THE GLOBAL INVESTMENT OUTLOOK

RBC Investment Strategy Committee

SUMMER 2011
The RBC Investment Strategy Committee

The RBC Investment Strategy Committee consists of senior investment professionals drawn from individual client focused business units within RBC. 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*.
Executive Summary

The global economy continues to progress through the recovery phase of the business cycle. However, several storm fronts have rolled in, resulting in light turbulence that has modestly rerouted the global economy. These clouds include the devastating events in Japan, the ongoing disintegration of Eurozone finances, the lingering effects of high oil prices and a spate of disappointing economic data. Together, they have produced a mid-cycle gut check for financial markets. Despite the assemblage of mediocre and bad headlines, we steadfastly believe that the economic recovery is still proceeding. The vast majority of indicators confirm a continuation of the economic recovery, if a slightly less ebullient one.

Given recent adverse developments, it is perhaps not surprising that financial markets have recently lost their upward momentum. Figuring centrally in the market’s hesitant attitude, economic data has lost the bounce in its stride. Quite a number of measures have either had their upward progress arrested, or outright reversed, and forecasters have scrambled to adapt to this new, more cautious reality by lowering their global economic forecasts. Our economic forecasts of a quarter ago were already a hair softer than the consensus, and this modicum of caution has proven appropriate. Our forecasts for this quarter are only modestly downgraded.

**HEADWINDS CONTINUE TO EVOLVE**

There are still a number of headwinds that must be monitored closely. Some of these are showing signs of improvement (employment, credit growth), while others continue to bounce along the bottom (housing) or deteriorate (the sovereign debt crisis in Europe). To the list of headwinds, we should now add the beginning of tightening monetary conditions globally and the mounting fiscal pressures on governments. However, the key event that looms on the immediate horizon is the end of QE2. The Federal Reserve is set to end its second round of quantitative easing in June. Some fear that this could prompt a substantial correction, but we believe the outcome should be much more benign.

A more credible market worry is Europe’s deteriorating fiscal situation. The odds of a default are quite high for Greece, Ireland and Portugal. However, the effects of any European sovereign defaults need not be catastrophic. The main effect of sovereign defaults will be to slow European economic growth as banks focus on recapitalization, and as governments focus on austerity. In fact, most of the developed world is grappling with the same basic problem on a (hopefully) more manageable scale: how to rein in fiscal excesses while simultaneously nurturing economic growth.

**DOLLAR BEAR MARKET CONTINUES, FOR NOW**

The U.S. dollar bear market, in its 10th year, brought the ‘greenback’ to undervaluation extremes. A weaker economy, ever-delayed expectations of Fed rate hikes contrasted with earlier-than-expected tightening by the ECB, and worries about worsening fiscal deficits are some of the reasons behind the weakness. Looking ahead, however, the odds of a turn in the dollar over the next 12 months have increased. After all, the end of QE2 will stop Fed balance-sheet growth dead in its tracks and maximum dollar liquidity will have been reached by July 1. In addition, with Greek credit spreads at twice the levels of a year ago, and disagreements in Europe regarding the steps required to achieve a workable solution, the European crisis is worsening at a time when the euro is very overvalued. It is also quite possible that by late summer, economic data in the U.S. will be better than expected after downward forecast revisions make forecasts easier to beat, another potential positive for the dollar.

**INFLATION LIKELY TO REMAIN ELEVATED**

Global inflation continues its resurgence and is now approaching the highest level since the fall of 2008. While rising commodity prices are currently among the main drivers of inflation, the greatest threat relates to central-bank decision-making. Some central banks appear set to delay monetary...
tightening in an effort to guarantee sustainable growth, at the cost of an extra whiff of inflation in a few years time. Conversely, the most compelling argument that global inflation is unlikely to spiral out of control is the simple economic reality that most countries continue to grapple with billowing economic slack – an environment that is inhospitable to sustained inflation pressures. We believe that inflation will likely remain at elevated levels while the effect of higher commodity prices continues to trickle in, but that debilitating inflation is unlikely.

CLEAR DOWNSIDE LIMITS TO BOND YIELDS

Ultra-low policy rates and renewed growth concerns have allowed real rates to remain very low. We believe bond yields are already at the very bottom of the appropriate range, given our economic outlook. Rising policy rates are likely to force short-dated yields higher over the coming year. This will certainly vary on a country-by-country basis, with the Eurozone, U.K. and Canada liable to lead in the early going, and the U.S. catching up as 2012 unfolds.

Our expectation of rising long-term bond yields across developed markets is grounded in the belief that this mid-cycle slowdown in economic data is not a harbinger of another recession. We see clear limits to the downside potential for yields. Longer-dated bond yields should experience upward pressure from policy normalization, plus a further upward tilt in inflation expectations and the beginning of a gradual increase to reflect sovereign risk.

NEAR-TERM CHALLENGES FOR EQUITIES

Despite the recent reduction in our equity weight (details below), we remain overweight stocks for two reasons: reasonable valuations and ongoing profit growth. Equities remain below fair value in most developed nations despite huge returns since the market trough of two years ago. Earnings are also supportive, although year-over-year comparisons are becoming more demanding following two years of improving margins and accelerating revenues.

We see two near-term challenges for equity markets. The first is related to the somewhat optimistic expectations currently built into forward earnings estimates. To date, consensus estimates do not seem to have entirely incorporated the downward revisions to U.S. and global growth that have emerged. The second is uncertainty surrounding the imminent end of QE2. After several quarters of healthy growth, the bar for equity markets has been raised, and the ability of companies to beat expectations will become increasingly difficult.

REDUCED EXPOSURE TO STOCKS, BUT REMAIN OVERWEIGHT

Tracking the gradual normalization of the global economy and reflecting relative valuations, our asset mix continues to overweight equities and underweight bonds. Following the worst trailing 10-year returns for stocks relative to bonds, prospects for equities appear far superior to fixed-income markets. Nevertheless, various threats to the equity bull market appear to be growing in scale and number as we enter the summer months. Although our positive longer-term view for equities, and especially for stocks versus bonds, remains, it seems prudent to modify our risk profile until greater clarity appears. Therefore, we have lowered the exposure to stocks in our global balanced profile by 2.5% to 58.5%, with the proceeds directed towards cash. For a balanced global investor, our current recommended weight in equities of 58.5% is above our neutral weight of 55% (within an allowable range of 40% to 70%). We remain modestly underweight fixed income at 36.5% versus a neutral setting of 40% (allowable range 30% to 60%). The remaining 5% is allocated to cash.
## Economic & Capital Markets Forecasts

### Economic Forecast (RBC Investment Strategy Committee)

<table>
<thead>
<tr>
<th></th>
<th>United States</th>
<th>Canada</th>
<th>Europe</th>
<th>United Kingdom</th>
<th>Japan</th>
<th>China</th>
<th>Emerging Markets[^1]</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>REAL GDP</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2010A</td>
<td>2.90%</td>
<td>3.10%</td>
<td>1.70%</td>
<td>1.30%</td>
<td>4.00%</td>
<td>9.80%</td>
<td>8.50%</td>
</tr>
<tr>
<td>2011E</td>
<td>3.00% (0.25)</td>
<td>2.75%</td>
<td>0.25</td>
<td>1.50% N/C</td>
<td>0.75%</td>
<td>(0.75)</td>
<td>9.25% 0.25</td>
</tr>
<tr>
<td>2012E</td>
<td>3.25% 0.25</td>
<td>2.50%</td>
<td>N/C</td>
<td>1.50% (0.25)</td>
<td>2.25%</td>
<td>0.50</td>
<td>8.75% (0.15) 6.90% N/A</td>
</tr>
<tr>
<td><strong>CPI</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2010A</td>
<td>1.60%</td>
<td>1.80%</td>
<td>1.60%</td>
<td>3.30%</td>
<td>(0.80%)</td>
<td>3.20%</td>
<td>5.50%</td>
</tr>
<tr>
<td>2011E</td>
<td>3.00% 1.50</td>
<td>2.50%</td>
<td>0.50</td>
<td>4.00% 0.25</td>
<td>0.25%</td>
<td>0.50</td>
<td>5.00% (0.10) 5.80% N/A</td>
</tr>
<tr>
<td>2012E</td>
<td>2.00% N/C</td>
<td>2.00%</td>
<td>N/C</td>
<td>1.75% (0.25)</td>
<td>2.25%</td>
<td>(0.25)</td>
<td>4.50% (0.40) 4.90% N/A</td>
</tr>
</tbody>
</table>

[^1]: GDP Weighted Average of China, India, Brazil, Russia, South Korea and Mexico

### Targets (RBC Investment Strategy Committee)

<table>
<thead>
<tr>
<th></th>
<th>May 2011</th>
<th>Forecast May 2012</th>
<th>Change from Spring 2011</th>
<th>1-Year Total Return Estimate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Currency Markets Against USD</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>USD–CAD</td>
<td>0.97</td>
<td>1.02</td>
<td>(0.03)</td>
<td>(4.0)</td>
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<tr>
<td>EUR–USD</td>
<td>1.44</td>
<td>1.25</td>
<td>0.05</td>
<td>(12.0)</td>
</tr>
<tr>
<td>USD–JPY</td>
<td>81.50</td>
<td>90.00</td>
<td>(2.00)</td>
<td>(9.6)</td>
</tr>
<tr>
<td>GBP–USD</td>
<td>1.64</td>
<td>1.61</td>
<td>0.01</td>
<td>(1.1)</td>
</tr>
<tr>
<td><strong>Fixed Income Markets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S. Fed Funds Rate</td>
<td>0.25</td>
<td>0.50</td>
<td>(0.25)</td>
<td>0.4</td>
</tr>
<tr>
<td>U.S. 10 Year Bond</td>
<td>3.07</td>
<td>4.00</td>
<td>N/C</td>
<td>(1.1)</td>
</tr>
<tr>
<td>Canada Overnight Rate</td>
<td>1.00</td>
<td>2.25</td>
<td>0.25</td>
<td>1.6</td>
</tr>
<tr>
<td>Canada 10 Year Bond</td>
<td>3.07</td>
<td>3.90</td>
<td>0.15</td>
<td>(1.5)</td>
</tr>
<tr>
<td>Eurozone Policy Rate</td>
<td>1.25</td>
<td>1.75</td>
<td>0.25</td>
<td>1.4</td>
</tr>
<tr>
<td>Eurozone 10 Year Bond[^*]</td>
<td>3.02</td>
<td>3.90</td>
<td>(0.35)</td>
<td>(2.4)</td>
</tr>
<tr>
<td>U.K. Base Rate</td>
<td>0.50</td>
<td>1.25</td>
<td>N/C</td>
<td>0.9</td>
</tr>
<tr>
<td>U.K. 10 Year Gilt</td>
<td>3.29</td>
<td>4.10</td>
<td>(0.15)</td>
<td>(0.8)</td>
</tr>
<tr>
<td>Japan Overnight Call Rate</td>
<td>0.10</td>
<td>0.10</td>
<td>N/C</td>
<td>0.1</td>
</tr>
<tr>
<td>Japan 10 Year Bond</td>
<td>1.16</td>
<td>1.75</td>
<td>N/C</td>
<td>(1.8)</td>
</tr>
<tr>
<td><strong>Equity Markets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>1345</td>
<td>1450</td>
<td>25</td>
<td>9.7</td>
</tr>
<tr>
<td>S&amp;P/TSX Composite</td>
<td>13803</td>
<td>14500</td>
<td>(350)</td>
<td>7.5</td>
</tr>
<tr>
<td>MSCI Europe</td>
<td>1588</td>
<td>1725</td>
<td>75</td>
<td>12.4</td>
</tr>
<tr>
<td>FTSE 100</td>
<td>5990</td>
<td>6425</td>
<td>25</td>
<td>10.5</td>
</tr>
<tr>
<td>Nikkei</td>
<td>9694</td>
<td>11000</td>
<td>(350)</td>
<td>15.4</td>
</tr>
</tbody>
</table>

[^*]: GDP Weighted average of Germany, France and Italy

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 income 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.

This tactical recommendation for the Balanced profile can serve as a guide for movement within the ranges allowed for all other profiles.

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**GLOBAL ASSET MIX**

<table>
<thead>
<tr>
<th>BENCHMARK POLICY</th>
<th>CASH</th>
<th>BONDS</th>
<th>STOCKS</th>
</tr>
</thead>
<tbody>
<tr>
<td>PAST RANGE</td>
<td>5.0%</td>
<td>40.0%</td>
<td>55.0%</td>
</tr>
<tr>
<td>SUMMER 2010</td>
<td>1.5% – 16%</td>
<td>25% – 54%</td>
<td>36% – 65%</td>
</tr>
<tr>
<td>FALL 2010</td>
<td>7.5%</td>
<td>35.0%</td>
<td>57.5%</td>
</tr>
<tr>
<td>NEW YEAR 2011</td>
<td>5.0%</td>
<td>35.0%</td>
<td>60.0%</td>
</tr>
<tr>
<td>SPRING 2011</td>
<td>2.5%</td>
<td>37.5%</td>
<td>60.0%</td>
</tr>
<tr>
<td>SUMMER 2011</td>
<td>2.5%</td>
<td>37.5%</td>
<td>60.0%</td>
</tr>
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</table>

**REGIONAL ALLOCATION**

<table>
<thead>
<tr>
<th>GLOBAL BONDS</th>
<th>CWGBI* MAY 2011</th>
<th>PAST RANGE</th>
<th>SUMMER 2010</th>
<th>FALL 2010</th>
<th>NEW YEAR 2011</th>
<th>SPRING 2011</th>
<th>SUMMER 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>30.1%</td>
<td>9% – 46%</td>
<td>25.0%</td>
<td>31.5%</td>
<td>33.9%</td>
<td>33.7%</td>
<td>35.1%</td>
</tr>
<tr>
<td>Europe</td>
<td>38.8%</td>
<td>40% – 90%</td>
<td>41.0%</td>
<td>38.0%</td>
<td>32.7%</td>
<td>32.4%</td>
<td>35.8%</td>
</tr>
<tr>
<td>Asia</td>
<td>31.0%</td>
<td>0% – 29%</td>
<td>34.0%</td>
<td>36.0%</td>
<td>33.4%</td>
<td>33.9%</td>
<td>29.0%</td>
</tr>
</tbody>
</table>

Note: Based on anticipated 12-month returns in $US hedged basis

<table>
<thead>
<tr>
<th>GLOBAL EQUITIES</th>
<th>MSCI** MAY 2011</th>
<th>PAST RANGE</th>
<th>SUMMER 2010</th>
<th>FALL 2010</th>
<th>NEW YEAR 2011</th>
<th>SPRING 2011</th>
<th>SUMMER 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>North America</td>
<td>54.3%</td>
<td>15% – 60%</td>
<td>57.0%</td>
<td>55.0%</td>
<td>54.5%</td>
<td>55.5%</td>
<td>55.5%</td>
</tr>
<tr>
<td>Europe</td>
<td>27.0%</td>
<td>30% – 70%</td>
<td>27.2%</td>
<td>30.0%</td>
<td>30.5%</td>
<td>29.5%</td>
<td>27.0%</td>
</tr>
<tr>
<td>Asia</td>
<td>13.3%</td>
<td>10% – 39%</td>
<td>15.8%</td>
<td>15.0%</td>
<td>15.0%</td>
<td>15.0%</td>
<td>12.0%</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>5.4%</td>
<td>N/A</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>5.5%</td>
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</table>

**GLOBAL EQUITY SECTOR ALLOCATION**

<table>
<thead>
<tr>
<th>MSCI** MAY 2011</th>
<th>RBC ISC SPRING 2011</th>
<th>RBC ISC SUMMER 2011</th>
<th>CHANGE FROM SPRING 2011</th>
<th>WEIGHT vs. BENCHMARK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Energy</td>
<td>11.39%</td>
<td>12.25%</td>
<td>11.40%</td>
<td>(0.85)</td>
</tr>
<tr>
<td>Materials</td>
<td>8.03%</td>
<td>8.75%</td>
<td>8.00%</td>
<td>(0.75)</td>
</tr>
<tr>
<td>Industrials</td>
<td>11.51%</td>
<td>12.75%</td>
<td>12.50%</td>
<td>(0.25)</td>
</tr>
<tr>
<td>Consumer Discretionary</td>
<td>10.32%</td>
<td>10.75%</td>
<td>11.30%</td>
<td>0.55</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>9.76%</td>
<td>8.00%</td>
<td>9.25%</td>
<td>1.25</td>
</tr>
<tr>
<td>Health Care</td>
<td>9.55%</td>
<td>8.00%</td>
<td>9.50%</td>
<td>1.50</td>
</tr>
<tr>
<td>Financials</td>
<td>20.02%</td>
<td>20.00%</td>
<td>19.00%</td>
<td>(1.00)</td>
</tr>
<tr>
<td>Information Technology</td>
<td>11.36%</td>
<td>13.25%</td>
<td>11.50%</td>
<td>(1.75)</td>
</tr>
<tr>
<td>Telecom. Services</td>
<td>4.22%</td>
<td>3.75%</td>
<td>4.25%</td>
<td>0.50</td>
</tr>
<tr>
<td>Utilities</td>
<td>3.84%</td>
<td>2.50%</td>
<td>3.30%</td>
<td>0.80</td>
</tr>
</tbody>
</table>

*Citigroup World Global Bond Index **MSCI World Index  
Source: RBC Investment Strategy Committee

Continued on next page...
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 Income 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 are, of course, dependent on the degree to which the expected scenario unfolds.

