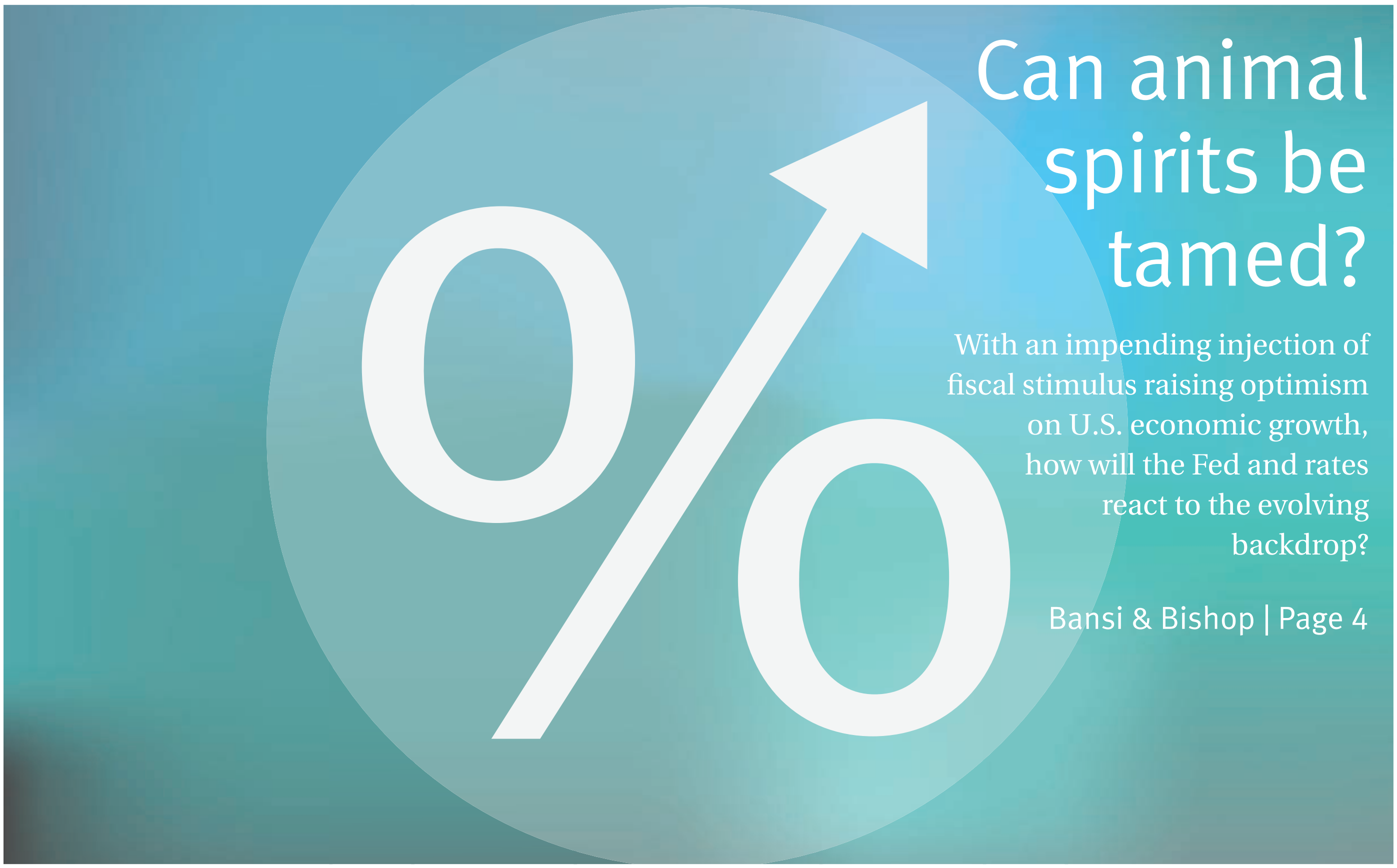
January 2017

RBC WEALTH MANAGEMENT

Global Insight

Perspectives from the Global Portfolio Advisory Committee



Can animal spirits be tamed?

With an impending injection of fiscal stimulus raising optimism on U.S. economic growth, how will the Fed and rates react to the evolving backdrop?

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RBC Wealth Management

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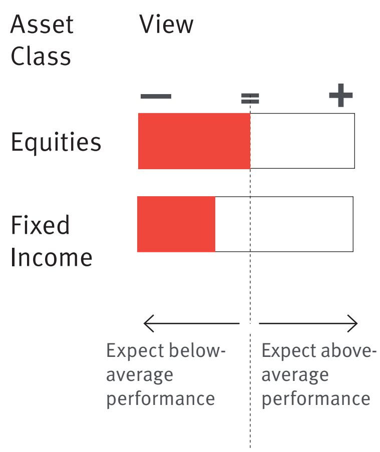

See “Views explanation” below for details

Source - RBC Wealth Management

Equities

- While equity markets will at some point consolidate following the strong post-U.S. election rally, we believe most developed markets will deliver worthwhile returns in 2017. Economic indicators have been improving across regions, suggesting growth is on a firm footing. Corporate profits should accelerate as bank earnings rise and the Energy sector flips into the black. Most markets are still reasonably valued, particularly given the low interest rate environment.
- We continue to recommend investors with a 12-month or longer time horizon maintain a full commitment to global equities with Overweight positions in the U.S. and Canada. Earnings growth is more durable and economic prospects are better in North America—even more so if the Trump administration’s fiscal stimulus proposals are passed and sweeping regulatory reforms occur.

Fixed Income

- Bond market volatility will likely ease in the near term as lofty expectations about U.S. fiscal stimulus seem baked into Treasuries and the market has caught up to the improved economic fundamentals. Investors should, however, expect yields to drift moderately higher in 2017 driven by the fact that economic growth could accelerate later in the year and inflation is likely to trend higher for major economies. The Federal Reserve, for now, will likely stick to gradually raising interest rates, but we should expect continued monetary stimulus in Europe and Japan.
- Even though yields could push somewhat higher (albeit while remaining low historically), we believe there are attractive opportunities for buy-and-hold investors, especially in the U.S. and Canada. We still prefer opportunities in corporate credit, but investors need to be selective.

Views explanation

(+/=/–) represents the Global Portfolio Advisory Committee’s (GPAC) view over a 12-month investment time horizon.

+ Overweight implies the potential for better-than-average performance for the asset class or for the region relative to other asset classes or regions.

= In-line implies the potential for average performance for the asset class or for the region relative to other asset classes or regions.

