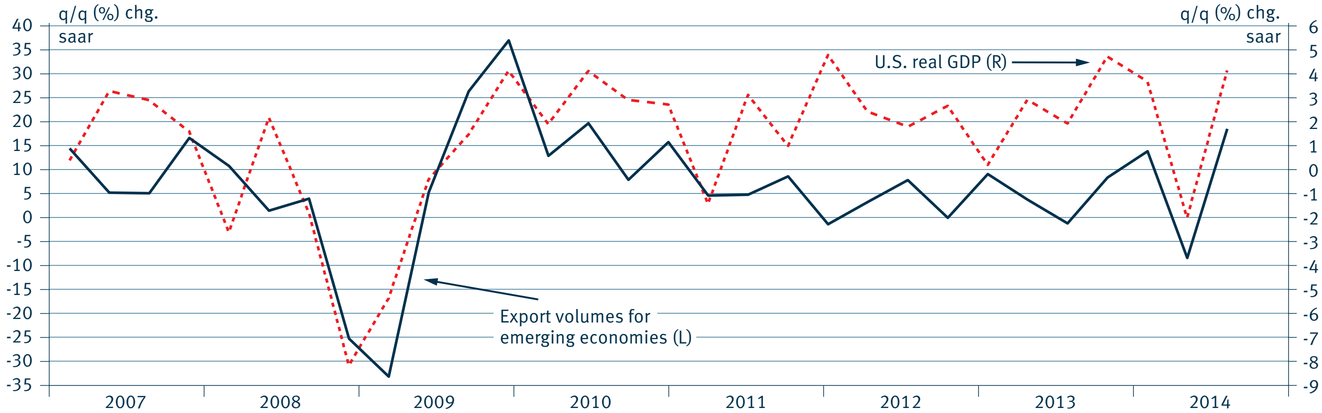
Investment Strategy

Global Economy

A disappointing first half of 2014 for the global economy is set to be followed by a better second half. Despite the continued stagnation of the eurozone, advanced economies as a group should do better, thanks to the combination of a stronger U.S. economy and monetary policy easing in Europe and Japan. In the emerging world, we take comfort from China's low CPI inflation, which should allow policy-makers to ease the grip of their monetary and fiscal tightening. China still has a lot going for it. Despite the crackdown on shadow banking, the People's Bank of China has kept monetary policy accommodative via low interest rates and lower reserve requirements intended to assist small business financing. The central government is also ramping up infrastructure spending to deliver on its plan to increase the urbanization rate, something that should further stimulate growth. The export sector is also stabilizing, as exporters seem to have adjusted to the stronger yuan. All told, despite the headwinds, China has enough momentum to remain the world's fastest growing major economy for another few years, helped by relatively low inflation. We remain comfortable with our forecast of 3.3% for global growth this year. For 2015, we continue to aim for global growth around 3.8%.

World: U.S. rebound bodes well for emerging economies

Emerging economies' exports versus U.S. real GDP



NBF Economics and Strategy (data via CPB, Datastream)

In this issue

NATIONAL BANK FINANCIAL
WEALTH MANAGEMENT

Financial Markets

Global equities are on track for a ninth straight quarter of gains, the longest such run since 1995–96. The MSCI All Country World Index has been posting record highs. Emerging markets, which were a cause for concern early in the year, have been doing particularly well since mid-year. An analysis of the year-to-date advance of global equities shows a substantial contribution from earnings improvement. In Canada, where the announcements season for second-quarter earnings is drawing to a close, profits have been more than satisfactory. Expectations were high, but the results beat them: Earnings were up 21% from a year earlier. With central bankers in no hurry to push their respective policy rates higher because of low inflation, the earnings outlook will continue to benefit from generally favourable conditions.

World: Profitability is improving

Trailing earnings for the MSCI World AC index

NBF Economics and Strategy (data via Datastream)

Investment Strategy

The summer months were marked by an increase in volatility, which led to a decline in risk assets at the end of July and beginning of August. It must be said that the stars were aligned with the combination of simultaneous geopolitical crises in Iraq, Syria, Ukraine and Gaza, the collapse of the Portuguese bank Espírito Santo and the default of Argentina on its sovereign debt. Overall, however, this correction was very short, and several indices crossed important psychological milestones to establish new highs. This is the case for U.S. indices, with the S&P 500 reaching 2,000 points for the first time in its history, and the Toronto stock index, which stayed above 15,000 points, well beyond its 2008 peak. In Europe, the correction was a bit more pronounced because of the closer links to the conflict in Ukraine, notably through the supply of natural gas to Germany. The weakening of the euro and the possibility of the European Central Bank (ECB)'s bond purchase program in the fall should, however, allow stock markets to quickly make up lost ground.

For the last three months of the year, we continue to capitalize on low interest rates, excessive liquidity and the acceleration of economic activity: The perfect cocktail for risk assets. At this stage of the economic cycle, we must not be distracted by the record levels of the main indices because the important thing is not the price you pay, but what you get for your money. Today, the S&P 500 is trading at 15 times the expected earnings of American companies, which is in line with the historical average. In short, while it is not a bargain, the market is not expensive either, and, as long as earnings growth is present, it may continue to advance. Thus, unless there is an escalation of tensions in Ukraine, forward earnings growth indicate that stocks are the asset class that has the best expected return in the short to medium term.

