

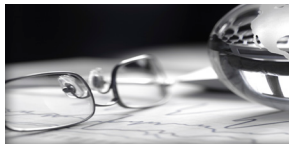
RBC Wealth Management | Global Insight



New central bank policies have calmed equity and fixed income markets. Does this mean all is quiet on the European front? (page 3)



In 2012, politics could have an even greater impact on markets than last year. The stakes are high. (page 5)



Stocks are relatively cheap in most markets, reflecting the challenges facing the global economy. Risks need to be acknowledged in portfolios. (page 9)



Within the fixed income sector, investment-grade corporates continue to offer attractive opportunities. (page 16)

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Priced as of January 31, 2012, unless otherwise stated.



RBC Wealth Management™

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Global Overview

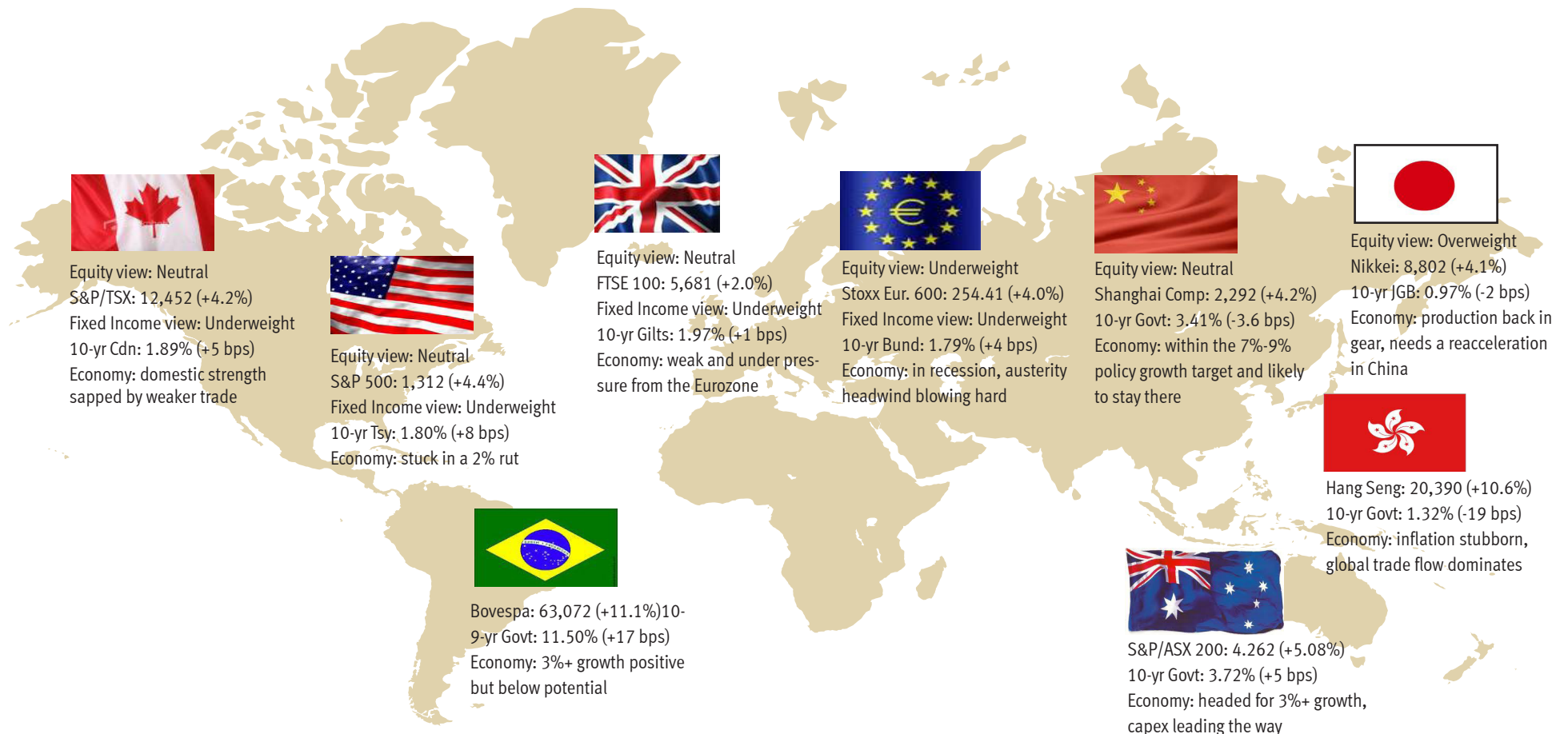
RBC's Investment Stance

The lingering Eurozone risks, combined with their potential spillover effects in the U.S. and China, are primary reasons we maintain our "Neutral" stance on global equities. To be clear, "Neutral" means including equities at a benchmark weighting in portfolios—that is, a weighting up to but not more than the long-term target allocation. After all, Eurozone officials could surprise markets again and announce new policies that would reduce the region's vulnerabilities. A sufficiently constructive announcement could trigger another worthwhile rally in equities.

Equally plausible, any of several tripwires (Greece, Portugal, politics, bank lending, etc.) could worsen the European and global outlook, and induce more painful volatility episodes. "Invested but vigilant" sums up our stance.

Global Asset Class View

Asset Class	View
Equities	=
Fixed Income	-
Cash	+



Equity index returns and fixed income change in basis points (bps) are for January 2012

Financial Markets Commentary

- › The ECB has taken great strides to protect the global financial system from bank defaults, and another round of stimulus is in the offing.
- › Even so, the Eurozone must negotiate many difficult hurdles in the coming months. Renewed global market volatility can't be ruled out. Now is not the time for investment complacency.

Equity Market Scorecard

Index (local currency)	Level	1 mo	6 mo	12 mo
S&P 500	1,312.41	4.4%	1.6%	2.0%
S&P/TSX Comp	12,452.15	4.2%	-3.8%	-8.1%
FTSE 100	5,681.61	2.0%	-2.3%	-3.1%
Hang Seng	20,390.49	10.6%	-9.1%	-13.0%
Dow (DJIA)	12,632.91	3.4%	4.0%	6.2%
NASDAQ	2,813.84	8.0%	2.1%	4.2%
Russell 2000	792.82	7.0%	-0.5%	1.5%
STOXX Europe 600	254.41	4.0%	-4.1%	-9.2%
German DAX	6,458.91	9.5%	-9.8%	-8.7%
Nikkei 225	8,802.51	4.1%	-10.5%	-14.0%
Straits Times	2,906.69	9.8%	-8.9%	-8.6%
Shanghai Comp	2,292.61	4.2%	-15.1%	-17.8%
Brazil Bovespa	63,072.31	11.1%	7.2%	-5.3%

Source: Bloomberg, equity index returns do not include dividends; data is through 1/31/12.

Financial markets breathed a sigh of relief after the European Central Bank forcefully intervened to prevent cascading bank failures.

The new policy represents more than a massive liquidity injection or back-door quantitative easing. It indicates central bankers are unwilling to stand idly by when weak institutions threaten to exacerbate a financial crisis à la the Lehman Brothers collapse in 2008. The ECB signaled it stands behind the banking system and, in turn, the global financial system.

No wonder most debt markets stabilized and equity markets traded higher after the ECB unveiled its Long-Term Refinancing Operations (LTRO) plan in early December. Continental European markets led the rally; the S&P 500 recorded its best January performance since 1997.

LTRO Round II

Markets are now focused on the next LTRO liquidity injection in late February. Eurozone banks will once again have the opportunity to borrow funds at 1% over three years instead of the ECB's typical one-year program. This provides more time to clean up balance sheets, recapitalize, and raise funds in the private debt market.

Market expectations are high, with some analysts forecasting banks will borrow over €1 trillion—far more than the €489 billion (\$641 billion) in loans issued during the first three-year LTRO tranche in December.

All Quiet on the European Front? Think Again.

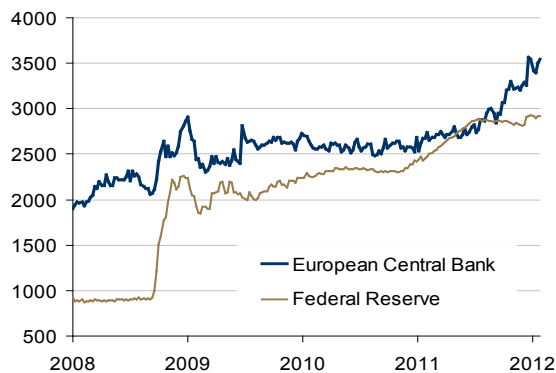
It's tempting to assume the ECB can solve most of the region's woes with this unprecedented program. This rare, positive development feeds into the understandable desire to cast Eurozone

concerns aside and focus primarily on market fundamentals.

But now is not the time to become complacent. All is not quiet on the European front:

- **Banks have a limited ability to support sovereign debt markets.** There have been media reports Eurozone banks could use February LTRO proceeds to purchase *sizeable* amounts of Italian and Spanish debt (and earn attractive returns in the process), thus further stabilizing the sovereign debt market and banking system. RBC Capital Markets' European bank analysts caution this is an unrealistic expectation and "at the bottom of banks' to-do list," based on recent management contacts. Sizeable purchases would make banks even more vulnerable to any renewed sovereign debt stress or disorderly defaults. Our analysts believe banks' first priority will be to use LTRO cash to pre-fund their corporate bond redemptions.
- **Sovereign yields could trend back up once the LTRO impact fades.** Italy, Spain, and others are scheduled to sell significant debt during the next few months. Positive sentiment about the LTRO program and abundant liquidity may help keep rates at manageable levels near term, but over time supply could overwhelm the market and funding costs could rise again—especially if countries miss their austerity and growth targets.
- **Greece may request additional write-downs or could succumb to a disorderly default** even if the country strikes a deal soon with private creditors to forgive a portion of its debt. Its debt-to-GDP ratio will remain unsustainably

Central Bank Total Assets in U.S. dollars (bln)



Source: Bloomberg; data through 1/31/12

Note: ECB total assets converted into U.S. dollars using spot EUR/USD exchange rates

high as long as the public sector (ECB, Eurozone central banks) is unwilling to take steep losses on its debt. The country is mired in a deep recession or worse. Its austerity plans have missed the mark on multiple occasions. There's no guarantee the next government—elections are tentatively scheduled for April—will honor previous austerity agreements.

- Portugal could slide deeper into a debt trap.** Its short- and long-term sovereign yields have soared despite the new LTRO program. Its credit default swaps are signaling a 70% chance of default. RBC Global Asset Management's Chief Economist Eric Lascelles anticipates Portugal will ultimately need to negotiate a debt writedown. We doubt global markets fully reflect this possibility.

