Equitable Life of Canada

Asset Management Group

INVESTMENT STRATEGY

Annual Strategy 2013

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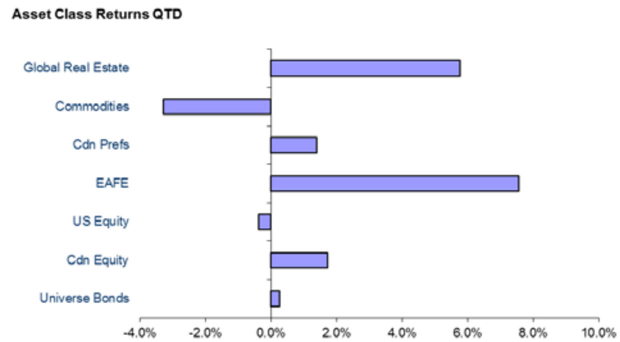
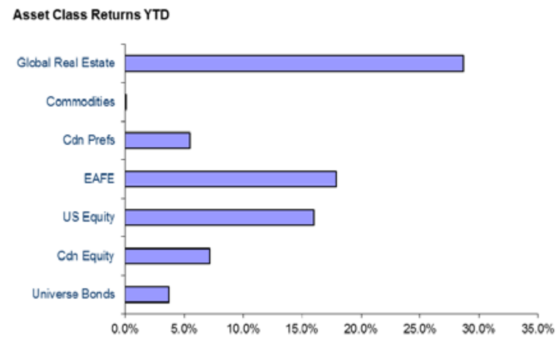
Executive Summary

2012 Asset Class Returns





(Source: Bloomberg, FTSE NAREIT, GSCI Commodity Index, S&PTSX Preferred Share Index, MSCI EAFE Index, S&P500 Index, S&PTSX Composite Index, Merrill Lynch Canada Bond Index)

2013 Outlook

Economic Outlook

- The long term deleveraging trend will continue to be an overriding global theme in 2013, dragging down economic growth. Deleveraging remains a global theme with European, the US, and Japan at the forefront.
- Bank recapitalization in Europe equivalent to 4% of GDP is required. This recapitalization will come at the expense of loan growth, further weighing on the European economy.
- In the US, banks have recapitalized, and the housing market has moved into a solid recovery. Offsetting this is weakening government spending. Growth from the stabilized financial and consumer segments will likely be offset by the deteriorated public finances, resulting in another 2+2 year in the US (2% growth, 2% inflation).
- In contrast to the US consumer, Canadian consumers are tapped out. The overleveraged balance sheets, and weakening housing market, will result in slowing growth over the course of 2013.
- In Japan, debt has grown to a massive 230% of GDP and the funding conditions have moved against them. As a result, they are implementing easing programs significantly larger than the programs implemented in other jurisdictions (relative to the size of their economy). These conditions could fuel currency trade wars.
- Conditions in China have improved from the mid 2012 slowing growth conditions.

Equitable Asset Management's Asset Class Positioning Biases

Asset Class	Benchmark Relative Weight*	Previous Weight
Cash	Underweight	Neutral
Fixed Income	Underweight	Overweight
Duration	Neutral	Neutral
Credit	Overweight	Overweight
Equities	Overweight	Underweight
Canada	Neutral	Underweight
US	Overweight	Underweight
International (Europe / Asia)	Underweight	Underweight
Global Real Estate	Neutral	Neutral
Other Asset Classes	Overweight	Neutral

**The stated positioning biases are relative to the benchmark allocation of the Equtiable Life Active Balanced ETF Fund, and are reflective of the outlook for 2013 as at the time of writing. These positions may or may not reflect the current positioning of the fund.*

