terms of infrastructure spending emanating from government stimulus packages, and from the inventory restocking cycle. Once employment improves, consumer spending will return and provide further support to the economy.
- While many of the leading indicators are pointing towards a recovery, concerns remain regarding the *speed* of the recovery due to high consumer debt loads. We therefore believe that the recovery is likely to be mild in the early stages.



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Market Outlook

Markets demand further evidence of recovery before pursuing on their course

- Since the beginning of the year, interest rates on government securities have risen, equity markets have rallied sharply from their low points reached in March, and corporate bond spreads have narrowed significantly in keeping with the equity market rally. The markets may have entered a period of stalemate, having moved in anticipation of an economic recovery, and now demanding further evidence of the magnitude and sustainability of the improvements before pursuing course.
- Investors sentiment seems trapped in a tug-of-war between inflationary forces and deflation fears. We are of the opinion that the economy will continue to improve and that inflationary forces will eventually prevail, in large part due to the massive amount of stimulus imparted on the economy in an attempt to stabilize the financial crisis and kick start an economic recovery.

Portfolio Positioning

- To take advantage of the improving economic environment, we will look to move cash into equities as opportunities present themselves.
- In equity portfolios, we are generally slightly underweight in commodities, and more so in financials. In some portfolios, we maintain an overweight position in the industrials space, driven by our positive view of the transportation segment. We also hold a favorable outlook on the agricultural space as there has been a general under application of fertilizer on a more or less global basis for the past few growing seasons. This will eventually need to be reversed in order to deal with the growing global food demand.
- Dividend growth remains a favoured theme. Companies demonstrating an ability to increase their dividends have generally been rewarded by investors with superior performance. There are still plenty of dividend growing companies in the S&P/TSX Index, where 36% of the constituents still classify as dividend growers, having raised their dividend at least once in the past year.
- The fixed income portfolios are positioned to protect capital in a rising interest rate environment with overall shorter than market portfolio durations. We have also begun to reduce our overweight position in corporate bonds as this market segment has moved closer to fair value following a very strong performance in the past several months.