Building your financial future

Investment Strategy

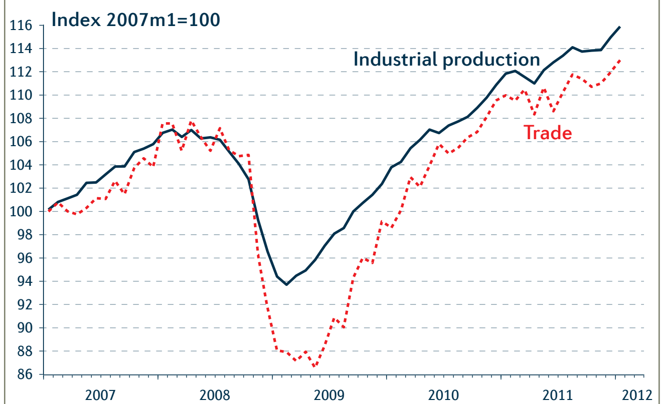
April 2012

Global economy

A disorderly Greek default has been headed off but the euro zone remains the powder keg of the global economy. Fears for Greece's public finances are still running high, though apprehensions about other troubled euro countries have abated somewhat since policymakers agreed to strengthen fiscal discipline across the zone and the European Central Bank (ECB) intervened vigorously to relieve liquidity strains and sovereign debt spreads. The economy of the zone shrank in Q4 – modestly (1.2% annualized), but on an ominously broad front. The contraction had a notable effect on China, which ships roughly 18% of its exports to the euro zone. Chinese factory output downshifted in March for a fourth consecutive month. Fortunately, Beijing has dry powder in its arsenal to offset export weakness. With Chinese inflation abating, monetary easing could go far to support the domestic economy and consumer spending, keeping GDP growth at about 7.5%. In our view, the U.S. revival and China's pursuit of a soft landing are likely to offset European weakness in 2012 as long as credit markets avoid a freeze-up. In a noteworthy development, world industrial production and volume trade flows rose to record highs in January. We continue to expect global economic growth of just above 3% in 2012.

World : Output and trade reached new highs in January

Industrial production and Trade



NBF Economy & Strategy (data via Global Insight)

Around the World

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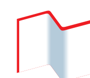
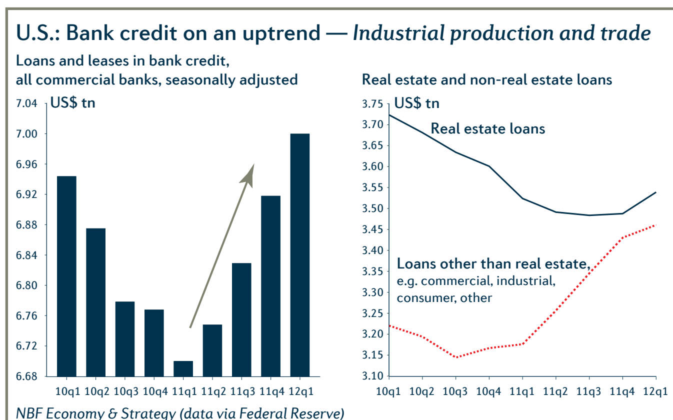


NATIONAL BANK FINANCIAL
WEALTH MANAGEMENT

United States

The laggard of the global growth story has become the white knight. The year has begun well for the U.S. – a very strong January employment report and healthy economic readings through the end of March. The extension of payroll tax cuts to the end of this year, the takeoff of the labour market and the apparent stabilization of the housing market are good news for confidence and thus for consumer spending. Real retail sales have risen at an annual rate of 7.5% since consumer sentiment bottomed last August (at the time of the debt-ceiling fiasco). That's the strongest five-month increase in volume retail sales since June 2010. In Q1, real retail sales growth has been tracking 2.4% annualized, consistent with moderating but healthy GDP growth.

