

# Asset Allocation Strategy

CIO Office | June 2021

## All that jitters is not gold

### Highlights

- › The overall market picture remained relatively unchanged in May, although stock markets did exhibit some jitters in the middle of the month after supply-demand imbalances gave rise to inflation figures significantly higher than expected.
- › Much of the answer to whether these price pressures are transitory or something more lasting depends on whether economic agents believe it to be transitory or not. For now, both market and consumer measures of expected inflation suggest they are leaning toward the transitory rise scenario.
- › Abundant liquidity and rising inflationary fears are a breeding ground for cryptocurrencies, but that hasn't stopped these digital assets from plunging in recent weeks. For pessimists, this marks the beginning of the end. For optimists, it's just another day at the office. For us, it is mostly a demonstration that the volatility of cryptocurrencies is significantly too high to justify a material weight in a portfolio that is subject to reasonable risk constraints. In addition, the claim that Bitcoin provides diversification from traditional risky assets isn't so clear anymore, unlike its distant cousin already aged by a few millennia: gold.
- › Turning to traditional currencies, the Loonie has shown a lot of strength recently, but a look at its key drivers suggests that it may be nearing its final destination.
- › Overall, our base-case scenario continues to bear out. Accordingly, we are keeping our asset allocation unchanged. Going forward, the key element to watch will be the evolution of the Federal Reserve guidance in tandem with the labour market recovery.

Table 1 Global Asset Allocation Views

	-	←	=	→	+	Δ
<b>Asset Classes</b>						
Cash						
Fixed Income						
Equities						
Alternatives						
<b>Fixed Income</b>						
Government						
Investment Grade						
High Yield						
Duration						
<b>Equities</b>						
Canada						
United States						
EAFE						
Emerging Markets						
Value (vs. Growth)						
Small (vs. Large)						
Cyclicals (vs. Defensives)						
<b>Alternatives &amp; FX</b>						
Inflation Protection						
Gold						
Non-Traditional FI						
Uncorrelated Strategies						
Canadian Dollar						

This table is for illustration purposes only. Bars represent the degree of preference of an asset relative to the maximum deviation allowed from a reference index. The further to the right (left) they are, the more bullish (bearish) our outlook for the asset is. No bars indicate a neutral view. The column under the delta sign (Δ) displays when our outlook has improved (↑) or worsened (↓) from the previous month. Consult Table 3 for details on the base-case economic scenario underpinning these views and Table 4 to see how they translate into a model balanced portfolio.

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## Market Review

### Fixed Income

- › Government bond returns were marginally positive in May, with longer-dated securities broadly supported by interest rates having ticked lower by month's end.
- › The slide lower for longer-term yields paradoxically coincided with the largest surge in annual U.S. Core CPI growth since 1996 and PCE growth since 1992.

### Equities

- › Global equity markets rose a further 1.6% last month, with Canadian stocks (+3.4%) topping their American (+0.7%) and EM (+2.3%) counterparts.
- › Even so, the U.S. enjoyed an especially favourable earnings season, with 87% of companies in the S&P 500 reporting earnings beats.
- › Meanwhile, the more cyclical and value-oriented sectors within the Index outperformed their defensive and growth-oriented counterparts.

### FX & Commodities

- › Oil prices further strengthened in May, as the economic revival from the easing of pandemic restrictions in many developed countries pushed demand for the commodity even higher.
- › Rising inflation worries and a weakening Greenback helped gold advance for a second month in a row, bringing year-to-date returns back into positive territory.
- › Broad USD weakness and rising oil prices buoyed the Loonie's value in May.

