

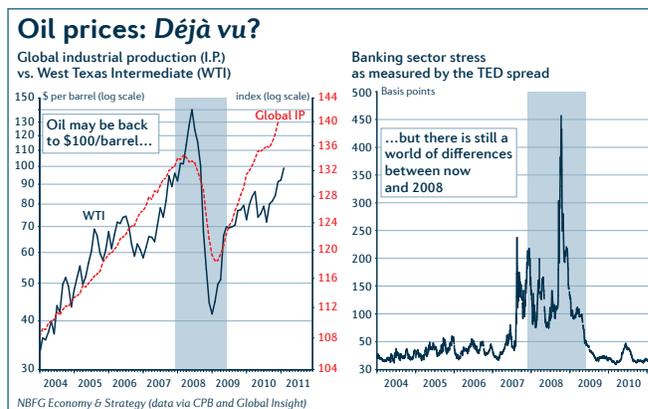
Investment Strategy

April 2011

A rise in geopolitical risks

Global equity markets have seen significant volatility over the last few weeks, ignited by rising geopolitical risks in the Middle East coupled with an earthquake, a tsunami and their disastrous consequences in northeastern Japan. In an assessment of the profit outlook for the next few months, certain questions are crucial. Where are we in the global economic cycle? What is the likelihood of an oil supply shock? When will full electric power be restored to Japanese industry? Are global credit markets still open for business (as they emphatically were not in 2008)?

Global industrial production and trade rose again in January. At this writing global exports were more than 2.5% above the peak of the previous cycle. Emerging economies remain the drivers with a double-digit surge led by Asia. January's advance brought industrial output to an all-time high. Encouragingly, the six-month change in OECD leading indicators, lethargic since early last year, has begun to perk up – a promising sign for the months ahead. Could this expansion be derailed by international events?



The risk premium incorporated in energy prices has rebounded in response to ballooning geopolitical uncertainty and military intervention in Libya. But in contrast to the 2008 oil price run-up, OPEC today has ample spare capacity – 4 million barrels a day, almost three times as much as in 2008. The International Energy Agency believes that the Libya's oil production shortfall can be offset by higher output from key gulf producers with spare capacity, led by Saudi Arabia. This implies that the recent price acceleration is unsustainable and that the threat to the global economy is likely to subside. A recent OECD study corroborates our view. The Paris-based institution says the latest rise of oil prices is unlikely to shave more than 0.2 percentage points from global GDP growth. If current energy prices are not enough to stop the expansion, what about Japan? The

In this issue ...

- Around the world: A rise in geopolitical risks* 1
- Financial Markets:** *Equities are volatile but credit markets remain tame* 2
- Japan:** *Japan's woes are unlikely to derail global expansion* 2
- Asset Mix:** *Equities – Still Our Number One Asset Class* 3
- United States:** *Employment finally perks up* 3
- Model Portfolios:** *Asset mix, geographic diversification and duration for five investor profiles* 4
- Forecast** 4

(CONTINUED ON PAGE 2)

Equities are volatile but credit markets remain tame

All major indexes have corrected significantly in recent weeks with Asian markets swinging the most. The Japanese market led the sell-off which fell as much as 18.7% from its recent peak. From a valuation perspective, however, markets remain generally well supported. The current 12-month forward P/E ratio of 13.2 for the S&P 500 is below the five-year average of 13.6. As for credit markets, it is important to note that their current state remains constructive. Rates for interbank lending in the U.S. and the euro zone have so far shown no major Japan effect on counterparty risk in the banking system. The corporate bond market also seems undaunted. Yields on

investment-grade and high-yield instruments have been relatively stable, reacting little to events in Japan and the Middle East. The yield spreads of U.S. investment-grade and high-yield corporate bonds (respectively 123.5 bps and 408 bps) remain close to cyclical lows despite the recent run-up of the 10-year Treasury yield. In fact the spreads of high-yield debt are

narrower than they were at the end of last year. In short, credit risk seems to have remained stable despite the increased volatility of equity markets. Furthermore, the effect of central bank policy on growth should not be underestimated. Global monetary policy remains highly accommodative and continues to push the reflation trade.

