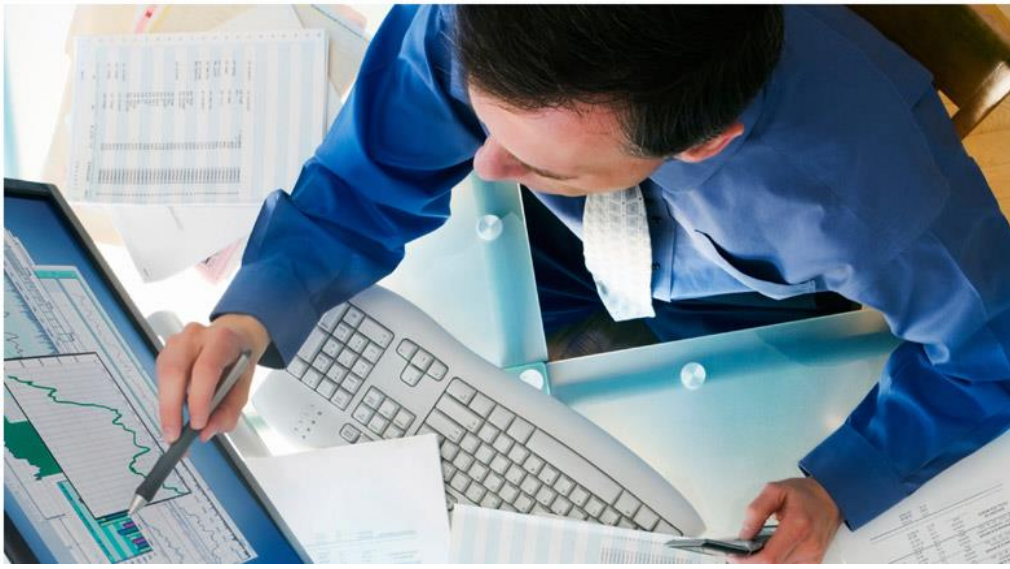
Equitable
Asset Management Group

ASSET ALLOCATION STRATEGY



Second Quarter 2014 Outlook

Content

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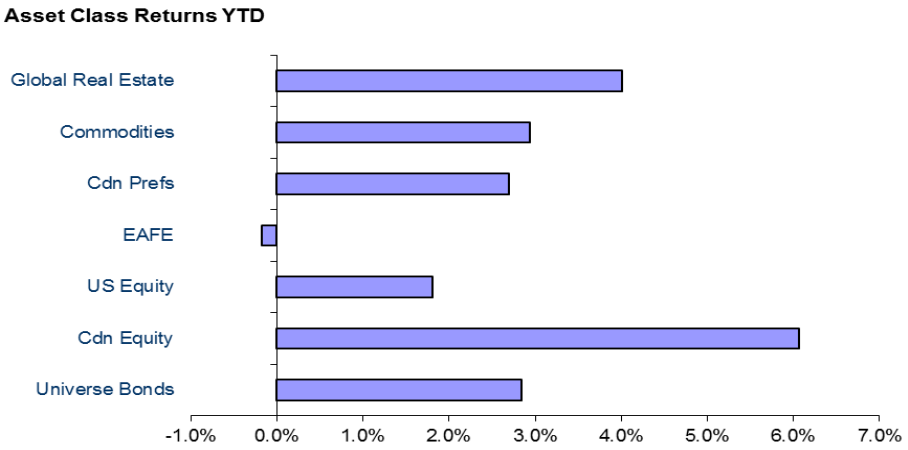
Asset Allocation

Asset Class Returns As of March 31st, 2014



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

Asset class strategy

Developed equity markets

- The combination of accommodative Fed policies and a slowly improving economy continues to favour investments in risk assets
- What characterizes this cycle as unique is the significant level of accommodation by US Fed policy; low interest rate environments are generally positive for equities
- We believe we are in the final phase of accommodation of the interest rate cycle and this should continue until mid-2015
- Forward equity yields of approximately 6% on the S&P 500 over credit yields of approximately 4% gives us confidence that investors will continue to prefer to allocate to equities
- From a valuation perspective, the S&P 500 is currently valued at 15.5 times forward earnings, roughly in line with historical averages which leaves potential for upside performance
- We expect record level profit margins to continue which supports our bullish views on developed equity markets
- While developed markets are more expensive compared to a year ago, we remain 60% valued relative to the peak of the dot com bubble in 2000; we do not believe we are in a bubble similar to the tech wreck
- Fears of a repeat of the 2000 sell-off, largely based on recent high flying performance of the biotech and technology stocks, are overblown
- We expect weaker performance on the S&P/TSX Composite Index, relative to US markets, based on weaker economic data and an overall lack of demand for commodities
- Both the Canadian and US markets are currently trading in line with each other from a valuation perspective

