RBC Global Asset Management

THE GLOBAL INVESTMENT OUTLOOK

RBC Investment Strategy Committee

SPRING 2012

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*.

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EXECUTIVE SUMMARY

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Equities and confidence have been trending higher since the start of 2012 on the back of favourable economic data. Not only has the economy rebounded, but memories of last summer's crippling U.S. political dysfunction are beginning to fade, and Europe has managed a series of deft policy manoeuvres that have dialled back the intensity of its crisis. The upward trend is clear in confidence, employment, consumer credit, purchasing managers' indexes, credit spreads and stock prices. And yet a degree of caution remains advisable. The rollercoaster ride that was 2011 reminds us that even the most promising of beginnings can be derailed by adverse – and oftentimes unforeseeable – developments. Moreover, levels of sustainable economic growth may simply not be very impressive in the present era.

Improved economic data, but risks remain

Consensus economic forecasts have responded to this barrage of good cheer by starting to flutter higher. Our own estimates are mostly unchanged, or even slightly weaker, relative to a quarter ago. With this publication, we introduce our 2013 forecasts. On the whole, they correspond to the view that 2013 will be reminiscent of 2012, with the expected continued application of the fiscal handbrake and a lingering financial crisis-induced hangover.

Europe remains a focal point for global markets, and our biggest worry. We can say with reasonable confidence that one-fifth of the global economy (the Eurozone) will be in recession in 2012. Interest rates are still enormously stimulative, but fiscal austerity is beginning to bite, and we expect big cuts in government spending to stifle growth in peripheral Europe, slicing about a percentage point off U.S. economic growth, and lesser amounts elsewhere. Perhaps most tellingly, economic forecasts still call for weaker growth in 2012 than in 2011, which was itself weaker than 2010. Europe has bought itself some breathing room by introducing several major initiatives, but we remain cautious about near-term prospects simply because much work remains to be done. Our long-term outlook has always been relatively benign: no failure of a large bank; no default by a large country (though smallish Greece and Portugal are another matter); and the survival of the euro in its current form. All of this is in the best interest of Europe, achievable, and ultimately likely.

The U.S. has enjoyed an impressive economic rebound since the fall. Two festering wounds of past dysfunction – the housing market and the job market – have begun to heal. The U.S. housing market is clearly in transition. We endorse the view that it has mostly stopped deteriorating and may even begin a modest rebound. However, a more ebullient move higher remains unlikely, despite improvement in some measures of sales activity. A big development over the past several months has been surging U.S. job creation. Employment gains have materially exceeded expectations and put the unemployment rate on track for a showing that was expected to take the better part of a year to achieve.

China remains a concern as it has clearly lost a step over the past year. But the Chinese economy now looks to be stabilizing, thanks in large part to policymakers who have taken full advantage of the window afforded by falling inflation to deliver further monetary stimulus and to prop up the precariously positioned housing and local debt markets. We continue to look for a Chinese soft landing in the near term. But credit excesses can only be solved with yet more credit for a finite period before bigger problems emerge. We fear a harder landing for China later this decade.

The dollar finds support

As for currency markets, the U.S. dollar remains a safe haven with an attractive valuation and the potential to eventually start trading based on the economy's brighter growth prospects. The long-term case for a higher dollar is also supported by a gradual improvement in the U.S. current-account deficit and stronger demographics. The country's relatively young population will boost the size of the labour force down the road, increasing the odds that U.S. workers can generate sufficient tax revenue to service high debt levels. Europe does not enjoy such support. We believe that a weaker euro is an integral part of the solution to the problems in the peripheral Eurozone. Now that the ECB has been adding liquidity in ever larger amounts and ever longer maturities, the single currency no longer enjoys the central-bank support that propped it up in 2011.

Mild inflation and low short rates ahead

Across most of the world, inflation remains reasonably well-behaved. Commodity prices are again rising, presenting an upside risk to inflation, but consumer food prices are turning down, providing some offset. There is certainly the chance of a whiff of extra inflation at some point down the road as the economy recovers and central bankers prove reluctant to tap on the brakes given prior traumatic experiences. But this is not a near-term prospect.

Global policy rates remain low as central banks deliver significant doses of unconventional stimulus with an eye towards stimulating economic growth. The Fed has articulated a plan to keep interest rates unchanged through 2014. In turn, the short end of the yield curve should remain extremely low for at least a few years to come. Other major central banks are unlikely to act much more quickly.

Upside risks to bond yields longer term, but flat in the near term

Policymakers appear committed to suppressing longer-term interest rates, at least in the near term. As a result of this, and the fact that risk aversion should remain elevated given fears about Europe and China risks, yields are unlikely to sprint higher in the near term. Should Europe deteriorate or another shock materialize, it is conceivable that U.S. 10-year yields could fall through their autumn 2011 levels.

In the longer term, however, our view remains that bond yields will eventually climb, perhaps sharply.

Ultimately, the economy will normalize and valuations within capital markets will line up with the interest and growth rates that prevail in the economy. In that scenario, government bonds are highly vulnerable to capital losses as investors decide that the probability of a return to crisis conditions has diminished. In fact, current yields are only sustainable in the event that tail risks emerge or economic growth is dramatically reduced for an extended period of time.

Investor confidence improves resulting in strong gains for equities

Stocks markets around the world have rebounded sharply from their autumn 2011 lows, mainly due to improved investor sentiment, as the pessimism that infected risk assets last fall has lifted. The diminishing risk of contagion spreading from Europe to the global financial system, and the low risk of a near-term U.S. recession are two factors supporting the market's advance. Some investors are questioning how much higher equities can go in the near term given the macroeconomic risks that are still apparent in Europe. Our view remains one of cautious optimism.

The long-awaited expansion in valuations appears to be emerging. Now that P/E ratios have moved higher, further equity-market gains may place valuations in a range that investors have been uncomfortable with since 2008. We still think this is possible, however, as the market remains well below fair value.

Alternatively, if valuations cannot advance from here, higher profits will be needed to drive stock gains. There is a rising hurdle rate on future profits because earnings have exceeded expectations for many quarters, and this earnings performance has been driven by cost cuts that will be increasingly difficult to replicate. While not impossible, this would require another surge in productivity growth, or a much stronger economy than we currently project.

Remain modestly overweight stocks, underweight bonds

Our recommended asset mix remains unchanged. The opportunity for patient investors to reap the benefits of normalization in stocks and bonds remains enormous and compelling. Moreover, these potential gains are not predicated on a return to above-average economic growth. Even relatively sluggish growth of 2% or so, accompanied by modest but positive profit growth and some further easing of investor risk aversion, would be sufficient to deliver extremely attractive relative returns for equity investors over the longer term. That said, we are reluctant to raise our equity overweight at this time, as we feel that stocks are vulnerable to a retracement or period of consolidation over the coming months. However, maintaining a cash reserve will allow us to act on opportunities as they present themselves amid a potentially volatile macroeconomic environment. Any reasonable longer-term view that assumes even a modest pace of continued economic expansion continues to argue for an underweight position in fixed income. For a balanced global investor, we recommend an asset mix of 57.5% equities (benchmark: 55% within an allowed range of 40% to 70%), 35.0% bonds (benchmark: 40% within an allowed range of 30% to 60%), with the balance of 7.5% in cash.

ECONOMIC & CAPITAL MARKETS FORECASTS

ECONOMIC FORECAST (RBC INVESTMENT STRATEGY COMMITTEE)														
	UNITED STATES		CANADA		EUROPE		UNITED KINGDOM		JAPAN		CHINA		EMERGING MARKETS[1]	
	Spring 2012	Change from New Year 2012	Spring 2012	Change from New Year 2012	Spring 2012	Change from New Year 2012	Spring 2012	Change from New Year 2012	Spring 2012	Change from New Year 2012	Spring 2012	Change from New Year 2012	Spring 2012	Change from New Year 2012
REAL GDP														
2011A	1.70%		2.30%		1.50%		0.90%		(0.90%)		9.25%		6.60%	
2012E	2.00%	N/C	2.00%	N/C	(0.50%)	(0.50)	0.50%	(0.50)	1.75%	(0.50)	8.25%	0.25	6.00%	(0.50)
2013E	2.00%	N/C	2.25%	N/C	0.50%	N/C	1.50%	N/C	1.50%	N/C	8.00%	(0.25)	6.00%	N/C
CPI														
2011A	3.10%		2.90%		2.70%		4.50%		(0.30%)		5.53%		6.50%	
2012E	1.75%	N/C	2.00%	N/C	1.50%	N/C	2.75%	0.25	0.00%	(0.25)	3.50%	0.50	5.00%	(0.50)
2013E	1.75%	N/C	2.00%	N/C	1.50%	N/C	2.00%	N/C	0.00%	N/C	3.50%	0.50	4.25%	N/C

A = Actual E = Estimate

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

TARGETS (RBC INVESTMENT STRATEGY COMMITTEE)				
	FEBRUARY 2012	FORECAST FEBRUARY 2013	CHANGE FROM NEW YEAR 2012	1-YEAR TOTAL RETURN ESTIMATE (%)
CURRENCY MARKETS AGAINST USD				
USD–CAD	0.99	1.04	N/C	(4.2)
EUR–USD	1.33	1.20	(0.05)	(9.1)
USD–JPY	81.15	83.00	3.00	(2.7)
GBP–USD	1.59	1.60	N/C	1.3
FIXED INCOME MARKETS				
U.S. Fed Funds Rate	0.25	0.25	N/C	N/A
U.S. 10-Year Bond	1.99	2.50	(0.50)	(2.5)
Canada Overnight Rate	1.00	1.00	N/C	N/A
Canada 10-Year Bond	1.99	2.75	(0.25)	(4.6)
Eurozone Policy Rate	1.00	0.50	N/C	N/A
Germany 10-Year Bund	1.82	2.50	(0.50)	(4.2)
U.K. Base Rate	0.50	0.50	N/C	N/A
U.K. 10-Year Gilt	2.15	2.50	(0.25)	(0.9)
Japan Overnight Call Rate	0.10	0.10	N/C	N/A
Japan 10-Year Bond	0.96	1.25	(0.25)	(1.7)
EQUITY MARKETS				
S&P 500	1366	1450	75	8.3
S&P/TSX Composite	12644	13250	(250)	7.7
MSCI Europe	1392	1435	35	8.0
FTSE 100	5872	6300	550	11.4
Nikkei	9723	9700	(50)	2.0
MSCI Emerging Markets	1079	1200	N/C	14.2

Source: RBC GAM

RECOMMENDED ASSET MIX

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

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

Each quarter, the RBC Investment Strategy Committee publishes a recommended asset mix based on our current view of the economy and return expectations for the major asset classes. These weights are further divided into recommended exposures to the variety of global fixed income and equity markets. Our recommendation is targeted at the Balanced profile where the benchmark setting is 55% equities, 40% fixed income, 5% cash.

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

This tactical recommendation for the Balanced profile can serve as a guide for movement within the ranges allowed for all other profiles. If, for example, the recommended current equity exposure for the Balanced profile is set at 62.5%

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GLOBAL ASSET MIX

	BENCHMARK POLICY	PAST RANGE	SPRING 2011	SUMMER 2011	FALL 2011	NEW YEAR 2012	**SPRING 2012**
CASH	**5.0%**	1.5% – 16%	2.5%	5.0%	7.5%	7.5%	**7.5%**
BONDS	**40.0%**	25% – 54%	37.5%	36.5%	35.0%	35.0%	**35.0%**
STOCKS	**55.0%**	36% – 65%	60.0%	58.5%	57.5%	57.5%	**57.5%**

REGIONAL ALLOCATION

GLOBAL BONDS	**CWGBI* FEB. 2012**	PAST RANGE	SPRING 2011	SUMMER 2011	FALL 2011	NEW YEAR 2012	**SPRING 2012**
North America	**31.9%**	17% – 26%	33.9%	34.8%	35.0%	33.7%	**36.9%**
Europe	**35.1%**	42% – 57%	32.7%	35.8%	34.5%	31.7%	**32.6%**
Asia	**33.0%**	22% – 35%	33.4%	29.5%	30.5%	34.6%	**30.5%**

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

GLOBAL EQUITIES	**MSCI** FEB. 2012**	PAST RANGE	SPRING 2011	SUMMER 2011	FALL 2011	NEW YEAR 2012	**SPRING 2012**
North America	**57.6%**	51% – 58%	55.5%	55.5%	56.0%	58.3%	**58.8%**
Europe	**24.3%**	28% – 35%	29.5%	27.0%	24.3%	23.3%	**23.3%**
Asia	**12.7%**	10% – 18%	15.0%	12.0%	13.3%	12.5%	**12.0%**
Emerging Markets	**5.5%**	0% – 6.5%	0.0%	5.5%	6.5%	6.0%	**6.0%**

GLOBAL EQUITY SECTOR ALLOCATION

	MSCI FEB. 2012**	RBC ISC NEW YEAR 2012	**RBC ISC SPRING 2012**	CHANGE FROM NEW YEAR 2012	WEIGHT vs. BENCHMARK
Energy	11.46%	12.71%	11.46%	(1.25)	100.00%
Materials	7.68%	7.62%	7.68%	0.06	100.00%
Industrials	11.30%	11.15%	13.30%	2.15	117.69%
Consumer Discretionary	10.54%	11.38%	11.54%	0.16	109.49%
Consumer Staples	10.31%	10.89%	10.31%	(0.57)	100.00%
Health Care	10.08%	9.52%	10.08%	0.56	100.00%
Financials	18.69%	17.03%	17.69%	0.66	94.65%
Information Technology	12.26%	13.32%	14.26%	0.94	116.31%
Telecom. Services	4.00%	3.44%	2.00%	(1.44)	49.96%
Utilities	3.67%	2.94%	1.67%	(1.27)	45.47%

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

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(i.e.: 7.5% above its benchmark of 55% and part way toward its upper limit of 70% for equities), that would imply a tactical shift of + 5.02% to 25.02% for the Very Conservative profile (i.e.: a proportionate adjustment above the benchmark equity setting of 20% within the allowed range of +/- 15%).

The value-added of tactical strategies 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 1977 – 2012, based on monthly results.
2. **Volatility:** The standard deviation of returns. Standard deviation is a statistical measure that indicates the range around the average return within which 2/3 of results will fall into, assuming a normal distribution around the long-term average.

VERY CONSERVATIVE

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
CASH & CASH EQUIVALENTS	5%	0-15%	7.5%	7.5%
FIXED INCOME	75%	55-95%	71.4%	71.4%
TOTAL CASH & FIXED INCOME	80%	65-95%	78.9%	78.9%
CANADIAN EQUITIES	10%	5-20%	10.6%	10.6%
U.S. EQUITIES	5%	0-10%	6.2%	7.0%
INTERNATIONAL EQUITIES	5%	0-10%	4.3%	3.5%
EMERGING MARKETS	0%	0%	0.0%	0.0%
TOTAL EQUITIES	20%	5-35%	21.1%	21.1%

	RETURN	VOLATILITY
35-YEAR AVERAGE	9.4%	6.2%
LAST 12 MONTHS	6.7%	1.9%

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

CONSERVATIVE

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
CASH & CASH EQUIVALENTS	5%	0-15%	7.5%	7.5%
FIXED INCOME	60%	40-80%	55.5%	55.5%
TOTAL CASH & FIXED INCOME	65%	50-80%	63.0%	63.0%
CANADIAN EQUITIES	15%	5-25%	16.0%	16.0%
U.S. EQUITIES	10%	0-15%	11.8%	12.9%
INTERNATIONAL EQUITIES	10%	0-15%	9.2%	8.1%
EMERGING MARKETS	0%	0%	0.0%	0.0%
TOTAL EQUITIES	35%	20-50%	37.0%	37.0%

	RETURN	VOLATILITY
35-YEAR AVERAGE	9.7%	7.5%
LAST 12 MONTHS	4.9%	2.9%

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

BALANCED

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
CASH & CASH EQUIVALENTS	5%	0-15%	7.5%	7.5%
FIXED INCOME	40%	20-60%	35.0%	35.0%
TOTAL CASH & FIXED INCOME	45%	30-60%	42.5%	42.5%
CANADIAN EQUITIES	20%	10-30%	21.1%	21.1%
U.S. EQUITIES	20%	10-30%	22.0%	23.2%
INTERNATIONAL EQUITIES	12%	5-25%	11.0%	9.7%
EMERGING MARKETS	3%	0-10%	3.4%	3.5%
TOTAL EQUITIES	55%	40-70%	57.5%	57.5%

	RETURN	VOLATILITY
35-YEAR AVERAGE	9.8%	8.9%
LAST 12 MONTHS	3.1%	5.2%

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

GROWTH

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
CASH & CASH EQUIVALENTS	5%	0-15%	7.5%	7.5%
FIXED INCOME	25%	5-40%	19.7%	19.7%
TOTAL CASH & FIXED INCOME	30%	15-45%	27.2%	27.2%
CANADIAN EQUITIES	25%	15-35%	26.2%	26.2%
U.S. EQUITIES	25%	15-35%	27.1%	28.5%
INTERNATIONAL EQUITIES	16%	10-30%	14.5%	13.1%
EMERGING MARKETS	4%	0-10%	5.0%	5.0%
TOTAL EQUITIES	70%	55-85%	72.8%	72.8%

	RETURN	VOLATILITY
35-YEAR AVERAGE	10.0%	11.1%
LAST 12 MONTHS	1.3%	7.0%

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

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
CASH & CASH EQUIVALENTS	5%	0-15%	5.0%	5.0%
FIXED INCOME	0%	0-10%	0.0%	0.0%
TOTAL CASH & FIXED INCOME	5%	0-20%	5.0%	5.0%
CANADIAN EQUITIES	35%	20-50%	35.5%	35.5%
U.S. EQUITIES	30%	15-45%	31.6%	33.1%
INTERNATIONAL EQUITIES	22.5%	10-35%	20.9%	19.4%
EMERGING MARKETS	7.5%	0-15%	7.0%	7.0%
TOTAL EQUITIES	95%	80-100%	95.0%	95.0%

	RETURN	VOLATILITY
35-YEAR AVERAGE	10.0%	13.7%
LAST 12 MONTHS	-2.1%	10.1%

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

CAPITAL MARKETS PERFORMANCE

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Between December 1, 2011, and February 29, 2012, the U.S. dollar rose against the Japanese yen and the euro, while falling against the Canadian dollar and the British pound. The greenback's gains were attributable to concern about the fate of European sovereign debt, while the yen was hurt by the Bank of Japan's use of an expanded toolbox to curb the currency's gains. In the latest 12 months, the U.S. dollar rose against the euro, the pound and the Canadian dollar, but declined versus the yen.

Fixed-income markets rose in the world's major developed countries, except for Japan. The Citigroup Japan Total Return Index declined 3.5% in U.S. dollar terms due to the yen's depreciation against the greenback. Meanwhile, the Citigroup Europe Total Return Index rose 5.9%, as investors shifted assets to German bonds amid uncertainty about the future of the Eurozone. The Barclays Capital Aggregate Bond Index, a broad measure of U.S. fixed-income performance, climbed 2.0%, and the DEX Universe Bond Index gained 1.8%. The Citigroup World Government Bond Index (WGBI) climbed 2.2%. During the 12-month period, all fixed-income indexes in developed markets recorded solid gains, led by the 10.0% rise in the DEX index, which was buoyed by global demand for top-ranked sovereign debt. The Barclays Capital index gained 8.4%, followed by the Citigroup Europe Index gain of 5.9% and the 4.0% rise for the Citigroup Japan Index.

EXCHANGE RATES (USD RETURNS)
PERIODS ENDING FEBRUARY 29, 2012

	Current USD	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
USD–CAD	0.9901	(2.93)	(2.81)	1.91	(8.03)	(3.28)
USD–EUR	0.7506	0.90	(2.73)	3.56	(1.65)	(0.14)
USD–GBP	0.6285	(1.34)	(2.36)	2.11	(3.47)	4.29
USD–JPY	81.2849	4.53	5.50	(0.81)	(5.97)	(7.28)

Note: all changes above are expressed in US dollar terms

CANADA (CAD $ BASIS)
PERIODS ENDING FEBRUARY 29, 2012

Fixed Income Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
DEX Universe Bond Index	1.79	0.11	10.02	7.40	6.15

U.S. (USD $ BASIS)
PERIODS ENDING FEBRUARY 29, 2012

Fixed Income Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
Citigroup U.S. Government	0.62	(0.30)	9.43	4.92	6.38
Barclays Capital Agg. Bond Index	1.96	0.85	8.37	7.52	6.36

GLOBAL (USD $ BASIS)
PERIODS ENDING FEBRUARY 29, 2012

Fixed Income Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
Citigroup WGBI	2.16	1.51	6.43	7.68	6.61
Citigroup Europe Government	5.92	5.65	5.87	7.35	4.83
Citigroup Japan Government	(3.49)	(5.00)	4.04	8.50	10.35

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

Source: Bloomberg/MSCI

All developed-market equity markets posted gains during the three-month period, in most cases in the double digits. Canadian stocks lagged, however. The S&P 500 rose 10.1% during the quarter, and climbed 5.1% in the latest 12-month period. The 4.3% gain in the S&P/TSX Composite Index was about half that of most other developed-market indexes. The performance of the benchmark Canadian index masked a significant difference in returns among large- and small-cap stocks. The S&P/TSX Small Cap Index climbed 9.0%, more than twice the 4.1% gain for the S&P/TSX 60 Index. For the 12-month period, the Canadian small-cap index fell 9.7%, while the large-cap index lost 9.2%. The S&P 400 Index, a measure of the U.S. mid-cap market, gained 11.0% over the latest three months and 2.6% for the 12-month period, while the S&P 600 Index, a gauge of small-cap performance, gained 10.2% over the three months and 5.1% over the 12-month period. Value and growth stocks had similar returns in the quarter, with the Russell 3000 Growth Index returning 10.7% and the Russell 3000 Value Index returning 10.1%. Over the last 12 months, however, the growth index outperformed significantly, returning 7.2% compared with a 1.8% return for the value index.

Among individual developed-country equity markets outside North America, the MSCI Germany performed best, with a 12.0% gain in U.S. dollar terms. The MSCI Japan came second, with a 10.7% rise, followed by MSCI France, at 9.4% and MSCI U.K., at 9.0%. The MSCI Emerging Markets was the best-performing major index, gaining 16.6%.

All 10 global equity sectors rose over the latest three-month period, but the range of performance was wide. The best performing sector was Financials, which returned 15.6%, followed by Consumer Discretionary with a gain of 13.6%, and Information Technology, up 12.8%. The worst-performing sectors were Utilities, which gained only 0.5%, Telecommunication Services, which rose 1.0%, and Consumer Staples, which climbed 5.3%. The best-performing sector over the latest 12-month period was Consumer Staples, and the worst-performing sector was Financials.

CANADA (CAD $ BASIS)
PERIODS ENDING FEBRUARY 29, 2012

Equity Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
S&P/TSX Composite	4.32	6.12	(8.15)	19.17	2.23
S&P/TSX 60	4.06	5.91	(9.24)	16.77	1.96
S&P/TSX Small Cap	9.03	11.40	(9.65)	30.01	1.54

U.S. (USD $ BASIS)
PERIODS ENDING FEBRUARY 29, 2012

Equity Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
S&P 500	10.11	9.00	5.12	25.56	1.58
S&P 400	10.99	11.40	2.55	31.50	4.67
S&P 600	10.20	8.83	5.14	31.41	3.37
Russell 3000 Value	10.08	7.95	1.77	25.22	(1.03)
Russell 3000 Growth	10.69	11.04	7.19	27.78	4.48
NASDAQ Composite Index	14.14	14.80	7.49	29.47	4.36

GLOBAL (USD $ BASIS)
PERIODS ENDING FEBRUARY 29, 2012

Equity Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
MSCI World*	10.09	10.15	(1.69)	22.66	(0.59)
MSCI EAFE*	10.32	11.38	(7.45)	19.74	(2.93)
MSCI Europe*	9.60	11.32	(7.77)	20.47	(3.19)
MSCI Pacific*	11.76	11.58	(6.62)	18.68	(2.31)
MSCI UK*	9.01	8.93	(0.22)	24.31	(1.47)
MSCI France*	9.35	13.01	(15.11)	15.25	(5.22)
MSCI Germany*	12.00	19.85	(9.03)	22.35	(0.96)
MSCI Japan*	10.70	9.80	(10.16)	12.21	(5.70)
MSCI Emerging Markets*	16.59	18.01	(0.11)	32.28	6.21

* Net of Taxes

GLOBAL EQUITY SECTORS (USD $ BASIS)
PERIODS ENDING FEBRUARY 29, 2012

Sector: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
Energy	7.64	8.31	(4.12)	20.45	5.10
Materials	8.99	14.12	(10.31)	27.73	2.57
Industrials	12.09	11.62	(3.19)	27.88	0.39
Consumer Discretionary	13.63	14.09	4.00	30.51	1.04
Consumer Staples	5.28	3.62	11.64	21.57	6.69
Health Care	7.76	4.36	9.95	17.93	2.37
Financials	15.62	15.37	(12.91)	23.57	(11.45)
Information Technology	12.84	14.62	5.74	27.52	4.24
Telecommunication Services	0.97	0.67	(2.92)	14.22	0.17
Utilities	0.53	0.90	(7.22)	7.42	(2.94)

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

Source: Bloomberg/MSCI

GLOBAL INVESTMENT OUTLOOK

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A good beginning

Equities and confidence have been wafting higher since the start of 2012 on the wings of a convection current of favourable economic data. Quite a lot has come together over the past few months. Not only has the economy rebounded, but memories of last summer's crippling U.S. political dysfunction are beginning to fade, and Europe has managed a series of deft policy manoeuvres that have dialed back the intensity of its crisis.