Another Wildcard

The European economy is another wildcard for markets and earnings in 2012, and could weigh on North American and Asian growth. As Eurozone banks shed assets to improve capital ratios, the result may be reduced lending to the region's businesses and households, thereby increasing the risk of a prolonged or deeper European recession. We also anticipate Eurozone banks will continue to reduce loans to emerging markets where they fund a meaningful share of private-sector debt.

Even though U.S. economic momentum has improved recently and China seems headed for a soft landing, neither region can completely sidestep these headwinds. Many large multinational companies are already beginning to see signs of sluggish European demand, and Asian export growth is relatively weak.

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Equally plausible, any of the tripwires noted above (Greece, Portugal, politics, bank lending, etc.) could worsen the European and global outlook, and induce more painful volatility episodes. "Invested but vigilant" sums up our stance.

Market Scorecard

Bond Yields	1/31/12	12/31/11	1/31/11	12 mo chg
US 2-Yr Tsy	0.215%	0.239%	0.562%	-0.35%
US 10-Yr Tsy	1.797%	1.876%	3.370%	-1.57%
Canada 2-Yr	0.955%	0.956%	1.667%	-0.71%
Canada 10-Yr	1.889%	1.941%	3.275%	-1.39%
UK 2-Yr	0.357%	0.327%	1.299%	-0.94%
UK 10-Yr	1.970%	1.977%	3.656%	-1.69%
Germany 2-Yr	0.158%	0.144%	1.372%	-1.21%
Germany 10-Yr	1.787%	1.829%	3.155%	-1.37%
Commodities (USD)	Price	1 mo	6 mo	12 mo
Gold (spot \$/oz)	1,737.60	11.1%	6.7%	30.4%
Silver (spot \$/oz)	33.18	19.2%	-16.8%	18.2%
Copper (\$/ton)	8,299.50	9.3%	-15.4%	-15.0%
Oil (WTI spot/bbl)	98.48	-0.4%	2.9%	6.8%
Oil (Brent spot/bbl)	111.62	2.7%	-4.7%	12.3%
Natural Gas (\$/mBtu)	2.52	-15.4%	-40.8%	-43.1%
Agriculture Index	434.46	0.0%	-8.5%	-19.7%
Currencies	Rate	1 mo	6 mo	12 mo
US Dollar Index	79.29	-1.1%	7.3%	2.0%
CAD/USD	1.00	1.9%	-4.7%	-0.2%
USD/CAD	1.00	-1.8%	5.0%	0.2%
EUR/USD	1.31	1.0%	-9.1%	-4.5%
GBP/USD	1.58	1.4%	-4.1%	-1.6%
AUD/USD	1.06	4.0%	-3.4%	6.5%
USD/CHF	0.92	-1.9%	17.1%	-2.5%
USD/JPY	76.27	-0.8%	-0.6%	-7.0%
EUR/JPY	99.78	0.1%	-9.7%	-11.2%
EUR/GBP	0.83	-0.4%	-5.3%	-2.9%
EUR/CHF	1.20	-1.1%	6.4%	-6.9%
USD/SGD	1.26	-3.0%	4.5%	-1.7%
USD/CNY	6.31	0.2%	-2.0%	-4.3%
USD/BRL	1.75	-6.4%	12.7%	4.8%

Source: Bloomberg, RBC Wealth Management; data through 1/31/12. Bond yields in local currencies. U.S. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing.

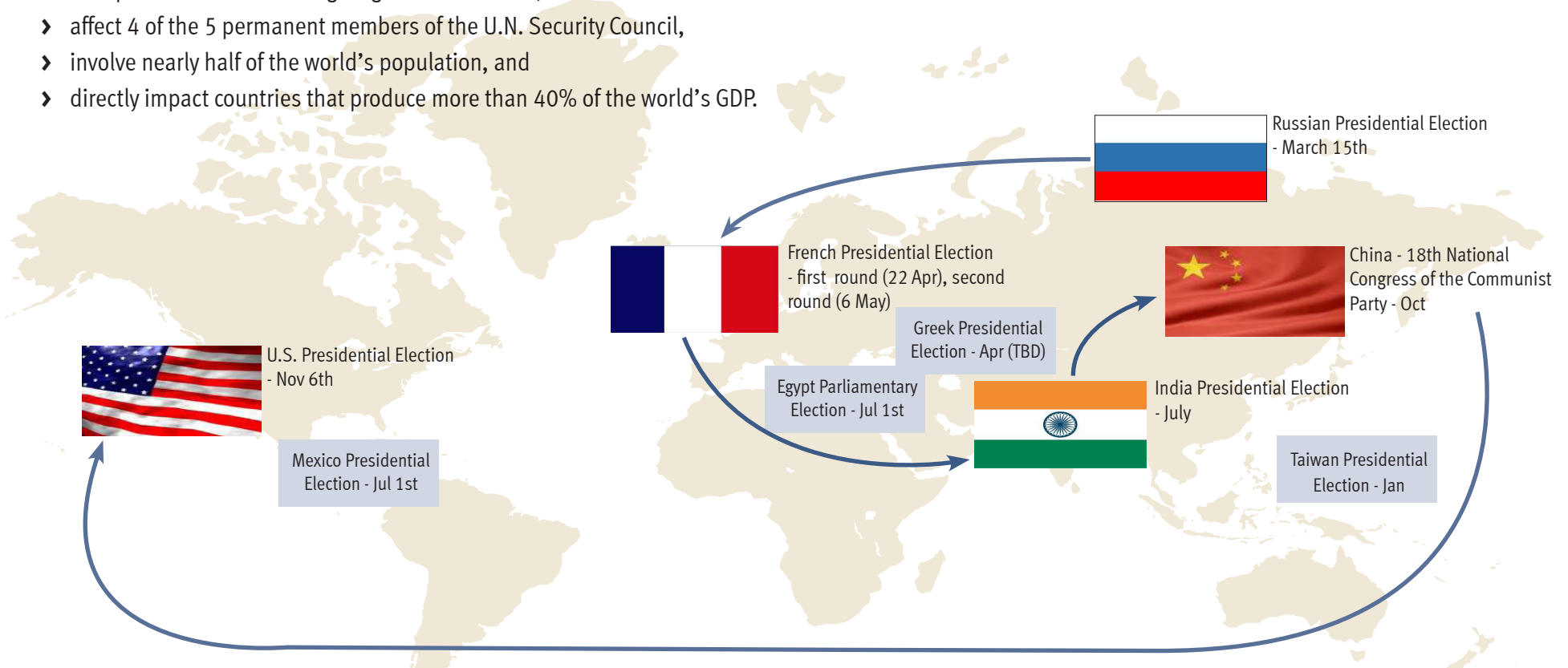
Examples of how to interpret currency data: CAD/USD 1.00 means 1 Canadian dollar will buy 1 U.S. dollar. CAD/USD -0.2% return means the Canadian dollar has fallen 0.2% vs. the U.S. dollar in the past 12 months. USD/JPY 76.27 means 1 U.S. dollar will buy 76.27 yen. USD/JPY -7.0% return means the U.S. dollar has fallen 7.0% vs. the yen in the past 12 months.



Politics in 2012: The Stakes are High

2011 was a year of significant political change—scheduled and unscheduled—that contributed to volatility across global markets. In 2012, politics could play an even greater role because more is at stake. Power shifts could ...

- › take place in 5 of the 10 largest global economies,
- › affect 4 of the 5 permanent members of the U.N. Security Council,
- › involve nearly half of the world's population, and
- › directly impact countries that produce more than 40% of the world's GDP.



Major Political Timeline →

Other Political Events

Throughout 2012, RBC Wealth Management will discuss key election issues with an emphasis on how they could potentially affect financial markets and investment portfolios.

In this article, the first in the series, we provide an overview of the French and U.S. elections and China's power transition.



Politics in 2012: The Stakes are High

Country	Election	Date
Taiwan	Presidential	January 14, 2012
Taiwan	Legislative	January 14, 2012
Finland	Presidential First Round	January 22, 2012
Egypt	Legislative Stage One	January 29, 2012
Finland	Presidential Second Round	February 5, 2012
Syria	Legislative (Tentative)	February 2012
Russia	Presidential	March 4, 2012
Iran	Parliamentary	March 29, 2012
Egypt	Presidential	March 2012
France	Presidential First Round	April 22, 2012
Greece	Parliamentary (Tentative/ Snap)	April 2012
South Korea	Parliamentary	April 2012
Palestine	Presidential	May 4, 2012
Palestine	Parliamentary	May 4, 2012
France	Presidential Second Round	May 6, 2012
France	Legislative First Round	June 10, 2012
France	Legislative Second Round	June 17, 2012
Iceland	Presidential	June 30, 2012
Mexico	Presidential	July 1, 2012
Mexico	Legislative	July 1, 2012
Kenya	Presidential First Round	August 14, 2012
Kenya	Parliamentary	August 14, 2012
Hong Kong	Legislative	September 2012
United States	Presidential	November 6, 2012
United States	Legislative (Congress)	November 6 2012
Romania	Parliamentary	November 2012
South Korea	Presidential	December 2012

In an environment fraught with contentious economic and fiscal policy issues, the 2012 election cycle will soon catch investors' attention. Election outcomes in France, the United States, and Greece, and China's power transition could have a considerable effect on investment portfolios around the world.

- › Many of the Eurozone's challenges remain unresolved, particularly the way the region will forge a closer fiscal union. **The French election in May should help determine whether Europe becomes more or less integrated** and if it takes on a German or French bent. It may also end up influencing whether the Eurozone as we know it today exists in the years ahead.
- › **In the U.S., voters will choose between two very different economic recovery plans** and approaches to tackle the federal deficit and debt. The election will lay the groundwork for the 2013 legislative agenda, which should be one of the busiest in years. More importantly, it could establish the course for the world's largest economy during the next decade.
- › **A major transition in Chinese leadership will begin this year.** Any significant policy shift would take some time to surface. But one thing is certain—a new generation of leaders will eventually make its mark on the world's second-largest economy and the global balance of power.

France – April/May

President Nicolas Sarkozy will likely face Socialist Party candidate François Hollande in his bid for reelection.

The Most Important Election in Decades

For France, the Eurozone, and global markets, this election is critically important.

First, France is under market pressure to adopt more austere economic and social policies to reduce its national debt—not ideal issues to discuss with voters during an election. The imposition of austerity measures in response to the crisis have proved highly unpopular. Opposition parties will push strongly for a change in policies.