Table 2 Market Total Returns

Asset Classes	May	YTD	12 MTH
Cash (3-month T-bills )	0.0%	0.0%	0.2%
<b>Bonds (FTSE CA Univ.)</b>	<b>0.6%</b>	<b>-4.4%</b>	<b>-1.7%</b>
FTSE CA Short term	0.1%	-0.3%	1.4%
FTSE CA Mid term	0.5%	-3.5%	-0.9%
FTSE CA Long term	1.4%	-9.9%	-6.3%
FTSE CA Government	0.7%	-4.9%	-3.3%
FTSE CA Corporate	0.5%	-3.0%	2.6%
BoAML Inv. Grade (\$US)	0.7%	-2.7%	4.0%
BoAML High-Yield (\$US)	0.3%	2.3%	15.2%
Preferred Shares	3.1%	14.6%	42.3%
<b>CA Equities (S&amp;P/TSX)</b>	<b>3.4%</b>	<b>14.4%</b>	<b>33.8%</b>
Energy	4.4%	28.8%	29.5%
Industrials	1.7%	6.5%	31.6%
Financials	4.4%	22.5%	54.1%
Materials	7.9%	6.1%	16.6%
Utilities	-0.4%	2.5%	19.4%
Cons. Disc	-0.7%	17.4%	57.0%
Cons. Staples	4.3%	7.0%	9.7%
Healthcare	-3.4%	20.9%	30.3%
IT	0.3%	3.0%	30.4%
Comm. Svc.	3.2%	13.9%	17.4%
REITs	1.7%	16.8%	37.7%
S&P/TSX Small Cap	4.3%	19.2%	65.8%
<b>US Equities (S&amp;P500 USD)</b>	<b>0.7%</b>	<b>12.6%</b>	<b>40.3%</b>
Energy	5.8%	39.2%	40.9%
Industrials	3.1%	19.0%	58.0%
Financials	4.8%	29.5%	66.2%
Materials	5.2%	20.9%	60.2%
Utilities	-2.4%	4.6%	12.8%
Cons. Disc	-3.8%	6.2%	38.6%
Cons. Staples	1.8%	5.2%	23.1%
Healthcare	1.9%	9.3%	22.0%
IT	-0.9%	6.4%	42.6%
Comm. Svc.	-0.1%	16.5%	43.7%
REITs	1.2%	19.5%	29.7%
Russell 2000 (USD)	0.1%	14.9%	62.8%
<b>World Eq. (MSCI ACWI)</b>	<b>1.6%</b>	<b>11.1%</b>	<b>42.5%</b>
MSCI EAFE (USD)	3.4%	10.4%	39.0%
MSCI EM (USD)	2.3%	7.4%	51.5%
<b>Commodities (CRB index)</b>	<b>3.0%</b>	<b>22.6%</b>	<b>55.7%</b>
WTI Oil (US\$/barrel)	4.3%	37.4%	86.9%
Gold (US\$/ounce)	7.7%	0.4%	10.1%
Copper (US\$/tonne)	4.3%	32.3%	91.5%
<b>Forex (DXY - USD index)</b>	<b>-1.4%</b>	<b>0.1%</b>	<b>-8.5%</b>
USD per EUR	1.6%	-0.1%	9.9%
CAD per USD	-1.8%	-5.3%	-12.4%

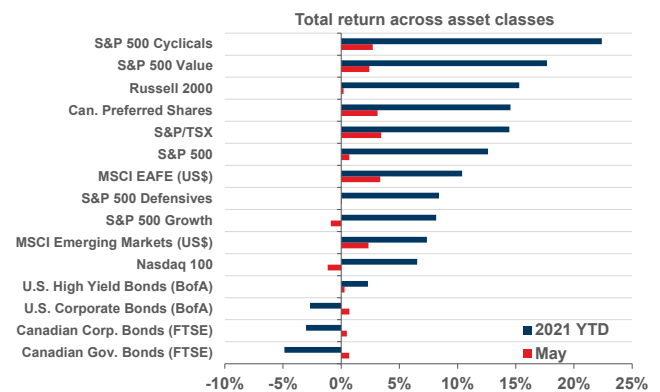
Data via Refinitiv

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## A little volatility for stocks...

The overall market picture remained relatively unchanged in May where equities with greater cyclical exposure posted gains, growth stocks posted small losses, and bonds traded water (Chart 1).

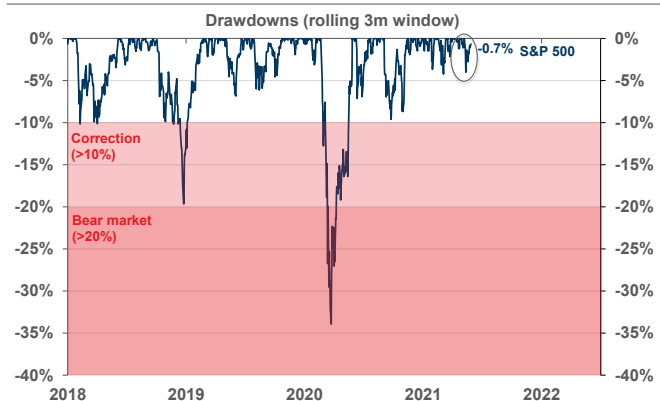
### 1 | Key market trends remain in place...



CIO Office (data via Refinitiv).

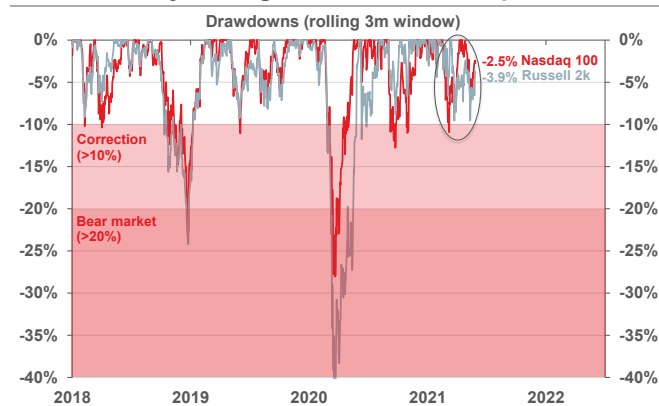
Nonetheless, stock markets did exhibit some jitters in the middle of the month. It was nothing particularly dramatic for the S&P 500, which has not experienced a decline of more than 5% in 7 months now (Chart 2), but still noteworthy for high-flying indices such as the Nasdaq (heavy in technology names) and the Russell 2000 (U.S. small-cap), which nearly reached the 10% correction threshold (Chart 3).

### 2 | ... despite a slight increase in volatility...



CIO Office (data via Refinitiv).

