Building your financial future

Investment Strategy

September 2013

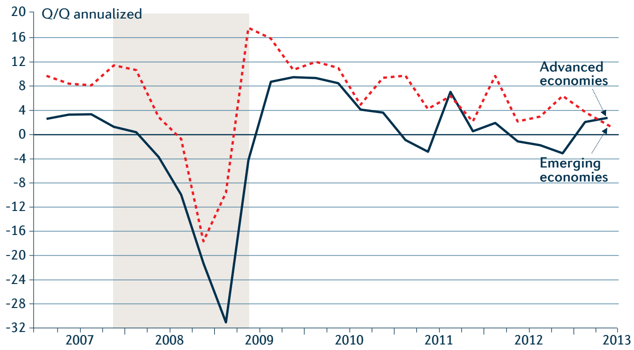
Around the World

Global Economy

Economic data in advanced economies have generally surprised to the upside in the last couple of months. The U.S. economy has arguably done better than first thought considering the impact of tax hikes at the start of the year and the ongoing sequester. Europe has also provided its share of positive surprises, although it must be noted that an extended recession had significantly lowered the bar for what would constitute good news there. For the first time since 2011, the U.K. economy managed to put in two successive quarters of growth with Q2's 2.4% annualized GDP print. Even the eurozone managed to post some growth in Q2, and that for the first time in seven quarters. The uptick in advanced economies contrasts with emerging market woes. Data point to the worst quarterly growth rate (in Q2) since 2009 for industrial production in emerging economies. China's rebalancing act away from investment and exports towards consumption is clearly biting into growth not just in the Middle Kingdom, but also across supply chains in emerging markets. Fortunately, data available for the month of August point to an abatement of economic deceleration. World GDP growth remains on track to grow 3% this year, but renewed geopolitical tensions will need to be closely monitored.

Advanced economies outpacing emerging

Industrial production



NBF Economy & Strategy (data via CPB)

In this issue

The Chief Economist and Strategist of National Bank, Stéfane Marion, has been ranked among the top 20 forecasters in the world by *Bloomberg Markets* magazine.

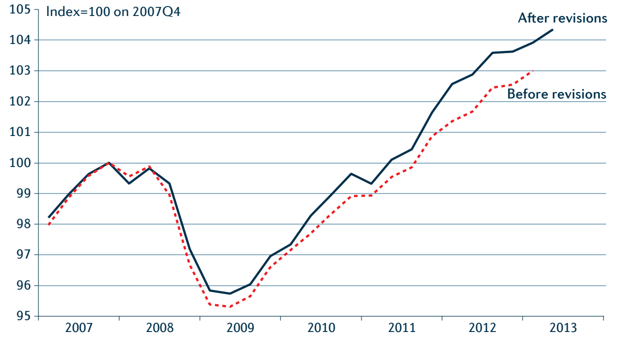
NATIONAL BANK FINANCIAL
WEALTH MANAGEMENT

United States

Just like that, the U.S. economy is a growth leader again in the advanced world. That's according to newly revised figures by the Bureau of Economic Analysis (BEA), which put last year's U.S. GDP growth at 2.8 %, the best annual performance since 2005. The BEA applied new methodology more in tune with international standards, such as putting personal wages, salaries and defined benefit pension plans on an accrual basis and expanding the definition of gross private domestic investment. The end result is that U.S. GDP at the end of 2013 Q1 was roughly 1 % higher than originally believed. Though the economy continued to improve at an accelerated pace of 2.5 % in Q2, the zigzag growth pattern is set to continue with a deceleration in Q3, courtesy of the sequester. Fortunately, labour markets are performing well enough to support consumption and keep the expansion going into 2014.

U.S.: Revisions show recovery going better than first thought

Real GDP before and after revisions



NBF Economy & Strategy (data via IHS)

Financial Markets

Since May 22, when Mr. Bernanke told Congress that the pace of Fed bond purchases could slow over the "next few meetings," the U.S. central bank has been preparing markets for a first adjustment to its asset purchase program before year end. Unless the upcoming employment report proves disastrous and/or geopolitical tensions flare up to threaten the economic outlook, the Fed will initiate a modest reduction of its asset purchases. With fear of eurozone redenomination having basically disappeared and the Fed getting ready to phase out QE, the underlying trend is for the yield of 10-year treasuries to move higher at a modest pace over the coming quarters.

Though the MSCI All-Countries World Index posted a pullback in August, it was still up 2.5 % from the beginning of the quarter and just over 10 % year-to-date. The advance so far this summer has been general across the world's regions. Europe continues to do well and though some emerging markets have struggled as of late, the MSCI EM index still showed a small quarterly positive return through the end of August. Canadian equities have also done much better in recent weeks, as earnings expectations are now much more attuned to the global backdrop. An improving global economy can be expected to limit further downgrades of S&P/TSX earnings estimates for calendar 2013.