– Underweight implies the potential for below-average performance for the asset class or for the region relative to other asset classes or regions.

Focus article

Can animal spirits be tamed?

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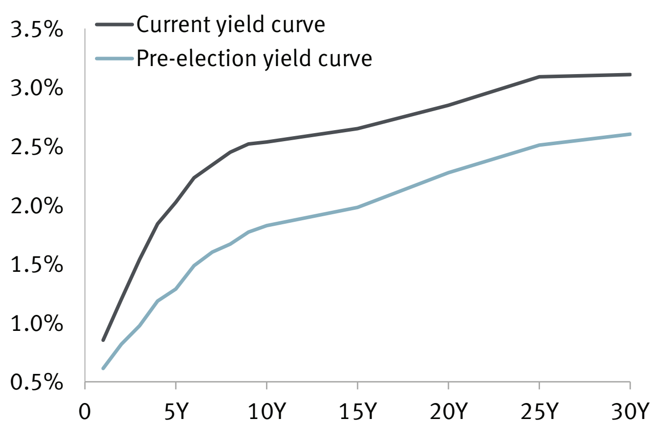
For some time monetary policy has done the heavy lifting to stabilize the U.S. economy. In 2017 we will see if the addition of fiscal stimulus puts the economy on a glide path to "breakout speed." Rates and the Fed have so far voted with their feet.

Move higher in rates

In his book *The General Theory of Employment, Interest and Money*, John Maynard Keynes coined the term "animal spirits" to encapsulate how emotions and confidence can drive consumer and investor behaviour. While a 25 basis point hike by the Federal Reserve in December received significant coverage, some government bond yields experienced a much larger jump. We believe it is largely these animal spirits that have been behind the recent surge in yields. In the U.S., Treasury yields have marched steadily higher since early November as financial markets price in expectations for higher growth and inflation under the administration of President-elect Donald Trump and a Republican-controlled Congress. The chart below illustrates how some yields have risen in excess of 75 basis points in just the last two months.

Expectations of fiscal stimulus fuels yield curve shift



U.S. Treasury yields "wake up" to the new administration's plans to loosen the reins on fiscal stimulus.

Source - RBC Wealth Management, Bloomberg

Yields soar to reflect reality

The primary catalyst moving bond yields higher has been the outcome of the U.S. elections. Financial markets are expecting a combination of tax cuts and a meaningful spend on infrastructure from the President-elect and Congress that will lift U.S. growth and put upward pressure on inflation.

But bonds may also have been ripe for a correction given yield levels were out of sync with fundamentals.

For example, the yield on the U.S. Treasury's 10-year bond in early November 2016 was at a similar level as four years prior despite a very different economic landscape. In November 2012, the unemployment rate was 7.7% and the core

Consumer Price Index (CPI) was 1.8% and expected to fall further. In contrast, the 4.4% unemployment rate in November 2016 was indicative of a tight labour market while core CPI of 2.2% was expected to trend higher in coming months.

The different approach by the Fed in each of these two periods highlights how the fundamentals stand in contrast. While the Fed hiked interest rates in December 2016 in anticipation of accelerating growth and inflation, in November 2012, the central bank announced its third round of quantitative easing to try to stabilize a fragile recovery and stoke higher levels of growth and inflation. In light of how strong the current economy is, and expectations for growth are, we think part of the recent correction was long overdue.

The Fed has clearly become more comfortable with the sustainability of the economy's growth trajectory.

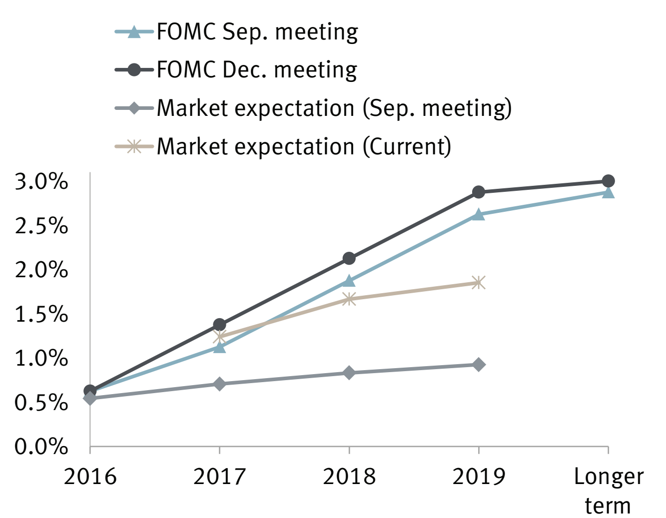
Evolving backdrop leaves the Fed less dovish

Bond yields are unlikely to plumb the lows achieved in recent years given expected improving trajectories of growth and inflation. That's especially true in light of how comfortable the Fed has become with the sturdiness of the economic expansion, a stance supportive of further interest rate hikes in 2017 while likely placing a floor on yields not far below current levels.

The central bank's Federal Open Market Committee (FOMC) indicated that it sees unemployment hovering close to the current level of 4.6%, which is noteworthy given its long-held estimate of "full employment" at a slightly higher level of 4.8%. While the Fed still expects growth to be somewhat meagre at approximately 2.0%, it has also firmed inflation expectations to be at around the same level. The Fed has clearly become more comfortable with the sustainability of the economy's growth trajectory.

The chart below highlights how the median estimate for the path of the Fed Funds rate shifted higher by about one hike throughout the horizon of the "dot plot," which captures the Fed's internal forecasts for the path of future rate hikes. Of some note is that the longer-term rate ticked slightly higher. Financial markets have sharply repriced expectations for rate increases in the next couple of years, but continue to harbour doubts about rate hikes beyond the 2% level. Even so, it is important to note the narrowed gap between Fed rate forecasts and market expectations for rates.

Market expectations begin to align with Fed forecasts



Source - RBC Wealth Management, Bloomberg

The realignment in expectations reflects something we haven't seen in years—a "hawkish" Fed.

In addition to a slightly more aggressive dot plot, Fed Chair Janet Yellen also appeared to back off prior comments that the Fed was willing to “experiment” with letting the economy “run hot” (basically letting inflation exceed the Fed’s 2% target) for a period of time. Given fiscal policy will be relied on to do the heavy lifting in the near term, we believe it’s prudent to wait and see if the Fed decides to take a more hawkish tone in 2017 to counter aggressive fiscal policy should budget deficits or inflation expectations become a greater concern.