Second, if the main opposition candidate, François Hollande, were to be elected, it could create uncertainty about the relationship between France and Germany—the two countries most active in resolving the Eurozone crisis.

Even though German Chancellor Angela Merkel and Sarkozy—dubbed “Merkozy” in the press—have disagreed on many occasions, the two managed to hammer out important compromises in an attempt to stabilize the crisis. Sarkozy's campaign is likely to lean heavily on his ability to influence key European leaders. Further, he advocates using Germany as an economic model and suggests some reforms to increase France's productivity.

A change atop France could not only alter the German-French relationship, it would possibly require previous Eurozone agreements to be reviewed and changed—if Hollande's rhetoric is to be believed. He has been critical of Merkel's demands for changes to European Union treaties to allow disciplinary actions against overspending Eurozone governments and has expressed a desire to renegotiate agreements from 2011. This would likely further delay any lasting solutions as well as create market volatility. Hollande also seeks to raise taxes on affluent French citizens.

The uncertainty created by the French election calendar and outcome could test German leadership. Merkel will be faced with a re-election

Politics in 2012: The Stakes are High

bid in 2013, which will require increased focus on domestic issues in 2012 and provide an incentive to stabilize the Eurozone crisis prior to her election campaign.

A Runoff is Likely

The French presidential election is based on securing a majority of the popular vote. If after the first round of voting (April 22, 2012) a single candidate has received over 50% of the vote, the election is over and (s)he is declared the winner. If no one secures a majority, there is a runoff between the top two candidates that would occur May 6, 2012. This ensures that one of the top two candidates wins a majority in the second round, and that winner becomes the next president.

There are 15 candidates for the first round, three of which are attracting some 70% of voter support; President Nicolas Sarkozy (Union for a Popular Movement; centre-right), François Hollande (Socialist Party; centre-left), and Marine Le Pen (National Front Party; extreme-right nationalist).

A poll published January 23 for the first round suggests Hollande (31%) leads President Sarkozy (25%), while Le Pen gathers 17% of the votes. Polls for the second round, focusing on Hollande (60%) and Sarkozy (40%), suggest the former is leading the race to become the next president.

U.S. – November

President Barack Obama will likely face Republican Mitt Romney or Newt Gingrich in his race for a second term. A high-profile, third-party candidate could also surface and alter the electoral arithmetic.

The national congressional elections should play a pivotal role in shaping U.S. economic policies. The Senate, currently controlled by Obama's Democratic Party, is in play. If Republicans achieve a net gain of four seats among the 33 seats

up for election, they would win control of this 100-member upper chamber—a real possibility. At this stage, opinion polls indicate the House of Representatives, the lower chamber, could remain in Republican hands, although their advantage could shrink.

Pocketbook Issues to Drive the Debate

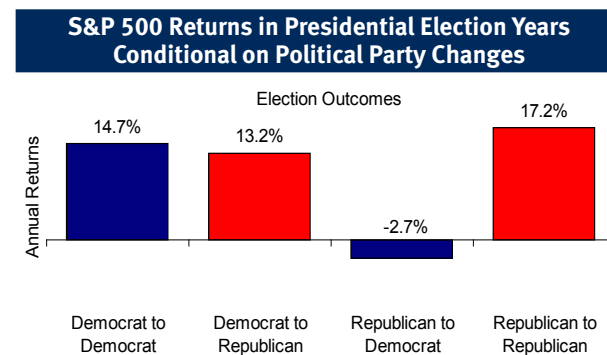
In addition to economic recovery and employment issues, many voters will consider candidates' spending and austerity proposals due to the high federal deficit (8.7% of GDP) and mounting federal debt (99% of GDP).

Eric Lascelles, chief economist for RBC Global Asset Management, estimates austerity measures already in place could reduce annual U.S. GDP growth by 1.0%-2.5% in 2013 and beyond, depending on which policies are actually implemented or allowed to expire. New austerity measures could add additional economic headwinds.

Tax policy almost always plays a big part in American elections; this election should be no different. Both parties favor overhauling the tax code for individuals and corporations, and there is a predictably wide gap in the way they would approach it. Regardless of who wins the presidency, Congress will play a key role in shaping the tax reform debate in 2013. Budget constraints could force a revenue-neutral plan. With a lot at stake, the race to control the Senate and House becomes crucial.

It's a Unique, State-by-State Process

Republicans are currently selecting their presidential nominee through a series of state-wide primary elections and caucuses that award "delegates" to the Party's national convention in late August. One candidate could begin to pull ahead in the primary race in February or March, and most states will have voted by early June. The



Source: National Research Correspondent; election years 1926 to present

candidate who accumulates at least 1,144 of 2,286 total delegates will become the nominee.

The campaign for president will begin in earnest when one of the Republican candidates has a plausible, mathematical pathway to winning a majority of delegates. The race will shift into full gear by early September, when the Democratic Party holds its convention and officially re-nominates President Obama.

The U.S. does not elect its president by popular, national vote. Instead, an "electoral college" process allocates "electoral votes" to be cast for candidates to all 50 states and Washington D.C., proportional to their populations. The overwhelming majority of states award all of their electoral votes to the candidate who wins the popular vote in that state. The candidate who can amass at least 270 of the total 538 electoral votes wins the presidential election. As a result, races in "swing states" or "battleground states" where votes for each candidate could be closely divided (such as Florida, Virginia, Pennsylvania, Michigan, New Mexico, and others) will attract more of candidates' time and attention compared to states where the electorate tends to be highly skewed toward one party.

Politics in 2012: The Stakes are High

China – Late 2012 and Beyond

Chinese politics have long been dominated by the Politburo Standing Committee (PSC). Although the National People's Congress is formally the ultimate decision-making body in China, in reality it is the PSC that holds the power.

Due to the PSC's informal rules on retirement age—leaders over 68 years should retire—2012-2013 will likely see a generational shift in leadership. The country's top two leaders will most likely relinquish their positions. In total, seven of nine PSC members may step down.

Currently, Hu Jintao is president and Wen Jiabao is prime minister. The two politicians widely expected to take over are, respectively, Xi Jinping (Xi is pronounced like “see”) and Li Keqiang (Keqiang is pronounced like “kur-chiang”). They will likely assume the top PSC positions in the fourth quarter of 2012 and take over the presidency and the premiership in March 2013 at the National People's Congress. According to the informal rule on retirement age, they would be the only two continuing PSC members.

Major Changes Could Occur in 2013

Leadership changes to the PSC have occurred a number of times before. What makes it different this time is the extent of change within the PSC and the position China now holds on the global stage.

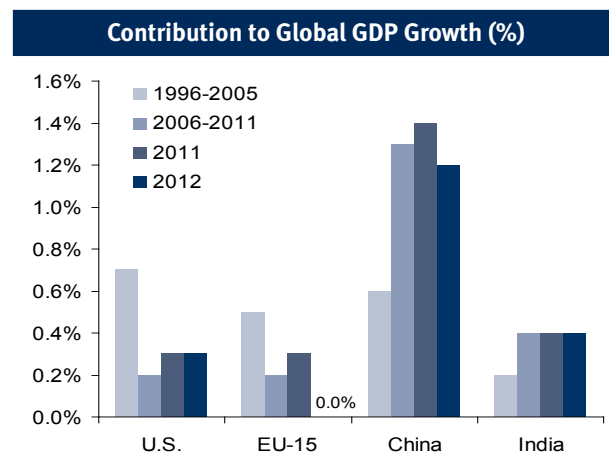
From an investment perspective, Chinese government policy typically has a conservative tendency during the transition year. It should be no surprise, then, that stable monetary and fiscal policy were set forth as two key themes for 2012 at the annual Central Economic Work Conference that ended last December.

Curbs on China's private housing market will likely continue in 2012 while the government brings to market large volumes of low-cost units to quell

widespread dissatisfaction with the availability and affordability of housing.

One might reasonably expect the mainland Chinese stock market, which is dominated by state-owned enterprises with the government as the majority shareholder, to exhibit less volatility this year. It is also unlikely investors will witness any dramatic moves in the value of the Chinese currency in 2012, in our view.

Most importantly, after a political transition occurs, major policy initiatives are typically introduced. That could make 2013 a particularly interesting year. Chinese/U.S. policy issues will be in focus, with potential leadership changes in both countries. Clearly any Chinese policy changes are likely to produce important domestic and global outcomes.



Source: The Conference Board; 2011-2012 data are projections

Other Elections

› **Greek parliamentary elections**, tentatively scheduled for April, will choose a new prime minister. Current Prime Minister Lucas Papademos, leader of the caretaker coalition government that negotiated recent bailout agreements, plans to step down. Eurozone and

IMF officials have repeatedly sought out and received written pledges from all Greek political party leaders that they will adhere to previously negotiated bailout and austerity agreements. Even so, there remains great uncertainty about whether the new Greek government will honor its commitments. As a practical matter, this may be impossible considering the country's extreme debt load and severe economic condition. The new government may ultimately determine whether Greece exits the Eurozone. Antonis Samaras, head of the conservative New Democracy Party, currently leads in the opinion polls but would likely need to form a coalition government to become prime minister.

- › It seems inevitable **Russian** leadership will officially shift back to Vladimir Putin in March—although in practical terms his power and influence have been dominant for years. At this stage it's unclear if there will be major changes in economic or foreign policies. Russia's economy is too small to have much impact on global growth, but its energy policy can impact Europe. Further, the anti-Kremlin protest movement will be monitored by investors to assess stability.
- › While **India**, the world's largest democracy, will also elect a president, the position is largely ceremonial. The country is governed primarily by Prime Minister Manmohan Singh, who was reelected to his second five-year term in 2009. As finance minister in the 1990s, he implemented important reforms to open up the Indian economy. He remains a respected leader, but as prime minister he has been less effective in advancing additional reforms and large-scale infrastructure projects than investors had hoped.
- › Presidential elections will take place in **Mexico**, **Finland**, **Egypt** (TBD), and **South Korea**.



Global Equities

Global Asset Class View

Asset Class	View
Equities	=
Fixed Income	-
Cash	+

Regional Equity View

Region	Weighting	
U.S.	Neutral	=
Canada	Neutral	=
Continental Europe	Underweight	-
U.K.	Neutral	=
Asia (ex Japan)	Neutral	=
Japan	Overweight	+

Attractive Valuations Overshadowed by Lingering Risks

A coordinated central bank move to ease banking system liquidity in Europe, together with an unexpected reserve requirement cut for Chinese banks, accompanied by better manufacturing and holiday spending data out of the U.S. allowed most markets to gain their footing in December and post worthwhile gains in January.

