Investment Strategy

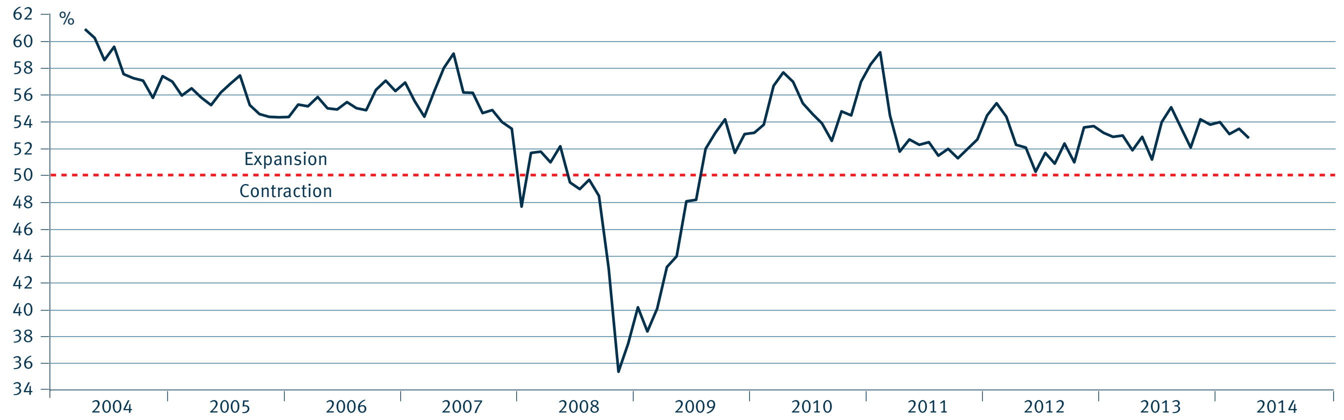
INVESTING

Global Economy

While the global economy continued to expand through the first quarter of the year, economic growth decelerated slightly. Japan's stellar Q1 was offset by disappointing performances in emerging economies, the eurozone and the U.S. The latter's weather-related slowdown was worse than we had anticipated, but the good news is that a rebound is in the cards as soon as Q2 2014. While policy missteps remain a concern in China, we note that the economy is still on track to expand at nearly 7% annually, despite Beijing's announcement of credit restrictions in some industries. On May 21, the Ministry of Human Resources announced that the bottom line for economic growth was the creation of "at least" 10 million jobs in cities. The jobs objective is consistent with the goal of increasing the urbanization rate from about 54% to 60% by 2020. All in all, we remain fairly optimistic about China's growth prospects through 2014 and do not anticipate a tightening of credit that would jeopardize demand for commodities. Our forecast for global GDP growth in 2014 is 3.5%, an acceleration from last year's pace.

Global economy continues to expand

Composite PMI index for the world economy (manufacturing and services)



NBF Economy & Strategy (data via Bloomberg)

NATIONAL BANK FINANCIAL
WEALTH MANAGEMENT

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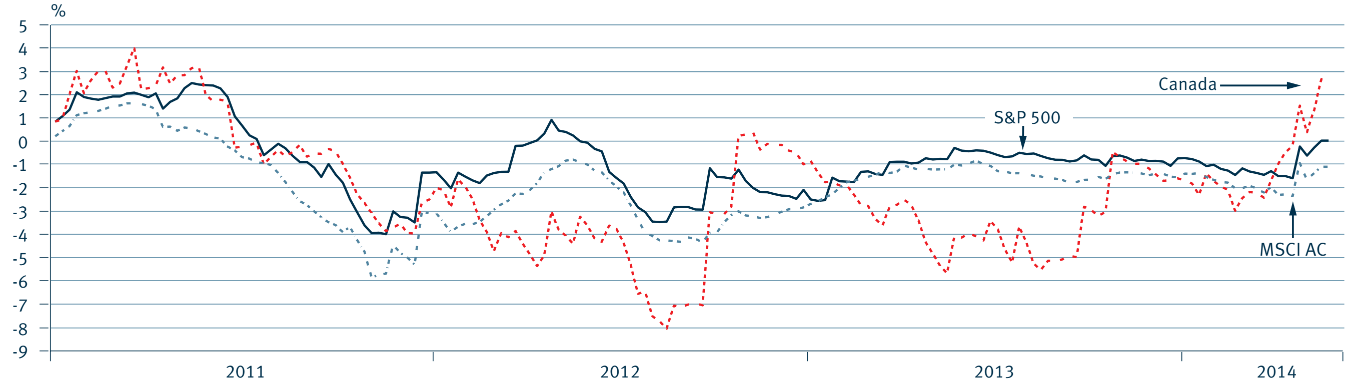
Canada

After a strong second half last year, Canada took a breather in the first quarter of 2014. Trade was hit hard by the weather-related slowdown in the U.S., and domestic demand somewhat softened. That, however, doesn't change our view about 2014 prospects. Re-leveraging in the U.S. suggests a quick rebound of Canada's exports in H2 2014. And thanks to much improved profits and a better economic outlook, business investment looks poised to bounce back. All told, we remain comfortable with our 2014 growth forecast of 2.3% for Canadian GDP. Such an above-potential growth rate just means that the output gap will narrow further as the year progresses, enough in our view to add to inflationary pressures. Note that in April, the annual inflation rate hit the Bank of Canada's (BoC) 2% target for the first time in two years. We expect the BoC to drop its dovish language later this year, something that will set the stage for the resumption of interest rate hikes during the first half of 2015.