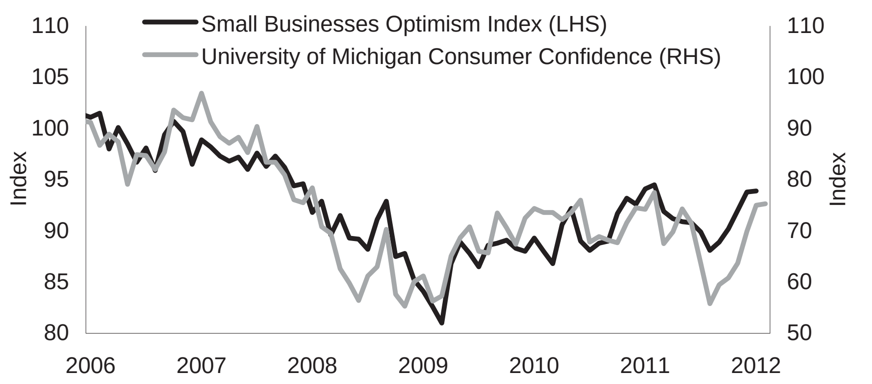
We are loath to cast a winter chill over the all-too-rare warm glow currently emanating from these events. And yet caution remains advisable. The rollercoaster ride that was 2011 reminds us that even the most promising of beginnings can be derailed by adverse – and oftentimes unforeseeable – developments. Moreover, levels of sustainable economic growth may simply not be very impressive in the present era.

Data is all smiles

Economic data has been all smiles in recent months, and there has been a much desired trifecta: the statistics have been good on an absolute basis; they are improving; and they have been better than expected.

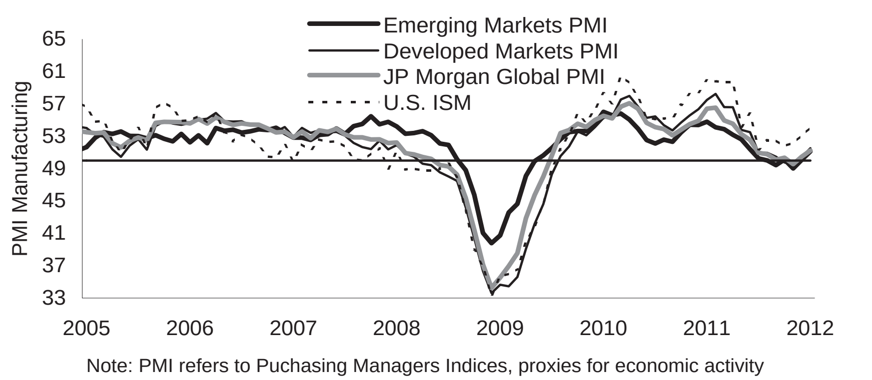
The upward trend is clear in confidence (Exhibit 1), employment, consumer credit and purchasing managers' indexes (Exhibit 2). Our compendium of leading indicators shows that economic data is now running at a slightly better-than-average clip, and that it continues to improve (Exhibit 3). This is quite a contrast to several months ago, when data was weak and deteriorating. However, the experience is hardly uniform for all countries, regions or sectors. Generally, U.S. data is doing somewhat better than elsewhere, and the business sector is outperforming. Even better, economic data has repeatedly exceeded market expectations (Exhibit 4). This has been especially true in the U.S., but also for the G10 and emerging markets.

EXHIBIT 1. U.S. Confidence Is Stronger



Source: Haver Analytics, RBC GAM

EXHIBIT 2. Purchasing Managers Surveys Reveal Recovery



Note: PMI refers to Puchasing Managers Indices, proxies for economic activity
Source: Haver Analytics. RBC GAM

Gossamer wings

Consensus economic forecasts have responded to this barrage of good cheer by starting to flutter higher. To date, this represents nothing more than a partial reversal of earlier weakness, and the forecasts are still mostly modest.

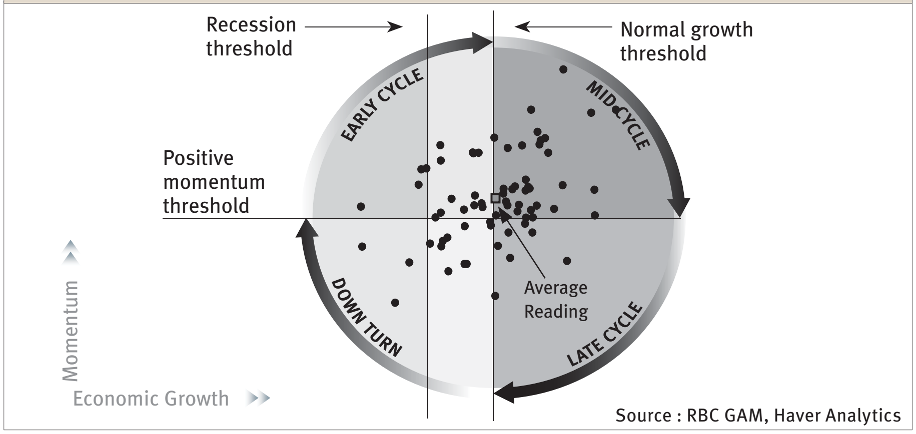
We acknowledge the resurgence of economic data. However, some of the improvement may be due to the flapping of gossamer wings that will struggle to remain intact should headwinds begin to build.

For one thing, it has been a very warm winter, which tends to inflate growth (Exhibit 5). Second, it's possible that the economic crash in the winter of 2009 is distorting seasonal factors, making the winters of 2010, 2011 and now 2012 appear better than they truly were or are. Third, strong economic data tells us a great deal about the present, but not much about the future. Good data today hints that the economy should be in reasonable shape three months hence. But its ability to predict any further than that is poor.

More distant forecasting success depends on the avoidance of future pitfalls. Predicting the future is not an easy task, a lesson taught all too well by the experience of 2011. A rollicking start to that year and universal optimism proved unrepresentative of what actually transpired: the disaster in Japan; the Arab Spring; and extreme political dysfunction in the U.S.

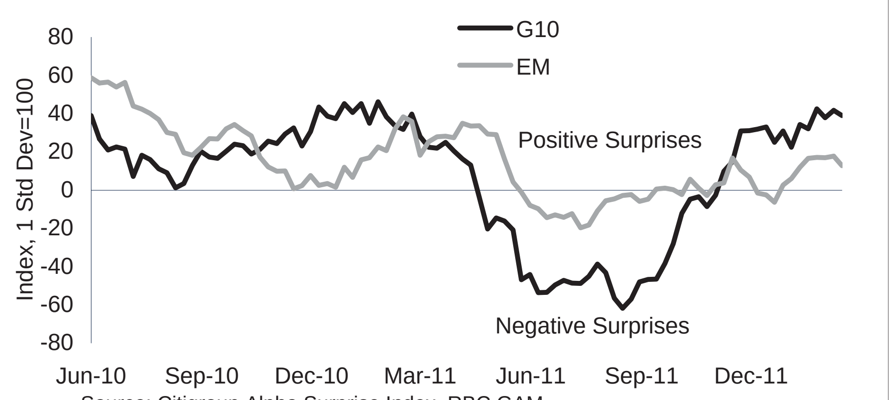
Commonalities with last year include the persistence of elevated geopolitical risks, and political tensions in the U.S. and Europe. The risk of an oil-price spike lingers as long as Iran remains at

EXHIBIT 3. Leading Indicators Are Picking Up Momentum



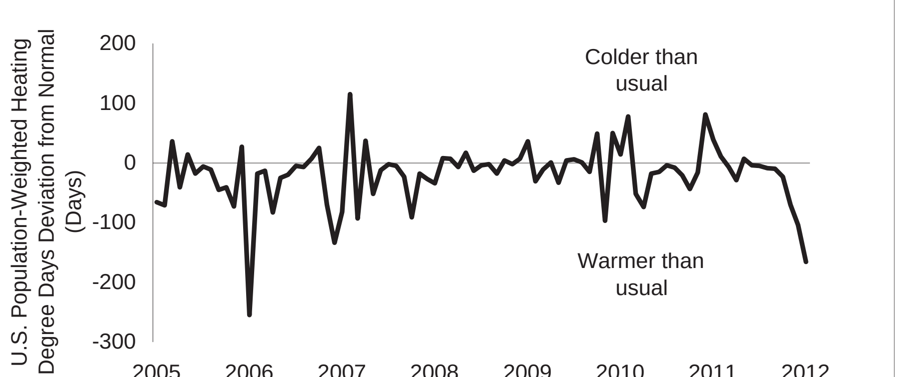
Source : RBC GAM, Haver Analytics

EXHIBIT 4. Global Economic Surprises



Source: Citigroup Alpha Surprise Index, RBC GAM

EXHIBIT 5. U.S. Has Managed an Unusually Warm Winter



Source: Haver Analytics, RBC GAM

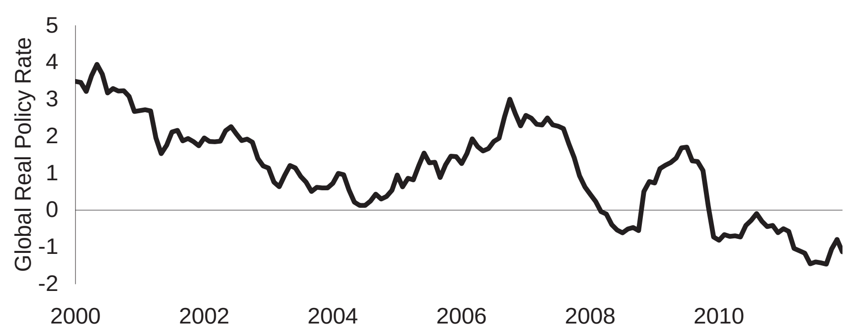
odds with the West and the Arab Spring continues to simmer elsewhere in the region. Meanwhile, political dysfunction could worsen, as the Eurozone descends into recession and as the U.S. autumn elections near. Businesses may opt to put off investments until uncertainty tied to U.S. elections passes.

Beyond that, we can say with reasonable confidence that one-fifth of the global economy (the Eurozone) will be in recession in 2012. Interest rates are still enormously stimulative (Exhibit 6), but fiscal austerity is beginning to bite, and we expect big cuts in government spending to stifle growth in peripheral Europe, slicing about a percentage point off U.S. economic growth, and lesser amounts elsewhere. Perhaps most tellingly, economic forecasts still call for weaker growth in 2012 than in 2011, which was itself weaker than 2010 (Exhibit 7).

Oil surges

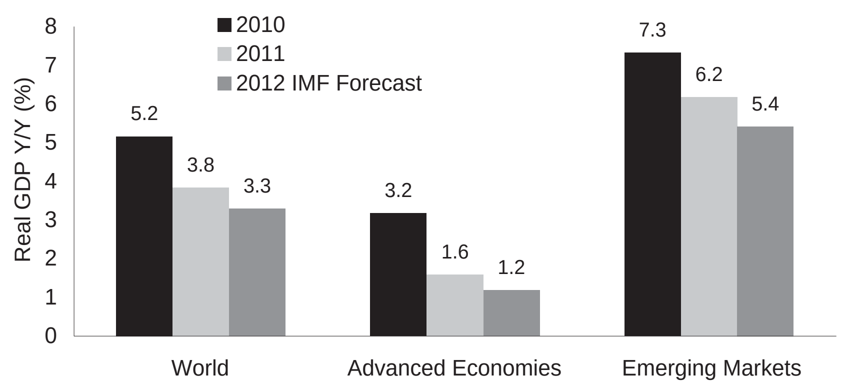
Commodity prices have again moved higher (Exhibit 8). Oil has been particularly strong, rising 10% in just a few weeks. The reasons for this move are varied, ranging from resurgent demand as the economy accelerates, to liquidity welling up from central-bank stimulus, to Iranian-centred fears. There are two possibilities that frighten the market concerning Iran. The first is that Iran halts its moderate exports of 2.2 million barrels of oil per day as tensions rise with the West. This would be notable, but OPEC claims to have enough spare capacity to mostly offset this. Far more worrisome would be a decision by Iran to obstruct the Strait of Hormuz, a pinch-point through which 17 million barrels (20% of the world's oil supply) travel each day.

EXHIBIT 6. Global Real Monetary Policy Rate



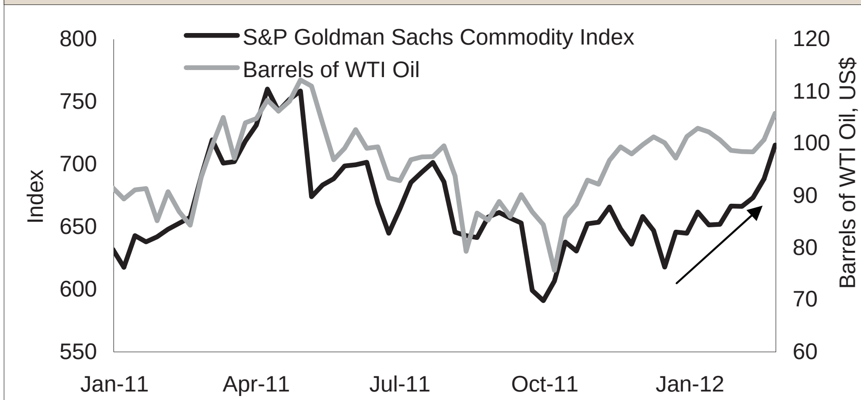
Regions included: U.S., Canada, U.K., Eurozone, Switzerland, Sweden, Norway, Japan, Australia,China, India, South Korea, Russia, Brazil, Mexico. PPP weights by GDP share.
Source: Haver Analytics, RBC GAM

EXHIBIT 7. Declining Trend in Economy



Source: Haver Analytics, RBC GAM

EXHIBIT 8. Commodities on the Rise



Source: Haver Analytics, RBC GAM

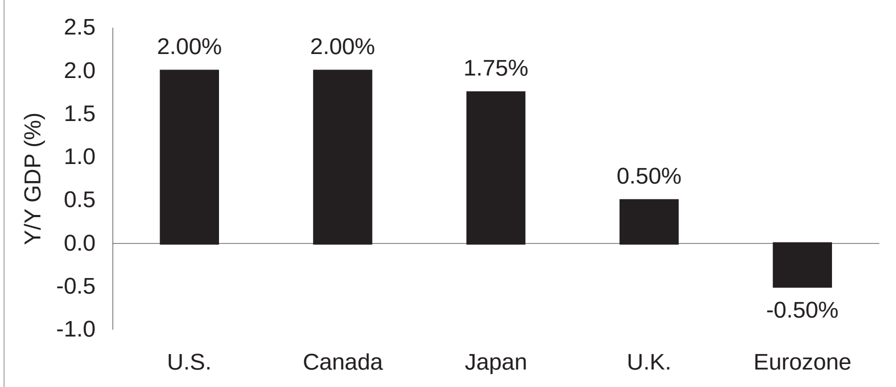
If sustained, higher oil prices have inflationary and economic implications. The recent spike could theoretically add half a percentage point to developed-world inflation, and subtract as much as half a percentage point from developed-world growth. It is premature to fully integrate this into forecasts because plummeting natural gas prices provide a considerable offset.

Forecasts resist upward bias

Our own forecasts are mostly unchanged, or even slightly weaker, relative to a quarter ago (Exhibit 9). We remain reluctant to raise our forecasts, recognizing how fleeting swings in sentiment can be, and with an eye on the mounting threat from oil. Our U.S. and Canadian GDP forecasts remain unaltered for 2012, at 2% real growth for both. The Eurozone and U.K. both face slightly worse growth prospects, with the Eurozone officially in recession and the U.K. not far from it. Japan's economic rebound also looks to be a bit less sprightly than previously envisioned, and emerging-market growth has also been shaved marginally, though the broad narratives remain the same.

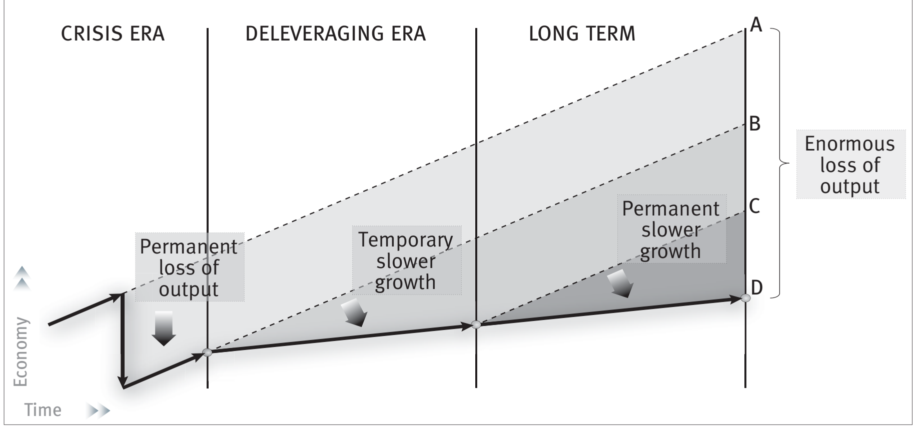
With this publication, we introduce our 2013 forecasts. On the whole, the forecasts correspond to the view that 2013 will be reminiscent of 2012, with the expected continued application of the fiscal handbrake and a lingering financial crisis-induced hangover. Those countries scheduled to suffer the worst economic damage in 2012 – the Eurozone and the U.K., most notably – should manage to rebound somewhat in 2013, but possibly not with the snap anticipated by some investors.

EXHIBIT 9. RBC GAM Forecast for 2012 GDP Developed Markets: Outlook



Source: RBC GAM Forecast

EXHIBIT 10. Slipping Beneath the Waves



Indeed, caution is the watchword for 2013, as we find ourselves with slightly below-consensus forecasts virtually across the board. Central to this view is our scepticism that economies are likely to snap back quickly after a deep recession.

Slow rider

We have recently conducted research into what constitutes sustainable economic growth. Three main themes have surfaced (Exhibit 10).

First, economic output is unlikely to fully rebound from the financial crisis, due mostly to the corrosive effect of stubbornly high unemployment rates (represented by the shift from Line A to Line B in Exhibit 10).

Second, economic growth is likely to remain slower than normal for several years. This is depicted by the shift from Line B to Line C in Exhibit 10. This is partly a natural consequence of the financial crisis, exacerbated by the unusual depth and global breadth of the event, and by the associated housing crash. The effects of deleveraging figure centrally in this (Exhibit 11). Temporarily slower growth also results from ebbing government stimulus and heavy debt loads.

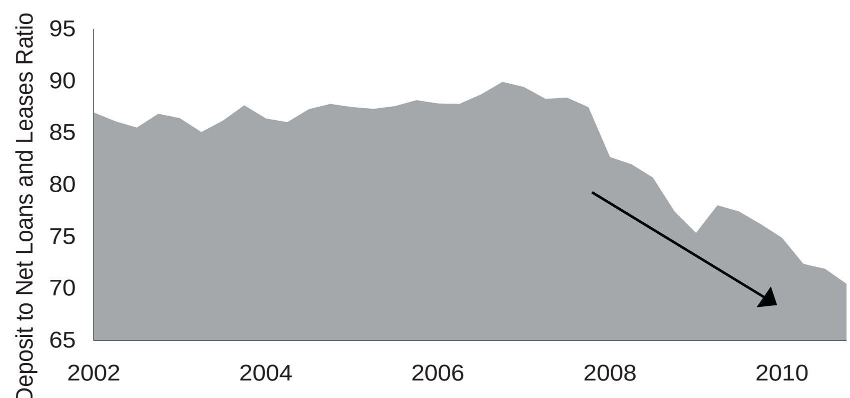
Third, assuming these factors fade at some point, economic growth may be somewhat more sluggish on a quasi-permanent basis. This is shown in the shift from Line C to Line D in Exhibit 10. The reason for this relates both to the loss of prior tailwinds and the addition of new headwinds. Tailwinds now lost include the free-flowing credit and low commodity prices that artificially boosted growth in the 1980s and 1990s. The new headwinds feature deteriorating demographics (Exhibit 12) as the Baby Boom enters retirement. Together these factors may reduce annual growth by one third to one half (Exhibit 13).

Europe suffers economic downgrade

Europe remains a focal point for global markets, and our biggest worry. The 2012 GDP outlook has deteriorated once again, from 0.0% to -0.5%, reflecting unrelenting fiscal austerity and confirmation that the region is descending into recession. The economy should return to growth in 2013, but only at a 0.5% clip.

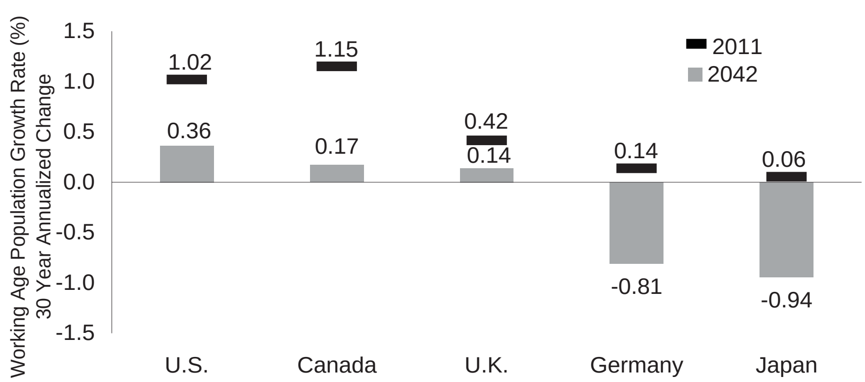
Fiscal austerity and structural reforms have a long way to go, and banks are in no position to lend (Exhibit 14). Germany, and possibly France, may avoid the technical definition of recession, but Italy, Spain, Greece and Portugal look rather less fortunate. If a systematic error has been made in forecasting the Eurozone over the past few years, it has been in turning a blind

EXHIBIT 11. U.S. Commercial Banks Are Deleveraging, Reducing Loan Availability



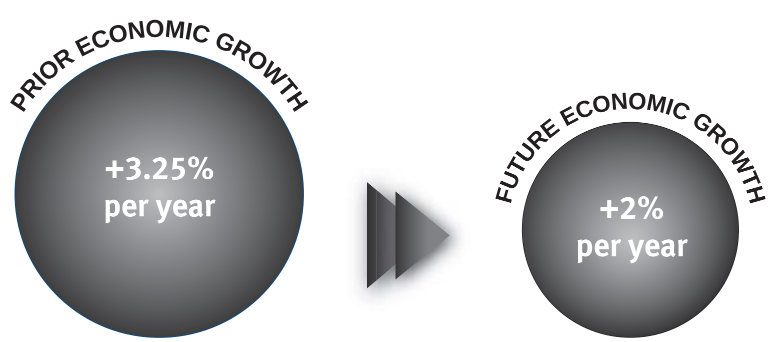
Source: Federal Deposit Insurance Corporation

EXHIBIT 12. Working-Age Population Growth Slows



Source: Haver Analytics, RBC GAM

EXHIBIT 13. Quantifying Slower Growth



Source: RBC GAM

eye to the full extent of pain predicted by our models. With this forecast, we endeavour to avoid repeating that mistake.

Good news?

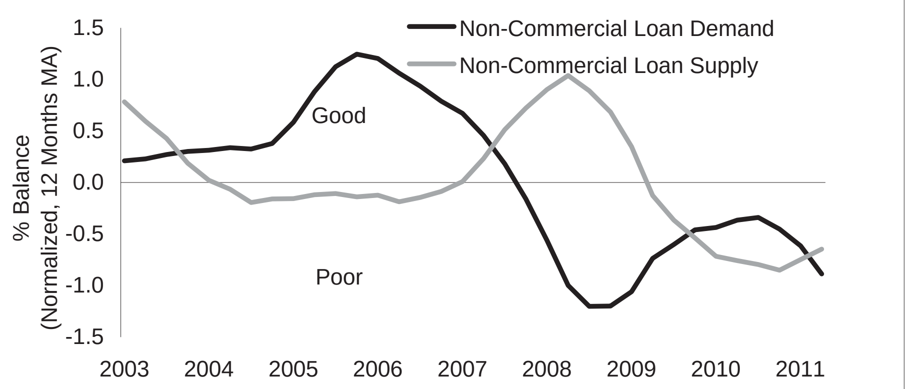
The good news is that the intensity of Europe's crisis has clearly and mercifully ebbed in recent months. The best proxy for this is a significant drop in borrowing costs for Italy and Spain (Exhibit 15). Another favourable metric is the resurgence in risk appetite (Exhibit 16). Money market funding costs are beginning to abate, taking some of the pressure off banks (Exhibit 17).

Europe has bought itself this breathing room by introducing several major initiatives. Most prominently, the ECB's three-year liquidity offerings have been a smash success, greatly alleviating a bank liquidity crunch and indirectly benefiting the sovereign-debt market. Another important development was the transfer of power in Italy to a technocratic government bent on economic reform. Greece recently managed to obtain a second bailout and is on the cusp of finalizing a major debt writedown with its creditors. A motley crew of longer-term solutions is beginning to appear.

Mixed European prospects

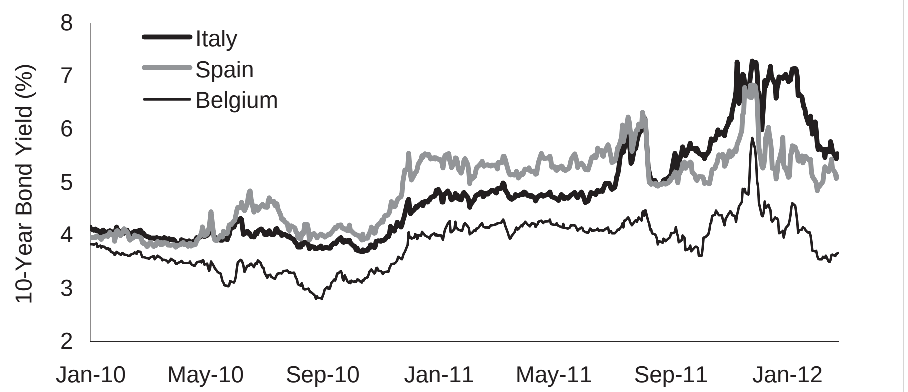
We remain torn over Europe's prospects. Our long-tem outlook has always been relatively benign: no failure of a large bank; no default by a large country (though smallish Greece and Portugal are another matter); and the survival of the euro in its current form. All of this is in the best interest of Europe, achievable, and ultimately likely.

