



RBC Global
Asset Management

THE GLOBAL INVESTMENT OUTLOOK

RBC Investment Strategy Committee

SPRING 2015

THE RBC INVESTMENT STRATEGY COMMITTEE

The RBC Investment Strategy Committee consists of senior investment professionals drawn from across RBC Global Asset Management. The Committee regularly receives economic and capital markets related input from internal and external sources. Important guidance is provided by the Committee's regional advisors (North America, Europe, Far East), from the Global Fixed Income & Currencies Subcommittee and from the global equity sector heads (financials and healthcare, consumer discretionary and consumer staples, industrials and utilities, energy and materials, telecommunications and technology). From this it builds a detailed global investment forecast looking one year forward.

The Committee's view includes an assessment of global fiscal and monetary conditions, projected economic growth and inflation, as well as the expected course of interest rates, major currencies, corporate profits and stock prices.

From this global forecast, the RBC Investment Strategy Committee develops specific guidelines that can be used to manage portfolios.

These include:

- the recommended mix of cash, fixed income instruments, and equities
- the recommended global exposure of fixed income and equity portfolios
- the optimal term structure for fixed income investments
- the suggested sector and geographic make-up within equity portfolios
- the preferred exposure to major currencies

Results of the Committee's deliberations are published quarterly in *The Global Investment Outlook*.

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EXECUTIVE SUMMARY

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For capital markets, 2015 has so far featured considerable uncertainty. Energy prices have convulsed, the Fed is planning its first rate hike in many years as other central banks are again easing policy, the European Commission is facing more challenges from Greece, Russian aggression and ISIS atrocities are dominating the news and, as before, global growth and inflation remain sluggish. We have lowered our economic forecasts slightly for 2015. Nevertheless, it is important not to overstate the extent of these challenges on our forecast revisions as the global economy still looks set to produce better economic growth than last year.

Lowering growth forecasts, but still cautiously optimistic

Despite our forecast revisions, we continue to believe that both global and developed-world economic growth will improve in 2015, and again in 2016. Our forecasts are all on or above consensus with the exception of Canada (due to oil), China (due to credit) and Russia (due to oil and sanctions). Much of our cautious optimism stems from the anticipated potency of sharply lower oil prices, a new round of monetary stimulus that has pushed bond yields even lower, and more competitive exchange rates. We also believe that the global business cycle should be capable of extending its gains given the historical precedent that deep recessions and financial crises are usually followed by a longer-than-normal period of expansion.

Oil prices continue to languish

The sharp decline in energy prices remains a key global theme. In our view, oil prices have overshot fair value and so should rise significantly over

the next several quarters. A price of around \$80 per barrel should balance medium-term supply and demand. While oil-producing corporations and oil-exporting countries have been punished in the markets, beneficiaries of low oil prices form a far larger list than that of countries that suffer. Among those that come out ahead are such goliaths as the Eurozone, Japan, China and India and the U.S. (which produces a large amount of oil but consumes even more). In fact, G7 economies have historically managed substantially faster growth after periods of declining oil prices.

Inflation remains low

Global inflation continues to fall. Both the Eurozone and U.S. now have consumer prices that are lower than a year ago. While deflation can have negative consequences, a fair chunk of the current downward trend in consumer prices falls into the category of “good” deflation as it originates from supply-side and/or external shocks, as opposed to anemic demand. We suspect

inflation rates will slip by more than the market is assuming in the near term, as the indirect effects of lower oil prices trickle through the system, and we have aggressively cut our inflation forecasts to reflect this. However, with oil prices likely rising substantially by the end of the year and given our longstanding opinion that there may be less economic slack in developed-world economies than commonly imagined, inflation should rebound by 2016.

Continued U.S. dollar strength

The dollar bull market is in full swing, with various factors playing a role in its strength at different times. Most recently, expectations of rate normalization by the Fed and consequences of the spectacular fall in oil prices have dominated investors’ attention. The fact that other key central banks are pushing on the monetary accelerator adds to the potential for this U.S. dollar bull market to unfold like others have, with currencies of the major U.S. trading partners falling into oversold territory.

Central banks tilt toward dovish stance

Although the next policy move for the Fed is very clearly to raise interest rates, other central banks have moved in the opposite direction. The European Central Bank (ECB) and Bank of Japan (BOJ) in particular are delivering more than enough stimulus to offset the Fed and, as a result, there is no shortage of money in the world today, with the consequences continuing to be felt via ultra-low yields around the world.

Bond yields likely to rise, but will remain low

Global bond yields remain at very low levels. We continue to believe that bond yields will begin to rise this year, with the most obvious catalyst being the beginning of a tightening cycle in the U.S. In addition, the ECB, BOJ and other central banks that are delivering major stimulus are unlikely to announce significant expansions to their programs over the year. We expect rate hikes to be gradual in the absence of inflationary pressures, but the impact of even modestly rising rates will still be significant given how low bond yields have fallen. As residual risk aversion from the financial crisis declines and unorthodox monetary policy is unwound, we expect that investors will eventually demand a higher after-inflation return on fixed-income securities. The resulting rise in real rates will pull nominal yields higher and deliver low or even negative total

returns for bond holders across most investment horizons.

Equity returns will depend more on earnings

Following a volatile start to the year, global equities have risen to new highs, pushing most major indexes closer to fair value. While higher valuations do not necessarily place the bull market at risk, we expect more modest total returns and higher volatility going forward. As valuations become less supportive, the market will depend on profit growth for returns. We have experienced fairly substantial downgrades to earnings expectations in recent months due to the significant decline in oil and the stronger U.S. dollar. Although lower earnings growth is seldom positive for stocks, these downgrades have been narrowly focused on these two themes, and are not indicative of a broad-based deterioration in the outlook for the economy and/or corporate profitability. Given the significant decline in estimates thus far and our view that the oil price has likely bottomed, we believe that much of the bad news has likely been absorbed.

Global equity markets have risen considerably over the past few years, causing many to question the sustainability of the rally. While it appears that the cyclical bull market may in fact be maturing, the experience of the last decade where severe bear markets wiped out the gains enjoyed during the preceding

bull phase may be a poor model going forward. A variety of indicators – including the depth of the last market and valuations at its conclusion – suggest that the way ahead may feature firm and durable bull phases interrupted by brief and comparatively mild corrections.

Relative return potential favours stocks

Our analysis of prospective total returns continues to favour equities over bonds across most time frames. In fact, while we have lowered our total-return expectations for stocks to reflect higher valuations and tamer earnings forecasts, sovereign bonds are expected to produce low or negative total returns through the relevant investment periods.

Reflecting all of this, we have maintained our overweight position in stocks and underweight in bonds. Within fixed income, we are generally maintaining above-benchmark exposure to higher-yielding corporate bonds as the additional coupon income should offset some of the pressure on returns in a rising rate environment. Within equities, we have shifted some of our exposure to Europe and emerging markets, harvesting gains made over the past few years in the U.S. For a balanced, global investor, we recommend an asset mix of 61% equities (strategic neutral position: 55%) and 38% fixed income (strategic neutral position: 40%), with the balance in cash.

ECONOMIC & CAPITAL MARKETS FORECASTS

ECONOMIC FORECAST (RBC INVESTMENT STRATEGY COMMITTEE)														
	UNITED STATES		CANADA		EUROPE		UNITED KINGDOM		JAPAN		CHINA		EMERGING MARKETS ¹	
	Spring 2015	Change from New Year 2015	Spring 2015	Change from New Year 2015	Spring 2015	Change from New Year 2015	Spring 2015	Change from New Year 2015	Spring 2015	Change from New Year 2015	Spring 2015	Change from New Year 2015	Spring 2015	Change from New Year 2015
REAL GDP														
2014A	2.42%		2.40%		0.88%		2.56%		0.00%		7.41%		5.00%	
2015E	3.25%	N/C	2.00%	(0.25)	1.25%	N/C	2.75%	(0.25)	1.25%	(0.25)	6.75%	N/C	4.75%	(0.50)
2016E	3.25%	N/C	2.25%	N/C	2.00%	N/C	2.50%	N/C	1.50%	N/C	6.25%	N/C	5.00%	N/C
CPI														
2014A	1.61%		1.89%		0.43%		1.47%		2.75%		2.06%		4.15%	
2015E	0.50%	(1.25)	1.25%	(0.50)	0.25%	(0.75)	0.75%	(1.00)	1.00%	(0.50)	2.00%	(0.75)	4.00%	N/C
2016E	2.25%	N/C	2.25%	N/C	1.50%	N/C	2.00%	N/C	1.50%	N/C	3.25%	N/C	4.25%	N/C

A = Actual E = Estimate ¹GDP Weighted average of China, India, South Korea, Brazil, Mexico and Russia

TARGETS (RBC INVESTMENT STRATEGY COMMITTEE)				
	FEBRUARY 2015	FORECAST FEBRUARY 2016	CHANGE FROM NEW YEAR 2015	1-YEAR TOTAL RETURN ESTIMATE (%)
CURRENCY MARKETS AGAINST USD				
CAD (USD–CAD)	1.25	1.33	0.15	(5.0)
EUR (EUR–USD)	1.12	1.05	(0.09)	(6.5)
JPY (USD–JPY)	119.60	130.00	5.00	(8.3)
GBP (GBP–USD)	1.54	1.45	(0.05)	(5.8)
FIXED INCOME MARKETS				
U.S. Fed Funds Rate	0.25	0.75	0.25	N/A
U.S. 10-Year Bond	1.99	2.50	(0.50)	(2.5)
Canada Overnight Rate	0.75	0.75	(0.25)	N/A
Canada 10-Year Bond	1.35	2.00	(0.50)	(4.5)
Eurozone Policy Rate	0.05	0.05	0.05	N/A
Germany 10-Year Bund	0.33	0.70	(0.80)	(3.3)
U.K. Base Rate	0.50	0.75	(0.25)	N/A
U.K. 10-Year Gilt	1.80	2.25	(1.00)	(2.2)
Japan Overnight Call Rate	0.10	0.10	N/C	N/A
Japan 10-Year Bond	0.34	0.50	(0.30)	(1.3)
EQUITY MARKETS				
S&P 500	2105	2200	25	6.6
S&P/TSX Composite	15234	16000	500	7.9
MSCI Europe	1705	1800	25	8.8
FTSE 100	6947	7250	250	8.3
Nikkei	18798	18500	500	(0.0)
MSCI Emerging Markets	990	1050	(50)	8.9

Source: RBC GAM

RECOMMENDED ASSET MIX

Asset mix – the allocation within portfolios to stocks, bonds and cash – should include both strategic and tactical elements. Strategic asset mix addresses the blend of the major asset classes offering the risk/return tradeoff best suited to an investor’s profile. It can be considered to be the benchmark investment plan that anchors a portfolio through many business and investment cycles, independent of a near-term view of the prospects for the economy and related expectations for capital markets. Tactical asset allocation refers to fine tuning around the strategic setting in an effort to add value by taking advantage of shorter term fluctuations in markets.

Every individual has differing return expectations and tolerances for volatility, so there is no “one size fits all” strategic asset mix. Based on a 35-year study of historical returns and the volatility of returns (the range around the average return within which shorter-term results tend to fall), we have developed five broad profiles and assigned a benchmark strategic asset mix for each. These profiles range from very conservative through balanced to aggressive growth. It goes without saying that as investors accept increasing levels of volatility, and therefore greater risk that the actual experience will depart from the longer-term norm, the potential for returns rises. The five profiles presented below may assist investors in selecting a strategic asset mix best aligned to their investment goals.

Each quarter, the RBC Investment Strategy Committee publishes a recommended asset mix based on our current view of the economy and return expectations for the major asset classes. These weights are further

divided into recommended exposures to the variety of global fixed income and equity markets. Our recommendation is targeted at the Balanced profile where the benchmark setting is 55% equities, 40% fixed income, 5% cash.

A tactical range of +/- 15% around the benchmark position allows us to raise or lower exposure to specific asset classes with a goal of tilting portfolios toward those markets that offer comparatively attractive near-term prospects.

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GLOBAL ASSET MIX							
	BENCHMARK POLICY	PAST RANGE	SPRING 2014	SUMMER 2014	FALL 2014	NEW YEAR 2015	SPRING 2015
CASH	2.0%	1.5% – 16%	4.0%	4.0%	4.0%	1.0%	1.0%
BONDS	43.0%	25% – 54%	38.0%	38.0%	37.0%	40.0%	38.0%
STOCKS	55.0%	36% – 65%	58.0%	58.0%	59.0%	59.0%	61.0%
Note: Effective September 1, 2014, we revised our strategic neutral positions within fixed income, lowering the 'neutral' commitment to cash from 5% to 2%, and moving the difference to bonds. This takes advantage of the positive slope of the yield curve which prevails over most time periods, and allows our fixed income managers to shorten duration and build cash reserves whenever a correction in the bond market, or especially an inverted yield curve, is anticipated.							
REGIONAL ALLOCATION							
GLOBAL BONDS	CWGBI* FEB. 2015	PAST RANGE	SPRING 2014	SUMMER 2014	FALL 2014	NEW YEAR 2015	SPRING 2015
North America	36.4%	18%– 40%	38.0%	37.7%	32.9%	39.6%	36.4%
Europe	40.5%	32% – 56%	38.2%	39.3%	41.9%	39.0%	40.5%
Asia	23.1%	20% – 35%	23.7%	23.1%	25.2%	21.4%	23.1%
Note: Based on anticipated 12-month returns in \$US hedged basis							
GLOBAL EQUITIES	MSCI** FEB. 2015	PAST RANGE	SPRING 2014	SUMMER 2014	FALL 2014	NEW YEAR 2015	SPRING 2015
North America	60.0%	51%– 61%	58.3%	58.7%	59.1%	60.5%	59.2%
Europe	21.8%	21% – 35%	25.0%	24.2%	22.3%	20.8%	22.8%
Asia	11.0%	9% – 18%	9.8%	10.2%	11.3%	11.3%	10.5%
Emerging Markets	7.3%	0% – 8.5%	7.0%	7.0%	7.3%	7.5%	7.5%
Our asset mix is reported as at the end of each quarter. The mix is fluid and may be adjusted within each quarter, although we do not always report on shifts as they occur. The weights in the table should be considered a snapshot of our asset mix at the date of release of the <i>Global Investment Outlook</i> .							
GLOBAL EQUITY SECTOR ALLOCATION							
	MSCI** FEB. 2015	RBC ISC NEW YEAR 2015	RBC ISC SPRING 2015	CHANGE FROM NEW YEAR 2015	WEIGHT VS. BENCHMARK		
Energy	7.94%	7.81%	7.44%	(0.37)	93.7%		
Materials	5.27%	4.23%	3.97%	(0.26)	75.3%		
Industrials	10.92%	12.12%	12.52%	0.40	114.7%		
Consumer Discretionary	12.54%	12.81%	14.54%	1.73	115.9%		
Consumer Staples	10.04%	9.81%	10.04%	0.23	100.0%		
Health Care	12.94%	14.21%	13.64%	(0.58)	105.4%		
Financials	20.36%	19.00%	17.86%	(1.13)	87.7%		
Information Technology	13.20%	15.02%	15.20%	0.18	115.1%		
Telecom. Services	3.41%	1.64%	1.41%	(0.23)	41.3%		
Utilities	3.37%	3.36%	3.37%	0.01	100.0%		

*Citigroup World Global Bond Index **MSCI World Index

Source: RBC Investment Strategy Committee

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This tactical recommendation for the Balanced profile can serve as a guide for movement within the ranges allowed for all other profiles. If, for example, the recommended current equity exposure for the Balanced profile is set at 62.5% (i.e.: 7.5% above its benchmark of 55% and part way toward its upper limit of 70% for equities), that would imply a tactical shift of + 5.02% to 25.02% for the Very Conservative profile

(i.e.: a proportionate adjustment above the benchmark equity setting of 20% within the allowed range of +/- 15%).

The value-added of tactical strategies is, of course, dependent on the degree to which the expected scenario unfolds.

Regular reviews of portfolio weights are essential to the ultimate success of an investment plan as they ensure current exposures are aligned with levels of

long-term returns and risk tolerances best suited to individual investors.

Anchoring portfolios with a suitable strategic asset mix, and placing boundaries defining the allowed range for tactical positioning, imposes discipline that can limit damage caused by swings in emotion that inevitably accompany both bull and bear markets.

1. **Average Return:** The average total return produced by the asset class over the period 1980 – 2015, based on monthly results.
2. **Volatility:** The standard deviation of returns. Standard deviation is a statistical measure that indicates the range around the average return within which 2/3 of results will fall into, assuming a normal distribution around the long-term average.

VERY CONSERVATIVE

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
CASH & CASH EQUIVALENTS	2%	0-15%	1.0%	1.0%
FIXED INCOME	78%	55-95%	73.8%	73.8%
TOTAL CASH & FIXED INCOME	80%	65-95%	74.8%	74.8%
CANADIAN EQUITIES	10%	5-20%	12.0%	11.5%
U.S. EQUITIES	5%	0-10%	7.0%	6.5%
INTERNATIONAL EQUITIES	5%	0-10%	6.2%	7.2%
EMERGING MARKETS	0%	0%	0.0%	0.0%
TOTAL EQUITIES	20%	5-35%	25.2%	25.2%
			RETURN	VOLATILITY
35-YEAR AVERAGE			9.4%	6.1%
LAST 12 MONTHS			11.2%	4.9%

Very Conservative investors will seek income with maximum capital preservation and the potential for modest capital growth, and be comfortable with small fluctuations in the value of their investments. This portfolio will invest primarily in fixed-income securities, and a small amount of equities, to generate income while providing some protection against inflation. Investors who fit this profile generally plan to hold their investment for the short to medium term (minimum one to five years).

CONSERVATIVE

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
CASH & CASH EQUIVALENTS	2%	0-15%	1.0%	1.0%
FIXED INCOME	63%	40-80%	58.4%	58.4%
TOTAL CASH & FIXED INCOME	65%	50-80%	59.4%	59.4%
CANADIAN EQUITIES	15%	5-25%	17.1%	16.6%
U.S. EQUITIES	10%	0-15%	12.1%	11.6%
INTERNATIONAL EQUITIES	10%	0-15%	11.4%	12.4%
EMERGING MARKETS	0%	0	0.0%	0.0%
TOTAL EQUITIES	35%	20-50%	40.6%	40.6%
			RETURN	VOLATILITY
35-YEAR AVERAGE			9.6%	7.3%
LAST 12 MONTHS			12.3%	5.2%

Conservative investors will pursue modest income and capital growth with reasonable capital preservation, and be comfortable with moderate fluctuations in the value of their investments. The portfolio will invest primarily in fixed-income securities, with some equities, to achieve more consistent performance and provide a reasonable amount of safety. The profile is suitable for investors who plan to hold their investment over the medium to long term (minimum five to seven years).

BALANCED

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
CASH & CASH EQUIVALENTS	2%	0-15%	1.0%	1.0%
FIXED INCOME	43%	20-60%	38.0%	38.0%
TOTAL CASH & FIXED INCOME	45%	30-60%	39.0%	39.0%
CANADIAN EQUITIES	19%	10-30%	21.1%	20.6%
U.S. EQUITIES	20%	10-30%	22.1%	21.6%
INTERNATIONAL EQUITIES	12%	5-25%	13.3%	14.3%
EMERGING MARKETS	4%	0-10%	4.5%	4.5%
TOTAL EQUITIES	55%	40-70%	61.0%	61.0%
			RETURN	VOLATILITY
35-YEAR AVERAGE			9.7%	8.7%
LAST 12 MONTHS			14.6%	5.7%

The Balanced portfolio is appropriate for investors seeking balance between long-term capital growth and capital preservation, with a secondary focus on modest income, and who are comfortable with moderate fluctuations in the value of their investments. More than half the portfolio will usually be invested in a diversified mix of Canadian, U.S. and global equities. This profile is suitable for investors who plan to hold their investment for the medium to long term (minimum five to seven years).

GROWTH

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
CASH & CASH EQUIVALENTS	2%	0-15%	1.0%	1.0%
FIXED INCOME	28%	5-40%	22.6%	22.6%
TOTAL CASH & FIXED INCOME	30%	15-45%	23.6%	23.6%
CANADIAN EQUITIES	23%	15-35%	25.1%	24.6%
U.S. EQUITIES	25%	15-35%	27.2%	26.7%
INTERNATIONAL EQUITIES	16%	10-30%	17.4%	18.4%
EMERGING MARKETS	6%	0-12%	6.7%	6.7%
TOTAL EQUITIES	70%	55-85%	76.4%	76.4%
			RETURN	VOLATILITY
35-YEAR AVERAGE			9.6%	10.8%
LAST 12 MONTHS			15.8%	6.3%

Investors who fit the Growth profile will seek long-term growth over capital preservation and regular income, and be comfortable with considerable fluctuations in the value of their investments. This portfolio primarily holds a diversified mix of Canadian, U.S. and global equities and is suitable for investors who plan to invest for the long term (minimum seven to ten years).

AGGRESSIVE GROWTH

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
CASH & CASH EQUIVALENTS	2%	0-15%	0.5%	0.5%
FIXED INCOME	0%	0-10%	0.0%	0.0%
TOTAL CASH & FIXED INCOME	2%	0-20%	0.5%	0.5%
CANADIAN EQUITIES	32.5%	20-45%	33.1%	32.1%
U.S. EQUITIES	35.0%	20-50%	36.1%	35.1%
INTERNATIONAL EQUITIES	21.5%	10-35%	21.3%	23.3%
EMERGING MARKETS	9.0%	0-15%	9.0%	9.0%
TOTAL EQUITIES	98%	80-100%	99.5%	99.5%
			RETURN	VOLATILITY
35-YEAR AVERAGE			9.6%	13.4%
LAST 12 MONTHS			18.0%	7.3%

Aggressive Growth investors seek maximum long-term growth over capital preservation and regular income, and are comfortable with significant fluctuations in the value of their investments. The portfolio is almost entirely invested in stocks and emphasizes exposure to global equities. This investment profile is suitable only for investors with a high risk tolerance and who plan to hold their investments for the long term (minimum seven to ten years).

CAPITAL MARKETS PERFORMANCE

Milos Vukovic, MBA, CFA

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RBC Global Asset Management Inc.

The U.S. dollar rose against all major currencies between December 1, 2014, and February 28, 2015, performing best against the euro with an 11.2% appreciation. The greenback rallied 9.3% against the Canadian dollar, 1.3% against the pound and 0.8% versus the yen. Over the 12-month period ended February 28, 2015, the U.S. dollar rose 23.4% against the euro, 17.5% versus the yen and 12.9% versus the Canadian dollar. The gain against sterling was 8.5%.

Fixed-income markets were mixed, with U.S. bonds rising and other major markets falling largely because of the impact of a strong U.S. dollar. Returns were generally positive in local-currency terms. The Barclays Capital Aggregate Bond Index, a broad measure of U.S. fixed-income performance, rose 1.2%. European bonds lost 5.2% in U.S. dollar terms as measured by the Citigroup WGBI – Europe Index. The FTSE TMX Canada Universe Bond Index, Canada's fixed-income benchmark, declined 3.9%, while Japanese bonds, as measured by the Citigroup Japanese Government Bond Index, lost 0.3%. In Canadian-

dollar terms, the Canadian bond benchmark returned 5.1% and the Japanese bond index returned 9.0% over the three-month period.

Major equity markets posted single-digit gains in the latest quarter. U.S. stock markets rose amid optimism that the U.S. economy would continue to gather strength. The S&P 500 Index climbed 2.3% during the three-month period, while the MSCI Europe rose 1.7%. Within Europe, the MSCI Germany climbed 3.2%, followed by a 2.4% gain for the MSCI U.K. and a 1.9% rise in the MSCI France. Over the 12-month period, the S&P 500 increased 15.5%. The MSCI France lost 6.3%, followed by a 4.6% drop in the MSCI Germany and a 2.8% fall in the MSCI U.K. The S&P/TSX Composite Index lost 4.8% in U.S. dollar terms during the three months, versus the 4.9% drop for the large-cap S&P/TSX 60 Index and the 5.4% decline in the S&P/TSX Small Cap Index. The MSCI Emerging Markets Index lost 1.1% during the three-month period and climbed 5.0% over the 12-month period. The S&P 400 Index, a measure of the U.S. mid-cap market,

rose 4.8% in the latest three months and 11.1% for the 12-month period, while the S&P 600 Index, a gauge of small-cap performance, appreciated 5.3% in the three-month period and gained 7.8% over the 12 months. The Russell 3000 Growth Index rose 4.2% during the quarter, and the Russell 3000 Value Index gained 1.4% during the period. Over the 12 months, the Russell 3000 Growth Index rose 15.5% and the Russell 3000 Value Index increased 12.7%.

Six of the 10 global equity sectors rose during the quarter ended February 28, 2015. The best-performing sector was Consumer Discretionary, which gained 6.0%, followed by Materials at 5.2%, and Health Care with a 4.2% rise. The worst-performing sectors were Utilities, which lost 2.7%; Energy, which lost 1.4%; and Financials, which declined 0.2%. Over the 12-month period, the best-performing sectors were Information Technology, Health Care and Consumer Staples, and the worst-performing were Energy, Materials and Financials.

EXCHANGE RATES						
PERIODS ENDING FEBRUARY 28, 2015						
	Current USD	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
USD–CAD	1.2501	9.28	7.60	12.93	8.08	3.51
USD–EUR	0.8936	11.19	8.13	23.35	5.99	4.01
USD–GBP	0.6477	1.31	0.96	8.47	1.01	(0.25)
USD–JPY	119.6250	0.80	(0.13)	17.51	13.75	6.12

Note: all changes above are expressed in US dollar terms

CANADA								
PERIODS ENDING FEBRUARY 28, 2015								
	USD					CAD		
	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
<i>Fixed Income Markets: Total Return</i>								
FTSE TMX Canada Univ. Bond Index	(3.86)	(2.89)	(2.24)	(2.72)	2.37	5.07	10.40	5.14

U.S.								
PERIODS ENDING FEBRUARY 28, 2015								
	USD					CAD		
	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
<i>Fixed Income Markets: Total Return</i>								
Citigroup U.S. Government	1.14	0.99	4.32	1.80	3.66	10.53	17.81	10.03
Barclays Capital Agg. Bond Index	1.23	1.14	5.05	2.76	4.29	10.63	18.63	11.06

GLOBAL								
PERIODS ENDING FEBRUARY 28, 2015								
	USD					CAD		
	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
<i>Fixed Income Markets: Total Return</i>								
Citigroup WGBI	(1.91)	(1.23)	(2.86)	0.03	2.26	7.20	9.70	8.11
Citigroup WGBI – Europe	(5.15)	(3.76)	(6.28)	2.31	2.98	3.65	5.84	10.58
Citigroup Japanese Government	(0.26)	(0.54)	(12.34)	(9.77)	(3.38)	9.00	(1.01)	(2.48)

CANADA								
PERIODS ENDING FEBRUARY 28, 2015								
	USD					CAD		
	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
<i>Equity Markets: Total Return</i>								
S&P/TSX Composite	(4.75)	(2.84)	(2.31)	1.47	4.95	4.09	10.32	9.67
S&P/TSX 60	(4.92)	(2.80)	(0.23)	2.43	4.91	3.91	12.66	10.71
S&P/TSX Small Cap	(5.40)	(3.61)	(16.69)	(8.84)	(0.02)	3.38	(5.92)	(1.47)

U.S.								
PERIODS ENDING FEBRUARY 28, 2015								
	USD					CAD		
	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
<i>Equity Markets: Total Return</i>								
S&P 500	2.31	2.57	15.51	18.00	16.18	11.81	30.44	27.54
S&P 400	4.80	3.94	11.14	17.25	17.02	14.53	25.51	26.72
S&P 600	5.25	2.32	7.75	17.79	17.63	15.02	21.68	27.32
RUSSELL 3000 Value	1.40	0.62	12.70	17.89	15.39	10.81	27.27	27.42
RUSSELL 3000 Growth	4.23	5.01	15.51	18.03	17.27	13.90	30.44	27.57
NASDAQ Composite Index	3.59	4.80	15.21	18.71	17.27	13.20	30.11	28.31

Note: all rates of return presented for periods longer than 1 year are annualized

Source: Bloomberg/MSCI

GLOBAL PERIODS ENDING FEBRUARY 28, 2015								
	USD					CAD		
<i>Equity Markets: Total Return</i>	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
MSCI World*	2.26	3.94	7.87	13.26	11.69	11.99	21.67	22.58
MSCI EAFE*	2.81	6.50	(0.03)	9.41	7.78	12.58	12.76	18.41
MSCI Europe*	1.70	6.27	(3.34)	10.14	8.31	11.37	9.03	19.21
MSCI Pacific*	5.11	7.06	6.92	8.10	7.01	15.10	20.61	16.99
MSCI UK*	2.36	5.19	(2.82)	8.31	9.35	12.09	9.62	17.23
MSCI France*	1.90	7.30	(6.25)	9.44	5.47	11.59	5.76	18.44
MSCI Germany*	3.18	7.95	(4.60)	11.56	10.61	12.99	7.61	20.74
MSCI Japan*	6.99	8.55	8.94	9.29	6.58	17.16	22.89	18.28
MSCI Emerging Markets*	(1.07)	3.71	5.01	(0.34)	3.64	8.34	18.45	7.86

GLOBAL EQUITY SECTORS PERIODS ENDING FEBRUARY 28, 2015								
	USD					CAD		
<i>Sector: Total Return</i>	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
Energy	(1.41)	(0.37)	(11.63)	(0.72)	4.60	7.96	(0.32)	7.44
Materials	5.24	7.54	(0.65)	0.99	4.06	15.25	12.07	9.30
Industrials	2.90	4.11	4.99	12.81	12.51	12.69	18.43	22.09
Consumer Discretionary	6.01	6.48	10.63	18.85	18.11	16.09	24.80	28.63
Consumer Staples	2.83	5.12	13.58	14.39	13.62	12.60	28.12	23.80
Health Care	4.20	6.91	17.27	24.67	17.94	14.11	32.28	34.93
Financials	(0.23)	1.21	4.94	14.23	8.64	9.25	18.37	23.63
Information Technology	2.76	4.38	18.83	15.52	14.52	12.53	34.05	25.02
Telecommunication Services	(0.01)	5.85	5.70	12.92	11.72	9.49	19.23	22.21
Utilities	(2.65)	(2.61)	6.20	8.46	5.62	6.60	19.80	17.38

* Net of Taxes

Note: all rates of return presented for periods longer than 1 year are annualized

Source: Bloomberg/MSCI

GLOBAL INVESTMENT OUTLOOK

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Slumping oil, printing anew, bailout sorrow, Russia blue

The past quarter was chock-a-block with key developments, as captured by our title's take on the classic wedding rhyme.¹ Naturally, "slumping oil" refers to the astonishing collapse in oil prices. We will discuss the consequences and outlook for this as it relates to economic growth, deflation and the oil industry.

"Printing anew" is mainly a reference to the massive money printing and bond buying recently undertaken by the European Central Bank (ECB), but also to a wave of retaliatory rate-cutting from the Eurozone's neighbors, a handful of commodity exporters and a number of emerging economies. At the other extreme, the U.S. Federal Reserve (Fed) remains firmly on track to raise rates this year, and that contrarian stance is a central reason for ongoing U.S. dollar strength.

"Bailout sorrow" is a nod to the recent Greek election and the new government's attempts to wriggle out from under its debt, austerity and reform commitments. Naturally, the resulting conflict has spurred renewed financial-market concerns about Greece's ability to remain in the Eurozone.

Finally, "Russia blue" is a reference to Russia's mostly self-inflicted woes, spanning military adventures,

¹ The old English poem indicates that a bride should wear "something old, something new, something borrowed, something blue" for good luck at her wedding.

EXHIBIT 1. Global Manufacturing Slowed

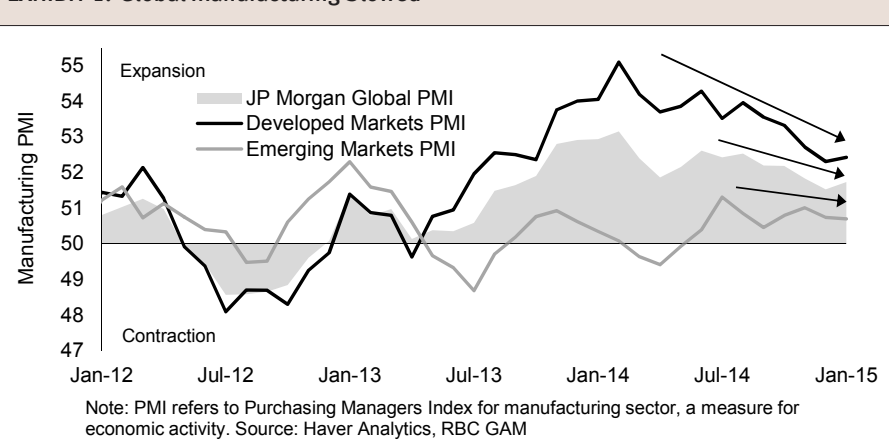
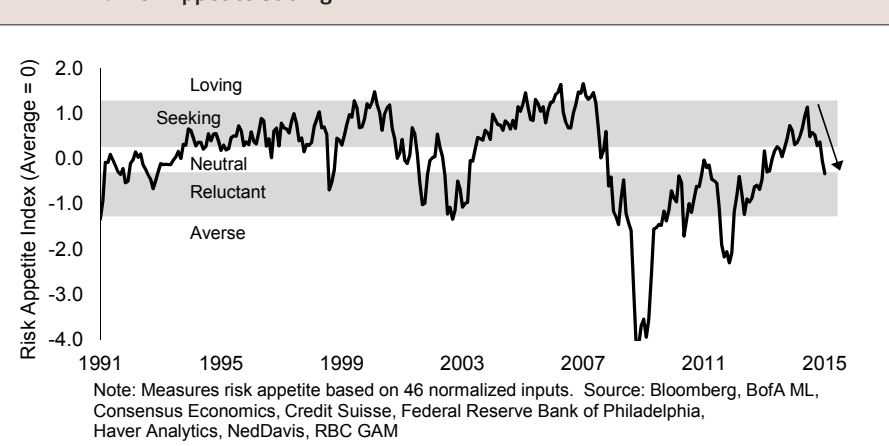


EXHIBIT 2. Risk Appetite Sliding



economic problems and external debt risks. These combine into quite a sour outlook for the country itself, and also represent a key global risk.

While the current economic narrative is unlikely to climax with a wedding as per the rhyme's customary usage, the global economy needs all the good

luck it can get given these additional downside risks, a slight deterioration in global growth (Exhibit 1) and a decline in risk appetite (Exhibit 2).

All the same, perspective is everything. This year still looks set to manage more economic growth than last year. And despite the many challenges, it

seems unwise to significantly reduce investment-portfolio allocations to risk assets such as equities and credit, since government-bond yields are now abysmally low.