Regular review of portfolio weights is an essential part of the ultimate success of an investment plan as it ensures that current exposures are aligned with the level 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 a discipline that can limit the 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 1973 – 2010, 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.
## BALANCED

<table>
<thead>
<tr>
<th>ASSET CLASS</th>
<th>BENCHMARK</th>
<th>RANGE</th>
<th>LAST QUARTER</th>
<th>CURRENT RECOMMENDATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASH &amp; CASH EQUIVALENTS</td>
<td>5%</td>
<td>0-15%</td>
<td>2.5%</td>
<td>5.0%</td>
</tr>
<tr>
<td>FIXED INCOME</td>
<td>40%</td>
<td>20-60%</td>
<td>37.5%</td>
<td>36.5%</td>
</tr>
<tr>
<td>TOTAL CASH &amp; FIXED INCOME</td>
<td>45%</td>
<td>30-60%</td>
<td>40.0%</td>
<td>41.5%</td>
</tr>
<tr>
<td>CANADIAN EQUITIES</td>
<td>20%</td>
<td>10-30%</td>
<td>21.8%</td>
<td>21.2%</td>
</tr>
<tr>
<td>U.S. EQUITIES</td>
<td>20%</td>
<td>10-30%</td>
<td>22.2%</td>
<td>21.8%</td>
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<tr>
<td>INTERNATIONAL EQUITIES</td>
<td>15%</td>
<td>5-25%</td>
<td>16.0%</td>
<td>15.5%</td>
</tr>
<tr>
<td>TOTAL EQUITIES</td>
<td>55%</td>
<td>40-70%</td>
<td>60.0%</td>
<td>58.5%</td>
</tr>
</tbody>
</table>

**RETURN VOLATILITY**

| 35-YEAR AVERAGE | 10.0% | 8.9% |
| LAST 12 MONTHS  | 13.2% | 4.6% |

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

<table>
<thead>
<tr>
<th>ASSET CLASS</th>
<th>BENCHMARK</th>
<th>RANGE</th>
<th>LAST QUARTER</th>
<th>CURRENT RECOMMENDATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASH &amp; CASH EQUIVALENTS</td>
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<td>0-15%</td>
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<tr>
<td>FIXED INCOME</td>
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<tr>
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<tr>
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</tbody>
</table>

**RETURN VOLATILITY**

| 35-YEAR AVERAGE | 10.1% | 11.1% |
| LAST 12 MONTHS  | 15.1% | 6.0%  |

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

<table>
<thead>
<tr>
<th>ASSET CLASS</th>
<th>BENCHMARK</th>
<th>RANGE</th>
<th>LAST QUARTER</th>
<th>CURRENT RECOMMENDATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASH &amp; CASH EQUIVALENTS</td>
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<td>0-15%</td>
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</tr>
<tr>
<td>FIXED INCOME</td>
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<td>0.0%</td>
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<tr>
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<td>0-20%</td>
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<td>2.5%</td>
</tr>
<tr>
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<tr>
<td>U.S. EQUITIES</td>
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<td>15-45%</td>
<td>31.6%</td>
<td>31.9%</td>
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<tr>
<td>INTERNATIONAL EQUITIES</td>
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<tr>
<td>TOTAL EQUITIES</td>
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<td>80-100%</td>
<td>98.0%</td>
<td>97.5%</td>
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</table>

**RETURN VOLATILITY**

| 35-YEAR AVERAGE | 10.3% | 13.7% |
| LAST 12 MONTHS  | 18.5% | 8.7%  |

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).
Between March 1, 2011, and May 31, 2011, the U.S. dollar fell modestly against the euro, the yen, the pound and the Canadian dollar. During the period, the dollar lost 4.1% against the euro, 1.2% against the pound, and 0.3% against both the yen and the Canadian dollar. In the latest 12 months, the greenback dropped 14.5% versus the euro, 11.6% against the pound and 7.1% versus the Canadian dollar. All major fixed-income markets rose in the latest quarter, largely because of the impact of a depreciating greenback on U.S.-dollar returns. European bonds performed best. U.S. bonds, measured by the Barclays Capital Aggregate Bond Index, were the second best performers, followed by Canada, as measured by the DEX Universe Bond Index in Canadian dollars. Specifically, the Citigroup World Government Bond Index gained 3.5% in U.S. dollar terms, while European bonds returned 4.8%, measured by the Citigroup Europe Bond Index. It was the second quarter in a row that European bonds gained more than 4%. The Canadian fixed income market returned 2.4%, and Japanese bonds returned 1.3% based on the Citigroup Japan Bond Index. During the 12 months ended May 31, 2011, European fixed income gained 3.5% in U.S. dollar terms, while European bonds returned 4.8%, measured by the Citigroup Europe Bond Index. It was the second quarter in a row that European bonds gained more than 4%. The Canadian fixed income market returned 2.4%, and Japanese bonds returned 1.3% based on the Citigroup Japan Bond Index.

Japan following the mid-March earthquake, which ranked among the worst natural disasters in decades. Canadian equity markets recorded modest losses, hurt by concern about the sustainability of global growth. The S&P/TSX Composite Index lost 1.8% in the three-month period, while gaining 20.4% in the 12-month period ended May 31, 2011. The Canadian Small-Cap Index declined 1.4% over the three-month period and gained 33.6% over 12 months, boosted by exposure to natural-resource producers. Strong corporate earnings helped lead the S&P 500 Index to a gain of 1.8% in the recent three months, and a 26.0% return over the 12-month period. The period between March 1, 2011, and May 31, 2011, was better for U.S. mid- and small-cap stocks. The S&P 400 Index, a performance measure for the mid-cap market, returned 3.8% over the three-month period, while the S&P 600 Index, a gauge of small-cap performance, gained 4.7%. In the 12 months ended May 31, 2011, the S&P 400 rose 33.0%, and the S&P 600 returned 29.7%. Over the past three months, the Russell 3000 Growth Index returned 2.6%, compared with a 1.9% return for the Russell 3000 Value Index. On a one-year basis, the Russell growth-
oriented index outperformed its value counterpart, with the growth index gaining 30.0%, compared with a 24.1% return for the value index.

During the latest three-month period, the best-performing equity markets in developed countries outside North America were the MSCI France and MSCI Germany, both of which returned 3.8% in U.S. dollar terms. The MSCI U.K. gained 2.2% and MSCI Japan lost 10.3%, as the earthquake interfered with global supply chains and resulted in a big drop in domestic consumption. The MSCI World Index returned 1.1% in the three months, while the MSCI Emerging Markets Index climbed 6.3% as tighter monetary policies in key economies spurred optimism that inflationary pressures might be controlled. In the 12-month period, the MSCI Germany led all major markets with a gain of 42.7%, as the country’s exporters benefited disproportionately from a weakening euro. The MSCI France gained 39.1%, and the MSCI U.K. rose 35%. The MSCI Emerging Markets Index gained 28.8% over the 12-month period.

Six of the 10 global equity sectors posted increases in the latest three months, led by a 10.6% gain for the Health Care sector. Next were two more defensive sectors, Consumer Staples, which gained 9.3%, and Telecommunication Services, which had a 4.3% return. The worst-performing sector was Financials, which lost 3.5%. The Utilities and Information Technology sectors were also drags on performance, with drops of 2.5% and 2.2%, respectively.
Several storm fronts have rolled in, resulting in light turbulence that has modestly rerouted the global economy. White knuckles and green faces have mostly been avoided (Exhibit 1), and yet the admonishment to “fasten your seatbelts” would be well heeded.

These clouds include Japan’s devastating earthquake-tsunami-nuclear meltdown combination, the ongoing disintegration of Eurozone finances, the lingering effects of high oil prices and a spate of disappointing economic data. Together, they have produced a mid-cycle gut check for financial markets.

Despite this, we continue to believe that the global economy remains en route to a self-sustaining economic recovery. Such transitions are common to most expansions. Recoveries usually experience a loss of momentum as the early-stage rebound morphs into a more modest longer-term expansion. Investors often mistake these periods for a turn back to recession. This is especially true today, since memories of the epic recession are still fresh and since Europe and Japan continue to capture the spotlight with severe challenges of their own. With the trendline pace of growth today estimated to be about a percentage point lower than in the past due to elevated government debt levels, any deceleration in growth, however transitory, brings us that much closer to stagnation.

In recent weeks, markets have been adjusting to this new climate of modestly slower growth at a time when peak monetary stimulus is about to slip into the past. We expect that this period of weakness may well persist into the summer. In early June, we reduced our exposure to equities to a 58.5% weighting in global balanced portfolios, from 61% previously (and vs. a 55% “neutral” weight). As the market continues to adjust, we anticipate that better buying opportunities will present themselves in the months ahead.

Looking beyond the next few months, we continue to believe the U.S. and Canadian economies will avoid falling back into recession. Legacy issues from the credit crisis will continue to fade in importance. Company earnings will continue to rise, and over time positive earnings growth should help draw equities to the midpoint of their valuation bands. So while passengers may emerge from the gate a touch later and a tad more rumpled than expected, once they retrieve their
luggage they will find they are not materially worse for the wear.

**MARKET REVERSALS**

Given these developments, it is perhaps not surprising that financial markets have recently lost their upward momentum. Equity performance has been mixed, with the S&P 500 effectively unchanged from the end of last quarter. This tranquility masked two things. First, there was considerable intra-quarter volatility, with a large 8% range between the high and low. Second, this flat outcome was disappointing in the context of the prior two quarters, both of which managed impressive 12% gains (Exhibit 2).

It was much the same for oil prices and fixed-income markets. A mid-quarter oil-price spike has lately been unwound, dropping oil back to the vicinity of $100 per barrel. The yield on the U.S. 10-year Treasury bond shed a substantial 30 basis points over the quarter, and now sits near 3.00%.

**DOWNWARD DATA TRACKING**

Figuring centrally in the market’s hesitant attitude, economic data has lost the bounce in its stride. Quite a number of measures have either had their upward progress arrested, or outright reversed. (Exhibit 3).

The extent of this recalibration has caught the market flat-footed, as demonstrated by “surprise indices” that track the gap between expectations and reality. Whereas reality regularly trumped expectations from October 2010 through March 2011, the reverse is now true (Exhibit 4).

Forecasts have scrambled to adapt to this new, more cautious reality by lowering their global economic forecasts. The consensus has sliced a third of a percentage point off 2011 global GDP growth, and added 0.6 percentage point to the inflation outlook, due mainly to additional pressures caused by rising commodity prices.

Regionally, a disproportionate share of the downgrade has occurred in Asia, largely because of the Japanese disaster. But North America has also lost a bit of shine, primarily as a result of the lagged effect of higher oil prices. European expectations were cautious to begin with and so have not suffered a significant downgrade, and yet the risks are skewed to the negative.

**OUR FORECAST**

The RBC GAM economic forecasts of a quarter ago were already a hair softer than the consensus, and this modicum of caution has proven appropriate. Even still, the
out-of-the-blue nature of Japan’s woes and the evident drag on the U.S. from higher commodity prices has prompted some minor nipping and tucking to our own forecast, amounting to a little less than a quarter-percentage-point decrease in the global GDP outlook, and a sizeable boost to the 2011 CPI forecast (leaving that metric a touch above the market consensus). On an absolute basis, the expected economic performance is still not bad.

**BUSINESS CYCLE WOBBLES FORWARD**

Despite the assemblage of mediocre and bad headlines, we steadfastly believe that the economic recovery is still proceeding. The vast majority of economic indicators confirm a continuation of the economic recovery, if a slightly less ebullient one. It bears repeating that this diminished outlook is one part natural disaster (and thus temporary), one part commodity shock (already partially in retreat), and one part a function of the idiosyncrasies of this particular recovery.

On this last subject, there is value in better understanding the nature of this oblong business cycle. Historically, the rate of economic growth settles down after the first few years of post-recession advancement, shifting from the rip-roaring recovery phase to a more sedate expansion phase. Framed in this way, the recent deceleration seems natural.

However, the U.S. economy opened up so much slack during the bad times of this cycle that it could easily continue growing at a rapid rate for several more years without encountering the usual set of capacity constraints or inflationary implications (Exhibit 5). By this logic, the business cycle should be capable of remaining locked in the normally rollicking recovery phase for several more years.

Why, then, has growth slowed? The reason is that, this time around, there are additional factors tapping the brakes on growth. The banking sector continues to recapitalize and to behave in a generally cautious fashion, which has contributed to constrained credit growth – a central enabler of economic growth. Households are gingerly deleveraging themselves of excessive debt, putting more money in the bank and less in shop tills. Many workers have been unemployed for so long that their skill-set has eroded, diminishing their employability (Exhibit 6). Others were employed in a bloated construction sector that has
since gone on a diet (Exhibit 7). Eventually, fiscal woes may impose a tax on economic growth in the form of higher borrowing costs. These factors add up to slower-than-usual growth.

In turn, while the economy should remain in the recovery phase for some time longer, it may lack the normal sweetness since it will be an unusually sedate recovery. A more muted set of market outcomes should extend from this.

**QE2 AFTERMATH**

On U.S. shores, one event above all others looms on the immediate horizon. The Federal Reserve is set to end its second round of quantitative easing (QE2) in June. The Fed’s decision to abruptly stop buying virtually the entire $90 billion net supply of U.S. Treasuries each month will leave quite a void, and some fear it could prompt a substantial correction.

We believe the outcome should be much more benign for several reasons. First, financial markets are forward-looking, and so can hardly claim surprise when the program finally ends. Second, the Fed understands that asset-price appreciation has been a main goal of QE2 and will be reluctant to do anything that would permit this progress to be lost. Third, the level of monetary stimulus does not begin falling in July—it simply peaks then. Fourth, the historical record shows that markets usually do fine as they come out of quantitative easing, or, for that matter, commence conventional tightening. Fifth, demand in the bond market is highly elastic, meaning that only a small increase in yield will be necessary to attract sufficient buyers.

**EUROPEAN FISCAL WOES**

A more credible market worry is Europe’s deteriorating fiscal situation. The latest Eurostat revisions show, once again, that budget deficits are bigger and debt loads heavier than previously imagined.

The question now is whether these countries can work themselves out from under their debts and deficits. In the cases of Greece, Ireland and Portugal, it is not at all clear that they can. Markets have rendered their judgment, concluding that the odds of default are rather high (Exhibit 8). The political will to tackle the fiscal excesses has so far been commendable, but it is starting to crumble, with a variety of incompatible proposals currently on the table and increasingly harsh...
recriminations. And the fiscal math is distinctly unfriendly: it is hard to find a path back to sustainability for any of these three countries. This motivates our belief that the odds of default are quite high for all three, ranging from 80% for Greece to 60% for Ireland and Portugal (Exhibit 9). The most likely time for a default is 2012 to give banks extra time to recapitalize. But, really, capitulation is possible any time between now and 2013. Lately there has been talk of a voluntary rollover of maturing debt, which constitutes a technical default. We suspect even this will prove inadequate to resolve the broader problems.

Countries almost never repudiate all of their sovereign debt because they must not anger markets so much that they are shut out from future borrowing, and because large writedowns are also damaging for domestic investors and institutions. And yet they must reduce their debt burden to a level that is sustainable. The appropriate writedown is likely to be in the 40%-60% range for these countries, implying a €315 billion default that would be the largest in history – bigger even than Argentina in 2001 and Lehman Brothers in 2008 (Exhibit 10).

The main effect of sovereign defaults will be to slow European economic growth as banks focus on recapitalization instead of lending, and as governments focus on austerity. Stirring this into our economic forecasts, it paints the Eurozone in a much dimmer light. GDP gains are unlikely to exceed 1.50% in either 2011 or 2012, and even this is only achievable because monetary policy will remain stimulative for some time. Of course, this tepid economic growth rate will mask a significant underlying divergence between the likes of Germany, which enjoys good prospects, and heavily indebted nations that will continue their flirtation with recession (Exhibit 11). The European Central Bank seems inclined toward more rate hikes, even though the economic and inflationary backdrop hardly demand it. While the ECB deserves commendation for its commitment to applying Germanic principles to European monetary policy, it is questionable whether policy should be conducted solely in the

| EXHIBIT 9. Greece Most Likely to Tumble, and Most Costly |
|---------------------|---------------------|---------------------|
|                     | Probability of Default | Expected Writedown   |
| Greece              | 0.8                  | 0.6                  |
| Ireland             | 0.6                  | 0.4                  |
| Portugal            | 0.6                  | 0.4                  |

Source: RBC GAM

| EXHIBIT 10. Europe on Track for Biggest Writedowns in History |
|----------------------|----------------------|----------------------|
|                     | Record corporate default | Record sovereign default |
| Portugal             | 65                    | 60                    |
| Ireland              | 60                    | 190                   |
| Greece               | 190                   | 80                    |
|                      | 80                    | 70                    |

Source: RBC GAM
German interest, as it now seems to be. The silver lining is that rates are sufficiently low that policy will remain stimulative for some time, despite this tightening (Exhibit 12).

Eurozone inflation should peak at 2.50% in 2011 before economic weakness pulls it back down to 1.75% in 2012. A disappointing economic picture should also enable the euro to soften substantially over the coming year. What might make a bad situation worse? One scenario would be a European bank failure because this could trigger a domino of failures, risk a market freeze and severely damage the ECB’s finances. A second problematic scenario would be if Spain’s fiscal position also became unsustainable. We have good reason to think this can be avoided given the country’s markedly superior fiscal positioning, but it is not impossible.

COMMON FISCAL CHALLENGES

Fiscal worries are hardly isolated to Europe, of course. Most of the developed world is grappling with the same basic problem on a (hopefully) more manageable scale: how to rein in fiscal excesses while simultaneously nurturing economic growth.

Different countries have responded to the challenge with different tactics. The U.S., for instance, is boldly calling the bond market’s bluff and pursuing another year or two of robust economic growth before the scrimping begins. By contrast, the aforementioned Eurozone has been forced into harsh austerity measures at the insistence of the bond market. The U.K. finds itself somewhere in the middle of the spectrum. The British bond market has not yet demanded austerity, but the U.K. has opted for it nonetheless in an effort to rebalance conditions as rapidly as possible. For those countries that choose to ignore their fiscal well-being, the bond market may eventually exact its revenge via higher borrowing costs.

At risk of being lost in the fuss over federal debt, second-tier governments and municipalities are also suffering financial shortfalls.

This problem is particularly acute in the U.S., where both levels have endured significant revenue shortfalls for the same reasons as the federal government. However, according to conventional measures, most U.S. states and municipalities do not actually have heavy debt burdens. For instance, both California and Illinois have debt-to-GDP ratios of just 18%. The greater challenge is often underfunded pension plans and the shackles of balanced-budget amendments that preclude deficits or bond...
issuance, and thus demand harsh austerity measures that can make a precarious situation worse.

**JAPAN’S DISASTER**

In mid-March, Japan was struck by a succession of disasters. First came a 9.0-magnitude earthquake – the biggest in Japanese history. This unleashed an enormous tsunami, and the combination of the two damaged several nuclear power plants, resulting in significant radiation releases in the surrounding region. The trio of events constitutes a human tragedy first and foremost, resulting in the loss of 20,000 lives.