Lower for longer, but higher than before

We believe longer-term yields in the U.S. will remain low in 2017 from a historical perspective, but the range will be higher than that of recent years. In 2017, we expect the U.S. 10-year Treasury to trade within a range of 2.50% to 3.00% with risks tilted to the upside should growth or inflation accelerate beyond current expectations. This compares to the 1.50% to 2.00% range that the 10-year stayed within for much of 2016.

Any further moves higher in the 10-year yield from here will be modest as ultimately fundamentals do matter.

It’s understandable for investors to be wary of a further move higher in rates after the outsized impact animal spirits have had in the last two months. But given the magnitude of the move that has occurred—the yield on the 10-year has nearly doubled from its 2016 lows reached in July—we think any further moves higher from here will be modest as ultimately fundamentals do matter. We believe the 10-year could rise above 2.75% in the short term, but any moves towards 3.00% should be viewed by investors as buying opportunities given the still subdued economic fundamentals and the relatively long lag time before fiscal stimulus measures are likely to gain traction.

The story is similar for the Fed’s benchmark Fed Funds rate. We are sticking with our expectation for two rate hikes by the Fed in 2017 versus the three hikes suggested by the latest dot plot. We would not characterize the Fed as hawkish even though it is in the midst of a tightening cycle. The incoming voting members of the FOMC in 2017 will be slightly more dovish on balance than the outgoing voting members. There are also downside risks to the global economy that should not be forgotten, most notably the impact of a strong U.S. dollar. In our mind, two hikes should be sufficient.

No wobble no trouble?

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The rejection of the Italian government's reform agenda stung one of the EU's core members and European stock markets responded with … a rally?!? But investors shouldn't jump several steps ahead and assume the political risk of populist fury is overblown as serious tests of the EU's sustainability remain.

European equities have rallied since voters in Italy said "No" to the question of constitutional reforms in a national referendum held on December 4. This seemingly counterintuitive rally has been sustained for much of December, such that many European bourses finished 2016 at or near the highest levels of the year. Is political risk, which has been our main concern for the region, fading?

We believe such a conclusion would be premature at this juncture. We remain preoccupied with political risk in Italy and France, two of the larger economies in the EU that continue to struggle with deep-seated structural problems. Should populist parties be able to form or even strongly influence governments in upcoming elections, we believe this would represent an existential threat to the EU. Whilst European equities have a lot going for them at this moment, our enthusiasm for the region is tempered by this significant risk.

Italy's revolving government doors

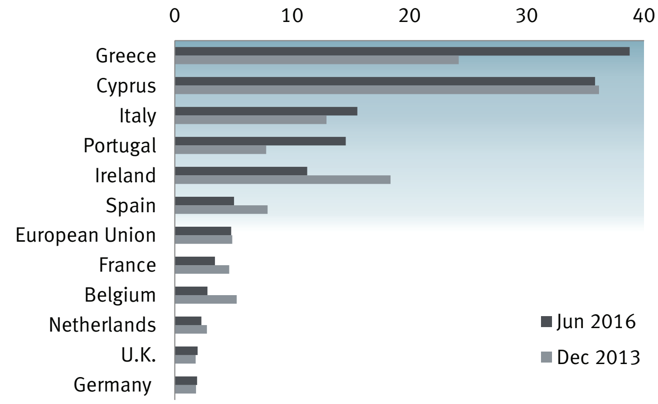
On December 4, Italian voters decisively rejected the constitutional reforms championed by Prime Minister Matteo Renzi. This outcome has significant implications for the current government as well as for the country's beleaguered banking system.

Firstly, the "No" vote dealt a crushing blow to Renzi's economic reform agenda as well as to Renzi himself, given his decision to resign following the vote. Uncertainty in the very near term was addressed when Minister of Foreign Affairs Paolo Gentiloni was swiftly appointed as head of a caretaker government, but his suggestion that elections could occur within the next 12 months leaves uncertainty on the horizon, especially given the eurosceptic Five Star Movement (5SM) is currently running close to the incumbent government in national polls. A snap election could usher in a new government inclined to challenge the status quo. While the 5SM has said it is committed to the EU, it has also called for a referendum on Italy's membership in the single currency union. While many hurdles stand in the way of such a change, this remains a risk we think investors should be cognizant of.

Secondly, this political volatility comes at a time when Italian banks are trying to remedy their chronic undercapitalisation. The banking system remains crippled by €360B in impaired loans, which equates to more than 15% of total loans. This is a precarious position for a country whose economy, Europe's third-largest, is stagnating. As a core member of the EU, Italy, unlike Greece, is much too large to bail out.

European banks laden with bad loans

Nonperforming loans of all banks (% of total loans)



Nonperforming loan ratios remain high in peripheral Europe.

Note: March 2016 data for EU and U.K. average for all domestic banks
Source - ECB, Haver Analytics, RBC Global Asset Management

The Italian banking sector is in a precarious position. A crisis may still be averted.

Unfortunately, the Italian government's hands appear to be tied.

Not only is it already heavily indebted, but recent EU rules bar governments from bailing out banks. These rules expect shareholders and bondholders, not taxpayers, to bear losses. Yet, this route could wipe out the savings of private investors given 50% of the debt issued by banks is owned by small individual investors. Loss bearing by these investors would not only be unpopular, but also catastrophic for consumer confidence and, thus, economic growth. In a worst-case scenario, should some banks have difficulty recapitalising, contagion to the rest of the eurozone could not be ruled out.

Credit rating agency Moody's recently downgraded the outlook for the Italian banking sector to "negative" from "stable" due to concerns regarding the slowdown in fiscal reforms and the risk of government change.

It doesn't need to come to a crisis point. Italy and the EU have shown the agility to come up with creative solutions in the past. Establishing a bank to hold bad loans, selective bail-ins, debt/equity swaps, and bank mergers may all be on the table. We believe restoring confidence in the banking system is key—but not easy to accomplish with only a caretaker government in place.

France: A seismic event?

By selecting François Fillon as the centre-right candidate for its presidential election in May 2017, France sent an encouraging signal, as Fillon promised a range of sweeping economic reforms, such as ending the 35-hour workweek and slimming down the public sector.

He is likely to face the far-right eurosceptic Marine Le Pen of the Front National in the second round of the elections. Polls suggest Fillon would win by a good margin. If this is the case, he may be able to push through a programme of strong reforms similar to those which transformed Germany in 2003–04.

But given pollsters' recent poor track record anticipating election results, financial markets are unlikely to shrug off concerns over the French election easily. A Le Pen victory could represent a seismic, pivotal event for the EU, and threaten the longevity of the euro by putting in question the increased fiscal and political integration of the EU—necessary, in our view, for its sustainability.

No wobble no trouble?