Treasury yields on the rise

Yield on U.S. 10-year Treasuries

NBF Economy & Strategy (data via IHS)

Canada

Canadian GDP grew just 1.7 % annualized in the second quarter. The economy was restrained by trade, but domestic demand bounced back after a weak Q1 thanks to consumption, government and residential construction, which more than offset the drag from business investment. Domestic demand should slow in the second half of the year as rising mortgage rates reduce activity in the housing sector. Consumption spending is also slated to soften as debt-burdened households reduce their credit intake and save more. Even considering a rebound in economic activity after the Alberta floods and the Quebec construction strike, GDP growth is unlikely to exceed 2 % in H2 2013.

Investment Strategy

The financial markets have experienced their share of volatility in recent months. Low trading volumes, increased geopolitical risks and a significant change in expectations about U.S. monetary policy have led the stock market to enter a consolidation phase. While improving economic data pushed U.S. indices to new highs in July, the continued rise in interest rates, escalating tensions in the Middle East and outflows from emerging markets have forced a decline in major stock markets around the world in August. This period of uncertainty has been favourable to the price of gold, which rebounded after having been on a downtrend over the past twelve months. This allowed the Canadian stock market to outperform during the period. In contrast, government bonds have not been able to play their safe-haven role and offset the equity pullback, as the rise in interest rates has affected bond values, resulting in net losses for investors.

For the last three months of the year, the outlook remains favourable for equity markets, as global economic growth is expected to accelerate. The latest figures were stronger than expected and, barring an armed intervention in Syria, market concerns should dissipate quickly. Of all the uncertainties, the one surrounding the tapering of bond purchases by the Federal Reserve seems to be overdone, as it takes place in a context where the economy is gaining strength and where the forward guidance suggests that increases in policy rates are not likely before 2015. In these circumstances, monetary policy will remain highly accommodative in developed countries and will continue to provide good support to risky assets.

In light of this environment, we are keeping in line with our strategy for the fourth quarter and continue to favour the stock market relative to fixed-income securities. In equity markets, we maintain a preference for developed markets versus emerging markets, as they remain bothered by some form of stagflation (slow economic growth and rising inflation), which has recently led to capital outflows. Our biggest overweight therefore remains the U.S. market, which is expected to benefit from both the improving economy and an appreciation of its currency. The Canadian market, for its part, could benefit from a catch-up effect, but the demand for raw materials is less buoyant than in previous years.

In terms of fixed income, bond yields should continue on a slight upward trend while the Federal Reserve continues to signal its intention to do less and less. As a result, portfolios should have a shorter duration compared to the benchmark. Moreover, while investment grade securities are increasingly expensive, we maintain our preference for high-yield issuers, which should continue to benefit from the improvement in the U.S. economy. For investors with a lower risk tolerance, we suggest the addition of non-traditional revenue strategies that allow some protection in the event of a gradual rise in interest rates.

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%	5.0%	3.0%	0.0%
Fixed-income (duration: 5.5 years)[1]	60% to 100%	70.0%	66.0%	0.0%
Canadian equities		10.0%	11.5%	0.0%
U.S. equities	0% to 30%	5.0%	9.0%	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.

Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Cash equivalents	0% to 15%	5.0%	3.0%	0.0%
Fixed-income (duration: 5.5 years)[1]	45% to 80%	55.0%	51.0%	0.0%
Canadian equities		20.0%	22.0%	0.0%
U.S. equities	20% to 45%	7.5%	11.0%	0.0%
Foreign equities		7.5%	8.0%	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.

Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Cash equivalents	0% to 20%	5.0%	1.0%	0.0%
Fixed-income (duration: 5.5 years)[1]	30% to 65%	40.0%	36.0%	0.0%
Canadian equities		25.0%	27.0%	0.0%
U.S. equities	30% to 65%	10.0%	15.0%	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.

Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Cash equivalents	0% to 25%	0.0%	0.0%	0.0%
Fixed-income (duration: 5.5 years)[1]	25% to 45%	35.0%	28.5%	0.0%
Canadian equities		25.0%	26.0%	0.0%
U.S. equities	40% to 75%	15.0%	20.0%	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 very high.

Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Cash equivalents	0% to 30%	0.0%	0.0%	0.0%
Fixed-income (duration: 5.5 years)[1]	0% to 30%	20.0%	12.0%	-4.0%
Canadian equities		25.0%	27.0%	0.0%
U.S. equities	55% to 100%	20.0%	25.5%	4.0%
Foreign equities		20.0%	20.5%	0.0%
Alternative investments[2]	0% to 30%	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

	2011	2012	Forecast 2013	Forecast 2014
Gross Domestic Product %				
Canada	2.5	1.7	1.6	2.2
U.S.	1.8	2.8	1.6	2.7
Inflation %				
Canada	2.9	1.5	1.0	1.6
U.S.	3.1	2.1	1.4	1.6

	September 2013		December 2013		December 2014	
	Canada	U.S.	Canada	U.S.	Canada	U.S.
Rate %						
Short-term rates (T-Bills, 91-Day)	0.98	0.04	0.98	0.04	1.21	0.10
10-year bond yields	2.74	2.80	2.82	2.91	3.42	3.46
30-year bond yields	3.16	3.81	3.27	3.96	3.92	4.36
Canadian dollar	U.S.$0.95		U.S.$0.94		U.S.$1.01	