Inevitably, the disasters have had an effect on the Japanese economy. In contrast to the 1995 Kobe earthquake, the 2011 quake has clearly subtracted from near-term economic growth due to production outages and supply-chain disruptions. We estimate that Japanese GDP may grow by just 0.75% in 2011, half our prior forecast. But it is important to recognize that this drop in output is likely just deferring a production boom spurred by rebuilding. Reconstruction should offset this year’s lost production, permitting higher 2012 GDP growth of 2.25%.

Lingering supply-chain issues in the auto and electronics industries should be mostly resolved within the next few months, and production is likely to go into overdrive as the effort to rebuild inventories and capture delayed consumption from the first half of 2011 ramps up.

The long-term consequences of the disasters can better be captured in a balance-sheet context than via GDP. The cost of the disasters is likely to total around $250 billion, an enormous sum, and awful timing given already strained finances. And yet this does not seriously compromise Japan’s net wealth of $30 trillion. In fact, the recurring lesson of natural disasters is that they do not ordinarily leave long-term legacies.

Contemplating Japan more broadly, we are less pessimistic than many. Japan’s economy over the past two decades has enjoyed the fastest rate of productivity growth in the G7 (Exhibit 13), suggesting that the real Japanese problem is demographic (an aging population), not economic. Japan’s fiscal position is frightening on the surface, but the reality is that Japanese government debt is owned almost exclusively by the Japanese public. Japan as a whole – governments, businesses and households combined – are actually the world’s biggest net lenders. Thus, righting Japan’s fiscal problems is a domestic matter, and one that therefore stands a decent chance of success.

Given the absence of inflation (we forecast CPI at 0.25% in 2011 and 0.50% in 2012), the Bank of Japan is unlikely to raise rates any time soon, keeping them at a rock-bottom 0.10% (Exhibit 14). The yen remains strong, near the 80-yen-per-dollar level. Earlier actions demonstrate that international monetary authorities are willing to intervene should it appreciate much beyond this threshold. This suggests that a weaker yen is the odds-on bet.

**EXHIBIT 13. Japanese Productivity Growth Actually Compared Well to G7 During “Malaise” Era**

<table>
<thead>
<tr>
<th>Country</th>
<th>Labour Productivity Growth, Annualized 1990-2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>2.0</td>
</tr>
<tr>
<td>U.K.</td>
<td>2.0</td>
</tr>
<tr>
<td>U.S.</td>
<td>1.9</td>
</tr>
<tr>
<td>Germany</td>
<td>1.7</td>
</tr>
<tr>
<td>France</td>
<td>1.3</td>
</tr>
<tr>
<td>Canada</td>
<td>1.3</td>
</tr>
<tr>
<td>Italy</td>
<td>0.7</td>
</tr>
</tbody>
</table>

Source: OECD, RBC GAM

**ARAB SPRING**

The Middle East and North Africa continue to experience a drawn-out democratic awakening. Tunisia came first, and was followed by Egypt. Now a battle is being waged over the fate of Libya, with further turmoil in Yemen and Syria. Bahrain appears to have cooled somewhat.

From a global perspective, the main market effect of these actions is...
the withdrawal of Libyan crude-oil supplies from the market, and the fear that supply disruptions could spread. This has elevated oil prices by about $15 per barrel. The economic effect of this supply shock is clear: global GDP growth in 2011 is likely to slow by around a third of a percentage point, and global inflation should rise by around two-thirds of a percentage point. The impact varies substantially by country, with “commodity countries” like Canada and Norway deriving slight benefits versus unmitigated pain for the U.S. and Japan.

As with all political matters, predicting the exact outcome of these conflicts is impossible. Even with NATO pressing matters in Libya, it is anyone’s guess when this conflict will end. Achieving stability afterwards will not be easy, and a resumption in crude output will take considerable time. It seems safe to assume for now that Libya’s production halt will persist for the foreseeable future, and thus that oil prices are not about to stage a significant retreat, at least not based on geopolitics. Meanwhile, Yemen and Syria are not major oil players. Their deterioration is notable, and yet of less relevance to the petroleum markets.

**INFLATION RISK**

Global inflation continues its resurgence, and is now approaching the highest level since the fall of 2008 (Exhibit 15). Several factors have supported this climb, while a number of others should limit further progress.

Rising commodity prices are currently among the main drivers of inflation. Commodities have enjoyed a helium-filled ascent on a combination of robust emerging-market demand, U.S. quantitative easing and a mix of supply shocks (Exhibit 16). More recently, however, this momentum has faded. In the near term, earlier commodity gains are set to continue feeding into consumer prices as lags work their way through the system. But even if commodity prices begin climbing again, they are not likely to match the torrid pace of the past eight months due to the imminent unwind of QE2, ongoing emerging-market policy tightening and the potential for demand destruction. Finally, some of the supply shocks – turmoil in the Middle East and North Africa, and poor growing conditions for agriculture – are temporary and will eventually fade even as growing conditions seem unfavourable in some regions for the second straight year. Commodity-driven inflation should rapidly peter out even if commodity prices

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**EXHIBIT 14. Japan Overnight Call Rate**

Equilibrium Range

<table>
<thead>
<tr>
<th>Year</th>
<th>Base</th>
<th>Mid</th>
<th>Current Range</th>
<th>Last Plot</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>12%</td>
<td></td>
<td>-0.44% - 0.54%</td>
<td>0.11%</td>
</tr>
<tr>
<td>1985</td>
<td>12%</td>
<td></td>
<td>-0.44% - 0.54%</td>
<td>0.11%</td>
</tr>
<tr>
<td>1990</td>
<td>12%</td>
<td></td>
<td>-0.44% - 0.54%</td>
<td>0.11%</td>
</tr>
<tr>
<td>1995</td>
<td>12%</td>
<td></td>
<td>-0.44% - 0.54%</td>
<td>0.11%</td>
</tr>
<tr>
<td>2000</td>
<td>12%</td>
<td></td>
<td>-0.44% - 0.54%</td>
<td>0.11%</td>
</tr>
<tr>
<td>2005</td>
<td>12%</td>
<td></td>
<td>-0.44% - 0.54%</td>
<td>0.11%</td>
</tr>
<tr>
<td>2010</td>
<td>12%</td>
<td></td>
<td>-0.44% - 0.54%</td>
<td>0.11%</td>
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<tr>
<td>2015</td>
<td>12%</td>
<td></td>
<td>-0.44% - 0.54%</td>
<td>0.11%</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Consensus Economics, RBC GAM

**EXHIBIT 15. Global Inflation**

IMF Aggregate Region CPI

<table>
<thead>
<tr>
<th>Region</th>
<th>Year 2005</th>
<th>Year 2006</th>
<th>Year 2007</th>
<th>Year 2008</th>
<th>Year 2009</th>
<th>Year 2010</th>
<th>Year 2011</th>
<th>Year 2012</th>
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</thead>
<tbody>
<tr>
<td>World</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>0.00%</td>
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</tr>
<tr>
<td>Emerging</td>
<td>0.00%</td>
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Source: IMF
hold steady at high levels over the next year because inflation is calculated as the rate of increase in prices, not the absolute level.

The greatest inflation threat for the future relates to central-bank decision-making. Some central banks appear set to raise interest rates later than tradition would dictate in an effort to guarantee sustainable growth, at the cost of an extra whiff of inflation in a few years time.

Another risk stems from inflation expectations. Although the commodity spike may have peaked and European sales tax hikes have only a one-off effect on prices, these observations aren’t of much use if the public misinterprets these shocks and concludes that inflation is going to be a problem down the road. There is a self-fulfilling aspect to such expectations, and central banks must remain on guard against this. Already the inflation-expectations genie is at risk of escaping from the bottle in the U.K., where inflation has been running above 4%.

Conversely, the most compelling argument that global inflation is unlikely to spiral out of control is the simple economic reality that most countries continue to grapple with billowing economic slack – an environment that is inhospitable to sustained inflation pressures. Not only are workers reluctant to demand wage gains because of the many idled workers that are competing for jobs, but companies are reluctant to jam through price increases as they jockey for market share in a world with a smaller-than-expected economic pie. The classic wage-price spiral is short-circuited on both sides.

In brief, inflation is higher than usual and is likely to stay that way, while the effect of commodities continues to trickle in, inflation expectations creep higher and some central banks – the Fed most prominently – delay tightening monetary policy. That said, debilitating inflation is quite unlikely.

**U.S. GAMBLING ON GROWTH**

U.S. policymakers continue to gamble on growth, hoping that maximum economic strength in the near term will more than compensate for fiscal pain down the road. This is not a strategy of happenstance: in the fall of 2010, the U.S. actively delivered additional fiscal and monetary stimulus in an effort to supercharge growth. This conduct provides a fascinating foil to Europe and the U.K., where fiscal imbalances have been tackled first, economic growth be damned. It is not clear which is the superior strategy since both dossiers – an economic recovery and a manageable fiscal position – are absolutely essential to a country’s long-term economic viability. Arguably, the U.S. is better placed than most to delay its fiscal reforms simply because it enjoys great privilege as printer of the world’s reserve currency, and has a much better demographic profile than its European counterparts. Despite much political posturing, we expect the debt ceiling to be raised by August. It is an open question whether the necessary fiscal austerity will begin in 2012 – an election year – or wait until 2013.

Despite the U.S. strategy of maximizing near-term economic growth, we have lowered our forecast for 2011 U.S. GDP to 3.00% from 3.25% due to the drag from oil (Exhibit 17) and supply-chain problems caused by Japan’s earthquake. We forecast growth of 3.25% in 2012. While these are perfectly adequate figures under normal circumstances, they will
only enable the unemployment rate and other metrics of economic slack to improve gradually. Preferable would be an economic growth rate closer to 4%. The U.S. growth outlook is nonetheless the fastest among the major developed regions. Inflation should average 3% in 2011, and retreat to a more normal 2% in 2012.

THE PILLARS OF GROWTH

Supporting this view that the U.S. recovery is sustainable, three of four key uncooperative factors from last fall are now playing ball, despite the recent round of poor economic statistics. Credit, employment and household deleveraging are starting to work, though the housing sector remains recalcitrant.

CREDIT

Credit is still not flowing with the normal fluidity, but it is at least making cautious progress. Even though mortgage lending remains in retreat, the stock of consumer credit is now growing steadily. Large businesses enjoy access to low bond yields in capital markets, and smaller businesses are beginning to borrow more from banks.

Bank lending standards are now easing in earnest (Exhibit 18), suggesting recent credit trends can be sustained. Surprisingly, the main drag is that businesses and households just don’t want to borrow. Survey-based measure of loan demand shows a less persuasive uptick in demand (Exhibit 19). There is reason to think that each of these metrics will continue to improve.
EMPLOYMENT

The U.S. labour market has turned the corner, with more than a year of uninterrupted private-sector job creation, and a three-month average that now runs in excess of 150,000 new jobs per month (Exhibit 20). The unemployment rate has fallen a full percentage point from its 10.1% peak (Exhibit 21). This is all good news.

However, it needs to keep getting better, and for a long time. At the current rate, it will still take the better part of four years to absorb the remaining 7 million workers who lost their jobs during the credit crunch. Jobless claims have recently soured marginally, suggesting that a further surge in job creation may not be a realistic expectation in the near term. At the same time, we do not look for sustained deceleration. As with the flow of credit, the direction is positive, but the rate of advancement uninspiring.

HOUSEHOLD DELEVERAGING

U.S. households spent most of the 1990s and 2000s levering themselves, as borrowing costs plummeted and lending standards softened. Thankfully, some of these excesses are now being unwound. The personal savings rate has tripled to 6% and the household debt-to-income ratio is finally declining (Exhibit 22). The financial-obligations ratio is at its lowest level in well over a decade. This is probably about as much retrenchment as one would want, given the simultaneous imperative of sustaining economic growth.
Sustaining the pace of deleveraging may become more difficult when policy rates eventually start to rise, as the burden of existing debt will naturally go up. Fortunately, households in the U.S. are less exposed to rising interest rates than almost anywhere else in the world, due to the preponderance of 30-year mortgage amortizations, which shelter existing homeowners from rising rates for the loan’s duration.

**HOUSING**

The U.S. housing market is the one instrument in the quartet that is still stubbornly playing out of tune. Housing starts continue to trundle along near their absolute lows (Exhibit 23) and home prices are edging lower. The overhang of home inventories is such that widespread construction is unlikely for quite some time. Americans turned away from the stock market and toward housing in the early 2000s in search of easy riches. The gains proved illusory, and the love affair has ended.

While an imminent housing resurgence is thus unlikely, there are several factors that point to a foundation being built for an eventual recovery. Mortgage delinquencies have peaked and are now beginning to recede. If one excludes foreclosed homes, home prices are beginning to edge higher (Exhibit 24). Nationally, there is a mismatch between where housing inventory exists and where Americans wish to live, so some renewed construction is likely. Some housing weakness is artificial, as U.S. housing agencies dump properties onto the market. Housing affordability ranges from so-so to excellent, depending upon the metric. Household formation has begun to move higher, pointing to a need for lodging. But it may well be a very long and hard slog before the U.S. housing market begins to regain forward momentum.

**THE FED AND THE GREENBACK**

U.S. monetary policy and the dollar are currently intertwined, as quantitative easing and ultra-low interest rates have held down the greenback. We expect the second round of quantitative easing to end as scheduled in June (Exhibit 25), with further incremental reversals likely in late 2011 and early 2012, culminating in a first rate hike in early 2012. From there, stimulus removal should be steady. It is notable that this tightening will come well after the ECB, which has already raised rates. Curiously, this divergence in policy has less to do with economic differences – the U.S. is in fact the
healthier of the two – and more to do with philosophical differences between the central banks.

Partially in response to the incremental end to U.S. monetary stimulus, the U.S. dollar is unlikely to fall much further. It is already extraordinarily cheap versus the world’s major currencies (Exhibit 26), especially given that the U.S. enjoys some of the best growth prospects. There is scope for appreciation.

**U.K. TAKES THE ROAD LESS TRAVELLED**

The U.K.’s woes bear a resemblance to those in the U.S. in that both economies have large financial sectors, were forced to bail out major banks during the credit crunch and are grappling with enormous deficits and large debts. To fix its problems, however, the U.K. is pursuing the opposite tack to the U.S., endeavouring to fix its fiscal issues now at the expense of near-term economic growth. The IMF forecasts that the British budget deficit will shrink to just 2% of GDP by 2013 (versus 6% in the U.S.) at the cost of economic growth, which we forecast at just 1.50% in 2011 and 1.75% in 2012.

The U.K. must deal with an inflation problem far worse than any other developed country. Headline inflation runs well north of 4%, and the core measure is not much lower (Exhibit 27). The Bank of England (BoE) was initially inclined to ignore the inflation spike given its origins in currency weakness and sales-tax hikes, both of which will roll out of the equation before long. The sales tax alone has
inflated CPI by around 2 percentage points, and will vanish from the annual figure in January 2012.

Unfortunately, British inflation is proving more and more difficult for policymakers to ignore. The BOE’s credibility is already in question given an earlier bout of inflation troubles towards the front end of the credit crunch. Furthermore, inflation expectations have begun a workmanlike ascent (Exhibit 28), and the risk of a self-fulfilling prophecy is mounting. This muddle of factors explains how the Bank of England has found itself in a rare three-way voting split, with some favouring easier policy, some favouring tighter policy, and the majority opting for the status quo of a 0.50% policy rate. Ultimately, we expect the BOE will be obliged to tighten several times in the next year, perhaps as soon as the late summer or fall (Exhibit 29). While we anticipate little change in the pound versus the U.S. dollar, higher rates should spur significant appreciation in sterling versus the even more beleaguered euro.

**QUIET CANADA**

The Canadian economy continues to plug away in relative anonymity. It mercifully lacks the U.K.’s high inflation, Europe’s fiscal problems or the U.S.’s housing issues. The Canadian economy is likely to continue its moderate advance, supported by a smoothly functioning banking system (Exhibit 30), elevated resource prices and good U.S. demand. We forecast GDP growth of 2.75% for 2011, and 2.50% for 2012. While these might seem meagre given a minimum of headwinds and a maximum
of monetary stimulus, Canada’s sustainable speed limit appears to be no more than about 2.00% growth per year. Thus, a fair chunk of slack will be eaten up by the economy over the next year, and much faster growth would be reckless.

Despite this, the Bank of Canada (BOC) has not tightened policy beyond a 1.00% overnight rate (Exhibit 31). There simply isn’t a lot of wiggle room left in the Canadian economy, credit continues to grow, home prices are rising, the unemployment rate is falling and inflation pressures cannot be too distant. Core inflation sits only moderately below the BOC’s 2% target. We forecast inflation of 2.50% in 2011 and 2.00% in 2012. All of this argues for tighter policy, even in the context of a fiscal authority that is itself working towards a 2014 balanced budget.

The muscle-bound Canadian dollar appears to be viewed as the justification for keeping the BOC on hold in the immediate future. Undeniably, the Canadian dollar is stronger than it should be, buoyed by reserve flows, rate spreads and an appetite for natural resources. This has adverse consequences for exporters, and indeed the overall economy. And yet the Bank of Canada itself continues to forecast decent economic growth that will see all slack gone no later than mid-2012. We believe some policy tightening in the summer or early fall would be useful, and several subsequent hikes will prove necessary. The Canadian dollar itself should soften moderately as the rise in commodity prices slows and as the U.S. dollar catches an updraft.

Emerging-market economies continue to grow at an impressive pace and on a reasonably promising trajectory for the future (Exhibit 32). We forecast EM-61 GDP growth of 7.20% for 2011 and 6.90% for 2012. Inflation is likely to top out at 5.80% in 2011 and then decline to a still-elevated 4.90% in 2012. This is not to say that emerging markets have totally escaped the latest round of negative shocks. They have not. Food inflation and rising energy costs are problematic, and governments are struggling to contain speculative inflows. These factors directly slow economic growth, and monetary authorities are compounding matters by tightening policy in an effort to contain inflation. Monetary tightening is the right policy.

1 A composite measure, containing the six largest Emerging Market nations of China, India, South Korea, Brazil, Mexico, and Russia
response, and more is needed: real interest rates in emerging markets are still quite low. For now, the upward pressure on emerging-market currencies is unlikely to stop.

