

Investment Strategy

December 2012

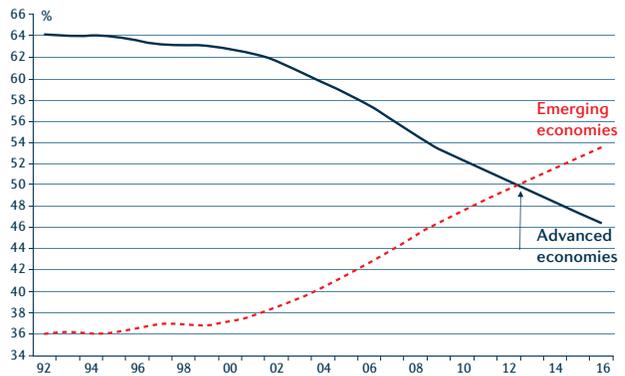
Global economy

Economic data in some parts of the world may have been a bit better than expected lately, but remain lackluster. The fact remains that global growth is fragile due to the extension of the European recession and sub-2% North American growth while emerging markets, the beacon of hope for the global economy, continue to sputter as trade activity is curtailed by weak demand in the OECD.

The caution about global growth is reflected in the International Monetary Fund's (IMF) latest *World Economic Outlook*. The agency's growth downgrades weren't all that surprising to us. Austerity tends to hurt growth, and the IMF's recalibration has now brought its growth forecasts closer to our own projections. We expect global growth at 3.1% this year and 3.3% for 2013, reflecting a situation where Europe continues to be the weak link in the global economy with stronger growth in the emerging economies, whose share of global GDP exceeds 50% (chart).

World: Emerging economies take pole position in 2012

Share of global GDP



NBF Economy & Strategy (data via IMF)

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**NATIONAL BANK
FINANCIAL**

WEALTH MANAGEMENT

United States

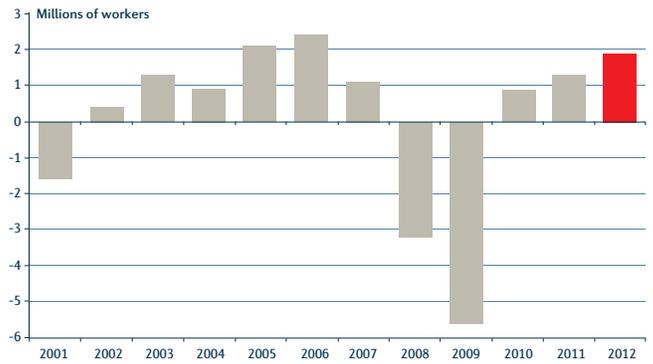
Growth so far this year has been better than most expected, considering the political impasse in Congress and a soft global economy. Third-quarter GDP growth was near 3% thanks in part to renewed strength in residential investment. Home prices are no longer deflating and consumer sentiment has improved on the back of better labour markets. More than 1.9 million full-time jobs were created through the first 11 months of 2012, the best showing in six years.

All told, going forward the U.S. economy should find support as consumers, housing and investment strengthen further. Of course, the assumption is that Congress manages to cushion the blow from the fiscal cliff while also proposing a credible path to balancing the budget over the longer term. If not, a U.S. credit downgrade by one or more rating agencies cannot be ruled out. Our base case scenario is that a deal will be reached to cushion the blow. While tax cuts for the wealthy are unlikely to be extended – recall that President Obama campaigned on that issue and was comfortably re-elected – there's likely to be a compromise regarding the automatic spending cuts

(i.e., sequestration), which would allow the U.S. economy to grow by just under 2% next year, not far from this year's performance.

United States: Best pace of full-time job creation since 2006!

Full-time job creation through the first 11 months of every year



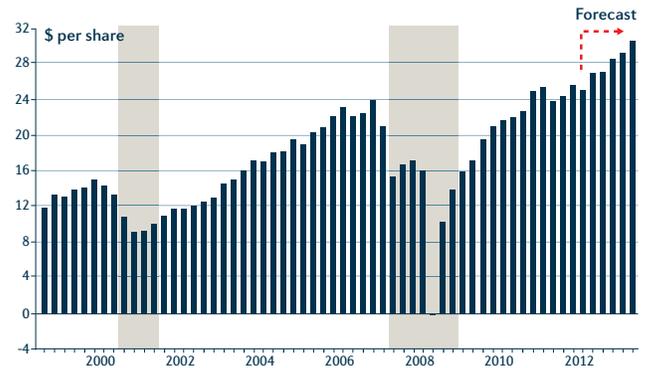
NBF Economy & Strategy (data via BLS)

