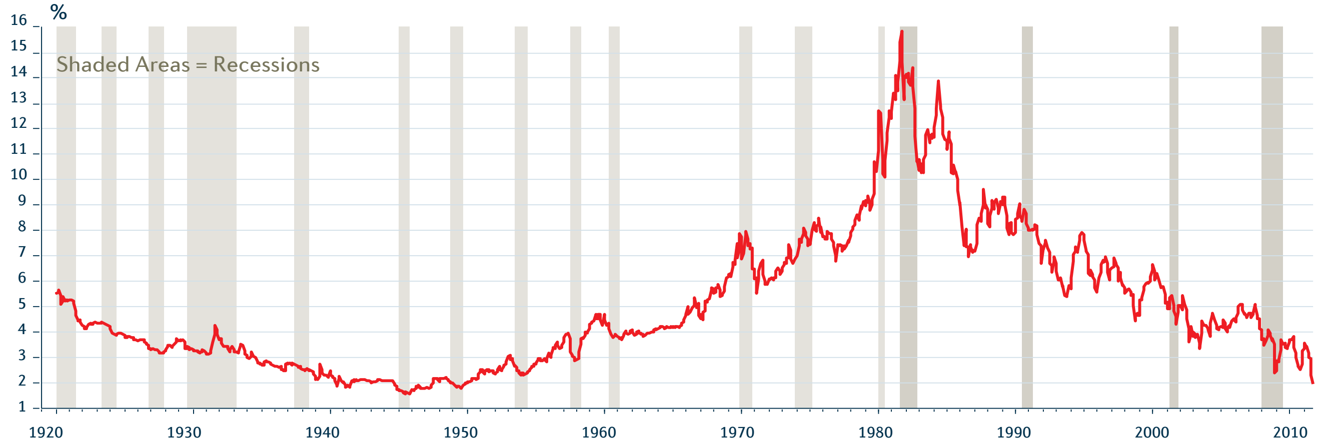
Building your financial future

Investment Strategy

October 2011

Financial Markets

Interest rates fall below 2% — Yield on the 10-year U.S. Treasury



NBFG Economy & Strategy

Equity markets have been on a roller coaster for the past several months. On August 8 the S&P/TSX sank to a low of 11,744, down 18% from peak. It was the sharpest correction of Canadian equities since the 49.7% slide of 2008, and close to the 20% decline that is widely accepted as the definition of a bear market. Though equities have since recovered some of their losses, downward revisions of growth forecasts combined with the crisis of public finances in some euro countries remain a source of major uncertainty. In September the yield of 10-year U.S. Treasuries fell to its lowest level since World War II, below 2%. Its decline is without doubt due in part to anticipation of further Treasury purchases by the U.S. Federal Reserve, since market expectations of long-term inflation are far from the near-zero readings of 2008. In other words, investors see a deflationary environment as unlikely at this time. Also, credit markets remain functional despite a recent rise of uncertainty about financial institutions. In contrast to 2008, therefore, central banks remain proactive in promoting an environment favourable to economic expansion. However, political uncertainty arising from the sovereign-debt problem will not soon dissipate. It will most likely remain a key consideration in investment strategies for years to come.

In this issue ...

NATIONAL BANK FINANCIAL

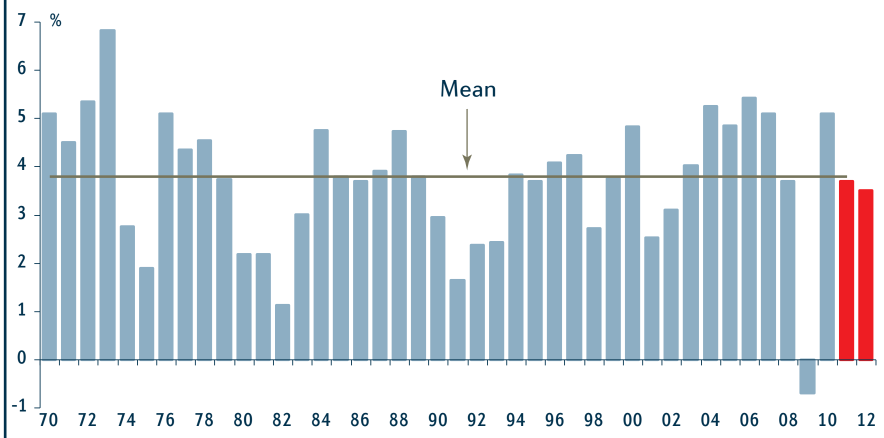
WEALTH MANAGEMENT

Global economy

The global economy continues to expand but the outlook has become more uncertain. The European and U.S. debt crises have clearly weighed on confidence globally and the fiscal austerity measures of the governments affected are set to produce further headwinds worldwide. The force of these headwinds will depend on policy mixes that must seek to re-establish investor confidence in the solvency of public finances without jeopardizing the recovery. In the euro zone, the epicentre of sovereign debt woes, policymakers are beginning to address the need for stronger governance and more convergence in social policies.