China remains the dominant emerging market, and its economic profile shares the contours of the broader emerging-market outlook. Growth is estimated at 9.25% for this year, followed by a decline to 8.75% in 2012. Inflation is a problem, but has likely peaked, and should come in around 5.00% in 2011 and 4.50% in 2012. The risk of a Chinese hard landing remains elevated (Exhibit 33) but is still best classified as a tail risk, especially given the vigorous tightening from the People’s Bank of China. Additional tightening is likely in the coming months, though the end may be nearing.

**BONDS VERSUS ECONOMY**

The bond market is usually linked more than other asset markets to macroeconomic foundations. The peaking and subsequent deceleration in global PMIs and the recent spate of soft U.S. economic data have forced U.S. 10-year yields back down to around 3%, toward the bottom end of their equilibrium channel. Our global bond-market composite recently dipped about 10% below equilibrium, from a neutral position at the end of last quarter (Exhibit 34). Ultra-low policy rates and renewed growth concerns have allowed real rates to remain very low (Exhibit 35), while breakevens – the inflation expectations portion of a bond – have trended higher (Exhibit 36). Combining the real rate and inflation components, nominal bond yields...
remain abnormally low, and the simple principle of mean-reversion suggests this is unlikely to persist.

Looking to the future, we believe bond yields are already at the very bottom of the appropriate range, given our economic outlook. Rising policy rates are likely to force short-dated yields higher over the coming year. This will certainly vary on a country-by-country basis, with the Eurozone, U.K. and Canada liable to lead in the early going, contributing to an initial underperformance at the short end versus the U.S. and Japan. The U.S. should begin to catch up to the Eurozone and U.K. as 2012 unfolds, while Canada may continue to fl it ahead with steady tightening of its own.

Our expectation of rising long-term bond yields across developed markets is grounded in the belief that this mid-cycle slowdown in economic data is not a harbinger of another recession. As usual, there are a number of wild cards that will influence the near-term direction of the bond market. Downside risks to yields revolve mainly around the possibility that Europe’s fiscal problems will balloon in an unexpected way, prompting a rush to safety. Alternately, U.S. growth may stumble further over the next few quarters (and if this triggers a third round of quantitative easing, Treasury bonds across the yield curve would enjoy some support). Upside risks to yields come primarily from inflation, which could come either from a resumption of stronger growth or from the effects of an unanticipated spike in commodity prices.
CLEAR DOWNSIDE LIMITS TO YIELDS

We see clear limits to the downside potential for longer-term bond yields. Longer-dated bond yields should experience upward pressure from the aforementioned policy normalization, plus a further upward tilt in inflation expectations and the beginning of a gradual increase to reflect sovereign risk. In addition, the expected increase in the U.S. debt ceiling will allow for a resumption in new Treasury issuance by mid-summer.

Buoyed by this, 10-year yields in the developed world are likely to congregate in the 4.00% range in a year’s time, well above current levels, though still moderately stimulative by historical standards. The U.K. may be forced to pay slightly more than this due to its dance with inflation (Exhibit 37). The Eurozone could enjoy a slightly lower yield as its strong member nations attract safe-haven bids from the beleaguered periphery (Exhibit 38). Canada may also enjoy a slightly lower yield, due to its structural attractions (Exhibit 39), and the U.S. should reside smack-dab in the middle (Exhibit 40). Even Japan could see a sell-off in its longer-dated bond market as inflation turns modestly positive and growth picks up in 2012 (Exhibit 41).

While we would not be surprised to see continued volatility inside our valuation bands, the anticipated economic environment will drive the equilibrium level for rates steadily higher, posing a persistent threat to fixed-income returns.
MUTED EQUITY-MARKET GAINS YEAR TO DATE

The year-to-date performance of North American equity markets has been fairly muted, with gains since December measuring in the low-to-mid single digits. This performance masks considerable intra-period volatility, with the S&P 500, for example, putting in rolling tops in February, April and May, and then slipping about 5% into early June. European indexes have been even weaker this year, hovering around break-even. Although even more near-term volatility would not be surprising given the economic obstacles detailed above, we are expecting all major equity markets to rise over the next 12 months. We forecast gains to range from about 7% for Canada to about 10% for the S&P 500. European and Japanese markets should post modest returns. The main driver behind these equity-market gains will be rising earnings, as elevated investor caution suggests that a meaningful boost from higher valuations may be a story that unfolds beyond the immediate 12-month period.

PROFITS REMAIN STRONG, BUT MARGINS MAY HAVE PEAKED

One of the most consistent themes in equity markets during this recovery has been the strength in profit margins. Sharp and rapid cost-cutting laid a durable foundation for profitability as the global economy recovered from the credit crisis. In time, economic normalcy was re-established, and recovering sales volumes delivered additional results to the bottom line.

As Exhibit 42 indicates, S&P 500 net margins have almost returned to pre-recession levels. In dollar terms, corporate profits have never been higher, an astounding recovery given the depths of despair just three years ago. Keeping that despair in mind helps us put some perspective on calls that this “peak margin” environment is set for reversal. Margins cannot accelerate indefinitely and are probably near, if not at, a cyclical peak. As sales volumes improve, firms are increasingly ramping up investment spending to ensure they can continue to meet orders. While beneficial for GDP growth, this spending will eat into profit margins, which means they won’t expand as rapidly as they have in recent years. That said, the mid-1990s period saw a similar post-recession resurgence in investment and hiring, and during this period, net margins were maintained at around 7%-8% for a number of years. We expect a similar result in the quarters ahead. In Canada,
profit margins have further room to expand as long as commodity prices hold firm (Exhibit 43).

**Earnings surprises are still to the upside**

This "peak margins" thesis has been a topic of discussion for several quarters, so it's worth reminding readers that margins have continued to expand. In the latest quarter, S&P 500 earnings came in above analyst expectations, and, as of late May, 68% of S&P 500 firms had beaten earnings expectations. More impressively, 67% of S&P 500 companies beat expectations on top-line sales, the highest figure since the profit recovery began. Nearly half of reporting firms beat expectations on both sales and earnings per share, while only 18% missed or were in-line on both (Exhibit 44).

The takeaway from the first-quarter U.S. earnings season is that, once again, analysts were premature in predicting that bottom-line earnings would decline. Instead, earnings per share rose 4.2% from the prior quarter and nearly 19% year-over-year. This latest positive quarterly result adds to a string of gains that has pulled recurring earnings nearly all of the way back to their cycle peak. Even so, Exhibit 45 shows that the severity of the recent downturn has left recurring earnings well short of levels typically seen at this point in the recovery.

**Lengthy list of profit drivers**

There are several factors that we expect to support earnings in the quarters ahead. First, borrowing costs remain low and are not expected to begin rising until 2012. Second, even as portions of the U.S. economy remain sluggish, many overseas economies continue to expand rapidly. With approximately half the pretax earnings of non-financial companies in the S&P 500 derived outside U.S. borders, exposure to these areas of strong demand will support earnings. Third, higher oil prices and, recently, natural gas prices have led to outsized Energy sector earnings, which have offset some of the negative effect of higher fuel prices on other sectors. Fourth, some industries, such as banking, remain in recovery and continued improvement could add a lot to overall earnings. Finally, while productivity likely slipped in the latest quarter, it has been very strong throughout the recovery, and will likely continue to deliver bottom-line results.

**Revenues continue to climb**

The positive story on top-line revenue growth – up nearly 10% year-
over-year in the most recent reporting period – is also instructive due to its signaling power for general economic conditions. A general upturn in sales volumes showed up about six to eight months ago, alongside a positive turn in employment growth. Typically, revenue growth struggles for 18 to 36 months following a recessionary trough, and this cycle was no exception. By our estimation, revenues still remain about 5% below their cyclical peak (Exhibit 46), suggesting there is still room for expansion.

A MATURING RECOVERY, A MATURING EQUITY MARKET

That said, the most recent data shows a modest easing in revenue growth, dovetailing with other macroeconomic statistics suggesting some loss in economic momentum. However, in the absence of renewed recession, we expect both sales and earnings to continue to grow alongside job creation, albeit at a slower pace than we’ve seen since the market trough in early 2009.

BEARISH DATA CONTRASTS WITH OPTIMISTIC CONSENSUS

While the economic data has recently softened, the positive earnings story has become increasingly incorporated into the consensus view, and analysts have increased their earning targets accordingly. According to Thomson Reuters, S&P 500 EPS estimates for 2011 are at $97, and above $111 for 2012 (Exhibit 47). Based on earnings of about $85 in 2010, this translates into annual gains of 15.4% and 14.4%, respectively.

We see two near-term challenges for equity markets. The first relates to the somewhat optimistic expectations currently built into forward earnings estimates given current economic risks. The second is uncertainty surrounding the imminent end of QE2.

NEAR-TERM RISK OF DISAPPOINTMENT TO OPTIMISTIC EXPECTATIONS

After several quarters of healthy growth, the bar for equity markets has been raised, and the ability of companies to beat expectations will become increasingly difficult. This is especially true amid pressures emanating from shocks like the Japanese earthquake and its impact on the auto and electronics industries, and the more generalized economic slowdown currently underway. The likelihood of a disappointing result, where an increasing percentage of companies do not deliver a positive surprise on either sales or earnings, not only becomes more likely as time
goes on, but also threatens to deliver a greater blow to markets where prices are based on an optimistic outlook. To date, forward earnings estimates do not seem to have entirely incorporated the downward revisions to U.S. and global growth that have emerged over the past few weeks (Exhibit 48).

Our real U.S. GDP forecast of 3.25% for 2012 is consistent with profit growth of about 8%, in line with the long-term average corporate profit growth rate of 8.2% measured by the National Income Accounts. That is still below the 13% growth rate derived from aggregating equity market analysts’ bottom-up estimates (Exhibit 49). In this context we would not be surprised to see a period of equity-market consolidation in the months ahead as expectations are re-aligned with a slower growth outlook.

For some time, our work has assumed a slower growth environment than is typical at this stage of an average recovery/expansion. Our tracking of the relationship between expected nominal GDP growth and corporate revenues confirms that the revenue growth (Exhibit 50) needed to meet our market targets is less demanding than that currently incorporated into analyst expectations, providing some margin of comfort to our projections.

**END OF QE2 MAY TRIGGER SOME JITTERS...**

The second challenge in the weeks ahead may be the end of the Fed’s QE2 asset-purchase program. The positive impact of the Fed’s two prior liquidity injections on asset prices has been well documented, as has...
been the period of market malaise that accompanied the period in between the two monetary easings. While we can quibble about the Fed’s role in the exact timing of last year’s stock-market correction, there can be little doubt that for a time last year investors had become convinced that the U.S. economy would founder anew in the absence of further official fiscal or monetary support. In response, the Fed re-applied quantitative easing to support risky assets by adding liquidity to global markets. In fact, Fed officials have clearly indicated that the major aim of QE1 and QE2 was to boost asset prices, on the premise that shoring up household and corporate balance sheets would foster spending and hiring.

So far, the program has had the desired effect. However, many investors argue that the lack of jobs created by the recovery means the Fed’s job is not done. With household balance sheets (and consumer confidence) under renewed threat from falling house prices, the Fed will be keen to ensure that equities do not further dent consumers’ finances. Some feel that reducing Fed support for asset prices now could trigger a slide in hiring and spending. As discussed earlier in the article, we believe the Fed is well aware of its effect on markets, and is actively monitoring the impact of asset-price changes on the economy.

**... BUT SHOULD ULTIMATELY BE A NON-EVENT**

More broadly, several points bear repeating. First, the Fed’s liquidity injections merely peak in June, at the QE2 wind-up, and do not begin to diminish until an as-yet-unspecified later date. Second, the end of QE2 should be taken as a signal of the economy’s health, i.e. that it no longer requires such extraordinary support. This is a good thing. Finally, as we demonstrate in Exhibit 51, equity markets usually tread water for a while before and after the first Fed step toward policy tightening, usually in the form of a rate hike, as they assess the path of the economy. But, once comfortable that the Fed is not triggering the next recession, equities tend to resume their upward march in short order. We expect a similar result this time.

In summary, the risk that the “end” of QE2 will deliver a serious blow to markets is probably overstated. However, the removal of the Fed as a marginal contributor of new liquidity is coming at a time when a range of other indicators, such as global PMIs, capital-goods orders, consumer confidence and housing prices have all taken a decidedly bearish turn. With this panoply of forces acting against risk-seeking behaviour by investors, a modest setback for equity markets would not be a surprise.

**ODDS OF QE3 ARE SLIM**

The more important question for equity and bond market investors is how the Fed will react if markets do weaken in the quarters ahead. That is, will there be QE3? So far, Fed commentary argues against this step, but its actions will depend on how badly any market downturn damages consumption and investment. We believe that the Fed has already sufficiently inflated asset prices and will be reticent to encourage markets to price in a “Bernanke put.” However, we also know that the Fed will do whatever it thinks is necessary to prevent another recession and deflation, so another market-pleasing round of quantitative easing can’t be ruled out. We will let well-known rules of thumb such as the Taylor Rule be our guide. A reversal in the required degree of monetary easing, as indicated by Evan Koenig’s version of the rule (Exhibit 52), will signal rising odds of QE3.
As long as economic growth remains reasonably healthy (that is, between 2% and 3%), interest rates remain low and inflation muted, the environment remains constructive for equities and other risk assets. In such an environment, investors will, in time, recognize that equity-market returns, while potentially modest, remain superior to those available from bonds or cash.

VALUATIONS REMAIN ATTRACTIVE

Our belief that equities offer the potential for higher returns than government bonds and cash is founded on two key building blocks. One is the earnings-growth story detailed above. The second is valuations: U.S., European and Japanese equity markets remain relatively cheap.

Our models of equilibrium valuations for major markets are shown in Exhibits 53 to 58. These exhibits place current stock-index levels in the context of a fair-value band. The midpoint of the fair-value band is the level at which markets would trade, at the intersection of current levels of inflation, interest rates, growth and an equilibrium P/E multiple to earnings. The upper and lower bands of the channel represent one standard deviation above and below estimated fair value.

S&P 500 STILL 30% BELOW EQUILIBRIUM...

As of late May, the S&P 500 was trading more than 30% below a one-year-forward fair-value estimate of approximately 1964.
Said differently, the S&P 500 would trade at 1464 given current levels of inflation, growth and interest rates if investors applied an equilibrium P/E multiple of 18 times. For reference, the current normalized P/E multiple is a lower 15.8.

**... BUT “NORMAL” VALUATIONS ARE NOT LIKELY FOR SOME TIME**

This analysis is not meant to suggest that we expect markets to surge to their calculated equilibrium levels in the near term. Clearly investors are discounting analysts’ forward earnings projections given the increased uncertainty surrounding those projections. Also weighing on valuations are uncertainty over the rate at which earnings or profit margins can expand, and concern that a shock emanating from Europe’s fiscal crisis could deliver a hit to risk assets.

The equilibrium bands do, however, give us a useful and reliable tool to assess a market’s current position relative to its long-term trend, and to judge the most likely direction for markets in an environment that is relatively free of market-threatening news. When market indexes lie outside these normalized earnings and valuation bands, the models have a powerful track record in signaling the direction of markets over the following years. The message from these bands is that, under normal conditions, markets would be trading significantly higher.

The equilibrium bands also provide a valuable gauge of current market sentiment. We know earnings have been strong, so the low levels of these indexes relative...
to calculated fair value provide a graphic representation of investor uncertainty, perhaps even pessimism.

Exhibits 59 and 60 show the S&P 500 data another way. Exhibit 59 shows the current P/E ratio and places it within a band where the midpoint is the normalized P/E ratio. Currently, the 15.8 multiple is well below the equilibrium multiple of 18 times forward earnings. Exhibit 60 also shows bands set at one and two standard deviations above and below the equilibrium multiple. Currently, the S&P 500 is trading at a multiple nearly one standard deviation below equilibrium. This suggests that over this market cycle, in the absence of further external shocks, there is significant room for the multiple to expand from here.

**TSX REMAINS THE DEVELOPED WORLD’S MOST EXPENSIVE MARKET**

As a result of this year’s exuberance for all things related to commodities, the TSX remains the most expensive developed-world market that we follow. The index crossed into the upper half of its fair-value band in January 2011 and has been there ever since. While the TSX is still reasonably valued relative to its own history, we also acknowledge that it is one of the markets most vulnerable to a correction.

Canada’s economy is relatively healthy and domestic demand has held up much better here than elsewhere over the past three years. Canada is well positioned to capitalize on the long-term trend of rising personal incomes in emerging markets and the raw materials
needed to satisfy such growth. However, consumers are starting to heed Bank of Canada warnings that they are carrying too much debt, and Canada’s economy is expected to post below-trend growth in 2012. Canada’s central bank has taken the lead among major developed markets in hiking interest rates. In addition, any significant drop in Chinese demand for global raw materials, even in the context of strong secular demand growth, would be felt acutely by mining companies and energy producers listed on the TSX.

Since early this year, we have been advocating that clients consider lightening their Canadian equity exposure. As compelling as the Canadian story is, the TSX’s current valuation and strong performance compared with other equity markets suggest that this story is well known (Exhibit 61). Exhibit 62 shows S&P/TSX trailing 10-year total returns less similar data for the S&P 500. From 1985 to 2000 investors in the TSX endured inferior returns relative to the S&P 500, but over the last 11 years the TSX has completely recaptured that relative performance. Trailing 10-year returns for the TSX now exceed the S&P 500 by 100%! The likelihood that this outperformance will continue diminishes with time.

Exhibit 63 compares the performance of the S&P/TSX relative to the S&P 500 with the performance of the S&P 400 mid-cap index relative to the S&P 500 large-cap index. Since 2000 the relationship has been very close. If one considers that on a market-cap basis the TSX is akin to a U.S. mid-cap index, the close relationship makes sense: TSX leadership is consistent with the relative strength of the mid-cap sector in the U.S., a move that, after 11 years, also appears to be maturing.

The Canadian dollar has also pushed beyond the outer limits of valuation. Since this topic is addressed in detail elsewhere in the Global Investment Outlook, we will not discuss it here. Suffice it to say, the odds of further Canadian dollar gains versus the U.S. dollar are low, exposing investors to currency risk (Exhibit 64).