EXHIBIT 14. Eurozone Non-Commercial Loan Conditions Are Tight



Source: Haver Analytics, RBC GAM

EXHIBIT 15. Selected Euro-Area 10-Year Bond Yields



Source: Haver Analytics, RBC GAM

EXHIBIT 16. Credit Suisse Global Risk-Appetite Index

Source: Credit Suisse

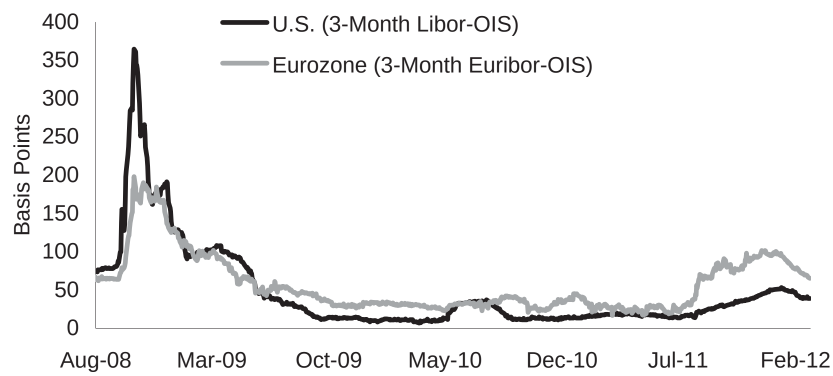
But we remain cautious about Europe's near-term prospects, simply because much work remains to be done (Exhibit 18). Europe must not squander the time it has bought. Greece has another bailout in hand and a diminished debt load, but likely requires more on both fronts to reach firm ground. Portugal may also require more assistance. Competitiveness in these and other peripheral countries remains problematic and will take many years to fix.

That the Eurozone could break up is unlikely but not impossible to imagine. Parliamentary votes and referendums loom. Elections are near for Greece and France, and surging opposition parties are talking tough. More generally, both public and political wills are likely to be tested in 2012 as the recession envelops the continent. Sympathizing with this, the euro would be justified in moving lower.

But the question for global markets is whether the balance for these problems has gone from being terminal to chronic. Banks have been made liquid by massive cash injections from the central bank. If the banks can also manage to regain a robust solvency, then the feeble status of Greece and Portugal's tiny economies are not by themselves of any great consequence to the global economy. Suddenly, global markets would be effectively unencumbered by European risk and free to go about their business.

We hasten to add that it is not yet crystal-clear that Europe's banks are entirely out of hot water. They are making good progress recapitalizing, but all bets would be off if Italy or Spain veered onto an unsustainable trajectory,

EXHIBIT 17. Money Market Funding Costs
United States and Eurozone



Source: Haver Analytics, RBC GAM

EXHIBIT 18. Parsing the Problem

COUNTRY	LIQUID	SOLVENT	COMPETITIVE
Greece	No	No	No
Portugal	No	So-So	So-So
Ireland	No	So-So	So-So
Italy	So-So	Yes	No
Spain	So-So	Yes	No
France	Yes	Yes	So-So
Germany	Yes	Yes	Yes

Note: **Liquid:** capacity to raise funds in bond market
Solvent: capacity to afford debt over medium to long term
Competitive: economic competitiveness versus rest of Eurozone
Source: RBC GAM

if Europe's struggling corporate sector began to renege on their bank loans en masse, or if the Eurozone fragmented.

Rebounding America

The U.S. has enjoyed an impressive economic rebound since the fall. Our models show that the risk of a recession has plummeted. Two festering wounds of past dysfunction – the housing market and the job market – have begun to heal. This could yet mark the beginning of something big for America. Alternately, it could represent a temporary tease of the sort that flitted by in early 2010 and 2011. We forecast sluggish real GDP growth of 2.0% in both 2012 and 2013.

The coming U.S. election has mixed economic implications. The final year of a presidential cycle has historically brought with it better-than-average economic growth. However, the degree of political dysfunction and towering deficits render major fiscal stimulus unlikely. In fact, significant fiscal drag is the more likely outcome as prior stimulus programs begin to expire.

Providing some salve, the Federal Reserve has committed to keeping interest rates ultra-low through 2014 and appears to have a low threshold for more quantitative easing. Current economic strength does not warrant immediate action and the appearance of electoral interference would grow if the Fed were to act past mid-year. A third round of quantitative easing is thus possible, though not at all certain, with a narrowing window of opportunity and odds somewhat shy of 50%.

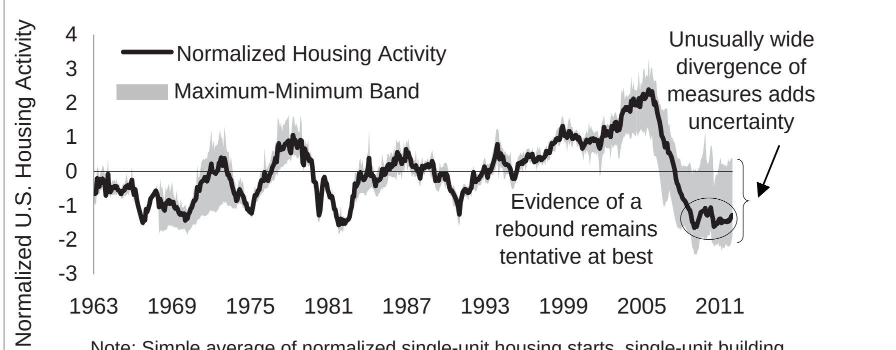
U.S. housing bottoms

The U.S. housing market is clearly in transition. We endorse the view that it has mostly stopped deteriorating and may even begin a modest rebound. However, a more ebullient move higher remains unlikely, despite improvement in some measures of sales activity (Exhibit 19).

American housing affordability is now stunningly good. The marriage of incredibly low mortgage rates (as low as 4% on 30-year mortgages) and home prices that have fallen by about one-third have combined to make homes more affordable than they have been in generations. Alas, this is a necessary but insufficient condition for a housing recovery. The housing market still has three black marks that require resolution (Exhibit 20).

First, credit conditions remain tight. They have loosened somewhat outside the mortgage market, but high mortgage-delinquency and home-foreclosure rates (Exhibit 21)

EXHIBIT 19. Normalized U.S. Housing Activity Has Bottomed



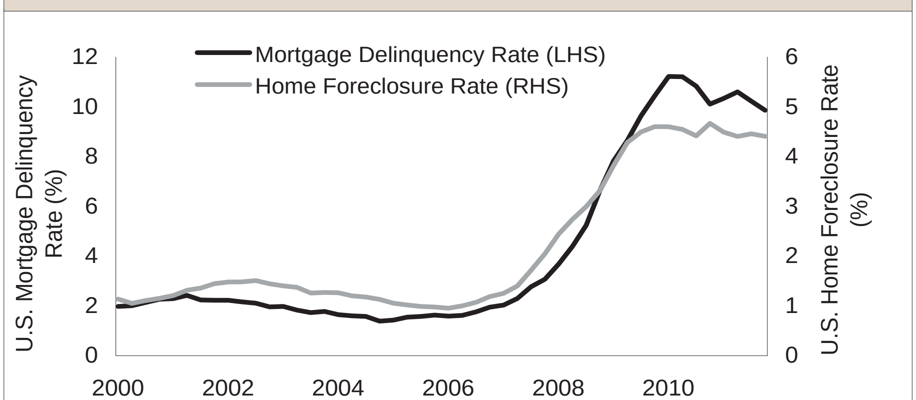
Note: Simple average of normalized single-unit housing starts, single-unit building permits, existing home sales, new home sales and NAHB housing market index.
Source: Haver Analytics, RBC GAM

EXHIBIT 20. U.S. Housing Recovery Scorecard

Affordability	Very Good
Leading Indicators	Mixed
Historical Precedent	Mixed
Credit Conditions	Poor
Psychology	Poor
Inventories	Poor
PROGNOSIS	MUTED, MULTI-YEAR RECOVERY

Source: RBC GAM

EXHIBIT 21. Housing Distress Remains High and Only Abates Slowly



Source: Haver Analytics, RBC GAM

have made banks understandably wary of lending. Surveys show that both demand and supply for mortgage credit remains extraordinarily difficult (Exhibit 22). Second, many prospective home buyers are reluctant to buy. They acknowledge that prices are attractive, but are uninterested in actually purchasing real estate. Third, and most damning, are the inventory statistics. Simply put, there are 2 million to 3 million too many homes in America. At a rate of household formation of 1 million per year, this backlog will take several years to absorb.

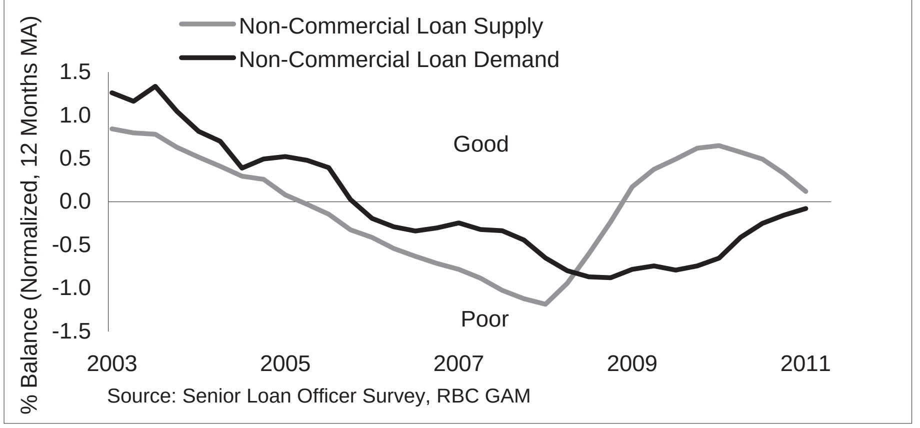
U.S. employment renaissance

A big development over the past several months has been surging U.S. job creation (Exhibit 23). Employment gains have materially exceeded expectations and put the unemployment rate on track for a showing that was expected to take the better part of a year to achieve. Were businesses to truly and sustainably climb aboard the hiring train, a virtuous circle of strong profits and strong hiring could finally begin.

The details of the job market confirm the recent upswing. Even the broadest unemployment measures are down (Exhibit 24). Jobless claims have fallen, and layoffs are declining (Exhibit 25).

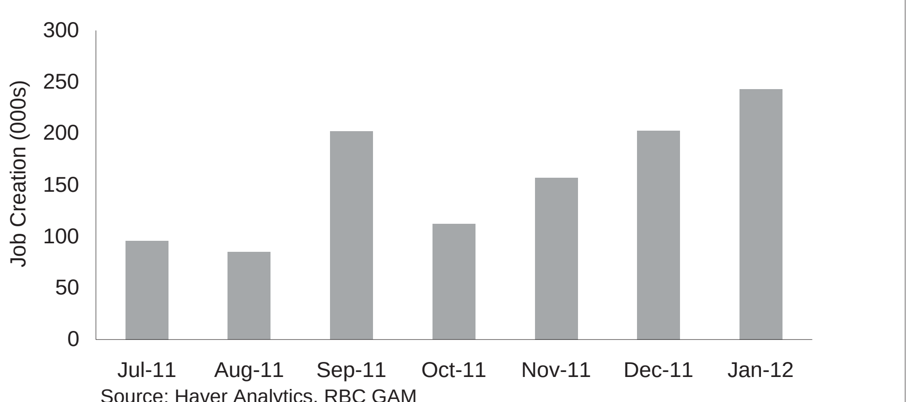
Not everything is normal, however. The average duration of unemployment remains extremely long, meaning skill atrophy is ongoing (Exhibit 26). Churn in the job market is still low, so fewer people are opportunistically hopping from company to company – normally an important source of productivity growth as workers and roles secure better matches. Various surveys of hiring intentions confirm a recent

EXHIBIT 22. U.S. Non-Commercial Loan Conditions Are Tight



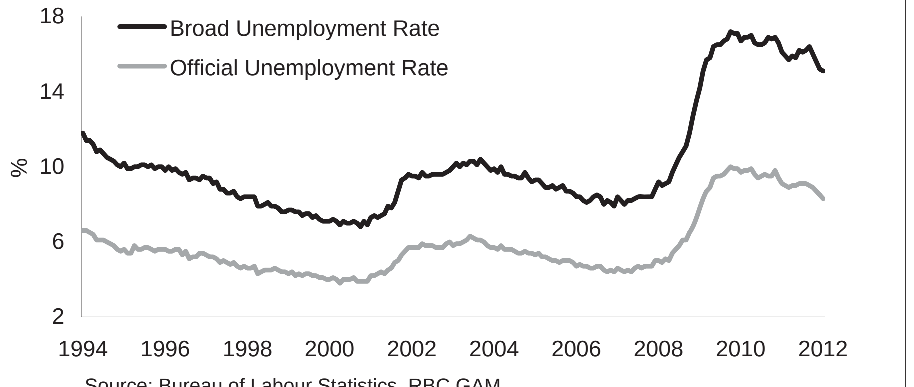
Source: Senior Loan Officer Survey, RBC GAM

EXHIBIT 23. U.S. Job Creation Is Picking Up



Source: Haver Analytics, RBC GAM

EXHIBIT 24. U.S. Unemployment Rate Is High but Falling



Source: Bureau of Labour Statistics, RBC GAM uptick, though nothing revolutionary (Exhibit 27). If economic growth reverts to a more sluggish trend as we expect, job creation may be dialed back to 100,000 to 150,000 new jobs per month, and the unemployment rate could stall out.

Elevated geopolitical risks

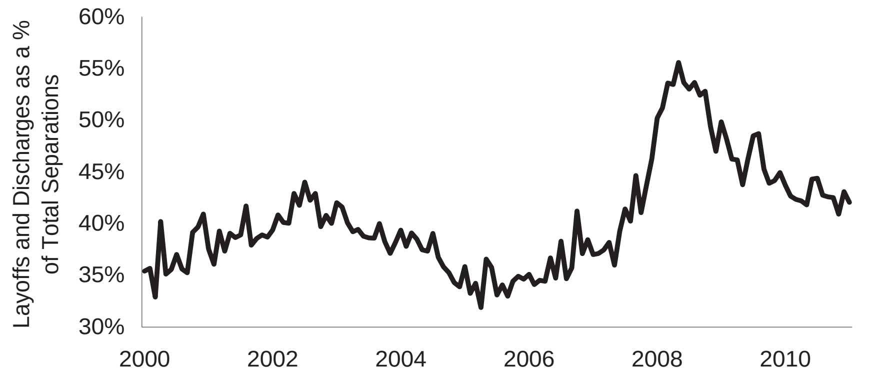
Geopolitical risks are currently elevated. This is largely a consequence of the unrest that has spilled forth from a cauldron of economic stagnation and volatility. This unrest is pooling in various hot spots around the world, at the opposite ends of the political spectrum in the U.S. (Occupy Wall Street and the Tea Party); in mass protests and recriminations in Europe; in the Arab Spring movement; and in a tilt back towards Russia and even autocracy in pockets of Eastern Europe. Iran's increasingly icy relations with much of the world are less clearly tied to recent economic events, but nonetheless weigh on sentiment.

British doldrums aren't forever

Dawn has been delayed for the U.K. Whereas the U.S. has yet to get a handle on its fiscal excesses, the U.K. has already set about righting its problems. This has not been as economically cost-free as had been hoped, but will nonetheless avoid trouble later, and the U.K. could yet be the envy of its peers in a few years.

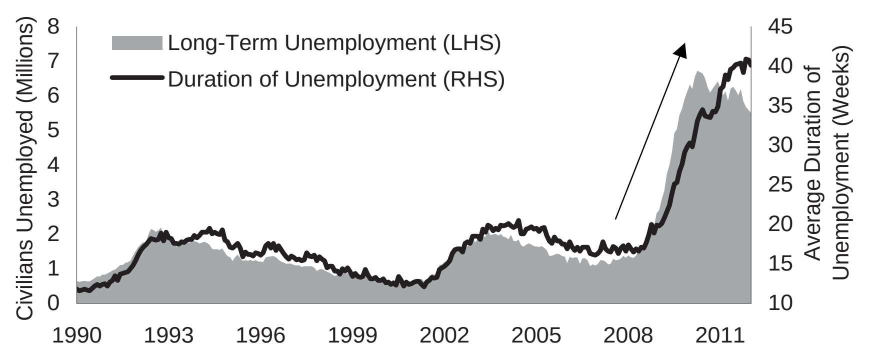
The Bank of England has stepped in to fill the economic void, delivering yet another round of monetary stimulus, and some members of the central bank's Monetary Policy Committee are leaning toward still more. Inflation has begun to abate now that the effects of

EXHIBIT 25. Involuntary Share of Job Turnovers Declining



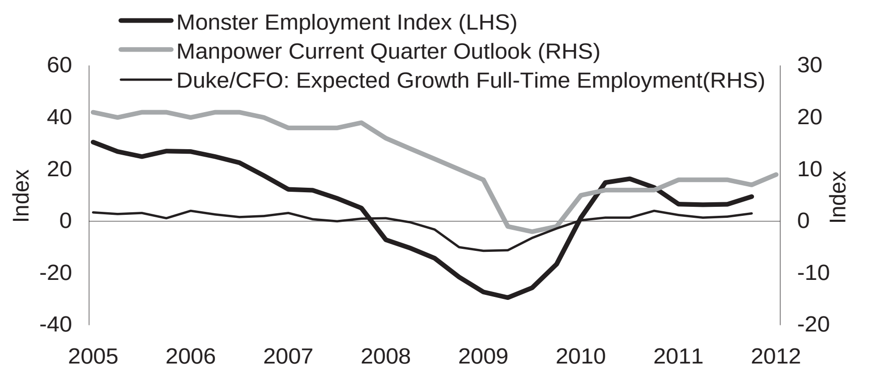
Source: RBC GAM, Haver Analytics

EXHIBIT 26. Long-Term U.S. Unemployment Is a Drag on Economy



Note: Long-Term Unemployment = 27 Weeks and Over
Source: Haver Analytics, RBC GAM

EXHIBIT 27. Hiring Intentions Edge Higher



Source: Haver Analytics, RBC GAM

past sales-tax hikes have fully filtered through the system (Exhibit 28).

None of this is likely to engineer an immediate economic recovery. In the near term, the British economy will continue to struggle and the unemployment rate will stay high. A recession may just be avoided, but we anticipate a mere 0.5% real GDP growth in 2012 before a halfway-decent recovery sets in, allowing 1.5% growth in 2013. The British pound remains one of the more stable currencies, with no major changes anticipated.

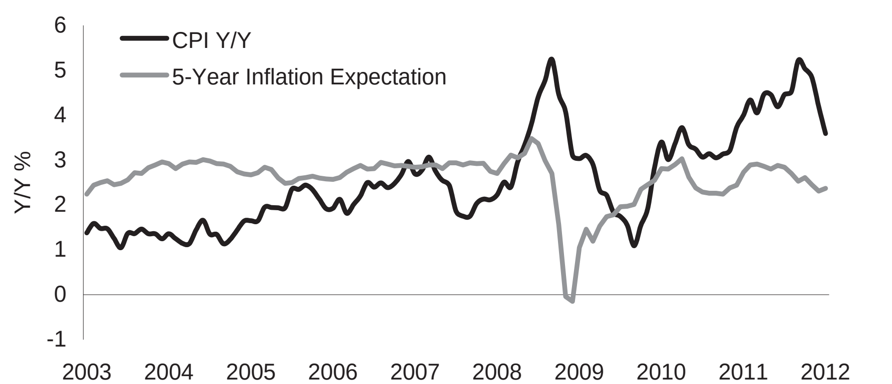
Canada stumbles

The Canadian economy is stumbling through a period of sub-par economic growth. Job numbers have regularly disappointed, squandering a quick start in 2011. While the U.S. unemployment rate has declined, Canada's has lately edged higher.

We suspect this underwhelming experience is mostly temporary, and that the resurgence in commodity prices may help the economy find its feet. Our best guess is that Canada will remain on an economic trajectory broadly similar to that of the U.S. (Exhibit 29), with 2% GDP growth in 2012 and hair better in 2013. Domestic demand remains a disproportionate contributor to the economy, and credit growth is robust. The Canadian dollar could soften marginally.

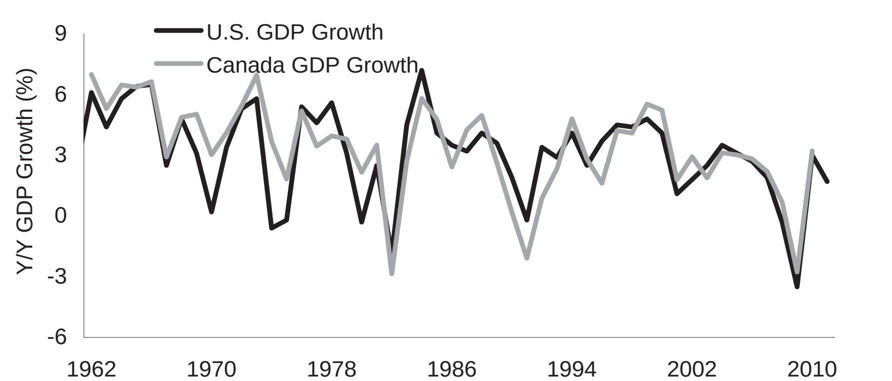
But it is clear that Canada suffers from various imbalances. While it does not have the same government debt problems as the U.S. or Europe, it is nonetheless dogged by excessive household debt (Exhibit 30), inflated home prices, languishing competitiveness and a current-account deficit.

EXHIBIT 28. U.K. Inflation Rate



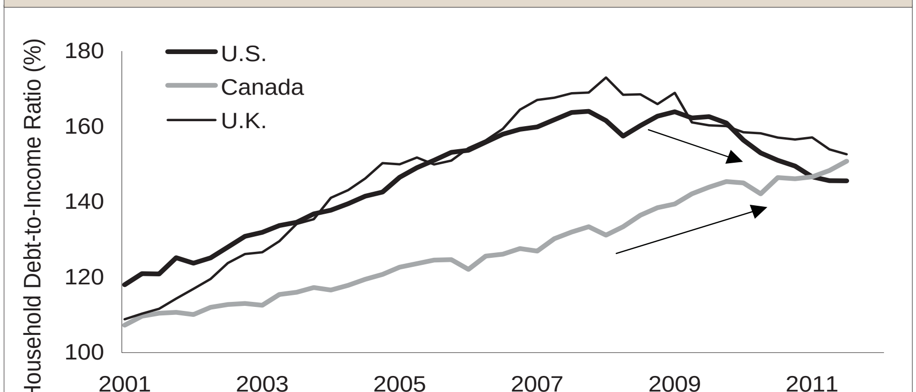
Source: Haver Analytics, RBC GAM

EXHIBIT 29. U.S. and Canada GDP Growth



Source: Haver Analytics, RBC GAM

EXHIBIT 30. Selected Countries Household Debt-to-Income Ratio



Source: Haver Analytics, RBC GAM

Some of these factors will naturally right themselves. Poor competitiveness is in large part (though not entirely) the result of a strong currency, which is outside of Canada's direct control. The current-account deficit is as much a function of slow economic growth beyond Canada's borders as Canadian profligacy. But household debt and housing excesses are home-grown issues. The pain of fixing these excesses won't start to hit until interest rates begin rising. This looks to be at least a year off, if not longer.

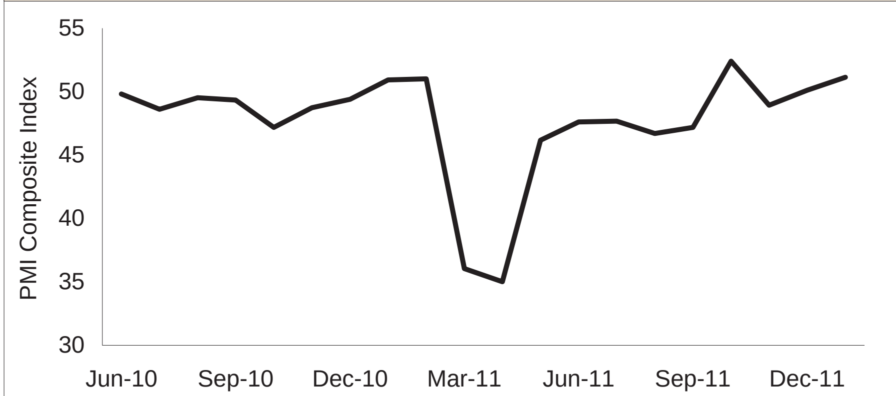
Japanese recovery continues

Japan continues to rebuild brick by brick after the 2011 earthquake and tsunami (Exhibit 31). Most metrics point to decent economic growth, and the latest industrial production figures confirm the upward trend. Accordingly, we forecast GDP growth of 1.75% for 2012, and 1.50% for 2013 – fairly good by Japanese standards. The Bank of Japan has continued to deliver stimulus, both by intervening to force down the strong yen and providing more quantitative easing.

Our outlook for Japan is slightly more restrained than previous forecasts, for a few reasons. Japan's unemployment rate has resumed edging higher. Ebbing fiscal stimulus, a disappearing trade surplus and ongoing political dysfunction threaten to act as drags on the economy.

Japan's longer-term prospects remain uncertain. Mainly, it is unclear how long the market will continue to put up with the Japanese government's unfathomable debt loads. So far, demand has held and Japanese government yields remain below 1%. The government's ambitious agenda of consumption-tax increases is in doubt, and so fiscal imbalances remain unresolved.

EXHIBIT 31. The Japanese Recovery Continues



Source: Haver Analytics, RBC GAM

EXHIBIT 32. China – Purchasing Managers Index

Source: Harver Analytics, RBC GAM

China engineers soft landing

Not only is Chinese economic data difficult to find and of uncertain trustworthiness, but it sends very mixed signals. China has clearly lost a step over the past year (Exhibit 32), but now looks to be stabilizing. This is thanks in large part to policymakers, who have taken full advantage of the window afforded by falling inflation to deliver further monetary stimulus and prop up the precariously positioned housing and local debt markets.

We continue to look for a Chinese soft landing in the near term, with growth likely to decline to 8.25% in 2012 and 8.0% in 2013 – sufficiently fast to avoid undue stress on Chinese society or the economy. But credit excesses can only be solved with yet more credit for a finite period before bigger problems emerge. We fear a harder landing for China later this decade.