Financial Markets

Though global equity markets have been on a rollercoaster this quarter, the MSCI AC index was back in positive territory in early December. In fact, North America was the main region to show a negative return. This skittishness is mainly due to investor uncertainty about U.S. taxation in 2013. Since investors, having enjoyed a double-digit return on the S&P 500 year to date, may feel uncertain about the outlook for profit growth and capital taxes, that market could still be prone to a wave of tax-hike selling. Though fiscal issues are certainly a concern for the U.S. economy, there are positive developments that are likely to guard against a large correction in equity markets. The U.S. Federal Reserve has announced that it would extend its expansionary monetary policy, meaning that the interest-payment burden for households and corporations is set to continue to ease. Low financial stress coupled with falling energy prices means that the 2013 profit outlook is one of continued growth, so long as the U.S. Congress does not go overboard with fiscal austerity.

Profit outlook still positive

Actual and expected earnings per share for the S&P 500



NBF Economy & Strategy (data via Global Insight)

Canada

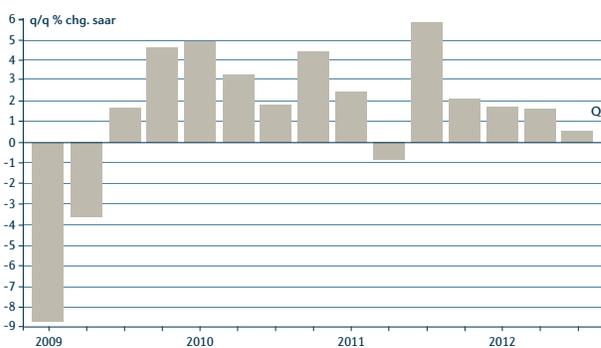
Canadian GDP grew just 0.6% annualized in the third quarter of 2012. In Q3, domestic demand was restrained as weakness in investment, government spending and residential construction offset healthy gains in consumption spending. Though labour markets remain a key pillar of growth in Canada, the current pace of job creation (113,000 jobs in the past three months alone) is

unsustainable. With corporate profits under pressure, residential investment slowing and continued unwinding of fiscal stimulus, employment growth is about to downshift. Fortunately, the economy can nonetheless still count on loose monetary policy for the next while, and that despite the Bank of Canada's insistence on keeping a tightening bias. True, the Central Bank has repeatedly

warned about household debt accumulation and threatened to raise rates to address that problem. But while deleveraging hasn't happened yet, the rate of debt accumulation is clearly diminishing and inflation is contained. With the Canadian economy unlikely to revert to 2% growth before sometime in 2013, interest rates will remain at near historical lows.

Canada: Economy decelerates further in Q3

Real GDP



NBF Economy & Strategy (data via Statistics Canada)

Investment strategy

By and large, the year 2013 promises to be just like 2012: weak global growth dominated by downside risks. Inevitably, Europe will keep investors on alert as adjustments linked to debt reduction will be felt over a long period of time. The Chinese economy was one of the greatest concerns. In China, while GDP growth slowed and the Chinese stock market posted new cyclical lows, investors became worried that last decade's economic engine of growth was grinding to a halt. However, the turnaround in the leading economic indicator suggests that the Chinese economy hit bottom recently and should accelerate anew in 2013. In the United States, the dichotomy between households and businesses continues. On the one hand, manufacturing activity remains weak partly due to the impact of hurricane Sandy on the east coast. However, it also appears that uncertainty regarding future taxation remains an obstacle to business expansion. To that effect, we believe that an agreement on the fiscal cliff will likely only come at the eleventh hour, but the intensity of discussions will probably increase throughout the month, prompting investors to bet on the inevitable: We don't see a policy-induced recession in the cards for 2013. On the other hand, the housing market continues to improve at an encouraging pace and suggests stronger growth from the private sector.

Although there are still significant issues to be addressed globally, the macro backdrop of high liquidity provided by ultra accommodative monetary policies should continue to protect against systemic risk. Since 2008, central banks have shown that they would do whatever it takes to keep the global economy on track. However, the full impact of the latest measures has yet to be felt, and investors should probably not try to fight this trend. Therefore, despite numerous risks, we continue to be moderately optimistic.

