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AROUND THE WORLD

The global economy on the road to recovery

The world's economies are still feeling the effects of the turmoil that began in August 2007 with U.S. subprime mortgages, and escalated in the fall of 2008 to a global financial crisis after the demise of U.S. broker Lehman Brothers. Unparalleled in its depth and amplitude, this crisis has severely impaired the global financial system for both emerging and advanced economies.

A simultaneous decline in all the major economic blocs has resulted in the first global economic contraction since the Second World War. The IMF forecasts that real GDP per capita will decline this year in about three-quarters of the world's economies.

Fortunately, an unprecedented combined effort of the governments and central banks of many countries has resulted in very accommodating monetary and budget policies, as well as measures to stimulate credit. Since the G20 summit in April, tensions on capital markets have been easing and trading volumes are on the rise again.

The OECD reports that its leading economic indicator for the main developed countries jumped 0.5% in April, the largest monthly increase since December 2003. Encouragingly, the reported improvement was widespread as well as substantial - for the first time in two years, our one-month diffusion index for 23 countries has moved well above the key threshold of 50. In our view, the most likely consequence, is the emergence of more green shoots of revival. We expect the global economy to start growing again in the second half of this year, and expand 3% next year.

UNITED STATES

Emerging from a long and painful recession

For the U.S. economy, still feeling the effects of the housing-market collapse and relentless home-price deflation, the last six months will probably have been the worst of the current recession.

Times are unquestionably tough for the U.S. labour force. About 4% of all workers have lost their jobs so far in this recession, worse than at the same point in the severe recession of 1982. Although the harshest monthly losses are likely behind us, the ranks of the unemployed are still growing and the unemployment rate is likely to rise for the rest of the year, peaking at about 10%.

However, the Federal Reserve and the government have stepped up to the plate. Although the Fed exhausted its traditional monetary policy tool when it cut its key rate to nearly zero, it was not out of ammunition. The U.S. central bank then proceeded to expand its balance sheet by buying assets. The purpose of this unconventional move, referred to as quantitative easing, is to inject liquidity into the economy when rate cuts are no longer possible. In March the Fed launched the Term Asset-Backed Securities Loan Facility (TALF) with the announced intention of purchasing a total of $1.25 trillion of asset-backed securities. The Fed also said it would buy as much as $300 billion in long-term U.S. Treasuries, sparking a rush to government bonds. The objective was to keep long-term rates low in the hope of boosting the housing sector in particular.

The U.S. Treasury is contributing as well through fiscal policy. The federal government has launched many initiatives targeting various sectors of the economy, and put in place an impressive number of fiscal stimulus measures in the last few months.

The U.S. economy is likely to have contracted again in the second quarter of 2009, but not nearly as much as in each of the previous two quarters. In our scenario, it will begin growing at a moderate pace in the second half of the year.

After the rain, sunshine

The first months of 2009 were as gloomy on financial markets as the last months of 2008. By mid-March the S&P 500 had retreated 56% from its October 2007 peak - the worst bear market since the Great Depression. However, North American equity markets then rebounded spectacularly, gaining more than 40% in a few weeks.

The spring rally was driven by hope that the economy is turning around and that corporate profits will start growing again. Now it is up to the economy - and companies - to deliver the goods.

First-quarter profits were dismal, down more than 35% in aggregate on both sides of the border. The second and third quarters are expected to be down as well. If the consensus is right, corporate earnings will not show year-over-year growth until the final quarter of this year. In light of this, investors will need reserves of patience over the next six months.

As we see it, however, the clouds over earnings are dissipating. When it comes to consensus expectations, downward revisions are the norm and upward revisions the exception. But over the last month the analysts who follow S&P 500 companies have raised their 12-month forward earnings forecasts. Now more companies have seen their earnings revised upward than revised downward.

Analysts covering U.S. stocks currently expect S&P 500 earnings for 2009 as a whole to be down 12.2% from 2008. In Canada, the consensus expects S&P/TSX earnings to be down 27.1%. These steep declines are consistent with the experience of past recessions. Next year and 2011 might be another story - analyst consensus currently calls for earnings growth of nearly 25% in 2010 and 20% to 22% in 2011. However, stiffer regulation and a reluctance of banks to take risks could put these very high expectations out of reach.

Despite the strength of the spring rally, we continue to prefer equities over fixed-income assets. There is upside remaining in equity markets. The S&P 500 is still about 40% below its November 2007 peak of 1565 and the S&P/TSX is nearly 30% below its peak.

Moreover, the recent decline left U.S. equity valuations the lowest in years. For the S&P 500 in the aggregate, the ratio of price to trailing earnings is now 14.7, very low by historical standards. In Canada the story is similar. The trailing P/E of the S&P/TSX is now only 13.5. So even after the rally, North American valuations remain acceptable.

