Building your financial future

Investment Strategy

July 2011

A Source of National Pride

Summer remains a popular time for rest and relaxation for many Canadians. For us, the season presents an opportunity to look back on recent achievements while keeping an eye on the future. In fact, just this past year, we have lots to be proud of!

For one, we are pleased to announce that National Bank Financial Group was named the strongest bank in North America and ranked third in the world by Bloomberg Markets, an internationally renowned financial information magazine, which based its rankings on the quality and stability of worldwide banks' holdings.

Another achievement worth highlighting is the Investor Education Award bestowed upon us at the Investment Funds Institute of Canada's 16th Canadian Investment Awards. This Award recognizes our excellent tools to help clients plan their retirement, focusing in particular on their quality, relevance and originality.

We're also proud to rank among Canada's 50 Best Employers once again this year. Compiled by Aon Hewitt, this prestigious list recognizes companies with exceptional work environments, and strong employee engagement practices.

These achievements are truly humbling and we owe a large part of our gratitude to you, our valued clients and investors, for choosing National Bank Financial Group as a partner of choice for all your investment needs. With our continued success, we are in a better position than ever to continue this work and create measurable wealth for you. Thank you!

We hope you'll enjoy this issue of *Investment Strategy*.

Louis Vachon
President and Chief Executive Officer
National Bank Financial Group

In this issue …

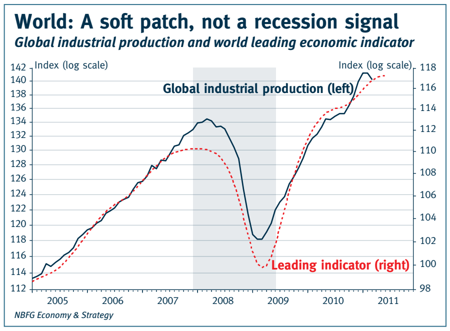
NATIONAL BANK FINANCIAL

Around the World

A pothole on the recovery road

Economic data have disappointed in recent weeks, particularly in the U.S. where the slowdown has been relatively abrupt. The index of economic surprises has moved precipitously to a level last seen in the 2008 credit crisis. Is the world's largest economy about to double-dip? We doubt it. A good part of the slowdown can be attributed to unusually severe weather and the impact on some industries of Japanese supply disruption. These are transient effects, unlikely to derail the global expansion. We expect many of the special circumstances that have affected the economy early in the year to be behind us in the second half. On the production side, supply-chain disruption will abate over time. Automotive output is projected to ramp up significantly in Q3. That would give economic growth and the labour market a considerable boost early in the second half of 2011.

In the emerging economies, monetary tightening appears to have succeeded in cooling an excessive pace of growth, at the same time easing pressure on commodity prices and inflation. At this point we think Beijing has mostly finished its financial tightening without taking the vibrancy out of the dragon economy. The result is a favourable environment in which crude prices have fallen more than 14% from the recent peak and gasoline prices have declined significantly. Even if the price of oil rises again somewhat, the decline of energy prices will still support domestic economic growth and exports will benefit from sustained expansion in foreign economies. All in all, and notwithstanding the uncertainty surrounding sovereign debt in the euro zone, global credit conditions remain accommodative, profits are still rising, businesses are investing and the threat of an oil-supply shock is waning. The OECD leading indicator of global economic activity remains consistent with world gross domestic product (GDP) growth of 4.0% this year.

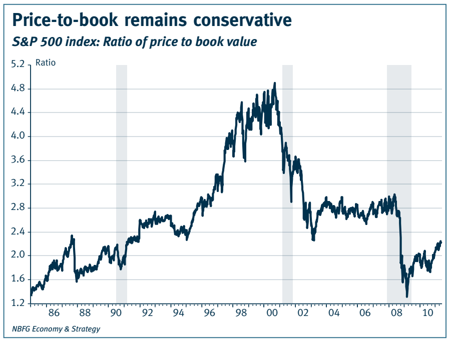


World: A soft patch, not a recession signal
Global industrial production and world leading economic indicator