Earnings outlook improving fast

3-month change in 12-month forward earnings



NBF Economics & Strategy (data via Datastream)

Investment Strategy

After a strong rally in February and March, markets have started Spring on the wrong foot with equities pulling back from their highs. Last year's favourites were particularly affected with U.S. small capitalization and biotechnology stocks reversing some of their frenzied pace. While the political tensions between Russia and Ukraine were a source of concern, perhaps a more plausible cause behind the market's hesitancy was that expectations for U.S. economic growth were simply too high following a strong second half in 2013. This is why bonds continued to defy gravity in April and May, with yields on U.S. 10-year Treasury notes falling to 2.5%. This tactical asset rotation was also visible in Canadian equities, which, with a rebound in the Materials and Energy sectors, outperformed other major stocks indices.

But all is not lost. It turns out that the economic stagnation in the winter was mostly related to abnormally cold and snowy conditions, and more recent data have since then indicated that the pace of activity should rise sharply. Net job creation is back to its 2012 highs, consumer confidence is on the rise and manufacturing activity is accelerating. Therefore, as overbought conditions have slowly been worked down in many markets, risk assets were able to rebound in May, taking the S&P 500 Index above 1,900 points for the first time ever.

In a context where global monetary policy will remain highly accommodative for many more quarters to come, we believe that stock markets still hold the highest growth potential over the short- and longer-term horizons. Therefore, we maintain our strategy for the third quarter of 2014 and continue to favour the stock market relative to fixed-income securities. In equity markets, our biggest overweight remains toward the U.S. market, which is expected to benefit from both the improving economy and an appreciation of its currency. European markets are also attractive and should soon benefit from the European Central Bank's support. Emerging market equities are probably the most undervalued, but the ongoing economic slowdown in parts of that region combined with the reduction of the Fed's easing program leaves developed markets with higher risk-adjusted expected returns.

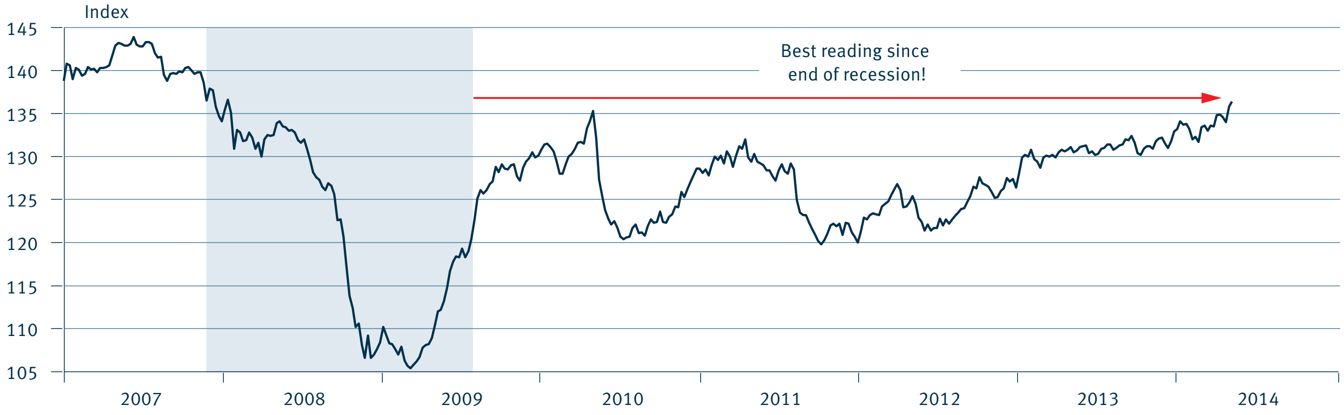
In terms of fixed income, portfolios should have a shorter duration compared to the benchmark. Although we do not expect a significant pickup in interest rates, current yields are hovering around technical support levels and risks remain more tilted towards an increase than a drop. Moreover, while investment-grade security companies are increasingly expensive, we maintain our preference for high-yield issuers, which should continue to benefit from the improvement in the U.S. economy.