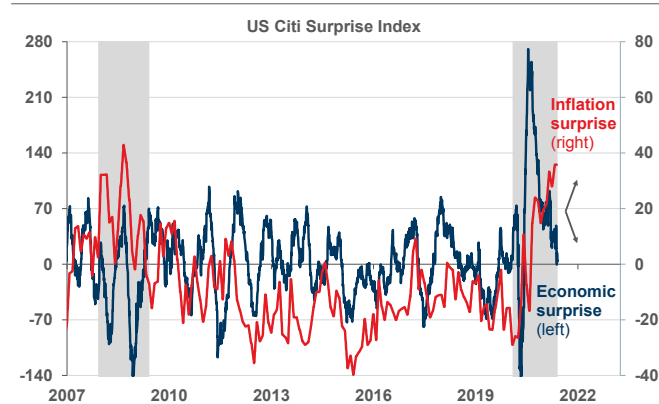
### 3 | ... notably for big tech and small cap stocks



CIO Office (data via Refinitiv).

Last month, we concluded our report mentioning that the impending rise in inflation was likely to prove uncomfortable for markets at times. This is indeed what happened in May after Consumer Price Index (CPI) figures turned out to be significantly higher than expected just as economic surprises were registering their lowest level in over a year (Chart 4).

### 4 | Significant upward surprise for inflation...



CIO Office (data via Refinitiv).

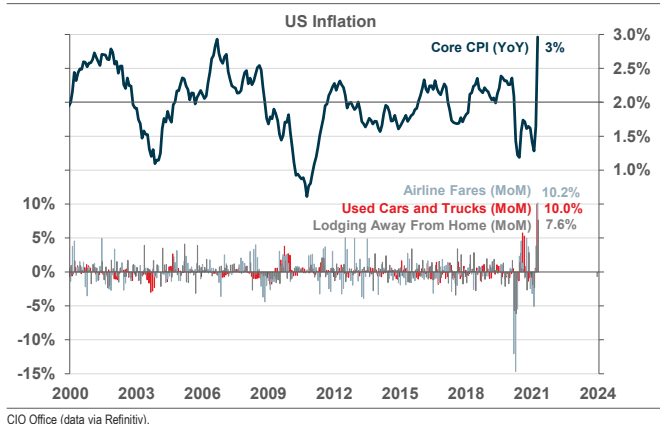
Such a divergence between inflationary and economic surprises has rarely been observed in the last 14 years – a period almost exclusively characterized by downward surprises for prices. Is this the beginning of a new era for inflation?

## ... a lot of volatility for prices

As we have been reporting on for some time, the process of “reopening” an economy after more than a year of restrictions and generous government handouts is inevitably causing supply-demand imbalances in certain sectors, which in turn puts upward pressure on prices.

This is exactly what we see when we examine the details of the latest core CPI inflation figures. Just over half of the monthly increase comes from exceptional jumps in prices of tourism-related categories (airfares, lodging away from home) and used cars and trucks (due to the shortage of semi-conductors affecting the supply of new vehicles<sup>1</sup>) (Chart 5).

### 5 | ... maybe not so surprising after all

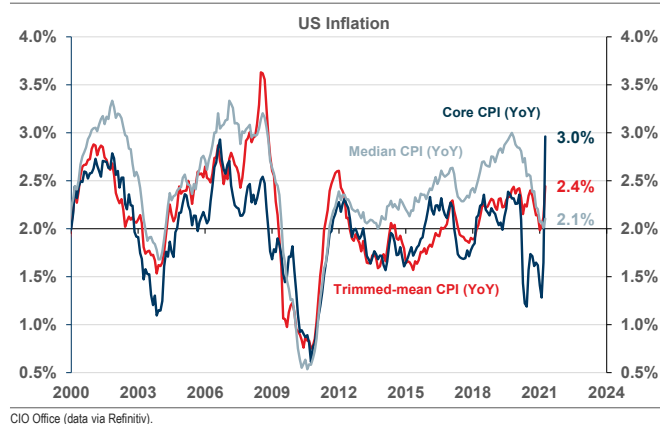


It is reasonable to assume that price increases in these three sub-sectors are mostly transitory adjustments. Regardless, the next few months are likely to see other bottlenecks emerge, occasionally generating other “abnormal” price jumps whose timing and magnitude are hardly predictable, and sometimes even anecdotal (ex: \$12k for a Habs vs. Leafs ticket at the Bell Centre<sup>2</sup>).

In such a context, measures of underlying inflation that correct for extreme movements in certain prices become particularly relevant. Indicators such as the trimmed-mean CPI (excludes the top 8%/bottom 8% of the monthly price change distribution) and

median CPI (middle of the price change distribution) have also rebounded recently, as expected, but their rise remains relatively contained (Chart 6).

