Building your financial future

Investment Strategy

January 2012

First class forecasting: NBF Chief Economist and Strategist ranked as the top forecaster for Canada

We are extremely proud that Stéfane Marion, Chief Economist and Strategist, Managing Director of our Economics and Strategy team and long-term contributor to this newsletter, has just been ranked as the best forecaster for Canada in the prestigious *Top Forecasters by Region Covered* published in the January 2012 issue of Bloomberg Markets magazine. Stéfane is no stranger to such honours – in November of this year he was recognized as one of the world's best foreign exchange forecasters – also by Bloomberg Markets magazine.

Congratulations Stéfane, and in the name of all our clients, thanks for sharing your wisdom with us each quarter in *Investment Strategy*!

Around the World

Chugging along without Europe

The global economy continues to feel the strain of the European sovereign debt crisis that has now spread to the core of the euro zone. Italy has been particularly hard-hit in recent weeks, its newly formed government forced to approve tough new austerity measures and economic reforms. In all likelihood, the euro zone will fall into recession. The depth and the length of the contraction will depend on the credibility of the policies being put in place to stabilize public finances and on the ability of the world's central banks to keep credit markets functional. Fortunately, the major central banks have recently announced concerted actions to support the global financial system through liquidity-support operations. At the same time, a number of emerging economies have eased their monetary policies. All in all, these efforts appear to be bearing fruit, with a number of heavyweight economies reporting expansions in Q4. As long as both the U.S. and China – 35% of global GDP, compared to 13% for the euro zone – remain in expansion mode, the world economy is likely to grow 3% in 2012 even without a contribution from Europe.

Euro zone: fiscal integration or bust?

Economists have long argued that a monetary union cannot be sustained without a fiscal union. Policymakers are now getting the message, thanks largely to pressure from financial markets. In December the euro countries announced a plan to reinforce the integrity of the zone by means of an enhanced Stability and Growth pact entailing much stronger coordination of economic policies. In essence, euro countries joining the new fiscal compact will lose sovereignty over their respective budgets if their deficits and debt breach certain thresholds. That is indeed a big step in the right direction, but it will take time for a fiscal union to develop. Since it generally also takes time for structural reforms to be acknowledged by the markets, an orderly transition will require the commitment of more financial resources. Fortunately, the ECB is starting to change its tone. Its new chief Mario Draghi has suggested that the central bank could take further steps to tackle the crisis if euro-zone governments send a credible signal by accepting "a fundamental restatement of the fiscal rules." The new rules are expected to be unveiled in the next three months.

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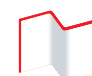


NATIONAL BANK FINANCIAL
WEALTH MANAGEMENT

United States

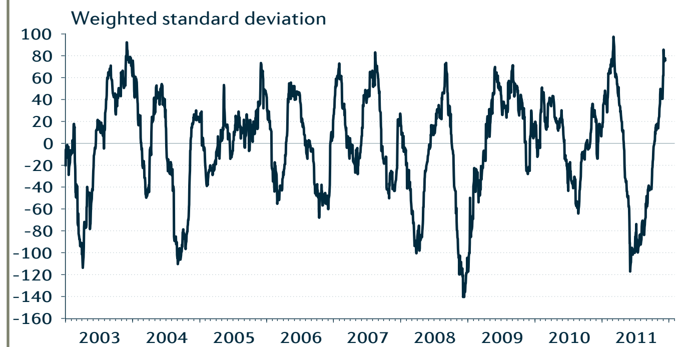
Accelerating growth

It is now clear that the U.S. economy not only avoided recession in 2011 but accelerated from quarter to quarter. With economic reports still coming in on the strong side, GDP in Q4 is tracking well above 2% annualized – the best quarterly performance of 2011. This is quite a feat considering that the U.S. was subjected in April to a near shutdown of government, in July and August to a debt-ceiling drama followed by an S&P downgrade of its credit, and in November to the failure of the supercommittee. With Congress apparently now keen to extend payroll tax cuts for another year, the economic momentum is likely to carry into 2012 on the strength of resilient domestic demand.

Much of that resilience can be traced to improvement in the labour market. Nonfarm payrolls are up almost 700,000 from six months ago, with all the gains coming from the private sector. Importantly, full-time employment now accounts for the bulk of new hiring. The improvement in employment has coincided with a firming of mortgage lending by banks. As a result, housing is showing signs of stabilization. Residential investment grew in both Q2 and Q3, the first back-to-back quarterly increases since 2005. The pace of home-price deflation seems to be finally moderating as supply and demand come into better balance. Domestic demand will also be supported in 2012 by the capital spending of businesses seeking to maintain the growth of productivity and profits. Of course, credit markets must remain functional if households and corporations are to take advantage of record-low financing costs. The good news is that despite the euro-zone sovereign debt crisis, financial stress indicators on this side of the Atlantic remain below levels normally associated with a credit crunch.