Financial Markets

Uncertainty takes a toll

After jumping almost 4% early in the second quarter, global equities, as measured by the MSCI AC index (in USD), have given back all their gains and then some, and now show a negative return for the year to date. This setback reflects uncertainty about the growth prospects of the emerging economies and policy responses to the debt-management challenges facing many developed economies. The most pronounced problems at this time are those of European nations including Greece, Ireland, Portugal and Spain. In Canada, the S&P/TSX had lost all of its 2011 gains by the end of June. Weakness has been concentrated in the resource sectors, where earnings were lower than expected. On a positive note, most other major sectors of the composite index have surpassed earning expectations. Uncertainty notwithstanding, financial stress as calculated by the Federal Reserve remains well below the threshold of marked



Price-to-book remains conservative
S&P 500 index: Ratio of price to book value

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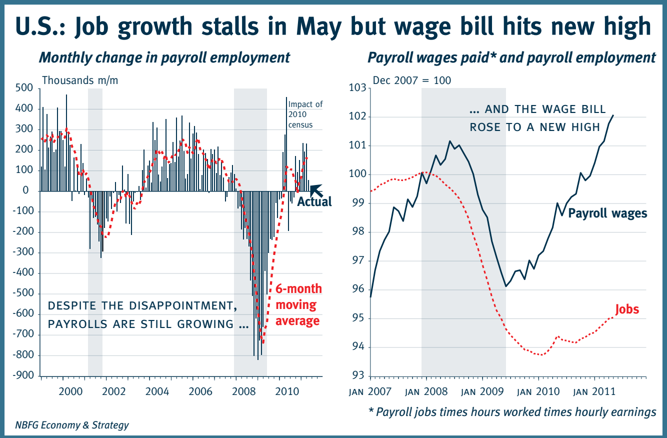
United States

Job creation decelerates

After the best four months of job creation in five years (729,000 jobs added from January through April), payroll employment undershot expectations with a gain of only 54,000 in May. This showing, the weakest since September 2010, was particularly disappointing as it came in the absence of credit market stress and in the wake of robust increases in corporate profits. We will need more data to gauge whether a worsening of this soft patch will derail our call of GDP reacceleration in the second half of the year. It should be kept in mind that in an economic recov-



U.S.: Job growth stalls in May but wage bill hits new high

Equities – Fundamentals *vs* Technical Analysis

Most stock markets around the world lost ground in the second quarter, with Energy stocks falling the most. Plunging gold and silver prices also had an adverse impact on Materials results. Persistent uncertainty concerning European sovereign debt, the fallout of the earthquake in Japan and an economic slowdown in the United States also contributed to the downturn. Equities remain the asset class of choice for the next quarter. Although we are currently witnessing a mid-cycle slowdown in economic growth, a double-dip does not appear to be in the cards. Equities remain an attractive asset class in the long term, as their fundamentals are favourable.

The weighting of Canadian equities was reduced in favour of international stocks, due to the decline in Commodity prices. International equities remain underweighted however, as sovereign debt problems continue to plague Europe.

We prefer to increase the weighting in cash for the coming months, combined with a more defensive stance in equities, following the current market correction and resulting uncertainty with regards to its duration.

We continue to maintain an underweight in fixed-income securities. A shorter duration is preferred, given that a decline in rates seems relatively unlikely. Central banks should hold steady on their current rates due to lacklustre economic figures. Only a potential for a new recession could justify a more substantial decline in the rate curve. At home, markets appear to be forecasting late-year rate hikes from the Bank of Canada. Federal bonds continue to be underweighted to the same extent as the previous quarter. The consensus is to maintain the overweight in provincial, corporate and high-yield bonds. Spreads are at attractive levels, all the more since they recently nudged upward. For investors seeking more lucrative returns, high-yield bonds remain an attractive solution in the fixed-income universe.