Despite the uncertainty, conditions in credit markets remain favourable to global economy expansion of slightly more than 3% in 2012. World growth will again be driven by the emerging economies, whose combined GDP is about to surpass that of the OECD countries and where a number of central banks are set to rescind last year's monetary tightening. The key risks to this outlook are policy responses to sovereign debt concerns, protectionism and competitive currency devaluation.

World: Growth to decelerate to 3%
Global real GDP

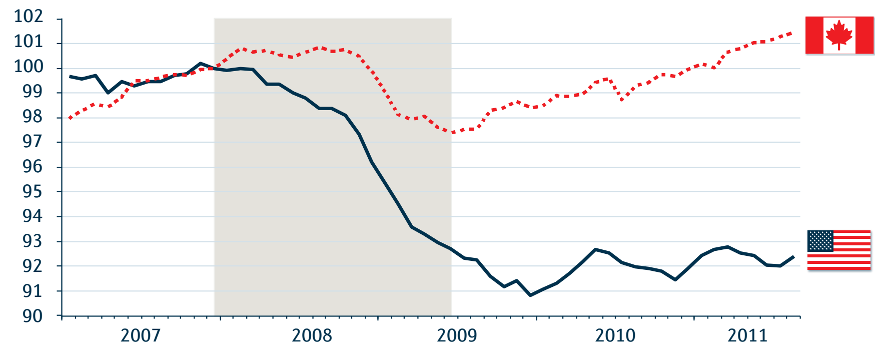


OECD, NBFG

Canada

Like most OECD nations, Canada hit a pothole in Q2. Its GDP contracted at an annual rate of 0.4%, with a significant drag from trade exacerbated by supply-chain problems originating in Japan's automotive industry. Despite this weakness, the economy showed strong underpinnings. Domestic demand expanded at a healthy 3% rate, buoyed by yet another solid performance of business fixed investment. Investment in machinery and equipment alone rose 31% annualized, the strongest quarterly expansion since 1996, and now exceeds the pre-recession peak. That puts business in a better position to weather the challenges of a strong Canadian dollar, which is likely to stay near parity against the U.S. dollar for the foreseeable future. Canadian growth was double that of the U.S. in the first half of the year, highlighting the benefits to consumer spending of relatively strong labour and housing markets. Canada has added 200,000 net full-time jobs over the past six months, the best showing in more than three years. Full-time employment reached a record 14 million in August, with the majority of provinces also reporting record workforces. Though the Canadian economy is poised to resume growth in Q3, its relatively strong domestic fundamentals and near-target inflation rate are unlikely to sway the Bank of Canada from its current stance, given the Bank's broader concerns about the global economy. At the same time, the central bank must be careful not to encourage Canadians to leverage excessively.

Full-time jobs continue to expand
Full-time jobs in Canada



NBFG Economy & Strategy

Equities: Uncertainty Seeps Back Into the Markets

Equity prices retreated sharply during the third quarter, on fears that the globe was headed back into recession, led by the U.S. and Europe. Standard and poor's downgraded America's sovereign rating, in reaction to what it described as "political bickering". The downgrade had its greatest impact on confidence, which fed positively into precious metals in general and gold in particular, which saw its price get ever closer to $2,000/oz. The rally in gold and other precious metals prices provided support to some commodity heavy markets such as Canada; however, the selloff was broad and did touch on every sector within the global equity universe. The Financial sector did bare the brunt of the selling, on fears of exposure to defunct bonds, however, other so-called "economically sensitive" sectors such as Energy and Industrials were also hit hard. Going into the third quarter, our view on equities has changed somewhat, from slightly bullish to neutral, as our outlook for global economic growth has changed. With the global economy now poised to grow at a slower pace than had been anticipated, price multiple expansion is expected to remain positive (provided that the economy does not relapse back into recession), but nonetheless limited.

Overall, exposure to equities remains tilted in favour of U.S. and Canadian stocks, to the detriment of international issues. With inflation in the emerging markets receding, a number of countries are now expected to ease monetary policy to stimulate growth. Consequently, demand for goods and services of large U.S. multinationals, as well as demand for commodities should pick-up and propel earnings growth in both the U.S. and Canada. In contrast, international equities could remain under pressure, especially the banking sector, on fears of sovereign debt defaults in a number of European countries, namely in the PIIGS (Portugal, Ireland, Italy, Greece and Spain).