Things are starting to fall into place for European equities, but political risk prevents us from being enthusiastic.

A year full of hurdles

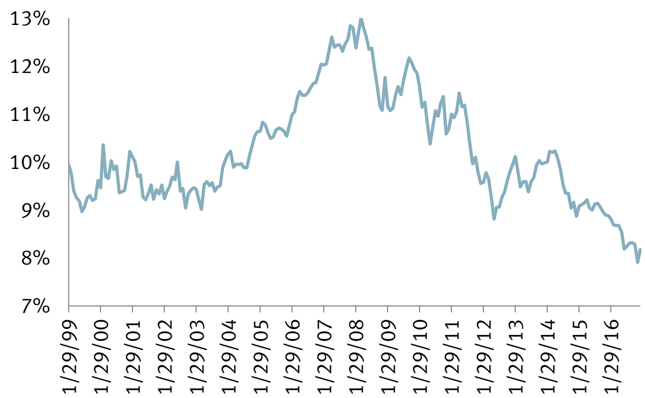
Equity markets shrugged off the Italian referendum result. Unlike the Trump victory in the U.S. or the Brexit vote, which were "surprise" outcomes, the "No" victory had been well telegraphed and largely discounted in financial markets.

European Central Bank (ECB) action helped. At its December meeting, the ECB extended its quantitative easing programme. While reducing monthly purchases from €80B to €60B, it tacked on another nine months to the scheme to December 2017, longer than anticipated. The ECB also reiterated it was ready to step in should market action make it necessary.

On the face of it, European equities offer many attractive characteristics. Earnings momentum has improved recently, as the recent pickup in the global economy feeds through. A weaker euro should underpin earnings momentum further, in our opinion. Valuations are now at an unduly large discount to the U.S. and could foster M&A activity. A perennial underperformer and having suffered large outflows in 2016, the region may attract tactical investors again.

Europe has been a perennial underperformer in USD

MSCI Europe ex UK vs. MSCI World (USD)



2016 was no different.

Source - RBC Wealth Management, Bloomberg

Despite this, we retain an Underweight position in European equities with a one-year view. Should the high political risk materialise, it could create an existential risk to the EU. We believe there are more straight-forward investment rationales in other regions. Nevertheless, there are attractive opportunities on a selective basis. We maintain our preference for Consumer Discretionary, particularly in media where digitalisation is opening new markets and opportunities, and Consumer Staples for their quality and cash flow generating attributes.

Still the place to be

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Economic activity has been strengthening in most major economies since the summer. And strong "new orders" readings indicate this should continue into Q1. What's more, the promised tax cuts/infrastructure spending/regulatory reform expected from the new U.S. administration and Congress have pushed global GDP growth estimates higher, produced a surge in U.S. consumer and business confidence, and reduced the risk of a U.S. recession arriving before 2019.

Normally the promise of stronger U.S. growth would be good news for most other economies. An expanding U.S. economy usually exerts a powerful "tractor" effect on the rest of the world—certainly on major trading partners like China, Mexico, and Canada—as U.S. imports from these countries are very large and typically grow faster than overall U.S. GDP. But in this case, the new administration has said it intends to declare a "jump ball" with respect to trade relationships and agreements, including NAFTA, raising the prospect, at the very least, of trade uncertainty for many countries.

Negotiating or renegotiating trade rules and agreements is one thing; unilaterally imposing tariffs, "border taxes," or other similar barriers is another, and one that typically provokes threats of retaliation. Trade wars have almost never been good for anyone.

The expected pickup in growth and the pushing out of the probable start date of the next U.S. recession persuade us that equities should fare well in the coming 12 months, and probably longer. However, trade issues together with the prospect of rising bond yields, an appreciating U.S. dollar, and higher oil prices are likely to deliver some episodes of volatility. We continue to recommend investors with a 12-month or longer time horizon maintain a full commitment to global equities.

Equity views

Region	Current
Global	=
United States	+
Canada	+
Continental Europe	–
United Kingdom	–
Asia (ex-Japan)	=
Japan	=

Source - RBC Wealth Management

We recommend an Overweight exposure to the U.S. market, where S&P 500 earnings are expected to increase by 8%–9% in each of the next two years. Canada also merits an Overweight as the important Energy sector stabilises and improves under the influence of higher oil and natural gas prices, while bank margins widen in response to cost cutting, rising interest rates, and improved credit trends. Political risks leave us Underweight both Europe and the U.K., while our rating for Japan and the rest of Asia is Market Weight.

Regional highlights

United States

- The post-election rally hasn't dampened our enthusiasm for U.S. equities. While the market seems due for a pullback, we remain Overweight U.S. equities because we anticipate the S&P 500 can deliver low double-digit total returns in 2017.
- The market's forward valuation is not so high that it would deter stock prices from rising further. The price-to-earnings ratio starts the year at 17.5x based on our $128 per share earnings estimate for 2017. Earnings

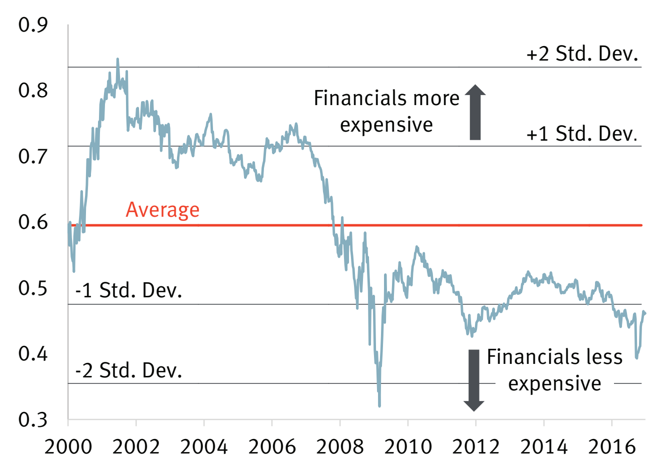
could exceed that level if sizeable corporate tax cuts and reforms are passed.

- We favor economically sensitive, cyclical sectors due to the possibility fiscal stimulus could boost GDP growth to its fastest pace since 2005. Related knock-on effects of a further move toward normalized interest rates and inflation expectations, a steeper yield curve, and somewhat tighter Fed policy could also support cyclical stocks.
- We would continue to Overweight the Financials, Industrials, Energy, and Materials sectors. Financials have surged 16.5% since the election. We would use pullbacks to add exposure as the sector should be a prime beneficiary of improved GDP growth, higher rates, and deregulation. We would also Overweight Health Care. Fears about prescription drug pricing regulations seem overblown, but this sector may lag early in the year if headline risks linger.

