



Investment Strategy

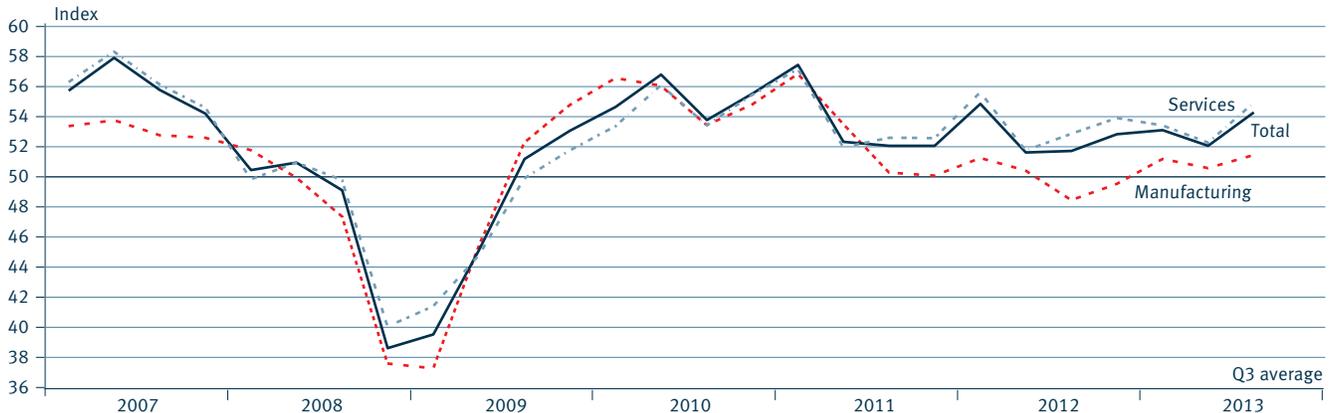
Global Economy

Economic data in advanced economies have generally surprised to the upside in the last few months and while it may be true that the emerging economies have downshifted, they nonetheless continue to grow. In fact, the summer of 2013 saw the first synchronized increase in activity among the three largest economic regions of the world. The United States, China and the eurozone are now all reporting an expansion in manufacturing activity. As a result, world GDP growth is well on track to achieve a 3% expansion in 2013 and accelerate to around 3.5% in 2014 on the back of accommodative monetary

policy. Renewed geopolitical tensions will need to be closely monitored as risks continue to flow from unfinished business in the euro area in restoring credit transmission. In China, the medium-term outlook remains encouraging in the wake of Beijing's unveiling of its most comprehensive reforms since the 1990s. Though most of these changes are to be phased in and will potentially translate into growth of no more than about 7%, we think the Chinese economy and financial system will change for the better over the next three years.

The global economy continues to improve

Global purchasing managers index



NBF Economy & Strategy (data via Bloomberg)

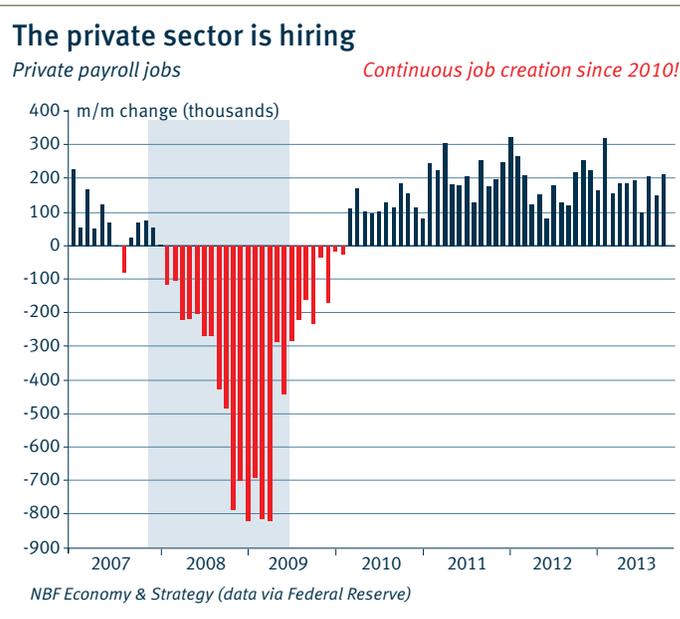
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United States

Though the US recovery continued to unfold at an unimpressive pace in 2013, the fact that the economy was able to grow at just under 2% despite a sizeable fiscal drag and ongoing political stalemate in the Congress about fiscal policy is a testament to the underlying resilience of the private sector economy. Consumers, in particular, have done their part to keep the economy going on the back of decent job creation, low interest rates, and a residential wealth effect coming from an increase of more than 10% in home prices. The balance sheet of households continues to improve and the debt service ratio remains at a 30-year low. There is plenty of room for consumers to start borrowing again in the coming quarters. Businesses should also contribute to growth as the continued surge in US production of oil and gas stimulate new investments in manufacturing capacity.