U.S. data beats expectations

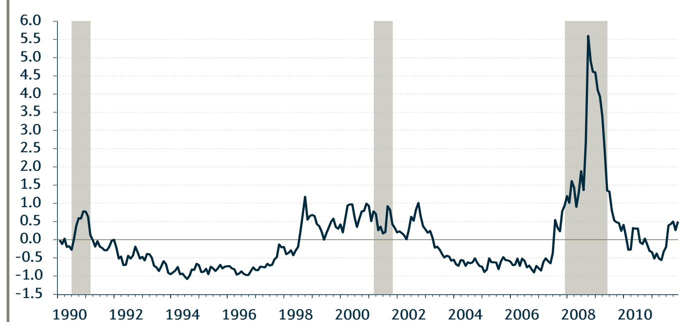
Citigroup Economic Surprise Index – U.S.



National Bank Financial Economy & Strategy (data from Citigroup via Bloomberg)

Perspective on financial stress in the U.S.

Financial stress index



National Bank Financial Economy & Strategy (data via Federal Reserve of Kansas City)

Canada

Bank of Canada sidelined

Canadian GDP growth rebounded to a robust 3.5% annualized in the third quarter after a small contraction in Q2. Encouragingly, our country remains well-positioned to benefit from its domestic strengths and from improvement in the U.S. economy. Exports are picking up, businesses are investing on the back of good profitability, and full-time employment is above the pre-recession peak. Canadian GDP is likely to finish 2012 near the head of the OECD pack with growth of 2.0%. This slight deceleration from 2011 will reflect a slowdown of consumption, which for a few years now has been fuelled by a strong wealth effect from home-price appreciation. The recent tightening of mortgage insurance requirements, coupled with global uncertainty, will slow the housing market and keep a lid on prices. We expect households to respond by keeping their consumption more closely aligned with disposable income, rather than by taking on more debt. Under these circumstances, the Bank of Canada's monetary policy stance will most likely remain unchanged in 2012.

RRSP Alert: "Significant interest" = potential for a significant penalty tax!

In its 2011 budget, the federal government introduced a number of anti-avoidance rules to prevent the use of RRSPs and RRIFs for aggressive tax avoidance strategies, and among them was the notion of prohibited investments. For these purposes, prohibited investments for a registered plan account include debt of the RRSP/RRIF annuitant, and investments in entities in which the annuitant or a non-arm's length person has a "significant interest".

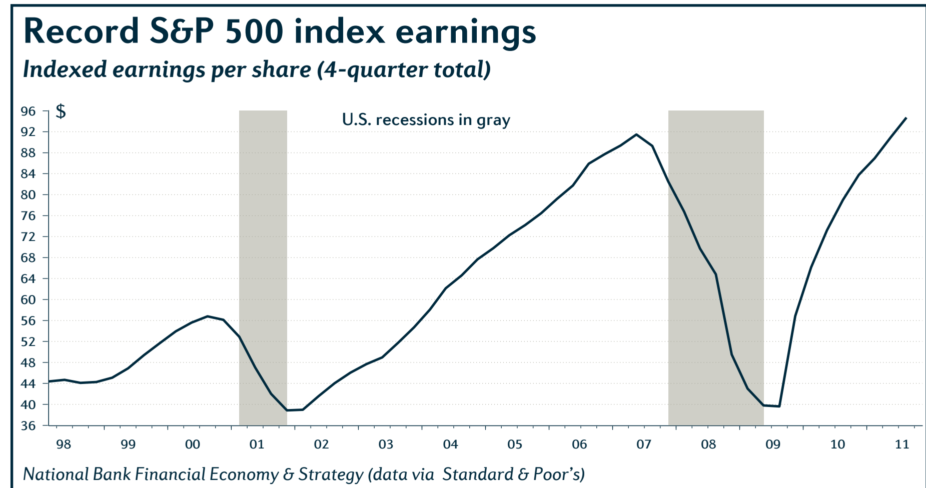
You will be deemed to have a significant interest in an entity if you or a non-arms length (your spouse, your children, your holding company, your RRSP, etc.) own:

- 10% or more of one category of shares of a public or private corporation or a related corporation, OR
- 10% or more of the fair market value of all the interests in a partnership or trust.

If you think you are holding investments in your RRSP in which you might be deemed to have a "significant interest", talk to your tax advisor or National Bank Financial Investment Advisor. In such cases, certain actions must be taken before March 31st, 2012 to avoid the being assessed a penalty tax.

No time for complacency

Volatility remains the order of the day in global financial markets. Equity indexes rebounded spectacularly in October and then gave back virtually all of their gains by December. Yet the latest earnings announcement season was a milestone in S&P 500 profits: the four-quarter sum of index earnings per share (EPS) reached an all-time high (chart). In Canada, S&P/TSX earnings are not far off their 2008 highs. Many equity indexes are trading more than 10% below their long-term-average earnings multiple. In Europe, price-to-earnings ratios are down to levels last seen in 2009, at the nadir of the global credit crisis. Meanwhile, the yield of 10-year Government of Canada bonds fell below 2% in December for the first time ever. Strategic focus is currently driven more by politics than by economic activity, a situation that is likely to endure. Though our base case scenario is still one of continuing global growth, the risk of adversity is high. As Bank of Canada governor Mark Carney noted in a recent speech: “Global liquidity has fluctuated wildly over the past five years, and we are on the cusp of another retrenchment. There are steps that can be taken to mitigate, but not eliminate, the negative effects of the current wave. How European banks choose to deliver will determine which ones authorities around the world need to take.” This is no time for complacency.