The successful inauguration of the European Central Bank's LTRO facility giving the region's banks access to low-cost funding for at least three years removed the immediate threat of a banking system meltdown and put a welcome bid into the market for French, Italian, and Spanish bonds.

That in turn allowed equity investors to switch their focus back onto market fundamentals (improving) and valuations (cheap).

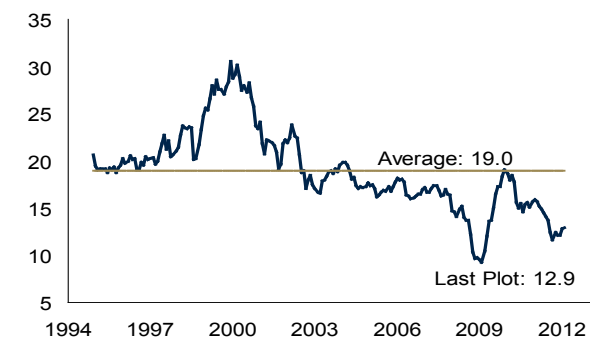
Because most major stock markets are still very attractively valued while bonds offer unacceptably low coupon returns as well as price risk, we would like to be able to recommend an "Overweight" commitment to equities. However, we find ourselves constrained by the recognition the Eurozone crisis could still deteriorate in a way that could jolt North America from slow growth into recession and prolong China's economic slowdown.

Were that to happen, earnings would come under pressure, today's price/earnings ratios would no longer look so attractive, and stocks would likely be vulnerable to an additional period of retrenchment.

While that is not our forecast, we rate the probability of it occurring at about 30%, high enough that it needs to be acknowledged.

We recommend a "Neutral" exposure to stocks—that is, portfolios should contain up to but not more than their long-term target allocation to equities. We also counsel vigilance since we expect many present uncertainties will be resolved over the next six months in a way that forces us off our "Neutral" stance in one direction or the other.

Global Equities are Cheap on a Historical Basis



Source: Datastream; World Index P/E data through 1/31/12

Neutral (=)

- The S&P 500 is trading at a compelling valuation, as the chart on page 23 illustrates. This lays the foundation for attractive returns over the long term.
- However, in the near term the market must contend with lingering Eurozone risks, economic headwinds, and potentially slower earnings growth. These factors argue for “Neutral” or benchmark exposure to U.S. stocks for the time being.
- The consensus S&P 500 earnings forecast for 2012 has pulled back to \$106 per share but remains above our \$101 forecast.

Sector View			
Consumer Staples	+	Health Care	=
Information Technology	+	Consumer Discretionary	-
Industrials	+	Materials	-
Energy	=	Telecommunications	-
Financials	=	Utilities	-

Source: RBC Capital Markets

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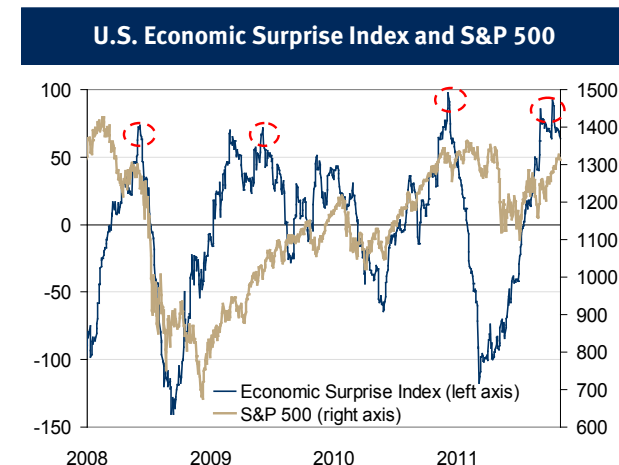
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Market Developments

- The S&P 500 has rallied 19.4% from its October low due to improved economic data and the ECB’s LTRO policy. Employment growth picked up, manufacturing activity expanded, and some housing indicators began to stabilize during the period.
- Because market expectations were set rather low last fall, it didn’t take much for data to surprise to the upside. The U.S. Economic Surprise Index, which measures whether the flow of economic data is exceeding or undershooting forecasts, began to rise meaningfully in October. By early January it reached its second-highest level since 2004. This also provided a catalyst for stock prices.
- History suggests the Surprise Index will eventually retreat as expectations become overly optimistic. It doesn’t necessarily follow that the stock market has to come down, too. But the record says it is unlikely the market will run away dramatically to the upside with expectations already so full.
- We also anticipate *actual* economic activity will moderate soon. GDP growth should pull back from its 2.8% fourth-quarter pace. We forecast 2.0% growth for all of 2012.
- Almost 40% of S&P 500 revenues come from outside the U.S., so a worsening global economic outlook combined with slow U.S. growth calls for subdued earnings expectations. S&P 500 earnings are near a record high as a share of GDP at a time when more sectors are experiencing profit margin contraction than expansion. We forecast S&P earnings will grow by only 4% this year, down from 13% in 2011.

Portfolio Recommendations

- Stick with high-quality, dividend-paying stocks; can better withstand periods of earnings erosion.
- Among cyclicals, favor Industrials (upgraded to “Overweight” from “Neutral”) and Technology. Industrial earnings revisions should rebound due to improved manufacturing activity. Technology valuations are cheap; company balance sheets sturdy.
- Financials are somewhat more attractive (upgraded to “Neutral” from “Underweight”). Bank earnings indicate U.S. financial system is finally beginning to heal.
- Decrease exposure to Utilities (downgraded to “Underweight”). Sector is expensive; trades at the high-end of its 30-year range.
- Limit exposure to Health Care (downgraded to “Neutral”). Earnings and revenue trends less attractive vs. 2011.



Source: Bloomberg; Citigroup Surprise Index data through 1/30/2012

Neutral (=)

- › We remain “Neutral” for Canada, on a global asset allocation perspective. While we remain concerned about the risks of a global slowdown, we believe current monetary policy, especially in the U.S. and Europe, should be supportive of the Canadian market for some months to come, given its significant resource exposure.

Sector View			
Consumer Staples	+	Health Care	=
Financials	+	Materials	=
Industrials	+	Energy	-
Telecommunications	+	Information Technology	-
Consumer Discretionary	=	Utilities	-

Source: RBC Capital Markets

Market Developments

- The TSX closed up in January, following a string of 9 out of 10 months of lower closes.
- RBC Capital Markets recently reduced its 2012 EPS estimate for the S&P/TSX to \$885. The sharp reduction in estimates is primarily the result of weakness in commodity prices and a stagnant U.S. economy, Canada’s largest trading partner.
- At current levels, the TSX is now trading at ~14x 2012 estimates, which is roughly in line with its long-term average.
- Shares of bank stocks have recovered significantly over the past few months as fears over Europe have somewhat abated. While still below its 15-year average, the valuation gap has narrowed significantly since Q411 earnings were reported in early December.
- We note that Canadian banks have limited direct exposure to Southern Europe; however, as with most global banks, concerns over Europe are still likely to weigh on valuations from time to time.
- A “soft landing” for China would be longer-term positive for Canadian stocks because of the high commodity weighting in the S&P/TSX Index.

Portfolio Implications

- We believe gold stocks offer a compelling opportunity at the present time. Shares of gold producers continue to discount a much lower gold price than is prevailing in the market, while global reserve additions continue to run at less than half of annual production.
- We have increased our recommended weighting on Industrials to “Overweight” from “Underweight” to reflect a more positive overall view on the macro backdrop. We also note that Canadian industrials have significant exposure to mining and energy where capex levels are expected to remain high.
- We have reduced our recommended weighting in Utilities to “Underweight”. While the sector offers attractive dividend yields, we believe valuations are rich and are at risk should the macro backdrop further improve.

Global Equities: Continental Europe

Underweight (–)

- › With the euro area entering recession and inflation being tamed, the European Central Bank (ECB), headed by the pragmatic Mario Draghi, should continue to provide support through liquidity provisions and monetary policy. Another three-year Long-Term Refinancing Operation (LTRO) is taking place at the end of February.
- › The weak macroeconomic backdrop continues, though there are signs some euro area countries are stabilising.
- › The Eurozone crisis is not over, and the region still faces an arduous road ahead. We remain “Underweight” the region.

Market Developments

- The recent ECB’s LTRO of €489bn served as a lifeline to Eurozone banks. Prior to the intervention, they faced severe liquidity stress and the prospect of a series of cascading bank failures. With its intervention, the ECB is effectively underwriting bank re-financing requirements for at least the next two years. Unlike the Fed balance sheet expansion in 2008/09 that dealt with the cause of the crisis—the financial system—the ECB’s LTRO does not address the root of the problem—namely, the sovereign debt crisis. It merely gives the banks breathing space to recapitalize.
- An abrupt market rotation occurred in January when the immediate risk of a financial system collapse was averted. The discrepancy between the highly valued defensives and lowly valued cyclicals was partially restored. Cyclical and value stocks outperformed while defensives lagged.
- The “flash” Purchasing Managers’ Index readings rose for the third-straight month in January, indicating stabilisation in euro-area economic activity. The surveys suggest that although business conditions remain challenging, economic headwinds may no longer be quite so intense. The pick-up in U.S. growth, the weaker euro, and the ECB policy stimulus are providing some relief for the economy. But with fiscal austerity set to intensify this year, the economy is expected to remain very fragile.

- With an onerous sovereign funding programme—Eurozone governments need to raise some €219bn in new bonds in the first quarter—risk remains. The biggest near-term danger is Greece, which is still negotiating an agreement on losses that private bond holders should bear on its government bonds. Even a 50% “haircut” on private debt would leave the country with an uncomfortably high and unsustainable 120% debt-to-GDP ratio by 2020. A much bigger haircut or a disorderly default could shock investors.

Portfolio Recommendations

- We continue to recommend investing in resilient companies with a solid market position, a high proportion of recurring sales, exposure to growing regions or industries, and a healthy balance sheet. Such companies should be well equipped to weather challenges in upcoming months.

European Central Bank’s Total Assets (€ billion)



Source: Bloomberg

Neutral (=)

- › The U.K. economy continues to suffer from the pressures of austerity. Tight credit conditions, eroded real disposable income, and unemployment all crimp consumption. Growth in exports has been disappointing and unable to offset the malaise in the domestic economy. RBC Capital Markets expects weak, but not necessarily disappointing, growth.
- › With fears concerning the Eurozone and its banks receding somewhat in January and global leading indicators improving, the U.K. stock market gained during the month. Further expansion of the Bank of England's quantitative easing programme expected in February should help support markets.
- › Recession risks continue to linger for 2012. These could weigh on corporate earnings and equity prices. A disorderly outcome to the European sovereign and Financial sector crisis remains the key risk, though we continue to expect this risk will not crystallise.