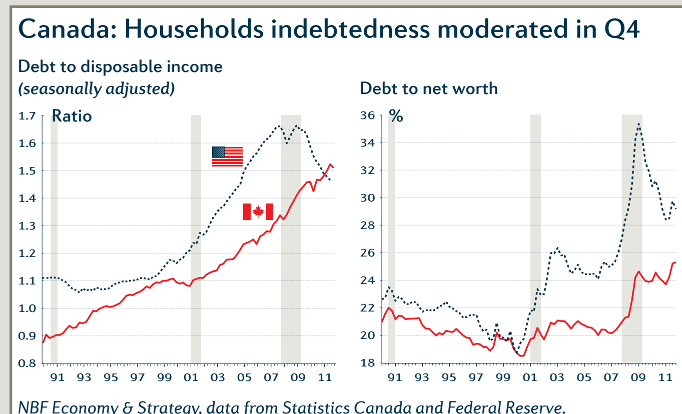
Consumer spending has support from an improving labour market. The U.S. has added 2.4 million full-time jobs over the last seven months, its best such run since June 2000. This is especially good news for the convalescent housing market, since landing a full-time job can bring both the confidence to buy a home and the creditworthiness needed to finance it. After a long period of balance-sheet repair, U.S. banks now seem in much better shape, as shown by generally positive results from recent stress tests. It's no coincidence that the transmission mechanism of U.S. monetary policy, long stuck in low gear, seems to be working again. Banks are once more doing what they're supposed to do – provide financing. Q1 is likely to show a fourth straight quarterly increase in bank credit, bringing total loans and leases outstanding to a 2½-year high of about US$7 trillion. And for the first time in years, that quarterly increase is driven by real estate lending.



NBF Economy & Strategy (data via Federal Reserve)

Canada

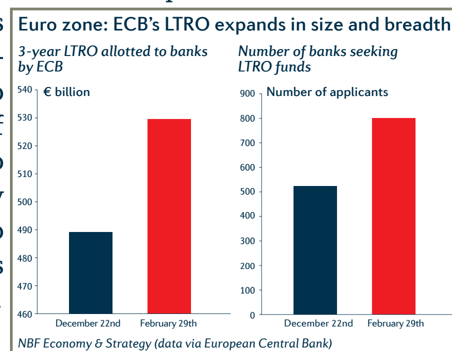
Trade exposure to the world's largest economy played in Canada's favour in the fourth quarter as exporters reaped the benefits of U.S. economic revival. That didn't stop GDP growth from moderating to a 1.8% pace in Q4 – a cooling was always in the cards after the very strong 4.2% rate of the third quarter. For 2011 as a whole, Canadian growth was 2.5% compared to 1.7% for the United States. Looking ahead, domestic demand is set for a boost from business capital spending, though consumer spending is likely to be restricted somewhat by the cooling of employment growth and household borrowing. The closely watched ratio of household debt to disposable income declined in Q4, by the most in almost four years.



NBF Economy & Strategy, data from Statistics Canada and Federal Reserve.

ECB to the rescue

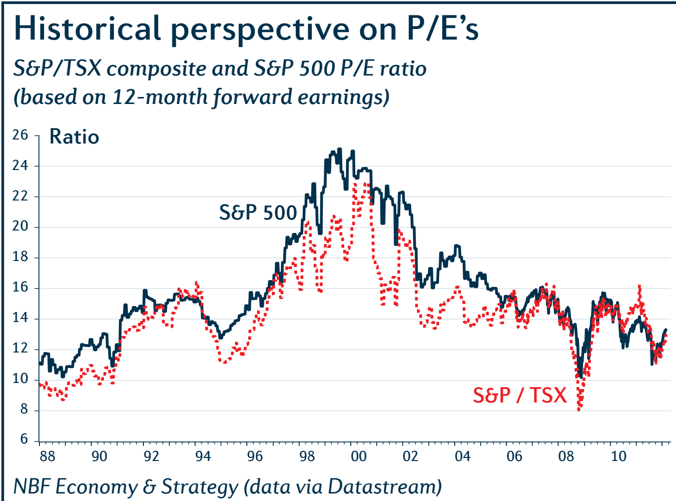
The new chief of the European Central Bank, Mario Draghi, honoured his pledge that the ECB would do more to tackle the sovereign debt crisis if euro-zone governments accepted "a fundamental restatement of the fiscal rules." In February the ECB launched a second Long-Term Refinancing Operation to provide term financing to commercial banks. LTRO 2 was even broader than LTRO 1. It attracted more applicants (with the help of looser collateral requirements) and ended with a larger uptake, a €529.5-billion allotment that left the ECB's total volume of low-interest three-year loans to European banks at an astronomical €1 trillion. These loans were intended to prevent a credit squeeze by boosting liquidity in financial markets and have been credited with bringing down sovereign bond yields in a number of countries. The hope is that an abatement of credit stress will prompt commercial banks to channel some of the liquidity into the economy by lending more to corporations and consumers.