Downgraded economic forecasts

Our economic forecasts for 2015 are mostly a bit lower than in the prior quarter, with three² of five developed economies revised downward (Exhibit 3) and four³ of six emerging economies moving in the same direction (Exhibit 4). The consensus global economic outlook has similarly slipped in recent months.

However, it is important not to overstate the extent of this pessimism, for three reasons. First, with the exception of a crumbling Russia, our downgrades are merely on the order of 0.25 to 0.50 percentage point of lost growth each. In contrast, we have left the outlook for three nations unchanged and nudged the forecast for growth in India higher.

Second, despite the diminished trajectory, we still anticipate that both global and developed-world economic growth will improve in 2015, and again in 2016 (we expect emerging-market growth to slow this year, but rise in 2016).

Third, our forecasts are all on or above consensus with the exception of Canada (due to oil), China (due to credit) and Russia (due to oil and sanctions).

² U.K., Canada and Japan

³ Korea, Brazil, Mexico and Russia

EXHIBIT 3. RBC GAM GDP Forecasts for Developed Markets

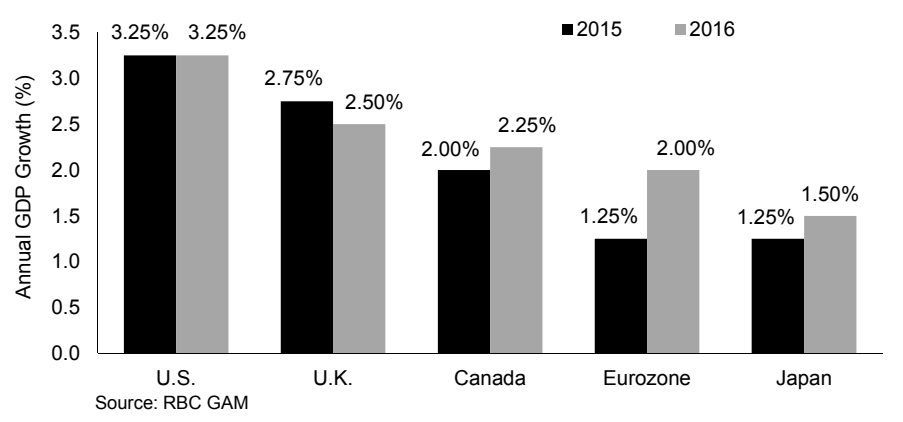


EXHIBIT 4. RBC GAM GDP Forecasts for Emerging Markets

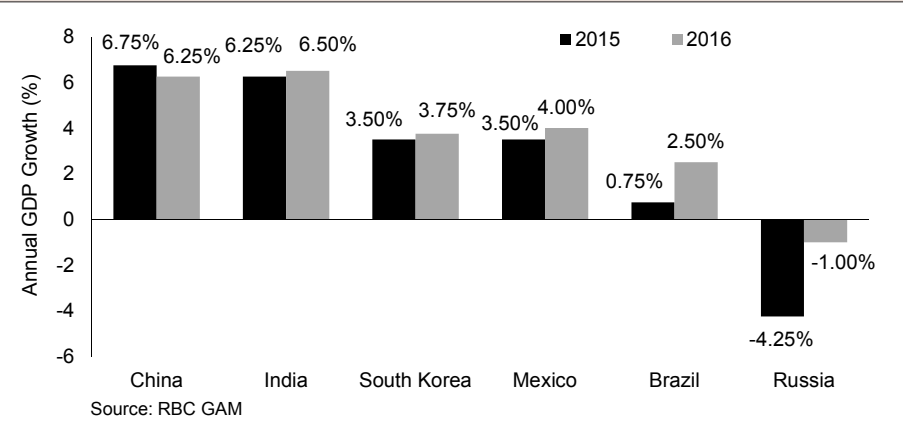
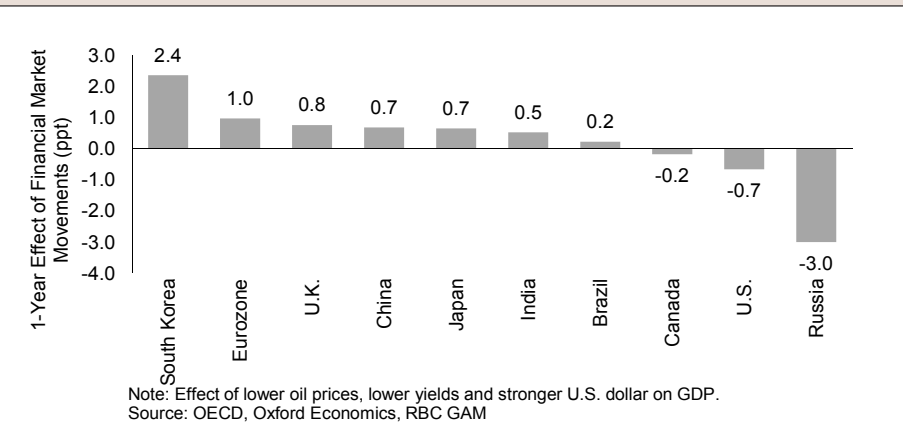


EXHIBIT 5. Low Oil, Low Rates, Strong USD Boost Global GDP



Much of this cautious optimism stems from the anticipated potency of sharply lower oil prices, a new round of monetary stimulus that has further undercut bond yields, and more competitive exchange rates (Exhibit 5).

We also believe that the global business cycle should be capable of extending its gains given the historical precedent that deep recessions and financial crises are usually followed by a longer-than-normal period of expansion (Exhibit 6).

Oil down...

The sharp decline in oil prices remains a key global theme, even though prices are no longer actively falling (Exhibit 7). We continue to believe oil prices have overshot fair value, and so should rise significantly over the next several quarters.

In the meantime, however, the effects of lower oil prices are ricocheting in several directions. On the negative side (Exhibit 8), oil-producing corporations and related industries have been punished in the markets through lower equity valuations and wider credit spreads. Oil-exporting countries have also suffered as holes appear in their budgets and their economic-growth rates slow. Geopolitical risks are also on the rise as beleaguered oil exporters become less stable.

Of course, this analysis has so far neglected the good news associated with diminished oil prices. Far more countries like low oil prices than dislike them (Exhibit 9). Beneficiaries include such goliaths as the Eurozone, Japan, China and India and the U.S. (which

EXHIBIT 6. This Expansion Should Be Longer Than Average

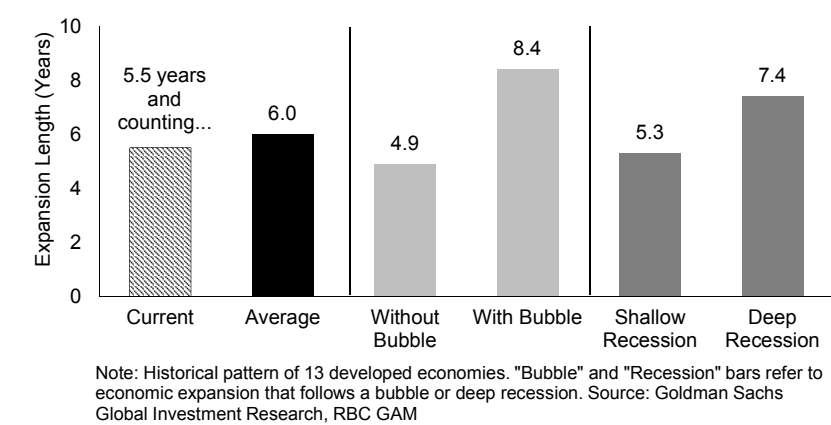
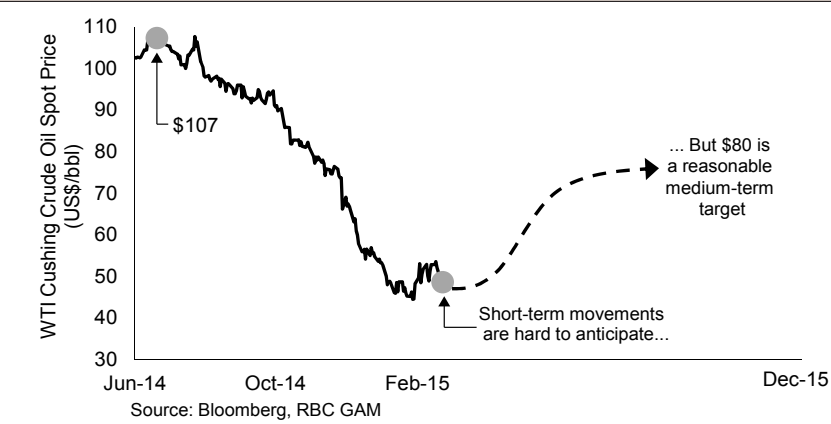


EXHIBIT 7. Expected Oil Trajectory



produces a large amount of oil but consumes even more). As a collective, G7 economies have historically managed substantially faster growth after periods of declining oil prices (Exhibit 10).

...then oil up?

Peering into the future, the main argument for higher oil prices in the coming quarters is that the global mismatch between oil supply and demand simply isn't very large (Exhibit 11). Global production exceeds

demand by no more than 2%, or 2 million barrels, per day. Moreover, low oil prices induce Pavlovian responses in both demand and supply. Our model of oil demand suggests that decent global economic growth paired with low oil prices should boost daily demand by a substantial 2 million barrels all by itself over the next year.

The supply side of the oil equation further demonstrates the unsustainability of current pricing: almost half of global production is unviable at these levels. This is

clearly excessive. Traditionally, OPEC has acted as an escape valve for exaggerated oil-price swings, but it has been coy so far. There is perhaps a one-in-three chance that OPEC cuts its production quota by June, based on growing pressure from some of the more vulnerable OPEC nations.

More likely, however, is that market forces will resolve the mismatch. The key in determining who will crack lies not so much in gauging where oil is most expensive to produce, but in determining where production naturally decays the fastest without constant reinvestment. The U.S. shale oil sector is the prime candidate given that its oil wells have such short production life cycles. Confirming this assessment, the U.S. oil-rig count is already declining quickly (Exhibit 12).

In our view, a price of around \$80 per barrel should theoretically balance medium-term oil supply and demand.

Diverse Russian risks

The world remains awash in geopolitical risks (Exhibit 13). The two biggest revolve around Russia and Greece, both of which we will discuss shortly. Other substantial – though lesser – risks relate to the geopolitical risks that arise from lower oil prices (already discussed) and the European political environment (discussed later). Finally – at least among the above-the-fold risks – ISIS and Ebola remain concerning, but seem incapable of achieving global economic significance.

EXHIBIT 8. Mapping Oil’s Damage

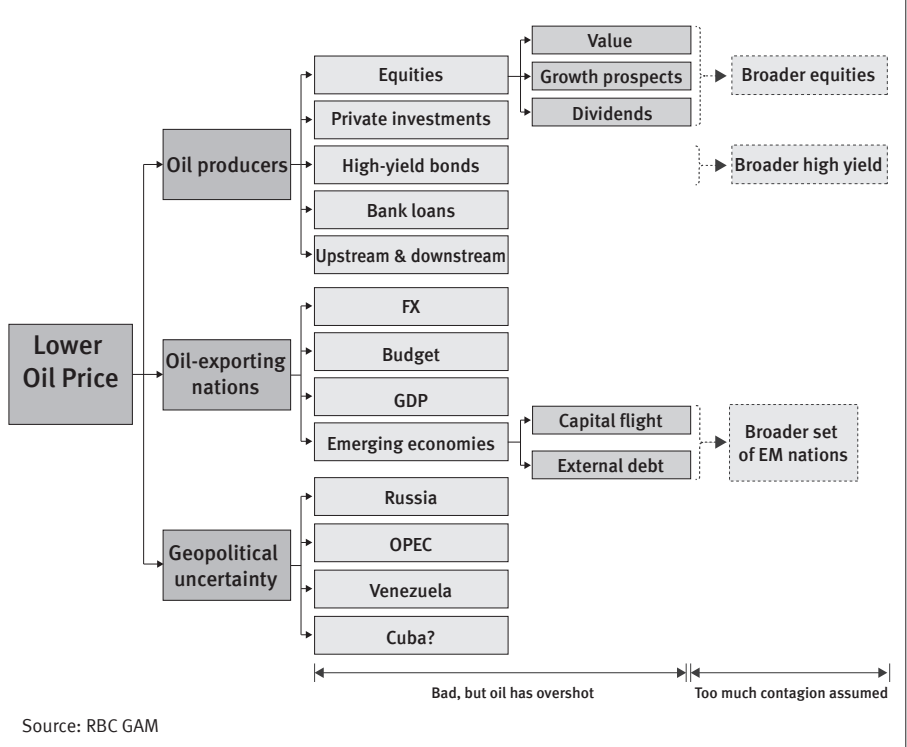
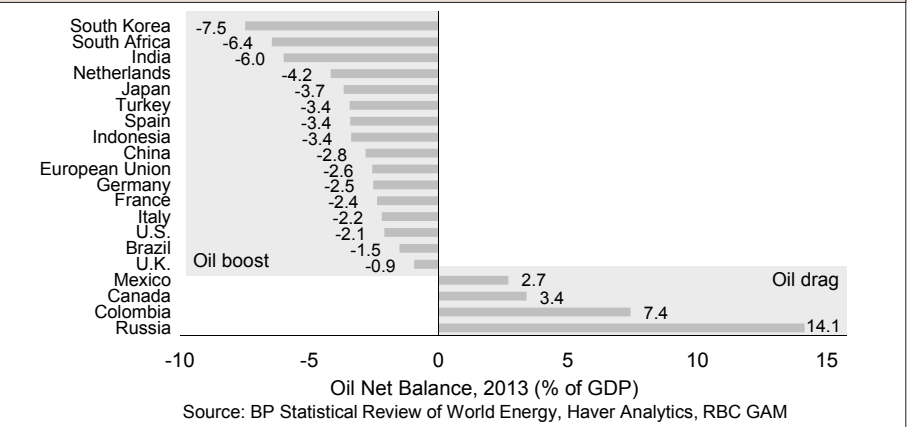


EXHIBIT 9. Lower Oil Prices: a Blessing or a Curse?



Russian risks are multi-faceted, relating to the country’s military undertakings in Ukraine, its economic problems and its debt vulnerabilities.

Despite a recently negotiated ceasefire, it is unlikely that the conflict in eastern Ukraine is over. Separatists and – by many accounts – Russian troops continue to expand their reach. The U.S. seriously contemplates arming Ukraine while Europe continues to prefer a diplomatic solution. Some fear that Russia could significantly expand its operations into the rest of Ukraine or other neighbor states such as the Baltics. Both are ultimately unlikely given that public support in Ukraine is limited beyond the occupied territory and Baltic nations are NATO members.

Russia’s economic problems are severe, with the economy set to shrink by more than 4% in 2015. This is due in roughly equal parts to economic sanctions that limit Russian trade and the sharp decline in oil prices. We continue to believe that the Russian economy will fare worse than the market consensus.

Russian debt is the third risk. It is not that Russian debt is unusually high. On the contrary, the country’s public-debt level is quite low and its external debt – what it owes foreigners – is a middling 35% of GDP.

Nevertheless, Russian indebtedness has become a serious risk for several reasons (Exhibit 14). First, roughly three-quarters of Russia’s external debt is denominated in a foreign currency, which makes Russia vulnerable to the currency market. Second, it so happens that the ruble has fallen by half since mid-2014,

EXHIBIT 10. Lower Oil Prices to Boost G7 Economies

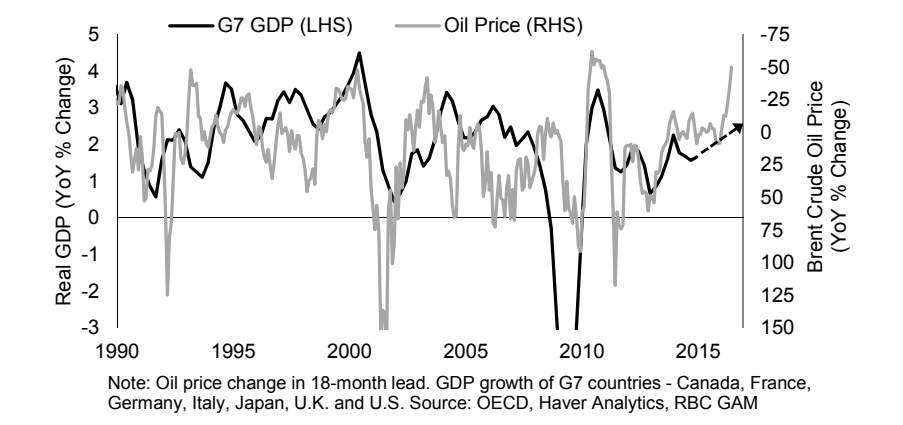


EXHIBIT 11. Oil Market Can Restore Balance Quickly

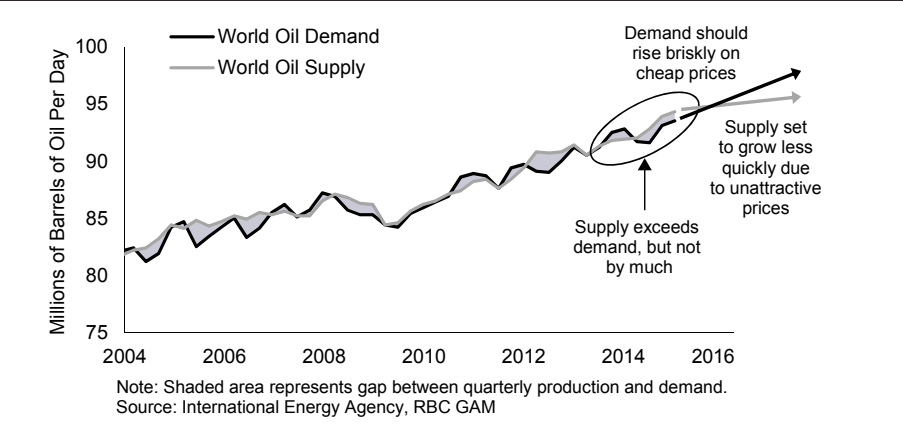
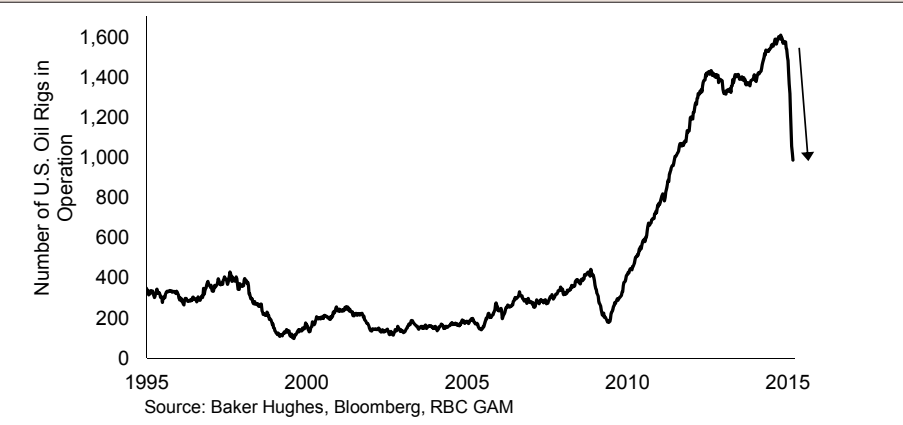


EXHIBIT 12. U.S. Oil Adjustment Begins



making this foreign-denominated debt suddenly feel twice as large to Russian borrowers. Third, Russian borrowing rates have roughly tripled as the central bank seeks to discourage further capital flight. Fourth, the bulk of the debt is in the corporate sector, rendering it both opaque and prone to default. Fifth, the Russian economy happens to be fairly large, such that the absolute figures being bandied about are material to the global economy. Russian non-financial firms owe around US\$300 billion in foreign-currency debt, which suddenly feels more like US\$600 billion given the depreciating currency. As a further complication, sanctions limit the ability of foreign lenders to continue financing Russian entities, even if they did otherwise have the means to afford the debt. Disaster can probably be averted by deploying Russia's significant, though dwindling, currency reserves and by securing additional public debt financing. Nevertheless, the cacophony of Russian complications is deafening.

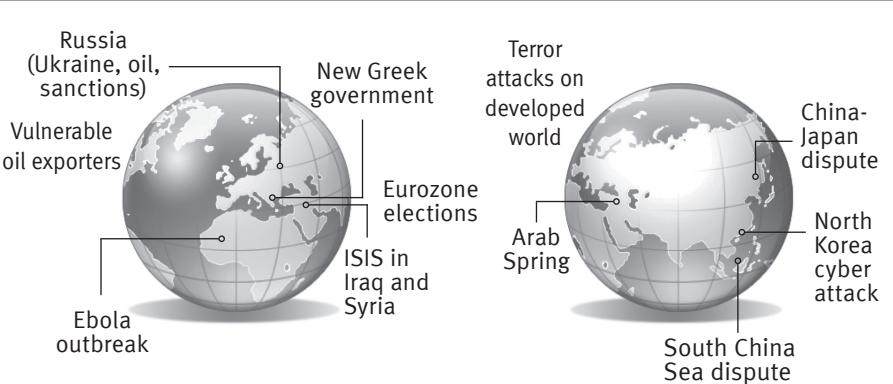
Greek complications anew

In early 2015, Greek voters elevated the far-left political party Syriza to power. This brought about a flurry of concerns that Greece might fall off the austerity/reform bandwagon. Indeed, Syriza initially played hardball with European bailout negotiators, but has since apparently blinked.

In theory, anyhow, Greece is now back on track for an extension of its bailout package. In turn, the risk of the country leaving the Eurozone has begun to decline, now sitting at perhaps 20%.

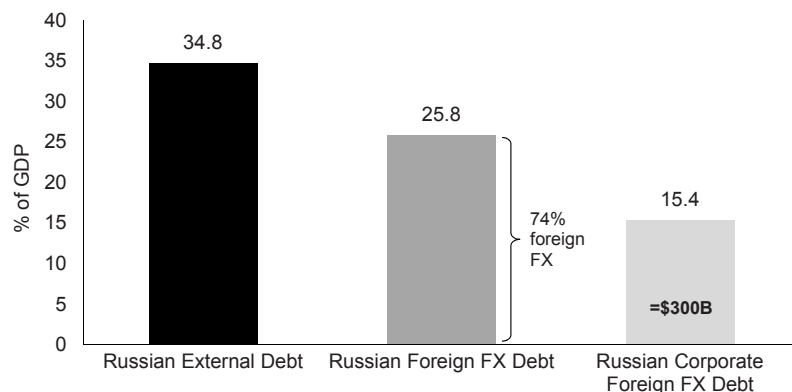
Still, this will be a difficult process and much could yet go wrong:

EXHIBIT 13. Substantial Geopolitical Risks



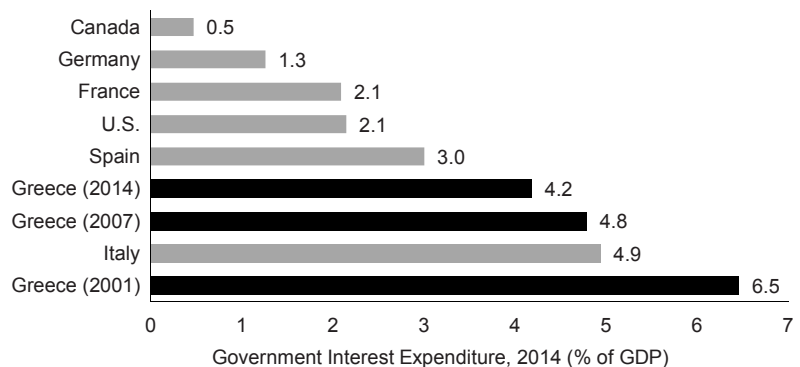
Source: RBC GAM

EXHIBIT 14. Russian Debt a Potential Problem



Note: Data for 2013. Source: Bank of the Russia, IMF, Haver Analytics, RBC GAM

EXHIBIT 15. Greek Interest Burden Is High but Not Unprecedented

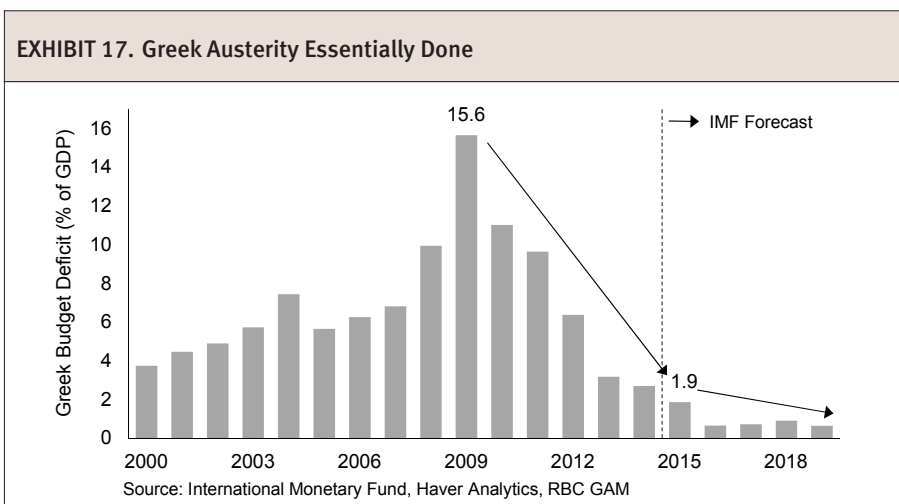


Note: Government interest expenditure for 2014 unless otherwise indicated. Source: Haver Analytics, RBC GAM

- The bailout details remain to be determined precisely, including the specific reforms to be implemented, the country’s primary surplus target, any further privatization of assets and whether any additional debt relief will be provided,
- European parliaments will have to approve the new bailout,
- The Greek parliament will need to approve the new bailout – a difficult task as both the Greek public and certain Syriza factions will be sorely disappointed by the final terms,
- The Greek economy has been damaged by the divisive election and contentious negotiations, resulting in diminished tax compliance and ferocious deposit outflows from Greek banks,⁴
- Reform implementation has not been Greece’s strong suit.

Perhaps the more important question is whether the Greek economy can survive with an enormous public debt of 175% of GDP. Fortunately, the absolute size of the debt matters less than the cost to sustain it. The combination of ultra-low global bond yields and special terms for Greece have kept the Greek debt burden surprisingly manageable (Exhibit 15). In fact, Greece spends less of its economic output servicing its public debt than does Italy, less than it did before the financial crisis struck in 2007, and less than it did before it joined the Eurozone in 2001. Moreover,

⁴ Motivated by the fear that a Greek Eurozone exit would result in capital controls, a depreciating drachma and perhaps even a bail-in of depositor money to recapitalize banks.



while the debt must eventually be repaid, Greece has an unusually long runway in which to do so (Exhibit 16). It is thus our interpretation that Greece is not currently in an unsustainable debt position.

Moreover, for all of the understandable unhappiness in Greece given high unemployment rates and several years of intense economic pain, Greece is actually turning the corner. The Greek fiscal deficit has plummeted from

an eye-watering 16% of GDP during the financial crisis to just 2% today (Exhibit 17). From a competitiveness standpoint, it has more than reclaimed the losses it incurred in the years leading up to the financial crisis. Furthermore, the Greek economy is now growing, and as we argued in a June 2014 Economic Compass entitled “Measuring Economic Upside,” economies that fall the furthest often enjoy the most vigorous rebounds.

Deflation threat

Global inflation continues to fall, with the Eurozone and its legacy of economic carnage at the center of the story. In fact, both the Eurozone and U.S. now have consumer prices that are lower than a year ago – a condition commonly known as “deflation.”

We have a more nuanced definition of deflation, recognizing that true, problematic deflation requires falling prices across a significant swath of goods and services, and that this condition must persist for a substantial period of time before a deflationary mindset fully sets in (Exhibit 18). Framed in this manner, it is premature to claim the onset of true deflation.

Furthermore, a fair chunk of the current downward impulse falls into the category of “good” deflation, in the sense that it originates from supply-side and/or external shocks, as opposed to anemic demand. Lower oil prices have more to do with enthusiastic oil production than falling demand, with the implication that it is essentially a tax cut for households and businesses. Lower Eurozone food prices are the result of unusually good growing conditions last year alongside trade sanctions that unnaturally constrain Russian demand for European food. A decline in education and health-care inflation also appears to be the result of supply-side forces more than a demand-side shock (Exhibit 19).

Certainly, a material part of low inflation in the Eurozone – and to a lesser extent, elsewhere – does indeed reflect weak demand. But it is not merely a story of demand, and

EXHIBIT 18. Declining Inflation Expectations

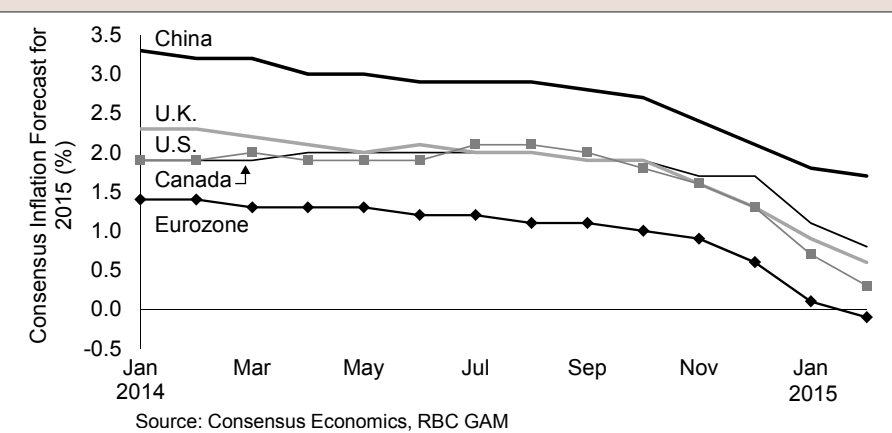
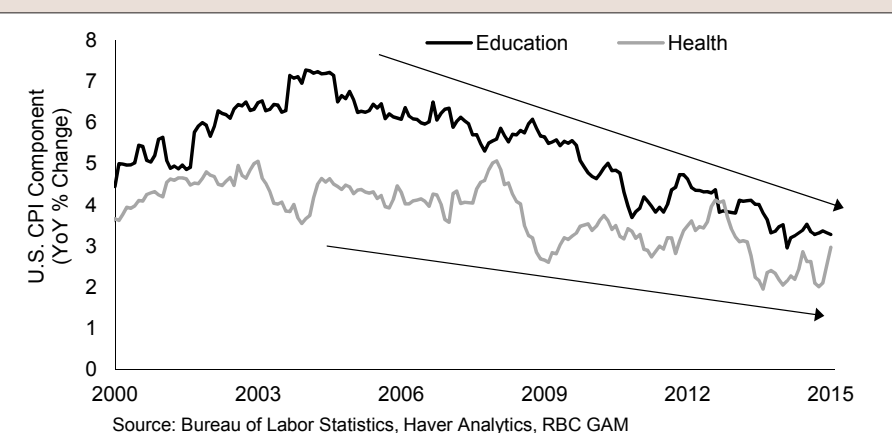


EXHIBIT 19. Supply-Side Factors Lead U.S. Disinflation Charge



so the spectre of deflation may be less frightening than it first seems. Nevertheless, we suspect inflation rates will decline by more than the market is assuming in the near term, as the indirect effects of lower oil prices trickle through the system. Accordingly, we have aggressively cut our own inflation forecasts, for the most part to below-market expectations (Exhibit 20).

However, with oil prices likely rising substantially by the end of the year and given our longstanding opinion

that there may be less economic slack in developed-world economies than commonly imagined, inflation should rebound substantially by 2016.

Central banks tilt dovish

The central-banking theme in past quarters was one of divergence, with some central banks set to tighten and others set to ease (Exhibit 21). That remains true, but the latest development is that most central banks are shifting in a more dovish direction.

In terms of their actions, central banks can be classified under five distinct headings. First are those still stubbornly planning on tightening, with the U.S. Fed leading the way and the Bank of England (BOE) also tentatively in this camp.

Second stands the Eurozone all by itself, having suffered from slow economic growth and deflationary pressures for several years. It finally overcame institutional inertia in early 2015 to deliver a whopping 1.1 trillion euros of quantitative easing (Exhibit 22).

Third are the set of Eurozone neighbours who were in turn jolted into motion by the ECB's bold action. European nations such as Denmark and Sweden felt obliged to deliver stimulus to keep their currencies from appreciating relative to their most important trading partner, and Switzerland was forced to ease rates and abandon its currency ceiling when euro pressures upon it grew too great.

Fourth are several emerging-market nations such as China, India, Turkey and Indonesia, which have used this period of declining global inflation to deliver additional monetary ease as a stimulant for their decelerating economies.

The fifth and final group of countries delivering monetary stimulus are commodity exporters such as Canada and Australia, whose economic prospects have diminished somewhat alongside lower resource prices.

Retreating from the level of individual nations to the global stage, it is astonishing to note that even as the

EXHIBIT 20. RBC GAM CPI Forecast for Developed Markets

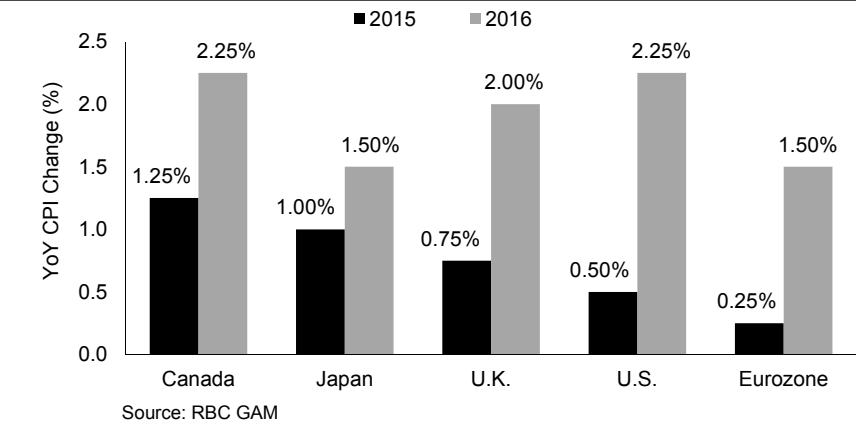


EXHIBIT 21. Divergent Central Banks

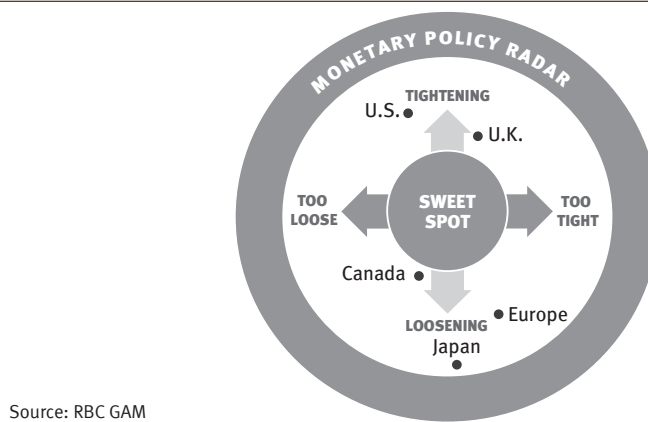
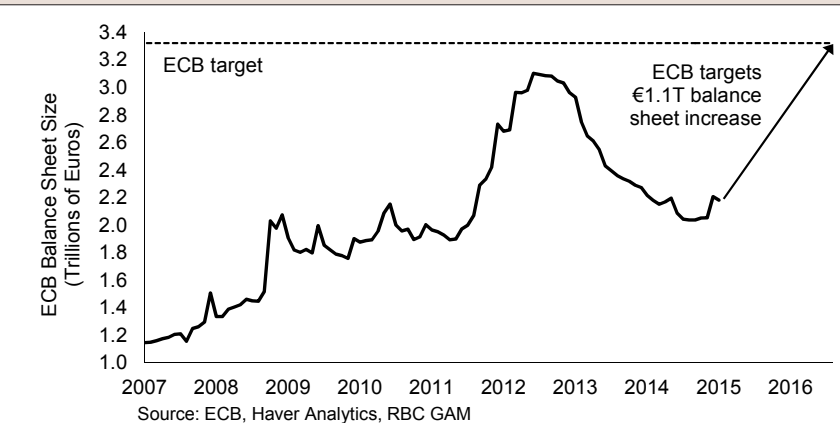


EXHIBIT 22. ECB Unleashes More Stimulus



Fed has halted its money-printing operations, the world's monetary base continues to expand at the same pace as it has throughout the post-crisis period, with the ECB and Bank of Japan (BOJ) substituting (Exhibit 23). There is no shortage of money in the world today, with the consequences continuing to be felt via ultra-low yields around the world.