United States

The first quarter of the year was one to forget in the U.S., as growth stalled. The bad weather clearly hurt the economy in Q1 (especially trade), and government spending was also surprisingly weak considering that the October shutdown had already caused a sharp decline in the prior quarter's expenditures. A positive, however, was that final sales found some support, thanks in part to healthcare-related outlays, which supported overall consumption spending. A rebound is underway in Q2, and we wouldn't be surprised to see annualized growth near 4% in the current quarter, with the leading economic indicator rising to a post-recession high in May. Meanwhile, U.S. labour market conditions continue to improve – more than 1.1 million net new full-time jobs have been created so far in 2014 – and many leading indicators of employment growth are now stronger than they were before the last recession. Improving labour markets coupled with an easing in lending conditions also explain the recent stabilization in homeownership rates. Housing should see a better contribution to GDP growth over the near to medium term.

Look ahead, not behind

Weekly leading economic indicator



NBF Economics & Strategy (data via ECRI)

Financial Markets

Global equities, as measured by the MSCI All-Country Index, seem headed for an eighth straight quarterly advance and their best run since 1995–97 (10 quarters). Last year's global equity gains, however, were due much more to rising multiples than to earnings growth. In recent months, we have argued that in 2014, earnings would play the dominant role. An analysis of returns so far in Q2 supports this view. The advance of the MSCI All-Country Index since March 31 is attributable more to profit performance than PE expansion. In Canada, not only have 12-month trailing profits improved, but forward earnings have been revised up by 2.7% in the past three months, the sharpest three-month rise since 2011. The earnings outlook continues to benefit from generally favourable conditions. The global economy is poised to accelerate in the second half of the year, monetary policy remains accommodative and corporate bond yields are near historic lows.

MODEL PORTFOLIOS

Income Portfolio	Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
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 low.	Cash equivalents	0% to 20%	5.0%	3.0%	0.0%
	Fixed-income (duration: 5.25 years)[1]	60% to 100%	70.0%	66.0%	0.0%
	Canadian equities	0% to 30%	7.5%	9.0%	0.0%
	US equities		7.5%	11.5%	0.0%
	Foreign equities		5.0%	5.5%	0.0%
	Alternative investments[2]	0% to 10%	5.0%	5.0%	0.0%
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.	Cash equivalents	0% to 15%	5.0%	3.0%	0.0%
	Fixed-income (duration: 5.25 years)[1]	45% to 80%	55.0%	51.0%	0.0%
	Canadian equities	20% to 45%	14.0%	16.0%	0.0%
	US equities		14.0%	17.5%	0.0%
	Foreign equities		7.0%	7.5%	0.0%
	Alternative investments[2]	0% to 10%	5.0%	5.0%	0.0%
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.	Cash equivalents	0% to 20%	5.0%	1.0%	0.0%
	Fixed-income (duration: 5.25 years)[1]	30% to 65%	40.0%	36.0%	0.0%
	Canadian equities	30% to 65%	17.5%	19.5%	0.0%
	US equities		17.5%	22.5%	0.0%
	Foreign equities		10.0%	11.0%	0.0%
	Alternative investments[2]	0% to 20%	10.0%	10.0%	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.	Cash equivalents	0% to 25%	0.0%	0.0%	0.0%
	Fixed-income (duration: 5.25 years)[1]	25% to 45%	35.0%	28.5%	0.0%
	Canadian equities	40% to 75%	20.0%	21.0%	0.0%
	US equities		20.0%	25.0%	0.0%
	Foreign equities		15.0%	15.5%	0.0%
	Alternative investments[2]	0% to 25%	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 high.	Cash equivalents	0% to 30%	0.0%	0.0%	0.0%
	Fixed-income (duration: 5.25 years)[1]	0% to 30%	20.0%	12.0%	0.0%
	Canadian equities	55% to 100%	22.5%	24.5%	0.0%
	US equities		22.5%	28.0%	0.0%
	Foreign equities		20.0%	20.5%	0.0%
	Alternative investments[2]	0% to 30%	15.0%	15.0%	0.0%

1) Dex Universe Index
2) Includes Hedge funds, Global real estate and Infrastructure, and Commodities

FORECAST

			Forecast	
	2012	2013	2014	2015
Gross Domestic Product %				
Canada	1.7	2.0	2.3	2.6
US	2.8	1.9	2.6	2.9
Inflation %				
Canada	1.5	0.9	2.0	2.0
US	2.1	1.5	1.7	1.9

	June 2014		December 2014		December 2015	
	Canada	US	Canada	US	Canada	US
Rate %						
Short-term rates (T-Bills, 91-Day)	0.93	0.08	1.03	0.11	1.96	1.42
10-year bond yields	2.42	2.69	2.93	3.18	3.49	3.55
30-year bond yields	2.92	3.45	3.36	3.89	3.83	4.17
Canadian dollar	US $0.91		US $0.92		US $0.93	

Investment Strategy – June 2014
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