

Quarter ending March 31, 2012

MARKET PERFORMANCE

Fixed Income

After pausing earlier this quarter, long-term bond yields in Canada and the U.S. increased sharply (and prices fell) in March, on signs of an easing debt situation in Europe. In the U.S., signs of strength in the economy also aided the yield increase in March. At the end of the quarter, the U.S. 10-year Treasury yield was at 2.23% (1.89% at the end of 2011), after reaching a high of 2.39% in March. The Government of Canada benchmark 10-year bond yield was at 2.11% at the end of the quarter (1.96% at the end of 2011), after reaching a high of 2.29% during March. As measured by the DEX Universe Bond Index, Canadian federal, provincial and municipal bond sectors posted negative absolute returns this quarter and were outperformed by corporate bonds. Overall, the Index lost 0.2% over the quarter.

Canadian Equity

The Canadian equity markets, as represented by the S&P/TSX Composite Index, moved higher in January (4.4%), with optimism fuelled by measures undertaken late last year to resolve the European debt crisis. After a brief hiatus mid-month, markets again climbed to finish higher in February (1.7%), led by the second round of liquidity injection through three-year loans to European banks. China's downward revision of its 2012 GDP target and pressure on gold prices after the Federal Reserve dampened expectations of a third round of stimulus (QE3) caused Canadian markets to retrench in March (-1.6%). Overall, the S&P/TSX Composite Index finished the quarter with a 4.4% gain. All sectors except Energy and Telecommunication Services posted quarterly gains.

Canadian Small Cap Equity

In the small-cap space, volatility was a consistent theme in each quarter of last year, and this year's first quarter was no different. Negative sentiment returned in March as China revised its 2012 GDP target downward and Federal Reserve dampened expectations of a third round of stimulus (QE3) causing gold prices to decrease. The S&P/TSX Small Cap Index finished the quarter with a 6.0% gain, after gaining 11.2% in the first two months. All sectors, except Utilities, gained during the quarter, and Industrials, Consumer Discretionary and Information Technology posted double-digit gains.

U.S. Equity

U.S. equity markets continued their tumultuous run in the first quarter of this year, after a great fourth quarter in 2011. The S&P 500 Index consolidated gains in all three months of the quarter to produce its biggest first-quarter gain since 1998 and its tenth-best first quarter so far, with a 12.6% gain (total return in U.S. dollar terms). In the Index, all sectors except Utilities posted positive gains in the quarter, with the Financials and Information Technology sectors posting gains more than 20%. The Canadian dollar depreciated 1.8% over the quarter, and for Canadian dollar-based investors, the returns on the Index were 10.6% for the quarter.

Global Equity

Global equity markets showed strong performance after positive sentiment in Europe caused nervousness to quickly recede in the first quarter. The MSCI World Index gained 11.6% for the quarter, with most regions posting double-digit returns. With the exception of Spain, all the countries posted positive gains in the developed market country indices. Germany topped the list with a 20.9% gain. In the Index, superior returns came from the Information Technology, Financials and Consumer Discretionary sectors over the quarter. Telecommunication Services and Utilities remained flat at the end of the first quarter.

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INVESTMENT OUTLOOK

Fixed Income

The Bank of Canada left its overnight rate unchanged, at 1.0%, on March 8, 2012, for the 12th consecutive time over the last year and a half. With low interest rates, monetary policy in Canada is stimulative and accommodative. The U.S. Federal Reserve has also been maintaining a highly accommodative monetary policy, with ultra-low interest rates intended to foster stability and growth. Through its purchases of long-term bonds, which are expected to continue until June 2012, the Fed is in control of the long end of the yield curve.

In this setting, bond yields are expected to remain at current levels, and any movements should be range-bound, with the latter implying less potential for capital gains. A longer-duration strategy offers the potential for higher returns in the current term structure, where long-term yield is higher than short-term yield. Corporate bonds continue to be attractive both in terms of higher yields than government bonds and new issue offerings. Provincial bonds also have attractive yield differentials over Canadian federal bonds.

Canadian Equity

Our Canadian Equity Team's outlook remains constructive for the year. The economy of our largest trading partner to the south continues to show gradual improvement, and the Federal Reserve stands ready to inject more stimulus should the economy falter. Across the ocean, headline news about European debt issues seems to have abated, putting another risk on the back burner for the time being.

Risks, particularly for the resource-heavy Canadian market, have now shifted to China, over the country's ability to successfully bring down inflation without causing a drastic slowdown to its juggernaut of an economy. Valuations for the Canadian equity market as a whole remain reasonable, as earnings growth more than kept up with market appreciation over the first quarter.

Canadian Small Cap Equity

The manager of Empire Life Investments Canadian Small Cap Equity Fund sees very attractive opportunities for investors exposed to this segment of the market. However, with the market seemingly focused on headline news rather than fundamentals, patience and a strong appetite for risk may be required to reap the benefits.

One factor suppressing valuations is China's slowing growth rate. The market sees a drop in China's official growth rate target from 8% to 7.5% as a harbinger of bad things to come. However, 7.5% growth today is more than 10% growth five years ago, when viewed from an absolute point of view, because the base is much larger now. This should mean sustained demand for resources and should particularly benefit Canada's small-cap market.

U.S. Equity

The U.S. economy is continuing to improve, slowly and steadily, with better housing starts, employment figures and manufacturing data. Consumer confidence is also improving as the economy gains traction. A recent round of stress tests conducted by the Federal Reserve on 19 banks saw most banks in good condition to withstand crises, signalling a recovery of this sector since 2008. The U.S. economy is positioned to benefit from decreasing commodity prices and should be less affected than most other developed economies by a hard landing for the economy in China.

At the end of the quarter, U.S. equity valuations were fairly reasonable (14 times forward earnings in the S&P 500), and looking ahead, there is room for earnings growth. In this environment, the outlook for U.S. equities remains constructive. The Consumer Discretionary sector, buoyed by housing stocks and retailers, reflects a more sustainable demand trajectory and appears attractive.

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Global Equity

Liquidity measures taken by the European Central Bank (ECB) in December last year and this February have reduced the odds of a crisis in the European banking system. With the ECB's cheap funding, sovereigns are relieved, at least temporarily, of the pressures related to refinancing their banks. This apparent decoupling of the banking system from the sovereign debt crisis is a positive sign for risky assets in Europe.

The Asia-Pacific (ex Japan) region is considered attractive because it is less sensitive to a hard landing in China. Buoyed by positive sentiment, the Financials sector in Europe gained this quarter; however, the overall outlook remains unattractive, with deleveraging and other challenges ahead.

Disclaimer

Past performance is no guarantee of future performance. Annual Compound Returns: Returns under 1 year are simple rates of return. All others are annual compound rates of return. All returns are calculated after taking expenses, management and administration fees into account.

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