Emerging markets stabilize

More generally, emerging-market economic growth has most certainly slowed due to weaker global demand. But falling inflation has allowed policymakers to deliver additional stimulus, resulting in acceptable growth. We forecast real GDP growth of 6.0% for the EM-6 basket of nations (China, India, Korea, Russia, Brazil and Mexico). China and India are on track to record fairly fast (though below-consensus) growth, but the rest have seen their prospects clipped to the 3%-4% range. Over the longer haul, emerging-market nations have ample room for expansion (Exhibit 33), especially as they adopt western technologies, agricultural practices and medicine.

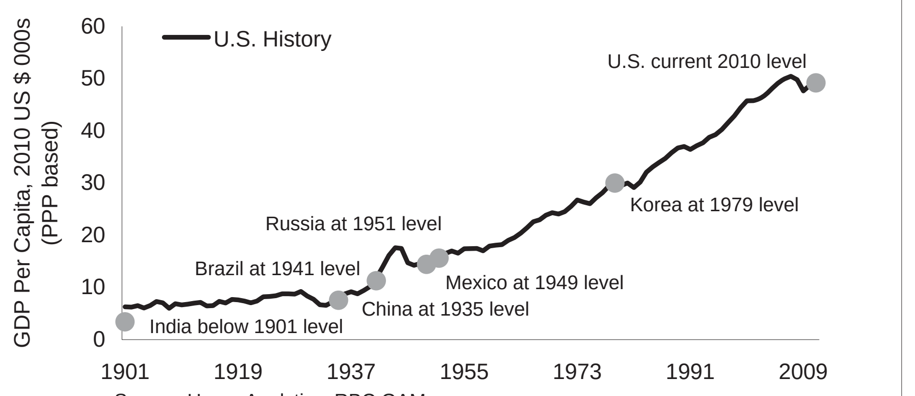
Moderate inflation

Across most of the world, inflation remains reasonably well behaved (Exhibit 34). Commodity prices are again rising, presenting an upside risk to inflation. However consumer food prices look to be turning down (Exhibit 35), providing some offset. Certainly, the yawning economic slack virtually everywhere argues that demand-side inflation shouldn't be a problem for some time.

The real story of inflation has been how it has remained remarkably well anchored despite enormous amounts of unorthodox stimulus and strong commodity prices. We anticipate more of the same, and our models confirm this assessment.

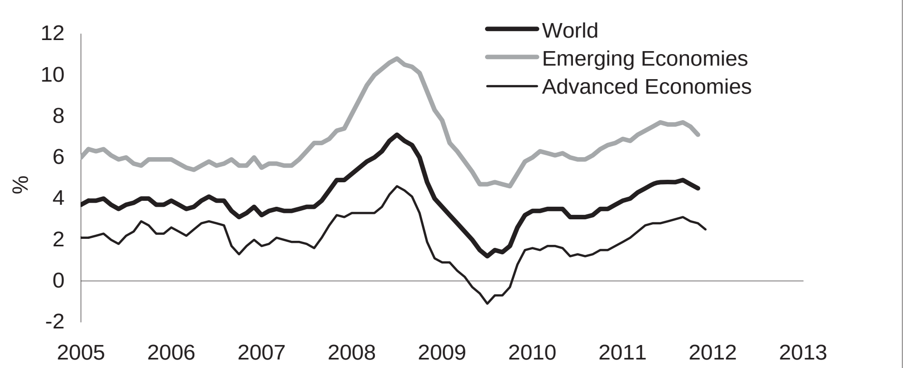
There is certainly the chance of a whiff of extra inflation at some point down the road as the economy recovers and central bankers prove reluctant to tap

EXHIBIT 33. Emerging-Market GDP Per Capita Has Ample Room for Further Convergence



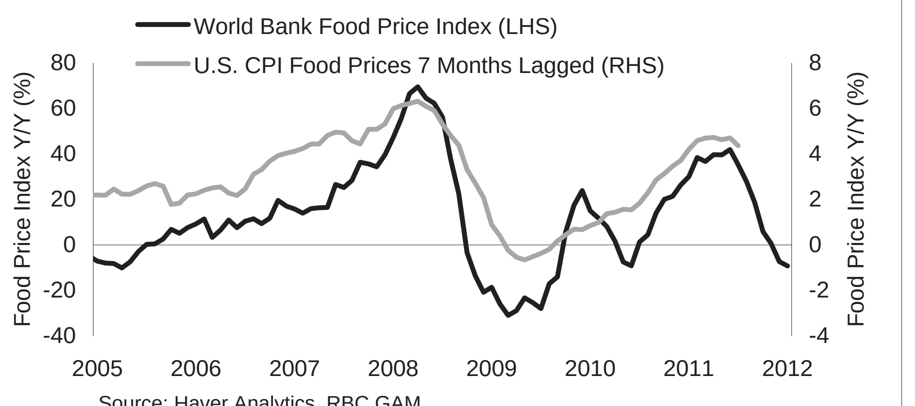
Source: Haver Analytics, RBC GAM

EXHIBIT 34. Global Inflation
IMF Aggregate Region CPI



Source: IMF, RBC GAM

EXHIBIT 35. Food Price Indexes



Source: Haver Analytics, RBC GAM

on the brakes given prior traumatic experiences. But this is not a near-term prospect.

Stimulative central banks

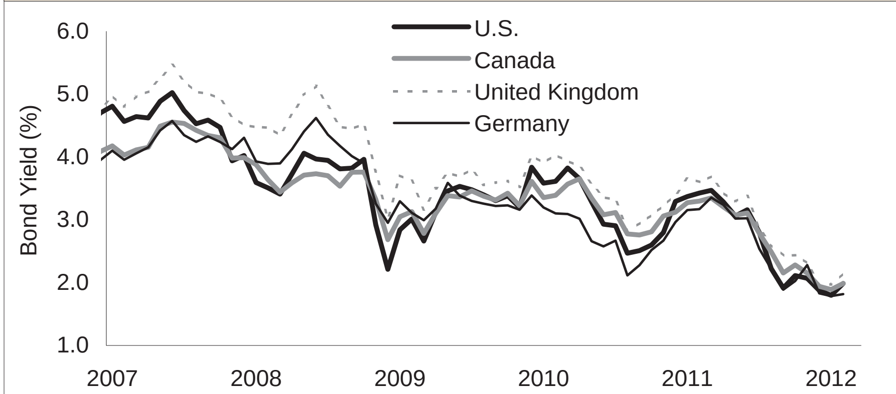
Central banks remain committed to ultra-low interest rates, both at the short and long ends of the yield curve. The U.S., U.K., Eurozone and Japan are delivering significant doses of unconventional stimulus with an eye towards achieving superior economic growth. The recent uptick in data suggests a possible lull in future activity, but the odds continue to tilt toward more stimulus as opposed to less.

The Fed has articulated a plan to keep interest rates unchanged through 2014. In turn, the short end of the yield curve should remain extremely low for at least a few years to come. Other major central banks are unlikely to act much more quickly. Canadian interest rates may be among the first to rise when the tightening cycle begins, but even this appears to be at least a year away, and Canada will struggle to get too far ahead of the U.S.

Low long-bond yields

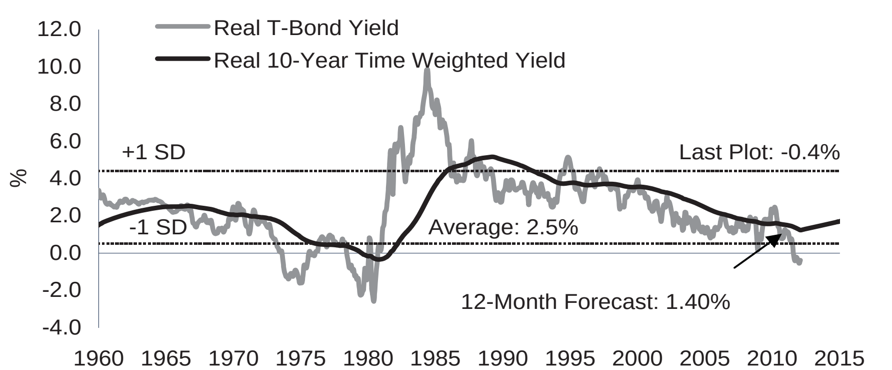
Moving further out the yield curve, 10-year bond yields should also remain quite low (Exhibit 36). Central bankers appear committed to suppressing longer-term interest rates, risk aversion should remain elevated given fears about Europe and China-related risks, and economic weakness will not encourage many to second-guess the situation. Yields may edge up, but are unlikely to sprint higher in the near term given that our base case outlook assumes a continuation of the current sluggish economic growth.

EXHIBIT 36. 10-Year Sovereign Bond Yields



Source: RBC Capital Markets, RBC GAM

EXHIBIT 37. United States
Real 10-Year T-Bond Yield



Source: RBC GAM

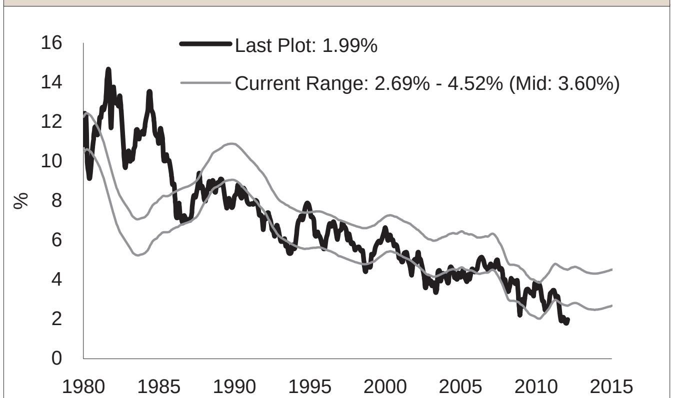
It is also conceivable that U.S. 10-year yields will fall through their autumn 2011 levels, handing further gains to holders of long Treasury bonds but likely dealing losses to holders of stocks and other higher-risk assets. In this scenario, U.S. Treasury bonds would become even more expensive than they are. At around 2%, the yield on the 10-year Treasury is unsustainably low. Today's ultra-low nominal yield is fully explained by the sharp drop in the real U.S. 10-year yield into negative territory (Exhibit 37).

Once growth picks up, investors will increasingly focus on the fact that most bonds are generating negative real returns – that is, bond holders are losing money once inflation is factored in. Absent contagion in Europe or further financial shocks, our view remains that bond yields will eventually climb, perhaps sharply. This reasoning lies behind our underweight position in fixed income.

Focus will also intensify on the low level of yields relative to equilibrium. A simple way to picture equilibrium is

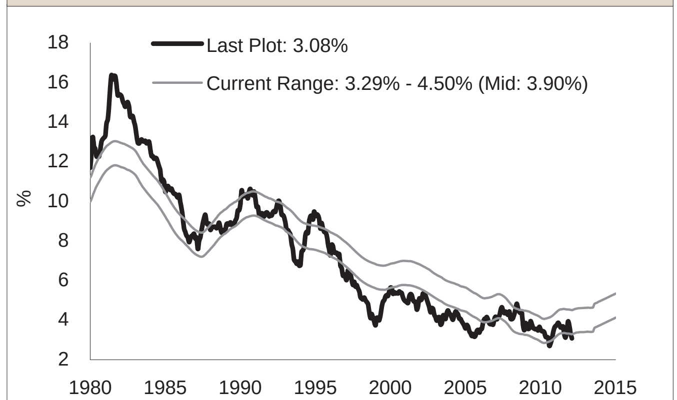
GLOBAL FIXED INCOME MARKETS

U.S. 10-Year T-Bond Yield
Equilibrium Range



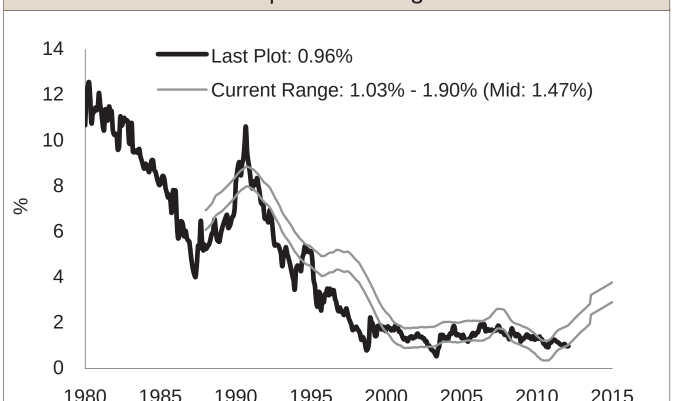
Source: RBC GAM

Eurozone 10-Year Bond Yield
Equilibrium Range



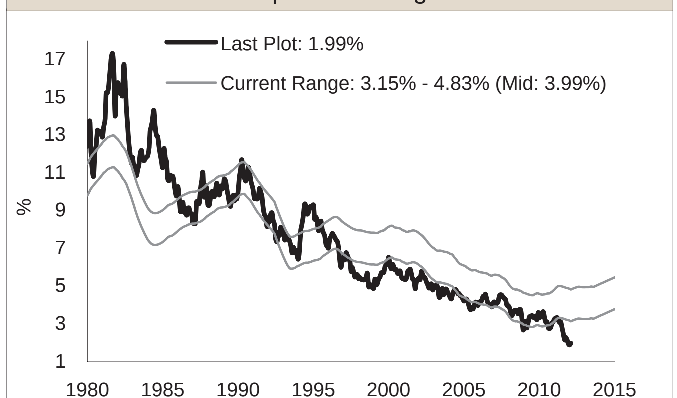
Source: RBC GAM

Japan 10-Year Bond Yield
Equilibrium Range



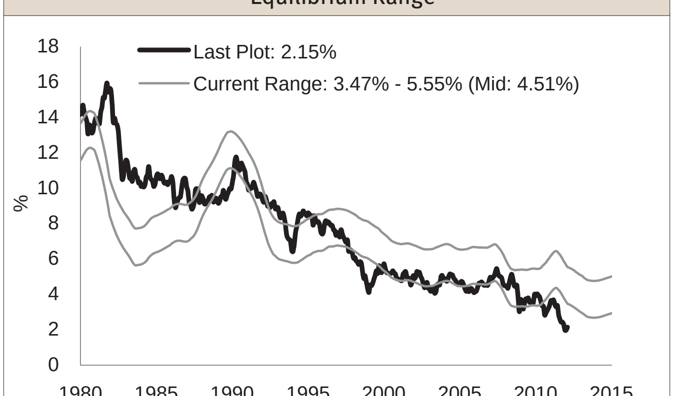
Source: RBC GAM

Canada 10-Year Bond Yield
Equilibrium Range



Source: RBC GAM

United Kingdom 10-Year Gilt
Equilibrium Range



Source: RBC GAM

“Government bond yields have drifted below equilibrium across all developed bond markets.”

to add a 2% inflation premium to a 2% long-run real GDP growth estimate, which produces an equilibrium nominal long-bond yield of 4%. In that context, the current 2% yield appears unusually low.

Our equilibrium models of 10-year government bond yields on page 24 provide a graphic of the degree to which yields have drifted below equilibrium across all developed bond markets. Ongoing economic normalization presents a significant threat to bond investors as yields adjust higher over time. Yields in the U.S., the U.K. and Canada are well below the lower boundary of their equilibrium bands, while Eurozone and Japanese yields are in the bottom half of their bands.

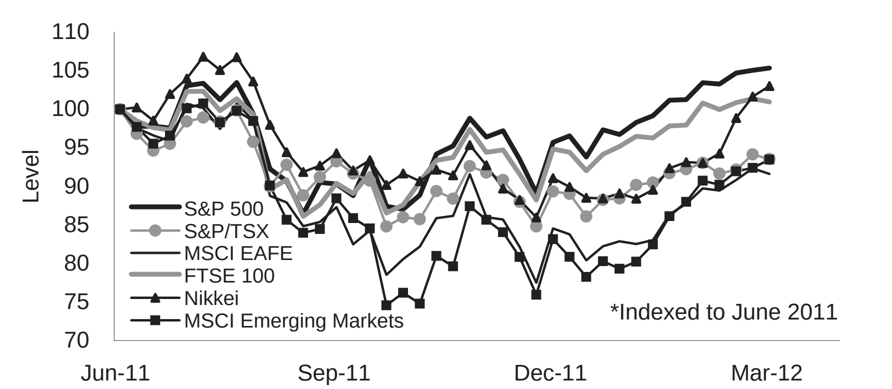
Stock markets up sharply from October lows

Stocks markets around the world have rebounded sharply from their autumn 2011 lows (Exhibit 38), and several key markets have even climbed past the levels recorded in the spring of 2010, before Greece emerged as a huge challenge for the global financial system. The charts on page 26 show our equilibrium models for the world's largest stock markets. Many investors are questioning how much higher equities can go in the near term given the macroeconomic risks remaining in Europe. Our view remains one of cautious optimism. The current rally is taking place in the context of still-cheap valuations. Two factors supporting the market's advance are the diminishing risk of contagion spreading from Europe to the global financial system and the low risk of a near-term U.S. recession. Equity valuations are still reasonable given the low cost of money in the corporate bond market, the strength of corporate balance sheets and the U.S. economy's improving momentum. However, we recognize that with suddenly higher near-term stock prices comes the potential for lower medium-term returns.

Investor confidence improves

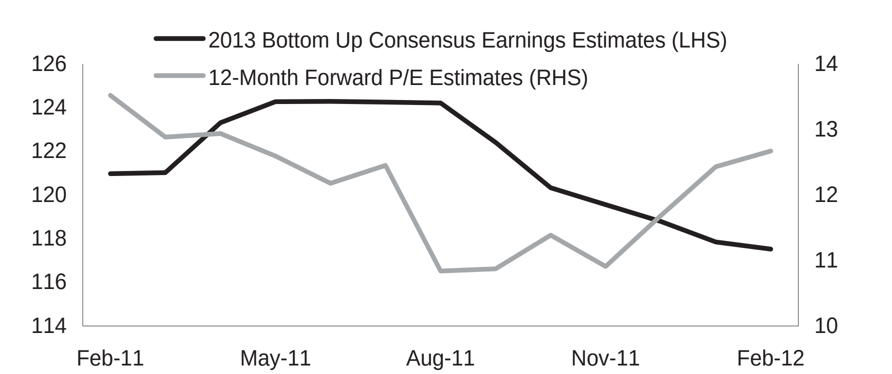
The market's 25% gain since early October has been mainly a story of improved investor sentiment, after the passage of the deep pessimism that infected risk assets last fall. The market's P/E ratio has moved higher, as investors have become somewhat more willing to pay up for future earnings (Exhibit 39). In contrast, consensus earnings expectations for 2012 and 2013 have slipped. The impact of higher P/E ratios has been a powerful tonic for stock prices over the 16 weeks leading up to the end of February.

EXHIBIT 38. Major Indexes



Source: RBC Capital Markets, RBC GAM

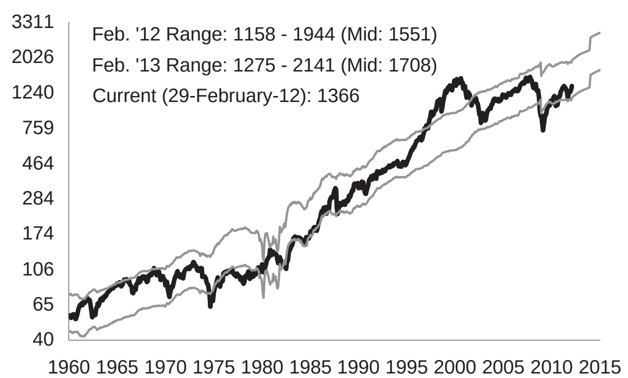
EXHIBIT 39. S&P 500 Earnings Estimates and P/E



Source: ThomsonReuters I/B/E/S, RBC GAM

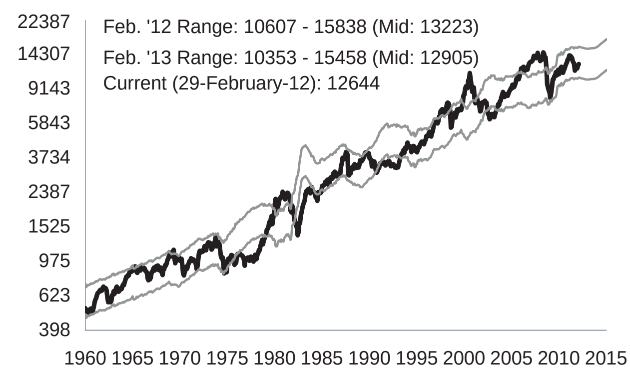
GLOBAL EQUITY MARKETS

S&P 500 Equilibrium
Normalized Earnings & Valuations



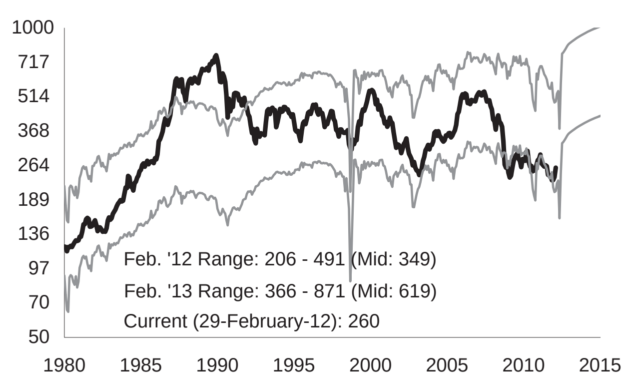
Source: RBC GAM

S&P/TSX Composite Equilibrium
Normalized Earnings & Valuations



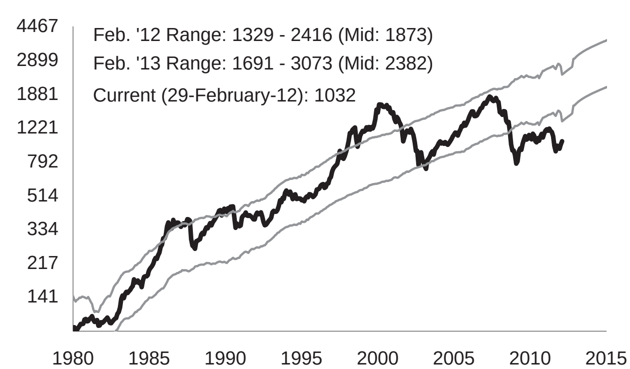
Source: RBC GAM

Japan Datastream Index
Normalized Earnings & Valuation



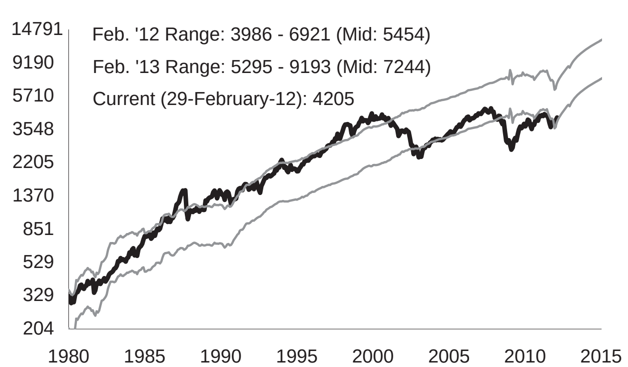
Source: Datastream, Consensus Economics, RBC GAM

Eurozone Datastream Index
Normalized Earnings & Valuations



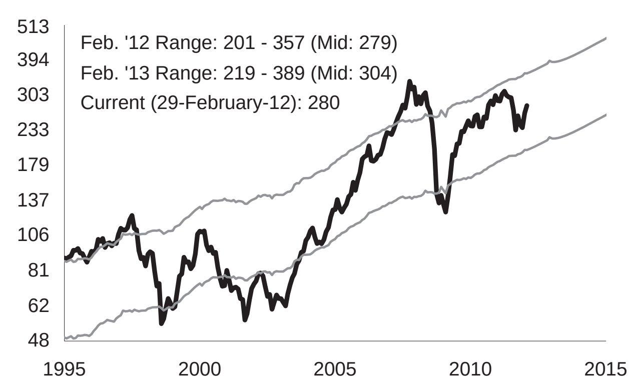
Source: Datastream, Consensus Economics, RBC GAM

United Kingdom Datastream Index
Normalized Earnings & Valuations



Source: Datastream, Consensus Economics, RBC GAM

Emerging Market Datastream Index
Normalized Earnings & Valuations



Source: Datastream, RBC GAM

Valuation not a barrier to further gains

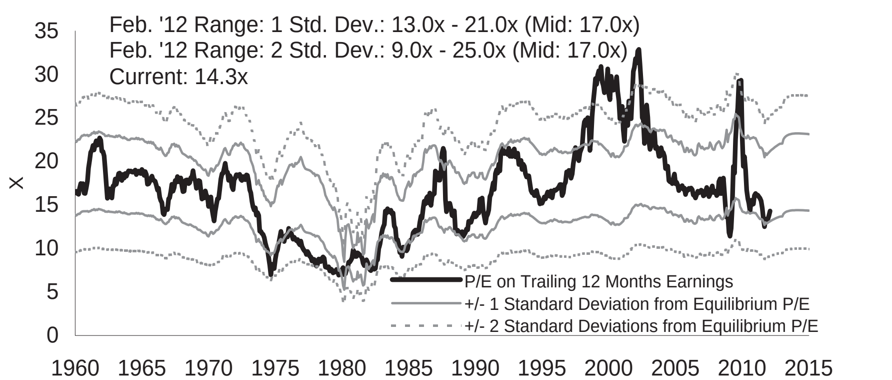
Despite some recent progress toward normalization in valuations, the market remains well below equilibrium. Exhibit 40 shows the 12-month trailing P/E ratio on S&P 500 earnings. It has increased from 12.5 times in September 2011 to 14.3 times at the end of last month. Our models suggest that, all else being equal, investors would normally be trading the market at a much higher 17 times given current levels of real and nominal interest rates, and inflation.

The bands in the exhibit sit one and two standard deviations above and below equilibrium. The distance that the current P/E ratio lies away from its equilibrium setting (the midpoint of the bands) tells us something about the degree of investor optimism or pessimism. As recently as a few months ago, the market was trading at less than one standard deviation below equilibrium. While the improvement from that lower band is welcome news for stock-market investors, pessimism remains well above normal.

Exhibit 41 shows the nexus of earnings and trailing P/E ratios that would be needed to hold the market at its current level. Actual reported earnings as of early March were $95.50. Based on the level of the S&P 500 at the time of writing (1366), we can calculate the market's current P/E ratio to be 14.3 times. A move above 1366 would require higher valuations or stronger earnings.