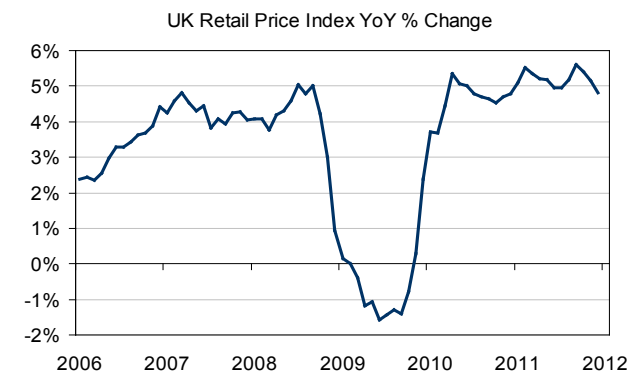
Market Developments

- Following the ECB's LTRO operation and with global leading indicators improving, the FTSE 100 gained in January. The FTSE 250 outperformed as small- and medium-cap stocks rallied. Greater risk appetite was also evident in the sector performance, with Financials and Basic Materials leading while Utilities, Health Care, Consumer Goods, and Energy lagged.
- Encouragingly, the manufacturing, services, and construction PMIs have all surprised on the upside, although still consistent with a weak economy.
- U.K. CPI inflation declined to 4.2% y/y in December. The deceleration in prices reflects base effects with transport and utility prices rising sharply in December 2010. These are now falling out of the annual comparison, and RBC Capital Markets expects this to take inflation down to below 3% by April.
- Unemployment increased to 8.4% in November, a little higher than expected, though the pace of the rise in unemployment seems to have moderated. Confidence remains weak, and real income growth is set to stay in negative territory throughout 1H12. However, slightly easing credit conditions for households, less real wages erosion as inflation becomes less punitive, and no marked deterioration of the unemployment picture should all help to attenuate headwinds later in the year.

Portfolio Recommendations

- We have been favouring companies with a relatively high exposure to North American customers and relatively low exposure to Europe, in particular Energy, Health Care, and Utilities.
- The recent outperformance of these stocks led to higher valuations, and further meaningful outperformance may be harder to come by in the short term.

U.K. Inflation Peaked in 2011



Source: Bloomberg, data through December 2011

Neutral (=)

- Asia ex-Japan equity performance continues to be capped by a slowdown in Chinese growth, slower global growth affecting demand for Asian exports, and negative investor sentiment from the European sovereign debt crisis. We maintain our “Neutral” stance on regional equity markets.
- However, we do note that leading indicators in the region may be in the process of bottoming, and equity performance at the start of 2012 has been more encouraging. Asian equity performance was particularly weak in the second half of 2011.
- While the Chinese economy faces numerous challenges, the base case still calls for a soft landing. We forecast 2012 Chinese GDP growth of 8.4% and moderate appreciation in the Chinese currency.
- Central banks are either staying on hold or selectively easing, while inflation is also moderating. Equity valuations are low. Equity performance over a 12-month time horizon has historically been favourable at these valuation levels once central banks have started easing.

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Market Developments

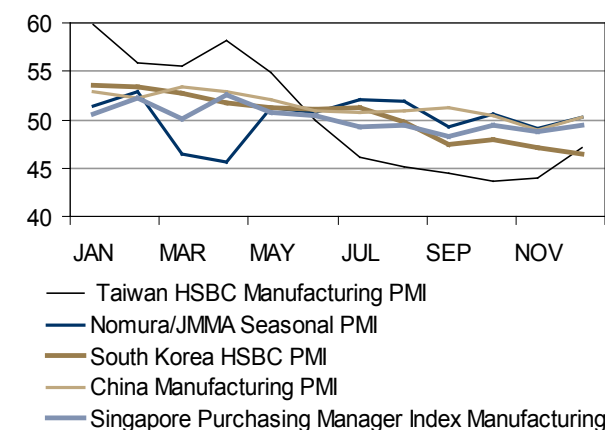
- For January, the Hang Seng Index rose 10.6%; the Singapore Straits Times Index 9.8%; the Nikkei 4.1%, South Korea’s KOSPI 7.1%, Shanghai A-Share Index 4.2%, and Australia 5.1%. Equity performance was strong in January despite the Chinese New Year, which is usually a quiet period for markets.
- Central banks in the region are no longer tightening. They are either on hold, as in Australia, New Zealand, South Korea, and China, or loosening policy, such as in Indonesia and, more recently, Thailand. Many central bank statements have referenced the weak global growth environment as an impediment to domestic growth.
- President Ma Yingjiu was elected to a second four-year term as Taiwan’s president, with nearly 52% of the vote. Taiwan has enjoyed closer ties with China under the rule of Ma’s Kuomintang Party.
- Chinese GDP data continues to indicate the economy is going through a soft landing. Fourth-quarter GDP was up 8.9%, slightly more than expected. The economy grew 9.1% in 2011. China’s CPI continued to moderate to 4.1% in December. We expect inflation to moderate further and the Chinese economy to grow 8.4% in 2012.
- South Korea’s fourth-quarter GDP grew at the slowest level in two years, rising 0.4% over the third quarter and 3.4% over a year ago. This was slightly below expectations and was the third-consecutive quarter of slower growth. Given that exports account for approximately half of South Korea’s GDP, the slowdown is reflective of the broader global slowdown over that period.
- Indonesia, the world’s fourth most populous country, had its sovereign credit rating raised by Moody’s for the first time in 10 years to investment grade, Baa3, with a stable outlook.

Fitch had already adjusted its rating in December 2011, and S&P may do the same in the next few months.

Portfolio Recommendations

- **General:** We prefer a “Neutral” benchmark weighting but recognize regional economic leading indicators may be bottoming. There may be an opportunity to consider an “Overweight” position later in the first half of the year if the stabilization in the regional economy is confirmed.
- **Countries:** We prefer Japan—lowest valuation in Asia on book value (see next page); Indonesia—strong domestic consumption theme; Australia—high dividend yield.
- **Sectors:** We prefer defensive, non-cyclical sectors but would selectively add to cyclical stocks in portfolios as the economic data stabilizes.
- **Style:** We prefer large-cap names, with supportive dividends.

Leading Economic Indicators for Select Asian Economies (January - December 2011)



Source: Bloomberg

Overweight (+)

- ▶ The “Overweight” call on Japanese stocks is largely a function of valuations—with Japan trading at the lowest price/book value multiple in Asia—as well as an expected economic rebound in 2012 following the devastating effects of the tsunami in March 2011.
- ▶ Japanese stocks are trading at significant discounts to historical valuations. The Nikkei 225 Index is trading at a forward price/earnings ratio of 11.7x, compared to the 5-year average forward valuation of 16.4x. The trailing price/book ratio is 0.9x, compared to the 5-year average valuation of 1.3x. Negativity prevails: Japanese stocks are priced for a 5% earnings decline in 2012.

Market Developments

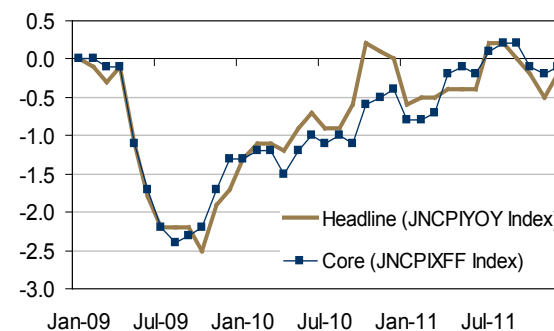
- As we head into Japanese earnings season the Nikkei 225 index has risen 4.6% since the start of 2012.
- Japan’s core CPI fell for the third consecutive year in 2011, down 0.3%. Core prices declined by 0.1% in December. One of the reasons deflation remains in Japan has been the continued strength of the yen in 2011. RBC Capital Markets forecasts the yen to appreciate to USD/JPY 70.0 by the middle of the 2012 before falling back to 75.0 by the end of the year.
- Japan posted a trade deficit in 2011, its first such deficit since 1980. However, this is likely not the start of a new trend of deficits for the world’s third-largest economy because a number of unusual factors hurt exports in 2011 and helped to contribute to the deficit. These include: the March tsunami and subsequent nuclear disaster that impacted the domestic supply chain; severe flooding in Thailand that impacted the regional supply chain; and the European sovereign debt crisis that dampened demand from that region. However, the strong yen—also a headwind—will likely persist in 2012.
- The Bank of Japan (BoJ) lowered its growth forecasts for fiscal-year 2012, which begins in April, to 2% from 2.2%. For the 2011 fiscal year, the BoJ forecasts a contraction of 0.4%, slightly higher than the previous forecast of 0.3%. The BoJ cites the European sovereign debt crisis as the biggest risk to domestic Japanese growth.
- Mr. Takanobu Ito, the President of Honda, Japan’s third-largest car manufacturer, forecast earnings for the company will be the best in at least five years on a rebound in domestic

auto demand, improved U.S. market share and demand, and strong sales growth in China after a weak 2011. Toyota, the largest Japanese manufacturer, also raised its 2012 sales forecasts, although this was on the back of a particularly weak 2011.

Portfolio Recommendations

- Japanese cyclical sectors, such as real estate and transportation equipment, that underperformed in 2011 have been the outperformers thus far in 2012. However, this may just be a short-term market reaction to the imminent threat of a European credit crunch dissipating over Christmas. We continue to favour large-cap, dividend-paying names as we wait for confirmation the regional economic data in Asia is stabilizing. We would selectively add to cyclical stocks in portfolios as the data improves.
- We also favor companies likely to benefit from civil infrastructure projects and reconstruction work resulting from the March 2011 earthquake and tsunami.