NBF Economy & Strategy (data via European Central Bank)

Financial Markets

Global equities, corporate bonds and commodities have done very well in recent months on the back of aggressive central bank action to promote access to liquidity. No fewer than 18 central banks have eased since the end of last year. Equity markets have been on a roll – at this writing, March 21, the *MSCI All Country* index has returned close to 10% year to date. Though the global economic and political news has been good of late, the skies have not entirely cleared. Europe is likely to remain a thorn in the side of investors. The odds appear to favour a further contraction of its economy in coming quarters and its turn to fiscal austerity offers little hope of a strong rebound this year. Current profit expectations are thus vulnerable to downgrades. Valuations could also be crimped by a new wave of volatility if U.S. and European elections bring on populist rhetoric. A final emerging hindrance is the recent surge of oil prices in response to rising geopolitical risk. Central-bank injections of liquidity in recent months have been key to soothing investor concerns and forestalling a doomsday scenario. The resulting optimism has been reflected in price/earnings ratios that are better aligned with their historical average.



Equities: Climbing the Wall of Worry

Buoyed by a general improvement in investor sentiment, equities locked in one of their best quarterly performances in years. Equities did however climb a wall of worry, as the European situation remained far from being resolved. Being worried, investors, with the help of central bankers (especially the Fed, the ECB and the BoJ), kept a bid under bonds, which limited the extent to which interest rates in North America would rise and actually pressured rates across many distressed European nations lower at the end of the quarter from the highs witnessed at the end of last summer. Rates on corporate and high yield bonds within the North American universe also declined, drawing comfort from an improving economic backdrop. Elsewhere, money flowed out of gold, as its shine was muddied by dwindling hopes for a third round of quantitative easing in the U.S. however, oil prices continued to climb on geopolitical fears, mainly those stemming out of Iran and Syria.

With equity prices rallying to a new cycle high, the risk of near-term correction has increased. Notwithstanding, the latest data out of the U.S. is indicating that the economy in that country has turned the corner, laying the foundation for stronger global growth, despite a contracting Europe. As such, we have slightly decreased our cash and bond positions and increased exposure to equities. With rates near historical lows and the prospect of a financial contagion diminishing, bonds are becoming less appealing while stock valuations remain attractive. Within bonds, we further increased our underweight in Canadian government bonds, where the risk/return trade-off remains unfavourable. In contrast, we raised our bet in the high yield space, where spreads remain the most attractive, within the confines of a low default environment.

Within equities, we have increased our exposure to Canadian equities, to reflect our improved outlook for commodity prices, and have maintained our overweight in U.S. and emerging stocks. Canadian equities, which have for the most part lagged their developed peers during the first quarter, are expected to outperform, as fears of a hard landing in the emer-ging markets dissipate. Conversely, emerging equities (especially in China and Brazil) are also expected to reward investors, as they react to the proactive stance that central banks in these countries have recently adopted in order to stimulate economic growth.

In the U.S., equity prices have risen to multi-year highs however, the potential for further gains remains. As such, we are continuing to overweight the region but are concentrating our exposure in large cap/high dividend paying stocks, which continue to benefit from the low interest rate environment, to access capital and invest and are less impacted by a slowdown in Europe. Last but not least, we are maintaining our underweight in international equities, mainly as a result of Europe, where earnings may actually disappoint, as the continent heads into recession.

Model Portfolios

Income Portfolio

Investor Profile: You want to preserve your capital or establish a source of periodic income to finance ongoing expenses. You do not find the stock market very attractive because of its volatility, but you are not against the idea of investing a small part of your portfolio in stocks, mainly to counteract the effects of inflation. Your tolerance for risk is very low.

Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Cash equivalents	0% to 20%	10.0%	12.0%	0.0
Fixed-income (duration: 5.9 years) [1]	60% to 100%	70.0%	69.0%	– 1.0
Canadian equities		10.0%	10.0%	0.0
U.S. equities	0% to 30%	5.0%	5.5%	+ 0.5
Foreign equities		5.0%	3.5%	+ 0.5

Conservative Portfolio

Investor Profile: On the whole, you want your portfolio invested in fixed-income securities. Although you can tolerate limited volatility to ensure that your assets will grow, you prefer having a portfolio consisting mainly of fixed-income investments for reasons of stability. Your tolerance for risk is low.

Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Cash equivalents	0% to 15%	5.0%	7.0%	0.0
Fixed-income (duration: 5.9 years) [1]	50% to 80%	60.0%	58.0%	– 1.0
Canadian equities		20.0%	20.5%	+ 0.5
U.S. equities	20% to 45%	7.5%	9.0%	0.0
Foreign equities		7.5%	5.5%	+ 0.5

Balanced Portfolio

Investor Profile: You give equal weight to income and capital growth. You can tolerate moderate volatility to ensure the growth of your capital, but you prefer having a portfolio with a significant exposure to fixed-income securities for reasons of stability. Your tolerance for risk is average.

Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Cash equivalents	0% to 20%	5.0%	6.5%	– 0.5
Fixed-income (duration: 5.9 years) [1]	30% to 65%	45.0%	43.0%	0.0
Canadian equities		25.0%	25.0%	+ 0.5
U.S. equities	30% to 65%	10.0%	12.0%	– 0.5
Foreign equities		10.0%	8.5%	+ 0.5
Alternative investments [2]	0% to 15%	5.0%	5.0%	0.0

Growth Portfolio

Investor Profile: Your main goal is capital growth. Although you can tolerate greater volatility in order to increase the value of your assets, you are not prepared to invest your entire portfolio in stocks. Your tolerance for risk is high.

Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Cash equivalents	0% to 25%	0.0%	2.0%	0.0
Fixed-income (duration: 5.9 years) [1]	25% to 45%	35.0%	33.5%	– 0.5
Canadian equities		25.0%	25.0%	0.0
U.S. equities	40% to 75%	15.0%	17.0%	0.0
Foreign equities		15.0%	12.5%	+ 0.5
Alternative investments [2]	0% to 20%	10.0%	10.0%	0.0

Maximum Growth

Investor Profile: You want to maximize the eventual return on your capital by investing all or most of your portfolio in the stock market. In doing so, you accept higher volatility of your investment returns in the hope that these returns will ultimately be higher. Your tolerance for risk is very high.

Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Cash equivalents	0% to 30%	0.0%	1.0%	0.0
Fixed-income (duration: 5.9 years) [1]	0% to 30%	20.0%	18.5%	– 0.5
Canadian equities		25.0%	25.0%	+ 0.5
U.S. equities	55% to 100%	20.0%	22.5%	0.0
Foreign equities		20.0%	18.5%	+ 0.5
Alternative investments [2]	0% to 25%	15.0%	14.5%	– 0.5

1) Includes conventional and real return bonds. Benchmark = 75% DEX Universe Index, 25% SC RRB Index.
2) Includes hedge funds and real estate. Benchmark = 50% Tremont Hedge Fund Index, 50% S&P TSX Cap REIT Index.

Forecast

	2010	2011	2012 (Forecast)	2013 (Forecast)
Gross Domestic Product%				
Canada	3.2	2.5	2.0	2.2
U.S.	3.0	1.7	2.5	2.5
Inflation%				
Canada	1.8	2.9	2.5	2.5
U.S.	1.6	3.1	2.2	2.3

	March 2012		December 2012		December 2013	
	Canada	U.S.	Canada	U.S.	Canada	U.S.
Rate%						
Short-term rates (T-Bills, 91-Day)	0.89	0.08	0.94	0.05	1.93	0.13
10-year bond yields	2.09	2.14	2.59	2.42	3.19	3.07
30-year bond yields	2.66	3.26	3.06	3.43	3.60	3.97
Canadian dollar	U.S.$1.00		U.S.$0.98		U.S.$1.01	

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