NATIONAL BANK FINANCIAL

Investment Strategy

JULY 2010

In this issue ...

17926-202

AROUND THE WORLD

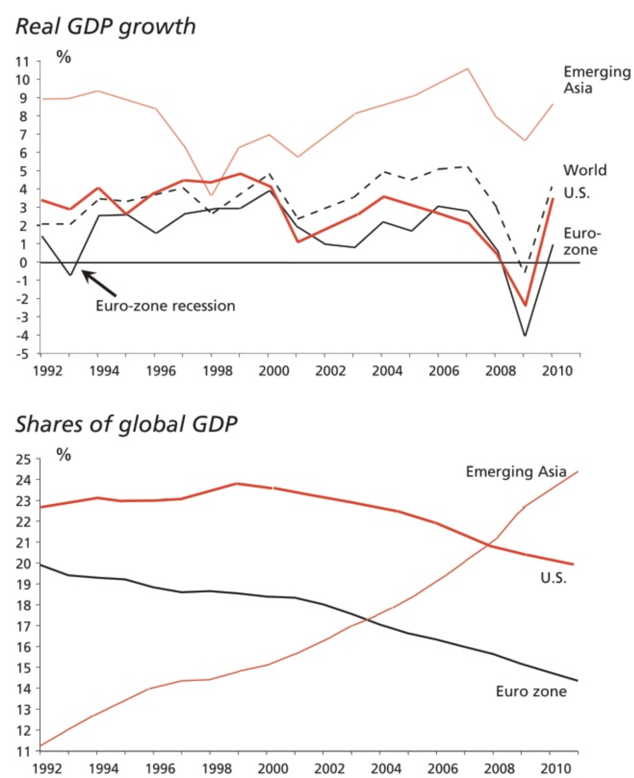
A tug-of-war

The past few weeks have certainly been eventful due to the escalation of the tug-of-war between strong cyclical forces and structural headwinds. What began this spring as concern about whether Greece would default on its debt evolved into a debate about whether the European currency is there for the long haul. The market reaction has been swift. The nadir came May 7, with the Dow Jones plunging 9.5% at one point in the trading day. Fortunately, policymakers are showing that they are aware of the importance in containing and reversing the destabilizing nature of their massive government debt. In turn euro-zone policymakers have responded by providing some important defensive ammunition to troubled nations. There was a significant breakthrough May 10 when euro-zone finance ministers announced support facilities of up to €750 billion to improve liquidity in the market for government bonds. This ambitious plan, though lacking in details, is unquestionably a step in the right direction.

While we recognize that fiscal austerity in many countries will slow European growth, it is unlikely to derail the global recovery. This is not the first time global growth will lose Europe as a contributor. It also happened in the early 1990s. The impact on the global economy was larger back then, because the countries now in the euro zone accounted for nearly 20% of global GDP. The world has changed dramatically since then. Emerging Asia now has a much larger GDP than the euro zone, with a greater share of its growth being driven by domestic demand as opposed to exports.

At this writing, the structural headwinds from the euro zone are not strong enough to derail the economic recovery or expansion in other regions of the world. Despite revising our outlook for Europe in 2010 downward, we maintain our forecast for global growth at around 4%.

World GDP: How fast can it grow if the euro zone weakens?



NBF Economy & Strategy (data via IMF)

Market jitters

During the first three weeks of May, the S&P/TSX lost 7%. Over the following three weeks, the index rebounded 5%. The VIX (an index of option price volatility) has surged in recent weeks to levels last seen in the midst of the 2008 financial crisis, and this emergence of increased volatility clearly points to heightened levels of uncertainty among market participants.