Dawn for the Eurozone

The European outlook is hardly favourable on the surface given deflation worries and a whole host of political/geopolitical/policy issues and developments (Exhibit 24).

Politically, Greece continues to deservedly capture the market's attention, but a variety of complications will also arrive this autumn via Portuguese, Spanish and Catalanian elections. All are potentially dangerous, if to varying degrees:

- Portugal appears set to shift from a centre-right government to a centre-left government, but seems capable of securing economic and reform continuity.
- A new austerity-skeptic political party in Spain called Podemos now leads in the polls, creating fears of a similarly messy outcome to the recent Greek elections. The risk is probably not quite as high: Podemos is still somewhat of a novelty and may yet lose support in the run-up to the election; it is also likely to require a moderate political partner to govern.
- The Catalanian election is somewhat frightening in that the Spanish province's separatist

EXHIBIT 23. Remarkably Steady Central-Bank Bond Buying

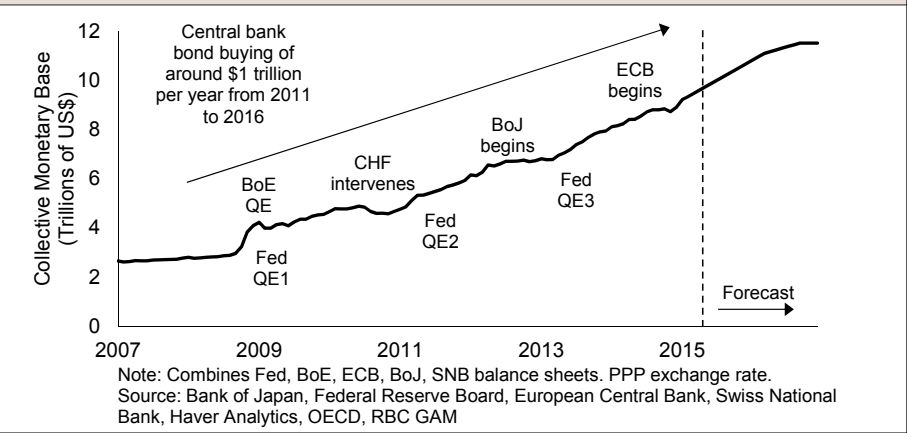
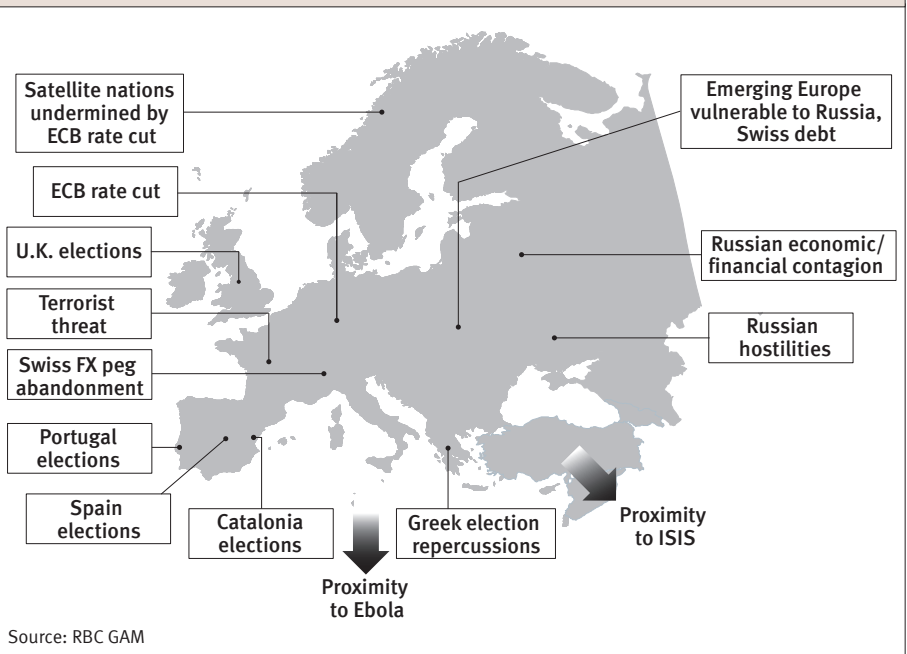


EXHIBIT 24. European Challenges



movement remains quite active and the coming election is being viewed as a referendum given national laws that ban an official referendum. A messy separation is not impossible, but the more likely scenario is that Spain simply makes fiscal concessions to Catalonia.

Despite the various risks, we believe economic recovery may be dawning for the Eurozone. Foremost, the trifecta of lower oil prices, lower European bond yields and a weakening euro are set to act as a potent economic stimulant, and should boost growth substantially.

Furthermore, Europe’s grim era of fiscal austerity is now fading fast.

Reflecting some of this, Europe’s long-beleaguered periphery is growing again (Exhibit 25), with Ireland racing forward, Spain trotting along with increasing confidence, and Greece and Portugal managing growth more often than not. Italy remains an unfortunate exception.

Core Europe has underwhelmed lately, with Germany bleeding momentum across much of 2014. Fortunately, this trend is also turning, with German sentiment now steadily improving once more (Exhibit 26). More broadly, recent purchasing-manager indices across the Eurozone are again rising.

Finally, the Eurozone credit impulse is also back in positive territory, signaling important healing (Exhibit 27). This is the result of many things, including the fact that Eurozone banks have recapitalized and passed reasonably vigorous stress tests, and that the ECB is finally printing money and buying government bonds (Exhibit 28).

Where does this leave us on the Eurozone? We don’t have especially bullish views by normal standards, looking for 1.25% GDP growth in 2015 and 2.00% growth in 2016. But these humble figures are more than the Eurozone has managed in years, and also more than the market currently expects. As such, this places us in the “optimist” camp and of the opinion that the Eurozone may be starting to achieve lift-off after many hard years.

EXHIBIT 25. Euro-Area GDP Growth Recoupling

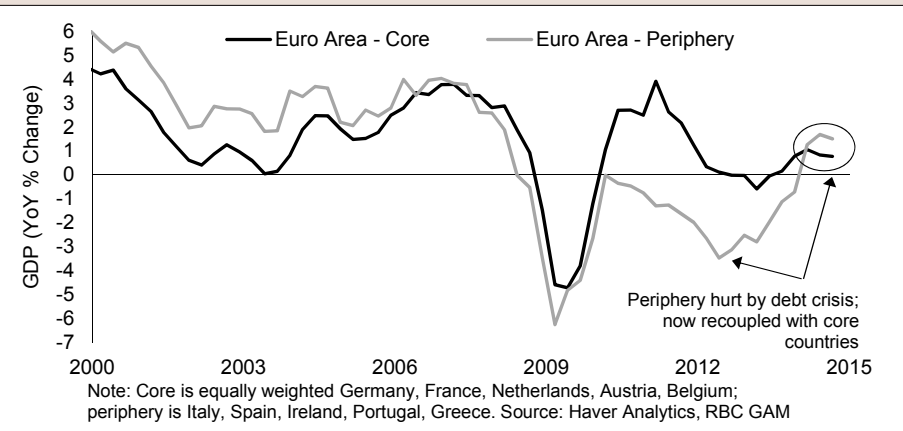


EXHIBIT 26. German Sentiment Improving Again

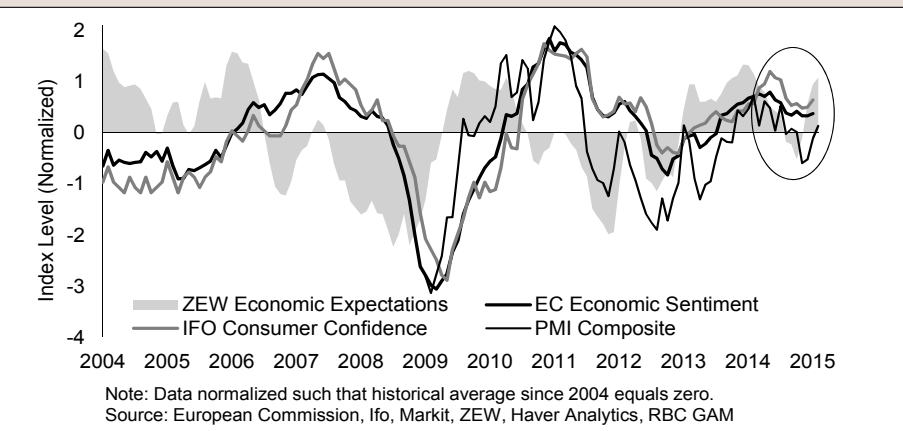
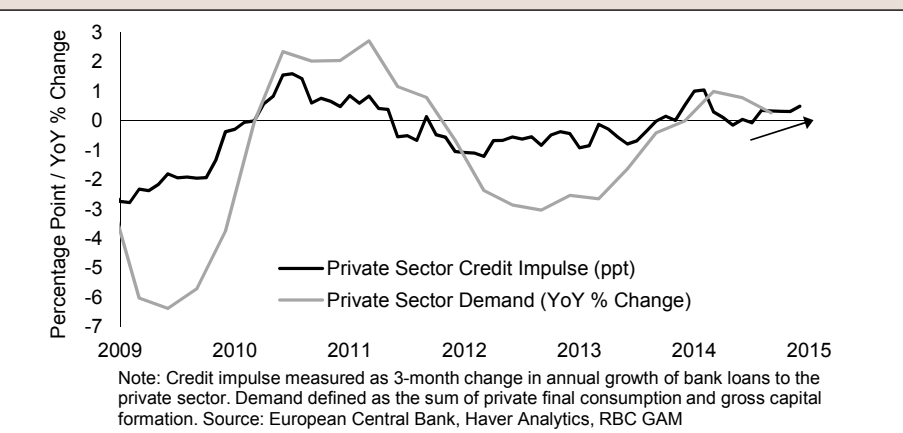


EXHIBIT 27. Faster Credit Growth to Revive Eurozone



U.S. cruises along

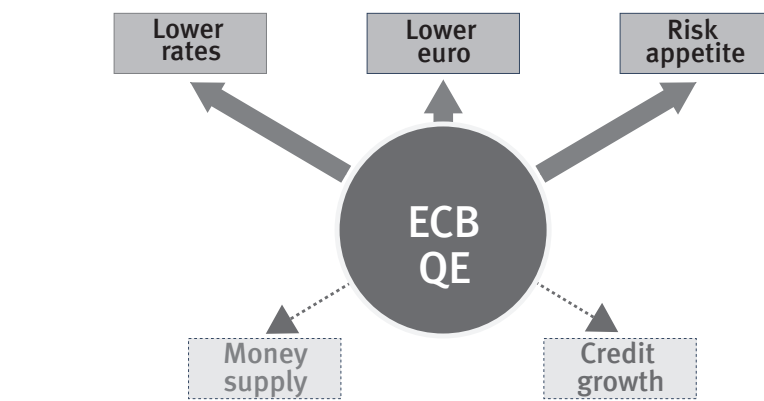
The U.S. economy continues to cruise along, having escaped the gravitational pull of the post-crisis malaise in 2014. It is likely to continue along this trajectory, even if a bit of turbulence is building. The most obvious two challenges are sluggish global demand and the strengthening U.S. dollar (Exhibit 29). Fortunately, the first constraint is mitigated by the fact that the U.S. is an inward-looking economy and so less vulnerable to international forces than most. The second one is tempered by the large fraction of U.S. exports that are unique or high-value-added products not easily substituted for, such as American entertainment and high-tech products.

We retain a niggling worry that U.S. GDP could lose a bit of altitude in the first quarter of this year, given a similar seasonal experience last year, the recent tailing-off in durable-goods orders, California port strikes and rising inventories.

Despite a recent decline in the ISM Manufacturing index – a classic U.S. leading indicator that focuses on medium-sized and large U.S. manufacturing companies – the overall level is still fairly normal and the decline is understandable in the context of a stronger greenback. Moreover, a wide-angle lens reveals that two other sectors crucial to economic health – consumers and small businesses – are both exuding more confidence than they have in a long time (Exhibit 30).

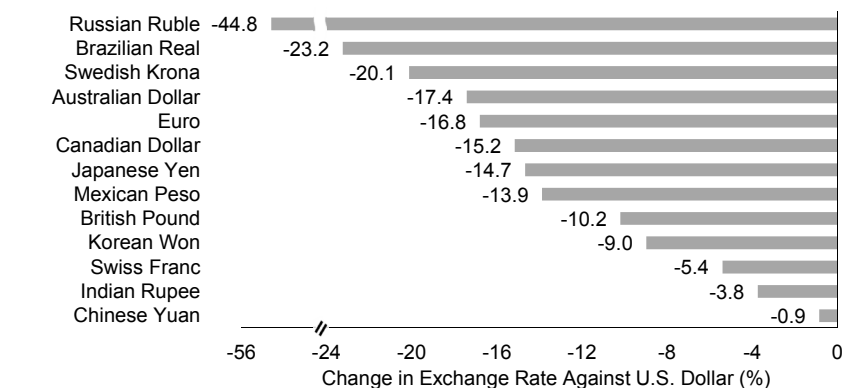
For all of the talk about U.S. shale-oil production, the country is still a significant net importer of oil and

EXHIBIT 28. ECB Finally Delivers QE



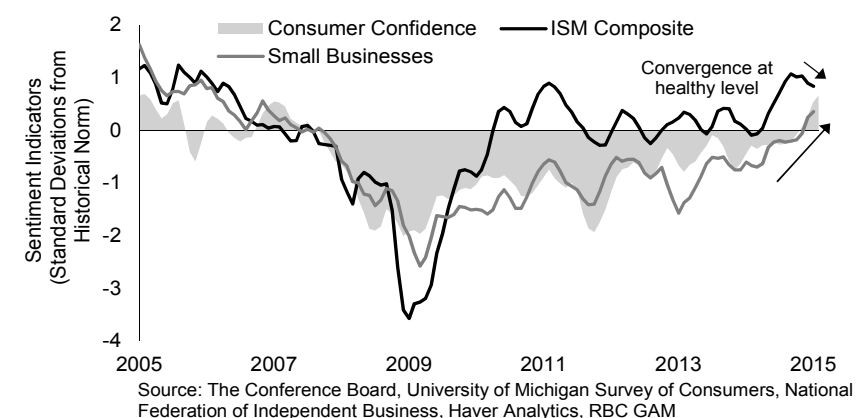
Source: RBC GAM

EXHIBIT 29. U.S. Dollar Strengthened Against Most Currencies



Note: As at 2/20/2015. % change since July 1, 2014. Source: WSJ, Haver Analytics, RBC GAM

EXHIBIT 30. U.S. Economy: Two Up, One Down



Source: The Conference Board, University of Michigan Survey of Consumers, National Federation of Independent Business, Haver Analytics, RBC GAM

so benefits economically from lower prices. Admittedly, the interpretation is more nuanced if the focus is instead on U.S. financial markets, since the oil industry occupies a disproportionate share of stock indices and the high-yield bond market.

The robust U.S. labour market shows no sign of letting up, churning out around a quarter of a million net new jobs per month. This is a key driver of the country’s positive consumer outlook, alongside the aforementioned improved consumer confidence, a positive wealth effect and the prospect of faster wage growth (Exhibit 31).

Wage gains remain sluggish for now (at least in nominal terms – inflation-adjusted gains are somewhat better), but appear ripe for acceleration. Labour-market slack is rapidly vanishing and wage expectations are moving briskly higher (Exhibit 32). High-skilled workers have long been in hot demand, and now a wave of U.S. retailers including Wal-Mart is raising wages for low-skilled workers as well.

U.S. housing has been only a slight contributor to economic growth recently, with home prices rising at a middling 4% per year and construction/resale metrics exhibiting only the slightest of upward momentum. Fortunately, household formation seems to be accelerating again after a period of subdued activity. This makes sense in the context of rapid hiring and growing household confidence (Exhibit 33).

EXHIBIT 31. U.S. Consumer Outlook Good

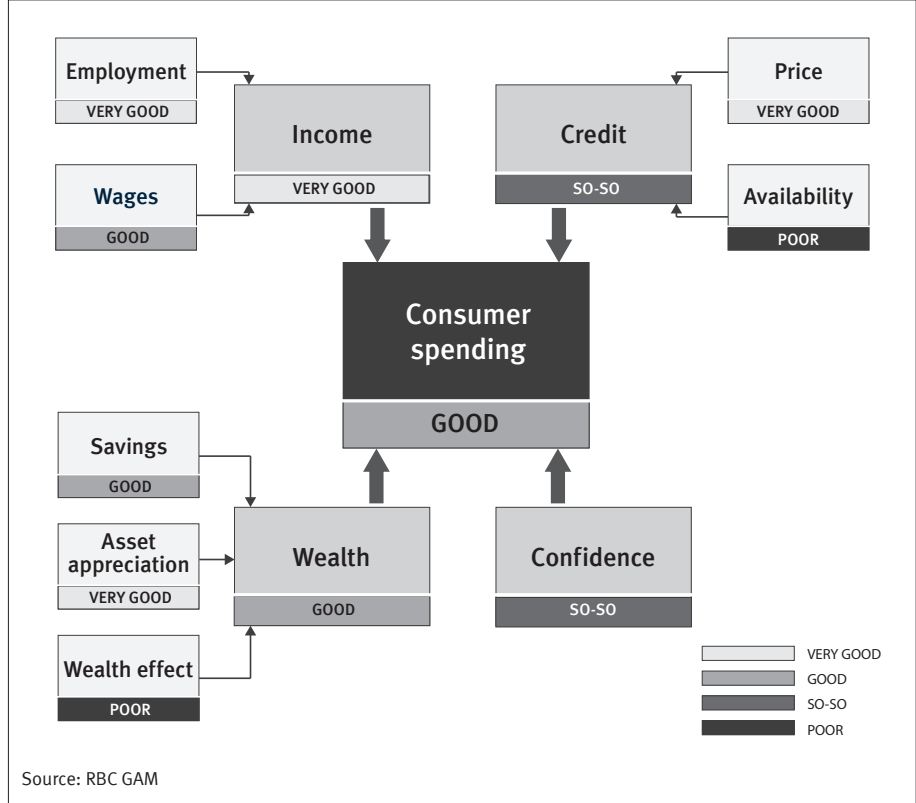
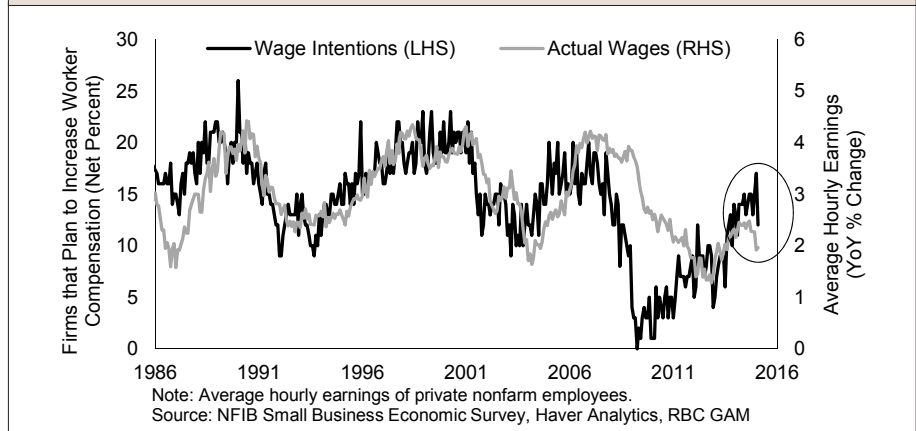


EXHIBIT 32. U.S. Wages Should Follow Intentions



All told, our U.S. economic outlook remains for robust growth of 3.25% in both 2015 and 2016. That said, we are no longer convinced that the U.S. economy can continue to pump out positive surprises given rising expectations by other forecasters and the negative effect of the strong U.S. dollar. The same assessment applies to the U.S. stock market, with the result that other markets such as the Eurozone look increasingly attractive, at least on a currency-hedged basis.

Most monetary-policy models now argue that the fed-funds rate should be lifting off from zero (Exhibit 34). Accordingly, we think the Fed remains on track to raise rates in 2015, likely in the summer or fall. The precise timing has a significant degree of data dependency, based on the extent to which hiring remains strong, wages accelerate and inflation shows signs of bottoming. In a tightening environment, the U.S. dollar should continue to make gains against its key rivals.

U.K. OK

The British economy is performing fairly well, with growth clipping along at between 2.50% and 3.00% annualized. The labour market remains a particular standout, generating surprisingly robust job creation (Exhibit 35) that has whittled away most of the U.K. economy’s remaining slack.

Looking ahead, growth is likely to come from a fairly broad array of contributors. Consumers have been a reliable source of growth given the healthy job market. Business investment, which has lagged since the financial crisis, has obvious

EXHIBIT 33. Household Formation Spiked Recently

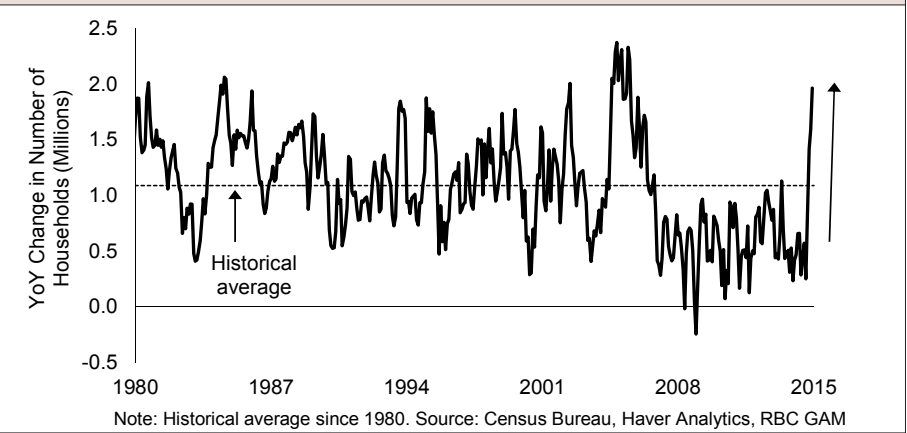


EXHIBIT 34. Model Suggests Higher Fed-Funds Rate

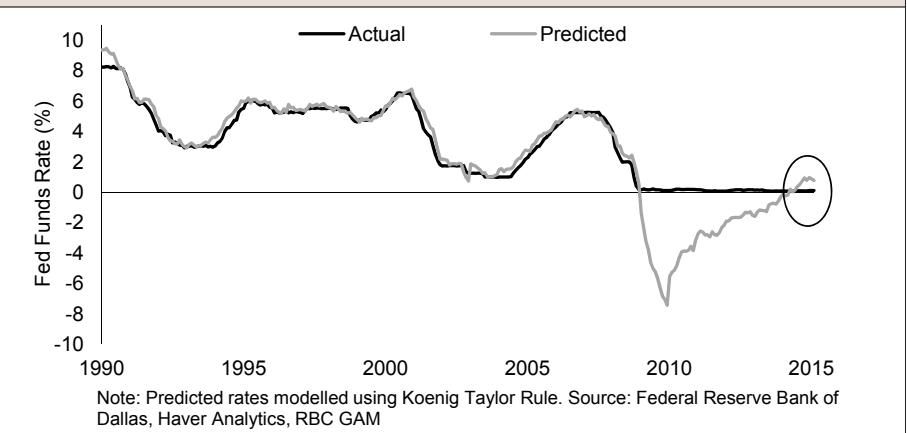
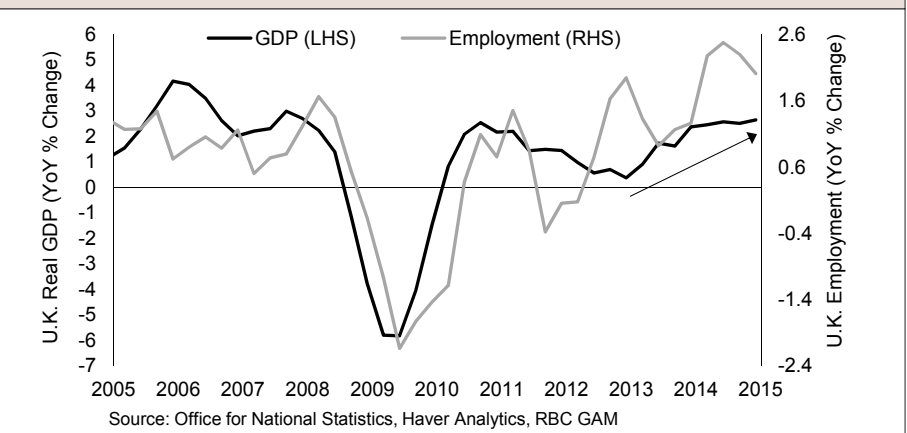


EXHIBIT 35. Strong U.K. Economy and Labour Market



room for improvement. The housing market may be sturdier than it is being given credit for. Export demand should also pick up as the Eurozone grows more quickly. Less promisingly, the U.K. is still enacting a significant amount of fiscal austerity, which may tether growth.

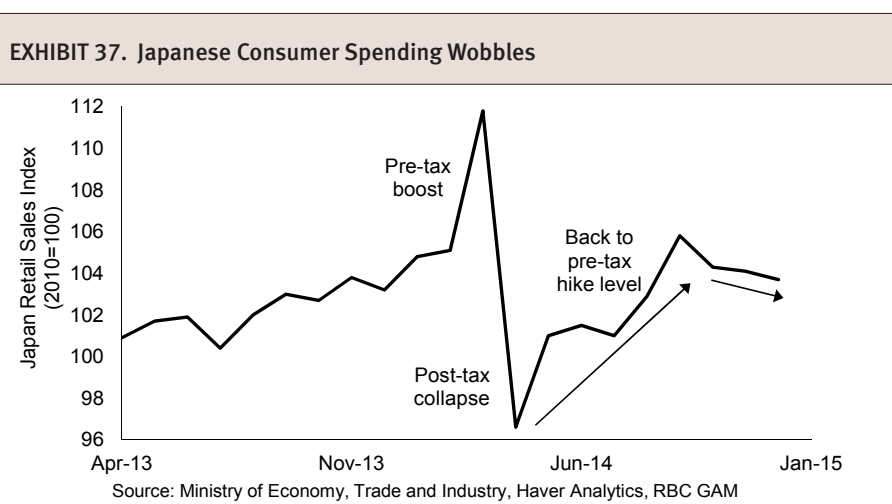
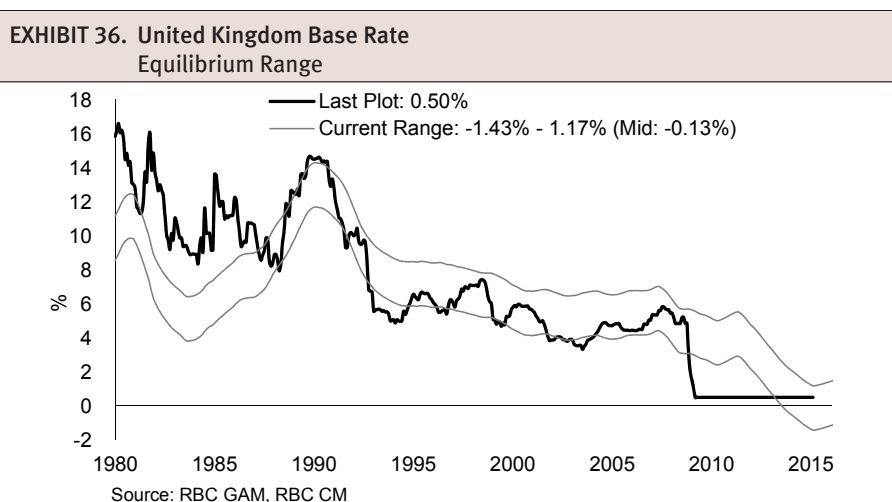
Our British economic forecast has generally been of an above-consensus variety over the past few years. We feel only slightly less positive today, but this has pushed us down to a roughly consensus view of 2.75% growth in 2015 and 2.50% in 2016.

The U.K. election in May is set to be one for the ages. Six parties will duke it out at the polls, vying for votes in an increasingly fractured political landscape. This segmentation is almost certain to produce another minority government, with several permutations conceivable given the closeness of recent polls. A Conservative coalition seems more likely to focus on deficit reduction rather than short-term growth, and EU membership would be cast into slight doubt. In contrast, a Labour coalition would be more likely to slow the rate of austerity and so elevate short-term growth at the expense of longer-term prospects.

The BOE has recently shied away from earlier verbiage about near-term rate hikes but still seems inclined to hike rather than cut. This should happen after the Fed tightens, but before the end of 2015 (Exhibit 36).

Japan's mixed messages

Japan remains a difficult economy to interpret given the contradictory



signals its economy emits. Pessimists observe that several economic indicators suggest that Abenomics is failing. Retail sales initially appeared to be recovering after the April 2014 tax hike, but have since sputtered (Exhibit 37). Similarly, the housing market – after initially soaring – has settled back to pre-Abe levels.

Optimists instead note that Japan is back in growth mode after a brief recession induced by the aforementioned sales-tax hike, and that the prior bout of weakness

seemed overdone. Japanese bank lending is growing more quickly, suggesting the credit spigot has been successfully opened by the BOJ's large-scale monetary stimulus. Although machinery orders have lately been weak, Japanese exports are finally soaring as one would expect given the remarkable competitiveness boost bestowed upon them by a plummeting yen (Exhibit 38).

On the subject of long-delayed structural reforms, the prognosis is beginning to improve. Some metrics

already speak to a shifting economic landscape, such as a long-awaited increase in female employment after two decades of decline (Exhibit 39). Anecdotally, Japanese corporate governance appears to be improving. Furthermore, Prime Minister Abe's December re-election would seem to prove that the public supports his reform plans, making it harder for political antagonists, both within and outside his party, to continue blocking key reforms.

Recognizing the unbroken will of Japanese policymakers and the substantial stimulus that flows from low oil prices, low bond yields (Exhibit 40) and a softening yen, we continue to look for slightly stronger-than-consensus economic growth of 1.25% in 2015 and 1.50% in 2016.

Given the political pressure Japanese corporations are feeling, we see good odds of unusually large spring salary increases this year. In turn, we look for Japanese inflation of 1.0% in 2015 and 1.5% in 2016. Of course, the 2015 figure is distorted by the sales-tax increase (higher) and oil prices (lower). Stripping out these factors, the underlying inflation rate would probably be around 1% this year.

Clipping Canada

Canada has recently been “clipped” in two ways. The first is that its economic outlook has been clipped by lower oil prices. The second is that the Bank of Canada (BOC) has responded by clipping interest rates with a surprise January rate cut.