Finally, emerging markets appear expensive, according to our models. While we continue to advocate long-term exposure to these economies, for the time being valuations appear to be more demanding in this market segment than elsewhere. Emerging economies boast better demographics, stronger growth and better fiscal positions, but, as with Canada, this story has become well known to investors.
**LARGE CAPS LAG AS SMALL-CAP LEADERSHIP REASSERTS ITSELF**

We count ourselves among the many investors who gravitate to higher-quality large-cap equities, and have been grappling with the lagging performance of these stocks compared to lower-quality small and mid caps for much of this recovery. Large caps display the high liquidity, relatively low volatility and steady growth demanded by our clients. As long as our investment style emphasizes stocks with track records of rising earnings and strong capital allocation, we will be somewhat on the defensive during times of small-cap leadership.

Markets tend to analyze small-cap stocks through the lens of survival or bankruptcy, a view that shifts with the economic cycle. These companies have less access to capital markets and so are heavily dependent on bank loans to stay afloat. They also tend to have less power in making prices stick than large companies. During the recent recession, being a price-taker at a time when larger competitors were slashing prices was extremely harmful. The fact that banks would often not provide bridge financing to carry these small companies threatened to be the final nail in the coffin for many. Once the recession ended, these pressures abated, and small caps shed their bankruptcy discount.

While the recovery of small caps is typical of all economic cycles, it usually lasts for only a quarter or two. This time, small caps have maintained their outperformance for most of the 26-month bull market (Exhibit 65).
Exhibit 66 tells a compelling story. Our equilibrium models indicate small caps currently trade at a valuation premium to large caps. The exhibit shows a history of the valuation premium for small caps (relative to the S&P 600) compared to the valuation premium for large caps (relative to the S&P 500). While elevated, today’s small-cap valuation premium is below prior peaks. The message, once again, is that small caps have done very well, but can still do better. There is no sign yet that this trend is running out of steam and no reason to believe that a reversal is imminent.

Recognizing this, we have taken action to mitigate the negative impact of this trend, without necessarily capitulating at what might be a small-cap market top. First, we are running larger portfolios. By increasing the number of stocks we hold, we are able to expose our portfolios to companies with smaller market capitalizations than are typical for our management style, while taking steps to ensure that our clients are insulated from any harm that comes from blow-ups in this riskier market segment. Diversification is critical in order to harvest the advantages of small-cap exposure without adding unintended risk.

The second action we have taken is to recognize that a great deal of the small-cap performance is being generated by companies exposed to natural resources. To the extent we are exposing our portfolios to smaller, more volatile companies, we are intentionally concentrating our efforts in this area, as our deep work on larger-cap companies in resources has given us insight into the expected behaviour of these sectors as a whole.

**EXHIBIT 66. U.S. Equity Styles: Relative Valuation**

<table>
<thead>
<tr>
<th>S&amp;P 600 % of Equilibrium Relative to S&amp;P 500 % of Equilibrium</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Index Level</strong></td>
</tr>
<tr>
<td>0.4</td>
</tr>
<tr>
<td>Current: 1.33</td>
</tr>
</tbody>
</table>

Source: RBC GAM

**EXHIBIT 67. S&P 500 Composite**

| Source: RBC GAM |

**TECHNICAL SIGNALS ARE MIXED**

We pay close attention to the market’s technical signals for guidance in forecasting its near-term path. A few examples are market breadth and investor sentiment. A market peak led by only a handful of stocks isn’t considered a durable advance, and we might decrease our exposure to this type of market. Similarly, a peak marked by high levels of investor exuberance suggests few buyers will be available to drive the market still higher.

The short-term technical signals within the S&P 500 are neither scary nor inspiring. Trading volumes haven’t been great. Daily, weekly and monthly momentum indicators are similarly lackluster (Exhibit 67). Investor sentiment is not at extreme highs or lows, and offers little guidance (Exhibit 68).
However, longer-term technical signals remain supportive. The S&P 500’s advances this year have come with excellent breadth (Exhibit 69). Demand-supply indicators remain healthy. In the absence of clear technical signals, we remain focused on our belief that the U.S. economy is unlikely to dip back into recession and that no aggressive monetary tightening is expected anytime soon. Earnings are expected to continue to grow, and valuations are undemanding.

**ASSET-MIX STANCE CAUTIOUS AND OPPORTUNISTIC**

For the past two years, equity markets in developed nations have been underpinned by a powerful snapback in earnings per share, driven initially by deep cost cuts and stellar productivity gains, and, more recently, by a resurgence in revenue growth. At any point in this profit recovery, earnings and revenues were so far beneath their long-run averages that investors could afford to be patient and wait out any challenges facing the economy, secure in the knowledge the eventual economic normalization would produce profit gains. Stronger profits would push stocks higher, and if they came with valuations that also rose from crisis lows, the returns would be even larger.

Recognizing these conditions allowed us to respond rapidly to the temporary dislocations in global equity markets that followed the Japanese earthquake in mid-March. A few days after the earthquake, global stocks had declined about 4% (as measured by the MSCI World Index). Coincident with this sell-off, we raised our equity weight by 1 percentage point to 61%. This put us near the high end of our historical range. Subsequent to that shift, the MSCI World Index rallied strongly, and by May 31 was up 7.5% from the post-earthquake low.

In recent weeks, accumulating signals suggest that the twin engines of earnings and valuations growth were running low on gas. In the U.S., profit margins are now at or near peak levels, and are much less likely to move higher from here. Revenues have climbed back close to pre-recession levels, and the loss of growth momentum argues for slower, not faster, revenue growth over the summer months. Once plentifully stocked, the cost-cut cupboard is now rather bare. Another economy-wide round of job cuts at this stage would probably reverse growth, instead of adding to corporate bottom lines. Valuations, while not back to equilibrium, have also improved to the degree that stocks are no longer at unprecedented valuation levels.
As well, the fiscal crisis in Europe appears to be intensifying. A debt default, no matter how well managed, may still produce negative side effects not only for European financial companies, but also for equity markets in general. Investors are also wary that monetary policy in the U.S., as well as in China and other emerging markets, is entering a less supportive phase. The U.S. fiscal-policy debate has taken on an unwelcome partisan tone.

This build-up of obstacles alongside the fading strength of profit and valuation underpinnings argues for less exposure to equities. Accordingly, in early June, we reduced our equity weight in global balanced portfolios by 2.5 percentage points, to 58.5% from 61%. The proceeds were added to cash, moving the weight to its benchmark of 5.0%.

It is important to recognize that our equity weight is still 3.5 percentage points above our neutral weight of 55%. U.S., European, British and Japanese equities remain well below normalized equilibrium. We still anticipate that returns for stocks will exceed those from bonds and cash by a sizeable margin over the year ahead.

Exhibit 70 shows 10-year rolling total returns from the S&P 500 less returns from the Barclays Capital LT Treasury Bond 10-Year Total Return Index. Stocks outperformed bonds during the vast majority of the rolling 10-year periods over the past century. There have been only two periods this century when bonds did better than stocks over a 10-year period – the Great Depression, and today. The performance gap in the current period is, in fact, worse than it was during the 1930s. Extremes in either direction have always been followed by a move back in the direction of the long-run average. In particular, periods when bonds outperform stocks are very rare and do not last long. This is to be expected in a market-based economy, where returns to risk-taking must exceed the risk-free alternative, or the system would cease to function.

The current positioning of equities relative to bonds is a key reason why we continue to maintain a strategic overweight position in stocks.

We have maintained our underweight in bonds, holding the fixed-income allocation at 36.5% versus a neutral setting of 40%. Bond-valuation work by the RBC Investment Strategy Committee, as well as on our global fixed-income desks, has long highlighted the expected upward route that government bond yields are expected to travel over the next few years of economic normalization. That work pushed us to initiate a 2.5-percentage-point underweight in bonds through the past winter, a position we expanded to a 3.5-percentage-point underweight in mid-March. This positioned us well for the past two quarters of negative returns in the fixed-income markets. Recently, 10-year bond yields have slid back to around 3% in concert with the recent upward spike in investor risk aversion, making bonds even more expensive relative to our expected path for yields over the coming years.

Our current asset-mix stance of 58.5% equities, 36.5% bonds and 5% cash leaves us well positioned to capitalize on any weakness in equities over the coming months, as investors recalibrate their expectations to a slower-growth environment. Short-term technical signals have become less supportive and suggest a weaker phase for equities may lie ahead. The gathering clouds on the economic horizon suggest the same. We are prepared to actively put those funds back into the equity market when a more attractive entry point presents itself.

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After rising sharply in the spring of 2011, government bond yields have plunged anew, testing the bottom of the trading range that has prevailed for most of the post-crisis period (Exhibit 1). The oversold market in the spring was fed by the intensification of Europe’s sovereign-debt crisis, soft economic data (Exhibit 2) and higher oil prices, which led headline inflation higher while core readings remained tame. These days, uncertainty has been building as investors wonder what to expect at the end of the Federal Reserve’s second round of quantitative easing, and as the congressional fight over the U.S. debt ceiling builds toward brinkmanship. Looking ahead, current yield levels are not sustainable in our view given that we expect the global economy to continue expanding and short-term interest rates to head higher. Our fair-value bands (Exhibit 3) argue for higher yields in the year ahead, and in the longer term as well.

**DIRECTION OF RATES**

Government bonds look rich based on indicators including the long-term expectations model, which compares yields to long-term GDP growth and inflation expectations. While a slowdown in economic momentum has supported bonds, investor sentiment has yet to reach the extreme levels typical of bottoms in yield. The market has priced in slower growth over the past few months and pushed out the timing of the Fed’s first rate hike (Exhibit 4), but our forecast in 2011 is for growth that is slightly above consensus. Should our forecast prove correct, inflation will increase
and the unemployment rate will fall, leading the Fed to tighten earlier than the market expects.

As the Fed gets closer to normalizing policy, an interesting debate is likely to emerge over what, exactly, constitutes the start of monetary tightening. Will it be the point at which the Fed stops buying securities, i.e. stops growing its balance sheet at the end of June? Or will investors wait for the Fed to start shrinking its balance sheet, by no longer investing proceeds of its securities portfolio, before agreeing that the central bank is in tightening mode? The final step of this process will, of course, be raising the fed funds rate. By the time this happens, it will likely have been telegraphed that the central bank is working to contain inflation, curb growth, or both. This uncertainty over the beginning of monetary tightening will make it harder for investors to predict when the Fed is about to raise rates.

Given our forecasts for the economy and interest rates, we think an underweight duration stance is appropriate. Should our forecasts play out, we would expect to see negative total returns in most regions, as coupon income would be unlikely to overcome falling bond prices. The end of QE2 will remove a market player that has essentially purchased the net supply of Treasuries this year (Exhibit 5). So while we do not expect the end of quantitative easing to have a marked effect on the bond market due to the fact that the program’s end has been well telegraphed, another buyer will be needed to provide that demand, which may come at higher yields.

Our regional outlook is as follows:

- **U.S.** – With the Fed on hold for the majority of our forecast period and inflationary policies likely to persist in the near term, we expect the yield curve to remain steep. A negative real fed funds rate is likely to persist for some time (with headline CPI currently above 3%), and this condition typically results in a steep yield curve (Exhibit 6). While Fed tightening will bring some flattening pressure, our forecast of higher long-term bond yields should mitigate the effect on the yield curve. Within our forecast period, we see a 250-basis-point spread between 2-year and 10-year bonds – a relatively steep level.

- **Germany** – We expect German yields to trade close to U.S. Treasuries as markets normalize over the next 12 months. While the European Central Bank’s hiking campaign should cause bunds to underperform in the near term, this should reverse somewhat when the Fed begins normalizing policy in 2012. The safety bid in bunds may have further to run as the sovereign-debt crisis in peripheral European countries intensifies, but we expect yields to move higher as conditions normalize in the year ahead.

- **Japan** – The unprecedented natural disaster in Japan will lead to fiscal strain, as the government is forced to raise money in the bond market to fund reconstruction, which should lead to stronger growth and inflation. This fiscal pressure should push up yields on Japanese government bonds, but we do not see yields breaking the 1.2%-2.0% range that has prevailed for most of the last decade.

- **Canada** – While the Bank of Canada’s process of rate normalization has been put off for a few months, we still see the central bank taking rates higher in the year ahead and
are boosting our forecast by 50 basis points to acknowledge another quarter on the clock and our stronger 2011 GDP outlook. The Canadian dollar will continue to be a headwind for the Canadian economy, but strong prices for natural resources should prove an offset. We see 10-year bonds slightly outperforming U.S. Treasuries due to a stronger fiscal position.

- **U.K.** – Inflation pressures continue to dog the U.K. Policymakers are split between those who insist that the uncomfortably high inflation is temporary and due to factors beyond their control, and those who are calling for the Bank of England to take action. While one can argue that items such as the VAT hike and lagged effect of the weak pound are temporary and unique to the U.K., the persistent inflation overshoot risks becoming entrenched in inflation expectations and pushing up interest rates to levels that overwhelm the economy. The cautious approach by the central bank is understandable, as the U.K. economy is struggling somewhat under fiscal austerity that could derail the recovery. This is reflected in our lower 2011 GDP and 10-year gilt forecast.

Risks to our rate forecasts include:

- **Inflation** – Headline inflation in many regions continues to reside above central bankers’ targets, leading to what we believe will be more ECB rate hikes. However, central banks such as the Federal Reserve and Bank of Canada focus on core inflation, which remains contained. Evidence of price pressures filtering into core measures would bring forward the timing of rate hikes for these central banks and push up long-term yields.

- **U.S. Debt Ceiling** – U.S. politicians seem to be on a collision course regarding an increase to the Congressionally mandated debt ceiling. With Republicans refusing to approve an increase without heavy spending cuts and Democrats looking for tax increases on the wealthy, this debate could go down to the wire. The U.S. has hit the ceiling already, but due to accounting tricks can get by

### Exhibit 5. 2011 Expected Treasury Gross Supply

<table>
<thead>
<tr>
<th></th>
<th>2YRS</th>
<th>3YRS</th>
<th>5YRS</th>
<th>7YRS</th>
<th>10YRS</th>
<th>30YRS</th>
<th>TIPS</th>
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<th>COUPON PAYMTS</th>
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<th>NET SUPPLY</th>
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<td>Jan-11</td>
<td>35</td>
<td>32</td>
<td>35</td>
<td>29</td>
<td>21</td>
<td>13</td>
<td>13</td>
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<td>13</td>
<td>115</td>
<td>50</td>
<td>69</td>
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<tr>
<td>Feb-11</td>
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<td>35</td>
<td>29</td>
<td>24</td>
<td>16</td>
<td>9</td>
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<td>35</td>
<td>98</td>
<td>47</td>
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<td>11</td>
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<td>7</td>
<td>108</td>
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<td>30</td>
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<td>165</td>
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<td>201</td>
<td>569</td>
<td>1330</td>
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Source: Citigroup
until August 2. While we feel it is unlikely that the U.S. Treasury will go into technical default, delaying interest payments to Treasury-bond holders, the closer negotiations go to the brink, the more markets are likely to price in such an outcome. These effects could include a temporary spike in Treasury yields and a rally in non-U.S. government debt such as bunds and Canadian bonds.

- **European Sovereign Debt**
  The crisis in Greece continues unabated, and a default or voluntary restructuring of debt could spread around the region, leading to a safety trade as seen last year at this time. We should keep in mind, however, that European banks are large holders of Greek debt, and will feel intense pressure from contagion as their trading partners are drawn into the crisis.

**REGIONAL PREFERENCES**

While we see higher yields across global bond markets, differences in valuations and rate cycles create relative-value opportunities that we seek to exploit. Given our forecasts, we look to overweight U.S. Treasuries (a proxy for North America) by 5%, with a corresponding underweight of 3% in bunds (Europe) and 2% in Japanese government bonds (Asia).

- **Overweight U.S. Treasuries 5%**
  - The Fed will lag the ECB when it comes to rate hikes, given that the ECB is already hiking while the Fed is still engaged in quantitative easing. We do not see the Fed hiking until the end of our forecast horizon.
  - The extreme steepness of the Treasury curve results in the potential for returns that are superior to bunds and JGBs, even as interest rates rise across the curve.

- **Underweight Bunds 3%**
  - The ECB has begun its rate-hiking campaign, as higher-than-acceptable headline inflation pushed the central bank into action many months ahead of the Federal Reserve.
  - The departure of Jean-Claude Trichet later this year means a new ECB president who will be eager to prove his inflation-fighting credentials, potentially leading to more ECB rate hikes than necessary. This could dampen bund returns.
  - The sovereign-debt crisis could have a negative effect on Germany’s fiscal situation, as it bears the largest load among its peers in supporting the bailout programs.

- **Underweight JGBs 2%**
  - This is a new position and is aimed at taking advantage of JGB yields that are too low based on our models.
  - Japanese bonds are at extreme valuations due to the earthquake and resulting nuclear and economic disaster, a condition that is unlikely to continue longer term.
  - The boost to growth and inflation from reconstruction should push JGB yields higher in our forecast period.
  - Japan’s deteriorating fiscal situation has prompted rating agencies to warn of credit downgrades.
The U.S. dollar bear market continued in the most recent three-month period, with the greenback falling to its lowest levels ever. All the arguments for dollar weakness are aligned: ever-delayed expectations of Fed rate hikes; worsening current-account and fiscal deficits; and concern about unsustainable debt relative to GDP. As if any more negatives were needed, S&P warned on April 18 that it might downgrade the U.S. debt rating if the country doesn’t get serious about fixing its fiscal mess. At one point, the dollar was down more than 7% from the beginning of the year, extending the drop in the current nine-year bear market to 40% (Exhibit 1).

**VALUATION**

From the perspective of purchasing power parity (PPP), the dollar sits at its lowest trade-weighted valuation since at least the early 1970s (Exhibit 2). The euro has now joined the Australian dollar, the New Zealand dollar, the Swiss franc, the Norwegian krone and the Canadian dollar as extremely overvalued versus the U.S. dollar (Exhibit 3). Based on our research, we know that the length of such episodes of extreme undervaluation or overvaluation is usually counted in months, not years.

**QE2 ABOUT TO END**

It is generally accepted that the Fed’s decision to embark on a second round of quantitative easing (QE2) has helped extend the two-year-old rally in a broad range of risk assets, from emerging-market debt to commodities. Once the Fed embarked on QE2, short-term interest rates became anchored...
near zero, which, combined with a moderate recovery, led to lower uncertainty, rising risk appetite and a frantic search by investors to find yield wherever they could. Currencies rose significantly against the U.S. dollar, although emerging-market currencies benefited less than those of major developed markets, as inflows into emerging markets were curtailed by central-bank intervention. The magnitude of this intervention is reflected in the continued build-up of foreign-exchange reserves (Exhibit 4). Exhibit 5 compares the impact of QE2 on exchange rates of developed-market and emerging-market currencies.