Though the US debt limit has since been suspended only through February 2014, a recent analysis by the Congressional Budget Office believes that the current ceiling is unlikely to be breached before May-June 2014 due to favourable seasonal patterns for government revenues and spending. In other words, the threat of another debt default showdown is unlikely in the near term. We expect to see real GDP growth of 2.6% in 2014, up from 1.6% in 2013.



Investment strategy

On the whole, 2013 has been good for stock markets, with the All-Country World Index returning more than 20% over eleven months. Returns in the United States for the period were even better, with gains of more than 25% for the S&P 500 and close to 35% for the Russell 2000 small cap index. On the flip side, the year will certainly not be remembered as a “good vintage” for fixed income returns. The value of US 10-year treasury notes has fallen by more than 7% since the beginning of the year, putting the total return in US dollar terms in the red by more than 5%. In Canada, with a shorter duration and a mix of higher-yielding corporate issuers, the DEX Universe bond benchmark did not fare as badly. But at -0.8% in CAD terms after eleven months, its total return is nonetheless far from the 8.3% average Canadian-dollar annual return this index has posted for the previous 25 years.

Although many continue to question the equity rally, we believe that a little more of the same is in store for 2014. With Janet Yellen at the helm of the Fed, monetary policy south of the border will stay highly accommodating for as long as the job market remains weak. And with inflation lower than expected, the Fed certainly has the leeway to lean against the wind for a little while longer. However, in a context where the economy is improving, chances are good that there will be a tapering of the Fed’s bond purchase program sometime in the first half of next year which, even if accompanied by strong forward guidance, will likely put upward pressure on longer-term bond yields and produce negative fixed income returns for the second year in a row. Therefore, with the International Monetary Fund (IMF) forecasting US real GDP

growth to accelerate from 1.3% in 2013 to 2.6% in 2014, and 3.5% in 2015, and with central banks maintaining a high liquidity backdrop, equities should continue to outperform other major asset classes in the coming year. We are certainly not foreseeing double-digit price appreciation again, but investors should know that exceptional years are usually followed by strong years, not correction years. Moreover, if this is the beginning of a long-term rally, annualized growth over the past four years has been lower than that of the past three secular up-trends we’ve observed since 1926, suggesting that the recent pace of appreciation hasn’t been exaggerated. It is true that US stock markets are becoming more expensive, but price/earnings ratios remain below historical averages and accelerating growth should translate into higher earnings, which will keep valuations at reasonable levels.

Therefore, we maintain our strategy in place for the first quarter of 2014. We continue to favour the stock market relative to fixed income securities. In equity markets, our biggest overweight remains for the US market which is expected to benefit from both the improving economy and an appreciation of its currency. In terms of fixed income, portfolios should have a shorter duration compared to benchmark. Moreover, while investment grade securities companies are increasingly expensive, we maintain our preference for high-yield issuers which should continue to benefit from the improvement in the US economy. For investors with a lower risk tolerance, we continue to favour the addition of non-traditional revenue strategies that allow some protection in the event of a gradual rise in interest rates.

Fine-tuning our model portfolios

The last page of this publication provides the recommended asset mixes for five model portfolios that correspond to our five investor profiles. In addition to a brief description of the 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 which 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 corresponding five investor profiles.

On a regular basis, our strategists will suggest small shifts in asset mix to better position these model portfolios for the market conditions they anticipate. These shifts really represent tactical calls, since they reflect adjustments we think will allow you to capitalize on short-term market opportunities or to reduce market risk if a correction in a particular asset is anticipated. From time to time, however, we also make more fundamental changes to our model portfolios that are more strategic in nature since they adjust for the “big picture” shifts we see taking place in capital markets. This quarter, we are making one of these strategic adjustments by changing the geographic allocation of our portfolio’s equity components.

The industrialization of China and India over the past decades has been a boon for most Asian economies as well as for commodity producers. The rapid increase in the demand for raw materials led to a commodity price boom which, combined with depreciation of the US currency, pushed the Canadian dollar to its highest level ever. For investors, the end result was that by investing in the Canadian market you could reap the benefits of double-digit growth in emerging markets, without the risks associated with the latter. As such, the strategic overweight in the Canadian equity contained in all of more growth-oriented profiles represented a clear benefit for investors. A historical analysis of the underlying fundamentals, however, suggests that the very factors which have been good for the Canadian market over most of the past thirteen years could now very well be turning against it.