Macro Economic Analysis
Global Perspectives

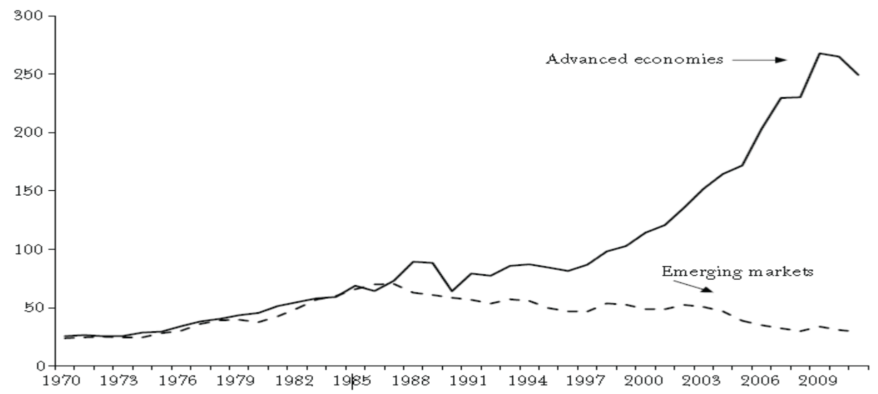
Critical Themes and Drivers

The economic backdrop continues to be dominated by long term deleveraging, and remains characteristic of a post crisis scenario, with longer overall healing periods, lower growth trajectories and potentially shorter interim business cycles. Within this backdrop, positive progress was made through 2012. Significant risks remain to the outlook and, at best, we anticipate a muddle through economy.

Deleveraging

Current conditions are dominated by a long term deleveraging trend. Advanced economies spent the greater part of three decades leveraging up, as the “borrow to spend” mentality took root. Across the globe, advanced market government debt bottomed in the 1970s just above 20% of GDP. Since that time, debt has ramped up to an unsustainable level close to 100% of GDP, and continues to grow. Over this same period private debt went from 60% to 160% of GDP. In the past couple of years, the trend in private debt has changed, while government debt continues to rise. This level of debt to GDP is unsustainable, and leads to weaker than normal economic growth going forward.

Gross Total (Public plus Private) External Debt as a Percent of GDP: 22 Advanced and 25 Emerging Market Economies, 1970–2011



Sources: Reinhard and Roegoff, Journal of Economic Perspecitves (Summer 2012);Reinhart and Rogoff (2009)

Bank Recapitalization

In the European banking system, the deleveraging is only at the incipient stage and more bad loans are likely over the next three years. According to the OECD, Euro-area banks need to raise around €400bn of capital (more than 4% of GDP). Among the major countries, French banks are in the worst position. The story is similar in the UK, with a recent report suggesting that banks need to raise an additional £20-50bn of capital. As a result of the low capitalization and bad loans, credit will be constrained in the Euro area for a long time, which ultimately will translate into subpar growth.

In the US conditions have improved, and US lending standards continue ease. US banks have successfully recapitalized over the past five years and capital levels are now at all-time highs.

US Economic Outlook

The four pillars of growth include personal consumption and housing, business investment, government spending, and trade. Of these, the first two have shown signs of stabilization and moderate growth. Offsetting the improving consumer is contracting government spending, which had grown to unsustainable levels. Trade will have limited contributions to US GDP as global exports are slowing.

After 2008, consumer lending declined. This was fuelled by both a fall in demand and a fall in supply. This trend has reversed, and consumer debt is climbing again. These loans are once again fueling private consumption and housing. Throughout 2012, personal consumption and housing added around 2% to GDP growth. While this is still well below the pre-recession levels, it was demonstrating signs of recovery. Looking forward to 2013, the consumer faces increasing headwinds. With the payroll tax changes agreed to in the fiscal cliff negotiation taking 2% out of wages, we can expect consumption will suffer in the first half of the year, picking up into second half as the impact is absorbed. Offsetting some of the weakness from the payroll tax hike is the improving housing market. New home starts show exponential growth, with solid signs that this will continue. The solid residential investments also leads to higher consumption of housing-related services coupled with home price appreciation (i.e., wealth effects and increased consumer confidence). Price gains also lead to collateral effects allowing the owner access to more credit or ability to finally refinance at lower rates.