Canada

- We maintain our Overweight recommendation for Canadian equities. The outlook for key sectors is positive while increasing global adoption of fiscal stimulus could provide additional support for resources.
- Outperformance in 2016 has put bank valuations at a modest premium to historical levels. We remain comfortable in anticipation of a benign credit environment in the year ahead relative to 2016 noting that capital levels have strengthened. Moreover, we expect cost-containment initiatives to support earnings growth despite revenue headwinds.
- The rise in long-term interest rates has sparked corresponding outperformance in life insurance stocks. Valuations now sit roughly in line with historical levels. However, in the event the strong move in rates is sustained, current earnings estimates may be overly conservative. While life insurance stocks can at times suffer from a lack of earnings visibility, we like them for the protection they provide income-focused portfolios against rising rates.
- The accords struck by OPEC and certain non-OPEC countries to curb crude output by a targeted 1.8 million barrels per day should help accelerate the rebalancing of the global oil market and facilitate the drawdown of record inventory levels. We expect this will support crude oil prices

S&P Financials sector vs. the S&P 500 on a price-to-book valuation



U.S. Financials sector valuation is rising, but it's still below historical levels.

Source - RBC Wealth Management, Bloomberg; weekly data and provide a positive backdrop for producers seeking to resume upstream growth and reduce balance sheet leverage.

- We continue to question the sustainability of the strength in several base and bulk commodities as RBC Capital Markets believes many markets will remain oversupplied. Support for recent commodity price gains may depend on the magnitude of expected fiscal stimulus announcements in 2017 and the continuation of credit-fueled stimulus in China.

Continental Europe & U.K.

- We are Underweight both U.K. and European equities. In the U.K., we feel the tailwinds that helped lift equities in 2016 will soon subside. The British pound has stabilized, while emerging economies and oil prices, two factors that provided the U.K. with a boost due to its comparatively high exposure, look set to pause in the short term. Moreover, the defensive nature of the U.K. market, with its relatively high exposure to sectors such as Pharma, Utilities, and Telecoms, means it tends to underperform at times of rising bond yields.

- We continue to be wary of domestic sectors which will likely feel the pinch of the uncertainty regarding Brexit, and would focus on exporters exposed to the U.S. market.

- As for European equities, undemanding valuations and improving earnings momentum are tempting but we are wary of political risk and prefer other regions with a clearer outlook.

Asia

- After a rocky start, Chinese economic data was generally stable in 2016. Indeed, some major leading economic indicators have accelerated recently. The official services Purchasing Managers’ Index (PMI) reached its highest level since mid-2014. The manufacturing PMI is at its highest level since early 2012. Investors will have plenty to watch in 2017 including: China’s capital outflows, which have moderated but remain sizeable; U.S. policy with respect to China; whether regional property tightening measures will have broader ramifications; and the movement of the yuan.

- Chinese equities may get some support from the bond and property markets given elevated property prices and rising bond yields. The recovery of the industrial price index will continue to improve the profitability of some traditional industries, but it may also raise inflation beyond target levels.

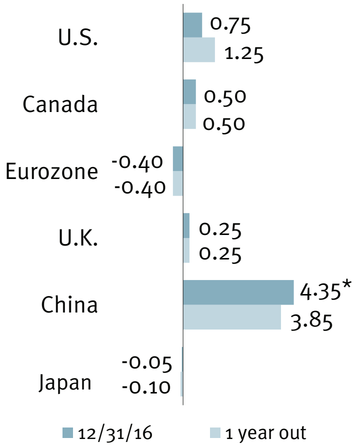
- RBC Capital Markets expects the yuan to continue to depreciate against the dollar in 2017 with a year-end target of USDCNY 7.50 (now: 6.95). It also forecasts the Singapore dollar to weaken to USDSGD 1.56, but for the Australian dollar to remain largely unchanged against the greenback.

- Investors have become more bullish once again on Japanese equities. The rise in commodity prices, a weaker yen, and the ever-tightening Japanese labour market should help inflation trends in 2017. Japanese stocks, still inexpensive relative to many major markets, rose by 22% in the second half of 2016 and should rise further if the yen remains weak due to significant operating leverage. Rising U.S. bond yields are negative for the yen. RBC Capital Markets expects the yen to weaken modestly in the first half of 2017.

Global fixed income

Resting before the next move

Central bank rate (%)



*1-yr base lending rate for working capital, PBoC
Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee, Consensus Economics

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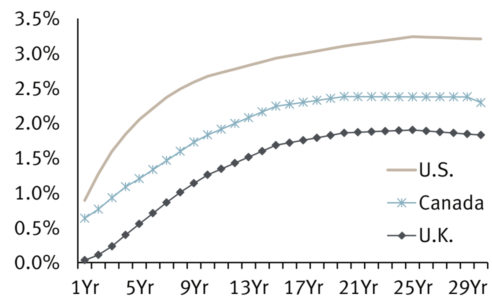
We expect global bond markets to be more stable this month after the sharp selloff that defined late 2016. Expectations for fiscal stimulus in the form of tax cuts and infrastructure spending in the U.S. are high, with investors focused on the first 100 days of President-elect Trump's administration. Should the scale and scope of fiscal stimulus that ultimately emerges fall short of expectations, bond yields will likely be flat to lower in January versus the end of 2016. This back-and-forth pattern could very well be what to expect for the next several months until markets have a better read on the scope of the new administration's proposals.

Yet, we think investors should condition themselves for an era of higher yields. We believe it's unlikely that the low yield levels reached in 2016 will be revisited this year and the likely trajectory for bond yields over the next 12 months is moderately higher. This view is based upon what we see as further stabilization in many global economies and a lessening of the deflationary fears that had gripped the markets through much of 2016. Nonetheless, the move to a new, higher range for bond yields is unlikely to be as disruptively abrupt as was the case in the last two months of 2016 since major global central banks are committed to continued monetary stimulus, or in the case of the Fed a gradual path to higher rates.

The sharp correction in the market has resulted in some changes in our views on positioning, most notably in Canada. We now advocate for investors in the Canadian market to add longer duration positions after having been reticent to make such a recommendation as recently as

Sovereign yield curves



Source - Bloomberg

November. And for both Canada and the U.S., even with the prospect of a modest move higher in yields from current levels, we believe entry points are too compelling for buy-and-hold investors to remain on the sidelines at the current time.