The recent poor performance of the U.S. dollar raises the question of what happens after QE2 is exhausted. While the end of QE2 won’t constitute a complete “off-switch” for stimulative, market-friendly policies, we must consider the possibility that some of the dollar’s losses may be reversed.

**GROWTH SLOWDOWN**

The end of QE2 requires us to scrutinize ever more carefully the sustainability of global growth. In 2010, we observed divergences between the performance of emerging-market leading economic indicators and commodity prices. Exhibit 6 shows emerging-market leading indicators and industrial production turning down last year. While commodity prices initially fell with the two indicators, they subsequently rallied in anticipation of and during QE2 – while the emerging-market indicators continued lower.
By April a slowdown was evident in the U.S.: initial jobless claims had returned above 400,000, the ISM had weakened two months in a row and the housing market continued to deteriorate. A slowdown in China’s purchasing managers index in the wake of monetary tightening (see Exhibit 7) also intensified worries about the global recovery.

END OF “CURRENCY WARS” AMID SLOWER GROWTH

Despite continued central-bank intervention (Exhibit 8), the appreciation of emerging-market currencies in the past quarter was the fastest since the fall of 2010. Faced with excessive inflation, countries including South Korea, Brazil, Russia and South Africa are finally acknowledging currency appreciation as a tool to relieve inflationary pressures. Even China has let its currency rise a tad, and Premier Wen Jiabao stated for the first time in early April that a stronger renminbi could help authorities combat rising prices. Shortly thereafter, the governor of the People’s Bank of China agreed that China’s more than $3 trillion in foreign reserves exceeds a reasonable level, implying less intervention and faster renminbi appreciation. More flexible currencies will continue to be one of many tools used by governments to contain inflation. But one of the implications is that China’s growth could slow more than markets would like, and economic-growth revisions have been moving in this direction.

Taking these changes into consideration, we expect emerging-market currencies to continue appreciating gradually against the U.S. dollar and other major currencies, including the Canadian dollar. In the long term, this is the only sure way to resolve global trade imbalances.

INTEREST RATES

Interest rates were once again a big headwind for the dollar during the recent quarter, as several events resulted in an effective loosening of what was already loose U.S. monetary policy. On February 2, the U.S. Treasury reduced the size of its Supplementary Financing Program (SFP), which was introduced after the Lehman bankruptcy to help the Fed manage the liquidity in capital markets. The SFP consisted of a series of Treasury-bill auctions amounting to $200 billion, and its unwinding led to the accumulation of additional excess reserves at the Fed. The second event came on April 1, when an FDIC rule change made the excess reserves of U.S. banks held at the Fed subject to deposit-insurance premiums, encouraging overnight money to find
a home in the open market. Both events contributed to a drop in the effective fed funds rate (Exhibit 9).

This situation may be about to reverse, as several developments will have the effect of tightening monetary policy in the months ahead. The latest on this front occurred May 24, when the Fed announced that government-sponsored entities (GSEs) will join the roster of counterparties (primary dealers and money-market funds) that will eventually be used to drain cash from the financial system using reverse-repo transactions. The shift diversifies the range of investment options for the GSEs, whose reliance on short-term lending to banks had helped drop overnight lending rates to the low end of the Fed’s current 0% to 0.25% target range.

At the margin, developments designed to drain excess liquidity are viewed as positive for the U.S. dollar, and represent steps in the long journey toward normalization of monetary policy and higher U.S. rates. For now, markets are assuming that the Fed will be the last major central bank to raise interest rates, while the ECB leads the way in hiking. Some even anticipate another round of U.S. quantitative easing, though we believe that the probability of QE3 is remote. At Bernanke’s first post-FOMC press conference, he stated that the marginal benefit of additional monetary stimulus would be negated by expectations of too much inflation. That is to say, the economy would be better served with 1% short rates and $80-a-barrel oil than rates at 0% and oil at $120 a barrel.

**U.S. FISCAL SITUATION**

As sobering as the S&P April warning was, the silver lining is that it has mobilized a political willingness to negotiate that didn’t exist just a few months ago. This willingness is critical for improving the long-term U.S. fiscal situation because the debt ceiling by itself is not such a big deal. According to the Wall Street Journal, the U.S. has reached the debt ceiling 74 times since 1962, usually without making much news. However, when Congress and the White House are on opposite sides of the political divide, the debt-ceiling debate becomes contentious. Despite the rhetoric, politicians know that the credit rating of the U.S. is not something to be toyed with. A downgrade would result in market chaos, necessitating massive portfolio adjustments to comply with mandates that assume the U.S. to be the safest of AAA markets. Even a brief ‘technical default’ would bring an automatic downgrade, which would be a disaster for financial markets and prompt a global reappraisal of U.S. economic power. The U.S. cannot take this risk.

The debate has brought forward consideration of fiscal tightening that otherwise would not have been on the table. While deeper-than-expected fiscal cuts would be bad for economic growth, they would hold down U.S. bond yields. As a result of these low yields, the U.S. government is in a position to cover its debt-service obligations easily, bolstered by the fact that the U.S. issues debt in its own currency and that government revenues are sufficient to cover interest payments 10 times over. Together with the end of employment-tax cuts and the winding-down of the Obama stimulus package, even small additional cuts could reduce the deficit by 1.5%-2% of GDP in 2012. More serious cuts will likely be delayed until after the general election later next year. In the longer term, debt reduction will be helped by supportive U.S. demographics, which should foster growth in tax revenues. The U.S. is rare among major developed economies (Canada is another) expecting meaningful growth in its working-age population over the next 40 years (Exhibit 10).
As an aside, one could argue that the lack of urgency to cut spending stems from ultra-low interest rates that the market affords the U.S. Paradoxically, bond yields are now lower than the last time the U.S. government was running a surplus, between 1998 and 2001, a period when the average 10-year yield was 5.48%. As of mid-May of this year, the one-year average was 3.08%. Higher interest rates might be what is needed to force fiscal responsibility, although the only Fed member espousing that view is the Kansas City Fed President, Thomas Hoenig. His views, however, will not matter until he begins voting on the Fed’s policymaking committee in 2013.

THE EURO

During the past quarter, the euro benefited from its status as the “anti-dollar.” This situation may end in June if the EU fails to finalize conditions of its longer-term rescue package for the peripheral countries, the European Stability Mechanism (ESM). Assuming that the details are worked out, any treaty changes would still need to be approved by the 27 EU member states by January 1, 2013. In most, if not all member countries, passage requires a parliamentary vote, and, in some cases, a public referendum will be needed.

According to some experts, the agreement would have to be unanimous, although abstentions would not derail its approval. One of the important ‘details’ to be worked out in June is the decision to increase the paid-in capital (money due upfront) of the ESM to €80 billion and its contingent callable capital to €620 billion – steps that will need to be approved by the national parliaments of the 17 Eurozone states. Finally, changes to the European Financial Stability Facility (EFSF), the interim rescue package that will be replaced by the ESM in 2013, are to be confirmed in a similar approval process. The EU Summit takes place on June 23 and June 24. June was also the month when results of the European bank stress tests were to be initially released, but the release was postponed to later in the summer.

Finally, towards the end of May, it became obvious that Greece would not be able to return to the capital markets in 2012, and that an additional bailout package (estimated at €50 billion) would be necessary. Negotiations to secure the rescue package will be difficult as the ECB resists any restructuring, while Germany and other countries are seeking haircuts for existing bond holders.
The euro heads into this potentially volatile period looking rather expensive (Exhibit 11). At the beginning of May it was trading above $1.45, reaching significantly overvalued levels (PPP level is $1.15). Historically, the euro has fallen an average of 1.3%, 3.5% and 5% in the 12-month, 18-month and 24-month periods after trading at levels that were more than 20% above purchasing power parity. The inverse was true in periods when the euro was significantly undervalued, which validates the use of this simple valuation tool when making longer-term currency-investment decisions.

**THE LOONIE**

Based on PPP, the Canadian dollar is among the most overvalued currencies against the U.S. dollar (Exhibit 12). Similar levels of overvaluation have historically not been sustained: their average duration was six months and that’s once we excluded one-month episodes. The loonie broke beyond its line in the sand in January, so May is its fifth month at the extreme. Predictably, it’s not difficult to find arguments why the loonie’s current levels are not only justified (‘in line with commodity rally’) but why they should extend even further (‘this time is different because the emerging-market growth pushed commodity demand to a new sustainably higher level’). We are skeptical. Terms of trade (prices for Canada’s exported goods relative to prices for what Canada imports) are not nearly as high now as they were in 2007 (Exhibit 13), and emerging-market growth is not nearly as
positive for Canada as when economic recoveries are U.S.-led.

Since PPP is often criticized for ignoring important factors, we use another valuation method, the Behavioural Equilibrium Exchange Rate valuation (BEER), as a secondary check. In addition to inflation, this model takes into account productivity, terms of trade and short-term interest rate differentials. Currencies mean-revert to fair value faster when measured against BEER than when measured versus PPP, although the research on BEER is less extensive than on PPP, and BEER analysis relies on more assumptions.

Interestingly, according to Deutsche Bank, many currencies rank similarly on BEER and PPP (Exhibit 14), and, importantly, the New Zealand dollar, the Swiss franc and the Canadian dollar are the most overvalued on both measures.

As for support for the currency from an expected rise in short-term interest rates, the Bank of Canada is at odds with the market. Many economists, and even the OECD, are expressing the view that the Bank of Canada is behind the curve and should be hiking rates now. We tend to give a bit more credit to the Bank of Canada’s governor and the bank’s research. What we find noteworthy is that the central bank is forecasting sequentially lower growth in Canada over the next three years (Exhibit 15). Among the reasons for the BOC worries are the strong currency, which has led to the worst current-account deficit in 20 years; the fragile nature of the U.S. recovery; debt-stretched households; and restrictive monetary policies in emerging markets. Exhibit 16 illustrates how rising exchange rates go hand in hand with wider trade deficits. Net cross-border spending by Canadians – spending by Canadians abroad minus spending by foreigners in Canada – hit a record C$3.5 billion in December 2010, and the Canadian dollar has appreciated even more since then.

Our view is that the Canadian dollar, trading at an average of C$0.97 per U.S. dollar over the past three months, has been priced for perfection on expectations of infinite demand from foreign-reserve managers and little leeway for a global growth disappointment. One doesn’t have to expect an outright recession to believe that. If your time horizon is a year or longer, the risk-reward calculation for holding Canadian dollars is poor at these levels.

THE JAPANESE YEN

The yen remains surprisingly strong. Japan is a large capital exporter,
and whenever risk-aversion strikes, the rush to repatriate money bestows safe-haven qualities on the currency. Moreover, since the financial crisis, many strategists have been recommending the yen as a hedge in high-risk portfolios, and this is a big reason the yen has performed better than is warranted by domestic fundamentals.

That said, there are three very real issues clouding the yen picture. First, while most of the world has been normalizing monetary policy, the BOJ will not be in a position to do so for a long time. Many countries are watching commodity prices nervously while they try to determine what their impact on inflation will be, but Japan can only hope that higher commodity prices will help put an end to its 13-year-old deflation problem. Second, the economic costs of the earthquake/tsunami/nuclear accident will have a material impact on the country’s GDP over the next few years. Third, foreign bonds, especially emerging-market bonds, remain attractive investments for retail and institutional investors. The potential for these flows to intensify is significant. According to UBS, savings invested with Japan Post amount to $3.4 trillion, and only a small portion (less than 2%) of this total is invested overseas. This gives plenty of scope for a rebalancing of these portfolios as the yen strengthens. A 1% shift overseas would result in net selling of $34 billion yen - far larger than any of the repatriation flows that can reasonably be anticipated.

POUND STERLING

Sterling continues to be tugged on from both sides. On one side are the austerity measures enacted to address a huge fiscal burden and slowing economic growth; and on the other is the possibility of higher interest rates as inflation remains stubbornly high. Recent economic data confirms fears of slower domestic growth, which is entirely expected for a nation on a serious fiscal diet and with only modest compensation so far from exports. Despite slowing momentum in purchasing managers indices, growth and house prices, inflation continues to ring in higher than the BOE target of 2% and has now exceeded this level in 51 of the most recent 60 months. While many dismiss this higher inflation as the temporary effect of commodity-price increases and value-added tax hikes, these effects are not expected to roll off until the beginning of 2012, and that’s assuming no new “temporary” factors surface. Can the BOE wait that long and retain its credibility?

Three BOE members have crossed the fence and are now voting for rate hikes, revealing division within the committee over the risk of higher-than-expected inflation over the medium term. The question remains whether they are joined by the remaining six (the governor among them), who are anxious about pinching already skittish consumers. Since the pound’s current value is relatively close to PPP versus the U.S. dollar, valuations between the two are of little interest to us, but against the euro the pound is on the cheap side, although not yet extremely so. That does not seem appropriate considering the debt issues in peripheral Europe, and the U.K.’s significant head start in dealing with its government debt problems.

Given the Bank of England’s poor track record, it is somewhat surprising that inflation expectations have remained so stable. If, in fact, these “transitory” factors do not recede soon, price pressures will soon become engrained – a very challenging trend to reverse. For this

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EXHIBIT 17. Market Capitalization of U.S.-Listed Currency ETFs

![Market Capitalization of U.S.-Listed Currency ETFs](chart)

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reason, we believe the BOE will raise rates this year. Rate hikes, along with fiscal responsibility, should help support the pound. On the other hand, trading links to the troubled Eurozone and the austerity-related economic slowdown will weigh it down. The most likely outcome is that the pound will appreciate against the euro, while barely holding its own against the U.S. dollar.

**POSITIONING**

Our review of positioning has determined that the negative view of the dollar among investors is well entrenched. IMM positioning (a proxy for speculators) shows the number of investors betting on a dollar decline is near the highest level in four years. Other positioning surveys – e.g. the customer base of a large, mostly American custodian (so-called ‘real money’) – show a similar bias. The bias is also found among U.S. retail investors as evidenced by their exposure to non-U.S.-dollar exchange-traded funds (Exhibit 17). Favourites on the other side of dollar wagers are the euro, sterling, and the Australian and Canadian dollars. The common theme in the foreign-exchange market is a dislike of the greenback.

**GOING OUT ON A LIMB**

“Prediction is very difficult, especially if it’s about the future.” This quote from Nils Bohr, a Nobel laureate in physics, is a humbling one. Knowing full well that our predictions will likely be wrong, we believe that the odds of a turn in the dollar over the next 12 months have increased, and that the turn may even come as soon as the third quarter of this year. Here is a list of potential reasons:

1. The dollar bear market is in its 10th year, historically close to the length of the longest dollar cycle.
2. The dollar reached extreme undervaluation in May and the extremes usually last months, not years.
3. The end of QE2 will stop the Fed balance sheet growth dead in its tracks. Maximum dollar liquidity will have been reached by July 1.
4. Signs of a slowdown in big emerging markets like China and Brazil will be evident by the second half of 2011.
5. A slowdown in Europe is implied by weaker Belgian business confidence, which tends to lead growth.
6. Commodities are likely to experience a setback as speculative positions are unwound by increased regulatory scrutiny and slower growth.
7. The U.S. budget-deficit deal will be achieved with more concessions from Democrats than the market expects.
8. Core CPI in the U.S. will start accelerating and the unemployment rate will fall, causing the market to review/bring forward the timetable for the Fed’s removal of extraordinary liquidity.
9. Finally, economic data will be better than expected by July, as the lowering of analyst forecasts makes them easier to beat.

To summarize:

- The dollar is overshooting on the downside – valuations are extreme versus the Australian dollar, New Zealand dollar, Swiss franc, Norwegian krona, Canadian dollar and euro.
- The dollar still lacks support from interest rates, but the end of QE2 is getting closer and a bi-partisan fiscal agreement is more likely now than at any time over the past 12 months.

**EXHIBIT 18. 12-Month Forecast**

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<th>CONSENSUS (May 9, 2011)</th>
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</tr>
<tr>
<td>CAD</td>
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</tbody>
</table>

Source: RBC GAM, Consensus Economics
Emerging-market exchange rates are moving in the right direction, even if appreciation continues to be slowed by central-bank intervention.

The euro has benefited again from its status as the “anti-dollar,” rather than its own fundamentals.

The Canadian dollar maintains its extreme valuation for a fifth month, while BOC worries about growth.

For the U.S. dollar to appreciate sustainably against the yen (or any other G-10 currency), higher U.S. rates are needed.

The U.K.’s proximity and trading connections to Europe will make it difficult for the pound to rally, despite hard fiscal decisions already having been made.

The extended dollar-bottoming is nearing its end, and we expect a decisive turn over the next 12 months.

Generally speaking, our forecasts call for a stronger U.S. dollar. Compared to consensus, our call is decidedly more bearish for the euro, with small differences for the other currencies (Exhibit 18).
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THE CURRENCY OUTLOOK: KEY FACTORS

EURO

**SUPPORTIVE**
- Thanks to its liquidity, the euro remains the default choice for investors seeking an alternative to the U.S. dollar during periods of negative dollar sentiment.
- The ECB has begun raising interest rates and the market expects further 75 basis points of hikes over the next 12 months.
- The dollar will remain a funding currency for the carry trade until the Fed starts removing monetary stimulus and short-term interest rates rise.
- Reserve managers need to diversify their U.S. dollar holdings and have shown renewed faith in the euro.
- When push comes to shove, European lawmakers will do what it takes to keep the Eurozone from falling apart.

**NEGATIVE**
- Significantly overvalued versus U.S. dollar based on purchasing power parity (22.6% as of May 2011).
- European crisis unresolved, peripheral CDS spreads wider. Greece and Ireland, and maybe others, will have to restructure their debt.
- Positioning still excessively long the euro, short the dollar.
- Fiscal burden growing as Portugal and Spain forced to borrow when interest rates are very high.
- European growth to weaken as ECB hikes and austerity measures take a bite.
- Long-term labour-force profile much worse than in the U.S., reflecting a shrinking taxpayer base.
- Communication discount necessary as European officials frequently contradict each other, eroding confidence in the currency.
- Worried about a return of the drachma, foreigners, corporations and individuals are withdrawing euro deposits from Greek banks.
- Market is too sanguine about the risk of accelerating U.S. inflation and the removal of monetary stimulus in the U.S.
- Euro is overbought versus 200-day moving average.

