Equitable Life of Canada

Asset Management Group

INVESTMENT STRATEGY

Q3 2013 Strategy

Content

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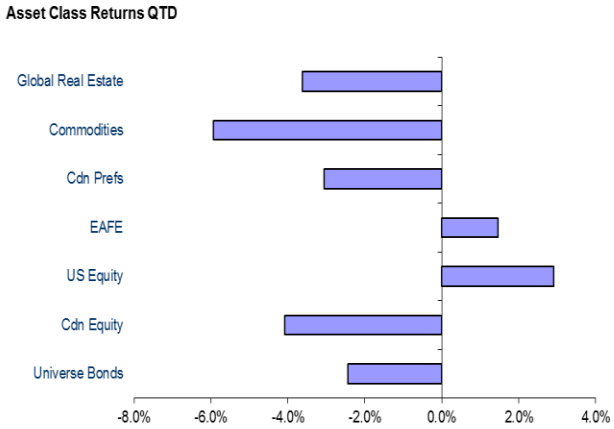
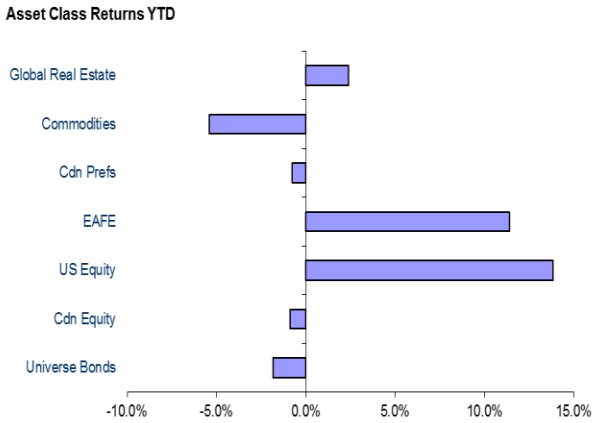
Asset Class Strategy

Asset Class Returns as of June 30, 2013





(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)

Developed Equity Markets

- Current S&P 500 standard valuation measures suggest that equity markets are more expensive than they have been on average over the past 3 years. Considering the record profit margins, slow earnings growth, very slow revenue growth and also anemic GDP growth expectations for both the US and global economies, this lends to a conclusion that equities are fully priced.
- Since 2010, equity trailing earnings yields remain very attractive compared to 10 year Treasuries on a mid-term perspective until very recently. Over the course of the current year we have moved from an attractive valuation perspective to a neutral position. This suggests most of the expected gains have already been realized unless there is a regime change.
- There remains a high degree of uncertainty in the global economic environment despite what the markets have priced in through indicators such as VIX or investor sentiment indices. Against a backdrop of larger than average uncertainty, one would expect that required risk compensation would be higher in order to accommodate for the chance of adverse outcomes.
- While not an immediate concern, there has been a rapid increase in leverage in the equity markets over the past year. The concern is that the market could have a significant correction when that leverage unwinds similar to 2000 and 2007.
- In terms of geographic allocation, we believe the US equity market will continue to outperform and it is too early to be contrarian.
- 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 mid to longer term horizon. This suggests a relatively neutral to underweight positioning compared to the other regions.
- The relative performance of the equity markets will be heavily influenced by policy actions, changes in the political landscape, and economic surprises.

Bond Markets

- The Fed looks ready to pull back on QE3 purchases in the second half of 2013. They maintain that they are in data dependency mode and, depending on how the economic data develops, they could taper or extend their asset purchase program. Market expectations are generally that the size of the purchases will shrink at the end of Q3. Our economic expectations are slightly less bullish than the Fed's projections, although we are not expecting growth to fall below 1% and therefore this is likely to result in only minor changes to the Fed's actions, and bonds could continue to unwind the QE premium.
- Inflation remains benign, in line with the lowest levels of inflation we've seen since 2008, and growth remains lethargic, therefore we should expect a low interest rate environment relative to historical standards.

- The downside risks that existed last year, with a potential Spanish default and the 'Fiscal Cliff', have diminished. Despite the reduced probability of imminent collapse, risks remain elevated against historical measures: peripheral Europe continues on life support; upcoming German elections create political uncertainty; and Japan is attempting a policy experiment of mammoth proportions. Meanwhile China appears to be slowing, and their policy is opaque at best, with motivations that may or may not be aligned with market interests.
- Our base expectation is that the Fed will continue regular QE purchases, even though the size of purchases may be falling and the forward timeline for these may be shorter than expected a few months ago. We expect rate volatility will continue without strong direction in the near future. The risks outlined above are likely to create regular disruptions, and keep the bond market from selling off too quickly. Looking forward to 2014, rates will start to move higher with increased economic stability and reduced market presence from the Fed.