Canada's new economic circumstances can best be thought of as a battle

EXHIBIT 38. Japanese Exports Surge

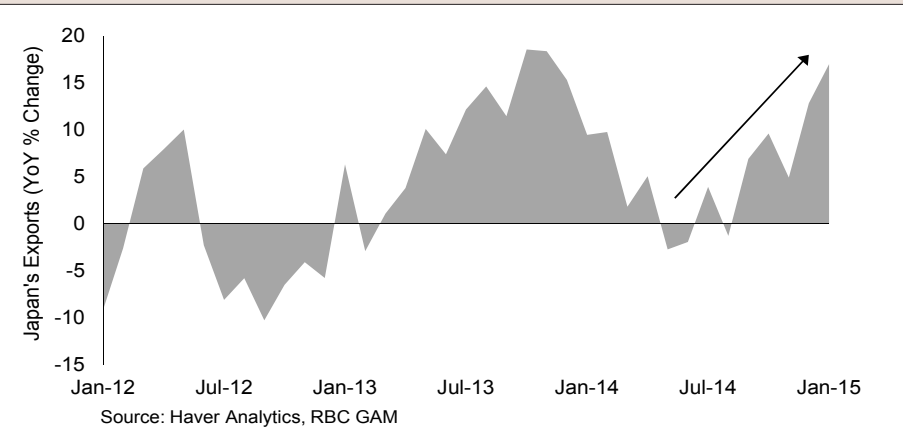


EXHIBIT 39. Japanese Women Return to Workforce

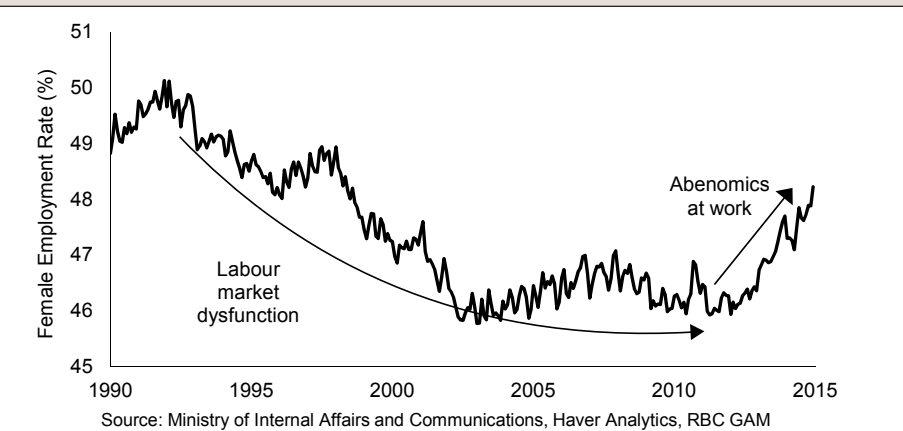
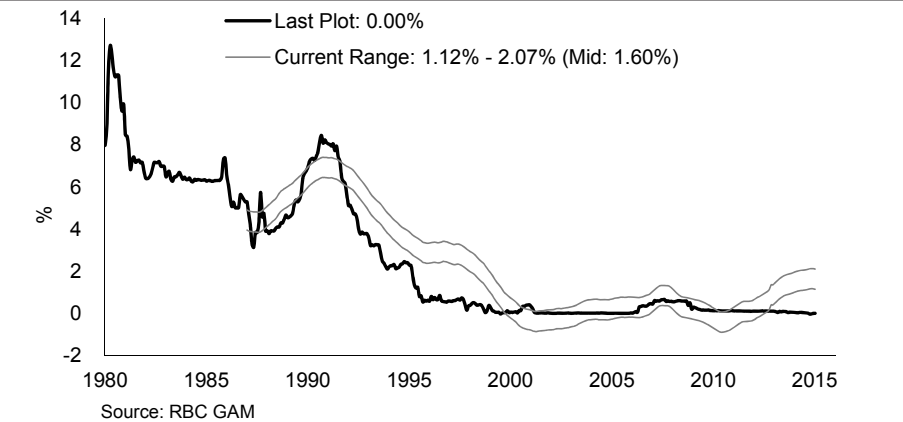


EXHIBIT 40. Japan Overnight Call Rate Equilibrium Range



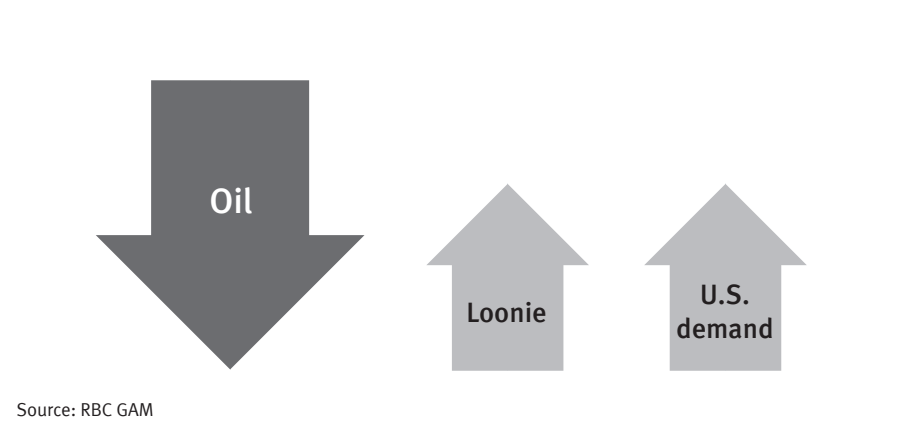
between lower oil prices and the tag team of a weaker currency and robust U.S. demand (Exhibit 41). The oil effect arguably “wins,” but by less than one might imagine given the benefits that accrue to households and especially non-energy exporters (Exhibit 42).

Our latest research on the Canadian housing market⁵ finds a surprisingly benign environment over the near term, with little signs of stress at the national level. Provincially, low oil prices are beginning to bite oil-oriented regions, with existing-home sales sharply lower in Alberta and Saskatchewan. If the 2008-2009 oil cycle repeats itself, home prices and housing starts should be much less adversely affected. The medium-term national housing outlook is somewhat more negative across the country, mainly as affordability eventually deteriorates alongside rising rates (Exhibit 43).

For all the talk of strong exports and a neutral housing market, the sharp decline in oil prices overwhelms all else, as is evident in our Canadian composite leading indicator (Exhibit 44). The blow has less to do with slumping oil production – this is actually holding up in Canada given the long life-cycle of existing projects and the deep pockets behind them – and more to do with an expected 30% drop in oil-oriented capital investment. This can theoretically chop a full percentage point off Canadian economic growth all by itself, but much of the resulting economic hole is backfilled by the beneficiaries of lower

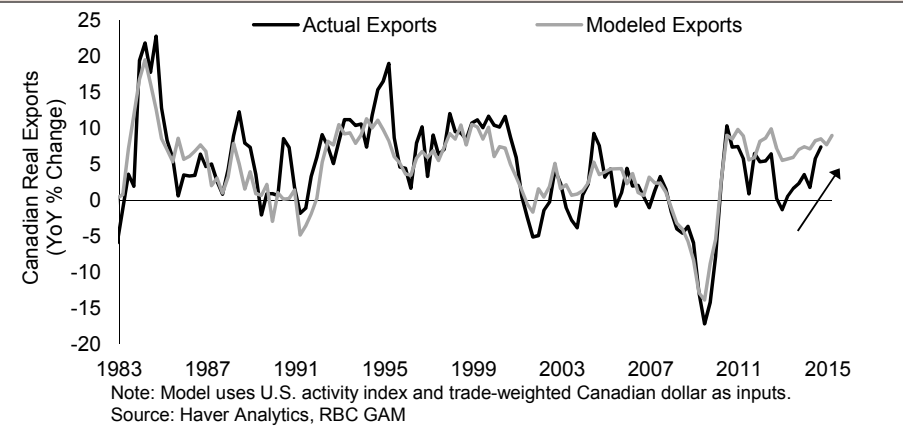
⁵ Detailed in a November 2014 *Economic Compass* entitled “Canadian Housing in Six Questions”.

EXHIBIT 41. Canada’s Competing Forces Offset Each Other



Source: RBC GAM

EXHIBIT 42. Canadian Export Recovery Continues



Note: Model uses U.S. activity index and trade-weighted Canadian dollar as inputs.
Source: Haver Analytics, RBC GAM

EXHIBIT 43. Canadian Housing Scorecard Not That Bad

	OUTLOOK	
	Near term	Medium term
Household debt	Neutral	Slight negative
Housing affordability	Neutral	Major negative
Construction sustainability	Neutral	Slight negative
Condo appetite	Slight negative	Slight negative
Foreign buyers and investors	Neutral	Neutral
Distribution of debt	Neutral	Negative
Economic implications	Neutral	Negative

Note: “Near term” defined as over the next year, “Medium term” as 1–5 years. Source: RBC GAM

oil prices and a weaker currency. All together, we have shaved our Canadian 2015 growth forecast from 2.25% to a below-consensus 2.00%.

Of course, the real story lies in the regional implications. Alberta and Saskatchewan are clearly suffering,⁶ while Ontario and others are holding up somewhat better, at least according to the Canadian Federation of Independent Business' provincial barometers (Exhibit 45). Alberta could conceivably fall into recession, but we think this may just be avoided if oil prices continue to rebound.

Over the next year, the Canadian economy will likely feel worse than it looks. Falling oil prices crimp nominal income and a weakening loonie raises import prices. Neither of these have any bearing on real GDP. They do, however, diminish nominal GDP, which is a superior gauge of government revenues, and nominal gross domestic income, which best reflects how the economy feels to Canadians (Exhibit 46).

The Canadian dollar is set to be buffeted by opposing forces. Further U.S. dollar strength will tend to push the loonie down, while rebounding oil prices will attempt to do the opposite. Across 2015, U.S. dollar strength should prevail, meaning a further few cents of decline in the Canadian dollar. After an earlier surprise rate cut, the BOC now appears content to remain on hold at a 0.75% overnight rate (Exhibit 47). We have long believed that Canada has less economic slack than

EXHIBIT 44. Canadian Economy Took a Sharp Turn

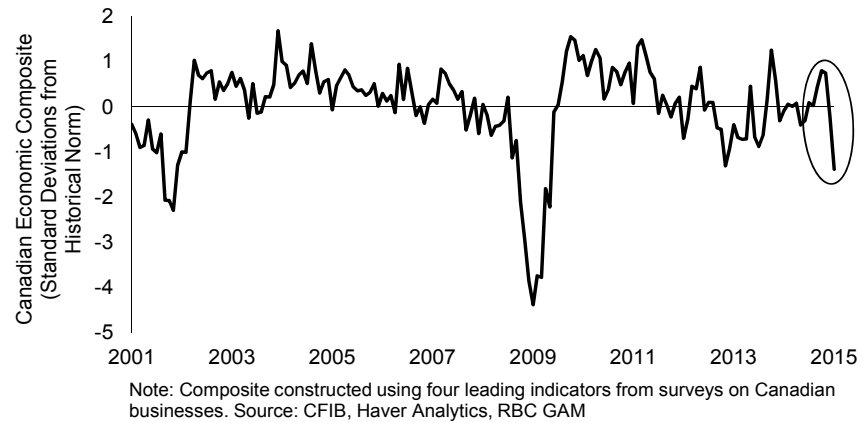


EXHIBIT 45. Oil-Producing Provinces Suffer

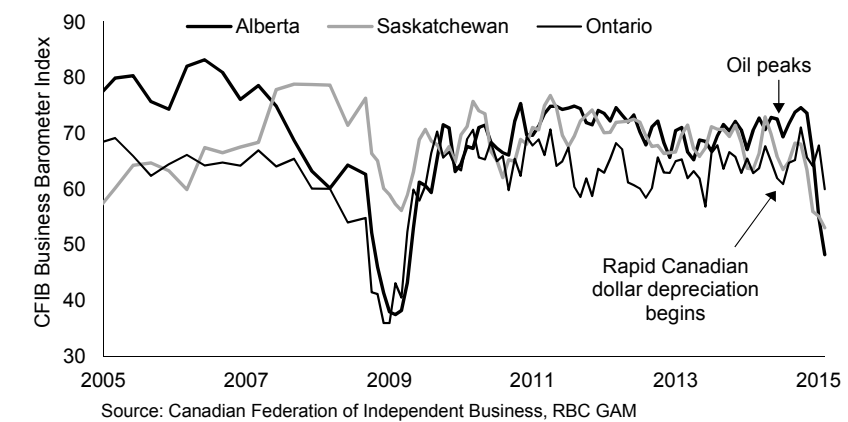
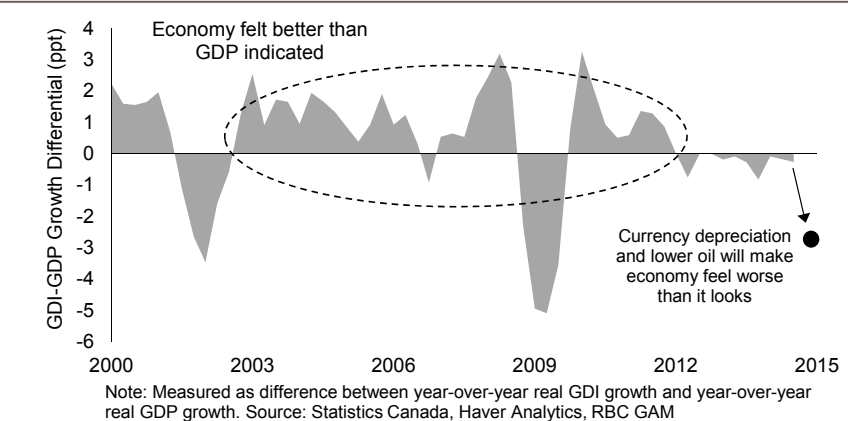


EXHIBIT 46. Canadian Economy to Feel Worse Than It Looks



⁶ Detailed in a November 2014 *Economic Compass* entitled "Canadian Housing in Six Questions".

commonly imagined, which argues that further easing is probably unnecessary.

Canada has a federal election this year – most likely in the fall – and the key issues look to be the economy and national security. In the context of lower oil prices and terrorist attacks, the former issue favours the opposition while the latter issue favours the Conservative government. Polls are still too close to call, but as per clichés, markets likely have a slight preference for the Conservative government they know over an unknown Liberal alternative.

Emerging markets in three thoughts

Emerging-market economies warrant discussion for three reasons: their debt vulnerabilities, the diversity of their economic outlooks and their performance relative to developed economies.

First, their external debt is more vulnerable than normal in the context of a rising U.S. dollar and given the possibility of higher U.S. interest rates (Exhibit 48). Russia is, as already discussed, the most acute in this regard given its currency woes, but other countries are also vulnerable given the extent of their external debt (Exhibit 49). History shows that a strengthening greenback has been associated with past emerging-market crises (Exhibit 50). To be clear, emerging-market countries are better positioned than they were in the late 1990s during the Asian financial crisis, thanks to larger currency reserves, smaller public debt loads and a greater inclination toward floating exchange rates. But

EXHIBIT 47. Canada Overnight Rate Equilibrium Range

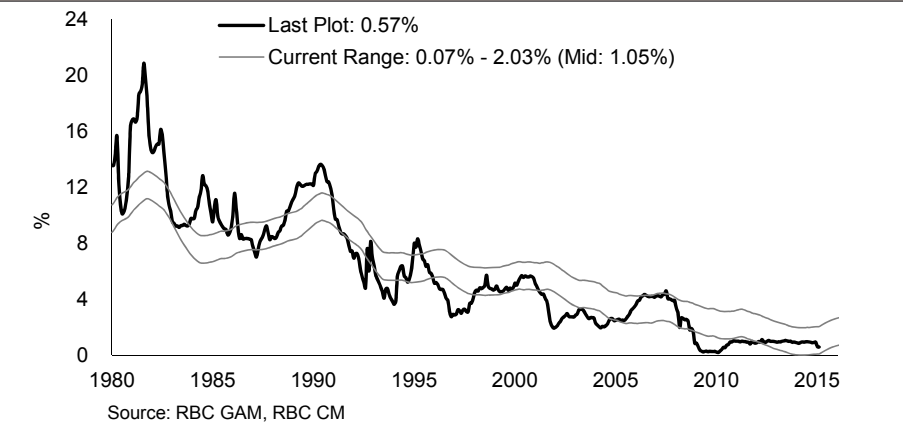


EXHIBIT 48. Emerging-Market Debt Vulnerability

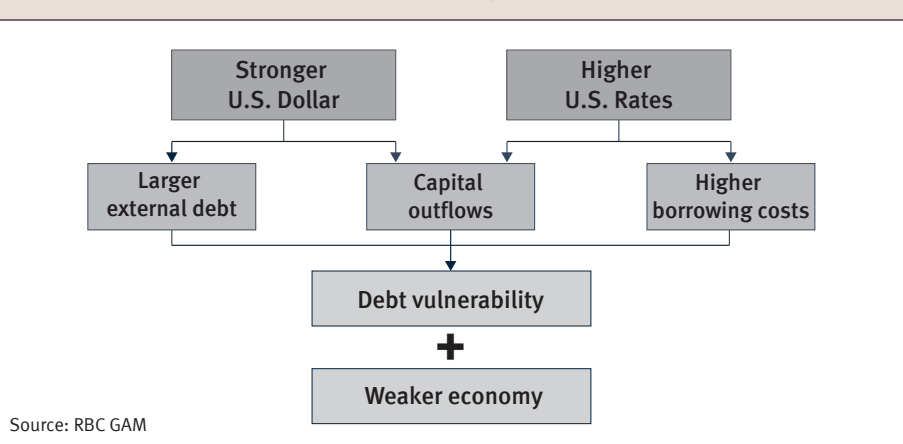
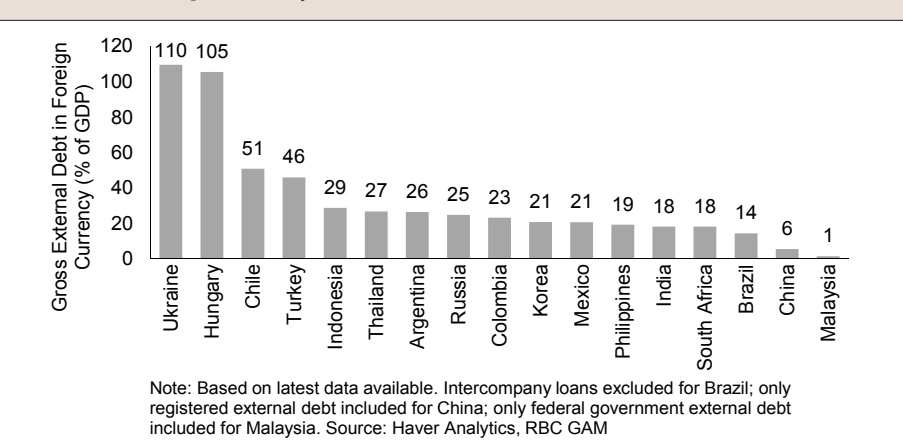


EXHIBIT 49. Foreign-Currency Debt Identifies Vulnerabilities



the foreign-currency corporate debt of emerging-market nations is not materially smaller as a share of GDP than it was then, and given that the total debt load sums to more than US\$3 trillion, this is no trivial matter.

Second, emerging-market economies have unusually varied outlooks for the next few years (Exhibit 51). We tend to gauge each country's relative prospects based on four main criteria: whether they are delivering structural reforms (good); whether they are suffering from credit excesses (bad); whether they are commodity exporters (bad, in the current context); and whether they are geopolitically stable (good). Based on these variables, India places at the top of the charts, with others such as Poland, South Korea and Mexico in close pursuit. On the other hand, Russia, Ukraine, South Africa and Nigeria appear set for additional struggle.

Third, after a period of unusually fast growth in comparison to developed nations, emerging economies appear to be shifting back down to their more usual rate of outperformance (Exhibit 52). A large part of their prior ebullience was the consequence of unsustainably fast credit growth and booming commodity prices. Neither factor is likely to be repeated in the immediate future. To be clear, though, emerging economies are still set to outpace their developed brethren, and emerging-market equities may also manage to best developed markets due to attractive valuations and improving outlooks. On this last note, while emerging-market economic growth is set to be slower in 2015 than 2014, we believe 2016 will see the trend turn

EXHIBIT 50. Emerging Markets Don't Like Strengthening Dollar

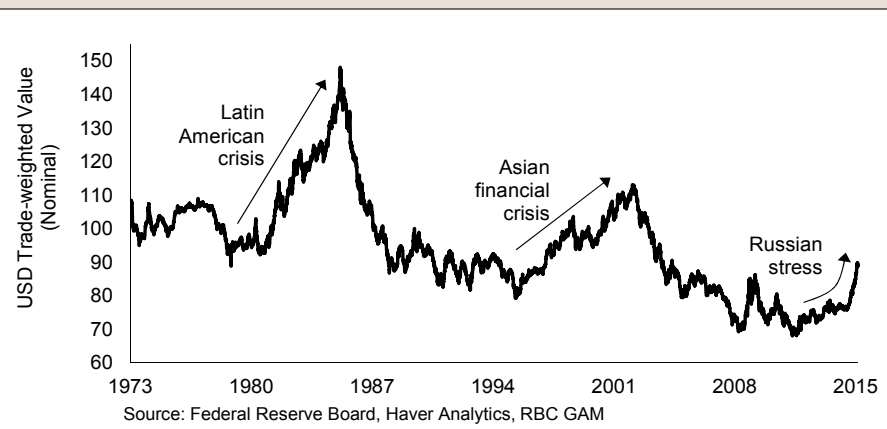


EXHIBIT 51. Emerging-Market Scorecard Shows Varied Prospects

	Reforms	Credit	Resource	Geopolitics
Better prospects ↑				
India	✓	-	✓	✓
Poland	-	✓	✓	-
South Korea	-	-	✓	✓
Mexico	✓	✓	X	-
China	✓	X	✓	✓
Indonesia	✓	-	X	✓
Turkey	✓	X	✓	-
Brazil	-	-	X	✓
Nigeria	-	✓	X	-
South Africa	-	-	X	-
Ukraine	-	X	-	X
Worse prospects ↓				
Russia	X	X	X	X

Note: Credit "X" means credit curtailment or large risk. Resource "X" means commodity exporter. Source: RBC GAM

back upwards. Meanwhile, emerging-market inflation is declining nicely, opening a window for the delivery of monetary stimulus in some countries.

Chinese credit weakens

As was our expectation, the Chinese economy has decelerated for several years, and we continue to look for a greater slowdown than financial markets anticipate. The rationale for

this view includes China's diminishing competitiveness and the repercussions of prior credit excesses.

On the latter, the Chinese housing market has been cooling for much of the past year as prior excesses are reined in. Reflecting the substantial remaining risks in the sector, non-performing loans are now growing at more than 30% per year

(Exhibit 53). Of course, context matters. The absolute rate of non-performing loans is barely more than 1%, meaning it will take a significant period of credit deterioration before lenders suffer. And, for all the potential credit-related woes threatening a cobweb of banks, builders and local governments, the national government still has sufficient resources to bail out vulnerable parties as necessary. With this rock-hard backstop, China remains primarily a narrative of slowing growth as opposed to one of financial woes.

Golden era of reforms?

With particular relevance to emerging-market economies, we detect the beginning of a new golden era of structural reforms that may help to stabilize or even augment economic growth rates. We wrote extensively on this in the January 2015 *Economic Compass* entitled “Seeking New Growth.” The rationale behind this prediction is that the emerging-market economic slowdown (Exhibit 54) creates the need for growth-enhancing reforms, while recent elections create the window of opportunity. The economic implications could be quite substantial (Exhibit 55).

The amazing vanishing bond yield...

Global bond yields continue to display a remarkable proclivity for defying expectations and plumbing new lows (Exhibit 56). Three things have enabled this. First, many central banks have cut rates. Second, inflation expectations have fallen as oil prices have dropped. Third, the bond market’s term premium has again vanished (Exhibit 57), in part as a result of quantitative easing

EXHIBIT 52. Era of Unusual EM Outperformance Ebbs

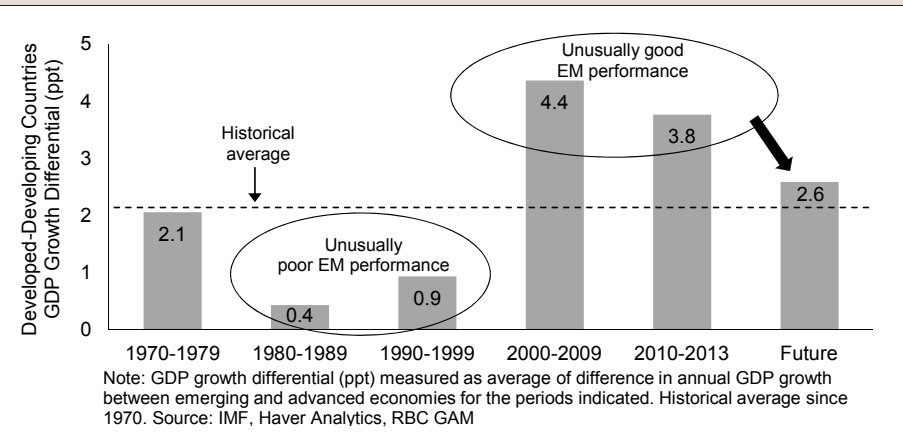


EXHIBIT 53. Non-Performing Loans in China Rising

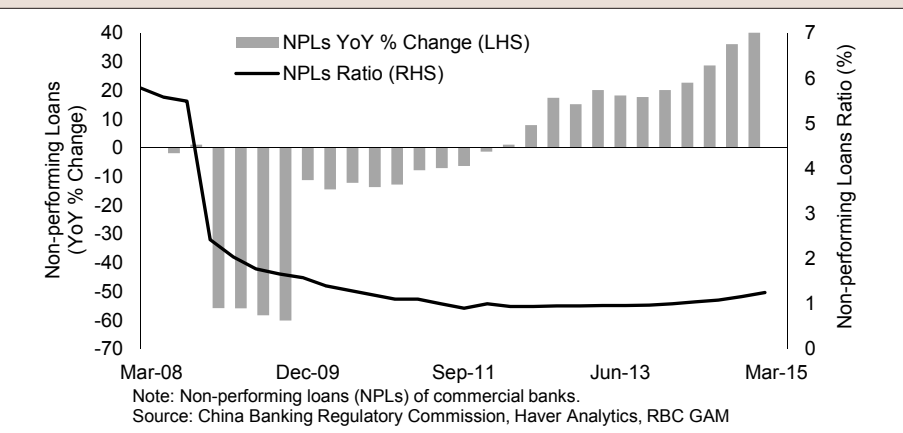
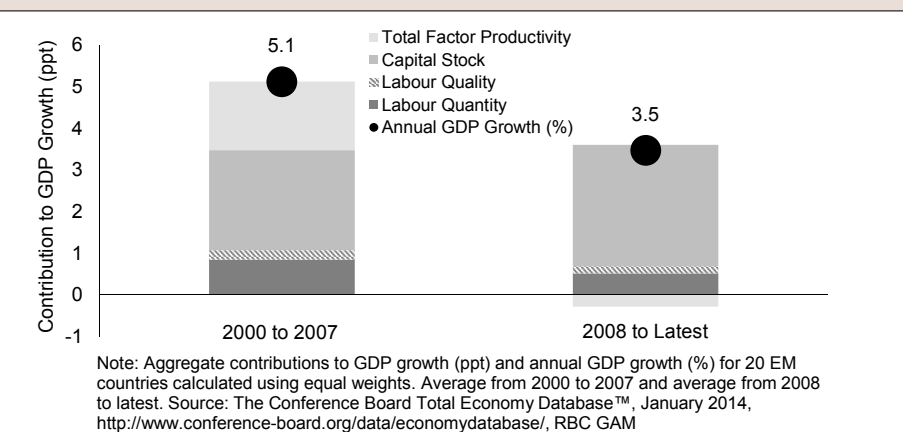


EXHIBIT 54. Declining Efficiency Gains Slowed EM Growth



directed at longer-dated bonds, and in part because yield-hungry investors are willing to venture further out the yield curve for even the slightest scrap of additional coupon. North American term premiums are then further compressed by European and Japanese investors looking for additional return.

Considering the graveyard of forecasters predicting higher bond yields – and given the market’s repeatedly premature expectation for Fed rate tightening (Exhibit 58) – we must acknowledge the possibility that yields remain surprisingly low in a year’s time.

Nevertheless, we believe bond yields should begin to rise this year. The main reason is that a tightening Fed is a game changer, representing the first new U.S. tightening cycle in nine years. The second reason is that the central banks delivering major stimulus such as the BOJ and the ECB are unlikely to announce significant expansions to their programs over the next year. Third, inflation expectations tend to overreact to falling oil prices, and so may need to unwind, all the more so as oil prices begin to revive. Finally, bond yields at current levels are unnaturally low even in the context of slow growth and inflation (Page 40).

...and the path higher

The most obvious catalyst for higher yields will be the beginning of a tightening cycle in the U.S. That said, there may not be much pressure for policy rates to rise materially. Exhibit 59 shows that the U.S. fed-funds rate is actually in line with our estimates of fair value. Subdued inflation and falling real rates of interest

EXHIBIT 55. Estimated Benefits From Structural Reforms

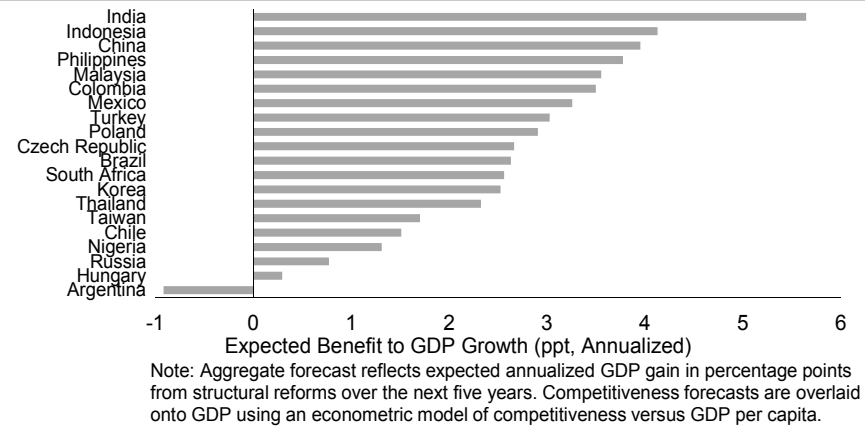


EXHIBIT 56. Yields Are Abnormally Low

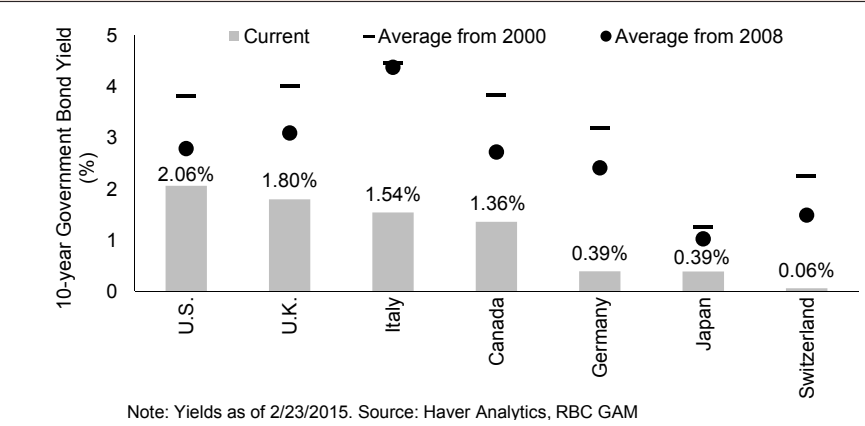
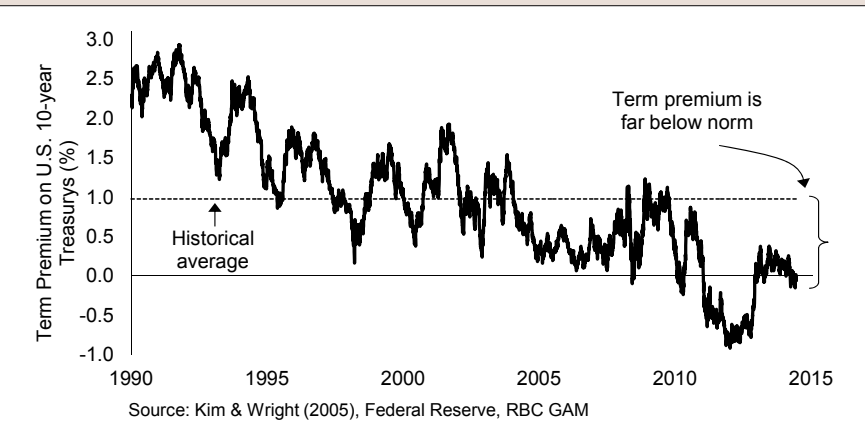


EXHIBIT 57. Term Premium Is Still Low



have lowered the fair-value band significantly and removed a lot of the impetus to increase rates. We believe the Fed will still need to embark on the next phase of monetary policy over the course of the next year, if only to reset the policy rate in preparation for future crises, but we expect rate hikes to be gradual and well-telegraphed in the absence of inflationary pressures.

The impact of even modestly rising rates on the long end of the yield curve will still be significant given how low bond yields have fallen. The risk is evident in the recent volatility of the 10-year U.S. Treasury bond. The rally through the beginning of 2015 pushed yields toward all-time lows before bonds sold off in anticipation of a rate hike (Exhibit 60). The resulting 35-basis-point rise in yields was enough to cause a 1.90% capital loss, effectively wiping out the bond's annual income.

Yields now trade in line with our estimates of fair value and we expect future risk to come from a gradual upward shift in the equilibrium band. Exhibit 61 displays the components of our model, which includes an inflation premium and a real rate of return. Reported inflation is currently slightly lower than our models reflect, but the larger threat to fixed-income investors comes from a normalizing real rate of interest. As residual risk aversion from the crisis declines and unorthodox monetary policy is unwound, we expect that investors will demand a higher after-inflation return. Rising real rates will pull nominal yields higher, resulting in low or even negative total returns for bond holders across most investment horizons.

EXHIBIT 58. Rate Hike Expectations Have Been Wrong

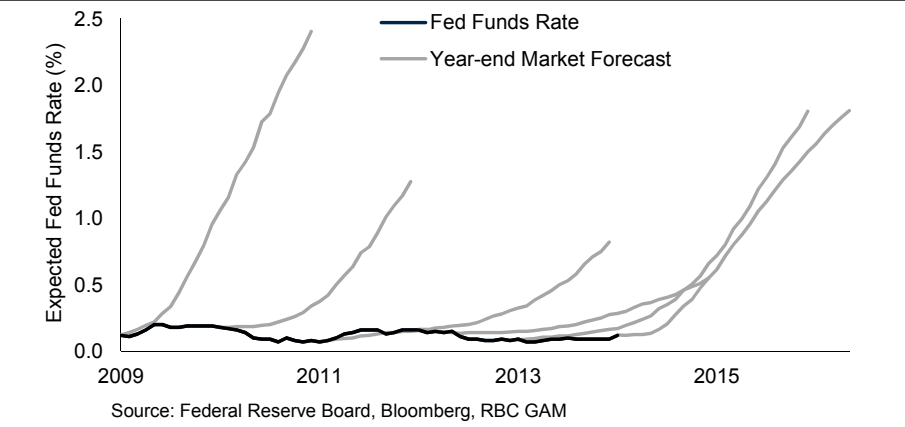


EXHIBIT 59. U.S. Fed Funds Rate Equilibrium Range

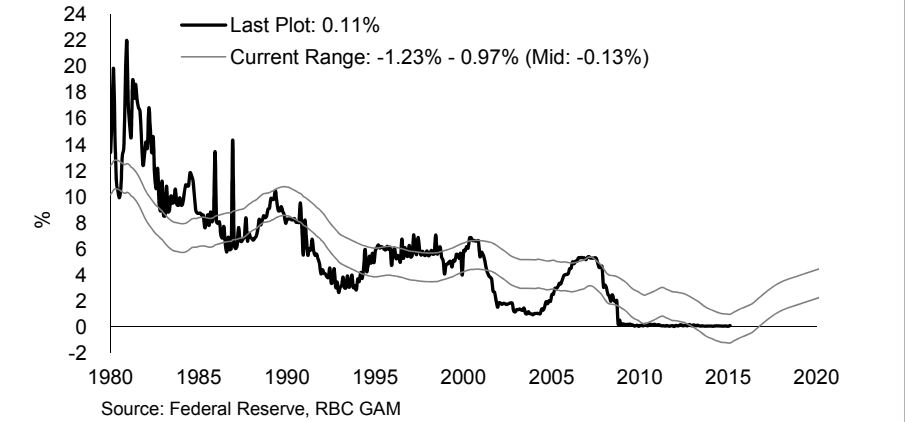
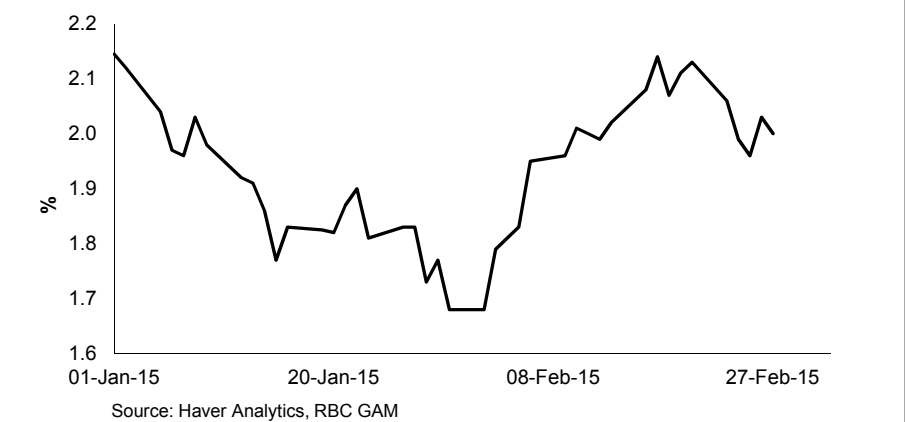


EXHIBIT 60. U.S. 10-Year Treasury Bond Yield Daily Data



In this environment, we prefer to focus on higher-yielding asset classes that are slightly less expensive and offer incremental coupon income to cushion the blow of rising rates. Investment-grade corporate credit and high-yield bonds both provide some ballast to a portfolio as global monetary policy tightens and yields turn higher.