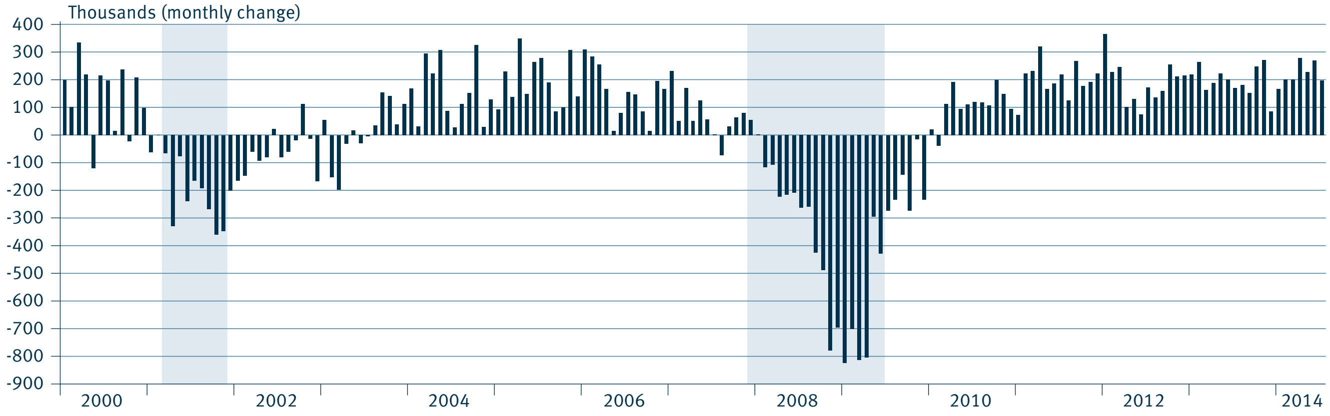
As for fixed income, we were surprised by the weakness of interest rates and the yields recorded by benchmark bonds since the beginning of the year. Nonetheless, the fact remains that the lower rates get, the less future expected returns will be. Without a shock to the financial system or an economic downturn, rates can hardly fall further, which suggests that the real yield of a government bond – that is, once you take inflation into account – could be negative for bondholders. In the short term, North American yields will remain depressed, due to downward pressure from European rates. However, in the context where the improvement of the American economy will force the Federal Reserve to gradually tighten its monetary policy, the risks seem more oriented towards a rise in interest rates.

United States

After a dismal start to the New Year, economic activity rebounded strongly in Q2 with a 4.2% increase in real GDP. Importantly, the indicators suggest continuing expansion. The Conference Board's Leading Economic Indicator (LEI) jumped 0.9% in July, with most of the gain concentrated in the non-financial components of the index. This is very good news because it implies that monetary policy is finally gaining traction in the real economy where labour markets have improved markedly. Non-farm payrolls grew over 200,000 for the sixth consecutive month in July, the best sequence since 2006. Better employment prospects, a relatively low debt burden (after the deleveraging during the recession) and the persistence of low interest rates should help lift borrowing and keep the economy growing at a relatively brisk pace over the coming months. This development is confirmed by increased lending at U.S. commercial banks, where loans and leases have grown notably in recent months. Releveraging by both households and businesses is a necessary condition for above-potential economic growth in the coming quarters, which is in turn a condition for achievement of earnings expectations. With robust job creation and household balance sheets largely restored, we think this scenario is on track.

U.S.: Robust labour markets

Private payroll employment



NBF Economics and Strategy (data via BLS)

Canada

Canada's GDP grew a consensus-topping 3.1% annualized in the second quarter of 2014. Domestic demand was very strong despite the soft business investment spending (the only disappointment from the report), and that was complemented by a solid performance from trade. Adding to the good news was the drag from inventories, a positive for production in the second half of the year. All in all, Canada grew at double the pace of the U.S. in the first half of 2014, i.e., 2% annualized versus 1%. It's unclear if domestic demand can maintain the pace over the rest of the year, as housing softens and debt-burdened households cap consumption spending. However, buoyed by solid corporate profits, business investment spending should be able to provide some offset over the rest of the year. Trade should also be well supported by the U.S. economy's resurgence. We remain comfortable with our 2014 growth forecast of 2.3%.

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 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: 5.25 years)[1]	60% to 100%	70.0%	66.0%	0.0%
Canadian equities	0% to 30%	7.5%	9.0%	0.0%
US equities		7.5%	11.5%	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: 5.25 years)[1]	45% to 80%	55.0%	51.0%	0.0%
Canadian equities	20% to 45%	14.0%	16.0%	0.0%
US equities		14.0%	17.5%	0.0%
Foreign equities		7.0%	7.5%	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: 5.25 years)[1]	30% to 65%	40.0%	36.0%	0.0%
Canadian equities	30% to 65%	17.5%	19.5%	0.0%
US equities		17.5%	22.5%	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: 5.25 years)[1]	25% to 45%	35.0%	28.5%	0.0%
Canadian equities	40% to 75%	20.0%	21.0%	0.0%
US equities		20.0%	25.0%	0.0%
Foreign equities		15.0%	15.5%	0.0%
Alternative investments[2]	0% to 25%	10.0%	10.0%	0.0%

Maximum Growth Portfolio

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 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: 5.25 years)[1]	0% to 30%	20.0%	12.0%	0.0%
Canadian equities	55% to 100%	22.5%	24.5%	0.0%
US equities		22.5%	28.0%	0.0%
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

	2012	2013	2014 (Forecast)	2015 (Forecast)
Gross Domestic Product %				
Canada	1.7	2.0	2.3	2.5
US	2.3	2.2	2.0	2.8
Inflation %				
Canada	1.5	0.9	2.0	2.0
US	2.1	1.5	1.9	2.1

	September 2014		December 2014		December 2015	
	Canada	US	Canada	US	Canada	US
Rate %						
Short-term rates (T-Bills, 91-Day)	0.96	0.03	0.96	0.03	1.96	1.36
10-year bond yields	2.31	2.54	2.47	2.73	3.30	3.37
30-year bond yields	2.86	3.33	2.96	3.45	3.64	3.93
Canadian dollar	US $0.92		US $0.92		US $0.89	