Business fixed investment, after weakness in mid-2012, is increasing both as a percentage of sales and as a percentage of cash flow. We have early indications that capital investments will continue this momentum early in 2013. The recovery in US corporate profits has been great during 2009-2011, but companies have not used their earnings to reinvest in the economy. All this led to massive increases in cash and liquidity on corporations' balance sheets. The gap between profit growth and decreasing borrowing costs historically led to strong capital spending. In this recovery however, the pace of capital expenditure growth has been slow, despite corporate bond yields close to historical low levels. If we see no meaningful deterioration in the consumer profile or escalation of systemic risks, we could witness a true revival in corporate investment.

Current government debt to GDP ratio stands at approximately 84% and rising, with the budget deficit exceeding 7% of GDP over the past four years. While politicians in Washington have slowly come to terms with their fiscal situation, the political will to address these structural problems remains ambiguous. In what continues to be a tepid economic growth environment, the likelihood of simply growing their way out this debt spiral is unlikely. This means that government spending cuts are necessary, and over the course of 2013 will detract from economic growth.

Canadian Economic Outlook

Unlike their southern counterparts, Canadian consumers have yet to deleverage. Personal consumption was the driver of Canadian GDP growth through 2012. Looking forward, there are signs emerging of a slowdown in the Canadian housing market. This is evident from the slowing starts and negative momentum since early 2012. This momentum is likely to be fueled by a number of factors including: already expensive/overvalued pricing in terms of prices versus rents; price versus disposable income; and mortgage lending rule tightening. The weakening housing market and high levels of consumer debt are likely to weaken personal consumption through 2013. Our stable southern partners will help Canada from falling off a cliff, and the net result will be a slowing, but not recessionary, economy.

Chinese Economic Outlook

The Chinese economic growth showed strong signs of acceleration at the end of 2012 after sluggish 2011 and most of 2012. The growth will continue into the first half of 2013. The momentum was distinguished in a variety of statistics, including exports, industrial production, accelerating inflation, improving capital spending in infrastructure as well as acceleration in bank credit.

We relate this cyclical revival in Chinese growth to a series of events, including a long string of monetary easing both domestically and globally, smooth political transition in China's governance, deferred production and normalization of sovereign risk in European Union. The risk of a housing bubble burst was also alleviated due to policy tightening in 2010-11 and the resulting cooling in housing activity.

Macro policies are shifting to encourage a more consumer-driven economy, but the process will be very gradual. Overall, we believe that China remains an infrastructure growth story. We also expect the Chinese saving rate to continue to stay elevated for the next decade

Similarly, we believe that China's competitive position as an exporter is likely to continue. Wages are rising rapidly in some sectors. However, this does not mean that China's trade surplus is being undermined by deteriorating competitiveness. The Chinese relative productivity versus its main trading partner continued to steadily improve during the last decade. Additionally, the rural share of population should supply sufficient resources to the industrial sector. Coupled with strong policy incentives to move production inland, this should maintain the Chinese manufacturing engine for the time being.

Japanese Economic Outlook

In Japan, economic conditions remain stagnant. Gross debt/GDP has risen to 230%, their fiscal deficit is projected at 10% of GDP, and more fiscal stimulus has been promised to prime the economy. Japan's ability to funding their debt and deficit will face challenges going forward. In the future, Japan will be more dependent on external funding sources as the domestic savings rate and trade balance has fallen. There will come a time, similar to European conditions of the past few years, when the market grows uncomfortable with their bonds, leaving no good alternatives for Japan.

The Bank of Japan, with prompting from Prime Minister Abe, has increased the target inflation rate to 2%. And they are willing to put the printing presses on overdrive to get there. Assuming they are successful in creating 2% inflation, the normal reaction would be for bond yields to rise. With their current debt, a 2% increase in yields would require 50% of tax revenues to be directed towards interest payments. Unfortunately this is not a sustainable prospect, so very likely those printing presses will be used to buy their own bonds, keeping yields at unnatural levels if inflation is rising. In manipulating the markets, the unintended consequences include high inflation and devaluation of their currency.