Global equity valuations diverge

Following a volatile start to the year, global equities have risen above the highs made in 2014. The rebound pushed most major indexes in the direction of fair value and propelled the S&P 500 to its highest valuation since the 2009 financial crisis mugged stocks (Page 41). Differences in valuations are now becoming more pronounced, with European, U.K. and emerging-market equities all trading significantly below fair value.

While the S&P 500 looks more expensive relative to the past few years, higher valuations do not necessarily mean the end of the bull market. Exhibit 62 shows that previous market cycles have supported much higher valuations in similar environments of controlled inflation and accelerating economic growth. However, without the support of low valuations we expect more modest total returns and higher volatility going forward.

Exhibit 63 plots a version of our equilibrium model in which fair value has been standardized to run through the centre of the chart. This series highlights just how far U.S. equities have come over the past six years, moving from deeply

EXHIBIT 61. Fair-Value Estimate Composition

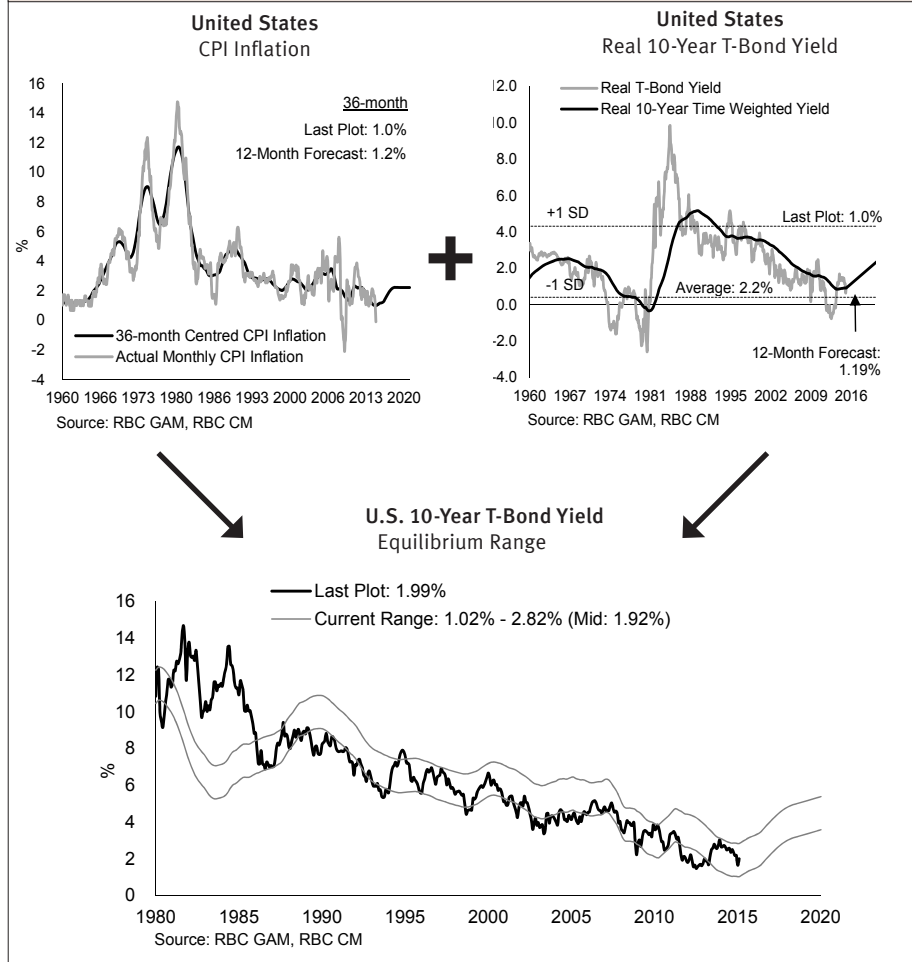
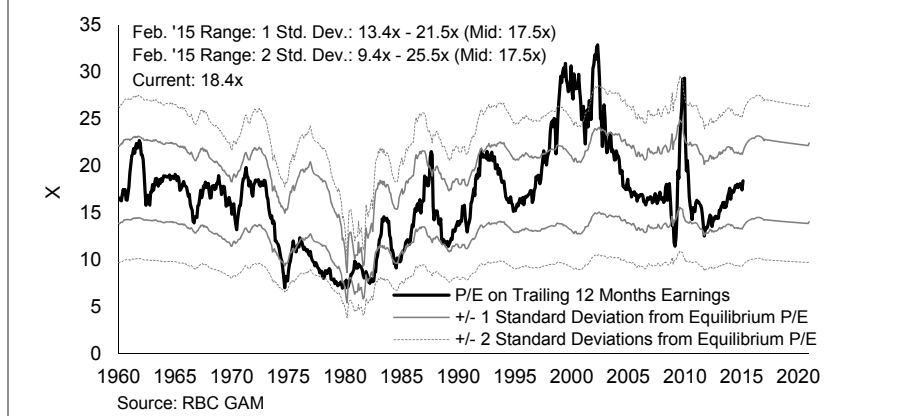


EXHIBIT 62. S&P 500 Index Normalized (Equilibrium) Price/Earnings Ratio



undervalued territory as the financial crisis decimated stock prices to modestly above fair value today. To gauge potential returns from these levels, we have segmented the data into valuation “buckets” according to their distance from fair value (Exhibit 64). Bucket 1 captures periods where the index lies furthest below its equilibrium value (i.e. the band’s midpoint, plotted as the dotted line in the chart) relative to equilibrium, while Bucket 4 is the most expensive. As one would expect, higher returns and batting averages (the incidence of positive returns) are consistent with the lower valuations in buckets 1 and 2. *The rally through 2014 pushed the S&P 500 from Bucket 2 into Bucket 3, where total returns are typically much lower and volatility increases.*

Future returns depend on earnings

As valuations become less supportive, stocks will increasingly depend on profit growth for returns. In recent months, however, the S&P 500 has sustained material downgrades to earnings expectations (Exhibit 65). Using data from Deutsche Bank Research, we estimate that nearly 30% of the downgrades were in line with the typical cuts analysts make to estimates throughout the year (Exhibit 66). Two-thirds of the remaining downgrades were the result of falling oil prices, while one-third came from the strengthening dollar. Although lower earnings growth is seldom positive for the stock market, the significant decline in estimates, the narrow base of those cuts, and the recent stabilization of oil and currencies imply that a lot of the bad news has been accounted for.

EXHIBIT 63. Standardized S&P 500 Fair-Value Bands

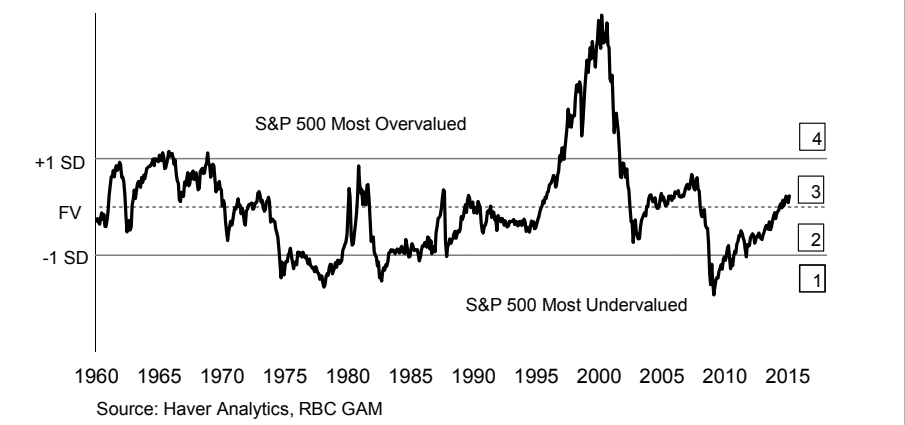
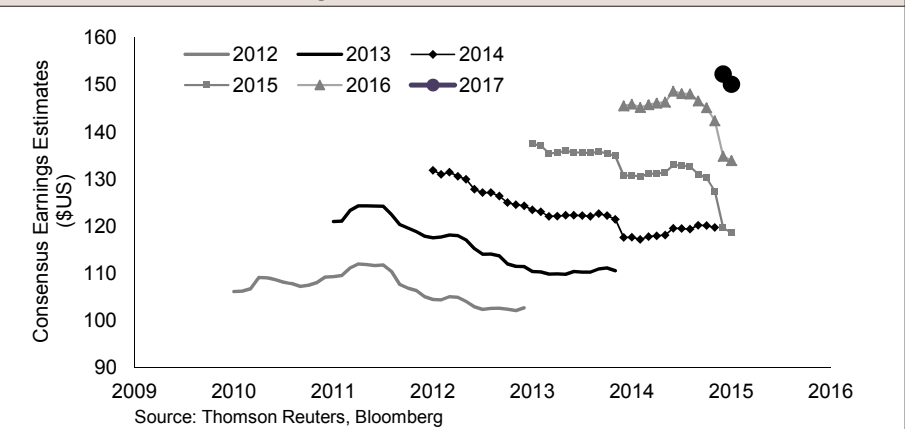


EXHIBIT 64. S&P 500 Index Return Prospects by Valuation Zone

Valuation	Data Set	1-Year Average Return	Batting Average [^]	1-Year Average Return in Win [*]	Max Loss
(S&P 500 most overvalued) 1 SD Above	4	(0.7%)	50.0%	14.8%	(27.5%)
Equilibrium	3	3.6%	61.0%	13.3%	(41.4%)
1 SD Above (S&P 500 most undervalued)	2	12.0%	84.6%	16.2%	(44.8%)
	1	14.7%	80.2%	19.9%	(12.8%)

^{*}Win = Periods where returns are above 0%
[^]Batting Average = Incidence of winning in any given period
 Source: RBC GAM

EXHIBIT 65. S&P 500 Index Consensus Earnings Estimates



Furthermore, this subdued outlook for earnings, combined with gradually expanding valuations, may be enough to drive the market higher, if at a slower pace than investors have grown used to. Exhibit 67 demonstrates the relationship between consensus estimates for earnings and equilibrium valuations to arrive at potential levels for the S&P 500. If valuations were to increase slightly to 0.5 standard deviation above equilibrium, 2015 earnings forecasts suggest the market could rise to 2300, or about 10% above current levels. Moving out to 2016, earnings estimates indicate even more upside. Without expanding valuations, however, potential returns to U.S. equities are more limited than they have been in the past few years.

Recognizing this, we have begun to tilt our portfolio toward other regions with more supportive valuations. European equities are beginning to look particularly compelling in this regard. Exhibits 68 and 69 indicate that European relative performance is at its lowest level in decades, and valuations are equally depressed. This backdrop, combined with our outlook for economic recovery in Europe, should contribute to the relative performance of European stocks.

Small caps to underperform

While regional valuation differences may be the next source of upside, there are also significant valuation discrepancies between styles. The S&P 500 is a cap-weighted index, meaning that larger companies are weighted more heavily than smaller companies in this list. As a result, the S&P 500's valuation masks just how expensive

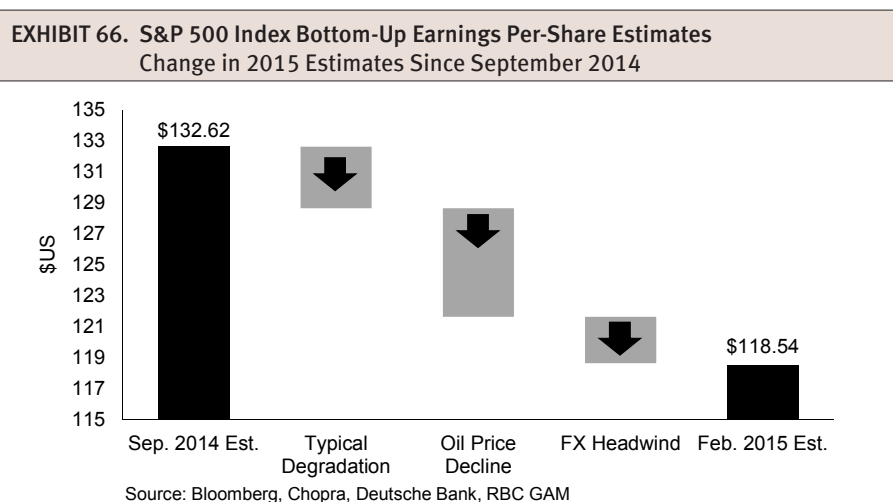
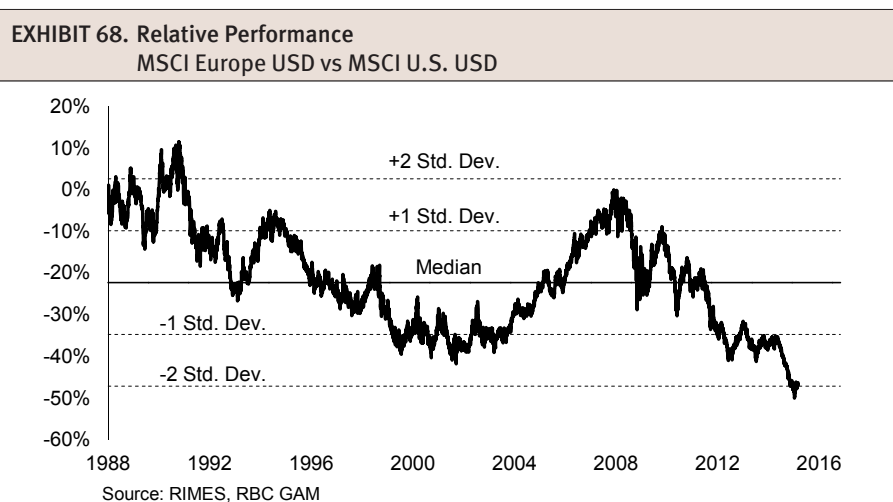


EXHIBIT 67. Earnings Estimates & Alternative Scenarios for Valuations and Outcomes for the S&P 500 Index

		Consensus		
		2015 Top Down	2015 Bottom Up	2016 Bottom Up
	P/E	\$123.4	\$118.5	\$133.9
+1 Standard Deviation	21.5	2652.8	2547.4	2877.5
+0.5 Standard Deviation	19.5	2403.8	2308.4	2607.5
Equilibrium	17.5	2154.9	2069.4	2337.5
-0.5 Standard Deviation	15.4	1906.0	1830.3	2067.5
-1 Standard Deviation	13.4	1657.0	1591.3	1797.4

Source: RBC GAM



small-cap stocks have become relative to large caps. Using the median P/E of a broader index like the Russell 3000 equally weights the contribution of all constituents to the calculation of index valuation. Following 15 years of strong relative gains, the much higher valuation of small- and mid-cap issues within the index drag the overall valuation of the Russell 3000 to expensive territory, when measured this way (Exhibit 70). This suggests that large-caps may be better positioned to outperform, and also that the mid- and small-cap market might be the most vulnerable in a significant market correction. While the Russell 3000 has risen far above fair value, focusing just on the largest 100 stocks in the U.S. (the S&P 100) indicates that valuations remain quite reasonable (Exhibit 71).

Value stocks may also continue to be an important driver for the market. Exhibit 72 shows that growth stocks outperformed coming out of the financial crisis but, as the economy improved and growth was no longer a scarce commodity, value took on leadership. With the global recovery gaining traction, we expect that investors will favour stocks with lower valuations and leverage to accelerating economic growth.

Asset Mix

Global equity markets have risen considerably over the past few years, putting into question the sustainability of the rally. However, it appears that while the cyclical bull market may in fact be maturing, the S&P 500 may have entered a secular bull phase after the ‘lost decade’ for returns that followed the tech collapse of 2000-2002. Using the U.S. market as

EXHIBIT 69. Relative Valuations
MSCI Europe/MSCI U.S. Price-to-Book

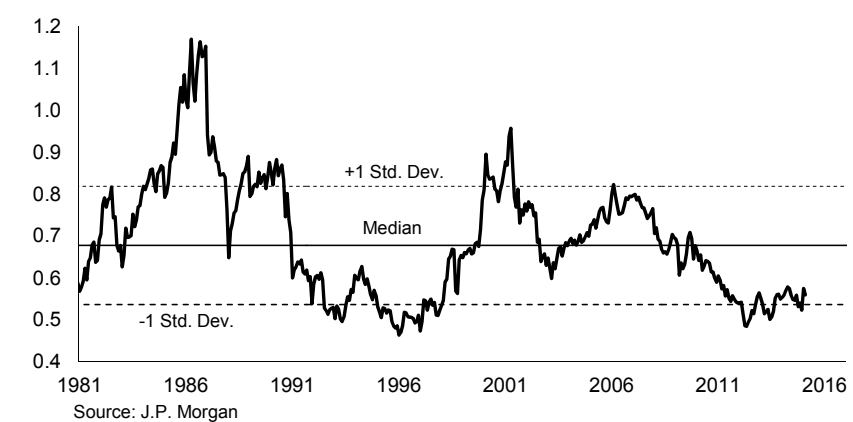


EXHIBIT 70. Russell 3000 Index
Normalized Earnings & Valuations Based on Median P/E

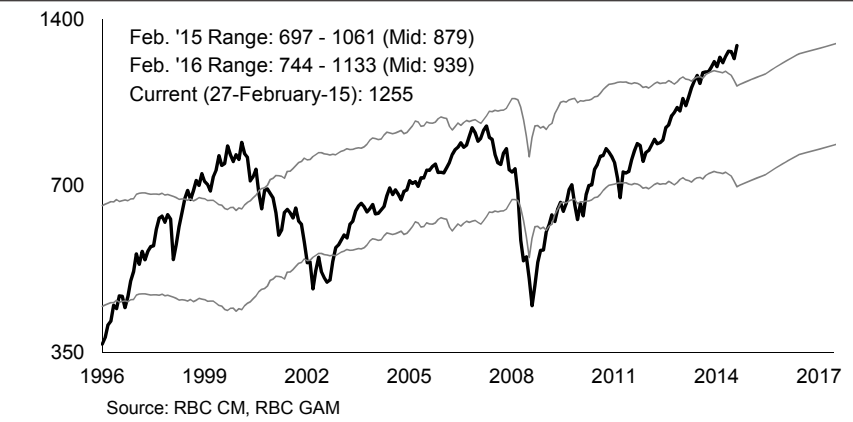
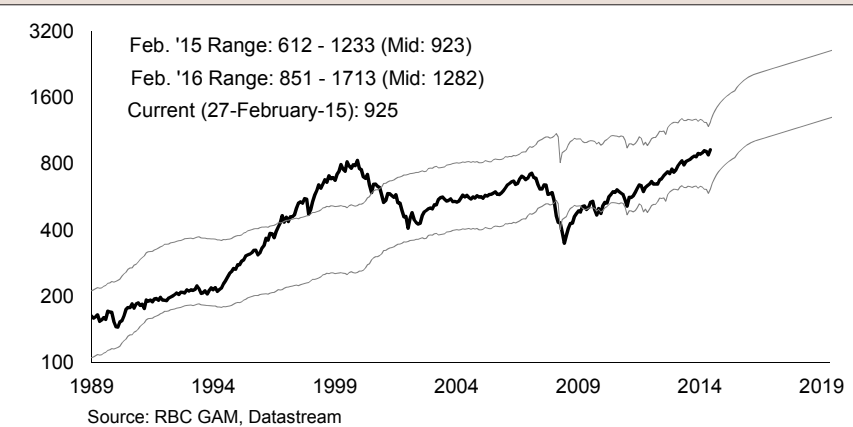


EXHIBIT 71. S&P MegaCap 100 Equilibrium
Normalized Earnings & Valuations

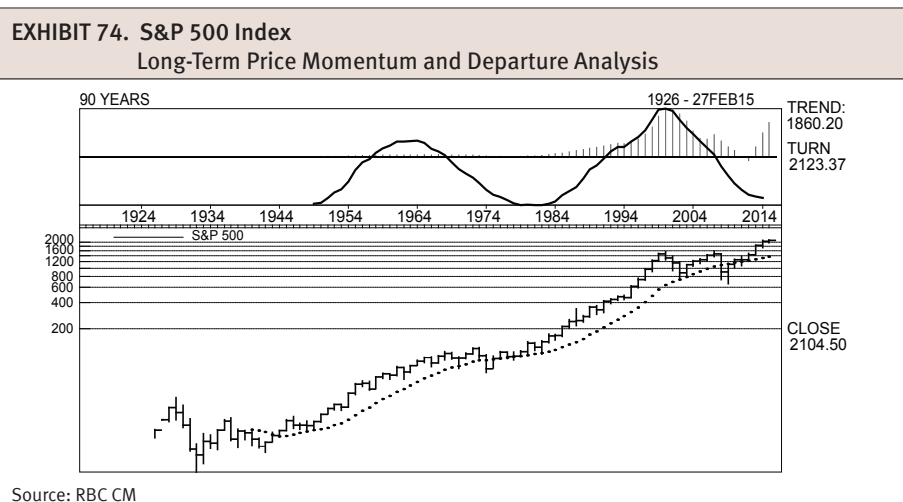
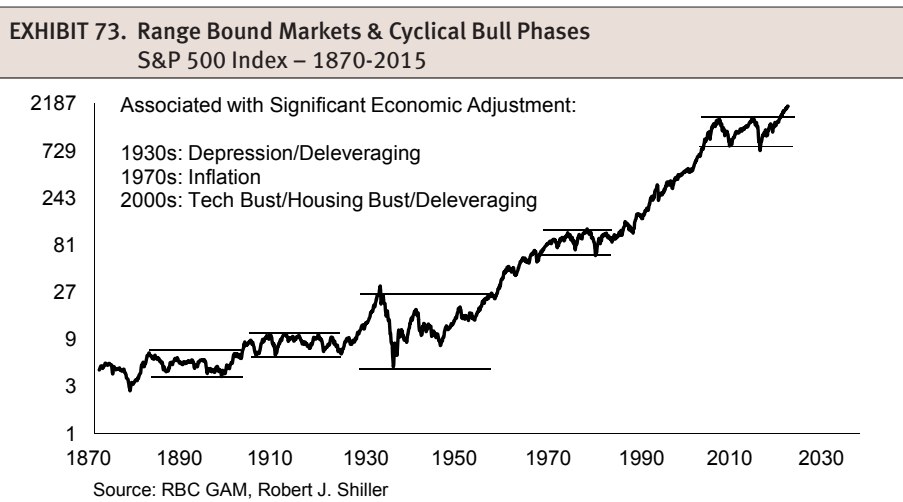
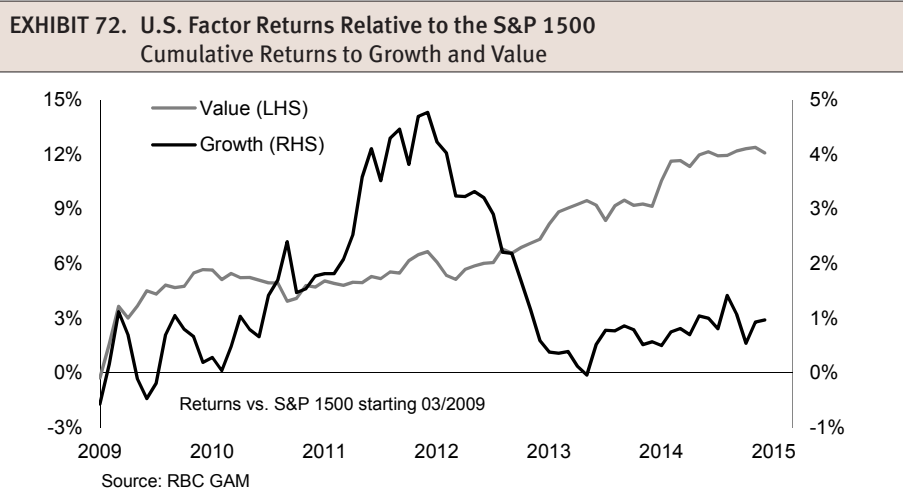


a proxy, Exhibit 73 plots nearly 150 years of price data for the S&P 500. The chart shows that extended periods of range-bound trading (secular bear markets) are often followed by long periods of rapidly rising equities (secular bull markets). As the S&P 500 broke through the highs from the previous crisis, it also pushed the index into what may be a new secular bull phase. RBC Capital Markets' proprietary technical indicator may soon support this thesis, with long-term price momentum approaching a bottom after declining for more than a decade (Exhibit 74).

To be clear, the start of a secular bull market does not rule out the possibility of a correction in the near term. However, *within secular-bull phases, bear markets are typically shorter and shallower, while rallies tend to last longer and produce larger gains – exactly the opposite of the past 15-year secular bear market (Exhibit 75).*

Secular bull markets also often begin from a point of extreme undervaluation and following an extended period of underperformance relative to fixed income. Exhibit 76 plots the 10-year return differential between stocks and bonds, showing the underperformance of equities through the decade leading up to the financial crisis. That trend reversed in 2009 and equities have outperformed significantly since then. The relationship, however, remains far below average and stocks continue to look well positioned for outperformance.

Exhibit 77 places this in the context of our fair-value models, contrasting the prospective returns to various asset



classes. Forecast total returns for equities appear attractive across most time frames, while sovereign bonds can be expected to produce low or negative total returns, and corporate credit should perform only modestly better should each of these markets move to their respective fair value over the time frames indicated.

We have maintained our overweight position in equities and underweight in bonds. Within fixed income, we are tilted toward higher-yielding corporate bonds, and our overweight in equities has been shifted to increase exposure to Europe and emerging markets, harvesting gains made over the past few years in the U.S. For a balanced, global investor, we recommend an asset mix of 61% equities (strategic neutral position: 55%), and 38% fixed income (strategic neutral position: 40%), with the balance in cash.

EXHIBIT 75. S&P 500 Secular Cycle Analysis

	Secular Bulls	Secular Bears	Latest Secular Bear Cycle (Feb. 2009 to Apr. 2013)
Number of Cycles	4	5	1
Average Length (Years)	16.8	12.9	12.7
Average Annualized Return	14%	(4%)	0%
Average Number of Cyclical Bulls	4.5	3.0	2.0
Average Cyclical Bull Return	104%	61%	104%
Average Cyclical Bull Length (Months)	36.8	28.7	55.5
Average Number of Cyclical Bears	3.5	3.6	2.0
Average Cyclical Bear Return	(18%)	(36%)	(49%)
Average Cyclical Bear Length (Months)	10.9	22.7	20.5

Note: Historical stock data dates back to 1870. Source: Robert J. Shiller, RBC CM, RBC GAM

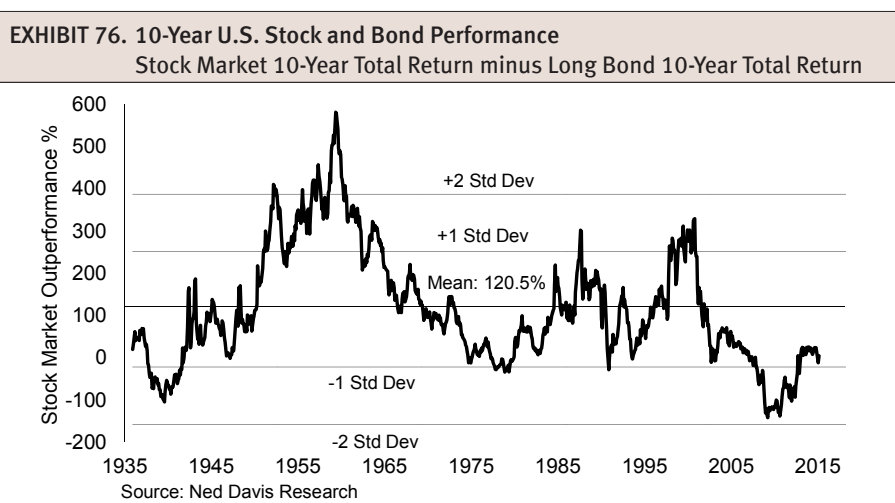
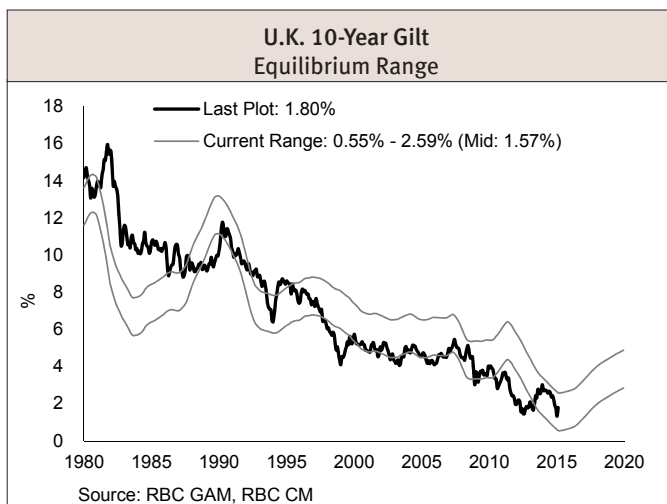
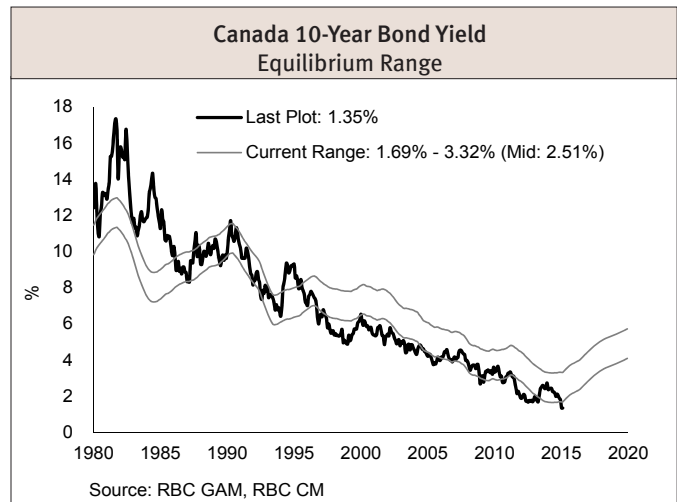
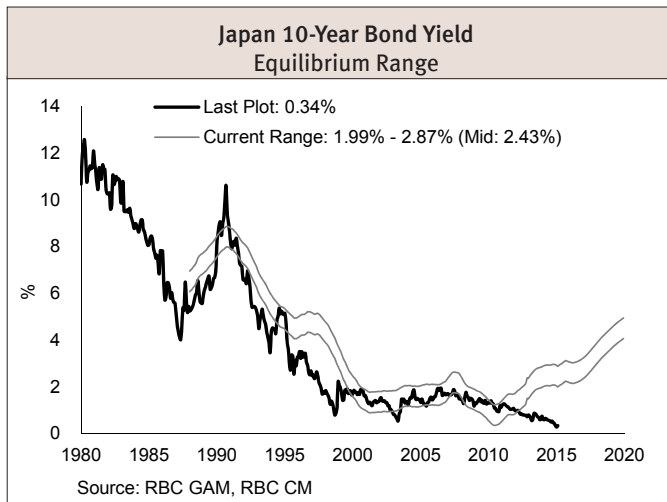
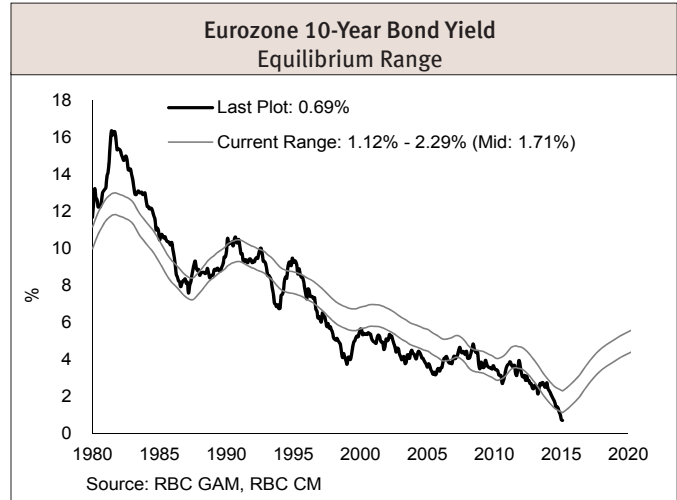
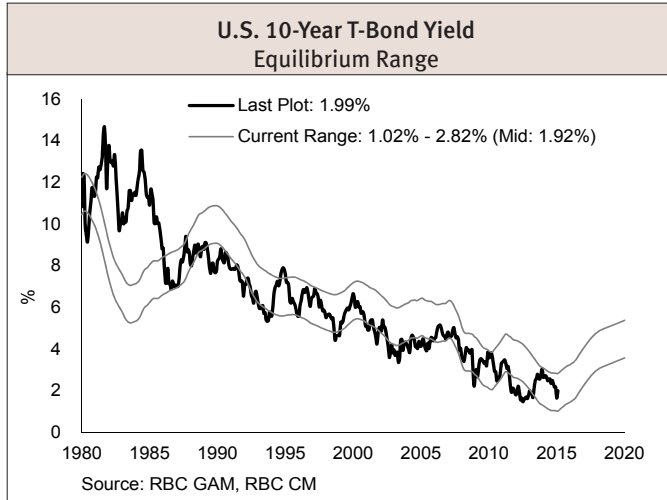


EXHIBIT 77. Asset-Class Forward Returns

Asset Class	Current Return ¹	1-Year Forward Return	2-Year* Forward Return	3-Year* Forward Return	5-Year* Forward Return	10-Year* Forward Return	15-Year* Forward Return	20-Year* Forward Return
U.S. Treasury Bill	0.07%							
U.S. 10 Year Treasury Bond	0.65%	0.34%	(1.55%)	(1.72%)	(0.38%)	0.72%		
U.S. 30 Year Treasury Bond	(4.31%)	(6.12%)	(7.20%)	(6.49%)	(2.91%)	(0.02%)	0.97%	1.47%
Canada 10 Year Government Bond	(10.16%)	(11.20%)	(6.62%)	(4.87%)	(2.57%)	(0.76%)		
U.S. Investment Grade Bond**	(1.16%)	0.05%	(0.76%)	(0.57%)	0.94%	2.16%		
Canada Investment Grade Bond**	(9.15%)	(8.79%)	(4.55%)	(2.91%)	(0.77%)	0.92%		
U.S. High Yield Bond***	(4.30%)	1.21%	2.43%	3.28%	5.03%	6.36%		
U.S. Stocks (S&P 500) Total Return	(6.30%)	22.45%	14.98%	12.25%	10.44%	9.56%	9.23%	9.05%
Canadian Stocks (TSX) Total Return	5.48%	11.06%	9.78%	9.00%	9.01%	8.87%	8.77%	8.69%