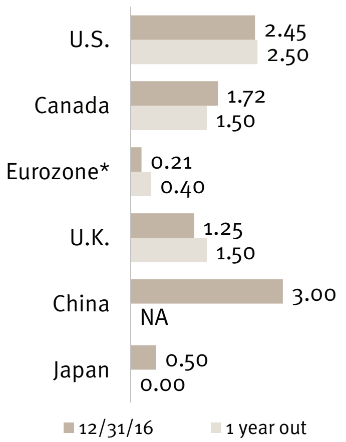
Regional highlights

United States

- Investors will likely have the Federal Reserve on the backburner this month on the heels of its rate hike in December. Attention will instead be focused on President-elect Trump's inauguration and his administration's plans for the first 100 days in office. The 75 basis points spike in 10-year Treasury yields since pre-election levels suggests lofty expectations with respect to impact on growth and inflation from proposed infrastructure spending and tax cuts. In our view, the realities of getting such legislation approved could be a challenge, and scaled-back compromises could provide the spark for a near-term rally in bonds before the upward trend in yields continues. RBC Capital Markets now expects the yield on the 10-year Treasury to end 2017 at 3.00% versus the 2.44% level it was at to finish 2016.

- Credit spreads tightened sharply in December in response to accelerating

10-year rate (%)



* Eurozone utilizes German Bunds
Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee

economic growth and declining recession risks. We believe spreads could continue to tighten and rally below the lows of 2014 thanks to a combination of fundamental and technical factors. Fundamentals are likely to improve thanks to earnings growth, while on the technical front a combination of corporate tax reform and repatriation of overseas cash could take some new bond supply out of the market in 2017. Tighter spreads should drive credit outperformance over Treasuries.

- Municipals bounced back strongly after the November rout, though fund outflows have now reached eight consecutive weeks. The market still provides some value, but we remain selective as concerns linger over the potential impact on the sector from tax policy changes under the Trump administration.

Canada

- We begin 2017 with a more-constructive view on long-term maturities than had been the case in recent months. A significant bond market selloff, set off in earnest by the outcome of the U.S. elections in early November, seems to have stabilized and left maturities in the 8-10 year part of the curve attractive for buy-and-hold investors.

- Market expectations for an interest rate cut by the Bank of Canada have evaporated and now a hike in 2017 is priced in as a much more likely event. While that may be premature, we also acknowledge that a dramatic shift in expectations has occurred in just two months. There is currently less than a 5% chance of an interest rate cut by the end of 2017, according to the futures market, which compares to a 20% probability of an expected cut by the middle of 2017 back in November 2016. The shift in expectations has less to do with domestic economic data, which has remained uneven, and more to do with expectations that U.S. growth and inflation will rise in 2017 in response to fiscal stimulus from the incoming government. Market expectations for a rate hike by the end of 2017 now stand at 35%, up from essentially zero in early November.

Continental Europe & U.K.

- In the U.K., we currently see value in the 5-7 year part of the curve as the market has stabilized after a global bond market selloff that began in early November. Weak economic data in December served as a reminder that fallout from the Brexit vote may still be working through the economy and could persist through 2017.

- The ECB continues its commitment to policy measures designed to boost eurozone inflation. The decision to extend asset purchases until at least December was expected, but it may not be the last of its stimulus as political risks on the horizon could hamper consumer and business confidence. We see risk to peripheral bond markets as we approach key national elections in Q1. Our current preference is for longer-dated core issuers as a result of this risk. Given the low yield environment, we recognize the scope for outright returns may be limited.

- The Italian banking crisis is the key story in European credit and it is likely to rumble on in 2017. We are some way off arriving at a sustainable bailout package that is well separated from the government. The uncertainty is unlikely to have significant contagion effect across the eurozone, but any wider selloff should be an opportunity to add exposure.

As good as gold

Commodity forecasts

	2017E	2018E
Oil (WTI $/bbl)	56.00	62.63
Natural Gas ($/mmBtu)	3.30	3.40
Gold ($/oz)	1,300	1,300
Copper ($/lb)	2.40	2.65
Corn ($/bu)	3.71	3.99
Wheat ($/bu)	4.39	4.95

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

Gold demonstrated its value as a portfolio diversifier amid economic uncertainty in the early part of 2016. More recently, a stronger outlook for the U.S. economy has improved investor confidence, reducing demand for safe-haven assets. In addition, rising U.S. interest rates have led to U.S. dollar strength, adding further pressure to gold prices.

Demand: For the first three quarters of 2016, demand for gold from various key sources declined with jewellery down 18% y/y, bar and coin down 13%, and central bank purchases down 34%.

During this period, jewellery demand fell by nearly half in India and by about one-quarter in China. In recent years, about 50% of global demand for physical gold (jewellery, bar, and coin) has come from these two nations. In addition to consumers facing higher prices, the Indian government introduced a 1% excise duty on gold imports, while in China reports have indicated the government has placed tighter restrictions on gold imports with decreased quotas and a slowdown in import licensing approvals.

Central bank purchases, which have been a source of strong demand for much of this decade, fell by about one-third for the first nine months of 2016 amid higher prices.

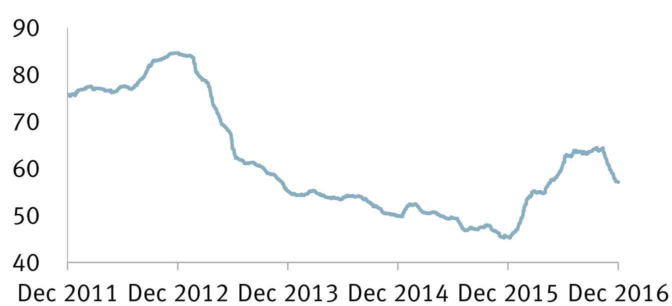
Supply: An environment of frugality amongst gold miners in recent years has resulted in significant cuts in capital investment. This has led to mine production plateauing since 2015 with a continuation of this trend expected by RBC Capital Markets for the year ahead.

Investment flows: Perhaps the most important driver of gold prices in the near term is the flow of investment dollars. Total gold exchange-traded fund (ETF) holdings rose markedly through the first half of 2016, but have declined sharply in recent months.

Gold "insurance policy": We continue to see a role for gold in client portfolios given its low correlation to bonds and equities. Low bond yields have reduced the traditional benefits of capital preservation and attractive income conferred to investors by fixed income. For equities, a long, multiyear run in U.S. stocks has pushed valuations above historical averages.

Finally, from a macroeconomic perspective, high government debt burdens and ultralow interest rate policies around the world have reduced the dry powder available to stimulate growth during the next recession. Gold offers investors a form of portfolio ballast against downside risks to the global economic outlook.