First, economic growth for Brazil, Russia, India and China, steadily rose from a weighted-average annual rate of 3.5% during the 1990s to reach a peak of 11.2% in 2007 just before the onset of the great recession.

Structurally, growth of this magnitude is simply unsustainable. Since the standards of living in emerging markets remain well below those in developed markets, economic growth in these countries should continue to be far greater. However, as the former try to achieve more balanced growth by steering their economies from an investment base to a consumption base, their marginal impact on the global economy will lessen.

Second, commodity prices will have a tough time posting new highs in such an environment. Historically, commodity prices have only increased in periods of high inflation, such as in the 1970s, or when demand significantly outpaced supply, which we witnessed in the early years of the millennium. Such periods – during which commodity prices increased threefold – have always been preceded by 20-year periods of either stable or range-bound fluctuations. Obviously, this is bad news for the Canadian dollar, which is closely correlated to fluctuations in commodity prices. As such, it is easy to see that at current levels, the loonie offers more downside.

We believe that in an environment where the US economy is leading the world out of recession, it will be difficult for the Toronto stock index to outperform its peers. This call is not tactical, but rather strategic in nature. From time to time, the TSX will likely catch up to the S&P 500, if only because of relative undervaluation. However, in the longer run, we expect US equities to continue outperforming their Canadian counterparts. With the loonie still close to parity, we now appear to have a very good entry point to start to look for opportunities abroad.

Therefore, we have decided to lower the Canadian equity weighting in all of our model portfolios and add corresponding exposure to US stock indices. Going forward, Canadian and US equities are now equally weighted in these portfolios. The true advantage of such a change comes in the diversification benefits inherent in the US market which is more broad-based across sectors and represents half of the world’s market capitalization. In contrast, the Canadian market represents only 3% of the world’s equity value and finds more than 35% of its listed companies in resources sectors.

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

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%	5.0%	3.0%	0.0%
	Fixed-income (duration: 5.5 years) ¹	60% to 100%	70.0%	66.0%	0.0%
	Canadian equities	0% to 30%	7.5%	9.0%	-2.5%
	US equities		7.5%	11.5%	2.5%
	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.	Cash equivalents	0% to 15%	5.0%	3.0%	0.0%
	Fixed-income (duration: 5.5 years) ¹	45% to 80%	55.0%	51.0%	0.0%
	Canadian equities	20% to 45%	14.0%	16.0%	-6.0%
	US equities		14.0%	17.5%	6.5%
	Foreign equities		7.0%	7.5%	-0.5%
	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.	Cash equivalents	0% to 20%	5.0%	1.0%	0.0%
	Fixed-income (duration: 5.5 years) ¹	30% to 65%	40.0%	36.0%	0.0%
	Canadian equities	30% to 65%	17.5%	19.5%	-7.5%
	US equities		17.5%	22.5%	7.5%
	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.	Cash equivalents	0% to 25%	0.0%	0.0%	0.0%
	Fixed-income (duration: 5.5 years) ¹	25% to 45%	35.0%	28.5%	0.0%
	Canadian equities	40% to 75%	20.0%	21.0%	-5.0%
	US equities		20.0%	25.0%	5.0%
	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.	Cash equivalents	0% to 30%	0.0%	0.0%	0.0%
	Fixed-income (duration: 5.5 years) ¹	0% to 30%	20.0%	12.0%	0.0%
	Canadian equities	55% to 100%	22.5%	24.5%	-2.5%
	US equities		22.5%	28.0%	2.5%
	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				December 2013		June 2014		December 2014			
	2011	2012	2013	2014	Canada	US	Canada	US	Canada	US		
	Gross Domestic Product %					Rate %						
Canada	2.5	1.7	1.7	2.2	Short-term rates (T-Bills, 91-Day)							
US	1.8	2.8	1.6	2.6	0.98	0.04	0.98	0.10	1.21	0.10		
Inflation %					10-year bond yields							
Canada	2.9	1.5	1.0	1.4	2.69	2.84	3.06	3.13	3.30	3.35		
US	3.1	2.1	1.5	1.5	30-year bond yields		3.24	3.94	3.52	4.07	3.68	4.21
					Canadian dollar		US \$0.93		US \$0.91		US \$0.95	

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