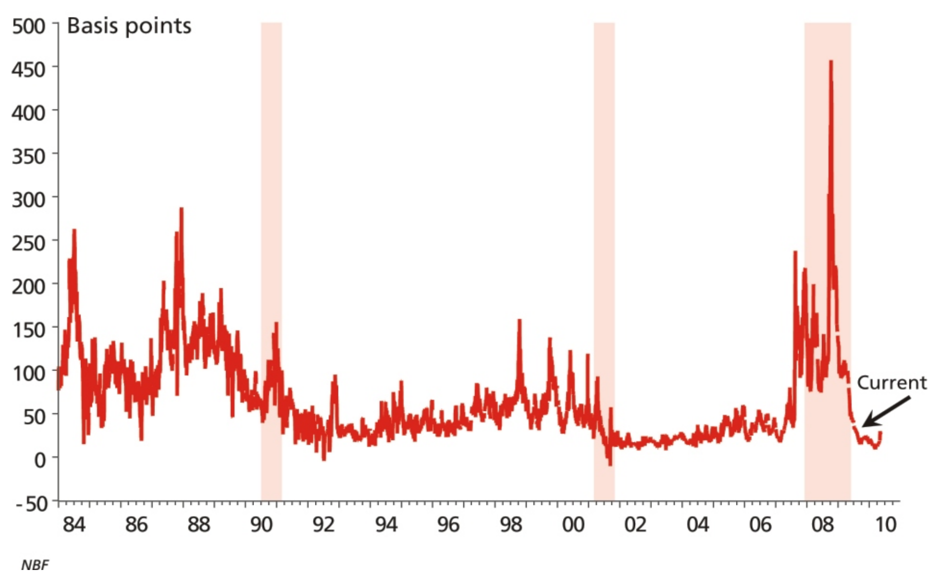
With global financial markets and appetite for risk taking a seemingly major hit as a result of the European sovereign debt problems, what effect will international stresses have on the U.S. and Canadian economies and earnings in Q2 and beyond? In our view, cyclical forces will continue to support earnings growth in the near term. These forces include an improving labour market and a boost to profit margins from continuing expansion. The behaviour of profit margins across the economic cycle is very important to keep in mind. Margins expand early in the cycle for several reasons. One of these is the low production capacity utilization of the economy as a whole. An increase in revenues at this point translates into a steeper rise in profits given that fixed costs are already covered and that all that remains is to pay for the variable costs of the additional production. We find corroboration for this view in corporate pre-announcements for Q2. The negative-to-positive ratio is running at an extremely low 1.2, less than half the long-term average of 2.1 and below the 1.5 of Q1.

From a North American perspective, it is important to keep in mind that while credit spreads have widened in recent weeks, the all-in cost of raising capital by issuing debt securities has not increased dramatically for investment-grade U.S. companies. This shows little contagion from Europe in the U.S. credit market and economy. Importantly, interbank lending rates have also responded fairly mildly to the recent volatility. The spread between Libor and the three-month T-Bill, a gauge of banking-sector stress, remains well below the levels normally associated with economic trumoil. This doesn't mean the sovereign debt crisis is unimportant, but it is not causing a seize-up of liquidity such as occurred in the fall of 2008.

The outlook for earnings and the economy remains favourable for equity markets, particulary in a context where interest rates are unlikely to become a hindrance to growth anytime soon. The current geopolitical backdrop, however, means that investors will need to deal with an environment of heightened volatility.

Long term perspective

Spread: 3-month Libor vs. 3-month U.S. Treasury



UNITED STATES

The recovery remains on track

U.S. real GDP grew at 3.2% annualized in Q1. This was a third straight quarter of expansion and it brought GDP within 1.2% of the pre-recession peak. Two of the three main components of U.S. demand – goods and services – have now topped their previous peak. The lagging component is construction, which accounts for only 7% of GDP. In other words, more than 90% of U.S. demand has now moved from a recovery to an expansion phase.

But more importantly, GDP growth is now accompanied by improving labour markets. Half a million jobs have been created in the private sector through the first five months of 2010 – the best performance in three years. Acceleration is likely in the coming months, but not without the participation of small and medium sized enterprises (SMEs), which generally account for two-thirds of job creation. Fortunately, things are starting to look up. Small business confidence jumped to a 20-month high in May, with a majority of SMEs announcing that they would start adding to headcounts. This development suggests that the U.S. recovery remains on track (GDP growth of around 3.5% 2010).

ASSET MIX

Glass Half Full...or Half Empty?

We are in the midst of one of those situations where a multitude of contradictory signals make it difficult to chart the course to follow. As mentioned above, we strongly feel that in spite of the storm clouds gathering in the euro zone, all of the fundamentals are in place for sustained economic expansion and meaningful earnings growth - which is of course a plus for the stock market. However, investor psychology plays just as big a role in moving the markets as economic data, and the spectre of a sovereign debt crisis has clearly prompted a shift in the pendulum of sentiment away from greed toward fear - which argues in favour of bonds. At this point we think that discretion is the better part of valour, and the time has come to adopt a somewhat more cautious approach until such time as sentiment shifts again and attention is refocused on what we see as healthy fundamentals.

Since the end of the first quarter of 2009 we have been favouring equities, and as of the previous quarter, our weightings for stocks were 2% - 5% over their benchmarks depending on the model portfolio. For the coming quarter, while we are maintaining an overweight position in equities, we will be cutting back slightly on our exposure to this asset class to bring it closer to the benchmark. What is taken out of equities will be temporarily redeployed into cash equivalents and fixed income in roughly equal proportions.