Credit

- Corporate health remains in improving territory, but the speed of improvement is approaching a plateau. Profit margins stabilized as sales growth moderated. The slight improvement in corporate health was due to lower leverage and better debt service ratios. Growing shareholder-friendly activities (special dividends at the end of 2012) were not sufficient to add to balance sheet leverage or offset the positive effects coming from an accelerating equity market.
- We started to see large outflows from investment-grade corporate bonds funds at the end of Q2, particularly in US. We relate this to the speed at which government bond yields were increasing during the month of June, as tighter investment grade corporate spreads did not offer sufficient offset and generated losses for total return investors. We remain vigilant for signs of shifts in asset allocation. Given our expectations of limited-range yield volatility, we expect corporate spreads to maintain their tightening trend for the remainder of 2013.
- We are cognizant that market volatility, especially at the end of Q3, could put at risk the spread return.
- Compared to last quarter, we recommend a more cautious sector allocation. This is warranted by the possibility of external shock (Eurozone elections, volatility in Chinese credit market), as well as developments that add industry specific risks at Canadian high-beta sectors.

Global Real Estate

- Global real estate was hit at the end of the second quarter from the back up in yields. Commercial real estate in particular is sensitive to rates as valuations are highly dependent on the discounted value of future rental rates. For the remainder of 2013 we anticipate that rates will have a lesser impact on real estate valuations.

Equitable Asset Management's Asset Class Positioning Biases

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

Economic Summary

Since the end of the first quarter, markets have moved significantly although the economic conditions remain substantially unchanged. Economic growth remains subpar, with US Q1 GDP falling below 2%. Resolution of the fiscal cliff and sequestration have reduced policy uncertainty and increased small business confidence but there is still work to be done. The impact of the tax increases related to the fiscal cliff has likely been realized, although the economic impact from the sequestration has the potential for a delayed impact as government agencies have until September 30th to realize their spending cuts.

There are some early indicators of a rebound in the Japanese economy. Consumer sentiment, represented by the monthly Cabinet Office Survey has escalated through May and is at its highest level since April 2007 and this has followed through to retail sales. Business sentiment has also rebounded as Japan's Tankan survey has rebounded in the first half of 2013. Lastly, we have seen a pickup in inflation and future inflation expectations. The improvement has been largely driving by exports on the back of a weaker yen. This may come at the cost of consumer spending. Japan is a heavy importer of energy and higher import costs for energy will be passed along to the consumer, directly and indirectly, and at the expense of discretionary consumption. So, while a pickup in inflation is realized, it may be in the form of an energy price shock.

In China export growth slowed during Q2 managing to gain only 4.2% year over year. It is still unclear whether this export slowdown is temporary (due to tight monetary conditions in June) or permanent basis (from the Japanese Yen devaluation, and slowing global growth). On a quarterly trailing basis, the export numbers seem to be performing in line with the soft landing scenario we have observed since the beginning of 2012. Industrial production was still running at a respectable 9.1% rate at the end of June compared to 10% at the end of 2012. Internally, the consumer health is resilient, with retail sales growing at 13.3% at the end of June.

We have been monitoring decelerating global trade for some time now. While it appears that so far the negative economic side effects have been contained, we have crossed into new territory with stall speed reached. We likely have been at the level longer than the numbers indicate due to inaccurate Chinese export numbers that appear to have been rectified in the most recent prints. When overall exports were still growing there was less chance of a particular country's exports shrinking as a result of aggressive actions such as Japan's currency devaluation. With the current situation of stalled global trade, it will be more challenging and politically sensitive with one country's gain at the expense of another country, increasing the likelihood of protectionism.

US Economic Outlook

US economic growth has been lethargic over the past few quarters, dragged down in large part by government spending and weak business investment. The consumer has been contributing about 1.5-2% to GDP over the past year, and we expect that as we get beyond the fiscal cliff impacts, and with a firming in the job market, this will continue near 2%.