Japanese Headline and Core CPI (Jan 2009-Dec 2011)



Source: Bloomberg

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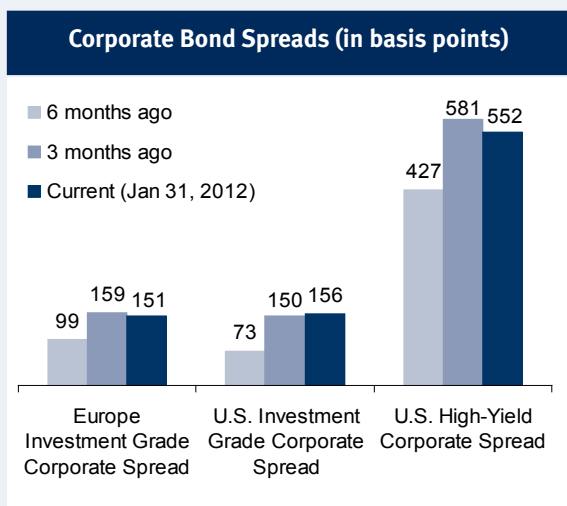
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Global Fixed Income

Global Asset Class View

Asset Class	View
Equities	=
Fixed Income	-
Cash	+



Source: Bloomberg; month-end data of Citigroup BIG and high-yield indices

Note: European spread vs. German Bund; U.S. spreads vs. U.S. Treasury

Pockets of Opportunity Exist within the Ultra-Low Rate Landscape

High-grade government yields moved higher for a few days in early December as investors digested the implications of the coordinated central bank move to head off a banking liquidity crisis and concluded an important systemic risk had been neutralized—at least for the time being. However, it was not long before those yields began to drift lower once again—in most cases getting back to or below their November lows.

This rapid yield retreat seemed to be in response to several factors:

- Recognition the sovereign debt crisis was unresolved and just as potentially dangerous as ever;
- Acknowledgement the Eurozone was in recession, a development likely to complicate and worsen the crisis;
- Confirmation inflation rates everywhere looked to have peaked and were falling, perhaps quickly, allaying investor fears about just how far safe-haven yields would back up if a crisis resolution arrived unexpectedly; and
- The revelation that Fed-think was focused on far-away late 2014 as the likely date of the first rate hike. At the same time, the FOMC continued to suggest QE3 was still on the table, and the Bank of England looked increasingly likely to enlarge its own quantitative easing efforts.

Yield-hungry investors, for their part, have had little choice but to search for pockets of acceptable coupon or dividend return while wrestling with just how much extra risk they can prudently rationalize away.

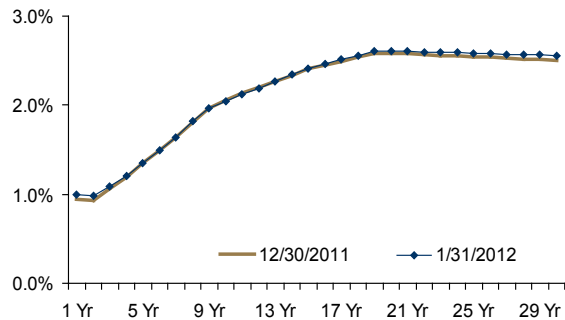
In our view, investment-grade corporate bonds still offer the best value in what has become a well-ploughed field, acknowledging the risk/return trade-off available today is not as attractive as it was a year ago—or even several months ago. But we continue to remind ourselves any Eurozone crisis resolution that permitted safe-haven government yields to move back above the rate of inflation would also substantially narrow the spread advantage on offer in the corporate sector today.

The high-yield sector presents investors with much the same choice as equity markets. Yields are high and attracting a lot of investor interest. Default rates have remained low and probably will continue to do so if the Eurozone downturn is mild and short lived. However, if the crisis were to worsen, pushing the U.S. into recession and exacerbating the Chinese slowdown, history suggests default rates would move appreciably higher as would yields. There continues to be relative value in this sector with spreads still above historical averages, but only for investors who can accept substantially higher risks.

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Global Fixed Income: A Canadian Perspective

Government of Canada Yield Comparison



Asset Class Yield Curve Comparison

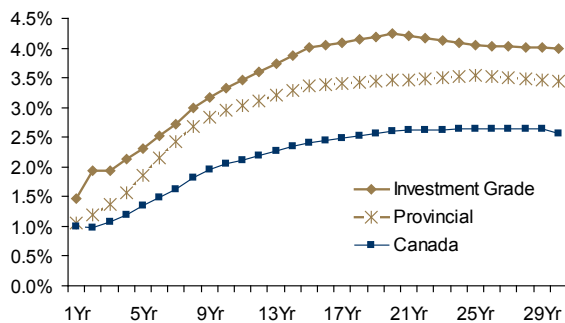


Chart Sources: Bloomberg

Canadas

- European sovereign debt pressures have eased slightly, causing bond yields to rise. Further efforts on the part of global policymakers to stabilize markets are supportive of riskier assets and could exert additional upward pressure on yields.
- Bank of Canada GDP growth forecasts for the Canadian economy were revised to 2% for 2012, implying limited risk to further declines in bond yields. Future rate hikes aren't forecasted until the second half of 2012, with only modest increases expected well into 2013.
- Even with the back-up in yields, we still believe Canadas are overvalued. But as yields approach the upper end of their anticipated trading ranges, there may be selective opportunities.

U.S. Treasuries

- Yields have remained volatile due to ongoing sovereign risks and economic uncertainties.
- The Federal Reserve announcement that current policy may remain in place until the end of 2014, coupled with the central bank's ongoing purchase of longer-dated securities, is supportive of a "lower for longer" rate environment and a flatter yield curve.
- In this low-rate, benign-inflation environment, we continue to prefer credit-sensitive sectors over Treasuries.

Provincials & Agencies

- Both provincial and agency bonds have outperformed government benchmark bonds in 2012. Provincial and agency yields compared to governments (spreads) tightened on the recovery, implying an increased appetite for riskier assets.
- Many issuers have already come to market in 2012, looking to take advantage of low interest rates for their annual funding programs.
- Further credit spread tightening could be limited.

Corporates

- Corporate bonds were the best-performing fixed income sector in January, and the difference in yield (the spread) between corporate credit and Treasuries tightened significantly. High-yield bonds exhibited particularly strong performance.
- Due to the low interest rate environment, corporations are expected to reduce their debt loads, which could cause credit spreads to narrow further.
- We believe corporate debt will continue to outperform government bonds over the short and medium term as global policy efforts remain supportive of riskier assets.
- Even with continued sluggish economic growth in North America, default risk remains low, which is positive for the high-yield sector.
- High yield spreads tightened significantly in January, but they remain above historic averages. We believe the asset class continues to provide opportunities for risk-oriented accounts.

Preferreds

- Preferred share prices rose significantly in January, causing an already expensive asset class to become even more so.
- Positive regulatory developments, improving risk appetite, and a low interest rate environment continue to support the asset class.
- New issuance is likely to remain elevated as corporations take advantage of low interest rates to minimize funding costs.
- The low level of yields likely will not deter taxable investors due to the tax-advantaged income and high-quality issuers offered by this sector.
- Lower quality preferreds—due to capital structure and poor liquidity—are more susceptible to price volatility. However, for investors willing to assume potential recovery risk, they could also provide above-average returns.

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Commodities

- Recent improvements in global manufacturing Purchasing Managers' Indices have been encouraging for economically sensitive commodities.
- Over the longer term, sustained growth in commodity-intensive economies—like China and India—together with constrained supplies, would suggest constructive market conditions.
- In the near term, the risk of a European banking crisis or disorderly sovereign default could lead to significant declines in all risky assets.

Commodity Forecast	2012E	2013E
Oil (WTI \$/Bbl)	100.00	106.00
Natural Gas (\$/mmbtu)	4.00	4.75
Gold (\$/oz)	1,800.00	1,800.00
Copper (\$/ton)	3.75	4.00
Corn (US\$/bu)	6.51	5.98
Wheat (US\$/bu)	6.83	7.20

Source: RBC Capital Markets forecasts (oil, natural gas, gold, copper), Bloomberg consensus forecasts (wheat, corn)

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Gold

- The month of December saw gold bullion trade down 10% towards the bottom of its multi-year trend channel. Fundamental supports remain unchanged, and the price has since rebounded.
- The price remains supported by:
 - › low real interest rates,
 - › the Eurozone sovereign debt crisis,
 - › longer-term U.S. debt and deficit concerns,
 - › emerging market demand driven by inflation and growing household wealth,
 - › central bank demand, and
 - › speculative buying.
- Gold ETF demand continues to rise, with 2011 up 7% following growth of 20% in 2010.
- Central Bank buying advanced considerably in 2011 with an estimated 430 tonnes of net purchases.

Energy

- Oil demand remains dominated by emerging markets, with RBC Capital Markets forecasting 2012 global demand to increase by 0.7 million barrels per day (mbpd), of which China makes up 60% (0.4 mbpd).
- Supply conditions are expected to remain tight with the return of exports from Libya providing some relief. Libya is estimated to produce oil at approximately two-thirds of its pre-war level and may see full production by mid-year. OPEC spare capacity is expected to remain a relatively tight 3.6 mmbpd in 2012, per RBC Capital Markets.
- In December, OPEC set a new production ceiling for the first time in three years, allowing the limit to increase to 30 mbpd, reflecting concerns that \$100 oil may lead to demand destruction.
- The wild card for supply is now Iran, which represents ~4% of global production and exports 2.5 mbpd. The U.S. has imposed new financial

sanctions over Iran's nuclear program, and European Union countries have decided to ban Iranian oil imports starting July 1, 2012. Iran has responded by threatening to prevent shipping through the Strait of Hormuz, through which the bulk of the region's oil passes.

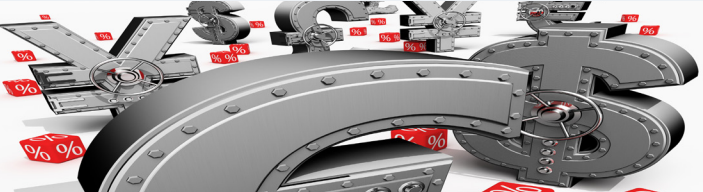
- The supply and demand balance for natural gas continues to deteriorate, with the commodity now trading under \$3.00/Mcf. Continued growth in industry-wide production in the U.S. combined with warm weather have led to U.S. storage levels rising to 3.1 Bcf, which is well above the 5-year average of 2.6 Bcf.

Copper and Industrial Metals

- Copper prices are well above their cost floor as demand from emerging markets, led by China, has remained robust.
- China is the world's largest consumer of copper, and the latest economic data, including 4Q11 GDP growth of 8.9%, are consistent with a moderation of growth into 2012, but not a hard landing.
- The global supply/demand balance for copper has been in deficit for two years; however, this is expected to shift to a mild surplus for 2012 when several large mine expansions come on-stream.

Corn and Agricultural Commodities

- For potash, economic uncertainty has led buyers to be cautious. Producers were piling up inventories in late 2011, with potash inventories at two major producers up 20% in December from the prior month and 13% over the 5-year average. The near-term weakness has been met with potash volume curtailment by Potash Corp. and Uralkali.
- Corn and soybean prices increased in January on heat and drought concerns in South America. Argentina, the world's second-largest exporter of corn, has dramatically lowered its corn production forecast. The drop represents 4.8% of the global corn export market.