With today's markets more volatile than before, economic and geopolitical worries could put the rebound to the test. The road to recovery will not be a straight line. That said, the recent rally is not inconsistent with our scenario for the global economy. Over the medium term, we expect the stock market to trend higher as investors begin factoring in the next expansion and a return to job creation.

CANADA

A recession affecting regions and industries unevenly

Canada has not escaped the financial crisis and the U.S. downturn. Our country's real GDP has dropped more sharply than at any time since the 1990-91 recession. More than 360,000 jobs have been lost since the pre-crisis employment peak and unemployment is still on the rise. If there is any consolation, it is that the picture is not as bleak as in the U.S. or as in past Canadian recessions. So far in this downturn, 2.1% of Canadian workers have lost their jobs, compared to 3.5% in 1990-91 and 5.4% in 1981-82.

The recession is affecting regions and sectors quite differently, with some provinces and industries more exposed than others to U.S. shocks and the financial crisis. The erosion of Canadian manufacturing in particular has been uneven. For example, Ontario, home of Canadian automaking, is suffering more because of the unprecedented ordeal that industry is undergoing.

On the whole, this Canadian recession is severe at first glance, but is proving much less so than the last two. One mitigating factor is the Bank of Canada's timing. Unlike other major central banks, the Canadian monetary authority began relaxing its key rate as soon as the U.S. slipped into recession. So whereas the Federal Reserve began lowering its key rate four months before the onset of the U.S. recession, the Bank of Canada began easing 12 months before the Canadian recession.

The Canadian economy will also benefit from a vigorous second-quarter rebound of resource prices. Thanks in large part to the most expansionary economic policies of the past 80 years, world commodity prices have taken off again in recent months. At this writing crude oil is trading at about US$70 a barrel, more than double the February low. Prices for non-energy commodities have also firmed: the Commodity Research Bureau metals index is currently up more than 25% from its bottom.

OUR FORECAST

	2007	2008	2009 (Forecast)	2010 (Forecast)
Gross Domestic Product (%)				
Canada	2.7	0.5	(1.4)	2.5
U.S.	2.0	1.1	(2.3)	2.4
Inflation (%)				
Canada	2.2	2.4	0.5	2.0
U.S.	2.9	3.8	(0.9)	1.8

	June 19, 2009	June 2010
Short-term rates (T-Bills, 91-Day) (%)		
Canada	0.30	1.42
U.S.	0.19	1.67
10-year bond yields (%)		
Canada	3.51	4.08
U.S.	3.79	4.44
30-year bond yields (%)		
Canada	3.96	4.45
U.S.	4.54	4.94
Canadian dollar	U.S.$0.88	U.S.$0.87

S&P / TSX Sector Rotation

Overweight	Underweight
Financials	Energy
Consumer Discretionary	Materials
Information Technology	Utilities

BENCHMARK ASSET MIXES

Changes to the equity component

The last page of *Investment Strategy* provides a wealth of information on recommended asset mixes for our model portfolios that correspond to our five investor profiles. We start with a brief description of the profile, and then give minimum and maximum weighting information for each asset class, showing the latitude our strategists have in adjusting the portfolios for different market conditions. Next, we provide benchmark asset weightings, sometimes referred to as strategic asset mixes. Under market neutral conditions, these benchmark asset mixes should enable investors who fit the profiles to reach their long-term objectives while respecting their tolerance for risk. The benchmark asset allocations really serve to communicate our vision of the optimal portfolio structure for each of our five profiles. This vision doesn't change very often, since we think that successful investment outcomes result from adopting a long-term approach. In fact, the last time we made any significant change to our benchmark asset allocations was almost 10 years ago.

From time to time our strategists will suggest small shifts in asset mix to better position the model portfolios for prevailing market conditions. This recommended weighting column is more of a tactical call, since it reflects adjustments we think will allow you to capitalize on shorter-term opportunities or to reduce market risk if some form of correction is anticipated. Therefore, our recommended weightings will change quarter to quarter, but the changes will be fairly small - usually on the order of 2 - 3% one way or the other. After all, better to be approximately right than totally wrong, as the old expression goes.

This quarter we are modifying the geographic allocation of the stock portion of these benchmark asset mixes, generally adding to our Canadian weighting, and reducing our exposure to alternative investments, U.S. and EAFE equities by a corresponding amount. Two reasons prompt us to make these changes.

First, National Bank Financial Group has recently undergone a major restructuring, creating three distinct lines of business. One of these is Wealth Management, which groups together our institutional portfolio management company, all of our mutual fund and other managed-asset manufacturers, our trust company, our individual investor services arm and a number of other business units. The reason for grouping all this expertise together is to find efficiencies and better leverage our talent pool. An immediate benefit of this restructuring has been the creation of an asset allocation committee that takes inputs from our Wealth Management businesses as well as our Economics and Strategy team, and provides guidance to all of the National Bank Financial Group. We are pleased to announce that going forward, the asset mix calls contained in *Investment Strategy* will be emanating from this Wealth Management asset allocation committee. The small changes to our benchmark asset mixes mentioned above reflect the sourcing of our asset mix call from this new committee.