While our overall exposure to equities is trimmed back slightly, we are leaving our geographic allocation unchanged – our preference continues to be North America at the expense of Europe and the Far East. We are also still positive on the perspectives for emerging markets because of the increasing part of global GDP growth that they account for. In terms of sectors, we are overweight energy, industrials and information technology, and have underweight positions in utilities and consumer staples.

Our recommendation for the duration of the fixed-income component of our reference portfolio remains unchanged – at 5.4 years we retain a slightly defensive bias compared to the 5.9 year duration of the DEX Universe index. In past quarters we have looked to high yield and corporate debt at the expense of federal and provincial bonds to compensate for an interest rate structure that was at a historic low and to capitalize on attractive spreads. In anticipation of the pendulum shifting towards quality at the expense of yield, we are trimming our high yield and corporate bond exposure somewhat and re-deploying that capital back into federal bonds.

OUR FORECAST

	2008	2009	2010 (Forecast)	2011 (Forecast)
Gross Domestic Product (%)				
Canada	0.4	(2.5)	3.6	2.1
U.S.	0.4	(2.5)	3.6	2.4
Inflation (%)				
Canada	2.4	0.3	1.8	2.4
U.S.	3.8	(0.3)	1.7	2.3

	June 2010	Dec. 2010
Short-term rates (T-Bills, 91-Day) (%)		
Canada	0.58	1.75
U.S.	0.10	0.49
10-year bond yields (%)		
Canada	3.33	3.85
U.S.	3.22	3.86
30-year bond yields (%)		
Canada	3.76	4.17
U.S.	4.15	4.61
Canadian dollar	U.S.$0.97	U.S.$0.96

S&P / TSX Sector Rotation

Overweight	Underweight
Energy Industrials Information Technology	Consumer Staples Utilities

CANADA

A pillar of strength

With support from continuing fiscal and monetary stimulus, the economy is firing on all cylinders. The real GDP increase of 6.1% (annualized) in the first quarter of 2010 was the largest quarterly rise since Q4 1999. Domestic demand has been buoyed by favourable terms of trade and a growing aggregate wage bill. Employment in May 2010 was only 108,000 below the October 2008 peak. Not only are jobs being created, but since July 2009 virtually all the gains (310,000) have been full-time jobs.

The Canadian economy is much farther advanced in the cycle than the U.S. or the euro zone. Its real GDP in Q1 was only 0.4% below the pre-recession peak. Given the current economic outlook and well-anchored inflation expectations, the need for a zero interest rate policy has passed. Accordingly, the Bank of Canada started its interest rate normalization campaign in June by raising its policy rate to 0.5%. Canada has thus joined a few newly industrialized countries and Australia in this march away from extreme monetary easing. However, even if interest rates are set to head higher over the coming months, Canadian monetary policy is unlikely to turn restrictive anytime soon. This means that the economy will continue to benefit from a low interest rate environment for the foreseeable future. Our policymakers are only taking their foot off the accelerator, not stomping on the brakes. We see Canadian real GDP growth in excess of 3% in 2010

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%	10%	—
Fixed-income (duration: 5.4 years) [1]	60% to 100%	70%	69%	+ 1
Canadian equities		10%	10%	– 1
U.S. equities	0% to 30%	5%	6%	—
Foreign equities		5%	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%	5%	+ 1
Fixed-income (duration: 5.4 years) [1]	50% to 80%	60%	60%	+ 2
Canadian equities		20%	21%	– 2
U.S. equities	20% to 45%	7.5%	9%	– 1
Foreign equities		7.5%	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%	6%	+ 2
Fixed-income (duration: 5.4 years) [1]	30% to 65%	45%	45%	+ 2
Canadian equities		25%	27%	– 2
U.S. equities	30% to 65%	10%	11%	– 1
Foreign equities		10%	6%	– 1
Alternative investments [2]	0% to 15%	5%	5%	—

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%	2%	+ 2
Fixed-income (duration: 5.4 years) [1]	25% to 45%	35%	33%	+ 3
Canadian equities		25%	28%	– 3
U.S. equities	40% to 75%	15%	17%	– 1
Foreign equities		15%	10%	– 1
Alternative investments [2]	0% to 20%	10%	10%	—

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%	5%	+ 5
Fixed-income (duration: 5.4 years) [1]	0% to 30%	20%	17%	+ 2
Canadian equities		25%	27%	– 3
U.S. equities	55% to 100%	20%	21%	– 2
Foreign equities		20%	15%	– 2
Alternative investments [2]	0% to 25%	15%	15%	—

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*