

Investment Strategy

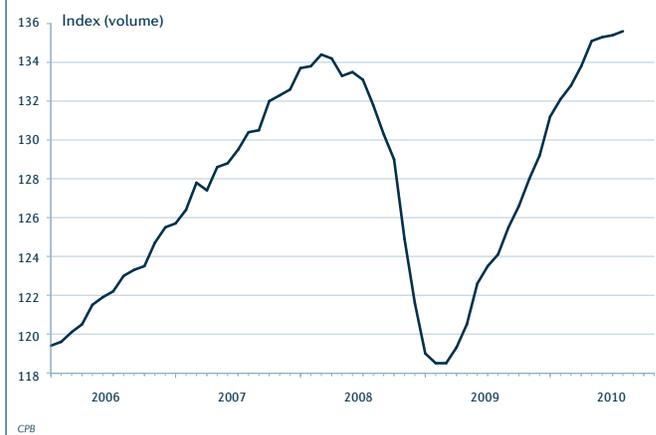
January 2011

From recovery to expansion

Over the past couple of months we have seen a wave of amelioration in key issues of global economic growth. Among the improvements are the recent alignment of U.S. monetary and fiscal policy to stimulate the economy, a perception that the Euro Zone has the ability and political will to contain its debt problems – at least in the medium term – and key economic indicators supporting solid global prospects for 2011. International trade and global industrial output are in expansion, which is to say they have topped their pre-recession levels. On the whole, global monetary policy, as measured by real short-term interest rates, remains just as accommodating as it was at the height of the 2008 financial crisis. Moreover, although some countries have begun to normalize policy, either by hiking key rates or by raising bank reserve ratios, their monetary stances are unlikely to cross into the restrictive zone over the next year. All this explains why consumption in these countries has bounced back with such vigour from the 2008 recession.

In our baseline scenario, the world economy is headed for expansion in the vicinity of 3.7% in 2011, a rate equal to the long-term average. In other words, growth is likely to come in for a soft landing next year after

Global industrial output



soaring to nearly 5% in 2010. The decoupling in this regard between emerging and developed economies can be expected to persist in the absence of more restrictive monetary policy in the former and the presence of more restrictive fiscal policy in the latter. In this scenario, commodity prices will remain buoyant, at least in 2011, especially in light of the strong likelihood of U.S.-dollar depreciation.

Sovereign debt remains a risk going into 2011. A shock from Europe to the global economy is more likely to occur through a financial channel with contagious effects on North American markets than through second-round effects on the real economy. In this regard, risk premiums on U.S. interbank rates are muted at this writing and the corporate bond market has not shown undue weakness. The cost of capital is holding at historically low levels.

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Policy aligned for a positive year

The past year has been challenging for investors. Financial markets around the world have had to grapple with significant headwinds. Among these have been global political stresses generating increased fears of protectionism, sovereign debt crises, ecological disasters, rising geopolitical tensions and lack of vigour in some key developed economies. In this environment, investors have had to be very sensitive to the prevailing risks, especially with the impact of the 2008 financial crisis still so fresh in everyone's minds. However, though many of these risks are still with us in one form or another, in the last couple of months we have seen a number of improvements on issues that are of key importance for global economic growth.

In our view, the stability of liquidity conditions in the interbank market over the past year, especially in periods of increased risk of European debt default, is a very posi-



tive sign. Despite the recent run-up in bond yields, we doubt that economic growth is threatened. We interpret this development as a repricing of U.S. growth expectations in response to fiscal stimulus that turned out more generous than expected. This view is corroborated

by the continued strength of global equity markets. As we see it, the rise in bond yields has been more than offset by double-digit increases in stock market indexes, which should lead to an overall easing of financial