(CONTINUED FROM PAGE 1 "AROUND THE WORLD")

consequences will be felt over two different time spans. The initial effects are losses of production, hours worked and international trade. In short, the shock is direct for Japan but indirect for other economies, and it will be temporary. Japanese GDP may well contract for one or two quarters but will then expand with post-quake reconstruction – helping support commodity prices in the medium term. The world economy remains on track to grow about 4% this year.

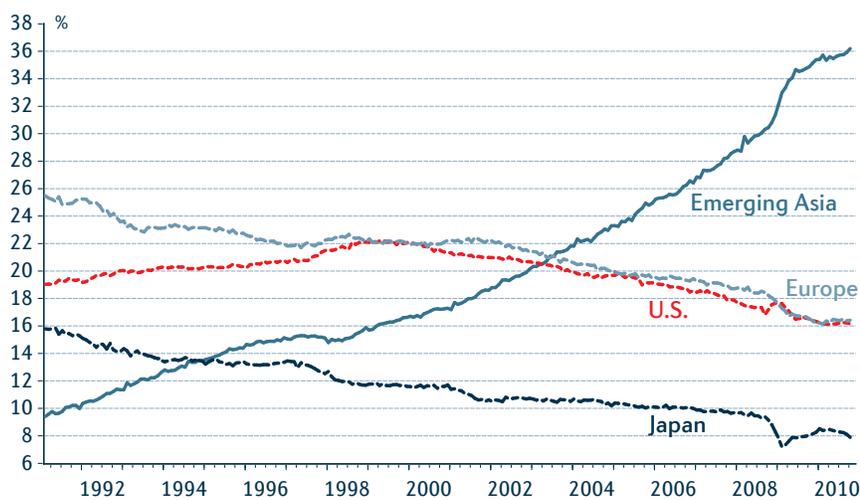
Japan's woes are unlikely to derail global expansion

There has been much discussion of the impact of the Sendai earthquake and Tsunami on the Japanese and the global economy. The most certain outcome is a drop in output in the very short term. The infrastructure damage will take time to

repair. Electric power, for example, will necessarily be rationed for at least the next few weeks as Japan struggles to replace lost nuclear generating capacity. That said, many regions have backup oil- or gas-fired generating capacity to

allow for reactor maintenance. If a nuclear worst case is averted, the potential is there for an economic rebound in the second half of the year. As idled capacity comes back on stream, expect further impetus from Japan's reconstruction effort. Its economy may very well show strong growth in its recovery from calamity. As for impact on the global economy, we think it will be marginal. According to the latest available information, the region hit directly by the tsunami accounts for about 8% of Japanese GDP, or 0.5% of global GDP. At the time of the 1995 Kobe earthquake, Japan accounted for 14% of world industrial production, almost as much as emerging Asia. Today Japan accounts for 8% and emerging Asia, unscathed by the disaster, for 36% (chart). A collapse of world trade is not in the cards.

World: Share of industrial production by region



NBF Economy & Strategy (data via Datastream and CPB)

Equities – Still Our Number One Asset Class

The global economic situation is favourable for equities. Despite a more volatile environment over the last month, the equity market is still our favoured asset class. And, even though some structural problems haven't been fixed – European and US government deficits for example –, the cyclical back-drop is improving enough for us to recommend being overweight in equities. World GDP growth is expected to reach 4% and the increase in oil price may turn out to be temporary. With a positive trend in earnings and reasonable valuation, we are confident that the Canadian, US and Global equity markets should provide positive returns on an absolute basis, and greater than those produced by cash and fixed income securities on a relative basis. Interest rates increases, if any, should be relatively modest and contained.

In term of country allocation, we still recommend to be overweight in the Canadian equity market, even though we would recommend to reduce the weighting and to take some profit. We are also overweight in the US equity market and are expecting positive returns, especially for larger growth companies that should benefit from global economic expansion. For international equities, the EAFE markets may represent the best value at this point, but with the risk associated with some sovereign debt markets, it may take some time for that value to translate into outperformance. Our long-term outlook for

developing economies remains very optimistic due to the growth of GDP that these countries will account for in the future. But because of inflationary pressures this year, some nations may be forced to implement more restrictive policies. We are more prudent for the short-term outlook.