European Economic Outlook

In some European jurisdictions there are small signs of slowing deterioration, as the speed at which the debt problem is growing has decreased. Greece, Spain, Italy, as with most of the region, continue to run budget deficits and so European debt continues to grow. Europe's debt problem was decades in the making, and will not resolve overnight unless we have a systemic failure and the costs of this debt are shifted. This is likely the worst possible outcome, as the risks and disruptions could be catastrophic. As a result, Europe will be a long time resolving, dragging global growth down, and creating market volatility. Expectations for improving economic conditions in Europe for 2013 are not supported. At this point retail, construction, and manufacturing show signs of accelerating weakness. It is more realistic to expect the contraction in Europe will accelerate in 2013. Although we continue to look for signs of green shoots, we remain alert to the more likely scenario of downside risk.

Asset Class Strategy

Equity Market Outlook

- The relative performance of the equity markets will be heavily influenced by policy actions, changes in the political landscape, and the evolution of the economic data. Our outlook for equities is heavily market dependent, skewed toward positive performance in the US and negative performance in Europe.
- We remain poised to adjust our positioning bias as required given the continued risks. Additionally, an early anticipation of positive resolutions regarding the US fiscal cliff could propel an equity rally.
- The US equity market will outperform given the economic fundamentals outlined above and the moderating of risk premiums.
- The US is also much more pro-market and pro-reform than that of other G7 countries and the Fed is well ahead of its counterparts in term of market reaction.
- The Canadian equity market has high exposure to the emerging markets via the resource concentration and has the potential for a housing correction on the horizon. At the same time, the Canadian financials will outperform if there is a European crisis. Our economic strategy highlighted several weakening aspects of the Canadian economy such as housing starts/sales slowdown. This suggests a relatively neutral to underweight positioning is in order compared to the other regions.
- Europe is in recession with no source of future growth yet visible. If there is a large overreaction in the market we could opportunistically go overweight European exposure, but the base case is to adjust our exposure between varying degrees of underweight and neutral. Further compounding the domestic European growth, the strengthening Euro may hinder exports in the coming quarters.
- While the Japanese economy is still up in the air, the weakening yen is supporting profits and equity prices but in US dollar terms the market movement is minimal.

Fixed Income Outlook

- Markets are still contending with a highly uncertain risk environment, a weak economic backdrop and the possibility of significant central bank policy administration. Economic and political uncertainty remains elevated but, on a relative basis, is improving with increased optimism that major tail risks have been reduced.
- Monetary policy will remain accommodative globally, with near zero benchmark interest rates and continued quantitative easing from the Fed and Bank of Japan. Increased global optimism, a rebound in emerging markets (led by China) and a Eurozone that continues to muddle through are all conducive to rates moving higher, albeit marginally higher from ultra-depressed levels.
- Rates will remain low as a result of the unresolved Euro crisis and fiscal situation in the US, but the risk of a Eurozone breakup has largely been taken off the table as the ECB and the union members seem determined (to borrow Draghi's famous words) to do “whatever it takes” to keep the Eurozone intact. Thus far, markets believe this to be credible.
- Tail risks remain such that any large single event could derail this fragile global economic recovery and result in a bid to bonds.

Credit Market Outlook

- We recommend a tactical overweight allocation to investment grade credit over 2013. The current phase of the credit cycle is confirmed by the expanding lending standards, expanding global liquidity and the recent emergence of M&A activity. Long term credit cycle analysis suggests a neutral allocation to the corporate credit with pockets of tactical overweight, with the majority of excess return coming from carry rather than spread movement.
- The tactical overweight recommendation is further supported by the strong bid the Canadian corporates are witnessing. We believe money will continue to flow into Canadian corporate bonds through 2013.

- We maintain a stance towards cyclical sectors; however opt for quality inside each sector. In Canadian space, we do not expect the economy to have a material impact on overall credit ratings.

Real Estate Market Outlook

- Given the economic backdrop, the outlook for real estate is mixed. In the US, improving housing market conditions and stable expectations for growth are supportive. In contrast, Europe continues to deal with a real estate correction. As a result, we remain neutral, looking for tactical opportunities to move over or under weight based on market conditions.

Alternative Assets – Gold

- We remain bullish on gold as a diversifying asset. Risks remain in Europe, are growing in Japan, and geopolitical issues remain. While the returns in gold have been subdued in recent months, we continue to like the asset class as a hedge against tail risk and the potential for global currency wars.