Gold ETF holdings (million troy ounces)



Ongoing outflow of investment funds remains a near-term risk to gold prices.

Source - RBC Wealth Management, Bloomberg

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Currencies

Currency forecasts

Currency pair	Current rate	Forecast Dec 2017	Change*
Major currencies			
USD Index	102.21	108.66	6%
CAD/USD	0.74	0.72	-2%
USD/CAD	1.34	1.38	3%
EUR/USD	1.05	0.96	-9%
GBP/USD	1.23	1.16	-6%
USD/CHF	1.02	1.13	11%
USD/JPY	116.96	110.00	-6%
AUD/USD	0.72	0.72	0%
NZD/USD	0.69	0.74	7%
EUR/JPY	122.97	106.00	-14%
EUR/GBP	0.85	0.83	-2%
EUR/CHF	1.07	1.08	1%
Emerging currencies			
USD/CNY	6.95	7.50	8%
USD/INR	67.92	73.00	7%
USD/SGD	1.45	1.56	8%
USD/PLN	4.19	4.45	6%

* Defined as the implied appreciation or depreciation of the first currency in the pair quote.
Examples of how to interpret data found in the Market Scorecard.
Source - RBC Capital Markets, Bloomberg

U.S. dollar

The election of Donald Trump as the next president of the U.S. has given our longstanding bullish view of the dollar a welcome and timely lift. Expected fiscal stimulus from the president-elect and the Republican-controlled Congress should boost U.S. GDP growth, inject some (healthy) inflation into the U.S. economy, and drive a faster pace of future Fed rate hikes. Indeed, the Federal Open Market Committee decision to hike rates in December was accompanied by a more-aggressive "dot plot," which has taken the Dollar Index to a multiyear high. We look for further dollar gains into 2017.

Euro

The European Central Bank (ECB) extended its quantitative easing (QE) programme until the end of 2017, at the same time announcing it will reduce the pace of monthly purchases by €20B to €60B, at the last Monetary Policy Committee meeting of 2016. With the ECB committed to QE at the same time as the U.S. is hiking rates, widening interest rate differentials should ensure the euro remains weak overall, and, as such, we maintain a bearish bias.

British pound

2017 promises to be an interesting year for the pound. With the U.K. government suggesting it will be triggering Article 50 early in the year, the formal "Brexit" process begins. We think this move will finally start to negatively affect the U.K. economy, which has held up pretty well since the referendum, and, as a consequence, the pound should struggle against this backdrop of ever-weakening economic activity. We remain bearish.

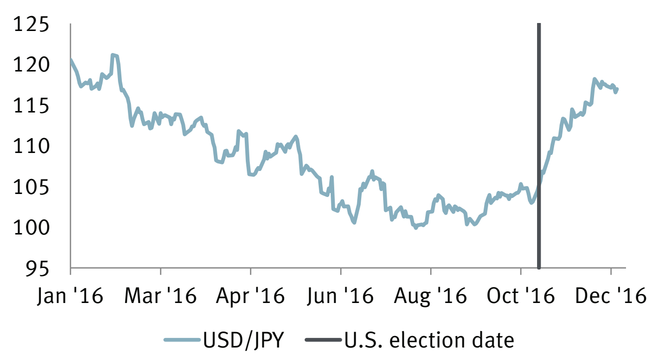
Canadian dollar

The prospect of rates rising faster than anticipated in the U.S. resulted in CAD/USD heading back to around the $0.74 level to end 2016. Prior to this move, the loonie had followed oil prices higher on the back of OPEC and non-OPEC nations agreeing on production cuts. With non-energy exports remaining weak, more protectionist U.S. policies in 2017 threatening U.S.-Canadian trade, and recent measures put in place to slow growth in the housing market, we would expect further weakness for CAD.

Japanese yen

The sharp rise in U.S. interest rates following the U.S. election caused the yen—the G10 currency most sensitive to U.S. interest rates—to sell off sharply, sending USD/JPY from 105 to as high as 118. Looking ahead into the start of 2017, we see scope for the yen to weaken further from here as the U.S. reflation story continues to underpin short-term U.S. interest rates.

USD/JPY on record-breaking rally following U.S. election



The yen remains highly sensitive to short-term U.S. rates.

Source - RBC Wealth Management, Bloomberg

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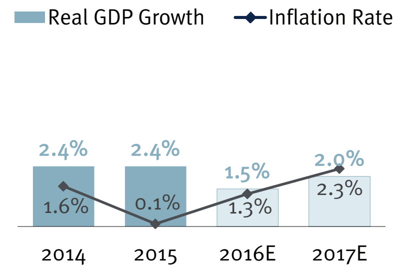
Key forecasts

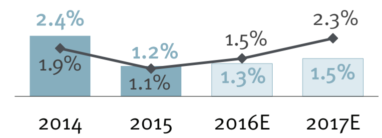
United States — sustained growth

- Q3 GDP growth rebounded to 2.4% as inventory liquidation abated. Mfg. PMI rose again in December, on a surge in new orders. Consumer and business confidence up sharply. Housing steady. Capex soft, but showing signs of bottoming. Q4 growth likely close to 3%. Leading indicators, confidence point to sustained domestic growth.



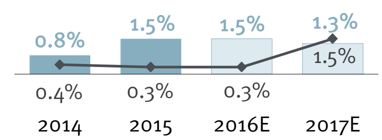
Canada — in transition

- Q3 growth rebounded to 3.5% as Fort McMurray effect fell out of the equation. House construction firm, PMI rose in December on new orders. Energy capex weak. Consumer attitude restrained by resource sector weakness/housing market uncertainty. Mfg. sales ex-petroleum products hanging in. Tourism very strong helped by weak loonie.



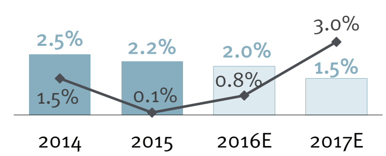
Eurozone — picking up

- Q3 growth steady at 1.6% y/y. Germany and Spain leading the way. France picked up, Italy lagging. Bank loans to private sector up year over year. PMIs improving again. Refugee crisis, fractious politics, Brexit, and upcoming elections weighing on sentiment. Tourism bookings down sharply. Italian banks keeping ECB ultraloose, euro soft. Full-year GDP growth steady in 2016, slipping modestly in 2017.