### 6 | Underlying inflation remains relatively contained



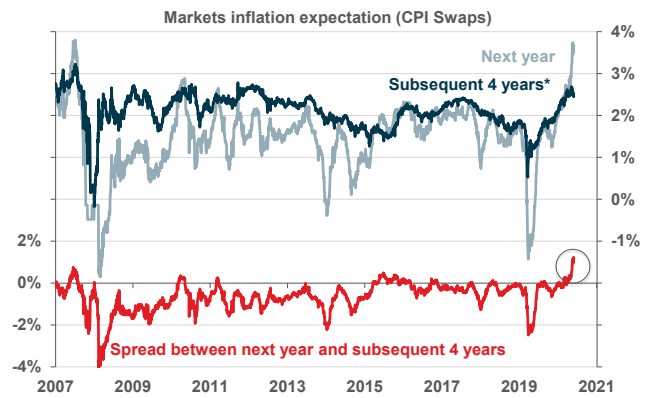
That said, the most important inflation metrics to monitor may not be those that give us a reading on the past, such as CPI reports, but rather those that reflect economic agents' expectations for the future. The reason is simple. If a majority of consumers are confident that long-term inflation will remain stable, any abnormal rise in prices should incline people to delay their purchases (when possible) until prices stabilize. Conversely, if a majority believes that prices are bound to continue to rise significantly faster, we are likely to see a self-reinforcing dynamic where consumers accelerate their purchases, businesses raise prices to preserve their profit margins, and workers demand higher wages to protect their purchasing power.

Simply put, much of the answer to whether the inevitable rise in inflation over the coming months will be transitory or not depends on whether economic agents believe it to be transitory or not. For now, both market (Chart 7, next page) and consumer (Chart 8, next page) measures of expected inflation suggest they are leaning toward the transitory rise scenario as the rate expected beyond the next year remains consistent with the Federal Reserve's long-term inflation target.

<sup>1</sup> As chip shortage goes on, cars are scarce and prices are up, ABC News, May 13, 2021

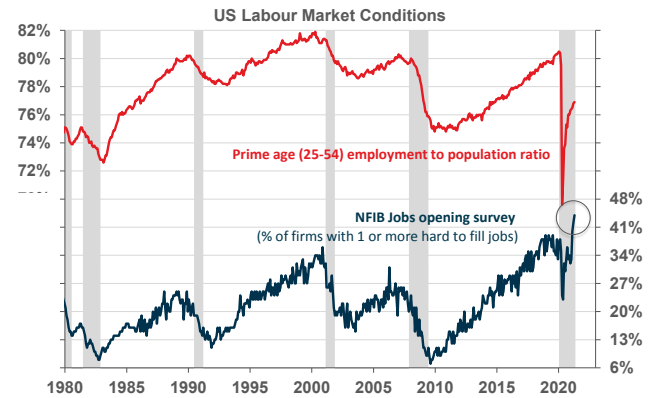
<sup>2</sup> A ticket to watch Habs vs. Leafs in Montreal could cost fans as much as \$12k, CBC, May 28, 2021

**7 | Markets expect a transitory inflation spike...**



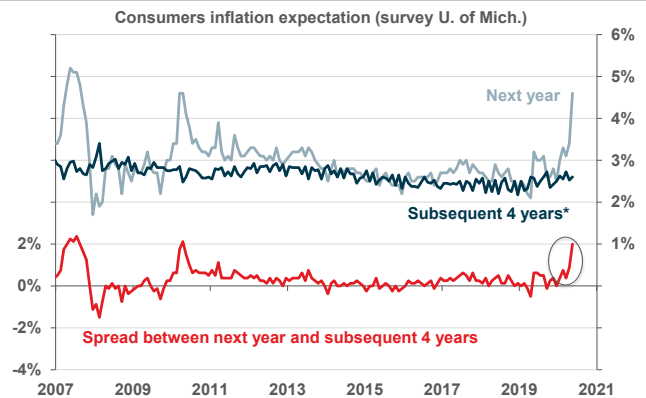
CIO Office (data via Refinitiv). \*Implicit rate derived from 1-year and 5-year CPI swap rates.

**9 | Demand for labour is at its highest...**



CIO Office (data via Refinitiv).

**8 | ... much like consumers**



CIO Office (data via Refinitiv). \*Implicit rate derived from 1-year and 5-year expectations.

**10 | ... how much will wages have to adjust?**



CIO Office (data via Refinitiv). \*Atlanta Fed wage tracker since 1997, total private nonfarm average hourly earnings before.

For this to remain the case, the U.S. Central Bank must ensure its credibility remains intact. For now, its intentions are clear: maintain accommodative conditions to ensure a complete recovery in the labour market without too much regard for inflationary pressures in the short term. Like any policy, this approach is not risk-free, especially in a context where, although the employment rate remains low, demand for labour is at an all-time high (**Chart 9**).

This "anomaly" should be remedied in part by the expiry of government support measures and the gradual recovery of the service sector, assuming that the pandemic continues to fade. How much wages will have to adjust remains to be seen, but for now, their growth also remains contained (**Chart 10**).