Bond markets

- Polar Vortex was the Q1 theme – rates rallied led by a 42 basis point decline in 10-year yields
- Long bonds (30-year) significantly underperformed and were down 22 basis points in the quarter
- Adding to the weather-induced, weak economic data was geopolitical concerns from Russia and Ukraine, another round of emerging market volatility and concerns for China's growth and credit risk
- Our outlook for US growth has improved, and we continue to expect improving data points south of the border to drive the directionality of Canadian yields (Canadian bond prices to decrease)
- We continue to forecast a 3.25% year-end target for yields on 10-year US treasury notes
- In general we expect curve steepness should be relatively range bound in the near term, but going into year-end we expect curve flattening to occur as the front of the curve prices in greater certainty regarding rate hikes

Credit

- Strong credit market performance realized during Q1 was in line with our expectations and in line with seasonal patterns observed over the last 3 years on the back of imbalances between strong demand for corporate bonds and lower new issuance
- We remain cautious on our sector allocations in the credit market warranted by poor valuations in some cyclical sectors
- Continued fatigue in many of the fundamental indicators for the credit market and the overall credit market remains more susceptible to external shocks
- We expect the negative correlation between corporate bonds and Canada bonds to prevail, i.e., as benchmark yields go up, corporate bond spreads have a tendency to tighten
- We are likely to downgrade our allocation to corporate bonds when banks start to tighten lending standards, signs of a disorderly flight of capital from emerging markets emerge or S&P 500 corporate earnings contract considerably

Global real estate

- Historically, as interest rate fears increase, REITs have performed poorly which has offered buying opportunities 6-12 months post rate-driven sell-offs
- In the current environment, the slowly improving US economy, the Fed's bond taper and improving unemployment data point to strong REIT performance
- Further support for REITs is derived from property price support seen in US bank quoting activity for commercial real estate credit and lending standards are easing
- Non-residential construction has not posed any concerns as there has been a lack of growth in this area, which has created some rental inflation
- Given the above, most REIT analysts will be looking for signs of convergence of REIT prices and US 10yr treasury yields
- Up until recently, a negative correlation has persisted, but with positive fundamentals for REITs continuing, treasury yield movements, we believe, will not influence REIT prices to the same degree as they have in the past

Equitable Asset Management's Asset Class Positioning Biases

Asset class	Benchmark relative weight*	Previous weight
Cash	Underweight	Overweight
Bond	Underweight	Underweight
Duration	Neutral	Underweight
Credit	Overweight	Overweight
Equity	Overweight	Neutral
Canada	Neutral	Neutral
Us	Overweight	Overweight
International (Europe / Asia)	Underweight	Underweight
Global real estate	Neutral	Neutral
Other Asset Classes	Neutral	Neutral

***The stated positioning biases are relative to the benchmark allocation of the Equitable Life Active Balanced Portfolios, and are reflective of the outlook for 2014 as at the time of writing. These positions may or may not reflect the current positioning of the fund.**

Macro-economic analysis

Global economic summary

Global economic activity was relatively subdued over the first quarter, and we expect measured improvement going forward. Temperatures in Canada and the US prevented the consumer from visiting malls and buying cars but we expect this trend to reverse in the coming weeks. Tightening credit in China is slowing the non-bank lending market, but we expect the People's Bank of China to conduct an orderly control of the shadow banking system. This gives us confidence that a slowdown in China does not threaten overall global growth. The ECB continues to keep a close eye on deflationary forces across the Eurozone as investors wait patiently in anticipation of positive forward developments. The flight path to recovery is complicated by several factors including the ability of the ECB's to effectively control liquidity through open market transactions, as well as Russia's aggressive tactics against Ukraine. We continue to monitor both situations closely.

US outlook

In our most recent update, we concluded that downward pressures on the US economy were subsiding and we're happy to report we continue to see gradual improvements in the week-to-week economic data points we monitor. Labour markets continue to show signs of improvement, albeit at a slow and measured pace, housing prices are up year-over-year across most major US urban centers, consumer confidence is increasing and a new wave of corporate investment appears to be imminent. We anticipate business investment will add 1% to GDP, up from the 0.6% contribution we discussed in our recent annual strategy. And while positives continue to emerge, headwinds do exist. In particular, net trade has been and will continue to be a net detractor to overall GDP growth in the US in the coming months. The few negatives we are seeing, however, do not outweigh the positives and we remain bullish on the US economy. As such, we have revised up our GDP forecast for 2014 to 2.9% growth.