On a sector allocation basis, we still continue to recommend overweight positions in resources and in the Canadian market. Energy stocks will benefit from the actual price of oil and from global GDP growth. Stocks in the Materials sector, including gold, should benefit from upward commodity prices and earning revisions. More defensive and interest sensitive sectors, like Consumer staples,

Utilities, Telecommunication services and Health care, should stay underweight.

In the fixed income market, while we don't expect major rate increases this year, we recommend to maintain a duration of 5.9 years, slightly shorter than the index at 6.1 years. We would retain overweight positions in provincial, corporate and high-yield bonds, but would take profits and cut back on some of our holdings, as the spreads relative to federal bonds are now tighter and offer less opportunities.

Employment finally perks up

Improving labour markets in the world's largest economy is the most positive development of the past quarter. The U.S. household survey shows more than one million jobs added in the last three months, a gain reflected in a significant decline of the unemployment rate. The 0.9-point drop in the unemployment rate over that period was the steepest since 1983 - a sign that the recovery is becoming more sustainable. This development has led the Federal Reserve to change its assessment of current economic conditions. Whereas the Fed viewed the recovery as too weak to bring a significant improvement in

labour markets last January, it now sees the economy on "stronger footing". It is comforting to see that latest surveys for the manufacturing sectors continue to echo this view. Both the New-York and Philadelphia indexes showed surprising vigour in March. The Philly Fed index actually showed the strongest current conditions since 1984. We are also encouraged by the fact that corporations are now expecting to increase investment by the largest proportion in over a decade. Animal spirit is returning. The U.S. economy is likely to expand at about 3% annualized during the first half of the year.

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%	9%	-1
Fixed-income (duration: 5.9 years) ¹	60% to 100%	70%	69%	0
Canadian equities		10%	11%	0
U.S. equities	0% to 30%	5%	6%	+1
Foreign equities		5%	5%	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%	4%	-1
Fixed-income (duration: 5.9 years) ¹	50% to 80%	60%	59%	+1
Canadian equities		20%	22%	-1
U.S. equities	20% to 45%	7,5%	8%	0
Foreign equities		7,5%	7%	+1

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%	4%	-1
Fixed-income (duration: 5.9 years) ¹	30% to 65%	45%	44%	+1
Canadian equities		25%	27%	-1
U.S. equities	30% to 65%	10%	11%	0
Foreign equities		10%	9%	+1
Alternative investments ²	0% to 15%	5%	5%	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
Fixed-income (duration: 5.9 years) ¹	25% to 45%	35%	33%	+1
Canadian equities		25%	28%	-1
U.S. equities	40% to 75%	15%	16%	-1
Foreign equities		15%	13%	+1
Alternative investments ²	0% to 20%	10%	10%	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.

Cash equivalents	0% to 30%	0%	0%	0
Fixed-income (duration: 5.9 years) ¹	0% to 30%	20%	18%	+1
Canadian equities		25%	28%	-1
U.S. equities	55% to 100%	20%	21%	-1
Foreign equities		20%	18%	+1
Alternative investments ²	0% to 25%	15%	15%	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				Rate %	March 2010		December 2011		December 2012		S&P / TSX Sector Rotation
	2009	2010	2011	2012		Canada	U.S.	Canada	U.S.	Canada	U.S.	
Gross Domestic Product %					Short-term rates (T-Bills, 91-Day)	0.91	0.08	1.97	0.72	2.73	0.72	Overweight Energy Materials
Canada	(2.5)	3.1	3.0	2.6	10-year bond yields	3.21	3.35	3.97	4.17	4.32	4.57	
U.S.	(2.6)	2.8	3.2	3.3	30-year bond yields	3.70	4.45	4.26	4.99	4.48	5.23	
Inflation %					Canadian dollar	U.S.\$1.02	U.S.\$1.01	U.S.\$1.00				Underweight Consumer Staples Health Care Telecommunication Services Utilities
Canada	0.3	1.8	2.6	2.4								
U.S.	(0.3)	1.7	2.5	2.0								

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