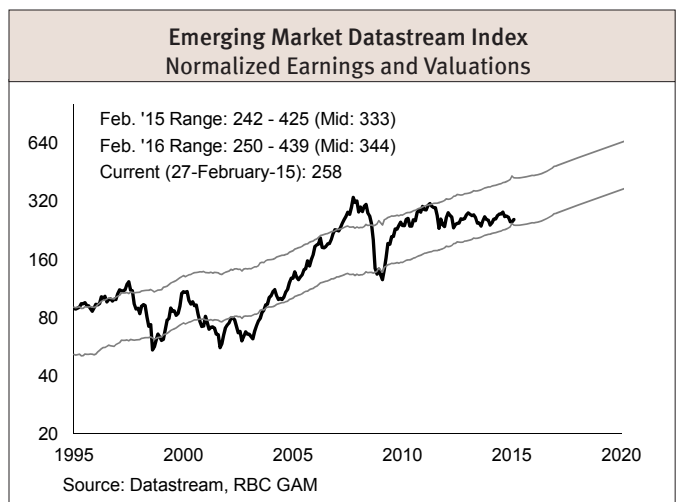
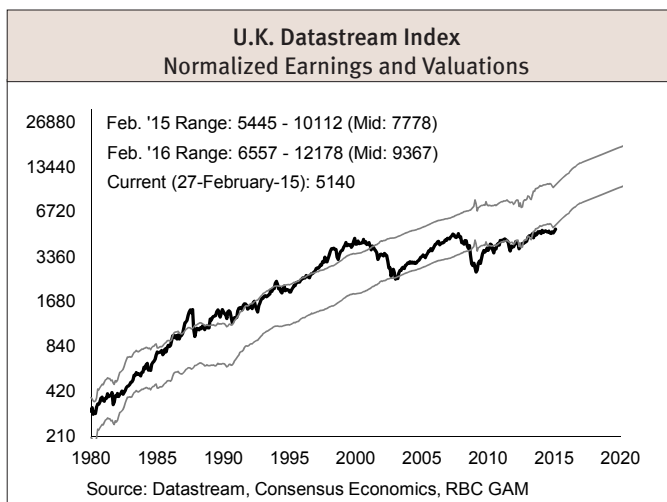
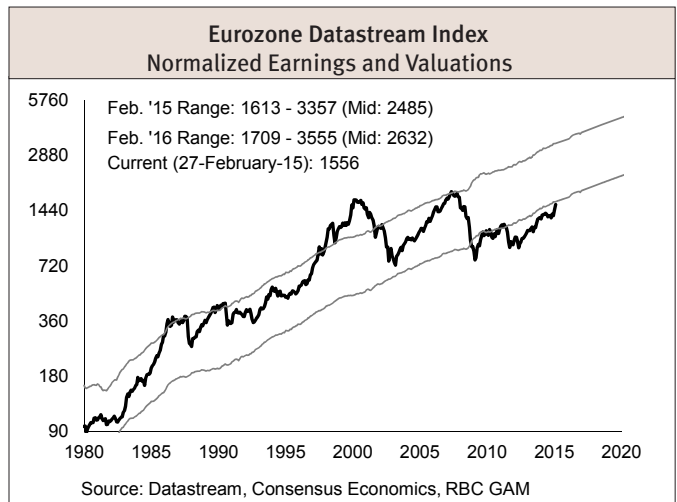
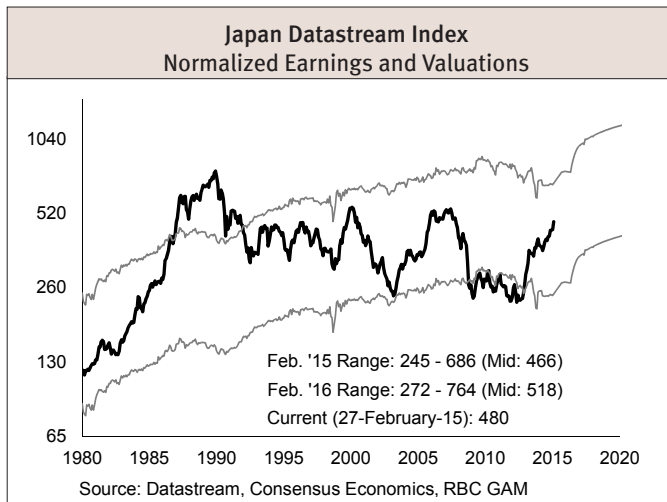
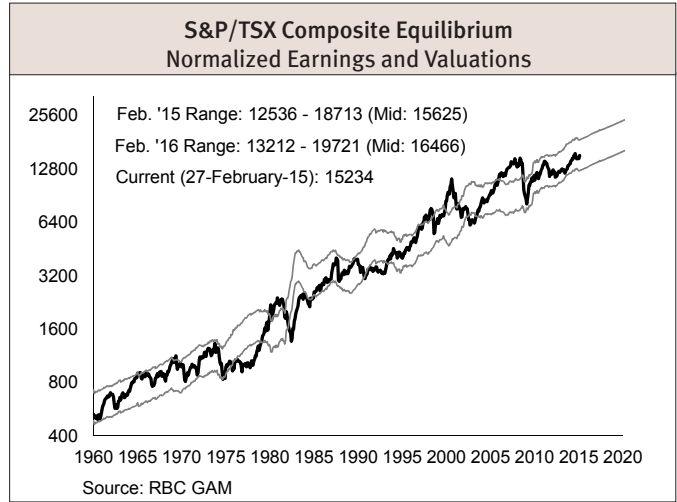
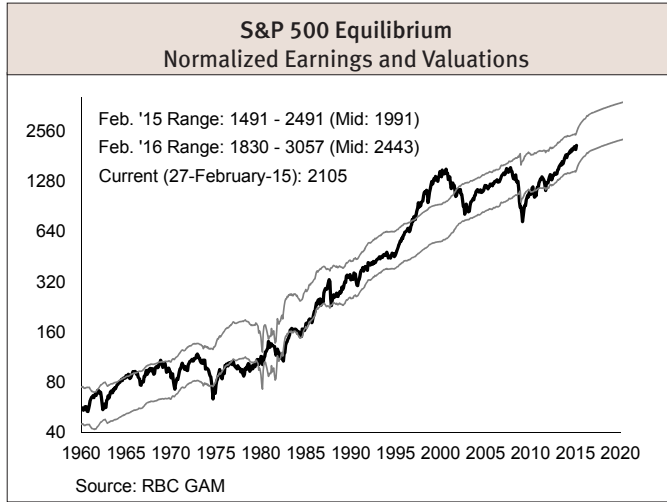
¹If market moves to equilibrium. *Annualized Returns **Bank of America ML Indexes, assuming long-term reversion to normal spread to T-bond, evenly through to end date Source: RBC GAM, Bloomberg

GLOBAL FIXED INCOME MARKETS



“Bond yields at current levels are unnaturally low even in the context of slow growth and inflation.”

GLOBAL EQUITY MARKETS



GLOBAL FIXED INCOME MARKETS

Soo Boo Cheah, CFA

Senior Portfolio Manager
RBC Global Asset Management (UK) Limited

Suzanne Gaynor

V.P. & Senior Portfolio Manager
RBC Global Asset Management Inc.

Market views

Central-bank intervention in major government-bond markets and lacklustre economic growth outside the U.S. and U.K. support a multi-year period in which bond yields will remain at historically low levels. We expect European government-bond yields to keep falling as central banks shrink the pool of assets available for investment and/or penalize investors by charging them to hold deposits at banks.

Consistently low yields are sending investors around the globe in search of higher returns, easing pressures for rising yields when the U.S. Federal Reserve (Fed) starts to hike.

In the U.S., improving economic fundamentals should prompt the Fed to gradually hike policy rates, increasing bond-market volatility and acting as a counterweight to the forces holding down longer-term yields. The Fed has signalled its desire to retreat from a half-decade of near-zero interest rates as the economy approaches full capacity, while remaining cognizant that moving too quickly could derail the economic recovery. The risk is that faster inflation takes root before the Fed starts to boost policy rates, leading to a sharp sell-off in bonds. With the Fed becoming more vocal about its intention to tighten policy, Treasury yields should start moving higher, and this will likely pull up global bond yields.

Our views have evolved over the past two years as central banks lined up

to rescue the global economy. We had believed that global economic improvement would be sufficient to reduce the need for central-bank intervention, but that scenario has obviously not materialized. The commitment of central banks to the relentless support of asset prices suggests that global bond yields will remain depressed for longer. As a result, we are lowering our bond-yield forecasts markedly.

In the absence of significant inflationary pressures, we believe that the pressure on yields to rise from Fed tightening will be mitigated by massive central-bank asset purchases, which we believe will keep a floor under bond prices. On January 22, the European Central Bank (ECB) announced long-awaited steps to rejuvenate the Eurozone economy and counter deflation – a stimulus package that was far more generous than many investors had expected. The ECB's €720 billion in planned annual asset purchases, combined with the Bank of Japan's (BOJ) ¥80 trillion plan, will squeeze bond yields in those markets, attracting investors to U.S. Treasuries.

Another force that we expect to put a cap on global bond yields is measures taken by central banks to dissuade investors from keeping their money in the bank. Usually, savers receive interest on bank deposits, which banks use to back loans. These days, European central banks are fiddling with this paradigm. The ECB, as well as

central banks in Switzerland, Denmark and Sweden, are actually charging people and companies to save. Given Switzerland's negative deposit rate, someone who puts 1,000 Swiss francs in a Zurich bank today would get 995 francs back if they withdraw their money in six months. Negative deposit rates have been used only twice in four decades – by the Danish central bank in 2012 during the European debt crisis, and by Switzerland in 1978. Negative deposit rates will lure investment away from these countries and make Treasuries relatively attractive (Exhibit 1).

We expect that the practice of charging savers on deposits will spread to other economies, and that it will create additional demand for global bonds. Next on the list of central banks that may officially embrace negative deposit rates is the BOJ, which has declined to officially endorse this tactic for the 20 years that it has battled deflation. However, in recent months, purchases of Japanese government bonds (JGBs) by the BOJ pushed yields on short-maturity JGBs into negative territory for the first time (Exhibit 2). A BOJ that commits to explicitly pursuing negative yields could spark capital flight from Japan and would likely support U.S. Treasury prices.

Penalty interest rates on savings will tend to improve government finances, and now is a time when governments could use such assistance. Since the 2008 global financial crisis, many

governments have been piling on debt to ward off economic collapse as households and businesses deleveraged. While governments keep the spending spigot open, the hope is that negative deposit rates will increase incentives for investors to funnel money to productive long-term investment and support economic growth. A healthy economy would over time allow governments to pay down debt, thereby lowering the yields that investors demand to hold government debt.

Direction of rates

Our view is that the Fed is inclined to raise its benchmark fed-funds rate sometime this year, and that the Bank of England (BOE) is similarly inclined. As a result, short- and medium-maturity yields in the U.S. and U.K. will increase at a faster pace than those of their longer-maturity peers.

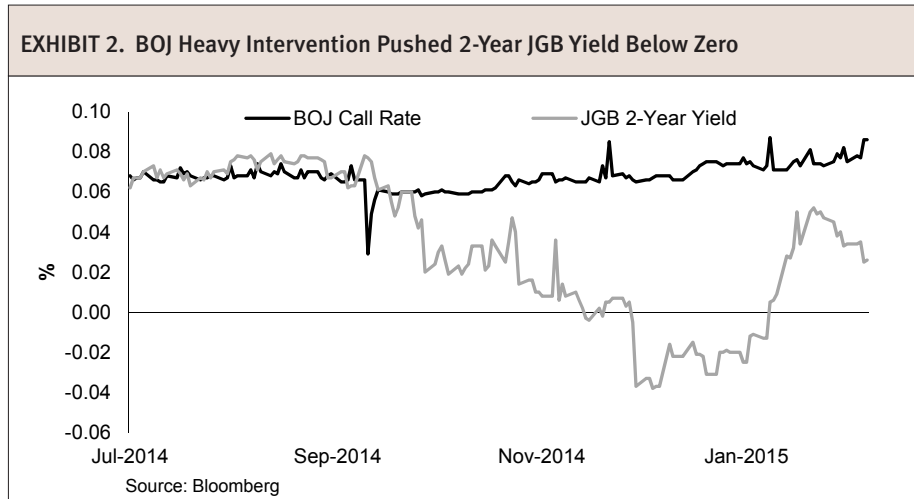
The ECB’s quantitative-easing program is ambitious in its potential economic firepower. The size of the program – €60 billion a month – amounts to 2.3 times net bond issuance by Eurozone governments, and the use of negative deposit rates guarantees no-cost financing for governments as long as QE is in effect. By comparison, the Fed never bought more than the U.S. government’s net new-bond issuance in its third round of QE, and yet the downward pressure on Treasury yields was meaningful.

Aggressive intervention by central banks in bond markets is making bond yields more volatile than usual, presenting trading opportunities for investors with longer time horizons. As central banks accumulate bonds, the securities are stored away and reduce

EXHIBIT 1. U.S. Treasuries Offer the Most Attractive Yields

10-YEAR YIELD	Local Feb-26	CURRENCY HEDGED YIELD			
		US\$ Investors	JPY Investors	EUR Investors	C\$ Investors
U.S.	1.95	1.95	1.42	1.43	2.38
U.K.	1.69	1.47	0.95	0.96	1.91
Canada	1.31	0.88	0.35	0.35	1.31
Japan	0.34	0.86	0.34	0.34	1.30
Germany	0.31	0.82	0.30	0.31	1.26
France	0.58	1.10	0.58	0.58	1.54
Spain	1.32	1.84	1.31	1.32	2.28
Italy	1.41	1.92	1.40	1.41	2.36
Denmark	0.24	1.47	0.97	1.01	1.91
Swiss	0.01	1.55	1.01	1.02	2.00

Source: RBC GAM



the amount available for investors to transact. That means that investors who want to sell bonds when market-moving news hits have a smaller pool of potential buyers, and this situation can exaggerate price movements. In the U.S., the dwindling pool of Treasuries available for investment has increased the intraday volatility, at times, to double the level we saw in 2014. JGBs are also demonstrating

greater volatility as the BOJ absorbs JGBs, and these price swings are probably here to stay even with bond yields trapped at historic lows (Exhibit 3).

U.S. – Members of the Fed’s policy-making committee have been vocal about wanting to wean investors off the assumption that interest rates will stay near zero indefinitely. We expect the

Fed to lay the groundwork for a policy-rate hike by first introducing measures aimed at reducing large cash stockpiles held by banks at the Fed, and then hike the policy rate by autumn.

To guide us in forecasting 10-year yields in an environment of Fed tightening, we look at the past two tightening cycles, 1994 and 2004. For the current cycle, we assume that the goal of the first rate hike will be to get money-market rates closer to the current target of 25 basis points by reducing the banks' US\$1.9 trillion cash hoard held at the Fed. Under such a scenario, we expect 2-year Treasury yields to increase, pushing the 65-basis-point spread between 3-month and 2-year securities to 100 basis points (Exhibit 4). For the relationship between 2-year and 10-year bonds, we expect that spread to fall to 100 basis points from the current 140 basis points (Exhibit 5). We derive our 10-year Treasury yield forecast of 2.50% by adding together the 0.75% fed-funds rate; the 1.00% term spread for the 2-year bond; and the 1.00% 10-year curve spread. We then discount the figure by 0.25% to reflect demand from foreigners.

For this quarter, we have increased our fed-funds forecast by 25 basis points to 0.75% and lowered our yield forecast for the 10-year Treasury by 50 basis points to 2.50%.

Germany – As long as the ECB is buying bonds, German bunds will benefit significantly. Germany does not plan to issue net debt in 2015 given expectations that the government will run a budget surplus, and issuance is replacing maturing securities to maintain the maturity profile of the

EXHIBIT 3. As More Bonds Are Tucked Away, Bond Yields Become More Volatile

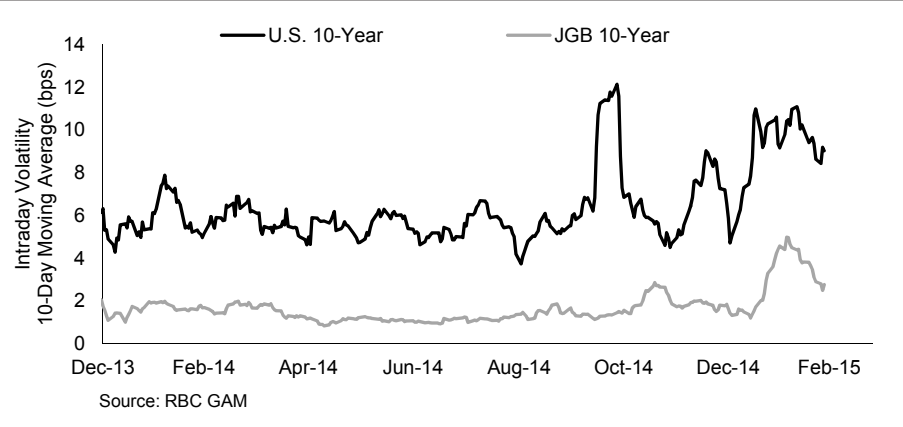


EXHIBIT 4. 2-Year Treasury Is Expected to Sell Off Closer to the First Fed Hike

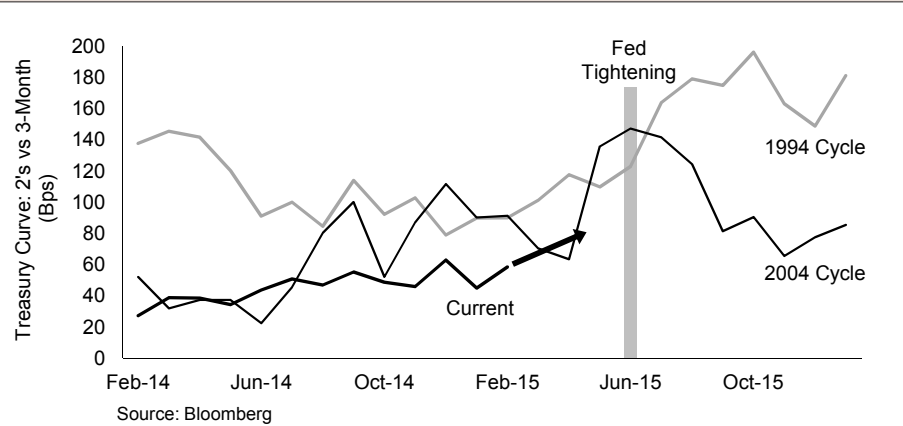
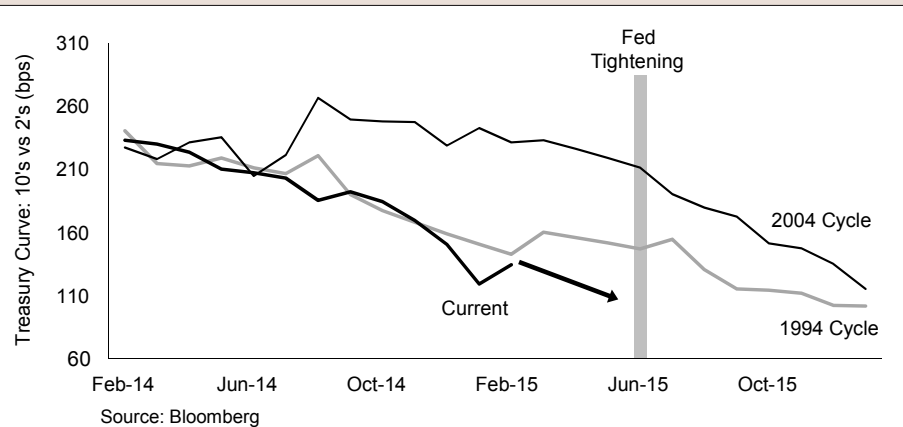


EXHIBIT 5. Treasury Yield Curve Is Expected to Flatten Further



debt portfolio. On the demand side, we expect QE bund buying to reach €113 billion this year, exerting significant downward pressure on German yields. We are keeping our policy-rate forecast at 0% and reducing our yield forecast on the 10-year bund to 0.70% from 1.50% previously.

Japan – We do not believe that JGBs are attractive on a risk-adjusted basis. Longer-maturity prices will fluctuate significantly in a market left with just two meaningful participants, the Ministry of Finance (MOF), which issues debt, and the BOJ, which is buying most of that issuance. Large price swings usually take place when there is a timing mismatch between MOF issuance and BOJ buying.

We are reducing our forecast for the 10-year JGB to 0.50% from 0.80% previously. We expect no change to the 0% policy rate but would not be surprised to see the BOJ experiment with negative deposit rates.

Canada – The Bank of Canada’s (BOC) decision to cut its benchmark interest rate on January 21 surprised many investors. Governor Poloz characterized the move as “insurance” against the sharp drop in oil prices that has occurred over the past six months. We do not expect any imminent moves from Poloz unless oil prices continue to fall.

We point out that Canadian yields across the curve are at record lows and now trade below their U.S. counterparts. International investors have taken to selling Canadian bonds, recognizing that weaker oil prices are likely to have a significant

INTEREST RATE FORECAST: 12-MONTH HORIZON						
Total Return Calculation: February 25, 2015 – February 24, 2016						
U.S.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.75%	1.50%	2.10%	2.50%	3.00%	(0.9%)
Change to prev. quarter	0.25%	(0.25%)	(0.40%)	(0.50%)	(0.65%)	
High	1.25%	2.00%	3.00%	3.25%	3.85%	(4.7%)
Low	0.25%	0.25%	1.10%	1.50%	2.00%	4.7%
Expected Total Return US\$ hedged: (0.80%)						
GERMANY						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.05%	0.20%	0.30%	0.70%	1.10%	(1.2%)
Change to prev. quarter	0.05%	(0.20%)	(0.60%)	(0.80%)	(1.10%)	
High	0.05%	0.25%	1.00%	1.25%	1.75%	(6.9%)
Low	0.00%	0.00%	0.10%	0.25%	0.85%	1.6%
Expected Total Return US\$ hedged: (1.10%)						
JAPAN						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.10%	0.05%	0.25%	0.50%	1.60%	(1.1%)
Change to prev. quarter	0.00%	(0.20%)	(0.15%)	(0.30%)	(0.40%)	
High	0.10%	0.30%	0.50%	1.00%	2.25%	(7.2%)
Low	(0.10%)	(0.10%)	(0.05%)	0.10%	1.00%	5.1%
Expected Total Return US\$ hedged: (0.70%)						
CANADA						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.75%	1.25%	1.40%	2.00%	2.50%	(3.6%)
Change to prev. quarter	(0.25%)	(0.25%)	(0.60%)	(0.50%)	(0.50%)	
High	1.25%	2.00%	2.50%	3.00%	3.40%	(10.7%)
Low	0.25%	0.20%	0.50%	1.00%	1.80%	3.5%
Expected Total Return US\$ hedged: (3.90%)						
U.K.						
	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.75%	1.25%	1.50%	2.25%	2.75%	(2.1%)
Change to prev. quarter	(0.25%)	(0.45%)	(1.15%)	(1.00%)	(0.70%)	
High	1.25%	2.00%	3.00%	3.25%	3.50%	(11.3%)
Low	0.25%	0.25%	0.60%	1.00%	1.75%	11.8%
Expected Total Return US\$ hedged: (1.90%)						

Source: RBC GAM

negative effect on the Canadian economy. However, Canadian yields look attractive relative to those in the Eurozone, as the ECB begins its massive bond-purchase program, which should mitigate selling pressures.

We expect the BOC to keep its policy rate at 0.75%, while the forecast for the 10-year government bond drops 50 basis points to 2.00%.

U.K. – We believe that the outlook for U.K. economic growth is positive and expect gilt yields to rise along with Treasuries as both become more

attractive to foreign investors. We do expect the Bank of England to lag the Fed in hiking its policy rate because the U.K. has general elections scheduled for May. The major concern for investors is that, with British politics becoming more fragmented, smaller parties will steal votes from the established parties and create parliamentary turmoil. Polls show that the U.K. election is too close to call, and this uncertainty should hold down gilt yields in the near term. We are reducing our 12-month forecast for the 10-year gilt to 2.25%, a significant

100 basis points lower than previous quarter. Our policy-rate forecast falls 25 basis points to 0.75%.

Regional preferences

We expect global bond yields to remain within their recent ranges, although we anticipate that rates will move higher toward the end of our forecast horizon. The lack of variation in projected total returns across U.S. Treasuries, German bunds and JGBs means that we are not recommending any regional bias.

CURRENCY MARKETS

Dagmara Fijalkowski, MBA, CFA

Head, Global Fixed Income & Currencies (Toronto & London)

It was not an average quarter in the foreign-exchange markets. How could it be when, in January and February, 20 central banks eased monetary policy, some of them multiple times (Denmark) and most of them unexpectedly. January helped seal what has been an extraordinary three-month period in the foreign-exchange world, with the U.S. dollar going from strength to strength, up almost 10% on a trade-weighted basis and pacing the U.S. dollar bull market to a 31% gain over the past four years. Once again, almost all major currencies weakened against the U.S. dollar during the quarter.

Naturally, after such gains, we ask ourselves: How much more is ahead? We don't have a crystal ball, of course, so we turn to history in trying to answer this question. First, we compare this cycle to prior episodes of U.S. dollar strength (Exhibit 1). There are lots of similarities: choppy bottoming, countertrend moves between 5% and 10%, and persistent recoveries. Based on these comparisons, we believe that this U.S. dollar bull market is only about half done. We turn to valuations (Exhibit 2) and observe that the U.S. dollar is trading near fair value against major U.S. trading partners based on purchasing power parity (PPP). Unfortunately, the only thing we can conclude from the valuation picture is that we are unlikely to stay here for a long time because currencies trade at fair value on average only every eight years. The U.S. dollar

EXHIBIT 1. Current Bull Market Versus Episodes of U.S. Dollar Strength

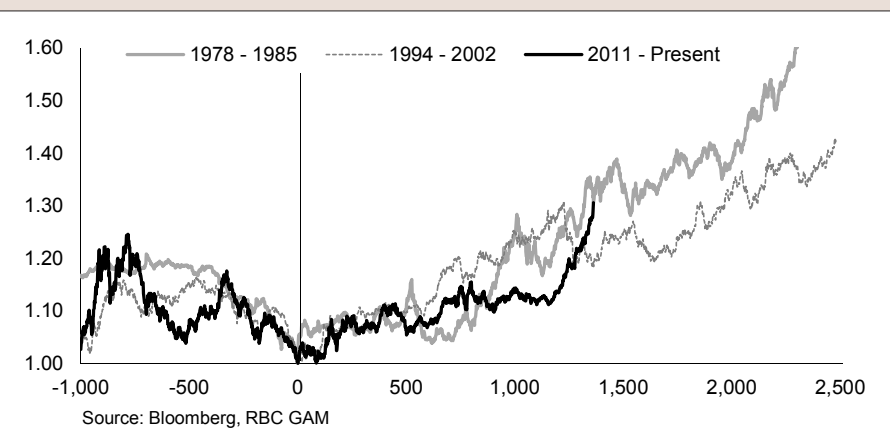
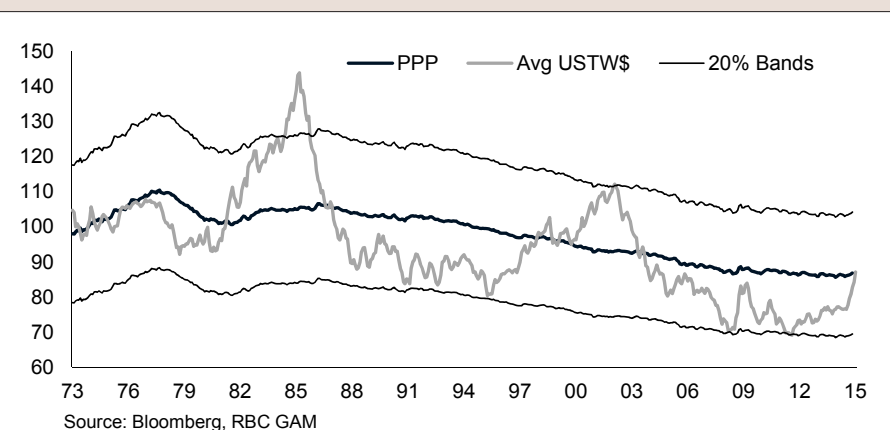


EXHIBIT 2. U.S. Dollar Purchasing Power Parity Valuation



typically moves from very undervalued to undervalued, through fair value, and then straight to overvalued and even very overvalued. Economists and currency traders refer to the final stage as overshooting. Think about the currency markets as toddlers, who go from a standing start to euphoria and then straight into a temper tantrum in the course of a few hours.

Given our belief that we are near the halfway point of the U.S. dollar bull market, now seems like a reasonable time to reflect on lessons that we can draw from the U.S. dollar move so far. We came up with at least four:

1. Correlations are not stable,
2. Central banks have been taking turns adding fuel to the fire,

3. The rise in the U.S. dollar happened despite many events that could be perceived as dollar-bearish, and
4. Not all currencies weaken at the same time.

We refer back to the world of “risk on – risk off,” which is where we were in 2012 and 2013. Risk appetite, higher yields and a lower U.S. dollar went hand in hand. These correlations started shifting with the taper-tantrum episode in 2013 to the exact opposite of what they were before. We don’t even have to go that far back to see how unstable the correlations are. In the second half of last year, the foreign-exchange market was focused on diverging monetary policies. The juxtaposition of a U.S. Federal Reserve (Fed) about to embark on normalizing interest rates while the central banks of Europe and Japan were digging deeper into the monetary-easing toolbox was too stark to ignore. This angle is still important, but much less so (Exhibit 3). What has popped into the picture is oil. Last quarter, the correlation of the oil price to movements in the euro versus the U.S. dollar was close to zero, and it’s almost 30% now. What changed? Bond yields, which were significantly negatively correlated to the euro but are not correlated now. The first lesson, then, is that blindly using rules of thumb, common wisdom or economic forecasts to predict currency behaviour is likely to fail. Changes in correlations are quite common and we have to accept that what worked last quarter may not be relevant now.

The next lesson concerns the role of central banks, which have been running a relay passing their monetary-

EXHIBIT 3. EURUSD Correlations With Major Drivers

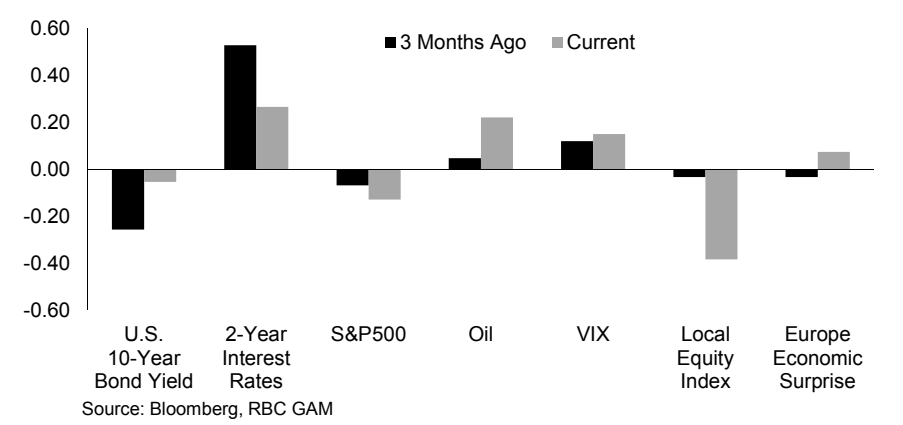


EXHIBIT 4. Phases of Dollar Strength

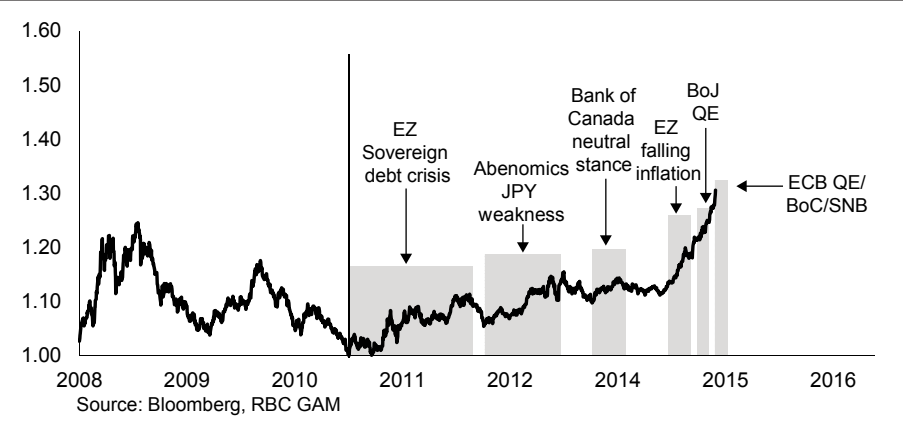
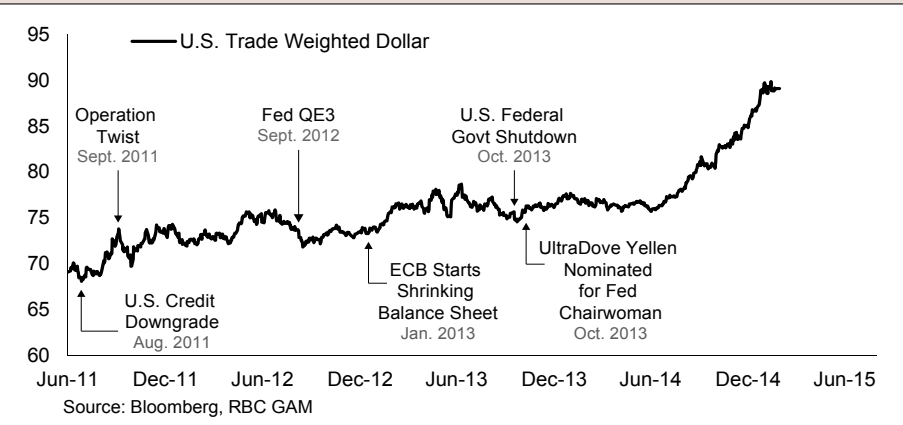


EXHIBIT 5. USD Trend Uninterrupted



easing baton from one central bank to the next (Exhibit 4). Each subsequent easing contributed to U.S. dollar strength. Open-ended QE from the European Central Bank (ECB) and the Bank of Japan (BOJ) have only just started affecting portfolio flows. The biggest contribution to U.S. dollar strength, we believe, still lies ahead since the Fed hasn't even started normalizing rates and Fed member projections suggest that short-term interest rates could reach 3.5% in two years, about the same time frame in which the ECB is expecting its balance sheet to expand by an additional €1.1 trillion. Therefore, relative central-bank policies are likely to continue as an important guide, although not the only or even the main one to currency behavior.