Exhibit 41 gives us a sense of the earnings that would be required if the market were to trade at a P/E ratio above or below its current level. If investors traded the market at 17 times earnings (the equilibrium P/E ratio), we would need about $80 in earnings to hold the market steady. If investors became more pessimistic and traded the market back down to one standard deviation below equilibrium, we would need $104.72 of S&P 500 earnings to keep the market where it is. December 2012 bottom-up consensus earnings estimates currently sit at $104.41. The message: in the absence of a negative shock to investor sentiment or profits, earnings now reflected in consensus expectations are consistent with levels required to hold stocks steady at current levels, even if valuations slip somewhat.

EXHIBIT 40. S&P 500 Index
Normalized (Equilibrium) P/E Ratio



Source: RBC GAM

EXHIBIT 41. S&P Earnings
Trailing 12-Month Earnings Required to Justify P/E at Current Price Level

		Current S&P 500	Required Earnings
Current	14.3	1366	$95.50
Equilibrium P/E	17.0	1366	$80.17
1 Standard Deviation Below Equilibrium P/E	13.0	1366	$104.72
2 Standard Deviations Below Equilibrium P/E	9.0	1366	$150.94

Source: RBC GAM

Scenario analysis shows extent of upside potential

Whereas Exhibit 41 assesses the market through the lens of trailing P/E ratios and earnings, Exhibit 42 shows potential levels for the S&P 500 if we adopt a variety of forward-looking earnings estimates and valuations. The current top-down consensus estimate for 2012 earnings is $101.50, 6.2% above the latest actual earnings figure of $95.50. If the market traded down to one standard deviation below its equilibrium P/E, $101.50 in earnings would cause the market to fall to around 1324, just 42 points below the S&P's level at the time of writing. Further downside movement requires a greater degree of pessimism. At two standard deviations below equilibrium – the valuation that prevailed at the depths of the credit crisis in the spring of 2009 – the market would decline to 918. Further downside opens up in a recessionary environment, but this is not a scenario that we consider highly probable at this time.

If, instead, investors priced current earnings at an equilibrium valuation consistent with a normal degree of risk aversion, the S&P 500 would rise to 1729 (27% higher) without being overvalued. In this context, our 12-month forecast of 1450 for the S&P 500 (an index gain of just over 6%) may err on the side of conservatism. At a multiple of 14.3, 1450 requires earnings of just over $101, 6% ahead of the latest reading and a level that already appears reasonably achievable given that consensus earnings estimate for December 2013 is nearly $118.

Average 1-year gain from current P/E is 14%...

Exhibit 43 shows the results of a study that examined the 12-month return following periods where the market traded at various P/E multiples ranging from less than 8 to more than 20. The data was grouped into ranges. As it turns out, the second-strongest average returns over the subsequent 12 months were generated when the market traded at a P/E ratio of between 14 and 16 – right where the S&P 500 is today! On average, the 12-month return from this valuation range is 13.7%, more than twice our conservative projection.

EXHIBIT 42. 2012 Earnings Estimates and Alternative Scenarios for Valuations and Outcomes for the S&P 500

		2012 Top Down	2012 Bottom Up	Trailing 12 months	Recessionary*
		$101.5	$104.4	$95.5	$71.6
Equilibrium P/E	17.0	1728.9	1778.5	1626.7	1220.0
1 Standard Deviation Below	13.0	1323.7	1361.6	1245.4	934.1
2 Standard Deviations Below	9.0	918.4	944.7	864.1	648.1

*Trailing 12-Month Earnings to November 2012 less 25%
Source: Bloomberg, Thomson Reuters, RBC GAM

EXHIBIT 43. P/E Ranges and Subsequent 12-Month Returns (since 1940)

‹8x:	Average 18.6% Median 18.8%
8x to 10x:	Average 8.8% Median 6.7%
10x to 12x:	Average 9.7% Median 9.6%
12x to 14x:	Average 10.5% Median 10.5%
14x to 16x:	Average 13.7% Median 17.0%
16x to 18x:	Average 5.1% Median 8.5%
18x to 20x:	Average 5.7% Median 6.3%
›20x:	Average -0.8% Median -0.6%

Source: Citigroup

...but even much higher returns are possible from here

Looking farther ahead, if we use the 2013 consensus earnings estimate of $118 and combine it with a 14.3 multiple, we generate an S&P 500 target of 1687, over 320 points ahead of our target. If instead we combine a conservative forecast of $110 in earnings in 2013 with an equilibrium P/E multiple of 17, we generate an S&P 500 level of 1870, fully 504 points, or 37%, higher than the level at the time of writing. At the absolute upper end of the range (at the intersection of $118 in earnings and an equilibrium P/E of 17) lies an index level of 2006, a 47% gain!

While we don't expect the S&P to travel to such heights in the next 12 months, this methodology highlights the potential for stock gains under a scenario of normalization in investor sentiment. At some point, pessimism will give way to optimism and truly open up the potential for these levels to be achieved. Meanwhile, we will continue to operate under more conservative assumptions for both earnings and valuations.

Onus falls on earnings to deliver

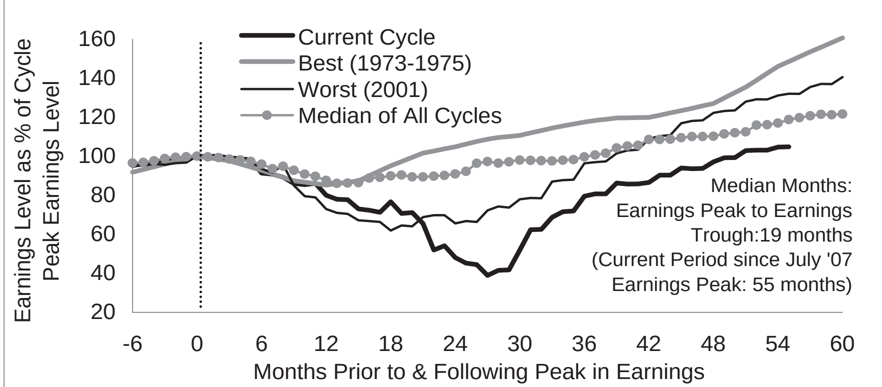
While some of our caution stems from the festering European fiscal crisis, we also recognize that there is a rising hurdle rate on future profits because earnings have exceeded expectations for many quarters. Readers might be surprised to note that, since the early-2009 trough, S&P 500 recurring earnings have been rising at the fastest pace of any post-war recovery (Exhibit 44), despite an environment of generally sluggish revenue growth (Exhibit 45). This earnings performance has been driven by cost cuts that will be increasingly difficult to replicate.

Slower-growth environment to last a while longer

As noted earlier in this article, we expect generally slower economic growth rates to prevail across the developed world during the period of recovery. In the U.S. and Canada, that means an average annual real rate of expansion of around 2%, whereas we might have expected 3% or higher before the Great Recession. Nominal GDP is expected to be about one percentage point lower.

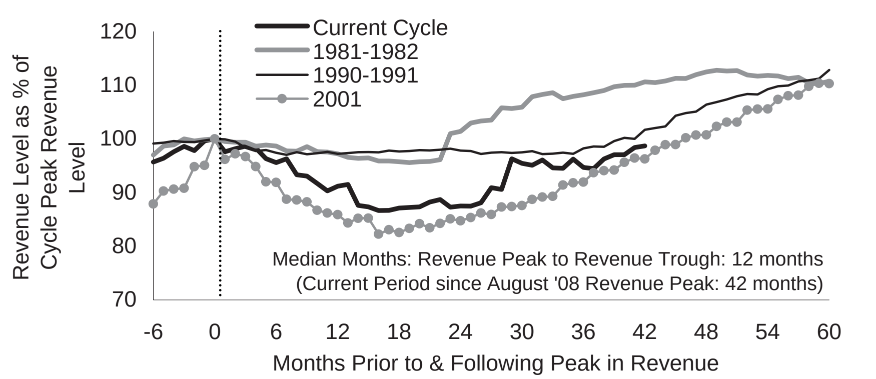
Exhibit 46 charts the relationship between nominal GDP growth and S&P 500 revenues. As can be expected, slower GDP growth tends to generate weaker revenue growth. Our 2012 nominal GDP growth forecast (i.e. real growth plus inflation) of 3.75% augurs for a possible revenue slowdown in

EXHIBIT 44. S&P 500 Recurring Earnings
(All Earnings Peaks Associated With Periods of Recession)



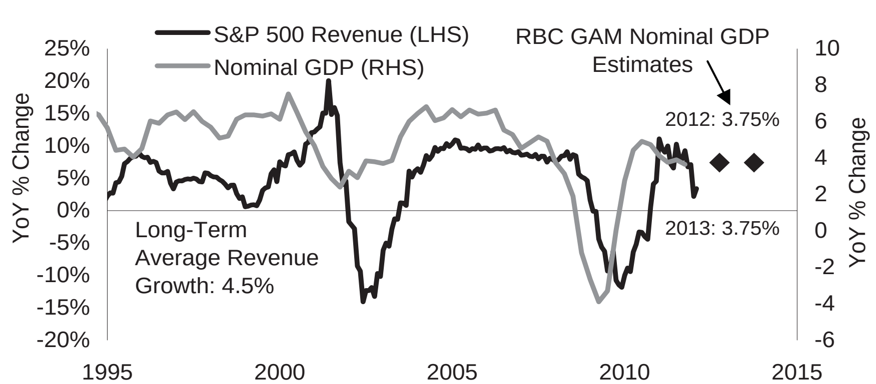
Source: RBC GAM

EXHIBIT 45. S&P 500 Revenue



Source: RBC GAM, RBC CM

EXHIBIT 46. United States
S&P 500 Revenue and Nominal GDP



Source: RBC CM, RBC GAM

the quarters ahead. This is consistent with anecdotal reports of companies reducing guidance for the coming quarters during the most recent earnings reporting season.

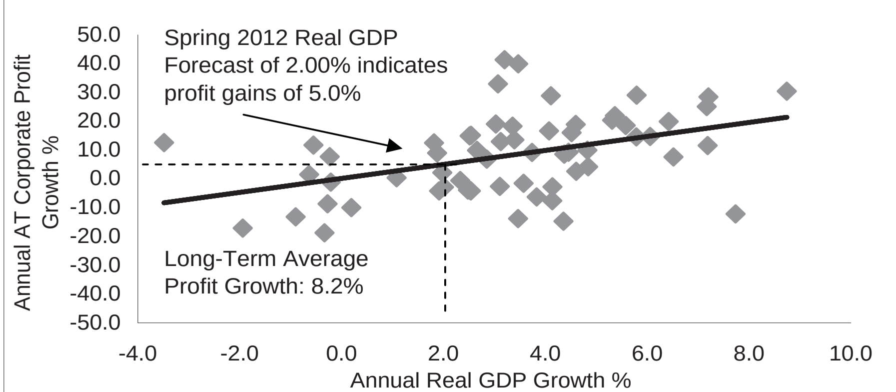
Weaker economy means slower growth in revenue and profits

Exhibit 47 shows that a similar relationship can be derived between real GDP growth and corporate profits. Although the long-term average growth rate of after-tax profits in the U.S. economy is 8.2%, the intersection of our 2012 real GDP forecast of 2% and the long-run trend line indicates a profit-growth forecast of just 5%, considerably lower than the long-run average. While not by any means catastrophic, a 5% growth rate in profits is a new, challenging dynamic for newly emboldened investors to contemplate. At lower rates of earnings growth, the wiggle room is much narrower.

Profits may have peaked as a share of GDP

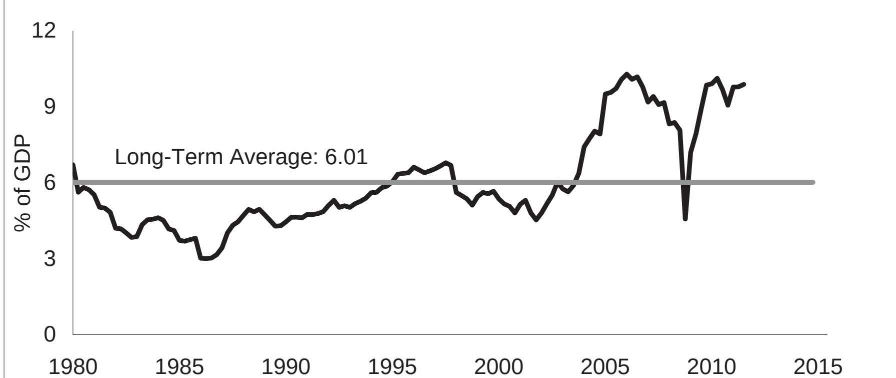
Elevated levels of corporate profits as a share of GDP in both Canada and the U.S. (exhibits 48 and 49) also suggest some threats to earnings in the near term. While there is no compelling reason to expect that the corporate share of the value created in an economy should return to the long-term mean, there is scope for profits to grow more slowly now that they have reached what has historically been a peak in relation to total income earned on an economy-wide basis. In addition, the lagged effect of Europe's recession should exert some downside pressure on U.S. corporate

EXHIBIT 47. GDP and Corporate Profits
Corporate Profit Growth as a Function of Real GDP Growth



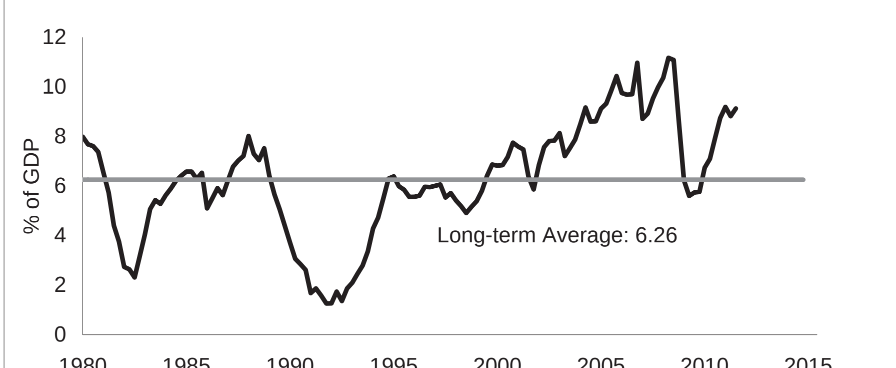
Source: RBC GAM

EXHIBIT 48. U.S. – After-Tax Corporate Profits as a Share of GDP
SAAR



Source: Haver Analytics, RBC GAM

EXHIBIT 49. Canada – After-Tax Corporate Profits as a Share of GDP
SAAR



Source: Statistics Canada, Haver Analytics, RBC GAM profits this year. Conversely, if the job market improves further, it makes sense that the economy-wide wage bill might rise, directing a larger share of earnings toward workers and away from companies' bottom lines.

Recent data points to earnings slowdown

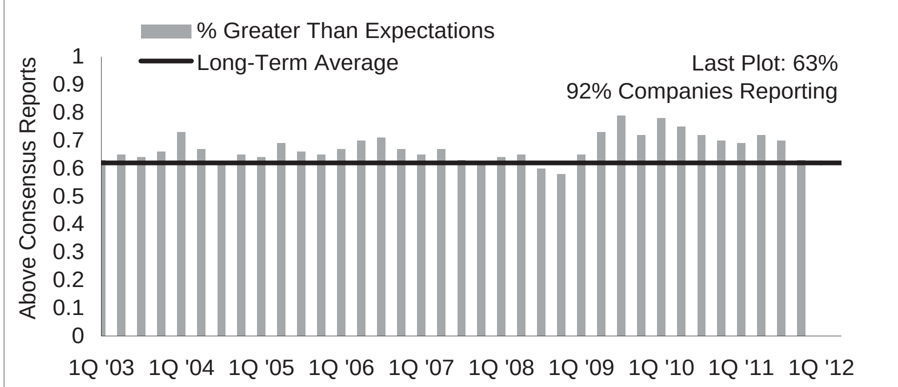
The most recent earnings reporting season provided some corroborating evidence that earnings growth might have temporarily lost some momentum. Exhibit 50 shows that a smaller percentage of S&P 500 companies beat earnings expectations. While the latest data point is still above the long-term average, the recent trend, if extended, points to a greater share of companies potentially disappointing the market, either as a result of slowing profit growth or aggressive expectations following three consecutive years of positive surprises.

Analysts appear to be reading from the same tea leaves regarding the sustainability of upside profit surprises. Exhibits 51 and 52 show that 2012 and 2013 consensus earnings estimates for both the S&P 500 and the TSX have come down by a fair amount. This recent trend of falling estimates was likely fuelled by last fall's equity-market volatility and by the risk of negative economic shocks emanating from Europe.

Market's surge has raised the stakes on future gains

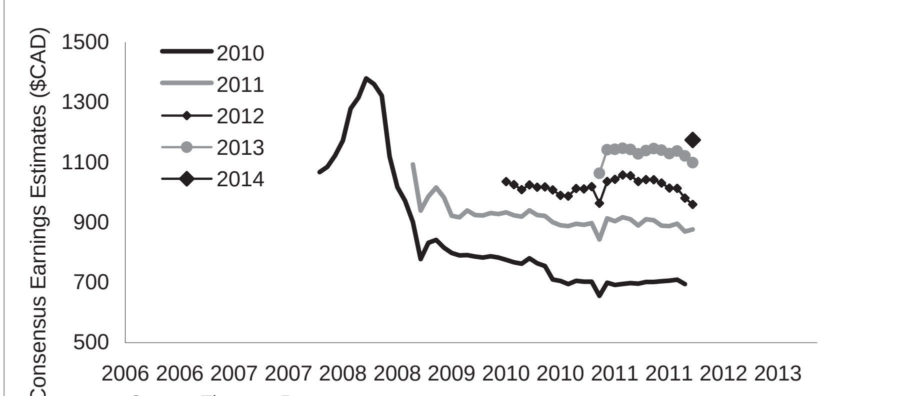
It is important to recognize the implications of the nice run in stock prices from the October lows. Now that valuations have improved from depressed levels, gains from here

EXHIBIT 50. Companies Reporting Results Above Consensus Forecasts



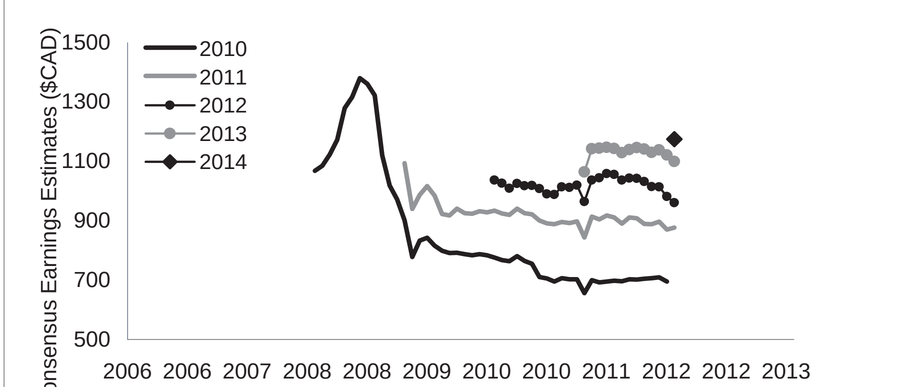
Source: ThomsonReuters

EXHIBIT 51. S&P 500 Composite Index
Consensus Earnings Estimates



Source: ThomsonReuters

EXHIBIT 52. S&P/TSX Composite Index
Consensus Earnings Estimates

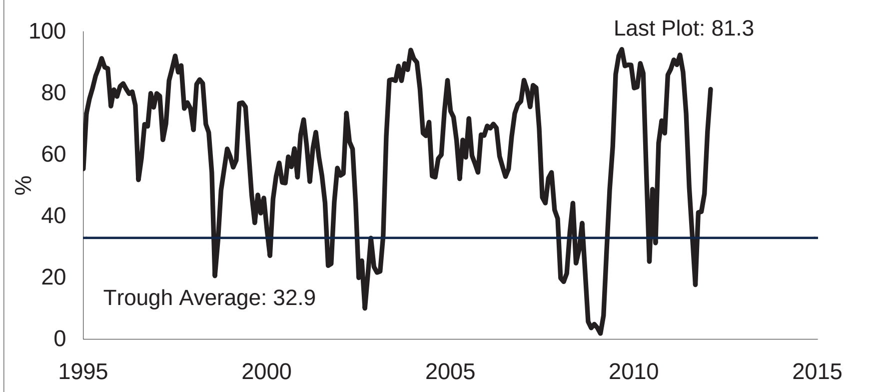


Source: ThomsonReuters

require valuations to continue to rise into a range that investors have been uncomfortable with since 2008. It remains to be seen whether the outlook has brightened enough that investors can push valuations into the 14-16 range on a sustainable basis. Alternatively, if valuations cannot advance from here, higher profits are required to drive stock gains. While not impossible, this would require another surge in productivity growth or a much stronger economy than we currently project. Until now, profit growth and richer valuations were quite likely to materialize from depressed levels at some point. Now that they have materialized, it is critical that they continue to expand if the market is to advance further.

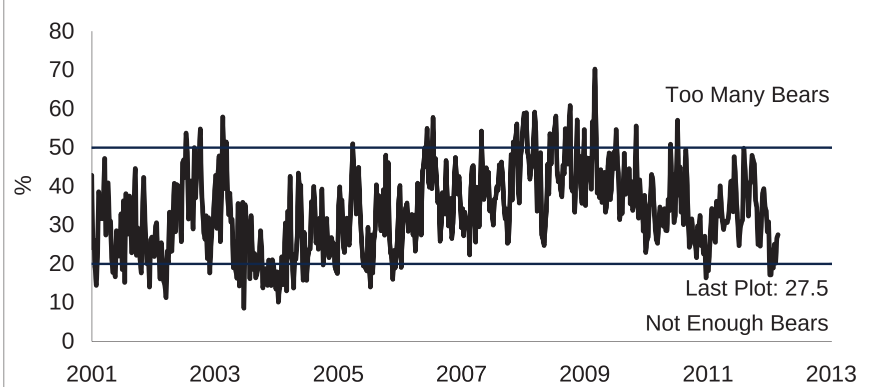
For this reason, our stock-market targets are more conservative than the consensus, and we don't need aggressively higher earnings in order to validate our 12-month equity-market projections.

EXHIBIT 53. **S&P 500**
Percentage of Companies Above 200-Day Moving Average



Source: RBC GAM

EXHIBIT 54. **AAII Sentiment Survey**
Percent Bearish



Source: American Association of Individual Investors (AAII)

Technical signs argue for caution

A variety of technical signs appears to be suggesting that the current equity-market rally may be due for a pullback or consolidation. For example, the percentage of companies in the S&P 500 Index that are above their 200-day moving average is approaching a level that, in the past, signaled a market peak of at least short-term significance (Exhibit 53). The percentage difference between the S&P 500 index and its 200-day average has also become elevated, though is not yet in "danger" territory. Investor sentiment is sending a similar message that the advance may run into increasing resistance as markets climb. For example, Exhibit 54 shows that bearish sentiment is hovering near lows that commonly come just prior to corrections. In theory, a plethora of bulls and a dearth of bears can leave the market vulnerable to decline. Again, while we are not in the danger zone yet, the technical background to the U.S. market has deteriorated somewhat as this rally has progressed.

Small-cap and low-quality stocks make a comeback

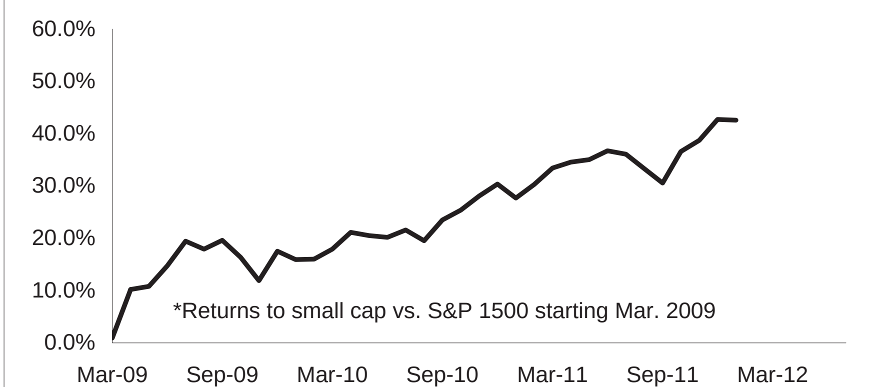
In the initial stages of the recovery from the 2008-2009 credit crisis, the strongest equity-market performers tended to be smaller or lower-quality stocks. These companies were at the brink of bankruptcy during the crisis. As the crisis eased, these stocks found a second life and roared back much faster than higher-quality companies that were more likely to survive a severe recession.

Large-cap, quality companies outperformed over last summer, when the Greek crisis intensified but again underperformed as stocks recovered in the fall. Since the October lows, small-cap stocks and lower-credit-quality companies have again led the market in a move reminiscent of the early days of the 2009 rebound. Exhibit 55 shows that a small-cap bias has returned to the market since mid-2011, and extends the long period of small-cap outperformance that began in March 2009.

Exhibit 56 shows returns organized by credit quality. Over the past year, companies with the strongest credit quality generated the best stock-price gains. That makes sense during a period when Europe's fiscal crisis may well have precipitated a banking collapse and subsequent liquidity shortage. But as the table shows, the sudden easing of financial-sector risk has kicked off a sharp two-month rally in stocks of the lowest-credit-quality companies. These companies were at risk of serious financial pressures a few months ago, but as that threat eased, their stocks snapped back smartly. This is again reminiscent of stock-market conditions that prevailed in mid- to late 2009.

The implications are still murky, but if history repeats itself, we can expect a period when smaller, lower-quality companies outperform, and once this runs its course, it may once again be followed by a swing in the market's attention back to larger and higher-quality stocks. This may provide a nice buying opportunity for patient investors to re-load on high-quality stocks that can be held comfortably in lower-risk portfolios.