Canada outlook

While Canada tends to follow the same path as the US, a highly indebted consumer, weak labour markets, slowing home sales, an overall negative environment for business investment, and fewer goods being exported to foreigners leaves us to conclude that economic growth in Canada is unattractive relative to the US. In particular weakening business investment and slowing net trade forces us to revise down our expectations for GDP growth from 2% to 1.7% for 2014. The Governor of the Bank of Canada, Stephen Poloz, recently commented on the net trade position: "As a trade-dependent economy…weak global demand is limiting the growth of our exports, and the associated uncertainty is holding back business investment in structures, equipment and software." And while a weaker Canadian dollar will eventually positively contribute to net trade, there is an associated lag which will prevent positive near-term contributions.

Emerging market outlook

In our annual stragy we emphasized that not all emerging markets (EM) are alike and we are now in an era where EM nations will decouple and need to be studied on a case by case basis. For example, early indicators for March showed a net in flow of $1.6B which represents the biggest monthly inflow since early 2013 into Thailand, Indonesia and the Philippines. Worth noting, this record inflow of capital was preceded by a record $4.2B outflow in the fourth quarter of 2013. It seems investors could be betting that these economies are strong enough to endure the Fed induced bond taper in the US. On the flipside, there has been a $60-70B outflow from Russia in recent weeks on the back of actions taken in Crimea, which has some analysts speculating Russia will instill capital controls.

Janet Yellen's first testimony caught market participants off guard as the front end of the curve sold off in drastic fashion placing the US dollar in rally mode. This type of mistep from the Fed and any ensuing volatility remain a risk to EM currencies, bond and stock markets. Our base case scenario is the Fed will continue to move towards a more "normal" monetary policy through removal of the low interest rate environment. This, coupled with the bumpy road ahead for Chinese growth (6-12 months), will prove to be a volatile period for EM capital flows. Investors tend to differentiate good emerging markets from bad emerging markets, but during periods of high risk, we tend to see emerging markets act as one to the downside. We maintain that the normalization of US monetary policy and a rebound in developed economic growth should be supportive of emerging markets in the long run and result in a healthy rebalance in the global economy.

Our conclusions remain unchanged from year-end when we deduced that problems are well contained within particular markets (the fragile five for EM, and a subset of the wealth products in China). The People's Bank of China has been slowly tightening credit for nine months, targeting the expansion of non-bank credit as well as the frothiness in the real estate markets. Additionally, the government has accelerated its countercyclical spending and the People's Bank of China has initiated a set of funding programs to avoid a liquidity crisis and normal transition from market-based funding to government-funding.

Despite doom and gloom projections, we believe the base case scenario will follow an orderly control of the non-bank credit market. And as long as China's nominal GDP growth is sustained at around 9-10% (nominal terms), most of market securities will have little problem generating sufficient income to meet their obligations. However, if nominal growth decelerates sharply to below 6-7%, the potential for systemic risks contaminating the global economy will escalate quickly, as the majority of the trust products would become unviable. We doubt that China's nominal growth will drop to such a low level, but even under such an outcome, Beijing would have enough assets to bail out creditors.

Our investment style

There have been numerous studies which have demonstrated that the greatest contributor to a portfolio's overall return variance (opportunity) is asset class selection. As such, we focus our efforts on trying to determine which asset class offers our clients the best opportunity to generate risk-adjusted returns.

To answer this question, the most effective investment style to employ is a macro-economic, top-down approach. We believe taking a big-picture, "10,000 foot view" of the investment landscape gives us a clear roadmap of the general direction of financial markets, and it is against this backdrop upon which we base our investment decisions. Gaining insight into broader economic themes such as labour markets, housing, global trade patterns and central banker policies helps us assess the potential impacts the economy will have on financial asset pricing.

As the investment manager of Equitable Life of Canada's general assets, we employ relatively conservative views when approaching asset class investment decisions. This does not mean we do not take risks, but rather our investment decisions are made against rigorous and repeatable processes that seek to optimize the balance between potential risks and returns. We believe this risk-adjusted approach offers significant value for your clients over the long-term.

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