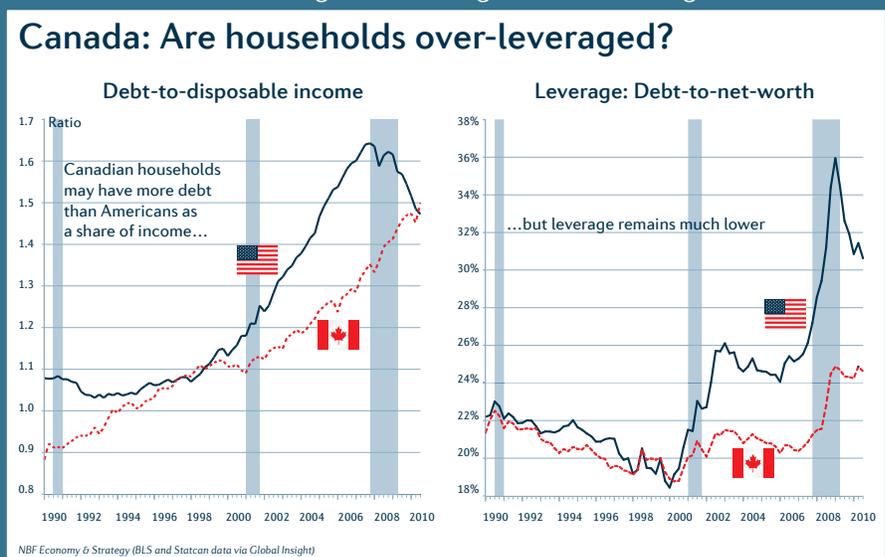
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Rising indebtedness

With the economy in expansion, the labour market strong and interest rates low, the homeownership rate hit a record high in 2010. As a result, Canadian households have taken on more debt. Their ratio of debt to disposable income rose to a record 1.5 at the end of September – just above that of Americans. While Canadians' growing indebtedness does warrant scrutiny from our monetary and fiscal authorities, we doubt that it jeopardizes economic expansion. Though households are more vulnerable to a rise in interest rates, most mortgages are at fixed rates. Also, since mortgage interest on personal residences and vacation properties is not tax-deductible in Canada,

households tend to hold much more equity in their homes than Americans do. As a result, though Canadian households have a higher ratio

of debt to income than Americans, their ratio of debt to net-worth is lower. By this measure their leverage is less alarming.



Equities – Our Favored Asset Class

After adopting an overweight position in stocks in June 2009, as a precaution we moved to a more neutral stance earlier in 2010 as the European sovereign debt crisis storm began brewing. While economic tensions still abound on the other side of the Atlantic, the positive signs we see emanating from around the world have prompted us to return to an overweight position in equities (common stocks, equity mutual funds and equity-based ETFs). Bolstering this appetite for stocks is our pessimistic outlook for the expected returns offered by the two other main asset classes – cash equivalents and fixed-income securities. Nothing on the horizon leads us to think that short-term money will be offering a positive return after the impact of taxes and inflation anytime soon. And the fact that the next major move in interest rates is much more likely to be upward than downward leads us to maintain our prudent stance with regard to bonds.

In terms of country allocation, our preferences have not changed materially over the last few quarters. Our long-term outlook for emerg-

ing markets remains very positive due to the ever increasing share of global GDP that these nations will account for going forward. However, while remaining overweight, we have trimmed our exposure to this asset class slightly because of the sheer volume of speculative capital that has been chasing after opportunities in these markets. We remain cautious when it comes to Europe in light of the potential for volatility while the credit crisis gripping parts of the Euro Zone is resolved, but we have reduced our underweight in this area compared to previous quarters, because the picture is slowly improving. As a leading supplier of the raw materials needed to fuel global economic growth, Canada remains our favourite developed stock market at the moment. And with the tax cut deal eliminating a major element of uncertainty south of the border, we also have a slight overweight position in U.S. equities.

Our sector allocation continues to be heavily tilted towards resources. Energy stocks should benefit from a global economy that is slowly but surely shifting from recovery

to expansion, and from the strong growth we expect from the less developed countries, many of which are net importers of oil and gas. We favour Materials, and the flurry of upward earnings revisions we have seen in this area increases our comfort with this overweight position. Within the Materials sector we particularly like gold stocks since we expect the price of bullion to remain buoyant for an extended period. The sectors we are underweight at this point are Utilities, Telecommunication Services and Consumer Staples.