The third lesson is that events can slow the trend, but don't usually stop it. Exhibit 5 shows a series of obstacles faced by the U.S. dollar bull market: S&P downgrading the U.S. credit rating from AAA in August 2011; the Fed embarking on QE3; the U.S. federal shutdown in 2013; and the nomination of known dove Janet Yellen as Fed Chairwoman were all perceived as unquestionably dollar-bearish. Yet none of these punches have reversed the trend. We must keep in mind that as long as the trend lasts, dollar-bearish events provide opportunities to buy U.S. dollars at attractive levels.

The fourth lesson is that while the U.S. dollar trend remains intact, not all currencies will weaken against the U.S. dollar at the same time. For example, the trend had been underway for 3½ years before we experienced

EXHIBIT 6. USD Strength in Phases

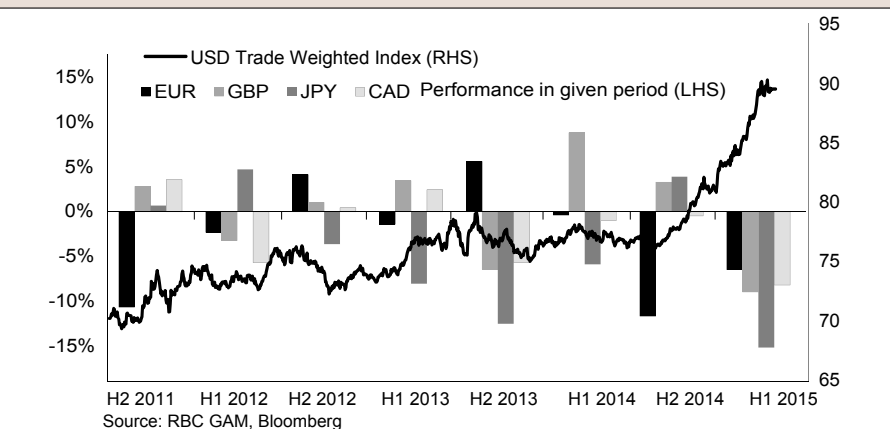
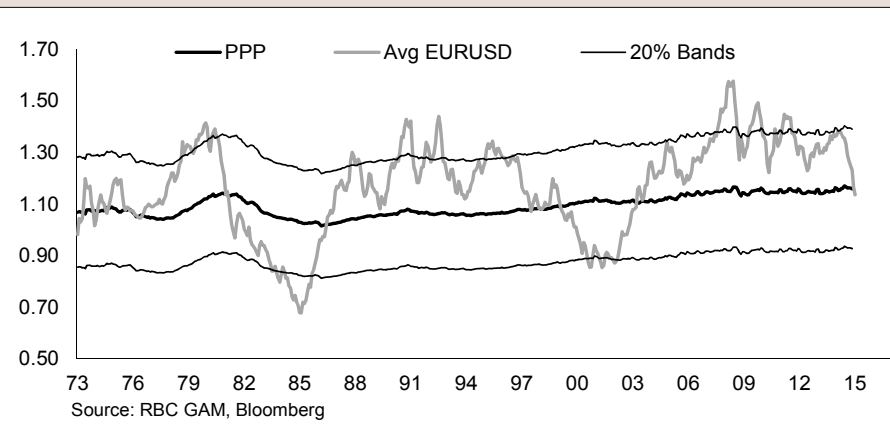


EXHIBIT 7. EURUSD Purchasing Power Parity Valuation



a six-month period during which all currencies fell against the U.S. dollar (Exhibit 6). In the end, we believe that all major currencies will succumb to the rising U.S. dollar trend.

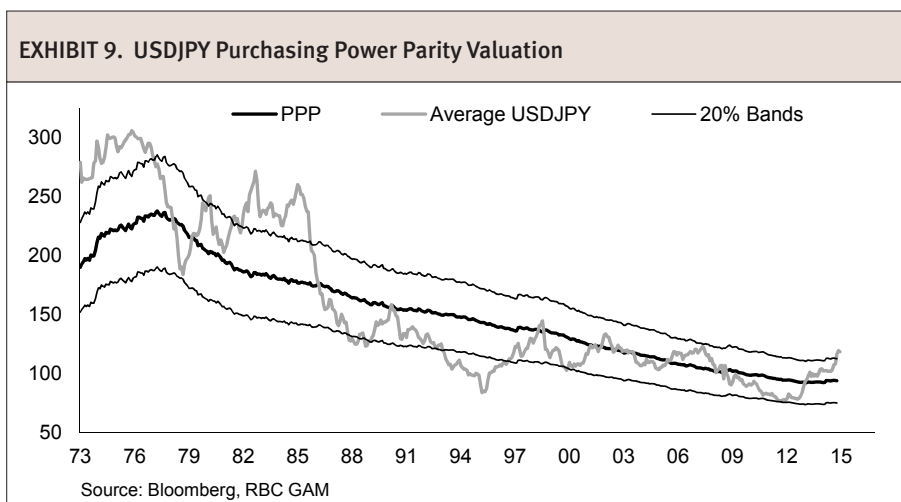
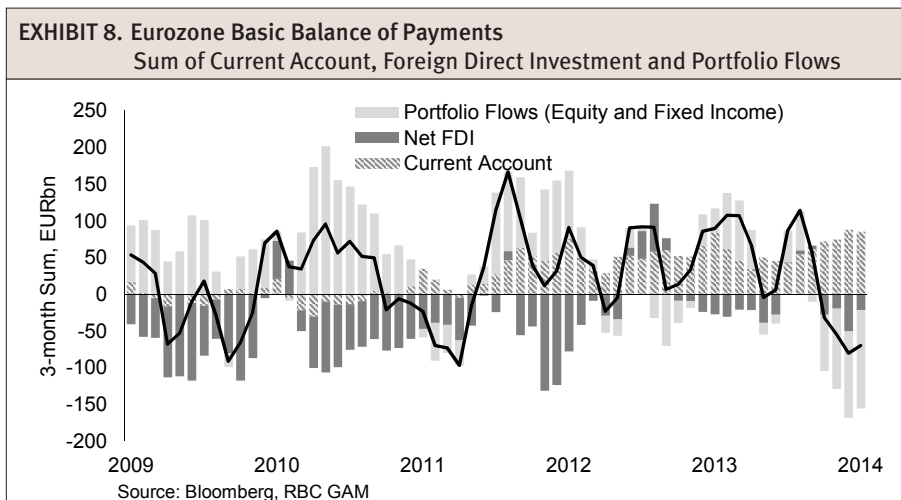
With these reflections in mind, our forecasts call for a broadly stronger dollar over the next two to three years, supported in large part by monetary-policy divergences, but also by other factors that will keep weaving in and out of the picture.

The Euro

The currency that will be most affected by the rise in the U.S. dollar is the euro. Exhibit 7 looks almost like a mirror image of the U.S. dollar's PPP. The euro exchange rate is near fair value, leaving plenty of scope for an overshoot. Despite other measures that rate the euro as undervalued, there are a few reasons why we continue to expect the single currency to depreciate.

First is the January announcement of QE by the ECB, which pledged to buy €60 billion of securities a month until September 2016, or as long as it takes to get inflation near 2%. Asset purchases didn't begin until this month, and so outflows from the Eurozone are just beginning to pick up, notably for fixed income and foreign direct investment (Exhibits 8). The equity side looks more attractive to investors now that the economy is poised to benefit from simultaneous declines in the currency, oil prices and interest rates. However, these equity inflows will be less supportive for the currency than in the past, since the hedge ratios have been rising for those buying into the European outperformance theme. Moreover, many reserve managers find themselves facing lower commodity prices (in particular emerging-market reserve managers, including those from the Middle East), yawning budget deficits and depreciating currencies. This means that their reserves in many cases have stopped growing or actually started shrinking, both of which are negative for the euro in a world where the currency had traditionally been supported by diversification demand.

Second, the ECB is determined to act. In July 2012, ECB President Mario Draghi didn't actually have to spend a cent to back up his "whatever it takes" promise, but this time he will have to deliver. The sovereign-bond purchases committed to in January should increase the ECB's balance sheet by €1.1 trillion by September 2016. If inflation fails to materialize, the purchases will last longer. National central banks will be tasked with implementation. The goal of the bond



purchases is to force banks to lend to the private sector or else accept negative deposit rates from the ECB.

Details of the asset-purchase program make clear just how powerful it will be. The ECB's ability to buy a large portion of each sovereign's outstanding debt over a wide range of maturities (2 to 30 years) – even if yields are negative – suggests a meaningful impact on the market. The relentless demand represented by ECB purchases should continue to suppress yields in the

Eurozone, working against the value of the single currency in the process.

The third reason that we expect further declines in the euro is that European politicians are not in a position to deliver on the structural and fiscal adjustments that Draghi has been calling for since he took office in 2011. These painful adjustments seem unlikely to materialize given the rise in strength of populist, nationalistic parties in Europe. Any concessions to Greece's new Syriza government could

dissuade leaders in Spain and Portugal from pursuing further austerity.

Given expectations of future divergences between the monetary policies of the U.S. and European central banks, valuations, and the need for the currency to compensate for the unfulfilled adjustments of fiscal policies, we forecast that the euro will trade at 1.05 in 12 months, and we are fairly confident that we'll see the lower line in the sand versus PPP before this U.S. dollar bull market is over.

Japanese yen

Moving on to the other QE-influenced currency, the yen, we continue to believe that it is cheap based on PPP and even very cheap using real effective exchange rates, which are essentially trade-weighted exchange rates adjusted for inflation (exhibits 9 and 10). While valuations don't suggest a weaker yen, other factors do. Chief among them are the policies being pursued by the Japanese government and the central bank.

Both the government and the central bank are facing credibility problems, since the linchpin of Abenomics – the return of inflation – hasn't panned out. It's certain now that the BOJ will not achieve its inflation target by the original deadline of May 2015. Core inflation excluding the hike in the consumption tax has been falling and is now below 1% (Exhibit 11), so either the inflation target of 2% must be reduced or the target date moved into the future. We know that BOJ Governor Kuroda has been an adamant supporter of the 2% target but wonder about the recent appointment to the BOJ board of Waseda University professor Yutaka Harada, who has

EXHIBIT 10. JPY Real Effective Exchange Rate



EXHIBIT 11. Japanese Inflation

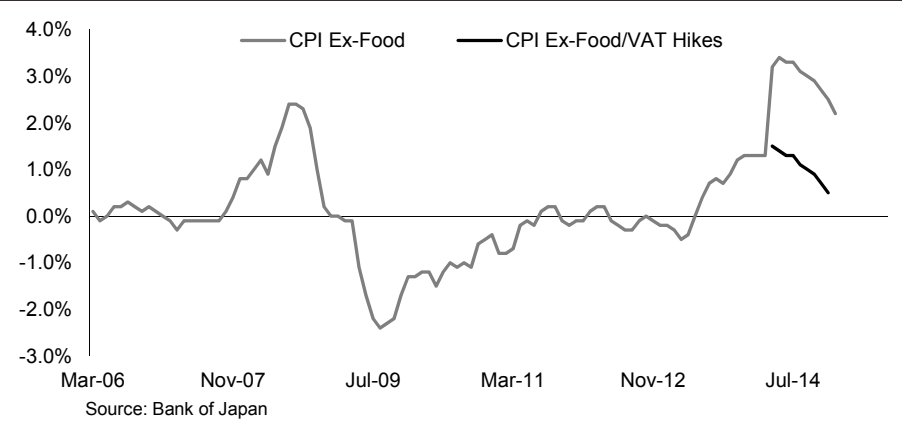
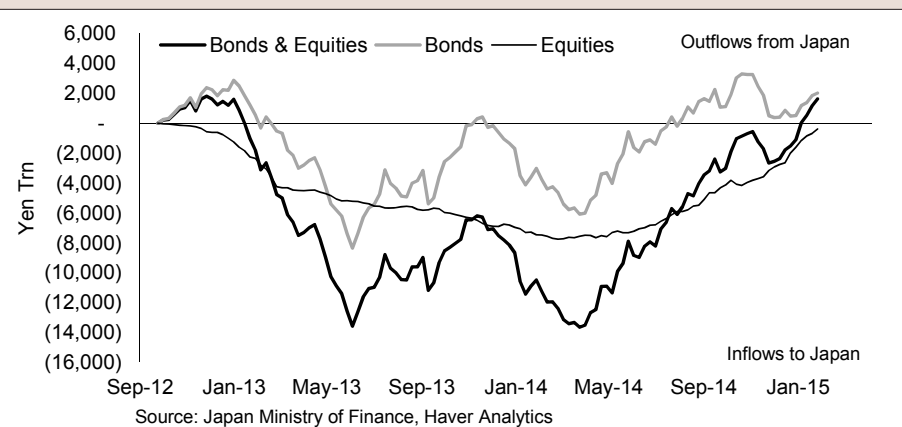


EXHIBIT 12. Japanese Net Purchases of Foreign Securities Cumulative Since Shinzo Abe's 2012 Election Win



spoken in favour of halving the inflation target and may argue for it after he joins the board in late March. If he is successful, the pressure to weaken the yen would subside.

In the meantime, the ECB announcement of QE bond purchases will lead to the ECB's balance sheet eclipsing the BOJ's in a couple of years. Given the pressure that some central banks feel to drive down their currencies, the BOJ is no doubt watching Europe's experiment with negative rates very carefully and may feel the need to reach for the same tool. The effect of QE on the yen has stalled, but we don't think the BOJ's resolve has disappeared, Harada's appointment notwithstanding. Negative interest rates are no longer taboo, and we think that the odds of another round of QE by the BOJ in the second half of the year have increased.

External factors, like falling oil prices, have been improving Japan's terms of trade, a development that ironically conspires to lower inflation down the road. Japan is also going to benefit from lower prices on renewed liquid natural gas import contracts which, indexed to oil, could drop to US\$10 this year from US\$18. Investors, sensitive about the near-term path for the yen in view of this unexpected windfall from cheaper energy imports, decided that it was prudent to reduce short yen positions, many of them in the money, before year-end. We monitor a sample of various positioning reports from real money, hedge funds and speculative investors, and all of them registered a reduction in risk taken to short the Japanese currency. These positions haven't been

EXHIBIT 13. GBPUSD Purchasing Power Parity Valuation

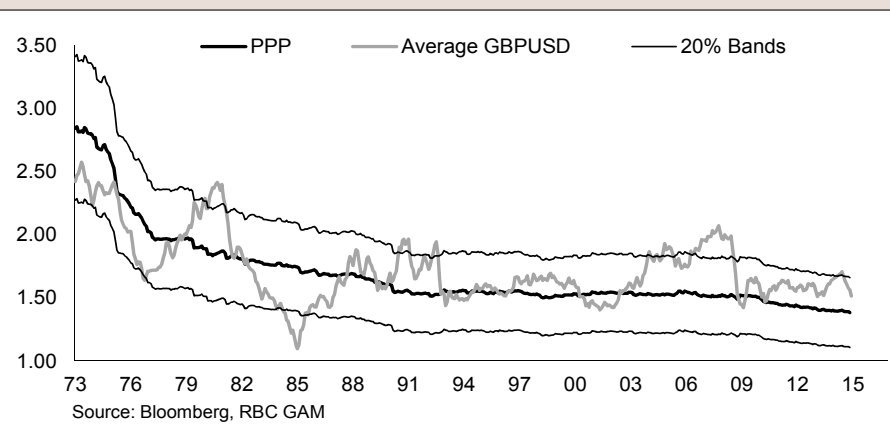


EXHIBIT 14. GBP Appreciation on a Trade-Weighted Basis



re-established, so at least the path to a weaker yen is less crowded now.

Among the factors that could push down the yen are equity and fixed-income portfolio flows. Net purchases of foreign equities by Japanese investors have been growing steadily for the past 12 months (Exhibit 12) and net purchases of foreign bonds, while slow recently, are expected to pick up due to the relatively attractive yields available outside Japan. In part, the bond and equity outflows are being driven by the \$1.1 trillion Government

Pension Investment Fund's decision to invest more internationally – a clear negative for the Japanese currency.

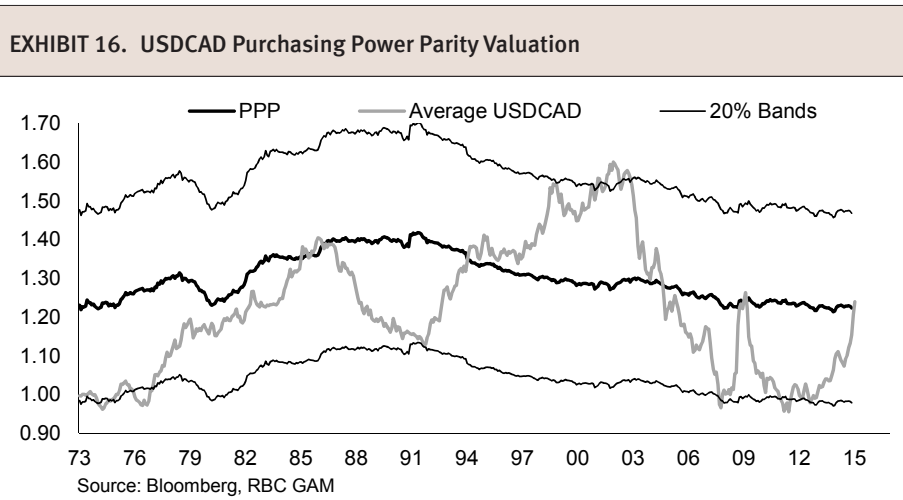
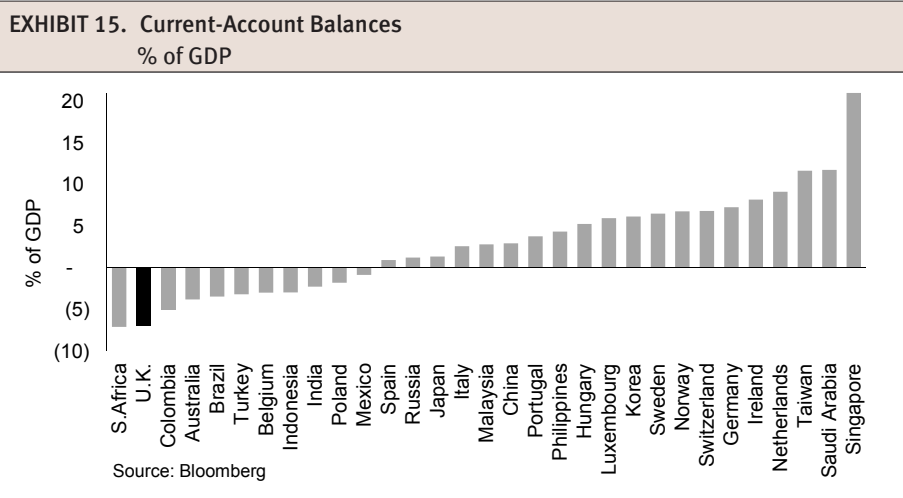
The bottom line for the yen is that valuations are cheap and terms of trade are improving, both of which make attaining the inflation target impossible in the near term. The government and the BOJ are unlikely to give up on the target and may resort to negative rates now that the path has been cleared by others. Such policy would likely give the yen another push lower at about the same time

as the Fed embarks on its interest-rate normalization. We forecast a dollar-yen exchange rate of 130.

The pound

Based on valuations and trajectory versus PPP, the pound has begun normalizing and it is retreating from its extremely overvalued levels of last summer (Exhibit 13). Valuation models other than PPP are also mixed in their estimates of fair value, with the Behavioural Equilibrium Exchange Rate model, which is sensitive to productivity and terms of trade, indicating about 10% undervaluation. We note the signals from these other measures, but for various reasons don't believe they matter at this point. We also note that we continue to hear that the pound is cheap now since it used to trade above 2 per U.S. dollar, but point out that the persistently higher inflation experience in the U.K. over the past decade has eroded the purchasing power of the pound. Even if we assume that safe-haven flows evident in London for the past 25 years prevent the pound from becoming extremely oversold, a fair-value test would result in another 10% drop toward 1.40 per U.S. dollar.

What can push the pound higher is the Bank of England (BOE), which these days is much more closely aligned with the Fed than the ECB. For the time being, the BOE is in no hurry to hike. Inflation is falling, the currency has appreciated 15% on a trade-weighted basis in two years (Exhibit 14), and wage growth is minimal. More recently, the rate-hike expectations that were once built into 2-year rate differentials have come down, and the pound has weakened



accordingly. Another push lower in the pound may require an increase in expectations for a Fed rate hike.

An additional factor that could weigh on sterling is cross-border flows. The U.K.'s current-account deficit now ranks among the widest alongside South Africa's and Colombia's. What's worse is that the gap continues to deteriorate. While there has always been confidence that international demand for U.K. assets would be sufficient to

finance that gap, weakness in the currency may be needed to sustain those inflows. We should also not forget that political risks raised by elections in May could weigh on the currency as the vote approaches.

Technically, the rally above 1.70 was a failed break, just as in the case of the euro rally to 1.40. The pound has come off sharply since then. A break of 1.50 would easily put that 1.40 fair value level in sight for next year. Our forecast is 1.45.

Canadian dollar

The Canadian dollar has lost 20% of its value versus the U.S. dollar in just six months, returning to PPP fair value for the first time since 2009 (Exhibit 16). Other valuation measures present a mixed bag. For the past quarter, crude oil and rate differentials have been the strongest drivers of the loonie. The collapse in Canadian terms of trade (the ratio of prices of exported goods to imported goods) has been spectacular (Exhibit 17) – so much so that the Bank of Canada (BOC) had to take out some “insurance” by unexpectedly cutting overnight interest rates to 0.75% in January from 1.00%.

The drop in oil has been so swift that it will be a while before its impact on the economy is evident. The Canadian dollar, as one would expect, was among the first currencies to react to the oil price. The adjustment in the real economy will take longer. We also have to acknowledge that even after the currency’s drop, the Canadian dollar is still merely 10% below its 2006 value, while the Mexican peso is more than 25% below that level and has been cheap for a long time (Exhibit 18). It is no wonder we have seen Canadian manufacturing jobs migrating south.

Even if oil based at current levels, the reprieve for the Canadian dollar would not be long-lasting. Most likely, we believe the Canadian dollar would correct, consolidate and then continue weakening versus the U.S. dollar. After all, oil is not always a reliable driver of the currency, and its correlations with the Canadian dollar fluctuate widely. Take the early part of 2014, for example, when the

EXHIBIT 17. Canada Terms of Trade

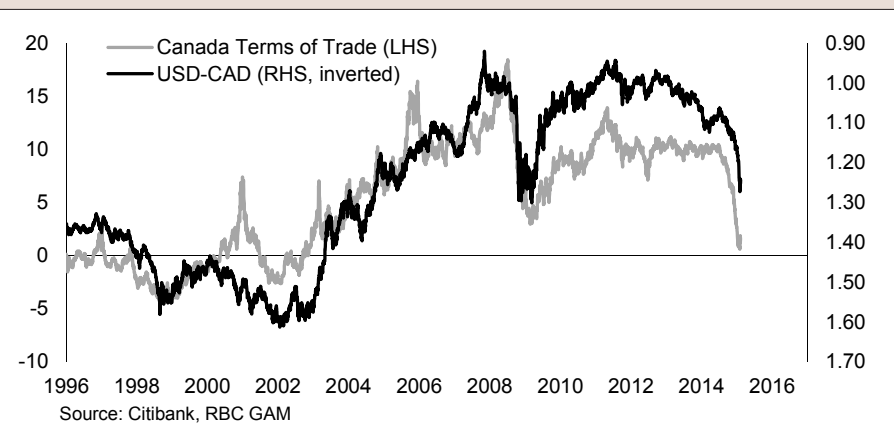
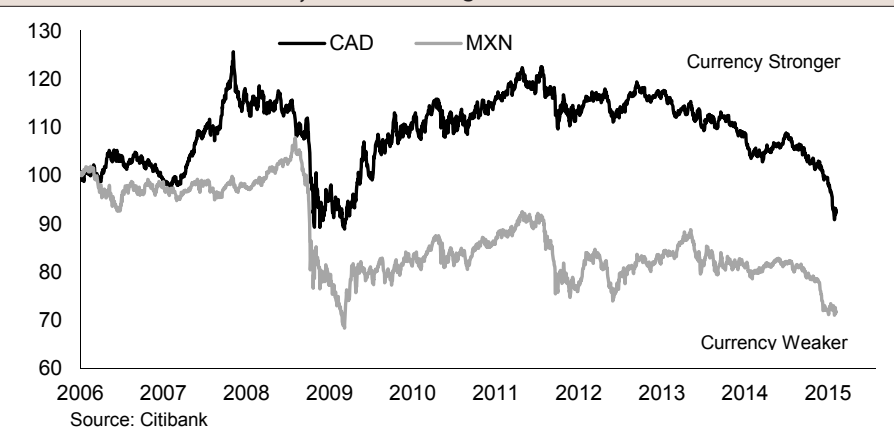


EXHIBIT 18. Canada vs. Mexico Relative Currency Performance Against the U.S. Dollar



correlation between the loonie and oil were routinely in the low 20% range, before jumping above 40% in the second half of the year. Other drivers may come into prominence and push the loonie down, be it a renewed focus on monetary-policy divergence, growth differentials or appetite for the U.S. dollar.

Given the BOC’s focus on manufacturing exports and its decision to abandon the forward-guidance framework, it’s easier in hindsight to

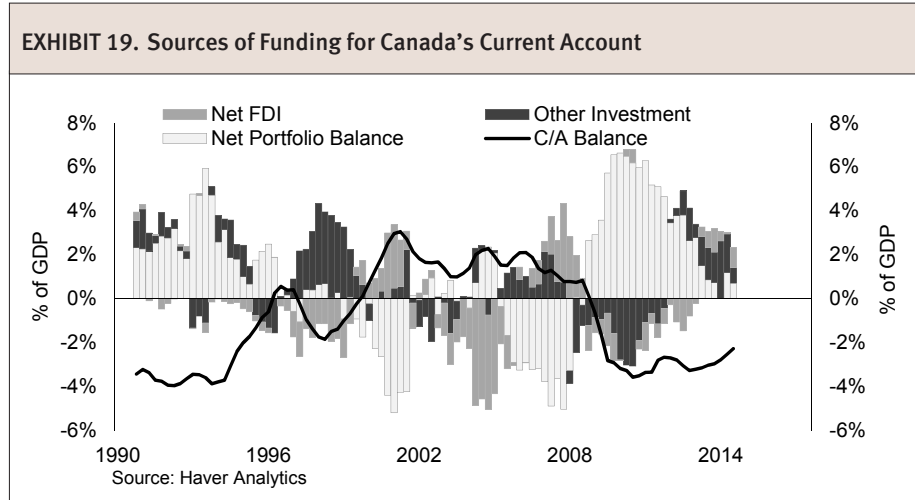
see the central bank’s rationale for the unexpected cut in short-term rates. Poloz didn’t have to wait for the data to know that falling energy exports will contribute to the trade deficit, and that the effect so far of a weaker loonie has been only to help halt the slide in manufacturing exports, not to contribute to an outright increase. Canada still has a current-account deficit, although it’s improving slightly and rests at 2.0% of GDP (Exhibit 19). The deficit continues to be funded by more precarious sources such as

portfolio flows and other short-term financing flows. A weaker currency should continue to narrow the current-account deficit and eventually attract more buyers of Canadian assets, bonds and equities, as well as stimulate foreign direct investment.

Our 1-year forecast calls for continued weakness in the Canadian dollar to 1.33. However, given valuation cross-currents, the Canadian dollar could actually rise 5% to 7% in the short term. We also believe that we are going to see the Canadian dollar on the extremely cheap side of PPP before this U.S. dollar bull market is over, but that is likely to take longer, perhaps two to three years.

Conclusion

The U.S. dollar bull market is in full swing, with various factors playing a role in its strength at different times. Most recently, expectations of rate normalization by the Fed and the consequences of the spectacular



fall in oil prices have dominated investors’ attention. The fact that other key central banks are pushing the monetary accelerator adds to the potential for this U.S. dollar bull market to unfold like others have, with currencies of the major U.S. trading partners overshooting into oversold territory. The euro and the yen are most vulnerable. The Canadian dollar should hold up better than the euro or

yen, but is still weighed down by the economy’s sensitivity to commodity prices. The British pound may be less affected than the others thanks to a monetary policy that is more in sync with the U.S., and London’s perennial ability to attract cash flows from troubled spots around the world.

REGIONAL OUTLOOK – U.S.

Ray Mawhinney

Senior V.P. & Senior Portfolio Manager
RBC Global Asset Management Inc.

Brad Willock, CFA

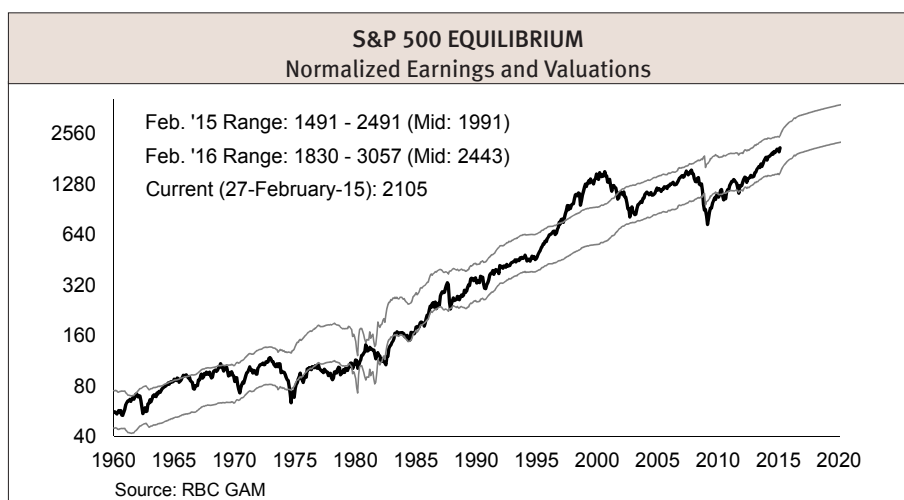
V.P. & Senior Portfolio Manager
RBC Global Asset Management Inc.

The U.S. stock market continues to march higher. The bull market is now in its seventh year and volatility has predictably increased as the U.S. Federal Reserve (Fed) moves closer to raising interest rates. The ride was bumpy during the first few years of the bull market but smoothed out until the autumn, when volatility spiked to levels not seen since late 2011. The increase in daily price swings was broadly attributed to a sharper-than-expected slowdown in economic activity in Europe, and Germany in particular, as well as general anxiety over the Fed's pending shift to tighter monetary policy. After setting a new all-time high in late December, the S&P 500 dropped about 5% into early February, before rebounding to set a record high at the end of the month. The strong move up at the end of the period was spurred by solid jobs data in the U.S., a larger-than-expected easing program from the European Central Bank, interest-rate reductions by eight other global central banks and reduced concerns regarding Greece and the Ukraine/Russia situation. The S&P 500 has generated a total return of almost 16% in the past year, 5.5% in the past six months and 2.4% in the past three months. These results place the U.S. equity market among the top major markets in the world over the past year, although Europe and some Asian markets have outperformed the U.S. more recently.

Despite the stock market's impressive gains, many questions remain. One of the principal debates over the market's future direction concerns

UNITED STATES RECOMMENDED SECTOR WEIGHTS		
	RBC INVESTMENT STRATEGY COMMITTEE FEBRUARY 2015	BENCHMARK S&P 500 FEBRUARY 2015
Energy	7.5%	8.1%
Materials	2.5%	3.3%
Industrials	11.5%	10.3%
Consumer Discretionary	13.5%	12.5%
Consumer Staples	9.8%	9.7%
Health Care	14.5%	14.9%
Financials	15.0%	16.0%
Information Technology	21.5%	19.9%
Telecommunication Services	2.0%	2.3%
Utilities	2.3%	3.0%

Source: RBC GAM



the involvement of central banks in global debt markets. Bears suggest that central-bank manipulation of interest rates is the main reason that stock markets have soared and that “it will all end badly” as central banks reduce their meddling in the bond market. Bulls, on the other hand, believe that the economy is on solid

footing and that there will be minimal impact on stocks as central banks normalize interest-rate policy. As usual, the truth likely lies somewhere in between these two views, and there is much we cannot know. As of October, the Fed had stopped buying U.S. Treasuries, so investors are highly focused on signs that the

economy and markets continue to function normally. So far so good, but it is too early to declare victory.

In the U.S., the fundamentals appear to be on track. Employment is improving as the number of people applying for unemployment insurance continues to drop, and more long-term unemployed people re-enter the workforce. In surveys, small businesses say they are more optimistic about their future than they have been since September 2007. Small-business owners say they intend to hire more people than last year and that it is harder to find the workers they need. Individuals report that they are more confident in the job market than at any time since July 2008, and more people are voluntarily quitting their current job to take a better one. The aggregate number of hours worked per week, the average wage gain and the number of people being added to the ranks of the employed are all improving. The economy added 335,000 jobs per month over the past three months, and the unemployment rate has been driven down to 5.7%. If the economy adds 250,000 jobs per month over the next several months, the unemployment rate should fall to a level that will likely cause wages to begin increasing.

While labour inflation is certainly something to worry about for 2015, other signs of inflation are muted. Commodity prices have been broadly under pressure over the past year, with oil and gasoline down roughly 40%, while most industrial metals and agricultural products are also down significantly over the same time frame. A stronger U.S. dollar has also helped keep inflation at bay, as the price of imports into the

U.S. has fallen by almost 2% over the past 12 months. Lower commodity prices should provide a tailwind to consumer spending during the first half of 2015 and may give a lift to some corporate earnings and perhaps stock valuations as well.

While the economy seems to be improving, earnings estimates have been steadily revised lower over the last four months as the price of oil collapsed. In fact, earnings for the Energy sector have been revised down by roughly 50% and this has been a significant drag on aggregate earnings of the market. Despite this, the S&P 500 has produced year-over-year earnings growth of about 5.9% in the most recent quarter, and that figure rises to 9.7% excluding the Energy sector. In addition, if one excludes the Energy, Utilities and the Financials sectors to focus on the sectors that are not energy-related or heavily regulated, incremental pretax profit margins are almost twice the base margin. These are impressive financial attributes for any point in a business cycle, but quite remarkable considering how long the recovery has been in place. In our opinion, margins have held up better than expected because the market has rewarded companies that control their capital spending and focus on cash generation. In a low-growth world, modesty and prudence are rewarded and hubris is punished.