Elsewhere, we have slightly increased the weighting of cash to reflect on our more cautious outlook and allow the economy and equity markets to stabilize at lower levels, a time at which an eventual redeployment of this cash would be affected.

With the Federal Reserve, the Bank of Canada and other Central Banks from across the developed world now committed to keeping interest rates unchanged throughout the rest of this year at the least, we have decided to increase exposure to fixed income securities slightly (but remain underweight) and adjusted duration closer to neutral. While we believe that federal government bonds are pricy, we are not discounting a further increase in their value, given the uncertain political and economic environment. On the other hand, we slightly increased the overweight in provincial, corporate, as well as high yield bonds, mainly as a result of their attractive valuations and investors' continued thirst for higher yields.

United States

Recent economic data have poured a bucket of cold water on the U.S. economic prospect, reporting first-half growth much weaker than had been thought and the recovery path more uncertain. This news came on top of a U.S. debt-ceiling saga that shook consumer and business confidence as well as financial markets. The loss of confidence was exacerbated by an unexpected downgrade of the U.S. government's credit – the first in history for the country behind the main global reserve currency. Standard & Poor's said it was prompted to lower the U.S. rating from AAA to AA+ by political rather than solvency issues. As frustrating as the downgrade may be for investors, its causes are much less unnerving than those behind recent downgrades of a number of euro countries. In contrast to those countries, the solvency of the U.S. is not in question.

Though the risk of recession has increased in recent weeks, we think the U.S. is likely to pull through with a slow-growth second half. Monetary policy remains very accommodative. To encourage risk-taking by investors and businesses, the Federal Reserve has vowed to keep its policy rate at rock bottom until at least mid-2013, and the Fed chairman has said he is prepared to use additional tools to promote a stronger recovery. One result is that financing costs have never been lower for U.S. businesses, whose balance sheets remain in very good shape on the strength of record earnings. Though this is an important ingredient for continued recovery, the economy also needs Congress to lift the uncertainty about future fiscal and tax policy that could weigh on corporate business planning and willingness to hire.

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%	11.0%	0.0
Fixed-income (duration: 5.9 years) [1]	60% to 100%	70.0%	69.0%	+ 1.0
Canadian equities		10.0%	10.5%	+ 0.5
U.S. equities	0% to 30%	5.0%	5.5%	– 0.5
Foreign equities		5.0%	4.0%	– 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%	6.0%	0.0
Fixed-income (duration: 5.9 years) [1]	50% to 80%	60.0%	59.0%	+ 1.0
Canadian equities		20.0%	21.5%	+ 0.5
U.S. equities	20% to 45%	7.5%	7.5%	– 0.5
Foreign equities		7.5%	6.0%	– 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%	6.0%	0.0
Fixed-income (duration: 5.9 years) [1]	30% to 65%	45.0%	44.0%	+ 1.0
Canadian equities		25.0%	26.5%	+ 0.5
U.S. equities	30% to 65%	10.0%	10.5%	– 0.5
Foreign equities		10.0%	8.0%	– 1.0
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%	1.0%	0.0
Fixed-income (duration: 5.9 years) [1]	25% to 45%	35.0%	34.0%	+ 1.0
Canadian equities		25.0%	26.5%	+ 0.5
U.S. equities	40% to 75%	15.0%	15.5%	– 0.5
Foreign equities		15.0%	13.0%	– 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%	+ 1.0
Canadian equities		25.0%	26.5%	+ 0.5
U.S. equities	55% to 100%	20.0%	20.5%	– 0.5
Foreign equities		20.0%	18.0%	– 1.0
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

	2009	2010	Forecast 2011	Forecast 2012
Gross Domestic Product %				
Canada	(2.8)	3.2	2.4	2.1
U.S.	(3.5)	3.0	1.6	2.2
Inflation %				
Canada	0.3	1.8	2.7	1.7
U.S.	(0.3)	1.7	2.9	1.2

Rate %	Sept. 16, 2011 Canada	Sept. 16, 2011 U.S.	December 2011 Canada	December 2011 U.S.	December 2012 Canada	December 2012 U.S.
Short-term rates (T-Bills, 91-Day)	0.87	0.01	0.83	0.03	1.79	0.05
10-year bond yields	2.29	2.05	2.31	2.07	2.86	2.51
30-year bond yields	3.32	2.93	3.34	2.96	3.68	3.30
Canadian dollar	U.S.$1.02		U.S.$0.95		U.S.$0.98	

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