With rising rates, mortgage refinancing will diminish and the resulting benefit will fade. There has been a huge benefit as consumers refinanced their mortgages at lower and lower rates. This has supported consumption, initially as it was combined with equity withdrawals, but in recent years isolated to lowering payments only. Mortgage rates have jumped dramatically returning to levels last seen in mid-2011 and over 1% above the average level during 2012Q4.

Despite higher rates, there continues to be strong evidence to support housing as a positive contribution to GDP growth. While early year growth has been slower than

expected, many of the key ingredients remain in place for this to pick up for the remainder of the year. The rapid increase in mortgage rates is an area of risk to the housing market, and has the potential to slow buyers at the margin even though affordability remains attractive.

Government spending will continue to be a drag on US growth through Q3. Government spending was almost a 1% drag on GDP in the first quarter, and could be of similar magnitude or larger in the second and third quarters as the impact of the sequestration is realized. Into the fourth quarter the US Debt Ceiling poses a risk to the US economy and could very well derail the fragile recovery. As with similar negotiations over the past couple of years, both political parties remain polarized with no bi-partisan agreement in sight.

Canadian Economic Outlook

Canadian GDP showed surprising strength in the first quarter, with oil exports to the US fuelling the growth. Increased pipeline capacity is cited as contributing to increased exports. Going forward, a stabilizing US economy and a weakening Canadian dollar should help trade. This will be offset by a lower contribution from personal consumption as consumer credit growth has leveled off. We expect the Residential component to have a positive contribution in Q2 and H2 given recent strong performance in housing starts.

We have identified the Canadian housing market as one that is overvalued and is likely to correct but is waiting for a trigger. Over the last quarter activity has been surprisingly stable despite previous concerns of downward momentum building. From a high of over 250k, starts had dropped to 180k to end Q1, but we've seen a rebound the last 2 months. This suggests that there still is some wind in the Canadian housing sail for now. Fixed rate mortgages have seen a sizable increase recently which may hamper things in the coming quarters, but at the very least the slowdown will not be as abrupt given the moderation evident YTD.

The new Governor at the Bank of Canada, Stephen Poloz, has noted the headwinds to the Canadian economy, and with slowing housing, slowing consumer credit, as well as the low levels of inflation, he has committed to keeping short term rates low. Based on this, we expect short terms rates in Canada are likely to remain on hold well into 2014 at which point the Bank of Canada will begin to tighten in a cautious manner.

European Economic Outlook

Europe remains in recession with European GDP falling 1.1% y/y in Q1. Germany, the one strength until late 2012 has fallen into negative territory on a y/y basis. The 'bright' spot is that Greece is shrinking at a slower pace. On a quarter over quarter basis, things improved marginally; the pace of decline improved in the region to a -0.8%, and Germany remained basically flat. These are seasonally adjusted numbers and, therefore, may suffer from some distortion from the large 11.7% drop in the Q1 2009 GDP. (Q1 2011 and 2012 saw small improvements, only to be followed by weak Q2 and Q4 data.)

Looking forward, manufacturing PMI, industrial production, and retail sales numbers show improvement. The PMI has shown a steady improvement since July 2012, and retail sales appear to have bottomed in 2012, although they are still shrinking at about 1% year over year. Overall, the pace of decline appears to be shrinking, but growth has yet to materialize.

Risks are somewhat reduced. Deposit outflow was a major concern through 2011 and 2012, particularly for Greece and Spain. The pace of outflows has fallen in Spain to 4.6%, from withdrawals of more than 10% through the second half of 2012. Meanwhile, in Greece deposits turned positive in February, growing by over 5% in May.

Overall there are more signs of stabilization in the Eurozone economy than there were 6 months ago, although these signs are fairly tentative and subject to downward shocks.

Economic Conclusion

Economic growth remains lethargic, with some signs of slowing from the emerging markets. This is offset by a lessening of the downside risks as Europe shows some tentative signs of improvement and a lessening of deposit outflow from the banking system and, in some cases, even deposit inflows.

The risks to economic growth have diminished over the past year with resolution of the fiscal cliff, and stabilization in Europe. Despite an improvement, above average risk remains. Europe continues to struggle with high unemployment and an undercapitalized banking system; China is attempting to rebalance its economy; Japan is undertaking a massive QE policy experiment; and the US is struggling with its growing debt and with a fractured political system. The backdrop of weak economic growth leaves little room to absorb these risks should they come to fruition.