Currencies

- ▶ The global interest rate cycle has turned down again. Central banks are generally cutting policy rates or keeping them near record lows. With interest rate differentials between developed economies converging towards zero, this removes one of the main tools currency forecasters use, that of relative monetary policy.
- ▶ In this environment we believe currencies are trading close to their longer-term fair values. Our targets reflect this backdrop, with most of our long-term forecasts unchanged since the end of 2011, suggesting only small potential movements are likely over our forecast horizon.

Currency Forecast	Current as of Jan 31, 2012	Forecast to Dec 31, 2012
CAD/USD	1.00	1.00
USD/CAD	1.00	1.00
EUR/USD	1.31	1.27
GBP/USD	1.58	1.59
AUD/USD	1.06	1.01
USD/CHF	0.92	0.99
USD/JPY	76.27	75.00
EUR/JPY	99.78	95.25
EUR/GBP	0.83	0.80
EUR/CHF	1.20	1.26
USD/CNY	6.31	6.10

Source: Bloomberg, RBC Capital Markets
 Example of how to interpret currency data: CAD/USD 1.00 means 1 Canadian dollar will buy 1 U.S. dollar.

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U.S. Dollar (USD)

- The Dollar's strengthening trend in December continued into the New Year before giving up some gains near the end of January. The driver of this strength was generally improving U.S. economic data and a realization the economy, while sub-par, was still looking healthier than many of its developed country peers.
- However, the January 25th Fed announcement that interest rates would likely remain low through the end of 2014 underscored the headwinds facing the economy and, by association, the U.S. dollar. The political divisions leading up to the presidential election this year will likely heighten the policy gridlock and add risk to the dollar.

Canadian Dollar (CAD)

- The CAD traded narrowly on the weak side of parity with the US. dollar through the end of 2011 as traders struggled to find a reason to push it higher. The BoC's interest rate policy remains on hold, and the rapid accumulation of new debt by households taking advantage of these low rates makes us doubt further cuts are imminent.
- This is in contrast to other commodity-focused countries, such as Australia, where rates continue to fall. With this backdrop, we expect the loonie to outperform its commodity currency peers this year as the preferred proxy for a deflation trade.

Eurozone Euro (EUR)

- The Euro was the worst-performing major currency at the end of 2011—and for good reason. The slow policy response to the peripheral debt crisis, even as growth declined, made the fiscal situation even worse. Just as confidence in the banking sector looked to be approaching a crisis point, the ECB launched its Long-Term Refinancing Operation (LTRO). This provided a huge liquidity injection with banks able to offer their sovereign bonds as collateral.

- This has stabilized the European financial system, but the surge in liquidity pushed the Euro even lower as traders saw the ECB's plan as a way to inflate away the debt. However, the market already appears to be very short on the Euro, so we believe a rapid decline is now unlikely. Instead, we expect only a slow, grinding weakness in the currency until a long-term fiscal solution is found.

U.K. Sterling (GBP)

- The direction of the pound continues to be driven by a trade-off between the weakness of the U.K. economy and the safe-haven aspect of the currency in comparison to the euro. As 2012 progresses, we expect the pound to be driven by the relative performance of the U.K. economy. That is, we expect it to strengthen against the currencies of countries with slower GDP growth (e.g., the euro), but to weaken against the U.S. dollar.

Japanese Yen (JPY)

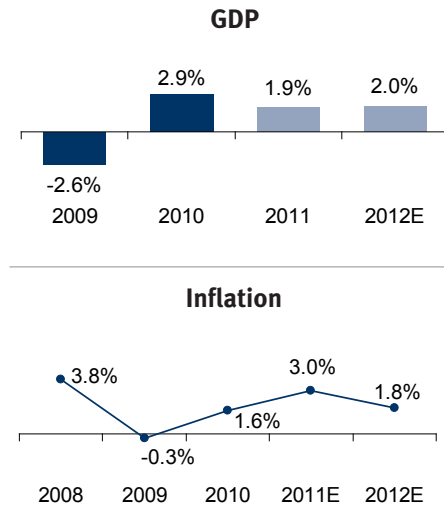
- Even though Japan hasn't fully recovered from the global recession, we still have the somewhat contrarian view the yen will continue to appreciate against major currencies. The only natural seller of yen is Japanese companies investing their funds overseas. In the current global low interest rate environment, these companies are able to hedge these flows very cheaply and, therefore, reduce the selling pressure on the yen.

Chinese Yuan (CNY)

- China's move to lower its bank reserve requirement from 21.5% to 21% in December was the first cut in three years. We expect this rate to fall by another 2.5% in the first quarter if inflation continues to fall. However, this should not weaken the yuan against the dollar, since political considerations suggest the yuan will be allowed to float higher in order to avoid an escalation in trade tensions.

Key Forecasts

U.S.



- Real disposable income fell year /over year in Q4. Modest spending growth in second half was fueled by savings draw-down. Confidence dampened by weak housing, anemic jobs growth, global uncertainty. Inflation set to recede; may give consumer a break in 2012.
- Fiscal drag to become more pronounced, even more if payroll tax cut not extended.
- Business capital investment was a bright spot all last year, but leading indicators of capex are mixed. Tax incentives were extended for 2012 but cut in half.
- Muddle through at 2% GDP growth, but slow growth makes economy vulnerable to external shocks from Europe, oil, geopolitics, etc. Recession not our forecast but can't be entirely ruled out.

Central Bank Rate

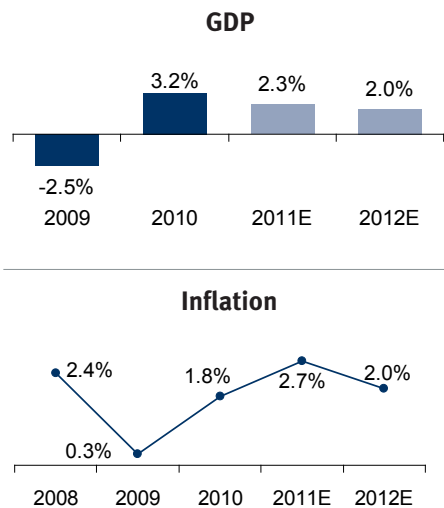
Today	1-year Out
0.25%	0.25%

10-year Rate

Today	1-year Out
1.80%	3.00%

- FOMC committed to no rate hike before late 2014. Fed continues to hint at new asset purchase program (QE3) targeted at mortgage-backed securities.
- Flight-to-safety has repeatedly driven 10yr Treasury yields below 2%. A Eurozone solution and a rebound in global economies could at some point push them back up to 3%+, but fast falling inflation and the likely rapid deployment of QE3 would limit the upside.

Canada



- After adding to employment in 20 of 24 months, Canada lost jobs in 3 of the last 5. Flagging employment growth may start to weigh on confidence. Inflation forecast to ebb; wage growth reasonable. Longer term, substantial build-up of household debt has left consumer too exposed to future rate increases.
- Weak U.S. growth and a longer-than-expected slowdown in China should make for a mixed export performance.
- Government stimulus all but gone; substantial cuts coming this year and next.
- Capex heavily skewed toward energy. Cross-border pipeline politics and weak natural gas prices could be a drag.

Central Bank Rate

Today	1-year Out
1.00%	1.00%

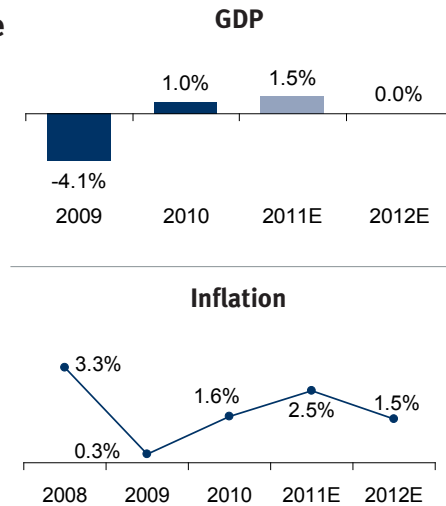
10-year Rate

Today	1-year Out
1.90%	3.00%

- The Bank of Canada lowered its growth forecasts out to and including 2013, citing substantial global headwinds including a longer, deeper European downturn. Expectations for a rate hike mid-2012 have come off the table. Possibility of a rate cut if the inflation threat wanes and global growth falters.
- An end to the flight-to-safety bid would drive Canada bond yields sharply higher with no contemplated Bank of Canada QE program to provide an offset.

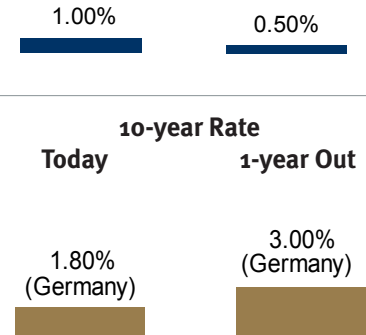
Key Forecasts

Eurozone



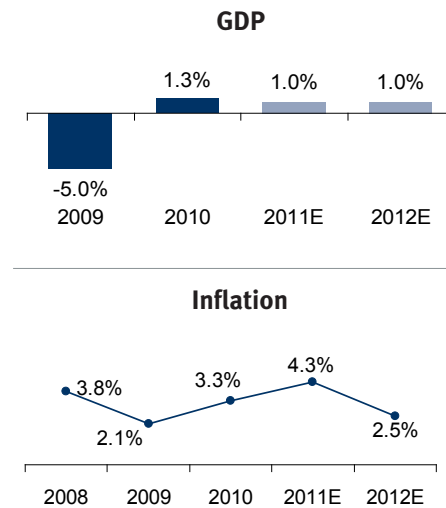
- Promise of deep austerity cuts to come, and inability to end the crisis sent consumer and business confidence plummeting in the second half. Spending weak; capex intentions uncertain. Region already in recession.
- Rate cuts welcome but won't have traction before second half and not then if banks raise capital by shrinking loan books.
- Weak currency should help core countries; peripheral outlook grim.

Central Bank Rate



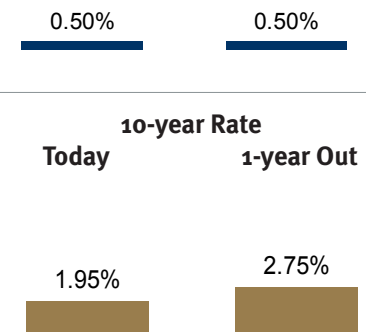
- The ECB surprised with two 25 bps rate cuts at President Draghi's first two meetings. Inflation receded in December, with more expected early in the New Year, making other cut(s) feasible in Q1.
- December move to give banks 3-year access to ECB funding has removed risk of area banks slipping inadvertently into a funding crisis. It has bought time and substantially narrowed Spanish, Italian, and French 10-year spreads over bunds.
- Big loser from "closer fiscal union" or "Eurobond" solution would be bunds.