EXHIBIT 55. U.S. Factor Returns
Cumulative Returns to Qube Small Cap



Source: RBC GAM

EXHIBIT 56. S&P 500 Returns by Credit Rating

	2009		2011/2012		
	3 Months Mar. 9 – Jun. 30, 2009	# of Stocks	2 Months Jan. 1 – Feb. 29 ,2012	12 Months Mar. 1, 2011 – Feb. 29, 2012	# of Stocks
AAA+ to AAA-	22.5%	5	6.6%	12.0%	4
AA+ to AA-	40.1%	22	4.7%	11.0%	16
A+ to A-	97.7%	131	10.3%	4.8%	148
BBB+ to BBB-	56.4%	187	9.0%	4.9%	210
BB+ to BB-	70.5%	68	12.5%	-2.6%	51
B+ to B-	138.2%	9	12.7%	-17.6%	8
CCC+ to C-	147.7%	3	119.2%	-15.9%	1
Not Rated (All)	49.7%	75	11.0%	3.7%	62
Not Rated (Tech)	45.5%	35	15.0%	0.5%	25
Not Rated (Other-Ex Tech)	53.4%	40	8.3%	5.9%	37

Note: Based on S&P500 Index constituents as of Feb. 27, 2012. Based on current credit rating as of Feb. 27, 2012. Credit Ratings based on S&P LT Issuer Local Credit Rating.

Source: RIMES Technology Inc., Bloomberg, RBC GAM

Correlations decline from all-time highs

For some time, we have been tracking the extent to which individual stock-price movements are correlated to the movement in the overall index. Last quarter, those correlations spiked to all-time highs (Exhibit 57) as investors seemed to abandon all pretence of caring about company-specific fundamentals and instead traded the market according to the latest headlines.

Fortunately, this tendency has diminished since late last year and correlations have come down meaningfully, although they remain higher than in most other environments since the 1970s.

Rewards to stock selection still not back to normal

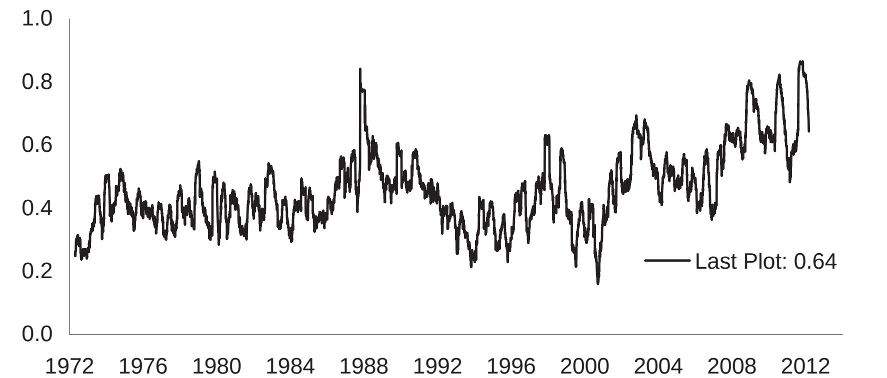
Ultimately, we will return to an environment in which stock-picking matters. Exhibit 58 shows that we may be trending back in this direction, but there is much more room to run. The exhibit shows the gap in returns between the hypothetical best stock picker and the worst stock picker. One would expect the 'best' stock picker to vastly outperform, and in most periods, one would be right. However, 2011 was not such a time. High correlations greatly reduced the penalty for bad stock-picking, as all stocks went up and down together. Actively managed portfolios thrive in an environment where good decisions are rewarded. Exhibit 58 suggests these conditions may be gradually returning.

Asset Mix

The RBC Investment Strategy Committee's recommended asset mix remains unchanged for the Spring 2012 edition of the Global Investment Outlook. Stocks continue to offer far more compelling horizon returns than bonds. Meanwhile, maintaining a cash reserve will allow us to act on opportunities as they present themselves amid a potentially volatile macroeconomic environment.

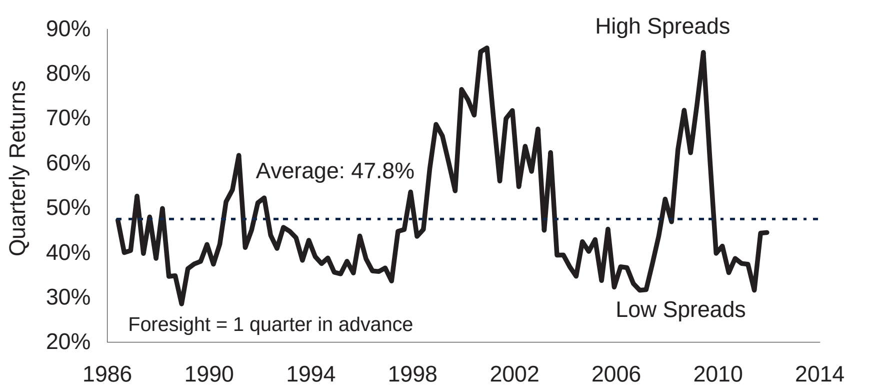
The recommended asset mix for a global balanced investor is as follows: overweight cash (7.5% versus a 5% neutral target), underweight bonds (35% versus 40% neutral), and overweight equities (57.5% versus 55% neutral).

EXHIBIT 57. S&P 500 Stock Correlations
Median Correlations of S&P 500 Stocks to the S&P 500 Index



Source: Ned Davis Research

EXHIBIT 58. S&P 500 – Returns to Perfect Foresight
Difference Between Median Performance of Top and Bottom Deciles



Source: Bank of America Merrill Lynch

The motivation behind maintaining an elevated cash position through this past winter was to preserve our ability to capitalize on a pullback in equity markets. While we expected the North American economy to grow at a moderate pace, we felt stocks were vulnerable and we wanted to have the ability to deploy cash as opportunities present themselves.

No pullback yet

That pullback has yet to arrive. After meandering a bit in November, stocks embarked on an upward trajectory with barely a setback. While the U.S. economy's improved momentum has helped offset some of the effects of Europe's recession, clearly the main event has been the dramatic drop in the risk of a global financial-sector crisis due to ECB liquidity injections. As a result, investors have become more optimistic that the worst-case outcome has been averted for now. Our long-awaited expansion in valuations appears to be emerging more rapidly than expected.

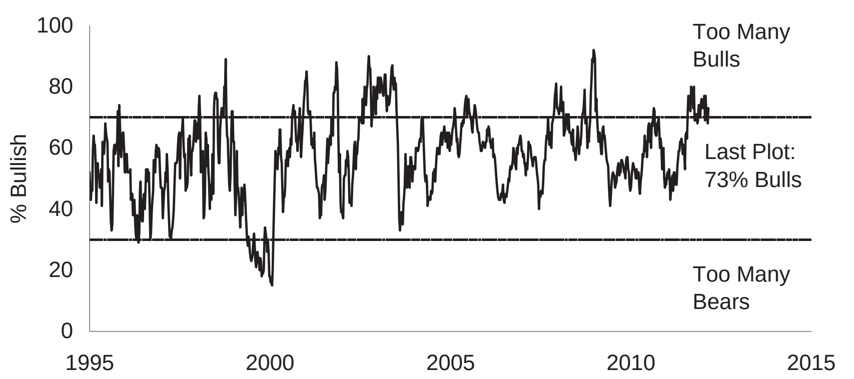
The recommended 2.5-percentage-point equity overweight has allowed us to capture the benefits of this surge in global stock prices for client portfolios. However, we remain disciplined in our approach and are diligent in sticking to our targets. This meant trimming our equity holdings as stocks advanced, in order to remove market drift and stay close to our target allocation. Otherwise, the equity position would have drifted to a larger and larger overweight and we felt this was undesirable.

We are reluctant to raise our equity overweight at this time, as we feel that stocks are vulnerable to a retracement or period of consolidation over the coming months. Equities appear to be overbought in the near term on a technical basis, and the largely one-way nature of the advance has also caught our eye. Both valuations and earnings have advanced to the point where further significant gains in both are now required to sustain the rally. Macroeconomic risks in Europe are lessened, but far from resolved. The recent increase in oil prices and the attendant risks to consumers are other issues that give us some pause, as does the potential for volatility ahead of the U.S. election.

Bonds not compelling

We gave consideration to the potential gains that could be harvested from directing some of the cash weight to bonds over the next few months to take advantage of higher yields farther along the yield curve. However, despite the Fed's promise to hold yields low for an extended period, the opportunity was not compelling enough given the risks of capital losses in the bond market if the economic outlook continues to improve.

EXHIBIT 59. U.S. 10-Year T-Bond Bullish Consensus



Source: Market Vane, RBC GAM

Yields on short-term commercial paper currently sit near 1% in Canada, while 2-year Government of Canada bond yields are barely higher at approximately 1.3%. Ten-year yields hover around 2%, close to their lowest level since the late 1940s. In our view, bonds remain highly vulnerable to a rise in interest rates. In just two months, for example, the Canadian bond market has gone from pricing in one Bank of Canada interest rate cut over the next few quarters to expecting no change. Further improvement in investor sentiment could easily push the market to price in a rate hike over the next two years, in which case the potential rise in yields from that change alone would eliminate the benefits from holding longer-term bonds instead of cash or short-term paper.

Any reasonable longer-term view that assumes even a modest pace of continued economic expansion (as opposed to a recession) continues to argue for an underweight position in fixed income. Bonds ended 2011 in the midst of one of the most powerful rallies of the past decade. Typical of a maturing bull market, investor sentiment in fixed-income markets has moved to levels indicative of an unhealthy complacency (Exhibit 59). Today's low bond coupons seem almost certain to be eaten away by the negative price movement that will come as bond yields normalize to higher levels over the coming years.

Stock versus bonds

We needn't rely exclusively on the likelihood of poor absolute returns for government bonds in the years ahead. The likelihood of poor relative returns for bonds compared to stocks makes for an extremely compelling story all on its own.

Consider Exhibit 60, which plots the U.S. 10-year Treasury bond yield advanced by a decade. We plot this against the subsequent 10-year compound annual nominal returns that accrued to bond investors. The idea was to determine the extent to which prevailing 10-year nominal bond yields did a good job of approximating the actual returns to bond investors over the time horizon of the bond. Since the market for 10-year bonds theoretically offers the best guess of returns available to investors, an efficient market in which everyone has the same information available to them should produce a highly efficient guess of future returns.

As it turns out, the two lines in Exhibit 60 track very closely together. As expected, the extremely deep and liquid U.S. Treasury market is a very efficient predictor of future realized nominal returns. The implication is clear. The current yield to maturity of the 10-year Treasury bond is a very good guide to what the trailing 10-year total return from Treasury bonds will be a decade from now: a skinny 1.99%!

Stock valuations low

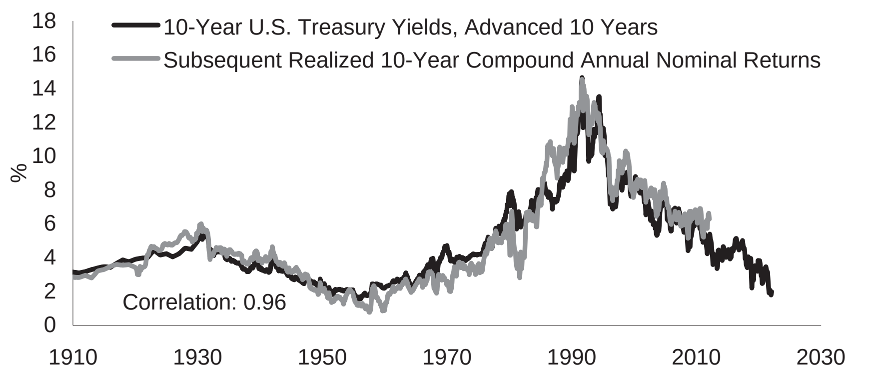
So our primary question should be: under our base case, what are the chances stocks will offer annual nominal returns over the next decade that exceed 2% per annum? In our view, the chances are very high. The current dividend yield on the S&P 500 exceeds 2%. Meanwhile, valuations remain below our estimates of equilibrium.

Exhibit 61 shows the potential returns available to patient investors if both bonds and stocks return to equilibrium over various time horizons.

If equilibrium is restored over the next year (an unlikely event given the scar tissue that remains from the credit crisis), returns are sharply positive for stocks and sharply negative for longer-term bonds.

An even more attractive argument for stocks over bonds comes when we look farther out. If it takes longer – five years, for example – for equilibrium

EXHIBIT 60. U.S. 10-Year Treasury Note & Returns



Source: Deutsche Bank, Haver Analytics, RBC Capital Markets

EXHIBIT 61. Asset Class Forward Returns

Asset Class	Current Return	1-Year Forward Return	2-Year* Forward Return	3-Year* Forward Return	5-Year* Forward Return	10-Year* Forward Return	15-Year* Forward Return	20-Year* Forward Return
U.S. Treasury Bill	(0.37%)							
U.S. 10 Year Treasury Bond	(13.42%)	(10.10%)	(2.87%)	(1.33%)	(0.14%)	0.80%		
Canada 10 Year Government Bond	(16.37%)	(15.29%)	(7.63%)	(5.23%)	(2.39%)	(0.18%)		
U.S. Investment Grade Bond**	(9.25%)	(3.95%)	1.27%	2.15%	2.83%	3.38%		
Canada Investment Grade Bond**	(11.30%)	(8.60%)	(3.19%)	(1.58%)	0.54%	2.17%		
U.S. Stocks (S&P 500)	13.59%	25.08%	25.30%	18.90%	13.23%	9.61%	8.39%	7.77%
Canadian Stocks (TSX)	9.52%	11.02%	6.22%	4.67%	3.47%	2.58%	2.27%	2.05%

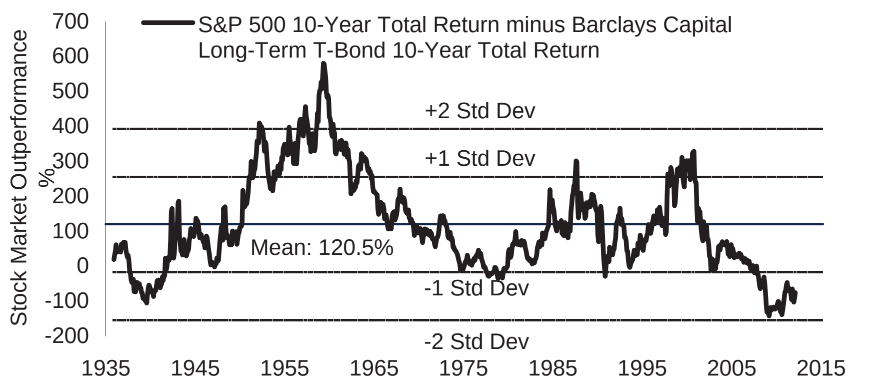
*Annualized Returns
**Bank of America ML Indexes, assuming long-term reversion to normal spread to T-bond, evenly through to end date
Source: RBC GAM, Bloomberg

to be restored, returns to U.S. equity investors would compound at a very attractive rate of around 13%, and U.S. and Canadian 10-year bonds would post losses. If normalization takes a decade, these equilibrium models suggest equities would still do much better than bonds.

When economy normalizes, bond losses will follow

We don't expect equities to roar back to equilibrium valuations overnight, but ultimately the economy and valuations within capital markets will normalize. In that scenario, government bonds are highly vulnerable to capital losses as investors decide that the probability of a return to crisis conditions has diminished. In fact, current yields are only sustainable in the event that tail risks emerge or economic growth is dramatically reduced for an extended period of time.

EXHIBIT 62. 10-Year U.S. Stock and Bond Performance
Stock Market 10-Year Total Return Minus Long Bond Total Return



Source: Ned Davis Research

The opportunity for patient investors to reap the benefits of normalization in stocks and bonds remains enormous and compelling (Exhibit 62). Moreover, these potential gains are also not predicated on a return to above-average economic growth. Even relatively sluggish growth of 2% or so, accompanied by modest but positive profit growth and some further easing of investor risk aversion, would be sufficient to deliver extremely attractive relative returns for equity investors over the longer term.

GLOBAL FIXED INCOME MARKETS

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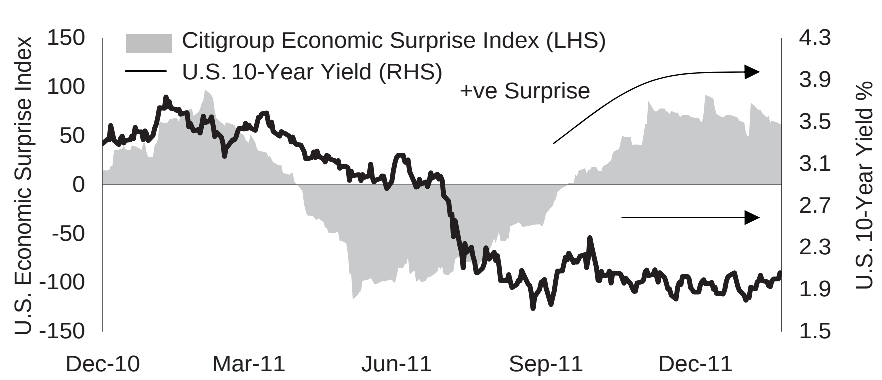
The bond market posted positive returns in the most recent period, notwithstanding rich valuations. Throughout the quarter, economic developments continued on balance to improve, but the bond market remained indifferent (Exhibit 1). The major catalyst since the New Year edition of the *Global Investment Outlook* has been the European Central Bank's three-year Long-Term Refinancing Operation (LTRO), which flooded the Eurozone banking system with cheap and abundant liquidity. This powerful program appears to have removed the tail risk of large looming debt redemptions in 2012 in the Financials sector, as well as sovereign-bond rollovers. The LTRO smoothed the path of balance-sheet repair. The cheap funding has also had a positive impact on sovereign-bond yields in Europe's peripheral nations, where banks have been borrowing at 1% to purchase sovereign bonds yielding 5% or more.

More importantly, this generous liquidity operation signified the pragmatism of the ECB, which until recently had been the key missing ingredient in addressing the crisis. With the ECB stepping up to aid the banks and covertly monetizing sovereign debt, investor sentiment rose from the abyss in the previous quarter. Consequently, global risk assets rallied, and European sovereign yields fell from alarmingly high levels.

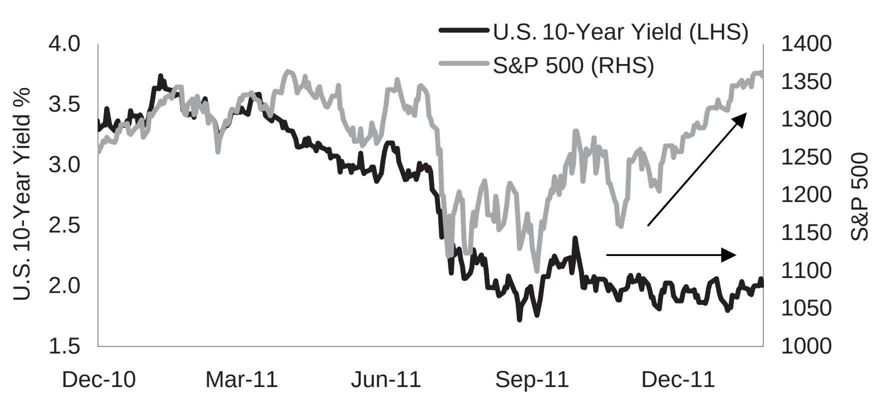
It is worth noting that assets perceived as carrying higher risks and those seen as safe havens have stopped moving in opposite directions. U.S. equities continued to charge higher, while U.S. Treasuries were largely flat (Exhibit 2). The most plausible explanation for this shift are efforts by the private sector to reduce leverage. According to the roadmap set out by economists Carmen Reinhart and Kenneth Rogoff, financial crises tend to be followed by multi-year periods of private-sector deleveraging, and most developed economies have so far endured only two of the first four most painful years of this process. To prevent a collapse in GDP as the private sector repairs its balance sheet, the public sector needs to increase spending and central banks must intervene in debt markets. For highly indebted economies, falling GDP equates to a death spiral, and policymakers are being forced to take measures to prevent abrupt price declines in stocks, real estate and other

EXHIBIT 1. Bond Yield Ignores Positive Economic News



Source: Citigroup, Bloomberg

EXHIBIT 2. Rally in Risky Assets Did Not Prompt the Sell-Off in Safe-Haven Assets



Source: Bloomberg

assets. This process is being played out across developed economies, with both government debt loads and central-bank balance sheets continuing to balloon (Exhibit 3). The preference for saving by the private sector, coupled with large-scale intervention by central banks, allows governments to continue borrowing at very low interest rates. Government bond yields in the U.S., Germany, Japan, U.K. and Canada are expected to remain low, hovering in the range that has been established over the past year (Exhibit 4). Our yield forecasts are a touch lower than in the previous quarter. These tweaks reflect our expectation of greater intervention from central banks, which could send bond yields to new lows in the near term, before yields head higher in the latter part of the forecast horizon.

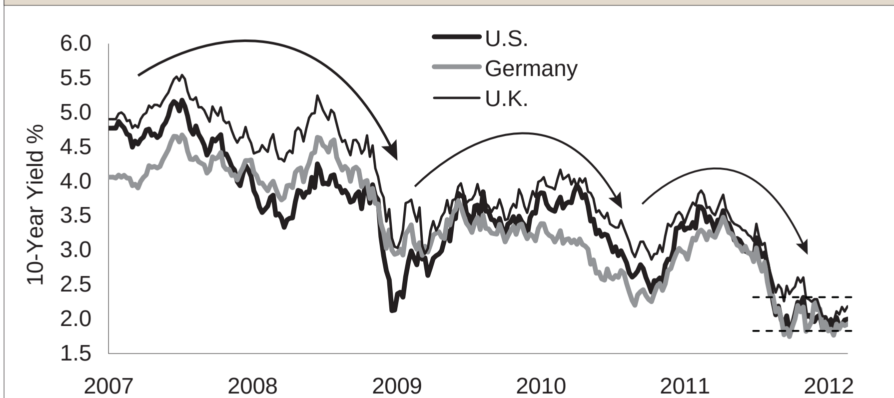
Risk appetite returned to the market as the new year got underway. We attribute this development to the deployment of excess cash and steps by portfolio managers to boost allocations to stocks and higher-yielding bonds after the stock rally took many investors by surprise. We note that gains in risk assets have not been accompanied by a sell-off in U.S. Treasuries, which suggests investors are still wary of social and political unrest in Europe. Likewise, a narrowing in European sovereign-bond spreads was not followed by a sell-off in German bunds. Headline risks in the Eurozone will probably worsen before they improve, increasing the (still unlikely) risk of a Eurozone break-up.

Outside Europe, geopolitical risks over Iran's nuclear program, and the conflict's ramifications for oil prices and overall sentiment, could hinder the nascent economic recovery.

EXHIBIT 3. Heavy Intervention by Global Central Banks
Total Central Bank Assets as a Percentage of GDP

Source: Haver Analytics

EXHIBIT 4. Bond Yields Are Falling in the Developed Economies



Source: Bloomberg

The U.S. political landscape is as polarized now as at anytime in history, which suggests much needed private investment is likely to stay sidelined until at least after the November election. All of these short-term risks could push yields to new lows within our forecast horizon.

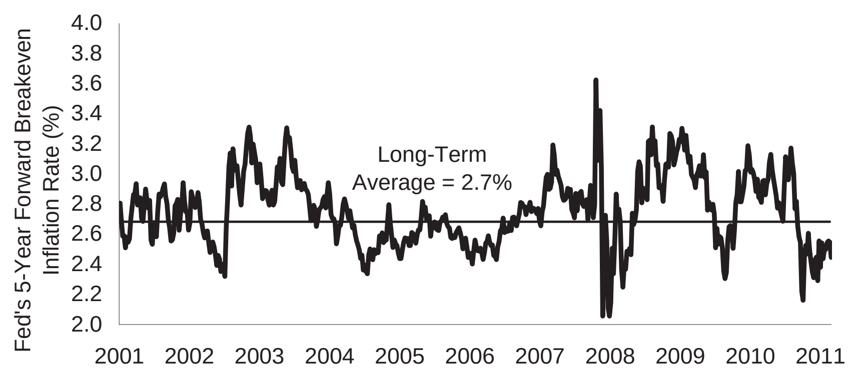
In the longer term, a reflation trade should emerge. This would be driven by the sheer amount of money being created by central banks in developed economies, in conjunction with anticipated monetary loosening in emerging economies, to combat slower growth. The combination could boost inflationary expectations and nudge investors out of safe-haven assets. Bond yields are most at risk under this scenario, especially given extremely rich valuations. This is the primary thinking behind our bias for higher rates, but we are conscious that we may again be early in expecting such developments.

Direction of Rates

Traditional methods for valuing conventional bonds remain ineffective in light of today's heavily manipulated fixed-income markets. For what it's worth, current U.S. inflation expectations have recovered from extremely low levels, although they are still on the low side of long-term averages (Exhibit 5). Moreover, the fall in longer-dated U.S. Treasury yields has translated into lower expected yields. Overlaying that with relatively stable inflation expectations reveals that current yields imply even more modest expectations for U.S. economic growth than the Fed's forecasts (Exhibit 6). An attempt to reconcile the message from the bond market versus the long-run growth forecast by the Fed is highly challenging. The key takeaway from the bond market, albeit distorted by government intervention, is that the market is pricing in a long period of low growth and low inflation.

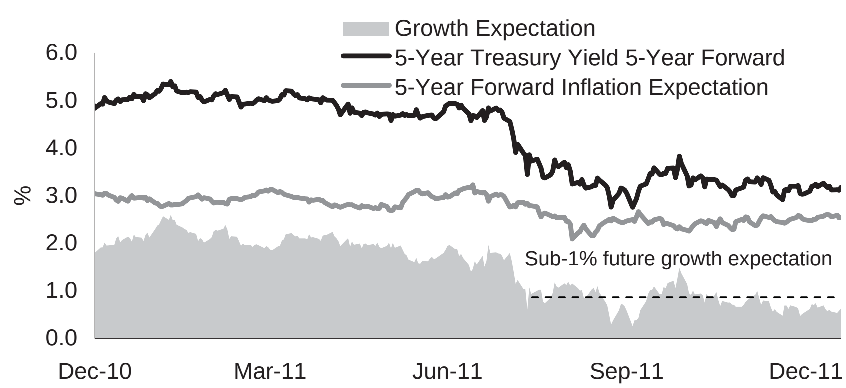
Given the headwinds facing the global economy and poor private-sector conditions, we expect major central banks to keep monetary policy accommodative in an effort to facilitate balance-sheet repair. In addition to staying passive on policy rates, we expect further asset purchases by central banks to ease lending and encourage investors to invest in riskier assets. Should Europe's crisis worsen, the ECB is likely to cut its short-term rate to 0.50% from the current 1.00%, and potentially implement further non-traditional monetary stimulus. We are conscious of the fact that these actions by major central banks, aimed at buying time for the financial system to address its solvency issues, leave little room for error. The unquantifiable risks of government policy could tilt this delicate balance, with unknown effects on the macroeconomic outlook and the direction of bond yields.