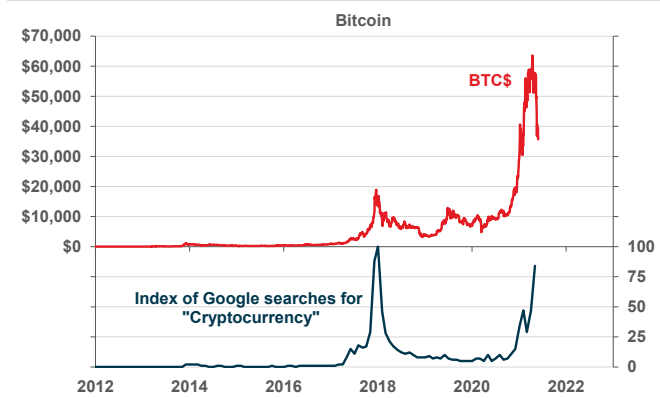
**All that jitters is not gold**

A backdrop of abundant liquidity and near-zero interest rates not only raises inflationary fears, it also fosters demand for assets perceived as providing protection against a potential devaluation of "traditional" currencies. Such is the case with cryptocurrencies, whose explosive gains since the beginning of the year are catching the attention of an increasing number of investors (**Chart 11**, next page).

However, it was actually for its sharp fall that cryptocurrencies' poster child, Bitcoin, made headlines last month after Elon Musk announced his company no longer planned to accept payments



### 11 | Cryptocurrencies are back in vogue...

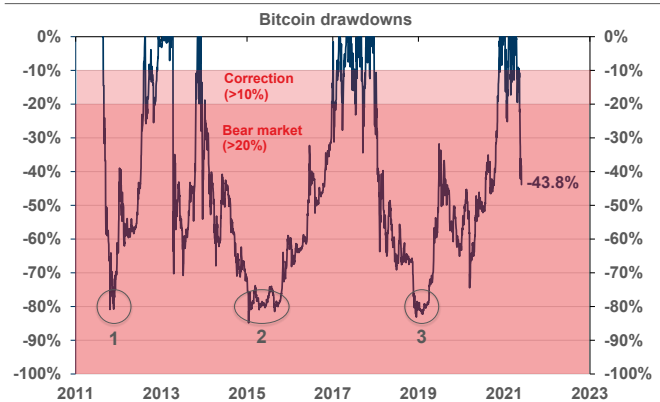


CIO Office (data via Refinitiv, Google Trends).

in Bitcoin, citing environmental reasons,<sup>3</sup> while China signalled increased oversight of the relatively new class of digital assets.<sup>4</sup>

For the pessimists, this marks the beginning of the end for the asset whose real utility remains nebulous. For the optimists, it's just another day at the office for the cryptocurrency which has already undergone 3 episodes of 80% drawdowns in its 10-year history (Chart 12).

### 12 | ... and visibly still keen on sky diving



CIO Office (data via Refinitiv).

For us, it is mostly a demonstration that the volatility of cryptocurrencies (about 22x that of bonds, 12x that of traditional currencies such as the USD, and 6x that of commodities/stocks, Chart 13) is significantly too high to justify a material weight in a

<sup>3</sup> Bitcoin's growing energy problem: It's a dirty currency, Financial Times, May 20, 2021.

### 13 | All that jitters (glitters)...

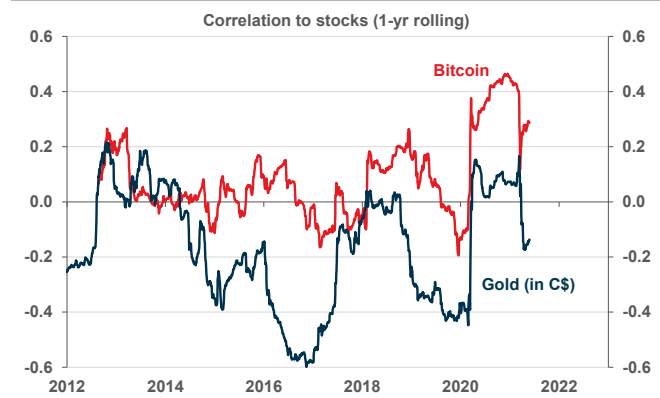


CIO Office (data via Refinitiv). Stocks = MSCI ACWI. Bonds = FTSE Canada Universe. Commodities = CRB Index. USD = DXY Index.

portfolio that is subject to reasonable risk constraints.

Moreover, the argument that Bitcoin provides diversification from traditional risky assets isn't so clear anymore. Case in point: its correlation with the global stock market has increased significantly in the past year, unlike its distant cousin already aged by a few millennia: gold (Chart 14).

### 14 | ... is not gold

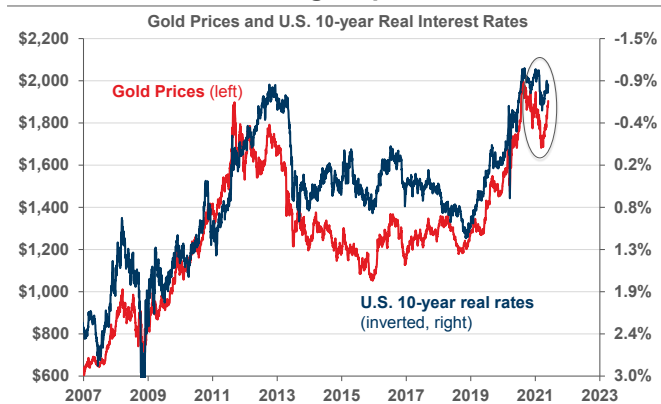


CIO Office (data via Refinitiv). Stocks = MSCI ACWI

After a challenging start to the year, gold prices have rebounded by 10% over the past two months, supported by the Federal Reserve's commitment to maintain accommodative monetary conditions until the economy finds its balance (Chart 15, next page).