U.K.



- U.K. economy continues to slowly weaken. GDP contracted in Q4. Consumer badly squeezed by inflation awaiting some reprieve as 2012 unfolds.
- Exports more than 30% of GDP and half are bound for the Eurozone. At risk as Europe slips into recession. Heavily exposed to Ireland in both trade and finance. Recession hard to avoid if Europe downturn worsens.
- Inflation fell sharply to 4.2% in December (from 5.2% in September). More to come as VAT increase and utility rate increases eventually fall out of the calculation. Bank of England forecasts a below 2% reading by year end.

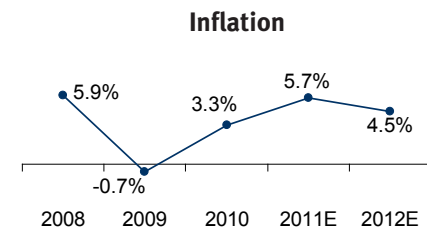
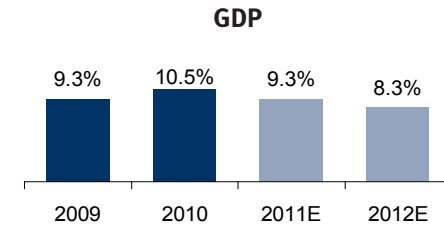
Central Bank Rate



- The BoE, unconcerned by inflation data distorted by one-time factors. Will continue balancing ultra-tight, austerity-driven fiscal policy with a very accommodative monetary stance. No rate change before 2013. New round of QE approved in October has since been increased. We expect another enlargement approved in the spring.
- Gilts benefitting from flight-to-safety bid and the Bank of England's extended and enlarged QE program. An end to both would herald a steep back-up in yields.

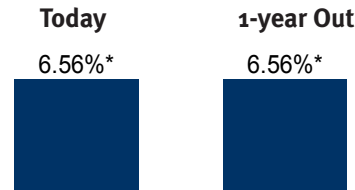
Key Forecasts

China

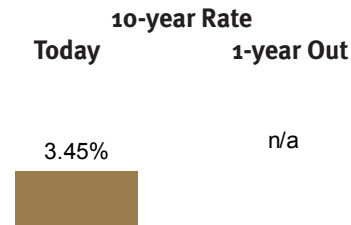


- Economy slowing, mostly because of weaker exports, especially into Europe. Export growth down from 25% to 13%.
- Credit crunch and tough home purchase regulations taking a toll on small-to-medium manufacturers and property developers. Real estate markets cooling off nationwide.
- Gov't housing construction picking up the slack. Consumer spending up by double-digit rates. Infrastructure investment a priority.
- Inflation now down to 4.1% led by food price moderation.
- Policy tightening over. Easing on the way. However, policymakers may allow GDP growth to moderate further rather than risk rekindling price pressures by reversing course too quickly.
- Our forecast is a "soft landing," but any reacceleration is some ways off.

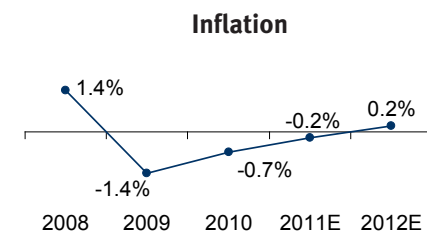
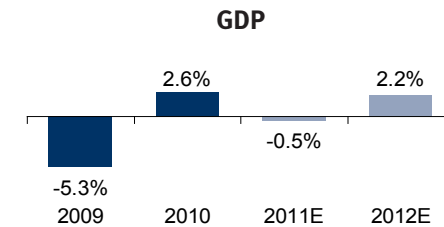
Central Bank Rate



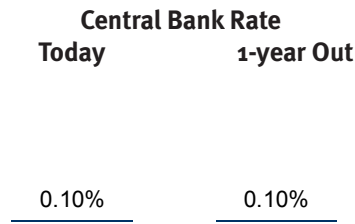
- Reserve requirements at 21.5% and base lending rate at 6.56% produced a credit crunch and brought money supply growth down to just 13%. Bank lending growth continues to slow. Inflation has fallen for 4 months running.
- Reserve requirements were lowered by 50 bps in December and another 200+ basis points was widely expected to arrive in Q1. However, the government has recently given plenty of indications easing will be more deliberate in pace. Interest rate cuts unlikely until inflation rate falls below one-year deposit rate (3.50%).



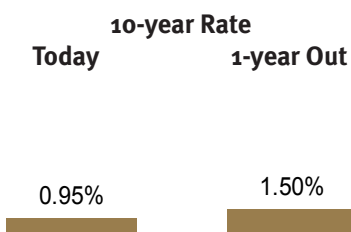
Japan



- Reconstruction and restart of the auto sector produced the promised V-shaped recovery from the earthquake-induced downturn, but industrial production has faded following the summer spurt. Currency strength a drag on trade.
- Growth in first half likely to be respectable against easy comps, although supply disruptions from Thai flooding a wildcard. Second half will need stronger demand from China.
- Retail trade and machinery orders both ticked higher in Q4. However, moribund domestic demand together with a more challenging export environment in 2012 suggest growth will quickly subside into the 2% +/- .5% range. Inflation not a factor.



- Bank of Japan provided plenty of liquidity during the Tsunami crisis and has now embarked on expanded QE program (55 trillion yen) buying JGBs. It cited European concerns and the strength of the yen. It also lowered its growth and inflation forecasts for 2012 and 2013.



Source: RBC Investment Strategy Committee and RBC Capital Markets
 *1-yr base lending rate for working capital, People's Bank of China; Source: Consensus Economics



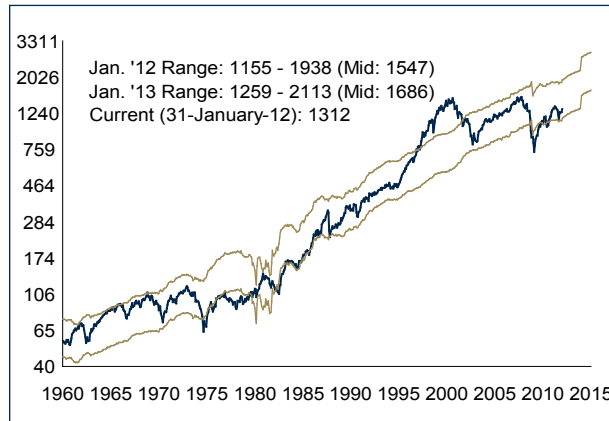
Market Valuation & Equilibrium Levels

› The RBC Global Asset Management Fair Value calculation looks at the returns on equity earned by the companies comprising the relevant market index back more than 50 years and relates them to the interest rates and inflation expectations prevailing at the time to get a “normalized ROE” for a given combination of rates and inflation. Using today’s interest rates and inflation, it calculates how the market has typically valued the corresponding “normalized earnings” to get “fair value,” which would lie at the mid-point of the band on the adjacent charts. The edges of the band lie one standard deviation either side of fair value.

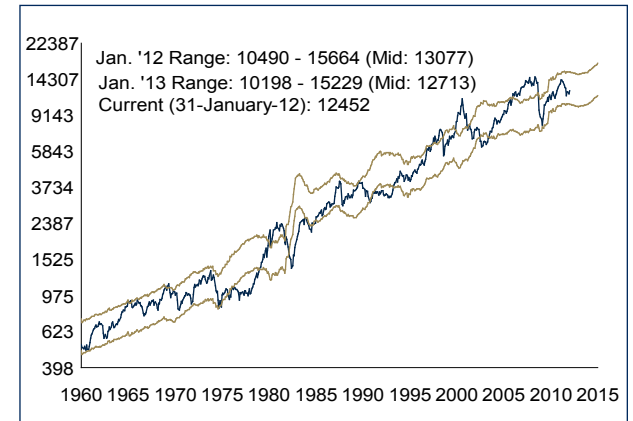
› The RBC Global Asset Management equilibrium valuation for bonds looks at how much of an interest-rate premium investors have typically demanded over and above the expected rate of inflation. Using today’s inflation expectations, it calculates which bond yield would provide that premium (the mid-point of the band). The band resides one standard deviation on either side of the mid-point.

Equity Charts

S&P 500 Equilibrium

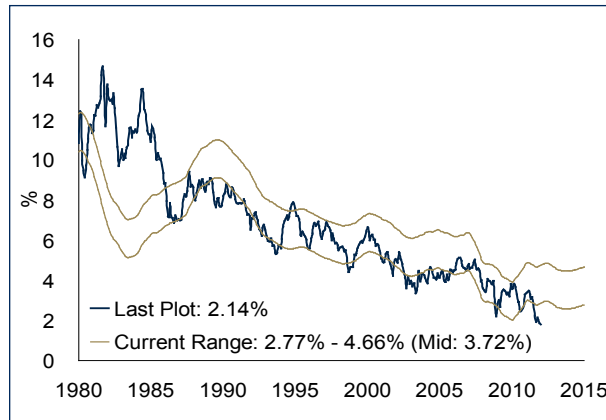


S&P/ TSX Composite Equilibrium



Fixed Income Charts

U.S. 10-year Treasury Bond Yield



Canada 10-year Bond Yield

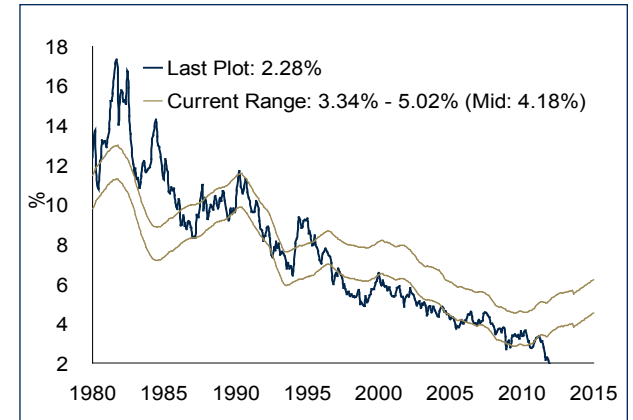


Chart Sources: RBC Global Asset Management

Research Resources and Important Information

Research Resources

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