EXHIBIT 5. U.S. Long-Term Inflation Expectation Remains Low



Source: Bloomberg

EXHIBIT 6. Bond Market Growth Expectations Are Lower Than the Fed's 2.3%-2.6% Long-Term Expectation



Source: Bloomberg

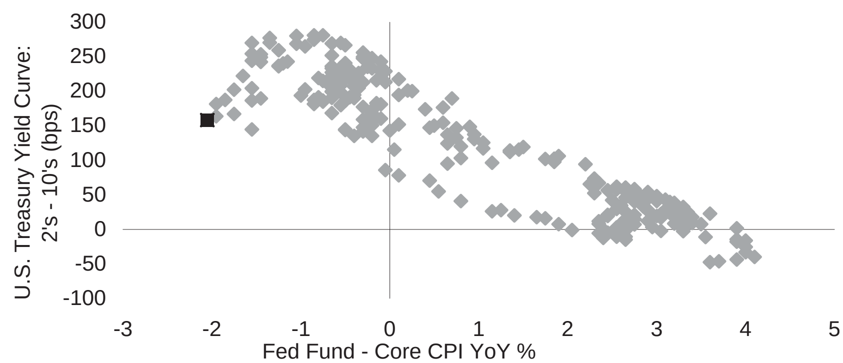
As long as real rates on short-term bonds stay negative, the U.S. Treasury yield curve is expected to remain steep (Exhibit 7). Nevertheless, further intervention by central banks to suppress longer-dated bond yields would flatten the curve given that front-end rates are already at rock-bottom levels.

We recognize that bond yields are far too low given traditional valuation measures, and that the fixed-income bull market may be in its last phase. It would be unreasonable to expect a repeat of 2011's spectacular performance, as that would require longer-dated bond yields to drop to levels not far from where they are for short-dated securities. However, near-term uncertainties suggest that we should not give up on bond allocations just yet. In an era of zero-interest-rate policy, Japanese government bonds (JGBs) have outperformed cash significantly and also served as a diversifying asset during volatile periods. Given the steepness of the yield curve and anchored front-end rates, bond investors are also benefiting from capital gains as maturities shorten. Animal spirits are dampened at the moment, and private-sector deleveraging requires more time. A rebuilding of private-sector savings translates into excess cash in the financial system, and much of this money could find its way recycled back into government bonds. In addition, we should expect policymakers to implement further measures that hold down bond yields and ensure that fixed-income markets function relatively smoothly. Considering that these near-term risks rank equally with concerns about rich valuations, we would recommend a neutral duration for a bond portfolio over the next quarter.

U.S. – There is no change to our forecast for the fed funds rate from the previous quarter. Our 0.25% forecast is in line with market expectations for continued low front-end rates. As long as the policy rate remains well anchored, we expect yields further out the curve to remain low. We note that U.S. economic data continued to surpass expectations in recent months. However, the data-surprise index historically snaps back in the other direction, as forecaster revisions can get too high (Exhibit 8). Given the extreme levels and long time frame of the current overshoot to positive surprises, we are looking for the data to moderate, and possibly disappoint.

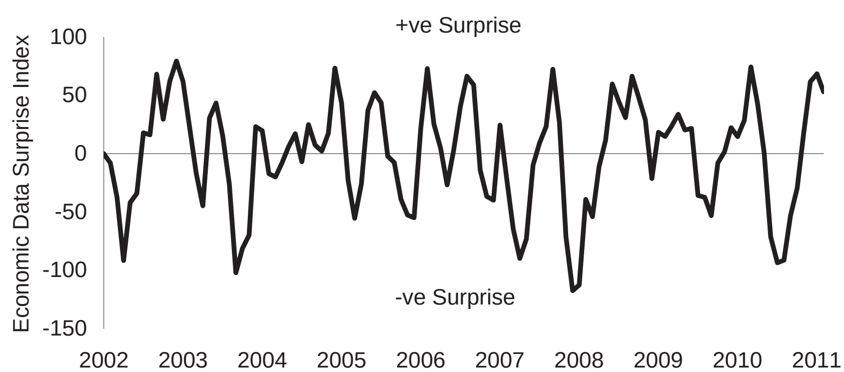
A study of the past two years also supports an increase in data shortfalls in the second quarter of this year (Exhibit 9). Combining the potential

EXHIBIT 7. Negative Real Rate Keeps Yield Curve at Steep Levels



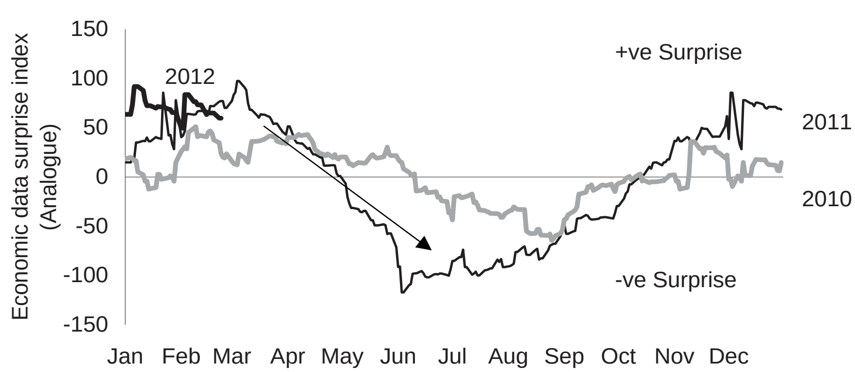
Source: Bloomberg, RBC GAM

EXHIBIT 8. Economic Surprise Index Tends to Mean-Revert



Source: Citigroup

EXHIBIT 9. Economic Surprise Index Pattern After the Financial Crisis

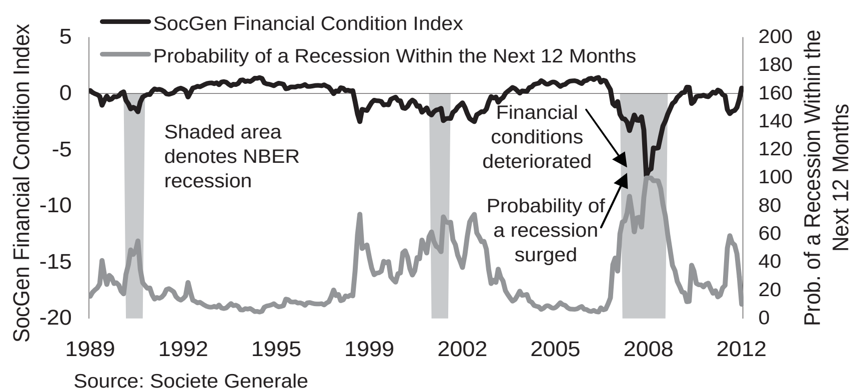


Source: Citigroup

for weaker-than-expected economic statistics and the recent behavior of safe-haven assets, which react more strongly to bad news than good, leads to the conclusion that yields could yet fall to new lows. Under such circumstances, we would expect the Fed to intervene. For now, the Fed's bias is toward balance-sheet expansion. That's because central-bank officials have learned from their mistake in the first half of 2011, when they prematurely discussed the likely sequence of steps to exit the Fed's accommodative stance. Such talk forced the Fed into further easing with "Operation Twist" and eventually into guidance for rates to stay low until late 2014. Until the case for a strong, sustainable economic recovery is iron-clad, the Fed is highly unlikely to even hint at changing its easing stance.

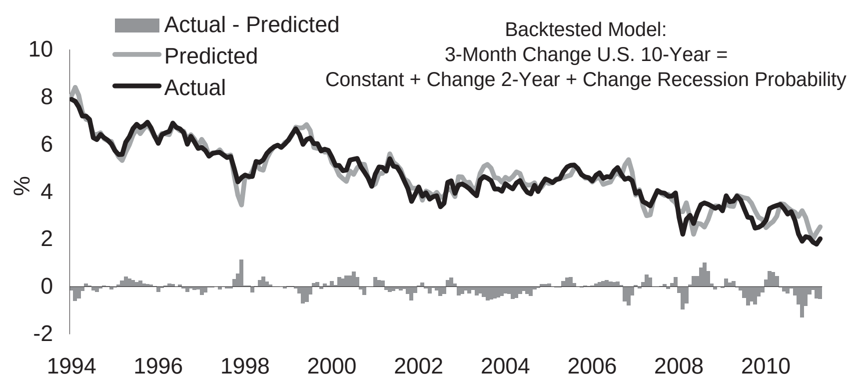
To get a better feel for the near-term direction of the U.S. 10-year Treasury yield, we developed a model based on the probability of a recession within the next 12 months derived from Societe Generale's Financial Condition Index (Exhibit 10) and movements in 2-year U.S. Treasury yields. The back-tested results, with a three-month lag, show a relatively good fit (Exhibit 11). In Exhibit 12, we use the findings to lay out scenarios for the fair value of the U.S. 10-year Treasury bond three months into the future. Given the very low probability of recession being priced into the market, 10-year bond yields rest at the top end of the recent range. In order for yields to break the recent low of 1.80% and possibly test the 1.50% level, we would need to see adverse scenarios unfold, i.e. a surge in the probability of recession and a significant drop in 2-year yields. Conversely, as long as the probability

EXHIBIT 10. Societe Generale Financial Condition Index and Probability of a Recession



Source: Societe Generale

EXHIBIT 11. Backtested Model for 10-Year Yield Forecast



Source: RBC GAM

EXHIBIT 12. U.S. 10-Year Yield 3 Months Forward Given the Forecast of 2-Year Yield and Recession Probability

Probability of a recession within the next 12 months (3-month forecast)	U.S. Treasury 2-Year Yield (3-Month Forecast)								
	0.09	0.14	0.19	0.24	0.29	0.34	0.39	0.44	0.49
0	1.71	1.80	1.89	1.99	2.08	2.18	2.27	2.36	2.46
10	1.64	1.74	1.83	1.92	2.02	2.11	2.21	2.30	2.39
20	1.58	1.67	1.76	1.86	1.95	2.05	2.14	2.23	2.33
30	1.51	1.61	1.70	1.79	1.89	1.98	2.08	2.17	2.26
40	1.45	1.54	1.63	1.73	1.82	1.92	2.01	2.11	2.20
50	1.38	1.48	1.57	1.66	1.76	1.85	1.95	2.04	2.13
60	1.32	1.41	1.51	1.60	1.69	1.79	1.88	1.98	2.07
70	1.25	1.35	1.44	1.53	1.63	1.72	1.82	1.91	2.00
80	1.19	1.28	1.38	1.47	1.56	1.66	1.75	1.85	1.94
90	1.12	1.22	1.31	1.40	1.50	1.59	1.69	1.78	1.87

* Dark-shaded areas denote information as at Feb. 22, 2012 Source: RBC GAM

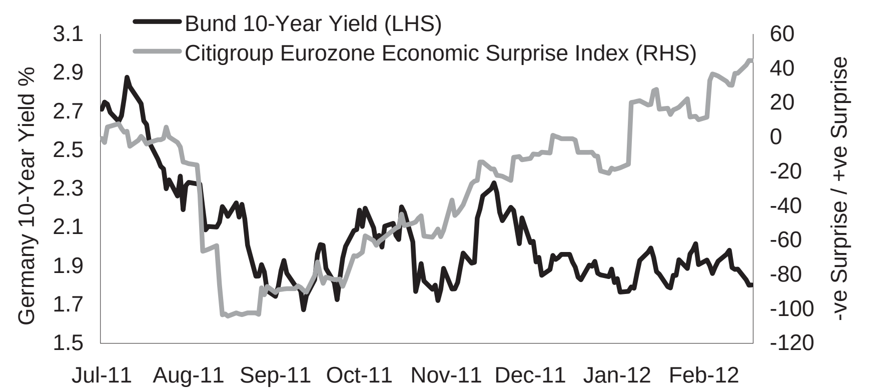
of a recession stays within the low 10%-20% range, 2-year yields would have to detach from the central bank's anchor and move 20 basis points higher for 10-year yields to visit 2.50% in the short term.

We are lowering our 12-month forecasts along the yield curve. Our forecast for the yield on the 10-year Treasury falls to 2.50% from 3.00%, reflecting near-term concerns and the possibility of further central-bank intervention.

Germany – Germany has maintained its safe-haven status amid the financial turmoil in Europe, and economic fundamentals have played only a minor role in determining yields. Just as better-than-expected U.S. data has failed to push Treasury yields higher, strong German economic statistics are having little effect on bund yields (Exhibit 13). The LTRO fueled a relief rally that led to a narrowing of sovereign-bond spreads versus bunds, but the absolute level of bund yields barely budged (Exhibit 14).

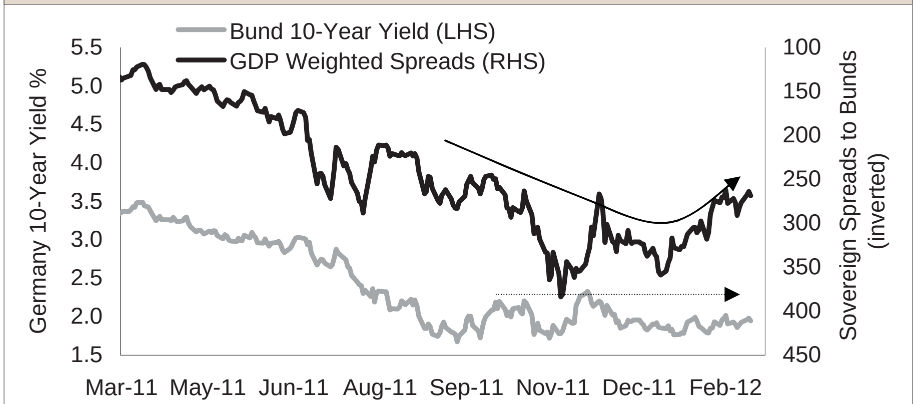
The rules of engagement in Europe are constantly changing, and headline risks are expected to remain high. The latest ECB measures temporarily boosted confidence, but solvency issues and a lack of competitiveness among peripheral members have not been adequately addressed. The commitment by central banks to flood the banking system with liquidity is expected to benefit bunds, as the excess cash should find its way into safer sovereign securities. Capital flight within the Eurozone tends to end up in the German banking system, and this also ultimately benefits bunds. Although a bleak economic outlook has been priced in for the Eurozone,

EXHIBIT 13. Bunds Are Not Trading With Economic Fundamentals



Source: Bloomberg, Citigroup

EXHIBIT 14. European Sovereign Spreads Tightened but Bunds Are Not Selling Off



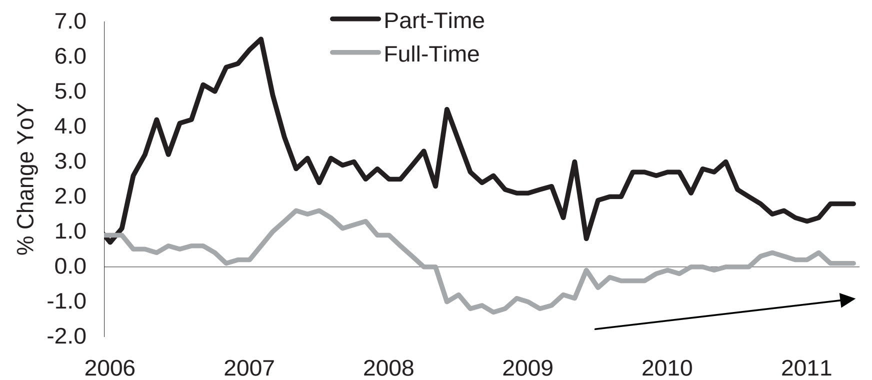
Source: Bloomberg, RBC GAM

the litmus test for asset prices will be when GDP is actually contracting. Bear in mind that total Eurozone asset writedowns since the financial crisis began have been far less than in the U.S., and a contraction in GDP would unmask the vulnerability of the European financial system. In this scenario, too, German bunds would benefit from a sell-off in other assets.

For all these reasons, we expect German yields to track the direction of U.S. Treasuries, and possibly breach the 1.68% low posted in September 2011. In terms of policy rates, we assign a high probability of the ECB reducing rates to 0.50% from the current 1.00%.

Japan – An examination of Japanese recoveries from earthquake-induced shocks bodes well for the country's economic growth. Following the 1995 Kobe earthquake, Japanese GDP picked up strongly about three quarters after the disaster. Using that as a blueprint for the March 2011 disaster, we should expect stronger 2012 economic growth driven by capital spending, residential construction, private consumption and government spending. Further supporting the growth argument are expectations that much of the reconstruction stimulus will start funneling into the economy this year. Recent labour statistics continue to indicate an increase in jobs, many of which are full-time positions (Exhibit 15). This development could help reduce two decades of deflationary pressures. In the case of Japan, a reduction in deflationary expectations is the rough equivalent of rising inflation expectations, and this reversal could stimulate consumption and investment. The strong spending and investment outlook is expected to slow growth in bank deposits, while increasing demand for loans. This shrinking pool of assets available for investment suggests that the Japanese government would need to compete for reconstruction funding, which would tend to push up yields on JGBs. However, we do not expect these factors to be strong enough to pull JGBs from the pattern of other bond markets. We are reducing our 10-year JGB yield forecast to 1.25% from 1.50% over the forecast horizon. As for monetary policy, we expect the Bank of Japan to continue with non-traditional measures to moderate the appreciation of the yen.

EXHIBIT 15. Japan
Full-Time Positions Are No Longer Falling



Source: Bloomberg, RBC GAM

Canada – At the Bank of Canada's last meeting, the central bank kept policy rates unchanged, giving it the distinction of being the only G10 central bank not to have eased in the past year. While downside risks to growth remain, the central bank's concern about rising household debt appears to be escalating. As long as the Fed remains ultra-accommodative (and considers additional monetary stimulus), we expect BOC Governor Mark Carney to delay rate hikes until 2013. We forecast that policymakers will keep the benchmark rate on hold for the next 12 months at 1.00%.

Longer-term bond yields should continue to fluctuate in line with U.S. rates. However, Canadian bonds could outperform due to Canada's stronger fiscal fundamentals and well anchored inflation expectations. We are lowering our forecast for yields on the 10-year Government of Canada bond to 2.75% from 3.00% last quarter.

U.K. – Inflation appears to finally be ebbing, as the effect of the VAT tax hike and spike in commodity prices last year are starting to fall out of the year-over-year data. The latest Bank of England inflation report indicated an inflation outlook that is below target in the near term, but with high uncertainty surrounding its trajectory. However, inflationary concerns are the least of the Bank of England's worries at the moment. On February 9, the central bank announced a 50 billion-pound increase in its asset-purchase program, bringing the total since early 2009 to 325 billion pounds. This decision attracted considerable debate given that the central bank also raised its GDP growth forecasts for the next two years.

Whichever way one analyzes the U.K. economy, the fiscal outlook is plagued with headwinds. The government is expected to carry on with austerity measures, which, coupled with the uncertainties surrounding GDP contraction in the Eurozone, hardly paints an upbeat picture of the U.K. economy. The positive contribution from the Olympics is expected to wane after the summer. According to a study by Citigroup, since 1964 GDP for a host country tended to be very strong in the two quarters before the Games, but slipped in the two quarters after their conclusion. Furthermore, the trajectory of public debt is forecast to continue rising, while private-sector deleveraging has yet to kick in. These developments suggest that the Bank of England will have no choice but to maintain policy rates at current levels and keep its options open for more quantitative easing. Gilts are expected to continue outperforming as long as additional quantitative easing does not lead to uncomfortably high inflation. We are reducing our outlook for the 10-year gilt to 2.50% from 2.75%.

In general, we are expecting higher yields by the end of the forecasting horizon for all regions, while acknowledging the possibility of bond yields reaching new lows in the near term. Listed below are the key risks to this base case.

Eurozone politics – The euro crisis is changing the European political landscape, as the stronger countries deepen their involvement in the affairs of the weaker ones. One could view this intervention as solidarity among member states, but also as a recipe for disaster that gives birth to populist movements. The result of the upcoming French presidential election could put Eurozone austerity programs in jeopardy. The ECB's LTRO changed investor sentiment, but the challenge facing Europe is implementing painful structural reforms. Should the Eurozone economy go through the projected contraction, we expect asset prices to be volatile. Sentiment will ping-pong between over-optimism and crisis as developments inevitably disappoint.

Overregulation – After the near collapse of the global financial system in 2008, policymakers are attempting to introduce regulations designed to prevent the possibility of a recurrence. Take the Dodd-Frank law of 2010, for example. The legislation's aim and strategy were sensible, but the details and implementation are proving far too complex. Many investors are also questioning the potential chilling economic effects of reining in

INTEREST RATE FORECAST – 12-MONTH HORIZON
Total Return Calculation: Feb. 24, 2012 – Feb. 23, 2013

U. S.	3-Month	2-Year	5-Year	10-Year	30-Year	Horizon Return (local)
Base	0.25%	0.60%	1.45%	2.50%	3.50%	-0.5%
Change to prev. quarter	*0.00%*	*-0.40%*	*-0.45%*	*-0.50%*	*-0.40%*	
High	0.25%	1.50%	2.50%	3.50%	4.50%	-5.4%
Low	0.00%	0.01%	0.25%	1.50%	2.45%	5.4%
Expected Total Return US$ Hedged: -0.41%						
Duration bias: Neutral						

GERMANY	3-Month	2-Year	5-Year	10-Year	30-Year	Horizon Return (local)
Base	0.50%	1.00%	1.50%	2.50%	2.85%	-1.7%
Change to prev. quarter	*-0.50%*	*-0.75%*	*-1.00%*	*-0.50%*	*-0.55%*	
High	1.00%	2.25%	3.00%	3.75%	4.00%	-10.1%
Low	0.25%	0.25%	0.50%	1.25%	1.85%	6.8%
Expected Total Return US$ Hedged: -2.25%						
Duration bias: Neutral						

JAPAN	3-Month	2-Year	5-Year	10-Year	30-Year	Horizon Return (local)
Base	0.10%	0.30%	0.55%	1.25%	2.30%	-1.4%
Change to prev. quarter	*0.00%*	*-0.10%*	*-0.15%*	*-0.25%*	*-0.20%*	
High	0.10%	0.45%	0.80%	1.75%	2.75%	-4.8%
Low	0.00%	0.00%	0.25%	0.80%	2.00%	1.5%
Expected Total Return US$ Hedged: -0.96%						
Duration bias: Neutral						

CANADA	3-Month	2-Year	5-Year	10-Year	30-Year	Horizon Return (local)
Base	1.00%	1.75%	2.25%	2.75%	3.25%	-2.4%
Change to prev. quarter	*0.00%*	*0.00%*	*0.00%*	*-0.25%*	*-0.35%*	
High	1.75%	2.50%	2.80%	3.25%	3.60%	-5.3%
Low	0.75%	1.00%	1.25%	1.75%	2.40%	3.9%
Expected Total Return US$ Hedged: -2.87%						
Duration bias: Neutral						

U.K.	3-Month	2-Year	5-Year	10-Year	30-Year	Horizon Return (local)
Base	0.50%	0.90%	1.50%	2.50%	3.30%	1.5%
Change to prev. quarter	*0.00%*	*-0.10%*	*-0.10%*	*-0.25%*	*-0.30%*	
High	0.50%	1.50%	2.30%	3.25%	3.75%	-4.0%
Low	0.25%	0.35%	0.50%	1.50%	3.00%	6.9%
Expected Total Return US$ Hedged: 0.65%						
Duration bias: Neutral						

Source: RBC GAM

financial innovation too much. More government involvement in the economy could make the road to recovery even more difficult.

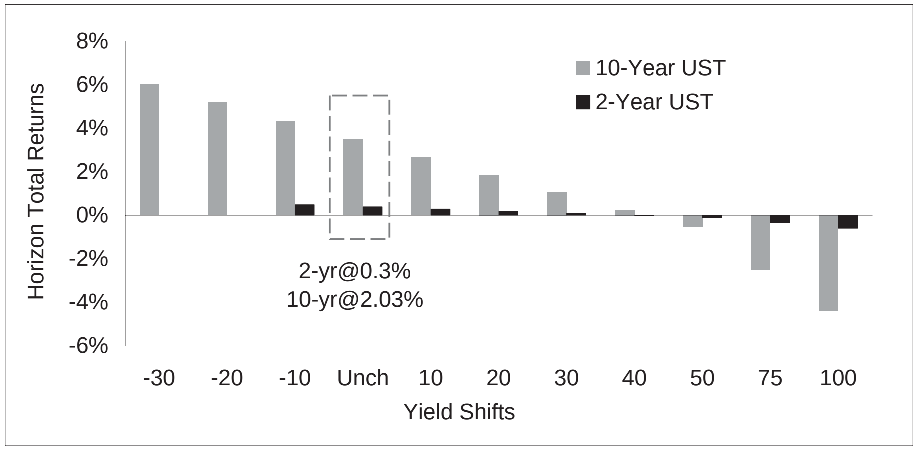
Deflation – One possible outcome of low economic growth and private-sector deleveraging is deflation. A deflationary scenario would support fixed-income assets, whose fixed payments retain their value better when inflation is low. If fears of deflation intensify, however, policymakers in the U.S. are likely to be extremely aggressive with short-term measures aimed at pushing up inflation expectations.

Fixed-Income subordination – The more intervention there is by central banks in bond markets, the more likely it is that private bond holders will have their rights subordinated to governments and other official creditors. This could lead investors to demand higher risk premiums if they are to continue funding government deficits. However, the added risk premiums will most likely be countered by increased efforts by policymakers to herd investors into low-yielding fixed-income securities (e.g. mandatory allocations to bonds for government-sponsored pension plans).