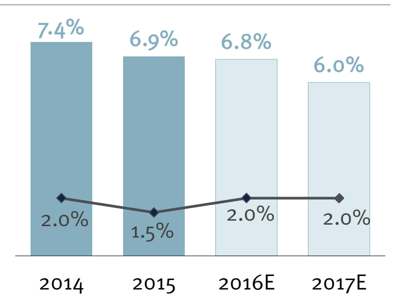
United Kingdom — period of adjustment

- PMIs, new orders have strengthened since the post-Brexit slump. Construction somewhat better. Unemployment and wage growth steady. Brexit drain more in evidence next year. Growth rate should ease moderately. Inflation surging with weak pound.



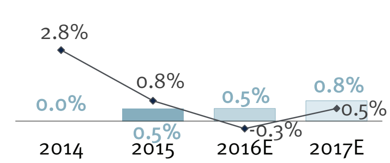
China — stabilizing

- Q3 growth steady at +6.7% y/y. Loans still growing faster than GDP. PMIs improved further in December. Employment, wages, retail sales, car registrations all growing. Exports somewhat better in December, industrial production steady. Fixed asset investment slowing. Currency weaker, capital outflows still a concern. House prices higher year over year in major centers.



Japan — weak growth, few catalysts

- GDP growth remained positive in Q3, for 3 quarters running. Leading indicators and PMIs improving. Corporate earnings solid, but business confidence weak. Wages growing (weakly). Household spending somewhat better. Stronger oil prices, weak currency putting inflation targets back within reach.



Source - RBC Investment Strategy Committee, RBC Capital Markets, Global Portfolio Advisory Committee

Market scorecard

Index (local currency)	Level	1 Month	YTD	12 Month
S&P 500	2,238.83	1.8%	9.5%	9.5%
Dow Industrials (DJIA)	19,762.60	3.3%	13.4%	13.4%
NASDAQ	5,383.12	1.1%	7.5%	7.5%
Russell 2000	1,357.13	2.6%	19.5%	19.5%
S&P/TSX Comp	15,287.59	1.4%	17.5%	17.5%
FTSE All-Share	3,873.22	4.9%	12.5%	12.5%
STOXX Europe 600	361.42	5.7%	-1.2%	-1.2%
German DAX	11,481.06	7.9%	6.9%	6.9%
Hang Seng	22,000.56	-3.5%	0.4%	0.4%
Shanghai Comp	3,103.64	-4.5%	-12.3%	-12.3%
Nikkei 225	19,114.37	4.4%	0.4%	0.4%
India Sensex	26,626.46	-0.1%	1.9%	1.9%
Singapore Straits Times	2,880.76	-0.8%	-0.1%	-0.1%
Brazil Ibovespa	60,227.29	-2.7%	38.9%	38.9%
Mexican Bolsa IPC	45,642.90	0.7%	6.2%	6.2%
Bond yields	**12/30/16**	**11/30/16**	**12/31/15**	**12 mo chg**
US 2-Yr Tsy	1.188%	1.113%	1.048%	0.14%
US 10-Yr Tsy	2.444%	2.381%	2.269%	0.17%
Canada 2-Yr	0.747%	0.703%	0.481%	0.27%
Canada 10-Yr	1.721%	1.585%	1.394%	0.33%
UK 2-Yr	0.084%	0.128%	0.651%	-0.57%
UK 10-Yr	1.239%	1.418%	1.960%	-0.72%
Germany 2-Yr	-0.766%	-0.727%	-0.345%	-0.42%
Germany 10-Yr	0.208%	0.275%	0.629%	-0.42%
Commodities (USD)	**Price**	**1 Month**	**YTD**	**12 Month**
Gold (spot $/oz)	1,152.27	-1.8%	8.6%	8.6%
Silver (spot $/oz)	15.92	-3.7%	14.9%	14.9%
Copper ($/metric ton)	5,523.00	-5.0%	17.4%	17.4%
Uranium ($/lb)	20.25	11.0%	-41.1%	-41.1%
Oil (WTI spot/bbl)	53.72	8.7%	45.0%	45.0%
Oil (Brent spot/bbl)	56.82	12.6%	52.4%	52.4%
Natural Gas ($/mmBtu)	3.72	11.1%	59.3%	59.3%
Agriculture Index	290.99	-1.1%	2.6%	2.6%
Currencies	**Rate**	**1 Month**	**YTD**	**12 Month**
US Dollar Index	102.21	0.7%	3.6%	3.6%
CAD/USD	0.74	0.0%	3.0%	3.0%
USD/CAD	1.34	0.0%	-2.9%	-2.9%
EUR/USD	1.05	-0.7%	-3.2%	-3.2%
GBP/USD	1.23	-1.3%	-16.3%	-16.3%
AUD/USD	0.72	-2.4%	-1.1%	-1.1%
USD/CHF	1.02	0.2%	1.7%	1.7%
USD/JPY	116.96	2.2%	-2.7%	-2.7%
EUR/JPY	122.97	1.5%	-5.9%	-5.9%
EUR/GBP	0.85	0.8%	15.8%	15.8%
EUR/CHF	1.07	-0.5%	-1.5%	-1.5%
USD/SGD	1.45	0.9%	2.0%	2.0%
USD/CNY	6.95	0.8%	6.9%	6.9%
USD/BRL	3.26	-3.9%	-17.8%	-17.8%

Canada led among major developed markets in 2016.

North American yields rose while European yields fell for the year.

After bottoming in February, crude oil rallied in eight of the last 12 months, including in December.

Brexit weighed heavily on the British pound.

Equity returns do not include dividends, except for the German DAX and Brazilian Ibovespa. Equity performance and bond yields in local currencies. U.S. Dollar Index measures USD vs. six major currencies. Currency rates reflect market convention (CAD/USD is the exception). Currency returns quoted in terms of the first currency in each pairing. Examples of how to interpret currency data: CAD/USD 0.74 means 1 Canadian dollar will buy 0.74 U.S. dollar. CAD/USD 3.0% return means the Canadian dollar has risen 3.0% vs. the U.S. dollar during the past 12 months. USD/JPY 116.96 means 1 U.S. dollar will buy 116.96 yen. USD/JPY -2.7% return means the U.S. dollar has fallen 2.7% vs. the yen during the past 12 months.

Source - RBC Wealth Management, RBC Capital Markets, Bloomberg; data through 12/30/16.

Research resources

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As of December 31, 2016

			Investment Banking Services Provided During Past 12 Months	
Rating	Count	Percent	Count	Percent
Buy [Top Pick & Outperform]	834	52.32	279	33.45
Hold [Sector Perform]	657	41.22	132	20.09
Sell [Underperform]	103	6.46	9	8.74

Distribution of Ratings
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