The biggest risks to the market are likely to come from Europe, where the economy remains fragile and threatens to drag down U.S. economic growth. Consumer and business confidence is weak and recent Russia/Ukraine tensions are not helping matters. Slower growth in emerging markets

is another source of potential risk, as policymakers attempt to deflate credit bubbles, cool inflation and adapt to lower commodity prices. China's economy continues to slow as it deals with the excesses created by a decade of rapid growth fueled by debt. Brazil remains in recession as it battles too-high inflation and stagnant growth. Russia is in deep recession as the falling price of oil and sanctions weigh on its economy.

In the U.S., the Fed is in the process of normalizing monetary policy, and clearly there is a risk that this process does not go well. Nobody can know how this will turn out, but rather than taking a side ahead of time, we intend to remain vigilant for signs of systemic stress. If companies can still access capital markets and take out bank loans, we will likely conclude the process is going well. If not, we will position more defensively.

While most fundamentals continue to improve, the big run in the stock market since the beginning of 2013 suggests that much of this improvement in the economy is already reflected in equity valuations. The S&P 500 currently trades well above its historical average at over 17 times estimated earnings for the next 12 months, but remains attractive based on free cash flow and earnings yields relative to bond yields. Still, given current valuations, more muted earnings growth and the potential for rising interest rates and a stronger U.S. dollar, investors should expect modest rates of return in the year ahead as the market adapts to the change in the Fed's interest-rate policy.

REGIONAL OUTLOOK – CANADA

Stuart Kedwell, CFA

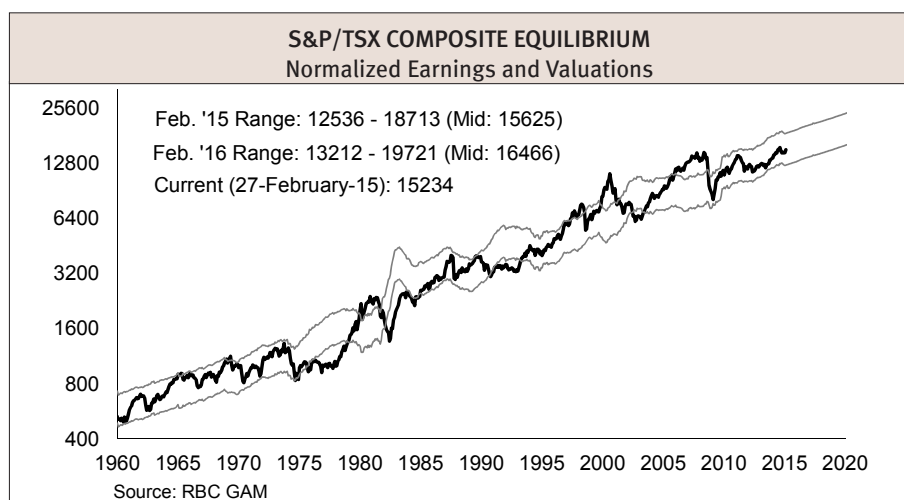
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On the surface, the S&P/TSX Composite Index posted a reasonable return in the latest three months. However, the performance was heavily influenced by a handful of non-financial, non-resource companies – most notably Valeant, which surged almost 50% – as the benchmark heavyweight Financials and Energy sectors posted negative performance during the period. Similar to the trend of 2014, the performance of the Canadian benchmark lagged its global peers, particularly on a currency-adjusted basis. The S&P/TSX delivered performance of 4.1% over the three-month period and 10.5% in 2014. This compares to S&P 500 returns of 2.3% and 14.1% in U.S. dollars, but 11.9% and 21% in Canadian dollars over the same period.

Energy prices continued their decline during the period, with West Texas Crude falling 25% to end below US\$50, while natural gas also tumbled over 30% despite very cold and snowy weather in the Northeast. Overall, price levels have been pressured by high inventories and uneven declines in drilling activity relative to expectations. The range of energy-company performance was wide, with long-reserve-life companies performing meaningfully better than some others in the Energy sector. On the whole, notwithstanding the commodity movement, the sector's decline was in the mid single digits on a percentage basis. Suncor actually notched a positive performance during the period.

CANADA RECOMMENDED SECTOR WEIGHTS		
	RBC INVESTMENT STRATEGY COMMITTEE FEBRUARY 2015	BENCHMARK S&P/TSX COMPOSITE FEBRUARY 2015
Energy	21.0%	21.1%
Materials	10.0%	11.2%
Industrials	10.0%	8.6%
Consumer Discretionary	7.5%	6.6%
Consumer Staples	4.0%	3.7%
Health Care	4.0%	4.9%
Financials	33.5%	34.5%
Information Technology	3.5%	2.5%
Telecommunication Services	4.3%	4.8%
Utilities	2.3%	2.2%

Source: RBC GAM



Our economic-growth forecasts for the U.S. remain above those for Canada and our 2015 forecast for Canada has been trimmed by 0.25% to 2.00%, so the near-term gap in economic growth has widened to 1.25% for 2015. With a surprise interest-rate cut by the Bank of Canada in January, the Canadian dollar's decline picked up speed and the currency declined over 8% during

the period. While a recovery in oil could cause a rally in the Canadian dollar, we remain of the view that a weaker Canadian dollar is probably with us for some time. Monetary policy is likely to tighten first in the U.S., while energy markets and a fully valued housing market will remain lingering concerns in Canada.

The aggregate 2015 earnings estimate for the S&P/TSX Composite declined meaningfully in the latest three months from \$1,000 to below \$850. Estimates for 2016 currently sit around \$1,000, although they too continue to decline. While headline valuations for the S&P/TSX Composite appear similar to the S&P 500 based on 2016 estimates, it is difficult to make the case for Canadian stock-market outperformance until the price of energy convincingly bottoms. While the ingredients for energy-price improvement are falling into place, this is a tough short-term call to make. Meanwhile, the non-financial, non-resource areas of the Canadian market are valued at the same or slightly higher levels than the comparable S&P 500 segments. For Canadian markets to outperform, Financials and Energy stocks are going to have to do the heavy lifting, and both require higher energy prices to improve in our view.

Valuations in the banking industry are slightly below average relative to history. Recent earnings reports have been better than expected, although they have not resulted in a material adjustment to future earnings views. Lower forecast economic growth, lower energy prices and the rate cut have combined to present additional headwinds to earnings growth in the

near term. All the while, provisions for credit losses remain at very low levels. Even in periods of more prolonged sluggish earnings growth and a corresponding slowing in dividend growth, current dividend yields coupled with low-to-mid-single-digit dividend increases provide reasonable total-return potential. In a more negative energy impact scenario, a year's worth of earnings growth could be consumed by rising credit provisions.

Insurance stocks continue to look interesting over the intermediate term. Uncertainty pertaining to regulatory and capital rules appears to be fading, and valuations are reasonable given the potential for high-single-digit earnings growth. Interest-rate uncertainty has clouded earnings-power forecasts, although, to insurers' credit, the impact of interest rates on capital strength has not been debated to the same degree relative to history. The focus on wealth management and markets outside Canada should result in increasing capital returns and lead to improved earnings and stock performance.

Oil prices are difficult to forecast in the short run, and it now appears that prices will be lower on average and more volatile than we have seen in the recent past. Longer term, the ingredients for a recovery are gradually

falling into place and we are more optimistic that prices will stabilize and then rise. Interestingly, the forward curve of oil is now in contango, suggesting you can buy it today, pay to store it and sell in the future at a profit. We would also note that a declining Canadian dollar softens the negative scenario to some degree for Canadian producers as the falling currency reduces costs. We continue to be of the view that most energy exposure should remain in well capitalized long-reserve-life companies with minimal declines in production.

As the performance of oil and financials companies has flagged, capital has flowed to other sectors of the TSX. The free-cash-flow characteristics of growth turbo-charged by acquisitions have been appealing to investors in these companies. While the businesses should be able to compound with future earnings growth, there is less room for error given current valuations.

In the Materials sector, our focus has been directed to free-cash generation and balance-sheet strength. Companies like Agrium and Methanex appear poised to generate attractive levels of free cash per share relative to current share prices.

REGIONAL OUTLOOK – EUROPE

David Lambert

Portfolio Manager
RBC Global Asset Management (UK) Limited

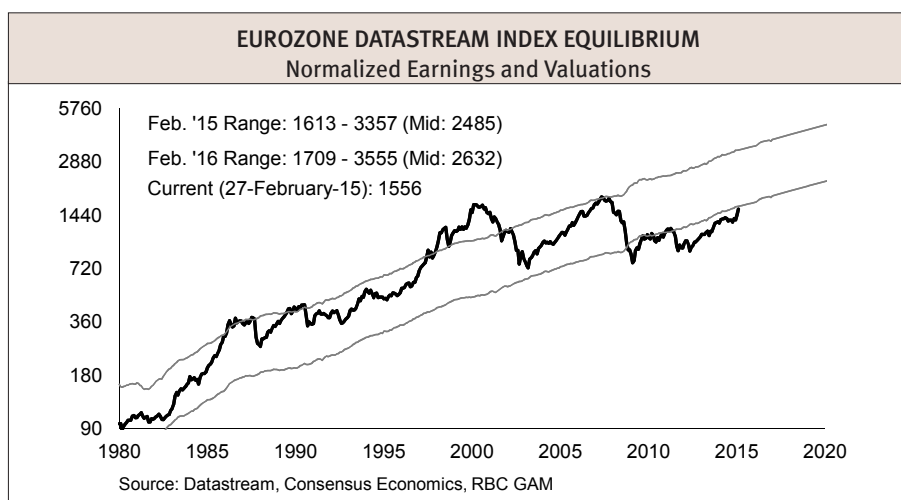
January's Quantitative Easing (QE) announcement appears to be good news for European equities. Adding sovereign-bond purchases to existing programs can play an important role in enhancing confidence, and the European Central Bank (ECB) is prepared to continue these transactions for as long as is necessary. The agency bonds target is large relative to the outstanding stock, suggesting that supply needs to rise and, with it, investment projects.

The QE transmission mechanism to the economy will be far from straightforward, acting through a number of channels including investor confidence, a weak euro, portfolio rebalancing and money growth. It is unlikely to do any harm.

Another recent positive development is evidenced in the ECB Bank Lending Survey, which showed a sharp acceleration in non-financial corporate-credit demand. Demand was already improving, but in January advanced to its best reading since early 2007. Driving this was an improvement in the demand for fixed-investment purposes. Credit demand from households also continued to rise. Notwithstanding this, the supply side also improved modestly relative to previous surveys – banks are more willing to lend – and this means we have had three surveys in a row that have been the strongest since 2006. These improvements are not confined to core Europe, as we have seen the phenomenon within the periphery countries too.

EUROPE RECOMMENDED SECTOR WEIGHTS		
	RBC INVESTMENT STRATEGY COMMITTEE FEBRUARY 2015	BENCHMARK MSCI EUROPE FEBRUARY 2015
Energy	7.0%	7.4%
Materials	6.5%	7.6%
Industrials	12.5%	11.1%
Consumer Discretionary	12.3%	11.5%
Consumer Staples	13.8%	14.1%
Health Care	15.0%	13.5%
Financials	21.0%	22.5%
Information Technology	5.0%	3.5%
Telecommunication Services	3.5%	4.9%
Utilities	3.5%	3.9%

Source: RBC GAM



So we are hopeful that these dynamics are a precursor to outright credit growth in Europe (which is still negative, but is beginning to stabilize). If such a credit impulse occurs, it could drive macroeconomic surprises and, in turn, drive equities higher. On the consumer-credit side, we have seen outright positive year-over-year growth

in December – the first time since 2009.

Another impetus for consumer spending is cheaper energy prices as a result of the collapse in the oil price. We could see a substantial boost to consumption growth in 2015. Even a small transfer of

spending away from energy and towards other goods and services could produce real GDP growth rates substantially in excess of those currently expected by the consensus.

If we assume a 20% decline in energy prices, the estimated impact on real GDP growth is between +1% to +1.6% in the major European economies. To put this in perspective, these estimated positive contributions to growth are actually greater than the absolute consensus expectations for 2015. Even a 10% energy-price-decline scenario could lead to a doubling of GDP growth in sluggish Italy this year, relative to consensus expectations.

So we have a confluence of...

- Easing credit conditions,
- Strengthening broad money growth,
- A weaker euro,
- A significant decline in oil prices,
- European QE – with asset demand in excess of supply,

...that lead us to be relatively optimistic about the medium term in Europe.

One other interesting dynamic, apparent in some of the U.K. data, is that U.K. equities have never been cheaper in the past 100 years relative to U.K. gilts from a yield perspective. The previous valuation extremes were 1940, 2008 and 2012. As we know, the biggest driver of this has been historically low 10-year gilt yields, but it nevertheless highlights the yield scarcity that exists. As a reminder, the current

dividend yield on European equities is around 3.5% versus the 0.23% yield on the 10-year German bund.

One could argue that equities have rarely, if ever, looked cheaper relative to bonds, and maybe have replaced bonds as the ‘default’ yield asset class. This also suggests that flat to growing dividends should support positive returns over the next 12-18 months.

From a style-cycle perspective, we are now in the fifth month of the ‘Recession phase.’ We are in this phase because the composite macro indicator continues to be weak (the weakest in two years), with the only components showing resilience being the German IFO and Pan European GDP forecasts. Typically we expect to see phases in the cycle last 9-12 months.

This phase of the cycle, although called ‘Recession,’ refers to the behaviour of stocks as opposed to economies within Europe. One distinct characteristic of this phase is increased volatility in markets – something we have certainly experienced. The type of stock that is favoured and typically outperforms in this period is High Quality, Low Risk and Larger Capitalization.

Given the potential underlying tailwinds to the European macro data already described, we could see the style cycle rotate through to ‘Recovery’ in the not-too-distant future as the composite indicator may begin to improve. In the ‘Recovery’ phase, the focus is on taking more risk and rotating out of quality and larger-

cap stocks. It is something we are monitoring closely, and we are adding cyclicity to the portfolios gradually.

From a sector perspective, the commodity space (Energy and Materials) has been understandably weak, but there has been some recent stabilization in these sectors. However, they still remain low-return, capital-intensive industries and are not a natural hunting ground for the portfolios.

The consumer sectors remain interesting, and one of the ways we are adding some cyclicity is through the Consumer Discretionary sector. This may come at the short-term expense of the Consumer Staples sector, but the longer-term stability, cash-flow generation and dividend payouts of the Staples space – especially in a low-interest-rate environment – means that we still want to have significant exposure to these names.

Another area of the market to garner cyclicity and act as a proxy for rising markets are the asset managers. Within Financials more broadly, we remain sceptical that banks will sustainably generate returns above their cost of capital over the long term, whereas asset managers are capital-light and exhibit good returns. So within Financials, we gravitate towards these names, especially if we expect the style cycle to transition into ‘Recovery.’

We continue to remain alert to the risks faced in both Ukraine and Greece and their potential impacts on equity markets and currencies.

REGIONAL OUTLOOK – ASIA

Mayur Nallamala

Head & Senior Portfolio Manager
RBC Investment Management (Asia) Limited

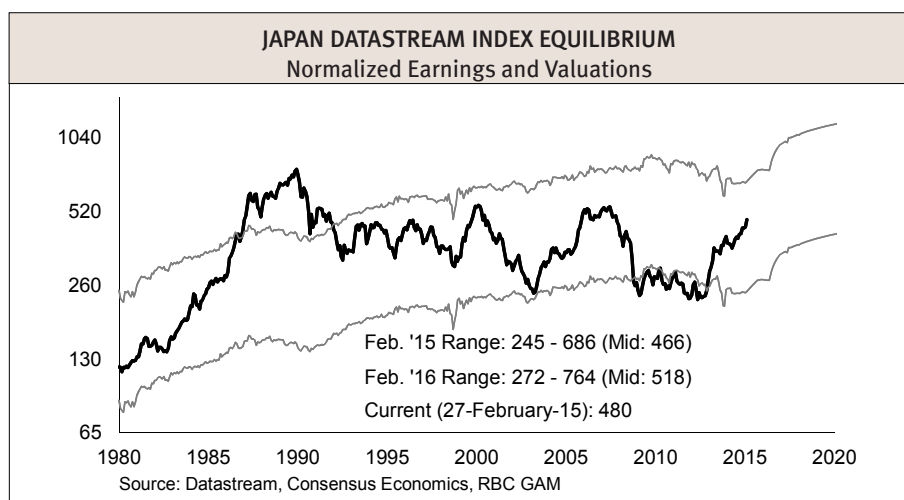
Asian markets declined during the three-month period but rebounded sharply in January as investors anticipated that the region would benefit from looser monetary conditions and lower oil prices. The Japanese market advanced amid investor optimism after Prime Minister Shinzo Abe's announced plans to postpone the second value-added tax (VAT) hike and the ruling Liberal Democratic Party won elections. Meanwhile, Indian equities extended their rally on the back of a surprise interest-rate cut in mid-January, and appear poised to benefit from lower oil prices, which will help address the current-account deficit. In reaction to sluggish economic data, China's central bank also embarked on stimulus measures that surprised the market but provided much-needed support for Chinese equities. Across the region, Southeast Asian markets were mixed as Philippines equities received a boost after the IMF lifted its growth forecast for the country, while Malaysian markets moved in the opposite direction after the government cut its economic-growth forecast. Elsewhere in Asia, government intervention into cement pricing in Indonesia is a negative development for the stock market if it becomes a feature of the new government's policies.

Japan

Japanese equities continued to rally during the period despite mixed economic data, headlined by a GDP print that showed the country's economy shrank by 1.6 percent in the third quarter of 2014. Despite that,

ASIA RECOMMENDED SECTOR WEIGHTS		
	RBC INVESTMENT STRATEGY COMMITTEE FEBRUARY 2015	BENCHMARK MSCI PACIFIC FEBRUARY 2015
Energy	3.0%	3.2%
Materials	6.0%	7.0%
Industrials	14.0%	12.6%
Consumer Discretionary	14.8%	13.2%
Consumer Staples	6.0%	6.1%
Health Care	5.3%	4.4%
Financials	28.5%	30.0%
Information Technology	16.0%	14.9%
Telecommunication Services	3.5%	5.5%
Utilities	3.0%	3.1%

Source: RBC GAM



the jobless rate extended its fall and the jobs-to-applicant ratio continued to increase, reaching new five-year highs. This is a reflection of Japanese companies facing increased difficulty filling roles, as job seekers are spoilt for choice and have more options. While this is a positive trend in the Japanese labour market, it has yet to be reflected

in higher consumer confidence or rising household incomes. The equity market's rally was fueled partly by the Bank of Japan's (BOJ) decision to double down on its quantitative-easing program in late October. Equally noteworthy, Japan's \$1.1 trillion Government Pension Investment Fund (GPIF) announced plans to increase

its overall equity holdings from 24% to 50% by reducing domestic bond holdings from 60% to 35%. In aggregate, the expanded BOJ asset purchases and the GPIF's shift in asset allocation to equities led to a steep decline in the yen, with the Japanese equity market reacting very positively during the period.

Meanwhile, sentiment regarding slowing consumer spending and weak inflation improved quickly after Abe's announcement to delay the second sales-tax hike by 18 months. In the near term, the BOJ's dovish stance towards monetary policy should help alleviate concerns that Japan could fall into another deflationary spiral or fail to reach its stated goal of 2% inflation.

China

Chinese equities advanced for much of the period despite deteriorating economic fundamentals, led by the A-share market that breached a five-year high in December. The onshore equity-market gains were powered by supportive monetary announcements after the People's Bank of China jumped on the easing bandwagon with a surprise interest-rate cut in November, the central bank's first since July 2012. Additionally, the central bank's decision to loosen loan restrictions in an effort to encourage additional lending by Chinese banks also boosted domestic investor sentiment vis-a-vis Chinese equities.

Much of the liquidity in the Chinese A-Share market was supplied by retail investors with an increased appetite for domestic equities. Trading activity reached record levels on the Shanghai

Composite as a result, more than double the highs in 2007 and 2010. We would note that the increased use of margin financing behind this equity rally can backfire since it is disconnected from economic fundamentals and company earnings. In response, Chinese regulators launched two rounds of investigations into stock-margin trading, and banks have been told to tighten lending supervision to avoid loans being funneled into stock markets.

In economic developments, the HSBC manufacturing PMI and the official PMI statistic in China both declined during the period, with the HSBC measure indicating a manufacturing contraction. Overall economic growth was in line with expectations as GDP rose 7.3 percent in the fourth quarter from a year earlier, the lowest print in more than five years.

Overall we maintain our relatively negative stance on Chinese equities due to dangerously high corporate-debt levels and weakening operating cash flows relative to debt.

Southeast Asia

The Philippines equity market rose to record highs as economic growth in the Southeast Asia region accelerated to 6.9% in the fourth quarter, led by government spending and manufacturing output that grew by 9.2%. Conversely, commodity-sensitive markets like Malaysia underperformed as its large exposure to the Energy sector was negatively affected by the sharp decline in the price of oil, as well as potential credit-rating downgrades in the first half of 2015.

In Indonesia, the government's ability to maintain a healthy business climate remains questionable as unpredictable policies being imposed on certain industries have dampened investor optimism. The latest misadventure is the announcement of government intervention into cement pricing, which we view as a negative development for the region.

Investor sentiment towards India remains relatively healthy with tailwinds from ongoing economic reform and continued popular support for Prime Minister Modi. The Reserve Bank of India surprised the market with an interest-rate cut in January. We continue to take the view that valuation premiums in India are justified due to the country's combination of growth and quality companies, and are watching to see the speed at which infrastructure projects are rolled out in the coming years. In particular, we see India as a key beneficiary of the low-commodity-price environment. On this note, India cut costly fuel subsidies during the three-month period due to the collapsing price of oil, a move which reduces pressure on the government budget and allows for future rate cuts.

Australian equities advanced marginally despite another disappointing three-month period for resources companies. Stocks in the Materials sector, which make up over 15% of the MSCI Australia benchmark, declined as weakness in iron ore persisted. The commodity fell 48% in 2014, causing Australia's large Materials sector to underperform throughout the year.

REGIONAL OUTLOOK – EMERGING MARKETS

Christoffer Enemaerke

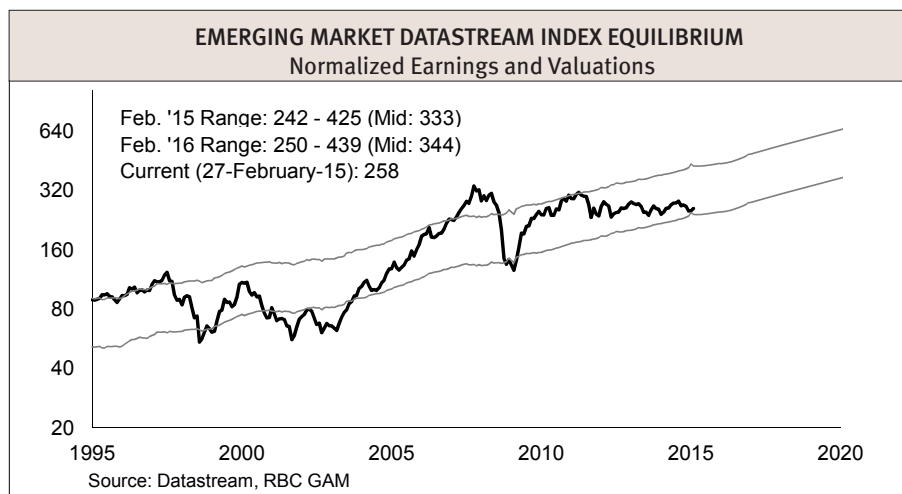
Analyst

RBC Global Asset Management (UK) Limited

Emerging-market equities underperformed developed markets in 2014 amid the headwinds of a strong U.S. dollar and weak commodity prices. However, emerging-market equities have recovered on a relative basis so far in 2015, with the two asset classes performing almost in line so far this year. The MSCI Emerging Markets Index increased 3.7% during the first two months of 2015 in U.S. dollar terms, compared with a 4.0% gain for the MSCI World Index.

Faster growth has historically been the key reason for investing in emerging markets and has driven long-term performance. However, for the last 3½ years, the MSCI Emerging Markets Index has traded in a relatively tight range, substantially underperforming developed markets. The key factor driving this underperformance has been a slowdown in the relative growth of emerging markets compared to developed markets, as there is a close relationship between relative growth and relative performance.

With this in mind, having a view on the expected growth differential is the key to one's view on future emerging-markets performance. A stabilization of emerging-market growth, coupled with a fall in developed-markets growth expectations, particularly in Europe and Japan, mean that the growth differential has already started to stabilize. In the medium term, IMF forecasts point to a stable growth differential in the coming years.



Although the focus recently has been on relatively slow emerging-market growth, these markets have driven global growth over the past decade and accounted for the bulk of global growth in 2013 and 2014. This faster growth has translated into much stronger earnings growth: over the past decade the compounded annual earnings growth rate in emerging markets was 12.8% versus 5.4% in developed markets.

The factors that have caused emerging markets to consistently grow faster than developed markets are very much intact – favourable demographics, lower debt, urbanization, the ability to raise productivity closer to developed-market levels, underpenetrated credit and a growing middle class.

In addition to a stabilization in the relative growth differential, 2015 is also shaping up to be a year of unprecedented political reform for

emerging markets. Countries including India, Malaysia, Mexico and China are showing signs of implementing meaningful reforms. As these economies transition from undeveloped to developed status, the structural economic changes unleash economic growth which, combined with higher levels of governance, should translate into attractive investment returns. Developed economies are characterized as having transparent and flexible markets for goods, services and labour, with prices determined by supply and demand. As emerging markets move closer to this model, the redirection of capital and labour to the most productive parts of the economy should result in higher productivity. It is this productivity growth that is the ultimate source of long-term sustainable returns for investors.

The failure of some governments to push and implement structural reforms has started to take its toll. Brazil offers

a noticeable example of such failure. The rise in inflation in Brazil even during times of particularly low growth reflects the fact that the country has reached, or even exceeded, its current output gap. A major component of this is that most of the country's spare capacity, which was created by the various financial crises and subsequent economic reforms, has been used up. Brazil needs labour and fiscal reforms to improve business conditions and boost savings and private investments in infrastructure.

In China, excess investment spending over the past decade has caused a chronic overcapacity issue, which has led to a decline in return on assets and a return on incremental invested capital that is now below the cost of capital. Reforms are thus crucial in China, with the key to reforms being that the market will play a decisive role in allocating resources going forward. The private sector accounts for a rising share of profits, and the Chinese government recognizes that the future health of what should become an increasingly consumption-driven economy lies with a private sector that employs 80% of the urban workforce and accounts for 90% of new jobs.

In some emerging markets, a failure to maintain growth and to improve living

standards threatens to frustrate the rising expectations of an expanding middle class, which could contribute to heightened social tension as seen recently in Turkey, Russia, Brazil, Egypt and Chile. It can be argued that a fast-growing and increasingly demanding middle-income class will put more pressure on political leaders and become an important driving force of incremental positive adjustments.

While the long-term growth outlook for emerging markets remains robust, a key risk is recent U.S. dollar strength, which has tended to be a headwind for emerging-market performance and a deflationary trigger more generally. There are, however, a number of mitigating factors that will help limit this headwind. A high relative level of interest rates, cheap valuations and better fundamentals in emerging markets compared to developed markets represent strong long-term supports. They also suggest that, even in a strong-dollar environment, many emerging-market currencies will perform well, and that the bulk of U.S. dollar strength will be against other developed-market currencies.

A second concern related to U.S. dollar strength is the impact it has on funding costs for emerging-market companies. There has been significant growth in

the amount of U.S. dollar debt issued by emerging-market corporates in recent years, and particular attention needs to be paid to companies that are heavily exposed to foreign debt.

The impact on emerging markets of the sharp fall in commodity prices, particularly oil, is also worth considering. The overall effect of the decline should turn out to be positive for most emerging markets, as a majority are net oil importers and stand to benefit from improved trade accounts and fiscal balances from falling subsidies.

For most of the past 15 years, rising commodity prices have been a significant headwind for a majority of emerging countries. A sustained period of lower prices should benefit consumption and boost profit margins. For emerging-market consumers, energy represents a much higher proportion of total expenditure than it does in developed markets.

Finally, the relative valuation case for emerging markets remains compelling. The best guide to valuation is the price-to-book ratio. Trailing valuations are at the low point of the last 12 years and at a 30% discount to developed markets.

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Daniel E. Chornous, CFA

Chief Investment Officer
RBC Global Asset Management
Chair, RBC Investment Strategy Committee

Dan Chornous is Chief Investment Officer of RBC Global Asset Management Inc., which has total assets under management of \$363 billion. Mr. Chornous is responsible for the overall direction of investment policy and fund management. In addition, he chairs the RBC Investment Strategy Committee, the group responsible for global asset-mix recommendations and global-fixed income and equity portfolio construction for use in RBC Wealth Management's key client groups including retail mutual funds, International Wealth Management, RBC Dominion Securities Inc. and RBC Phillips, Hager & North Investment Counsel Inc. He also serves on the Board of Directors of the Canadian Coalition for Good Governance and is Chair of its Public Policy Committee. Prior to joining RBC Asset Management in November 2002, Mr. Chornous was Managing Director, Capital Markets Research and Chief Investment Strategist at RBC Capital Markets. In that role, he was responsible for developing the firm's outlook for global and domestic economies and capital markets as well as managing the firm's global economics, technical and quantitative research teams.



Stephen Burke, PhD, CFA

Vice President and Portfolio Manager
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Stephen is a fixed-income portfolio manager and Head of the Quantitative Research Group, the internal team that develops quantitative research solutions for investment decision-making throughout the firm. He is also a member of the PH&N IM Asset Mix Committee. Stephen joined Phillips, Hager & North Investment Management in 2002. The first six years of his career were spent at an investment-counselling firm where he quickly rose to become a partner and fixed-income portfolio manager. He then took two years away from the industry to begin his Ph.D. in Finance and completed it over another three years while serving as a fixed-income portfolio manager for a mutual-fund company. Stephen became a CFA charterholder in 1994.



Dagmara Fijalkowski, MBA, CFA

Head, Global Fixed Income & Currencies
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As Head of Global Fixed Income & Currencies at RBC Global Asset Management, Dagmara oversees 15 investment professionals in Toronto and London, with more than \$40 billion in assets under management. In her duties as a portfolio manager, Dagmara looks after foreign-exchange hedging and active currency-management programs for fixed-income and equity funds, and co-manages several of the firm's bond portfolios. Dagmara chairs the RBC Fixed Income & Currencies Committee. She is also a member of the RBC Investment Policy Committee, which determines the asset mix for RBC balanced products, and the RBC Investment Strategy Committee, which establishes global strategy for the firm.



Stuart Kedwell, CFA

Senior Vice President and
Senior Portfolio Manager
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Stu began his career with RBC Dominion Securities in the firm's Generalist program and completed rotations in the Fixed Income, Equity Research, Corporate Finance and Private Client divisions. Following this program, he joined the RBC Investments Portfolio Advisory Group and was a member of the RBC DS Strategy and Stock Selection committees. He later joined RBC Global Asset Management as a senior portfolio manager and now manages the RBC Canadian Dividend Fund, RBC North American Value Fund and a number of other mandates. He is co-head of RBC Global Asset Management's Canadian Equity Team.



Eric Lascelles

Chief Economist
RBC Global ASSET Management

Eric is the Chief Economist for RBC Global Asset Management Inc. (RBC GAM) and is responsible for maintaining the firm's global economic forecast and generating macroeconomic research. He is also a member of the Investment Strategy Committee, the group responsible for the firm's global asset-mix recommendations. Eric is a frequent media commentator and makes regular presentations both within and outside RBC GAM. Prior to joining RBC GAM in early 2011, Eric spent six years at a large Canadian securities firm, the last four as the Chief Economics and Rates Strategist. His previous experience includes positions as economist at a large Canadian bank and research economist for a federal government agency.



Hanif Mamdani

Head of Alternative Investments
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Hanif Mamdani is Head of both Corporate Bond Investments and Alternative Investments. He is responsible for the portfolio strategy and trading execution of all investment-grade and high-yield corporate bonds. Hanif is Lead Manager of the PH&N High Yield Bond Fund and the PH&N Absolute Return Fund (a multi-strategy hedge fund). He is also a member of the Asset Mix Committee. Prior to joining the firm in 1998, he spent 10 years in New York with two global investment banks working in a variety of roles in Corporate Finance, Capital Markets and Proprietary Trading. Hanif holds a master's degree from Harvard University and a bachelor's degree from the California Institute of Technology (Caltech).



Ray Mawhinney

Senior Vice President and
Senior Portfolio Manager
RBC Global Asset Management

As Chairman of the U.S. Equity Committee, Ray and his team are responsible for managing U.S. stock investments. Ray brings a wealth of expertise to his role, having specialized in U.S. equities since 1984, and has been involved in managing almost all of the firm's U.S. equity funds. He joined the firm in 1992. Ray is also a member of the RBC Investment Policy Committee, which determines asset mix for balanced products, and the RBC Investment Strategy Committee, which establishes a global asset mix covering mutual funds, as well as portfolios for institutions and high-net-worth private clients. Ray graduated from the University of Manitoba with a bachelor's of commerce degree in finance, with honours.



Martin Paleczny, CFA

Vice President and
Senior Portfolio Manager
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Martin Paleczny, who has been in the investment industry since 1994, began his career at Royal Bank Investment Management, where he developed an expertise in derivatives management and created a policy and process for the products. He also specializes in technical analysis and uses this background to implement derivatives and hedging strategies for equity, fixed-income, currency and commodity-related funds. Since becoming a portfolio manager, Martin has focused on global allocation strategies for the full range of assets, with an emphasis on using futures, forwards and options. He serves as advisor for technical analysis to the RBC Investment Strategy Committee.



Sarah Riopelle, CFA

Vice President and
Senior Portfolio Manager
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Since 2009, Sarah has managed the entire suite of RBC Portfolio Solutions, including the RBC Select Portfolios, RBC Select Choices Portfolios, RBC Target Education Funds and RBC Managed Payout Solutions. Sarah is a member of the RBC Investment Strategy Committee, which sets global strategy for the firm, and the RBC Investment Policy Committee, which is responsible for the investment strategy and tactical asset allocation for RBC Funds' balanced products and portfolio solutions. In addition to her fund management role, she works closely with the firm's Chief Investment Officer on a variety of projects, as well as co-manages the Global Equity Analyst team.



William E. (Bill) Tilford

Head, Quantitative Investments
RBC Global Asset Management

Bill is Head, Quantitative Investments, at RBC Global Asset Management and is responsible for expanding the firm's quantitative-investment capabilities. Prior to joining RBC GAM in 2011, Bill was Vice President and Head of Global Corporate Securities at a federal Crown corporation and a member of its investment committee. His responsibilities included security-selection programs in global equities and corporate debt that integrated fundamental and quantitative disciplines, as well as management of one of the world's largest market neutral/overlay portfolios. Previously, Bill spent 12 years with a large Canadian asset manager, where he was the partner who helped build a quantitative-investment team that ran core, style-tilted and alternative Canadian / U.S. funds. Bill has been in the investment industry since 1986.

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