Building your financial future

Investment Strategy

June 2013

In this issue

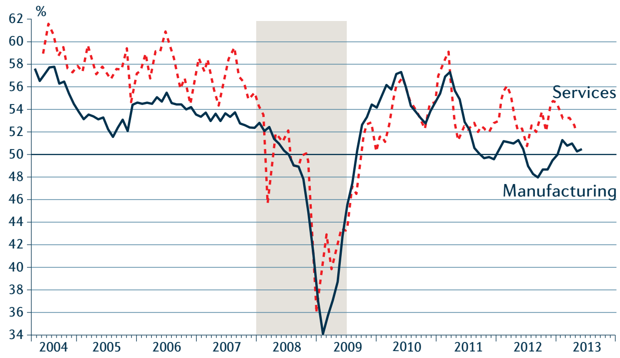
Around the World

Global Economy

Global economic growth remains unimpressive so far in 2013. The euro zone is mired in recession, China is in transition to a more domestic-led model of economic growth and the U.S. is feeling drag from higher taxes and federal government spending cuts. On the other hand, the outlook for Japan has turned distinctly sunnier. The new prime minister has vowed to break the country's deflationary spiral through structural reforms and the Bank of Japan has launched unprecedented monetary stimulus. The country's GDP expanded at an annual pace of 3.5% in Q1, its best quarter in a year. Meanwhile, central banks in Southeast Asia and Europe have reduced interest rates in recent weeks and some euro countries have been given permission to delay their austerity programs. These developments should help revive the global economy in the coming months. All told, world GDP growth is on track to meet our forecast of just over 3% this year.

Unimpressive economic growth

JP Morgan Global PMI



NBF Economy & Strategy (data via Bloomberg)

Financial Markets

Financial Markets

Many of the world's major equity benchmarks have posted stellar returns so far in 2013. At the end of May the MSCI global index was up 13.2% from the beginning of the year. The S&P 500 was up an even stronger 14.3%, its best first five months of the year since 1997. The Asia-Pacific index has done well on the back of strong monetary stimulus in Japan, and the main European bourses continue to trend up. With credit markets functioning well in most markets, the current backdrop is one of low financial stress. An improving growth outlook has recently sent the yield of 10-year U.S. Treasuries up about 50 basis points to more than 2.1%. Much of the rise has been due to fear that the Fed will announce an imminent tapering of quantitative easing (QE). While we too expect such an announcement, we doubt it will come before September. Absent continued disinflation and external shocks, we think the path of least resistance for bond yields will be to drift closer to 3% in the coming months as the Fed begins disengaging from QE3. That would leave interest rates still low enough to keep the U.S. recovery on track. The two most recent episodes in which the 10-year bond yield approached 3% (early 2009 and 2011) were characterized by a lacklustre labour market and home-price deflation. These conditions no longer apply. In fact the continued improvement of loan performance at U.S. commercial banks – delinquency rates on commercial & industrial (C&I) and consumer loans have fallen to historical lows – argues for more vigorous lending and stronger GDP growth in the second half of 2013. The U.S. economy seems healthy enough to put aside its QE crutches.

National Bank Financial: ranked first among Canadian financial institutions for Canadian dollar currency forecasts according to *Bloomberg's Foreign Exchange Forecast Center*.

NATIONAL BANK FINANCIAL
WEALTH MANAGEMENT

Investment strategy

Global equity markets continued to grow at a good pace in the second quarter as major central banks around the world pursued their reflation efforts. Beyond the U.S. Federal Reserve, which has kept its bond purchases to $85 billion per month, the Bank of Japan has embarked on an aggressive program of quantitative easing to boost its economy, and the European Central Bank has reduced its key interest rate to a historic low. These measures have been particularly beneficial to the Japanese and U.S. markets where year-to-date returns were respectively close to 25% and 16% in U.S. dollars in mid-May. Since then, however, the markets have entered a phase of consolidation as investors have started to question the Fed's willingness to do even more.

In our opinion, this adjustment period, which will clear some of the market excesses after a rapid rise in stock prices, looks temporary. Although economic growth remains disappointing and fiscal austerity measures still raise concerns, it seems that things are about to improve in the second half of the year in the United States. It must be said that the rebound of the U.S. housing market and increased energy production are very promising and should allow economic activity to accelerate.

In this context, we have taken this opportunity to enhance our equity overweight. Considering that the U.S. market will continue to take leadership in the very short term, we increased the portfolio weight of the United States about two percentage points by lowering the weight of fixed income securities. The reversal of the cyclical sectors to more defensive ones should be beneficial to the Canadian market by the end of the year. However, the vitality of the U.S. dollar against all currencies will continue to have a negative impact on commodity prices, which will persist as long as China does not accelerate its stimulus measures.

In terms of fixed income, bond yields are expected to remain on a slightly upward trend while the continuous improvement of the labour market in the United States could lead the Federal Reserve to slow the pace of its bond purchases. Therefore, the risks to bondholders have become asymmetrical given that the benchmark duration, i.e. the price sensitivity of a bond to a small rise in interest rates, is much too high compared with the yield to maturity. 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 will allow some protection in the event of a gradual rise of interest rates.

For this time only, the economic information on the U.S. and Canadian markets will be available only on our website, at **nbfwm.ca** (Financial information > Financial publications > Investment Strategy).

Fine-tuning our model portfolios

The last page of *Investment Strategy* provides the recommended asset mixes for five model portfolios that correspond to our five investor profiles. In addition to a brief description of each profile, you will find the minimum and maximum weighting for each asset class, which shows the latitude our strategists have in adjusting the portfolios for different market conditions. We provide benchmark asset weightings for each portfolio that we think represent the best compromise between expected return and risk under neutral market conditions. In other words, these benchmark asset mixes communicate our vision of the optimal portfolio structure for our five investor profiles. This vision does not change often, since we believe that successful investment outcomes result from adopting a long-term approach.