(CONTINUED FROM PAGE 2 "FINANCIAL MARKET")

deterioration of the economy. In fact, S&P/TSX and S&P 500 earnings revisions show momentum exceeding the historical average. At this juncture, it is worth noting that the correction of equity markets has not been accompanied by the kind of volatility that would suggest investor capitulation on the outlook for the economy and profits. Profit growth coupled with reasonable valuations, healthy balance sheets and an S&P/TSX dividend yield in excess of 2.5% (2% for the S&P 500) remains supportive of North American equity markets. In the U.S. market, the ratio of price to book value is currently at the low end of its 20-year range. In the bond market, an improving economy and the end of quantitative easing in the U.S. is likely to translate into slightly higher yields in the months ahead.

ery it is not unusual for a few good months of job creation to be followed by weaker ones. The key is to avoid losses (such as those that occurred last year). At this point, we remain comforted by aggregate wages paid in the U.S., which rose a very respectable 0.3% in May to a new record (chart). This is the key to sustained consumption going forward.

Surprising resilience

Canadian economic indicators have held up surprisingly well in recent weeks. Real GDP grew at 3.9% annualized in Q1, more than twice the U.S. rate of 1.8%. Encouragingly, the growth mix was less skewed than in previous quarters as business investment and exports took over from consumer spending. The very strong increase in nominal GDP (8.7% in Q1 after a rise of 9.3% in Q4) helped propel profits to a new cyclical high. The strong performance of the Canadian economy is confirmed in the labour market. More than 140,000 full-time jobs have been created in the past three months and seven of the ten provinces show record employment levels. Though growth is likely to slow in Q2, we expect a reacceleration in the second half of the year. For 2011 as a whole we anticipate a Canadian economic expansion of 2.9%, the strongest in the G7. With spare capacity dwindling and inflation accelerating, the Bank of Canada has announced that the considerable monetary stimulus currently in place will eventually be withdrawn.

Canada: A new high in full-time employment

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%	11%	+ 2
Fixed-income (duration: 5.9 years) [1]	60% to 100%	70%	68%	– 1
Canadian equities		10%	10%	– 1
U.S. equities	0% to 30%	5%	6%	0
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.

Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Cash equivalents	0% to 15%	5%	6%	+ 2
Fixed-income (duration: 5.9 years) [1]	50% to 80%	60%	58%	– 1
Canadian equities		20%	21%	– 1
U.S. equities	20% to 45%	7,5%	8%	0
Foreign equities		7,5%	7%	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%	6%	+ 2
Fixed-income (duration: 5.9 years) [1]	30% to 65%	45%	43%	– 1
Canadian equities		25%	26%	– 1
U.S. equities	30% to 65%	10%	11%	0
Foreign equities		10%	9%	0
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.

Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Cash equivalents	0% to 25%	0%	1%	+ 1
Fixed-income (duration: 5.9 years) [1]	25% to 45%	35%	33%	0
Canadian equities		25%	26%	– 2
U.S. equities	40% to 75%	15%	16%	0
Foreign equities		15%	14%	+ 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.

Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
Cash equivalents	0% to 30%	0%	1%	+ 1
Fixed-income (duration: 5.9 years) [1]	0% to 30%	20%	18%	0
Canadian equities		25%	26%	– 2
U.S. equities	55% to 100%	20%	21%	0
Foreign equities		20%	19%	+ 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

			Forecast	
	2009	2010	2011	2012
Gross Domestic Product %				
Canada	(2.5)	3.1	2.9	2.5
U.S.	(2.6)	2.8	2.6	3.2
Inflation %				
Canada	0.3	1.8	3.1	2.6
U.S.	(0.3)	1.7	2.9	2.1

	June 2011		December 2011		December 2012	
Rate %	Canada	U.S.	Canada	U.S.	Canada	U.S.
Short-term rates (T-Bills, 91-Day)	0.98	0.05	1.75	0.72	2.44	1.96
10-year bond yields	3.07	3.10	3.75	4.03	4.22	4.48
30-year bond yields	3.51	4.30	4.16	4.95	4.41	5.22
Canadian dollar	U.S.$1.02		U.S.$1.02		U.S.$1.00	

S&P / TSX Sector Rotation

Overweight

Industrials
Materials

Underweight

Consumer Staples
Telecommunication Services
Utilities

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