Second, the global economy has undergone a profound transformation over the last decade, and its impact has to be incorporated into our benchmarks. With countries like China and India rapidly developing their infrastructure and manufacturing base, and with their huge populations seeking to slake a bottomless appetite for the consumer goods we take for granted in the western world, demand for Canada's energy and materials should be very strong over the coming years once we finally emerge from the current global recession. Furthermore, Canada's banking system has gained tremendous credibility worldwide during the recent crisis, which we think will strengthen the competitive positioning of Canadian banks in the global marketplace.

With energy, materials and financial services making up more than 70% of the S&P/TSX index by capitalization, we see Canada's stock market garnering increasing attention from institutional investors around the world going forward. In making alterations to our benchmark asset mixes, we sought to maintain our split between bonds and stocks unchanged so as not to change the overall risk/return characteristics of our model portfolios. This of course means that increasing our exposure to the Canadian stock market has to come at the expense of reducing our weightings in other equity and proxy for equity asset classes - in this case U.S. and EAFE equities as well as alternative investments.

ASSET MIX

Green shoots - Over-indulgence could lead to indigestion

It's hard to open a newspaper without reading about the green shoots emerging all over the place. In this context, the green shoots refer to signs that economies in North America, and to a lesser degree, around the world, are showing signs of turning around. Of course this is welcome news - the recession we are currently experiencing has had a brutal impact on many sectors of our economy, and any news that it may be abating is cause for rejoicing.

This being said, investors should not let the emergence of these green shoots become the primary consideration in determining their investment portfolio's asset mix. We remind you that financial markets are leading indicators - for instance, history shows us that stocks tend to rally a good 6 months before the underlying economies turn the corner. In the present case, the S&P/TSX is up by close to 35% since March 9th, so anyone thinking that the green shoots currently being discussed signal an opportunity to load up on stocks and harvest easy gains is showing up at the party a little late. There is still punch in the bowl, but a good deal less than when stocks were at a 5-year trough a mere four months ago.

Above, we talked about the changes we have made to our benchmark - or long-term strategic asset mixes. Now we will discuss our recommendations at the more short-term tactical level. We currently have a slight overweight position in equities, and from a geographic perspective, our preference goes to Canada and the U.S. with an underweight position in Europe and the Far East. At this

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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
Cash equivalents	0% to 20%	10%	10%
Fixed-income (duration: 5.8 years) [1]	60% to 100%	70%	68%
Canadian equities	0% to 30%	10%	11%
U.S. equities		5%	6%
Foreign equities		5%	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.

Asset Class	Minimum/ Maximum	Benchmark	Recommended Weighting
Cash equivalents	0% to 15%	5%	4%
Fixed-income (duration: 5.8 years) [1]	50% to 80%	60%	58%
Canadian equities	20% to 45%	20%	22.5%
U.S. equities		7.5%	9.5%
Foreign equities		7.5%	6%

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
Cash equivalents	0% to 20%	5%	4%
Fixed-income (duration: 5.8 years) [1]	30% to 65%	45%	43%
Canadian equities	30% to 65%	25%	28%
U.S. equities		10%	12%
Foreign equities		10%	8%
Alternative investments [2]	0% to 15%	5%	5%

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
Cash equivalents	0% to 25%	0%	0%
Fixed-income (duration: 5.8 years) [1]	25% to 45%	35%	30%
Canadian equities	40% to 75%	25%	30%
U.S. equities		15%	18%
Foreign equities		15%	12%
Alternative investments [2]	0% to 20%	10%	10%

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
Cash equivalents	0% to 30%	0%	0%
Fixed-income (duration: 5.8 years) [1]	0% to 30%	20%	15%
Canadian equities	55% to 100%	25%	29%
U.S. equities		20%	23%
Foreign equities		20%	18%
Alternative investments [2]	0% to 25%	15%	15%

1) Includes conventional and real return bonds. Benchmark = 75% SC 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

(CONTINUED FROM PAGE 3 "Asset Mix")

stage, our recommendation is to favor early cyclical companies in the Financials, Information Technology, Consumer Discretionary and Telecommunications sectors. While resources have typically lagged the market in end-of-recession rallies, the fact that China is revving up in anticipation of supplying a U.S. recovery, we are watching this sector carefully, looking for an entry point. Resources could start outperforming the overall market earlier than in previous recoveries.

With our cash position being neutral, the slight overweighting we are recommending for stocks comes at the expense of having reduced our exposure to fixed-income securities by a commensurate amount. With equity markets on a tear, save havens offer less of an attraction, which has dramatically reduced demand for government bonds, and federal government bonds in particular, explaining our relative lack of interest in these securities. Our preference in the fixed-income asset class goes to corporate bonds. Given that we think interest rates will be trending upwards, we have kept our duration at 5.8 years, a little bit shorter than the benchmark duration of 5.96 years.

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