<sup>4</sup> Bitcoin gyrates on fears of regulatory crackdown, Financial Times, May 19, 2021

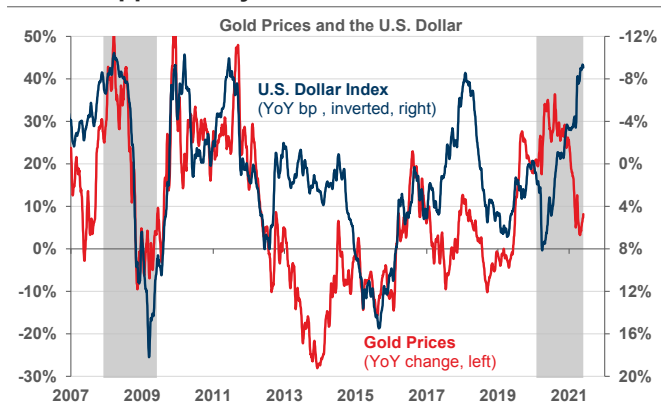
### 15 | Marked rebound for gold prices...



CIO Office (data via Refinitiv).

We continue to hold a positive view of the precious metal, not in the perspective of hitting a home run, but for its diversification properties in an environment where a strong recovery in global growth combined with accommodative monetary policies should continue to put downward pressure on the U.S. dollar (Chart 16).

### 16 | ... supported by a weaker US\$



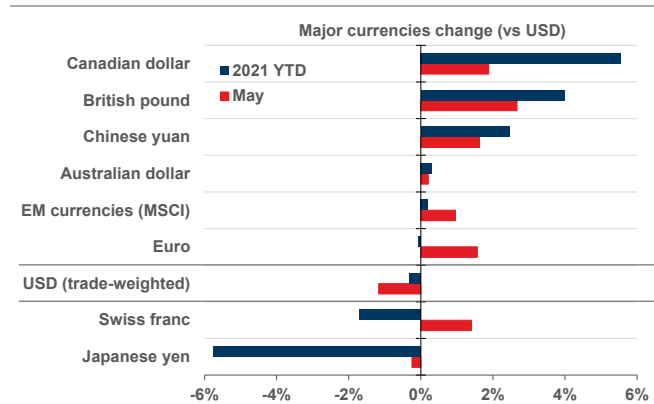
CIO Office (data via Refinitiv).

### Arrival at destination for the Loonie?

The Greenback's decline in recent months has been particularly evident against the Canadian dollar, up 1.9% in May and 5.5% so far in 2021 (Chart 17). Should we expect the Loonie to continue to gain altitude at this rate?

A look at the primary driver of the currency pair's value – the spread between our respective interest rates – tells us two things. First, the recent rise in the Loonie looks like a catch-up since the interest

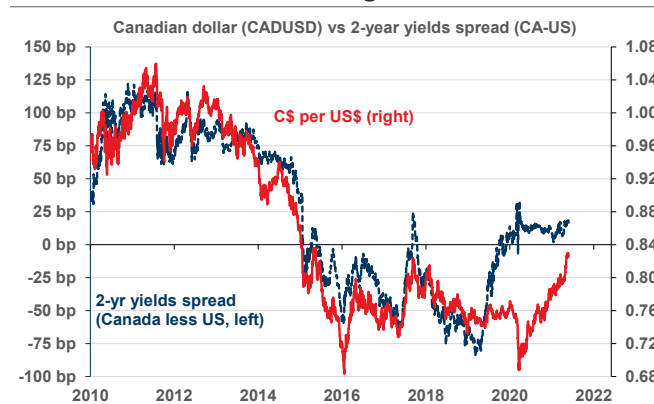
### 17 | The loonie took off in 2021...



CIO Office (data via Refinitiv).

rate differential between Canada and the U.S. narrowed at the end of 2019. Second, this process appears to be nearing its final destination, assuming that the Bank of Canada will avoid going its own way by raising rates significantly above that of its neighbour to the south (Chart 18).

### 18 | ... but seems to be nearing its final destination...

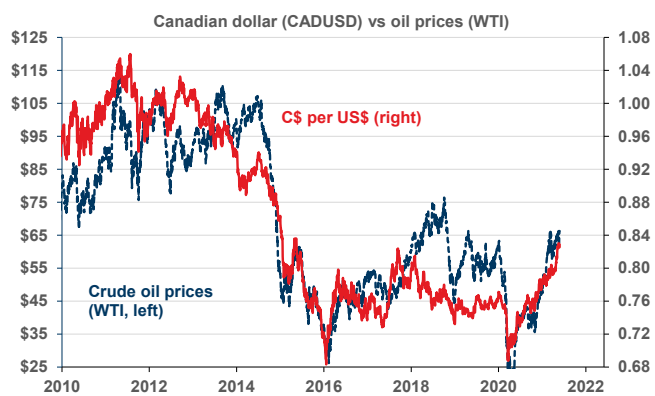


CIO Office (data via Refinitiv).