12-MONTH FORECAST: Rallies not sustainable, target 1.25

POUND STERLING

**SUPPORTIVE**
- Inflation expected to force the Bank of England to raise rates.
- Increased competitiveness of exports to Europe and revenues from tourism due to weakness versus euro (first-quarter GDP release showed a sizable contribution from net exports).
- PMI manufacturing and services indexes above 50, usually a good indicator of real GDP growth.
- May see buying interest at the margin from reserve managers.

**NEGATIVE**
- Assuming fiscal tightening and perception that inflation spike is temporary, the Bank of England could leave rates lower for longer. Governor Mervyn King favours this course.
- Bank of England risking credibility with inflation persistently higher than target (51 of previous 60 months).
- Housing surveys show continued weakness.
- Highly vulnerable to renewed global financial-system stress (possibly triggered by Greek “reprofiling”).
- Budget deficit among highest in G-8, with IMF, OECD and EU forecasts all greater than 8% in 2011.
- Higher taxes risk driving business and wealth away.

12-MONTH FORECAST: Very volatile trading expected with the 12-month forecast little changed at 1.60
CURRENCY MARKETS • DAGMARA FIJALKOWSKI, MBA, CFA

CANADIAN DOLLAR

SUPPORTIVE
- Best fiscal profile in G-8.
- Bank of Canada expected to raise interest rates ahead of the Fed and Bank of Japan.
- Housing market and financial institutions in better shape than their U.S. counterparts.
- Aggressive foreign demand for Canadian bonds and a pick-up in M&A activity targeting Canadian companies.
- Strong demand for oil and other commodities expected to continue.
- High oil prices are positive for Canadian dollar, as long as U.S. growth is not significantly dented.
- China adding commodity currencies to its sovereign wealth fund, demonstrated by the opening of the fund’s first foreign office in Toronto.

NEGATIVE
- Sensitive to a slowdown in global growth as China and other emerging markets tighten policy to fight inflation, U.S. data has surprised on the weak side and European austerity measures have continued.
- Sustained oil prices beyond $120 per barrel believed to negatively impact global growth.
- BOC reluctant to tighten due to concerns about consumer debt, a widening current-account deficit and low productivity.
- Extreme overvaluation on purchasing power parity suggests limited sustainable upside from current levels.
- Currency strength exceeds what would be justified by improving terms of trade.
- Canadian housing vulnerable to a correction.
- Sentiment and positioning extremely bullish.
- Bank of Canada expects lower growth through 2013.

12-MONTH FORECAST: Strength below parity not sustainable, our forecast for 12 months is 1.02

YEN

SUPPORTIVE
- The yen benefits during flare-ups of risk aversion.
- Historic interest rate disadvantage eroded as interest rates in other developed markets very low.
- Low inflation relative to other developed markets increases the purchasing power of the yen.
- Earthquake reconstruction to have positive effect on growth in medium to longer term.
- Proximity to China and other emerging markets is positive for Japanese exports and GDP growth.
- Real effective exchange rates 30% lower than in 1995.
- The relatively large size of the market for Japanese government bonds means Japan could be the next major destination for reserve diversification.
- Steep U.S. yield curve encourages Japanese investors to hedge purchases of U.S. Treasuries, limiting need to sell yen.

NEGATIVE
- Worst gross public debt/GDP ratio of any major economy (210% estimate for 2012 from the OECD).
- Threat of further intervention – weaker yen on the political wish list.
- Worst demographic profile of any major economy over the next 40 years.
- The yen is the most overvalued currency on Behavioural Equilibrium models.
- Bank of Japan will be left behind once the global rate-hiking cycle begins.
- Japanese public entities and individuals diversifying into emerging-market bonds on an unhedged basis.
- Japanese insurers and the postal bank underexposed to foreign assets (1% shift by Japan Post would result in $34 billion of yen selling).
- Short-term costs of earthquake/tsunami/power disruptions likely to be greater than currently estimated.
- Auto manufacturers moving production overseas to reduce risk.

12-MONTH FORECAST: Yen strength not sustainable. Target: 90
REGIONAL OUTLOOK – U.S.

ECONOMIC BACKDROP

In March, the S&P 500 broke below the psychologically important 1300 level, spurred by investor concerns over unrest in the Middle East and North Africa, disruptions to global supply chains caused by the earthquake and tsunami in Japan, European sovereign-debt issues, and inflation caused by elevated commodity prices. The market proceeded to rebound sharply, aided by strong corporate earnings reports. Investor attention has been occupied by the imminent unwinding of the Federal Reserve's second round of quantitative easing. While Fed Chairman Ben Bernanke has reiterated his commitment to accommodative monetary policy, the end of QE2 presents uncertainties.

The most recent earnings season was typified by strong corporate earnings, with companies reporting robust operating margins driven by rising revenues. Corporate results were aided by a weak U.S. dollar, subdued wage pressures and relatively low levels of depreciation and interest expense. In fact, pretax profit margins for S&P 500 companies (excluding financials) have approached 40-year highs.

Over the past three months, commodity prices proved volatile, with gold, silver and corn approaching or exceeding all-time highs before retreating. During the first week of May, silver shed roughly a quarter of its value and WTI crude registered its largest single-session slide in two years. Geopolitical unrest, U.S. dollar weakness, the imminent end of QE2 and worries over the European debt crisis all contributed to the volatility.

In Washington, a divided U.S. Congress sparred over measures to address the country's $1.4 trillion budget deficit (roughly 10% of GDP) and $14 trillion debt. The inability of legislators to agree on a budget that addresses the nation's fiscal issues led Standard & Poor's to warn that it may at some point lower its long-term rating on U.S. government debt.

We consider U.S. equity markets to be in the mature stages of the advance that began in March 2009. While markets have lost a measure of momentum, the upward trend remains in place. It seems likely, in our opinion, that the S&P 500 will reach 1375 to 1450 sometime in 2011, as long as earnings remain robust and geopolitical events do not worsen. Large-cap stocks are beginning to outperform mid- and small-cap stocks in certain sectors, and defensive sectors have generally outperformed. Growth stocks continue to lead value stocks. The market is not without risks. China's economy is in danger of overheating, while fiscal cutbacks in...
effect across much of Europe could tip some of its economies back into recession. Finally, S&P’s U.S. debt warning suggests the U.S. may need some austerity to right its budget impasse, and any cut in federal spending could hurt growth.

**SECTOR ANALYSIS**

The past three months have proven to be a volatile period for companies in the **ENERGY** sector. Oil prices have remained elevated due to continued geopolitical turmoil and speculation in futures markets. Demand remains strong, as fuel consumption in developing countries continues apace. In contrast to crude, natural gas prices remain depressed. Following significant outperformance since the fall, we are downgrading our position to market weight from overweight.

The **CONSUMER STAPLES** sector has outperformed as investors rotated back into many of its large-cap stocks. The sector’s defensive characteristics are appealing due to uncertainty produced by the end of QE2, the European debt crisis and U.S. budget travails. Many companies have begun increasing prices in reaction to rising raw-material costs. We favour certain food retailers and manufacturers, along with tobacco and global soft-drink makers. While the sector may outperform over the near term, we expect more economically sensitive groups to regain leadership as the summer ends. We remain underweight.

The diversity of the **CONSUMER DISCRETIONARY** sector presents numerous attractive opportunities. The sector tends to react well to falling commodity prices and low interest rates. Given our view that commodity prices may have peaked in the intermediate term and that market interest rates are likely to remain low, we are upgrading the sector to overweight from market weight.

**HEALTH CARE** outperformed all other sectors over the past three months, as investors have become increasingly cautious. The threats of health-care reform and patent expiries in 2012 are largely reflected in the sector’s historically low valuations. As a result we are upgrading our position to neutral from underweight.

The **INDUSTRIALS** sector remains a leadership group amid the global economic recovery, due in part to the substantial operating leverage of many companies. Machinery and electrical-equipment companies are posting surprisingly strong revenue growth and profit margins. While valuations have expanded, earnings growth is expected to remain robust as the developing world continues industrializing and the developed world slowly recovers. We remain overweight.

Despite improving fundamentals, the **FINANCIALS** sector has had trouble gaining traction. Consumer credit quality is improving, but loan growth remains tepid. Other headwinds include falling home prices and increased regulation. Although valuations are attractive, the regulatory environment is likely to continue to temper enthusiasm. We remain underweight.

The **MATERIALS** sector is a beneficiary of global growth and, until recently, had outperformed on the surge in demand for metals, chemicals and forestry products. However, concerns over a slowdown in growth and a rebound in the U.S. dollar have triggered a sell-off, with metals and forestry companies among the hardest hit. We are concerned that investor sentiment and valuations have reached extremes and are downgrading our exposure to market weight from overweight.

The **INFORMATION TECHNOLOGY** sector has traded within a range over the past three months. Large PC makers have been under pressure as demand shifts to tablets from laptops and netbooks. Business spending on technology is robust, so our focus remains on select semiconductor and storage providers, as well as companies that provide software services to large enterprises. Given slowing economic momentum, we are reducing our stance to slightly underweight from overweight.

The **TELECOMMUNICATION SERVICES** sector recovered sharply this quarter, spurred in large part by AT&T’s offer to buy T-Mobile in an attempt to consolidate the industry. Investors have also noted the attractive dividend yields offered by some of the sector’s larger services companies. These yields rival, and in some cases exceed, those of North American utilities. Given the strong outperformance of late and the prospect for rising interest rates in the back half of the year, we remain neutral.

The **UTILITIES** sector has outperformed recently as investors turned toward less economically sensitive sectors. While the sector offers an attractive dividend yield, pricing power remains limited and costs to comply with pending regulations are considerable. Given the recent outperformance, we remain underweight, although less so than previously.
ECONOMIC BACKDROP

After a strong start to the quarter, the Canadian stock market sold off as global macroeconomic concerns took centre stage. The S&P/TSX Composite Index finished the quarter modestly in the red. By comparison, the S&P 500 Index advanced, while the MSCI World Index was flat in U.S. dollar terms. Concerns about the end of quantitative easing, coupled with signs of a slowdown in global growth, weighed on cyclical components of the S&P/TSX. The Energy sector led the S&P/TSX’s decline after oil prices fell more than US$10 from the intra-quarter high, although they did finish slightly higher over the period as a whole. Notwithstanding heightened merger-and-acquisition activity, with Barrick Gold bidding for copper company Equinox, the broader Materials sector also underperformed. Research In Motion declined significantly as investors re-evaluated the company’s earnings prospects.

The Canadian dollar was flat almost US$1.02 after surging to near US$1.06. We continue to believe that the strength of the Canadian dollar versus the U.S. dollar has largely run its course, given that the Canadian currency’s value significantly exceeds its purchasing power. We expect Canadian economic growth to moderate in 2011, mostly because of a slowdown in the housing sector. Our forecast calls for 2.5% economic growth in 2012 and 2% inflation, both unchanged from last quarter.

While valuations remain attractive globally, earnings-growth momentum looks set to ease in the face of headwinds. After raising our equity exposure modestly following the terrible events in Japan, we are lowering our allocation to stocks. Total projected earnings for the companies in the S&P/TSX are not far from the all-time high of $940, and we expect this to be eclipsed next year. While The S&P/TSX composite remains one of the developed world’s more fully valued equity markets and now sits slightly above the midpoint of our estimate of fair value, the market should move forward with earnings growth.

Canadian stocks are widely viewed as a way to gain exposure to Chinese demand growth through a developed market. China’s stock market finished the quarter...
down 6%, as monetary-tightening measures designed to keep inflation in check weighed on global equity markets. The impact on Materials and Energy stocks was felt this quarter, as Canadian stocks had largely ignored this modest cautionary flag. Movements in emerging-market stocks will remain an indicator for Canadian equities.

**SECTOR ANALYSIS**

While bank investors are concerned about consumer loan growth and stiff competition in domestic banking, industry valuations remain within their 10-year range on a forward-P/E basis. Dividends, coupled with modest payout growth, should provide reasonable returns in the year ahead. RBC raised its dividend, leaving Bank of Montreal and CIBC as the only banks to have not increased theirs so far this cycle. Investors are focused on when the Bank of Canada might raise rates, as an increase would alleviate some of the pressure on net interest margins. While insurers have taken steps to dampen their exposure to interest rates, volatility in rates continues to drive sentiment on the group. One industry whose valuations have moved to elevated levels is real estate, as falling interest rates have lowered the capitalization rates implied by company valuations. Given the modest cash-flow growth of this sector, valuations are vulnerable to a change in rates. We are lowering our recommendation on the FINANCIALS sector to a modest underweight from a modest overweight.

We have maintained a market-weight position in the MATERIALS sector. At current commodity prices, free-cash-flow generation will be significant. Valuations have corrected recently and now reflect commodity prices that are below prices implied in the forward market, presenting investors with more reasonable valuations. We are looking for an opportunity to re-establish an overweight position. Supply data, in the case of copper in particular, remains supportive of elevated prices. A number of gold stocks have struggled to reap the rewards of higher gold prices in their financial results. After moving strongly with the price of bullion for a lengthy period, stock selection in this area has increased in importance.

Given the surge in both oil prices and related stocks late in the quarter following turmoil in the Middle East, it is difficult to figure out what is and is not priced into the ENERGY sector at this juncture. While an ebbing of Middle East tensions would lead to an easing in crude prices, the improvement in valuations of long-life reserves in stable regions is likely more permanent. We are closely monitoring the effect that higher oil prices are having on demand, and calculate that share prices for larger Canadian oil producers seem to reflect an oil price in the range of $80, which should provide support. Meanwhile, natural gas continues to suffer from a relative lack of demand and has not risen with the run-up in crude prices – meaning that natural gas trades at a substantial discount based on energy content. Our stance remains market weight in the sector.

Many companies in the INDUSTRIALS sector have performed well, reflecting the likelihood of faster economic activity. While some portion of recovery has been priced into valuations, capital investment and infrastructure projects will continue to be areas of growth. We remain overweight.

The INFORMATION TECHNOLOGY sector falls to market weight. Uncertainty about sector heavyweight Research In Motion continues to increase. While Blackberry Messenger, RIM’s exposure to large institutions and a strong balance sheet should provide support, potential margin and unit growth have become tougher to predict. Smaller components in the sector have reasonable valuations, and, coupled with healthy growth prospects, offer good investment alternatives.

We are slightly more positive on the CONSUMER STAPLES and CONSUMER DISCRETIONARY sectors. These sectors are dominated by well-run businesses with strong free-cash-flow generation. The arrival of Target in Canada, coupled with a more frugal consumer, could present challenges.
ECONOMIC BACKDROP

European equity markets have been remarkably resilient so far this year, in the face of numerous headwinds. Strong corporate balance sheets and cash flows, low valuations and increased M&A activity have helped offset a more challenging macroeconomic environment.

The economic headwinds weighing on global growth pose near-term risks for cyclical companies in the consumer and Industrials sectors, which benefited most from a robust recovery. While we expect any slowdown to be temporary, export-based economies such as Germany and Scandinavia would be vulnerable. However, in the context of Europe’s two-speed economy, these areas will likely outperform. Companies exposed to domestic demand in these economies should continue to prosper relative to those exposed to peripheral Europe and the U.K.

While analysts continue to raise their earnings estimates for European companies, there has been little change in overall GDP growth expectations. The consensus is for earnings to grow 13% in both 2011 and 2012. Following a strong recovery in profit margins, top-line growth should increasingly take over as the main driver of earnings. Corporate profits remain vulnerable to deterioration in the economic outlook, but current valuations leave room for equity markets to absorb downgrades.

Valuations in Europe remain attractive, both on an absolute basis and relative to other markets and asset classes. The MSCI Europe is trading at 11 times consensus earnings estimates for 2011, a 10% discount to global developed markets. Robust cash flows and low payout ratios should support returns to shareholders through buybacks and/or payout growth. Europe’s projected 2011 dividend yield of 3.7% is high relative to other major markets. Strong corporate balance sheets and low valuations should also drive an increase in M&A activity.

On balance, we continue to believe that continued economic recovery, alongside reasonable earnings growth, strong corporate balance sheets and attractive valuations, provide a favourable backdrop for European equities over the medium term. However, near-term risks have risen. As a result, our best expectation is for markets to grind higher, but with the probability that there will be periods of weakness associated with any macroeconomic uncertainty. Periods of weakness should be seen as buying opportunities.
We remain wary of the Financials sector and companies exposed to southern Europe, both of which are adjusting to the new macroeconomic landscape, but we are not too underweight in either area. Expectations of a near-term slowdown in the global economic outlook point to a portfolio focus on high-quality, growth stocks with positive earnings momentum in cyclical and defensive sectors. This results in a fairly balanced portfolio, albeit one that has a small bias towards northern European markets and cyclical sectors.

**SECTOR ANALYSIS**

Our stance on the INFORMATION TECHNOLOGY sector falls to neutral. We view software stocks as later-cycle investments and a beneficiary of corporate spending. Expectations remain relatively low, and managements are demonstrating capital discipline. There are a number of opportunities in both the mid-cap and large-cap areas, where we see a combination of good earnings momentum and the potential for improved returns over time.

The MATERIALS sector falls to underweight from overweight. Profits at mining companies are historically high, and we remain concerned that returns may have peaked. We prefer chemicals producers, which boast improved operations and attractive valuations.

We have increased our weighting in the UTILITIES sector to near neutral from underweight. Capital expenditures are high, and balance sheets are stretched. While dividend yields in the sector are attractive, growth remains low and valuations look quite full.

The CONSUMER STAPLES sector remains quite fully valued but has lagged the market. We have marginally reduced our underweight position. Many companies in the sector have been hurt by rising raw-material costs, but this effect appears to have passed its peak and pressure on profit margins should be reduced.

We have moved from underweight to a slight overweight in the HEALTH CARE sector. Strong balance sheets, cheap valuations, attractive dividend yields and robust cash flows are clear positives for large-cap pharmaceutical companies. However, medium-term revenue growth will be challenged by patent expiries. Our exposure to the sector continues to be focused on a number of large-cap pharmaceutical companies with low valuations and relatively good growth prospects.

We remain underweight FINANCIALS, and, within the sector prefer insurance to banks. Banks, which are stuck in a trading range, will continue to be affected by regulatory changes and exposure to bonds issued by Europe's peripheral economies. The performance of life-insurance companies is tied to movements in bond yields, and we expect that to continue. In reinsurance, pricing is generally soft and earnings will be hit by losses on catastrophes. Insurers in other areas are starting to benefit from price increases.