With regard to fixed income, while we don't expect major rate hikes in the near future, we are maintaining a duration of 5.4 years - slightly shorter than the benchmark index. In this low interest rate environment, we continue to think that spreads drive the strategy. Consequently, we remain underweight federal bonds, although slightly less than in the previous quarters. We retain our overweight positions in corporate, high yield and provincial bonds, although we have cut back on our provincial holdings slightly.

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conditions. The outlook for earnings, already promising, can only benefit.

Profits are set to post another double-digit gain in both Canada and the U.S. in the coming year. The expansion of the price/earnings ratio has been muted despite the very strong showing of equity markets in recent months. Interest rates are set to drift higher in 2011, but more slowly than in recent weeks. We do not expect bond yields to become a major drag on growth.

More stimulus from Washington

The vote by Congress to extend all of the Bush-era tax cuts has lifted a huge weight from a fragile U.S. economy. This move eliminates an apprehended drag on the economy from tighter fiscal policy in 2011. In addition to a two-year extension of the Bush-era tax cuts, the plan provides a 13-month extension of emergency employment benefits, a one-year reduction of payroll taxes and an accelerated-depreciation incentive for business investment. These measures introduced over and above the tax-cut extension are likely to add approximately

0.5 percentage points to U.S. real GDP growth next year. From a practical perspective, the package removes the uncertainty that had been weighing on households and businesses about their disposable income over the next two years. It also takes pressure off the Federal Reserve, which had been doing all it could to stimulate the economy. On December 13, the Fed launched its quantitative easing program which had been announced in November. In the first month it bought close to \$75 billion in assets out of the projected total of \$600 billion.

Income Portfolio

	Asset Class	Minimum/Maximum	Benchmark	Recommended Weighting	Change from Previous Quarter
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.	Cash equivalents	0% to 20%	10%	10%	0
	Fixed-income (duration: 5.4 years) ¹	60% to 100%	70%	69%	0
	Canadian equities		10%	11%	0
	U.S. equities	0% to 30%	5%	5%	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.	Cash equivalents	0% to 15%	5%	5%	0
	Fixed-income (duration: 5.4 years) ¹	50% to 80%	60%	58%	-2
	Canadian equities		20%	23%	+1
	U.S. equities	20% to 45%	7,5%	8%	0
	Foreign equities		7,5%	6%	+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%	5%	-1
	Fixed-income (duration: 5.4 years) ¹	30% to 65%	45%	43%	-2
	Canadian equities		25%	28%	+1
	U.S. equities	30% to 65%	10%	11%	0
	Foreign equities		10%	8%	+2
	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%	-2
	Fixed-income (duration: 5.4 years) ¹	25% to 45%	35%	32%	-1
	Canadian equities		25%	29%	+1
	U.S. equities	40% to 75%	15%	17%	0
	Foreign equities		15%	12%	+2
	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%	-5
	Fixed-income (duration: 5.4 years) ¹	0% to 30%	20%	17%	0
	Canadian equities		25%	29%	+1
	U.S. equities	55% to 100%	20%	22%	+1
	Foreign equities		20%	17%	+2
	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 %	December 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 %												Overweight Energy Materials Underweight Consumer Staples Telecommunication Services Utilities
Canada	(2.5)	2.9	2.3	2.5	Short-term rates (T-Bills, 91-Day)	0.99	0.12	1.97	0.72	2.73	2.17	
U.S.	(2.6)	2.8	3.0	3.3	10-year bond yields	3.27	3.35	3.95	4.17	4.22	4.51	
					30-year bond yields	3.68	4.47	4.28	5.05	4.44	5.29	
Inflation %					Canadian dollar	U.S.\$1.00	U.S.\$1.01	U.S.\$0.96				
Canada	0.3	1.8	2.4	2.4								
U.S.	(0.3)	1.6	2.0	2.0								

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