On a regular basis, our strategists suggest small shifts in asset mix to better position these model portfolios for the market conditions they anticipate. Found in the Recommended Weighting column, this information represents a tactical call, since it reflects adjustments we think will allow you to capitalize on short-term market opportunities or to reduce market risk if a correction is anticipated.

Much less frequently, we make more fundamental changes to our model portfolios that are strategic in nature since they adjust for the "big picture" shifts we see taking place in capital markets. We may modify how we define an asset class or the benchmark weighting we give to it. From time to time we also alter the maximums and minimums for each asset class, or even add new asset classes. As explained below, in addition to our regular tactical call, this quarter we have redefined two of our reference indices and increased our exposure to the Alternative Investment asset class.

Changes to our Fixed Income reference index

We have decided to remove the 25% real return bond component from our Fixed Income reference index, which means that it is now 100% composed of Canadian DEX Universe Bonds. While exposure to real return bonds has served us well in the past, issuers have largely ceased coming to market with this type of security, and we don't see this changing any time soon. We have concluded that, going forward, there is little point to including a category of securities in our benchmark that is increasingly difficult to purchase.

Alternative Assets: Change to the reference index, inclusion in all model portfolios

While we believe the next major move for interest rates will be upward, we nonetheless expect to be in a relatively low interest rate environment for some time to come. This gives us ample reason to look more carefully to non-traditional or "alternative" assets as a tool for providing better protection against inflation and low or rising interest rates. As a result of this analysis, we are making changes to our reference index for Alternative Assets and will begin including them in our Conservative and Income model portfolios as well.

In the past, our reference index for Alternative Investments was a 50/50 blend of the Tremont Hedge Fund Index and the S&P/TSX Capped Real Estate Investment Trust Index. We will now be adding commodities and infrastructure to this reference index to better reflect the universe of investment opportunities that offer good inflation protection and a low degree of correlation with traditional securities. Our new Alternative Investment reference index will be composed as follows: 1/3 hedge funds, 1/3 commodities and 1/3 real estate, the latter being separated equally between REITs and infrastructure.

Alternative Investments have been part of our Balanced, Growth and Maximum Growth model portfolios for almost two decades. Given the low interest rate environment we are operating in, we think the time has come to add this asset class to our Income and Conservative model portfolios as well. At the same time, we are slightly increasing our Alternative Investments exposure for our three other model portfolios. In each case, we have reduced the weightings of Cash Equivalents and Fixed Income to compensate, because we expect little in the way of return in these asset classes.

How do these changes impact you?

As mentioned above, the change to our Fixed Income reference index is a bit of a non-event since it has been difficult to purchase real return bonds recently, and the DEX Universe is the standard benchmark for individual and institutional investors for this asset class. The increased focus on Alternative Investments sends a strong message that NBF Wealth Management feels they will play an increasingly important role in managing risk and enhancing returns going forward. These changes give your Investment Advisor a broader spectrum of investment vehicles to help you diversify and optimize your portfolios. While the universe of Alternative Investment vehicles available to individual investors is still limited, it is growing and we will be focusing our attention on exploring ways of including this asset class in our clients' portfolios.

Should you have any questions regarding the above, we invite you to contact your Investment Advisor.

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%	-2.0%
Fixed-income (duration: 5.7 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%	2.0%
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%	-2.0%
Fixed-income (duration: 5.7 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%	2.0%
Foreign equities		7.5%	8.0%	0.0%
Alternative investments[2]	0% to 15%	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%	-3.0%
Fixed-income (duration: 5.7 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%	3.0%
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: 5.7 years)[1]	25% to 45%	35.0%	28.5%	-2.0%
Canadian equities		25.0%	26.0%	-1.0%
U.S. equities	40% to 75%	15.0%	20.0%	3.0%
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: 5.7 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) Dex Universe Index
2) Includes Hedge funds, Global real estate and Infrastructure, and Commodities

Forecast

			Forecast	
	2011	2012	2013	2014
Gross Domestic Product %				
Canada	2.5	1.7	1.5	2.2
U.S.	1.8	2.2	1.8	2.7
Inflation %				
Canada	2.9	1.5	1.0	1.6
U.S.	3.1	2.1	1.3	1.8

	June 2013		December 2013		December 2014	
	Canada	U.S.	Canada	U.S.	Canada	U.S.
Rate %						
Short-term rates (T-Bills, 91-Day)	0.95	0.08	0.98	0.09	1.21	0.11
10-year bond yields	2.03	2.06	2.65	2.73	3.28	3.19
30-year bond yields	2.63	3.23	3.16	3.81	3.58	4.06
Canadian dollar	U.S.$0.96		U.S.$0.94		U.S.$1.01	

National Bank Financial is an indirect wholly-owned subsidiary of National Bank of Canada which is a public company listed on the Toronto Stock Exchange (NA: TSX). The particulars contained herein were obtained from sources we believe to be reliable, but are not guaranteed by us and may be incomplete. The opinions expressed are based upon our analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein. National Bank Financial may act as financial advisor, fiscal agent or underwriter for certain companies mentioned herein and may receive remuneration for its services. National Bank Financial and/or its officers, directors, representatives or associates may have a position in the securities mentioned herein and may make purchases and/or sales of these securities from time to time on the open market or otherwise.

CIPF Canadian Investor Protection Fund MEMBER

FPO