This is also the message we are getting from commodity prices, the second determining factor for the Loonie. Indeed, the weakness of several commodities, notably oil, appears to be what was holding the Loonie down for some time. Now that most commodities have risen substantially since the beginning of the year, their upward potential is no longer as compelling (Chart 19, next page).

Besides, our colleagues from NBF Economics and Strategy are projecting quarter-end targets of \$62 to

### 19 | ... provided that crude oil prices remain stable



CIO Office (data via Refinitiv).

\$65 for WTI oil prices<sup>5</sup> and \$0.82 to \$0.84 (1.22 to 1.19 USD/CAD) for the Loonie<sup>6</sup> throughout the rest of the year – not far from where we stand now.

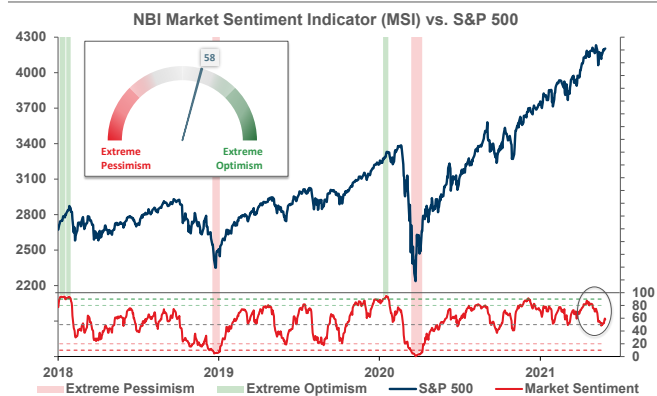
### The bottom line

Overall, our base-case scenario assuming (1) a sharp recovery in economic activity driven by a significant reduction in the constraints imposed by the pandemic, (2) strong upward pressure on prices, and (3) the maintenance of an accommodative stance by major central banks, continues to bear out. Accordingly, we are keeping our asset allocation unchanged.

As the summer progresses and some form of normalcy sets in, economic data will likely continue to produce surprises given that there is simply no precedent in modern history to provide meaningful insight to a post-pandemic world. Nonetheless, the volatility that followed the announcement of high inflation figures last month has already somewhat tempered market's optimistic sentiment (**Chart 20**), suggesting a more limited downside risk for stocks.

Going forward, the key element to watch will be the evolution of the Federal Reserve guidance in tandem with the labour market recovery. For now, bond markets appear to be standing exactly where the Fed wants them: real rates remain negative, long-term inflation expectations have recovered to

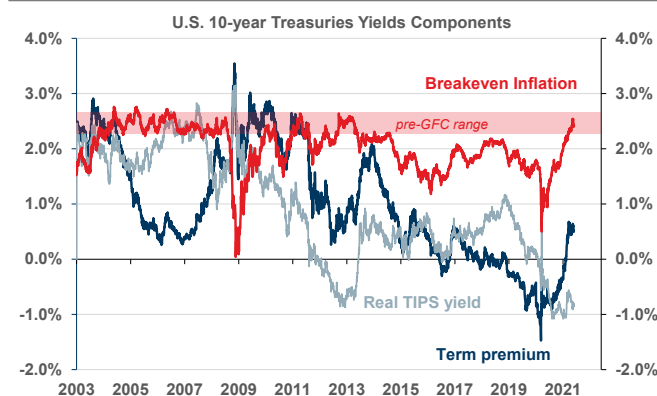
### 20 | Market optimism tempered in May



CIO Office (data via Refinitiv, Bloomberg).

levels consistent with its objective, and the term premium remains relatively low (**Chart 21**).

### 21 | The Fed could hardly ask for better



CIO Office (data via Refinitiv).

For this to remain the case, the U.S. Central Bank will have to strike the right balance between coherence, credibility, and predictability... no easy task. The next step should be to begin discussing more openly/publicly its intentions with regard to tapering its asset purchase program. Ultimately, this setting should put modest upward pressure on 10-year rates and continue to give a slight advantage to the more cyclical segments of the stock market (**Chart 22**, next page).

<sup>5</sup> Monthly Economic Monitor, May 2021, NBF Economic and Strategy

<sup>6</sup> Forex, May 2021, NBF Economics and Strategy



## 22 | Modest upside for rates and cyclical leadership



CIO Office (data via Refinitiv). \* Value/Cyclicals = Financials, Industrials, Materials, Energy, Cons. Discr.. Growth/Defensive = Technology, Staples, Healthcare, Utilities, Communication Services.