Although we do not see any significant interest rate increases in the near future, given current record-low yields, the expected returns for bonds are not compelling. With inflation hovering

above 2%, the real return on 10-year treasury notes is currently negative. Consequently, bond investors should seek out more attractive interest coupons by accepting higher issuer risk while maintaining a neutral duration for their portfolios. We reiterate our preference for investment-grade credit, very liquid high-yield securities and emerging market debt denominated in local currencies. While yields on the aforementioned credit products are also near historic lows, they continue to trade at large spreads above benchmark securities and should provide a decent capital gains cushion if interest rates remain at current low levels or rise slightly.

As an asset class, we continue to prefer equities. With a long-overdue correction induced by worse-than-expected earnings, the U.S. elections and the uncertainty linked to the fiscal cliff, equities have now pulled back from this summer's overbought conditions and offer a better risk/reward ratio. On average, dividend yields remain higher than bond yields across a wide spectrum of stock exchanges. And the equity risk premium (i.e., the difference between the yield on earnings and real interest rates) has never been higher and compensates investors well for choosing riskier assets. However, we think that the trend of the last 24 months which saw U.S. equities leading the pack will likely be reversed. At this point, we prefer emerging markets where growth potential is better. In the same vein, our reference portfolio continues to be overweight in Canadian equities. European equities are now standing near historical lows in terms of relative valuations with the U.S. – something we only see every 15 years or so. Undervalued European assets such as banks or peripheral countries could also benefit from the backstop provided by the ECB. We feel that a lot of bad news is already priced into European stock markets and that the upside potential currently appears greater than the downside. Therefore, we are bringing our U.S. equity exposure to a slight underweight position and increasing our EAFE (Europe, Australasia and Far East) exposure back to a neutral weighting.

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%	10.0%	11.0%	0.0%
Fixed-income (duration: 5.9 years) ¹	60% to 100%	70.0%	67.0%	-2.0%
Canadian equities		10.0%	12.0%	0.5%
U.S. equities	0% to 30%	5.0%	4.5%	-1.0%
Foreign equities		5.0%	5.5%	2.5%

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%	5.5%	0.0%
Fixed-income (duration: 5.8 years) ¹	50% to 80%	60.0%	57.0%	-2.5%
Canadian equities		20.0%	23.0%	1.0%
U.S. equities	20% to 45%	7.5%	6.5%	-1.5%
Foreign equities		7.5%	8.0%	3.0%

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%	5.0%	-0.5%
Fixed-income (duration: 5.8 years) ¹	30% to 65%	45.0%	42.0%	-2.0%
Canadian equities		25.0%	28.0%	1.0%
U.S. equities	30% to 65%	10.0%	9.0%	-2.0%
Foreign equities		10.0%	11.0%	3.5%
Alternative investments ²	0% to 15%	5.0%	5.0%	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%	0.5%	-0.5%
Fixed-income (duration: 5.8 years) ¹	25% to 45%	35.0%	32.0%	-2.0%
Canadian equities		25.0%	28.0%	0.5%
U.S. equities	40% to 75%	15.0%	13.5%	-2.5%
Foreign equities		15.0%	16.0%	4.5%
Alternative investments ²	0% to 20%	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: 5.8 years) ¹	0% to 30%	20.0%	18.5%	-1.0%
Canadian equities		25.0%	28.0%	0.5%
U.S. equities	55% to 100%	20.0%	17.5%	-4.0%
Foreign equities		20.0%	21.0%	4.5%
Alternative investments ²	0% to 25%	15.0%	15.0%	0.0%

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 2012		June 2013		December 2013	
	2010	2011	2012	2013		Canada	U.S.	Canada	U.S.	Canada	U.S.
Gross Domestic Product %											
Canada	3.2	2.6	2.0	1.4	Short-term rates (T-Bills, 91-Day)	0.98	0.08	0.98	0.12	1.17	0.14
U.S.	2.4	1.8	2.2	1.8	10-year bond yields	1.78	1.69	1.96	1.80	2.49	2.33
Inflation %					30-year bond yields	2.35	2.88	2.52	2.99	2.94	3.29
Canada	1.8	2.9	1.6	1.7							
U.S.	1.6	3.1	2.1	1.8	Canadian dollar	U.S.\$0.99		U.S.\$0.97		U.S.\$1.02	

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