Equities: A Revitalisation of Confidence

Equities staged a comeback during the fourth quarter, on renewed investor optimism that the global economy will avoid recession and Europe’s sovereign debt problem will be contained. With confidence on the mend but uncertainty still lurking, investors sold down their exposure to gold, increased their bet on oil, (which climbed back above the century mark for the first time since June), but held on to their U.S. dollars for liquidity reasons. Meanwhile, Financial Services stocks continued to retreat, on fears of European sovereign defaults, which prompted Standards and Poor’s to downgrade a number of big banks, in the U.S. and Europe. While equity investors celebrated, bond traders worried. By voicing their concerns, they helped keep yields on Canadian and U.S Treasuries near record lows, but pushed yields of some European sovereign issues, mainly Italy and Spain, higher.

The surge in equity prices during the fourth quarter transpired on hopes for a European resolution plan, better-than-expected U.S. economic data, short covering, and portfolio rebalancing. However, equities could come under pressure again until such time when a credible plan by European officials is announced. Consequently, we are neutral equities, as a result of a steep underweight in international stocks (Europe in particular) that is counter balanced by an overweight in U.S. equities. This stance stems from the fact that, U.S. shares continue to offer a lower beta and are more attractive in times of uncertainty. Lastly, the weighting in Canadian equities has also been maintained, on solid earnings expectations, even though commodity prices may remain under pressure.

Elsewhere, cash has been increased for safety. New governments were put in place in Greece and Italy but implementing unpopular measures will be a difficult task and will take time. In recent weeks, U.S. liquidity swaps outstanding have increased significantly and the European Central Bank is borrowing U.S. dollar for its financial institutions, highlighting the fragility of liquidity conditions in the zone.

Meantime, central banks in developed economies remain committed to low interest rates policies, while others from China to Brazil, Turkey and South Korea have reversed course and are now poised to ease. Although yields are near record lows, if the ECB does not take on a role of lender of last resort and Germany does not put its balance sheet as collateral, the flight to quality trade and demand for government bonds, especially in safe jurisdictions such as Canada, will persist. Slow growth, European woes and the Federal Reserve actions (Operation Twist etc.) will also help keep a bid under bonds. As such, the underweight in federal bonds has been reduced, while exposure to provincial issues had been brought back to neutral. Finally, the overweight in corporate and high yield issues has been slightly decreased, however in both instances the opportunity to add value remains, given the strength of corporate balance sheets

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%	+ 1.0
Fixed-income (duration: 5.9 years) [1]	60% to 100%	70.0%	70.0%	+ 1.0
Canadian equities		10.0%	10.0%	– 0.5
U.S. equities	0% to 30%	5.0%	5.0%	– 0.5
Foreign equities		5.0%	3.0%	– 1.0

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%	+ 1.0
Fixed-income (duration: 5.9 years) [1]	50% to 80%	60.0%	59.0%	0.0
Canadian equities		20.0%	20.0%	– 1.5
U.S. equities	20% to 45%	7.5%	9.0%	+ 1.5
Foreign equities		7.5%	5.0%	– 1.0

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%	7.0%	+ 1.0
Fixed-income (duration: 5.9 years) [1]	30% to 65%	45.0%	43.0%	– 1.0
Canadian equities		25.0%	24.5%	– 2.0
U.S. equities	30% to 65%	10.0%	12.5%	+ 2.0
Foreign equities		10.0%	8.0%	0.0
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%	+ 1.0
Fixed-income (duration: 5.9 years) [1]	25% to 45%	35.0%	34.0%	0.0
Canadian equities		25.0%	25.0%	– 1.5
U.S. equities	40% to 75%	15.0%	17.0%	+ 1.5
Foreign equities		15.0%	12.0%	– 1.0
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%	19.0%	0.0
Canadian equities		25.0%	24.5%	– 2.0
U.S. equities	55% to 100%	20.0%	22.5%	+ 2.0
Foreign equities		20.0%	18.0%	0.0
Alternative investments [2]	0% to 25%	15.0%	15.0%	0.0

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

			Forecast	
	2009	2010	2011	2012
Gross Domestic Product %				
Canada	(2.8)	3.2	2.3	2.0
U.S.	(3.5)	3.0	1.8	2.5
Inflation %				
Canada	0.3	1.8	3.0	2.2
U.S.	(0.3)	1.7	3.1	1.8

	December 2011		June 2012		December 2012	
	Canada	U.S.	Canada	U.S.	Canada	U.S.
Rate %						
Short-term rates (T-Bills, 91-Day)	0.86	0.01	0.90	0.06	1.17	0.05
10-year bond yields	2.06	2.06	2.37	2.25	2.73	2.62
30-year bond yields	2.66	3.11	2.88	3.28	3.15	3.62
Canadian dollar	U.S.$0.98		U.S.$0.95		U.S.$0.97	

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