We remain overweight in the CONSUMER DISCRETIONARY sector, although our exposure is concentrated. Our main area of preference is consumer services, an area that provides relatively low risk exposure to recovering demand in the developed world through companies that hold market-leading positions. We have no exposure to retailers, which are tied to a tough consumer backdrop in Europe and rising prices for raw materials.

We also remain overweight the INDUSTRIALS sector. Shares of capital-goods producers had a soft start to the year on evidence that margins were under pressure, but more recent results suggest that the strong profit momentum witnessed last year is set to continue. We worry about risks to global growth over the next 12 months but want to stay overweight areas of the sector that exhibit growth at a reasonable price. We are seeing improved momentum in some of the later-cycle stocks.

Our rating on ENERGY stays at slightly overweight. The sector has lagged the recent strong gains in oil prices. Earnings momentum has been robust, and the sector trades at a substantial discount to the overall market while offering a dividend yield near 4%. Exposure to both integrated and oil-service companies has been increased. The latter will continue to benefit from capital expenditures by oil and gas explorers.

We suspect that top-line momentum may creep back into the TELECOMMUNICATION SERVICES sector, as pricing power returns in tiered mobile-data packages, but we have seen only limited evidence of this so far. For this reason, we remain slightly underweight. That said, the sector is fundamentally cheap, with excellent dividend and free cash-flow yields.

REGIONAL OUTLOOK – EUROPE • MICHAEL JOYNSON
REGIONAL OUTLOOK

The economic disruptions caused by the March 11, 2011, Tohoku earthquake continue to reverberate. As the effects of the disaster on the global supply chain fade, however, we believe that the economic focus will shift to concern about the inflation taking root in many parts of the world. Importantly, global demand for Asian products remains intact, even as many countries in the region gradually raise interest rates and allow their currencies to appreciate. Such policy tightening is likely to continue for at least a few more quarters, or until sequential GDP growth slows meaningfully and inflation eases. In the near term, we expect Asian equity markets to grind higher, supported by earnings growth and relatively low valuations. Volatility will remain.

Asian exports of technology, consumer goods, capital equipment and specialty materials should recover swiftly as supply chains are restored. Some restocking is likely in the second half of 2011 due to pent-up demand, benefiting South Korea and Taiwan in particular. Japanese growth should accelerate into 2012 on spending to rebuild areas devastated by the earthquake. In China, inflation has not started to ease even though the economy started slowing in the first quarter of 2011. The Australian equity market will remain under pressure.

Asian equity valuations remain below near-term averages given the current environment. A potential challenge will be uncertainty over whether the end of QE2 turns out to be destabilizing for stocks and bonds.

In Japan, the negative impact of the earthquake on manufacturing will probably linger until late summer, eroding corporate profits for the fiscal first half ending September 30. While motor-vehicle production will likely fall, inventory restocking will begin soon for the Christmas season, and a sharp rebound in overall corporate profitability is probable. The Fukushima nuclear power plant is likely to remain a potential threat to Japan’s recovery, but this risk should diminish over time.

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The Japanese market reflected a high risk premium after the earthquake, but in reality most of Japan, including Tokyo, is considered safe and is functioning almost normally. Nonetheless, for investors to jump back in with both feet, a clear sign is needed that the nuclear situation is contained.

In China, a 550-basis-point cumulative rise in the bank reserve-requirement ratio since January 2010, a 100-basis-point increase in the

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**REGIONAL OUTLOOK – ASIA**

**YOJI TAKEDA**
Director & V.P., Asian Equities – RBC Investment Management (Asia) Limited

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**ASIA RECOMMENDED SECTOR WEIGHTS**

<table>
<thead>
<tr>
<th>Sector</th>
<th>RBC INVESTMENT STRATEGY COMMITTEE MAY 2011</th>
<th>BENCHMARK MSCI PACIFIC MAY 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>ENERGY</td>
<td>3.2%</td>
<td>3.0%</td>
</tr>
<tr>
<td>MATERIALS</td>
<td>12.7%</td>
<td>12.4%</td>
</tr>
<tr>
<td>INDUSTRIALS</td>
<td>17.1%</td>
<td>16.1%</td>
</tr>
<tr>
<td>CONSUMER DISCRETIONARY</td>
<td>14.8%</td>
<td>13.8%</td>
</tr>
<tr>
<td>CONSUMER STAPLES</td>
<td>5.7%</td>
<td>6.1%</td>
</tr>
<tr>
<td>HEALTH CARE</td>
<td>4.0%</td>
<td>4.4%</td>
</tr>
<tr>
<td>FINANCIALS</td>
<td>27.8%</td>
<td>28.8%</td>
</tr>
<tr>
<td>INFORMATION TECHNOLOGY</td>
<td>7.9%</td>
<td>8.2%</td>
</tr>
<tr>
<td>TELECOMMUNICATION SERVICES</td>
<td>3.3%</td>
<td>3.7%</td>
</tr>
<tr>
<td>UTILITIES</td>
<td>3.5%</td>
<td>3.6%</td>
</tr>
</tbody>
</table>

Source: RBC GAM

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**JAPAN DATASTREAM INDEX EQUILIBRIUM**

*Normalized Earnings and Valuations*

Source: Datastream, Consensus Economics, RBC GAM

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May ‘11 Range: 272 - 653 (Mid: 463)
May ‘12 Range: 366 - 879 (Mid: 622)
Current (31-May-11): 262
central bank’s key lending rate since October 2010, and steady renminbi appreciation (4.8% year over year) are hurting various industries. However, growth momentum is not likely to fall significantly within the region, especially with solid job and income growth supporting domestic consumption. One caveat is rising oil prices, whose inflationary impact tends to be harshest in South Korea and India. Asian central banks started tightening monetary policy about a year ago, while developed markets, with the exception of the Eurozone, have kept policy rates as loose as possible. The consensus is calling for a peak in Chinese inflation during the second quarter of 2011. While more tightening may occur in the near term, Asian stock markets have already started pricing in the end of the current cycle, particularly in China.

Australia’s mining-related investment boom should extend into 2012 amid strong commodity prices and robust demand. However, limited spare capacity in both the supply chain and labour markets poses inflationary risks. A downturn in commodity prices or demand is a big risk to the economy because growth in other areas has been hit by the effects of a record-high currency and rising interest rates on non-mining manufacturing, construction and tourism. Without a fall in commodity prices and/or an increase in spare capacity, Australia’s central bank is expected to keep monetary policy tight for the foreseeable future. From a stock-market perspective, therefore, a near-term expansion in P/E ratios appears unlikely.

SECTOR ANALYSIS

Our stance on the FINANCIALS sector remains slightly underweight. Although Asian financial companies have generally reported good results, the prospects for further improvement are limited as monetary tightening continues. We expect growth at real estate and insurance companies to slow, and Japanese banks remain under pressure.

We remain overweight the INDUSTRIALS sector. Demand for equipment and productivity-improving machinery is strong, as wages are rising rapidly. Capital investments in mining and infrastructure such as power generation and railroads are also robust. However, transportation remains generally weak, as there is ample capacity.

The CONSUMER DISCRETIONARY sector remains overweight. Demand for automobiles remains strong in China and is recovering in Japan after the earthquake. Although domestic consumption is stagnant in Asia, except for China, rising wages should eventually push spending higher.

The MATERIALS sector stays at overweight. Commodity prices have already risen substantially and they are likely to consolidate. But various specialty chemicals and materials in which Asian suppliers tend have a global market share remain in high demand.

We have cut our rating on the INFORMATION TECHNOLOGY sector to underweight from overweight. Although world demand for smartphones and tablets is strong, sales of PCs and flat-panel TVs have been less than expected. Investments in semiconductor manufacturing may weaken, and supply-chain disruptions are making production forecasts more difficult.

We maintain a slight overweight position in the ENERGY sector. Producers are benefitting from elevated energy prices, and refiners can sometimes enjoy better profit margins when the price of oil is rising.

We maintain our underweight rating on CONSUMER STAPLES. Domestic consumption in Japan remains weak, and Australian consumers are less willing to spend as monetary tightening weighs on housing prices and boosts interest costs. Cigarette taxes were recently raised in Japan.

We are leaving our rating on the HEALTH CARE sector at underweight. Earnings at Japanese health-care companies are declining because of patent expiries, and the industry’s use of mergers and acquisitions to grow out of the problem may prove costly. Australian health-care companies are being hurt by the strong currency.

We remain underweight the TELECOMMUNICATION SERVICES sector. Growth prospects are limited, even in China, as the industry matures. Sector dividends remain attractive.

We are raising our rating on the UTILITIES sector to neutral from underweight. This is a defensive sector and offers attractive dividend yields. Electric power companies in Japan have largely priced in the rising cost of fossil fuel and the potential cost of new safety-related investments.
ECONOMIC BACKDROP

As the year started, a much-hyped view prevailed that investors should switch out of emerging markets and into developed markets. This position was supported by two arguments: first, that the uncertain developed-market economic recovery would prove to be strong and sustainable; and second, that many emerging markets were behind the curve in monetary tightening and that the resulting policy adjustment would cause their economic growth rates to slow. While developed markets strongly outperformed emerging markets at the start of the year, almost all of the outperformance has been given up since mid-February.

Why haven’t things unfolded as forecast? The optimism about developed-market growth at the start of the year has diminished, and growth forecasts for many developed economies, including the U.S., are now being revised down as the impact of higher oil prices bites. At the same time, growth forecasts for emerging markets have held up, as faster income growth has offset the negative impact of higher commodity prices. Moreover, tightening cycles in many emerging markets, including China, are now extended, and inflation in emerging economies appears to have peaked.

A recent report from the IMF provides optimism that global growth will continue in the medium term, despite negative headwinds such as the earthquake in Japan, unrest in the Middle East and rising commodity prices. The agency expects world GDP to exceed 4% both this year and next, with emerging economies forecast to grow by 6.5% in both years. Clearly this scenario would be vulnerable if an escalation of troubles in the Middle East leads to a sustained oil-price spike.

Apart from geopolitics, we see two key downside risks to this relatively benign scenario. High levels of U.S. public debt and Europe's fiscal crisis have the potential to constrain growth in the West. In the U.S., federal debt as a percentage of GDP is projected to rise above 100% this year, while the debt burdens of Europe's peripheral economies remain a serious overhang. As governments scale back their fiscal support, growth rates are likely to stay muted and interest rates low in the developed world for a considerable time. While emerging markets will not be immune from the fallout, their public finances are healthier, and this should help them to continue delivering much higher economic growth.

If, on the other hand, global growth remains strong, the key risk becomes the possibility of a surge in inflation around the world. Most countries are currently enjoying trend or above-trend growth, combined with below-normal interest rates. At this stage, there remains considerable uncertainty over the inflation threat across emerging markets. While recent inflation forecasts have risen, the consensus is that CPI inflation for emerging markets as a whole will peak over the coming months. Equity markets will likely anticipate this top, and a peak in monetary tightening as well. For China, this scenario makes sense given that CPI, which is largely driven by food, looks set to top out in the coming quarter. There is also growing evidence that Chinese authorities have credit growth under control. Other emerging economies such as India, Turkey and Brazil may face stronger-than-expected inflationary pressures, particularly amid a backdrop of strong global growth. We believe that inflation in individual emerging markets will vary significantly in 2011.

Valuations for emerging-market equities remain attractive. Earnings are now forecast to rise 19% in 2011,
up from 15% three months ago. This translates into a P/E of 10.9 for the MSCI Emerging Markets Index in 2011 and 9.8 in 2012. For 2011, this leaves the emerging markets index at a 13% discount to the MSCI World Index and an 18% discount to its long-term average.

SECTOR ANALYSIS

We retain our structural preference for sectors that will benefit from domestic emerging-market growth, which we believe will be the dominant theme for these economies in the coming years. Disposable income is growing strongly, and we expect consumption to surge over the next five years as the emerging-market middle class swells. We therefore have a positive stance on the CONSUMER DISCRETIONARY sector, which stands as the prime beneficiary of the shift in emerging markets from exports to domestic demand. This trend is supported by rising per-capita incomes, easier access to finance, pro-growth domestic policies and the soaring numbers of households that can afford durable goods.

We are also overweight the CONSUMER STAPLES sector, which we like longer term for similar reasons. The shift to domestic demand has made the sector more attractively valued, and we have therefore moved to an overweight position. The sector also has good long-term growth prospects and many high-quality companies with strong cash flows.

In order to accommodate the overweight in the consumer sectors, we hold large underweight stances in Materials and Energy. Commodity prices have risen this year, helped by global growth and the weak U.S. dollar. Even with high commodity prices, it is becoming increasingly difficult for MATERIALS companies to benefit due to problems including rising production costs, and higher taxes and royalties. We also believe that there is scope for a correction in commodity prices, particularly if global growth expectations start to disappoint or speculative interest decreases.

It is hard to find many emerging-market ENERGY companies that will benefit from oil prices at elevated levels. The sector is no longer cheap following strong relative performance so far this year. While emerging-market companies have been relatively successful at replenishing and increasing reserves and production, free cash flows have generally been poor, and the high levels of capital expenditures planned by Russian, Chinese and Brazilian producers mean this situation is likely to persist. We are, however, positive on the outlook for Russian oil stocks, whose particularly attractive valuations can offset the drag of higher capital costs.

We are neutral FINANCIALS. In the short term, the sector faces the negative headwinds of tighter monetary policy. Looking further out, we like the sector because rising wealth levels in emerging markets will lead to demand for mortgages and other banking services, and because we believe that interest-rate-sensitive stocks will perform well once inflation expectations peak. We are therefore looking at opportunities to increase our exposure to this sector. Furthermore, emerging-market banks have rising profit margins, increased loan volumes and fee growth, and lower loan-loss provisions.

The INFORMATION TECHNOLOGY sector is a small underweight. While technology will be a prime beneficiary of a pick-up in U.S. capital expenditures, and demand for consumer products in emerging markets is strong, stock multiples are no longer attractive and we have therefore reduced our weighting. We also have short-term concerns about the effect of the Japanese earthquake on supply-chain disruptions, although much of this impact is already reflected in stocks.

We are also underweight the INDUSTRIALS sector, which looks expensive because profits are being squeezed by higher raw-materials costs, on the one hand, and an inability to raise prices enough to compensate for those costs, on the other. Within the sector we prefer stocks that will benefit from capital investments.

The TELECOMMUNICATION SERVICES sector looks attractive and is a sector where the market appears to be underestimating the number of quality opportunities to be found. We are therefore overweight. Valuations for the sector are attractive, with the sector trading at a single-digit forward P/E, and with many companies offering 5% yields and even higher free-cash-flow yields. The majority of operators can look forward to an explosion of new data services, the rise of smart phones and the next generation of services.
RBC INVESTMENT STRATEGY COMMITTEE

MEMBERS

DANIEL E. CHORNOUS, CFA
CHIEF INVESTMENT OFFICER,
RBC GLOBAL ASSET MANAGEMENT, INC.
CHAIR, RBC INVESTMENT STRATEGY COMMITTEE

Dan Chornous is Chief Investment Officer of RBC Global Asset Management Inc. that have total assets under management more than $200 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.

JIM ALLWORTH
PORTFOLIO STRATEGIST,
RBC WEALTH MANAGEMENT

Jim has been in the investment business for 39 years as both a research analyst and portfolio strategist. He is currently a director of RBC Investments and also Vice-Chair of the RBC Capital Markets Investment Strategy Committee. Through his 33 years at RBC Dominion Securities (and predecessors), Jim has played a key role in developing investment policy for the firm and translating that worked into solutions for individual clients. He presents extensively on the topic.

JANET L. ENGELS
SENIOR V. P. AND DIRECTOR,
PRIVATE CLIENT RESEARCH GROUP
RBC WEALTH MANAGEMENT

Janet has more than 27 years of experience in the securities industry. She joined Tucker Anthony, later RBC Dain Rauscher, in 1982. Over the course of her career, she has held the positions of Director of Equity Research for Sutro & Co. and Director of Equity Strategies for Tucker Anthony. In 2002 she was named Director of the Private Client Group at RBC Dain Rauscher, now RBC Wealth Management, where she is also a member of the Director’s Circle.

DAGMARA FIJALKOWSKI, MBA, CFA
HEAD, GLOBAL FIXED INCOME & CURRENCIES
(TORONTO AND LONDON),
RBC GLOBAL ASSET MANAGEMENT INC.

As Head of Global Fixed Income & Currencies at RBC 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 V. P. &
SENIOR PORTFOLIO MANAGER,
RBC GLOBAL ASSET MANAGEMENT INC.

Stu Kedwell 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.
Martin Paleczny, with 16 years of experience in the investing field, 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 to the RBC Investment Strategy Committee for technical analysis.

George has more than 30 years experience in the Financial sector, with over 18 years of investment experience. He is a Fellow of the Securities and Investment Institute. Prior to joining RBC, he worked with Lloyds Bank International in their trust businesses in the British Isles and Monaco. George joined Royal Bank of Canada in 1985 and moved to Guernsey where he was appointed Director of Royal Bank of Canada Investment Management (Guernsey) Limited in 1993. In March 2000, he moved to Geneva, Switzerland, where he was appointed Chief Investment Officer of Royal Bank of Canada (Suisse) in June 2002. In January 2006 George was appointed Head, Global Investment Solutions and relocated to Guernsey.

Andrew Mitchell, CFA
V.P. & Institutional Portfolio Manager, RBC Global Asset Management Inc.

Andrew began his career at RBC Dominion Securities and has nearly two decades of experience in the investment industry. He is currently an institutional portfolio manager and a member of the firm’s Phillips, Hager & North Canadian Equity team. He is also a portfolio manager at RBC Global Asset Management. Prior to joining PH&N, Andrew was a top-ranked sell-side equity analyst and Managing Director at Scotia Capital. Andrew holds an MSc from the London School of Economics. He was appointed to the RBC Investment Strategy Committee in 2009.

Eric Lascelles, CFA
Chief Economist, RBC Global Asset Management Inc.

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 of 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.

Andrew Mitchell, CFA
V.P. & Institutional Portfolio Manager, RBC Global Asset Management Inc.

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Eric Lascelles, CFA
Chief Economist, RBC Global Asset Management Inc.

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 of 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.
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