Table 3 Base Case Scenario

Scenario (prob.*)	Key elements and investment implications
<b>Base case 70%</b>	The coronavirus vaccination campaign accelerates. With the vast majority of the most-at-risk population in developed countries immune, new cases remain relatively low, pressure on the health care system eases, and mortality falls sharply. COVID-19 effectively becomes a secondary issue by early summer in the United States, and by late summer in other developed countries.
	The global cyclical recovery gathers pace. A gradual and permanent reopening of the economy leads to a rise in consumer sentiment and a sharp recovery in the service sector.
	The majority of developed countries policy makers maintain a significant level of fiscal support to businesses and consumers. In the U.S., the Biden administration works for the passage of a major infrastructure plan and moderate tax increases, in line with his campaign pledges.
	Annual inflation rises considerably, driven by a combination of base effects, strong demand and supply bottlenecks. Concerns of economic overheating and potential rate hikes grow occasionally, but central banks stay the course and keep accommodative monetary measures unchanged through the year.
	→ <b>Bond yields rise modestly while global equities continue to rise along their long-term trend. Leadership remains volatile but edge in favor of cyclical and emerging markets equities. Mega-cap stocks lag.</b>
<b>Bullish 20%</b>	A multiplication of high-efficacy vaccine alternatives speeds up the immunization process. COVID-19 effectively becomes a secondary issue by late spring in the United States.
	→ <b>Bond yields rise while the U.S. dollar depreciates. Global equities surge above their long-term trend. Small caps, cyclical, value, emerging markets and EAFE equities significantly outperform.</b>
<b>Bearish 10%</b>	Vaccination campaigns fail to outpace the rapid spread of coronavirus variants. Global growth slows down due to an increase in cases, the extension/renewal of containment measures, and weaker consumer sentiment.
	→ <b>Bond yields fall and the U.S. dollar shoots higher. Equities venture in correction territory. Leadership shifts to government and high-grade bonds. Defensive stocks outperform.</b>

CIO Office. Last update: April 1, 2021 (updated quarterly unless an event demands a revision). \*Subjective probabilities based on current market conditions and subject to change without notice.

Table 4 Global Asset Allocation - Model Portfolio Weights (in CAD)

	Benchmark		Model Portfolio				Comments
	Total	Asset Class	Total		Asset Class		
			Allocation	Active Weight	Allocation	Active Weight	
<b>Asset Classes</b>							
Cash	0%	-	0.0%	0.0%	-	-	Early in a new economic cycle, the outlook for equities compares favourably to bond markets, which are showing yields close to an all-time low. Alternatives allow for better control of the total risk of the portfolio and offers protection against a potential recovery in inflation. Overall, this positioning is pro-risk.
Fixed Income	40%	-	31.0%	-9.0%	-	-	
Equities	60%	-	64.0%	4.0%	-	-	
Alternatives	0%	-	5.0%	5.0%	-	-	
<b>Fixed Income</b>							
Government	28%	73%	17.5%	-10.5%	55%	-18.3%	Highly accommodative monetary conditions and a gradual recovery in economic activity should lead corporate bonds to outperform government securities. For risk control purposes, we are sticking to investment grade credit. Treasury yields should rise modestly as inflation expectations normalise, but we expect real yields to remain negative.
Investment Grade	12%	27%	14.5%	2.5%	45%	18.3%	
High Yield	0%	0%	0.0%	0.0%	0%	0.0%	
Duration	7.8 yrs	-	7.5 yrs	-0.3 yrs	-	-	
<b>Equities</b>							
Canada	21%	35%	22.4%	1.4%	35%	0.0%	We expect emerging markets to outperform U.S. equities under a backdrop of broad-based global growth and easy monetary policies, with a preference for cyclical and value sectors in EM (RAFI Fundamental, 3%). In the U.S., we favour the high-quality (MSCI Quality, 4% weight) dividend-paying (Div. Aristocrats, 4%) companies and the equal weight index (4%) for their diversified and cyclical properties.
United States	21%	35%	21.0%	0.0%	33%	-2.2%	
EAFE	12%	20%	12.8%	0.8%	20%	0.0%	
Emerging markets	6%	10%	7.8%	1.8%	12%	2.2%	
<b>Alternatives</b>							
Inflation Protection	0%	0%	2.0%	2.0%	40%	40.0%	The macroeconomic environment remains favourable to gold, with real interest rates likely to remain negative and the U.S. dollar to depreciate. Accordingly, TIPS should outperform their nominal counterparts, in addition to providing more direct inflation protection and little volatility. This asset mix offers low correlation with traditional assets.
Gold	0%	0%	3.0%	3.0%	60%	60.0%	
Non-Traditional FI	0%	0%	0.0%	0.0%	0%	0.0%	
Uncorrelated Strategies	0%	0%	0.0%	0.0%	0%	0.0%	
<b>Foreign Exchange</b>							
Canadian Dollar	61%	-	55.4%	-5.6%	-	-	Our overall portfolio strategy places us overweight in U.S. dollars versus our benchmark, solely through our gold position. Although our base case scenario is consistent with a slight appreciation of the Canadian dollar, we maintain this positioning solely for risk management purposes as gold in CAD offers more attractive historical properties from a portfolio construction standpoint.
U.S. Dollar	21%	-	24.0%	3.0%	-	-	
Euro	5%	-	4.9%	0.3%	-	-	
Japanese Yen	3%	-	3.3%	0.2%	-	-	
British Pound	2%	-	1.8%	0.1%	-	-	
Others	9%	-	10.7%	2.0%	-	-	

CIO Office. The fixed income benchmark is 100% FTSE Canada Universe. There are no alternative assets in the benchmark as their inclusion is conditional on improving the risk/return properties of traditional assets (60/40). The amplitude of the color bars under the "Active Weight" columns are proportional to the maximum deviations of the portfolio (+/- 10% for stocks and bonds, +10% in cash, +20% in alternative assets).

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## General

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