Growth surprise – Although the U.S. has been steadily losing its global competitiveness over the years, it has not lost its status as the preferred destination for foreign direct investment. According to the UN Conference on Trade and Development (UNCTAD) World Investment Report for 2011, the U.S. and China maintained their top position in inflows, and the U.S. has been ahead of China in both absolute inflows and the growth

12-MONTH HORIZON TOTAL RETURN BREAKEVEN ANALYSIS: 10-YEAR UST (USD TERM)
Changes in Yield From Current Level (bps) as of February 22, 2012

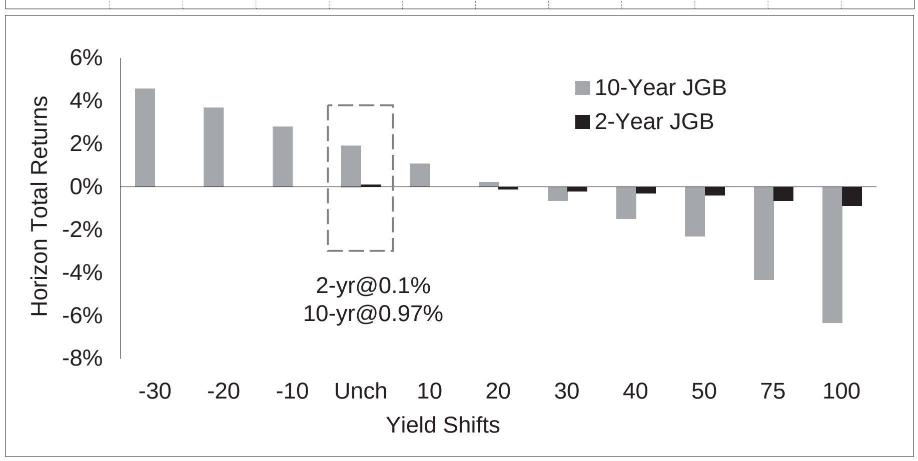
	(30)	(20)	(10)	Unch	10	20	30	40	50	75	100
2-Yr UST			0.49%	0.39%	0.29%	0.19%	0.09%	-0.01%	-0.11%	-0.35%	-0.60%
10-Yr UST	6.03%	5.18%	4.34%	3.51%	2.68%	1.87%	1.06%	0.26%	-0.54%	-2.49%	-4.40%



Source: RBC GAM

12-MONTH HORIZON TOTAL RETURN BREAKEVEN ANALYSIS: 10-YEAR JGB (JPY TERM)
Changes in Yield From Current Level (bps) as of February 22, 2012

	(30)	(20)	(10)	Unch	10	20	30	40	50	75	100
2-Yr JGB				0.11%	0.01%	-0.09%	-0.19%	-0.29%	-0.39%	-0.64%	-0.88%
10-Yr JGB	4.6%	3.7%	2.8%	1.9%	1.1%	0.2%	-0.6%	-1.5%	-2.3%	-4.3%	-6.3%



Source: RBC GAM

rate of those flows since 2009. This is a potential catalyst for the U.S. economy over the long run, as the comparative advantage of emerging markets is slowly dissipating. By the same token, the possibility of a significant economic slowdown in China should not be ignored, as the Chinese economy is going through a significant transformation. Relative wages are rising rapidly, the wealth gap is widening and governments are scaling back subsidies. These factors point to an economic-growth path that is anything but smooth.

Regional preferences

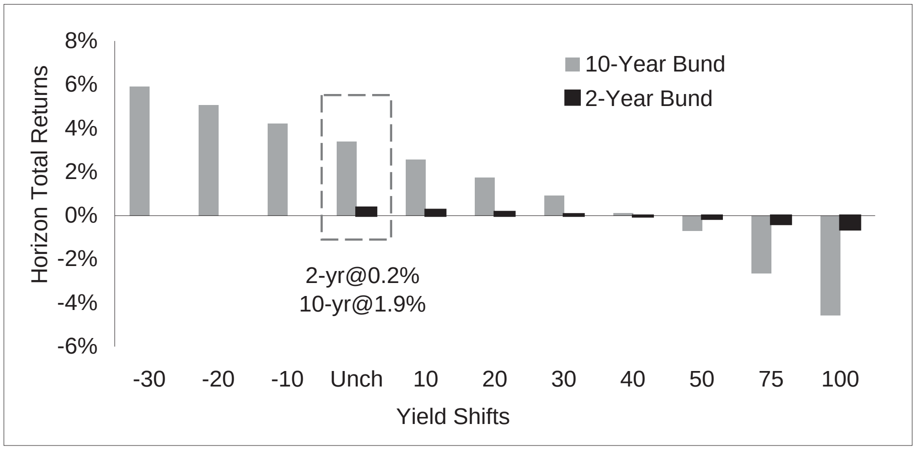
While fundamentally bearish on bonds over the longer term, we are unenthusiastically lowering our yield forecasts across most regions to reflect the highly uncertain environment over the next 12 months. Given this backdrop, we look to overweight U.S. Treasuries by 5%, with equal 2.5% underweights in German bunds and JGBs. This is a change from the previous quarter, when we were overweight both Treasuries and JGBs by 2.5%, respectively, and underweight bunds by 5%.

Overweight Treasuries – Treasuries are the best safe-haven candidate in an uncertain world. Although we forecast that yields will ultimately move higher, we are relatively more upbeat on U.S. Treasuries, given the strong willingness of the Fed to purchase debt.

Underweight JGBs – The upbeat growth outlook in Japan and rising inflation expectations are expected to push yields higher.

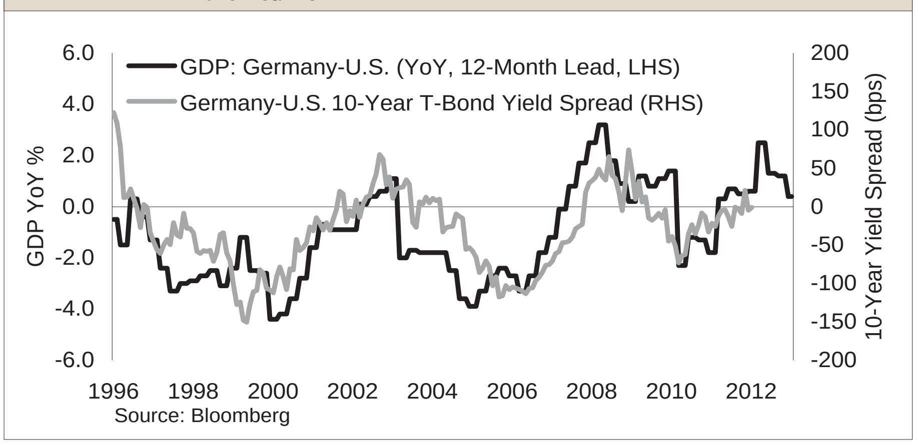
12-MONTH HORIZON TOTAL RETURN BREAKEVEN ANALYSIS: 10-YEAR BUNDS (EUR TERM)
Changes in Yield From Current Level (bps) as of February 22, 2012

	(30)	(20)	(10)	Unch	10	20	30	40	50	75	100
2-Yr BUND				0.36%	0.26%	0.16%	0.06%	-0.04%	-0.14%	-0.39%	-0.63%
10-Yr BUND	5.9%	5.1%	4.2%	3.4%	2.6%	1.7%	0.9%	0.1%	-0.7%	-2.6%	-4.6%



Source: RBC GAM

EXHIBIT 16. U.S. 10-Year Treasury Expected to Outperform German Bund in the Near Term



Underweight Bunds – Germany is the liquidity and safe-haven warehouse of the Eurozone. Should the ECB become more aggressive in non-traditional measures, bunds are expected to benefit less than other assets in the Eurozone. Our GDP growth-differential model also suggests better performance of U.S. Treasuries relative to bunds in the coming quarters (Exhibit 16).

CURRENCY MARKETS

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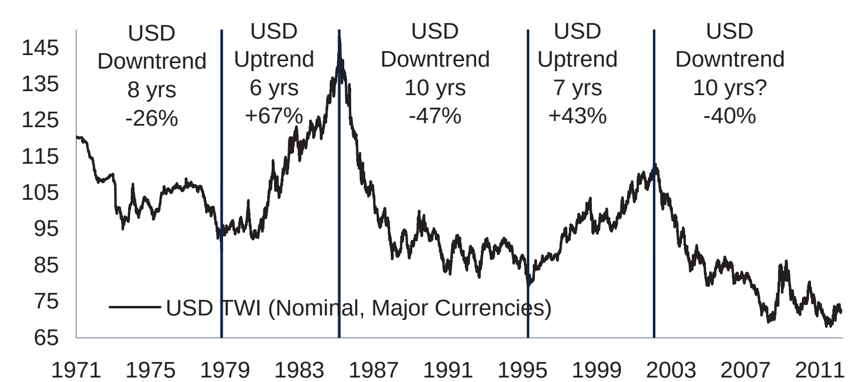
RBC Global Asset Management Inc.

Happy 10th Birthday to the U.S. dollar bear market! An entire generation of investors has now grown up in the age of the feckless greenback, but considering the length and depth of the typical currency cycle, we should be cautious about extending bearish bets (Exhibit 1). The U.S. dollar rose last month on a trade-weighted basis in an obvious safe-haven rally, benefiting from concerns about global growth, as well as the European sovereign-debt crisis and its disruptive effects on regional politics.

We believe that the dollar is attractive apart from its safe-haven qualities, especially for investors looking at the longer term. From that standpoint, the case for a significant further decline in the U.S. dollar is weaker now for three major reasons:

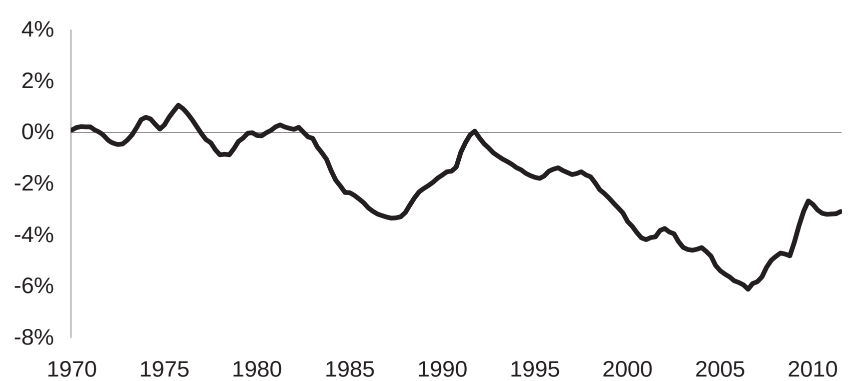
1. The American current-account deficit – the energy deficit in particular – has been improving.
2. The U.S. dollar is 15% undervalued on a trade-weighted basis, a level that is near historical extremes.
3. Long-term demographics in the U.S. are more positive than for any other developed country.

EXHIBIT 1. **Long-Term U.S. Dollar Cycles**
Trade-Weighted USD Index (Nominal, Major Currencies)



Source: Bloomberg, Deutsche Bank

EXHIBIT 2. **U.S. Current-Account Deficit**
% of GDP



Source: Bloomberg

An improving current-account deficit

One little noticed development that bodes well for the U.S. dollar is a gradual improvement in the current-account deficit (Exhibit 2). Even with all the criticism of the U.S. for its reliance on foreign oil, the energy component of the deficit has quietly started to narrow. U.S. oil imports peaked in September 2006 (Exhibit 3), while natural gas imports crested in December 2007 (Exhibit 4).

From a currency manager's point of view, an improvement in the current-account deficit parallels a slower accumulation of foreign reserves by emerging-market countries and oil exporters. The foreign-exchange reserves are the other side of the U.S. current-account deficit coin.[1]

It makes sense, then, that we also see evidence that emerging-

[1] In the years since the financial crisis erupted, the U.S. deficit has halved from roughly 6 percent of GDP to 3 percent of GDP, and China's surplus has declined significantly as well.

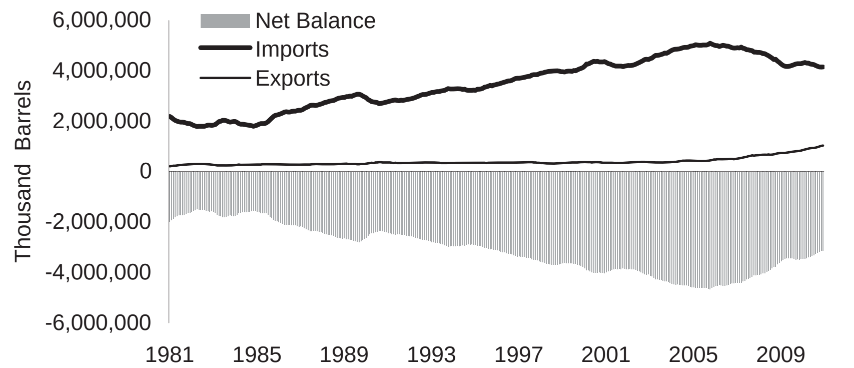
market countries have slowed their accumulation of foreign-exchange reserves over the past few years. Exhibit 5 charts growth rates of known foreign-exchange reserves. Whether measured on a three-month or 12-month basis, reserve growth peaked most recently in 2009. Chinese reserves, which are the largest in the world, posted an actual decline in the fourth quarter – the first quarterly decline since 1992.

The slowdown in reserve growth reduces the need for central banks to diversify assets out of the U.S. dollar. We have always observed that in months when reserves grew strongly, reserve managers used every dip in the euro, sterling, Australian dollars and others to buy more of them. One would expect reserve managers to retain these non-U.S. dollar currencies in times when reserve growth slows, but this has not been the case. They have instead been selling currencies for U.S. dollars during months of lacklustre or no reserve growth, supporting the U.S. dollar.

Valuations

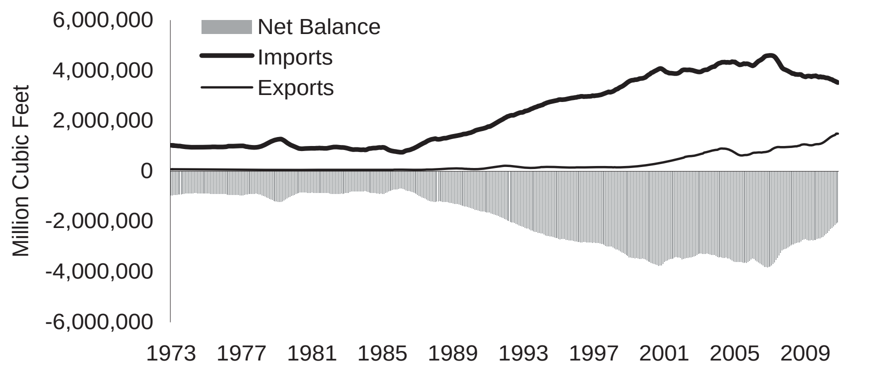
As with all currencies, the value of the U.S. dollar cannot deviate indefinitely from its purchasing power parity before snapping back. Think of an elastic band. Since 1973, the greenback has traded within 18-percentage-point bands on either side of purchasing power parity 90% of the time. By comparison, the U.S. dollar's average value in February was within 2% of extreme undervaluation. Yes, the undervaluation can extend further in the short term, but these periods typically last months, not years (Exhibit 6).

EXHIBIT 3. U.S. Trade in Crude and Petroleum Products



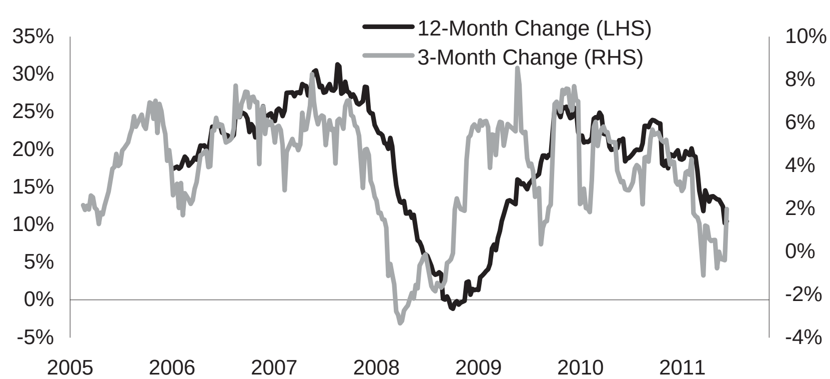
Source: U.S. Energy Information Administration

EXHIBIT 4. U.S. Trade in Natural Gas



Source: U.S. Energy Information Administration

EXHIBIT 5. Growth of International Reserve Assets



Source: Bloomberg

Demographics

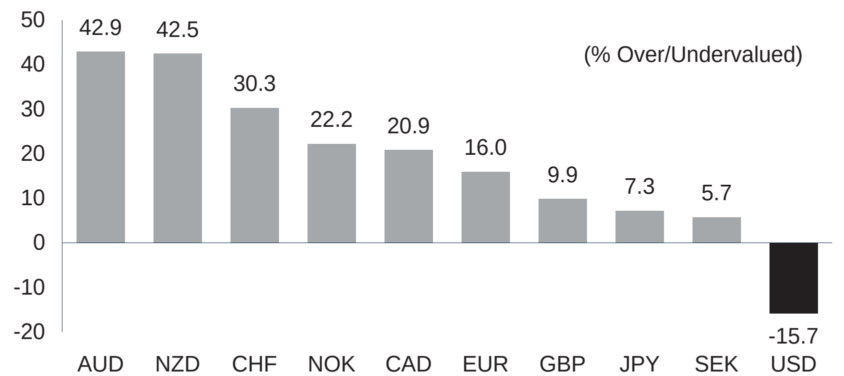
According to a UN population study, the U.S. is the only major economy where the labour force is forecast to expand over the next 40 years. While America's debt burden is as worrisome as any, the U.S. will be in a much better position to service its debt given that a greater portion of its population will be employed – and therefore paying taxes (Exhibit 7). For details, please see the *Global Investment Outlook*, Spring 2011.

Quite apart from the longer-term positive outlook for the U.S. dollar, we can make a short-term case for holding some U.S. dollars in our portfolios because of its safe-haven attributes. After all, the U.S. dollar is the currency that benefits most during growth wobbles or "Black Swan" sightings. For several years, the greenback has tended to move in the opposite direction of risk assets, and the correlation of the U.S. dollar with risk assets recently diverged the most in 40 years (Exhibit 8). For the past few years, when investors turned positive on risk assets, they sold the U.S. dollar.

It's worth remembering, however, that this correlation is not stable, and that over the past four decades the average correlation between the U.S. dollar and risk assets was near zero. While the current situation lasts, U.S. dollar holdings, if appropriately scaled, act as insurance for risk-carrying portfolios.

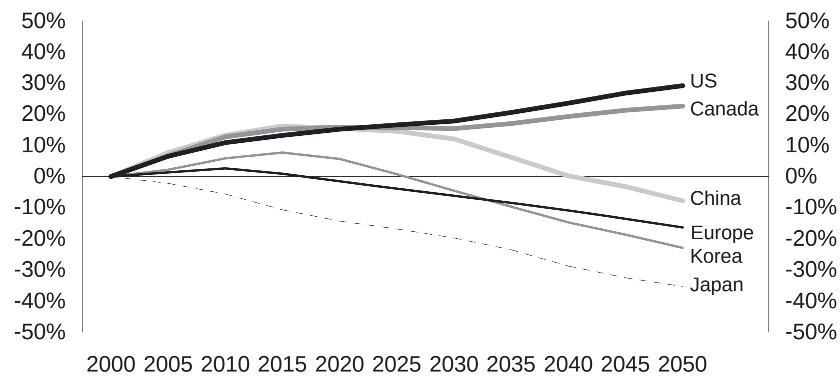
Since we are pretty certain that this inverse relationship cannot last forever, we monitor it closely and observe that it has lessened in recent months. We believe that for the dollar and risk assets to begin moving in tandem, the

EXHIBIT 6. PPP Valuation
February 2012



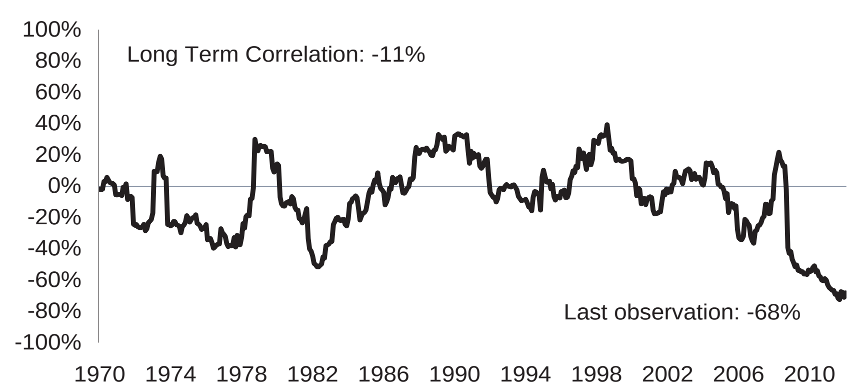
Source: Deutsche Bank

EXHIBIT 7. Labour Force Growth (Age 15-64)
Forecasted by United Nations Population Division



Source: UN, Deutsche Bank

EXHIBIT 8. Correlation of the U.S. Dollar and U.S. Equities (S&P 500)



Source: Bloomberg, RBC GAM

dollar would have to be supported by some combination of:

1) A yield premium. While the Fed has said it expects to hold rates at extraordinarily low levels through the end of 2014, stronger employment data could challenge that resolve. Higher U.S. front-end yields would ultimately revive foreign inflows.

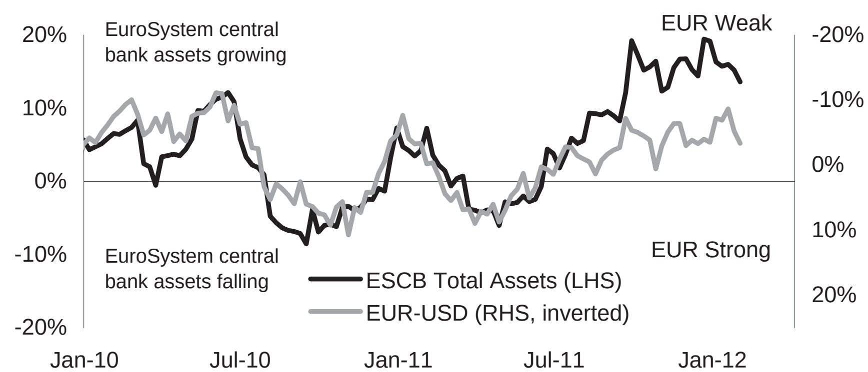
2) Equity inflows. Foreign investment in U.S. equities in recent years has been largely offset by U.S. investor demand for foreign stocks. A reversal in this relationship would support the greenback.

3) M&A inflows. Net foreign direct investment (FDI) has generally been flat or negative in recent years, as the U.S. continues to be a net supplier of M&A financing to the rest of the world. The U.S. actually attracted $228 billion of FDI in 2010, double China's share, excluding Hong Kong. The increased attractiveness of the U.S. could reverse this relationship and bolster the value of the U.S. dollar.

We will be the first to admit that these shifts do not look imminent. But we have little confidence in our ability to predict the precise turn of events or project what might be top of mind for currency managers a year from now. We are confident, however, that the U.S. dollar will at some point start trading as a "good news currency." For now, we take note of these factors, and watch the correlations to make sure we don't miss the turn.

We have one more observation on the U.S. dollar's correlation with equities. Some could conclude that being bullish on the U.S. dollar in the short term implies that we are bearish on equities. Not necessarily. If the dollar gains more during risk-off days than it loses on risk-on days, then it can appreciate even during times when equities perform well. The bottom line is that we like the U.S. dollar as a safe haven in the short term and over the longer term due to valuations that limit the downside. Our advice is to buy the greenback during periods of weakness.

EXHIBIT 9. EUR vs. Total Assets of EuroSystem Central Banks
3-Month Change



Source: Deutsche Bank, ECB

The Euro

The euro suffered a swift 10% drop between the end of October and mid-January, bringing the decline to 15% from its highs in early May. By the turn of the year, the negative-euro story was so well broadcast that the cover of the Economist magazine read: "Is This Really the End?" and ratings agency S&P put 15 European countries on negative credit watch. The subsequent downgrade coincided with the single currency bottoming on January 13 of this year. The latecomers to the bearish euro story had to cover their shorts at the first whiff of a deal between Greece and its private creditors.

The positioning-driven, short-covering rally, however, should not obscure the seeds of structural decline in the euro. After all, if there were any doubts about the monetary policy of the European Central Bank (ECB), they should have been dispelled after the ECB fully embraced unorthodox monetary easing in December. The introduction of the three-year Long Term Refinancing Operation (LTRO), the latest step by the ECB to offer liquidity in ever larger amounts and ever longer maturities, is known elsewhere as quantitative easing, even if the ECB chooses to eschew this label (Exhibit 9). The Eurosystem balance sheet increased by 42% in the second half of 2011.

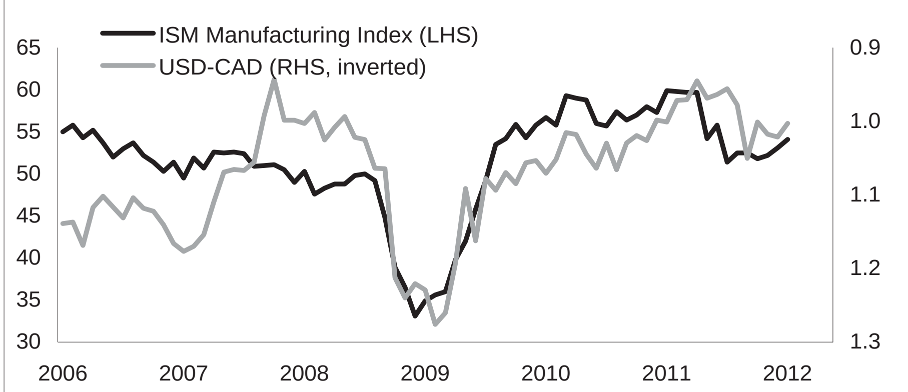
While the outline of the deal announced on February 20 lowered the probability that Greece will run out of cash within a month, it has hardly inspired longer-term confidence in the creditworthiness of the country or its ability to return to the markets in the near or medium term. If everything goes according to the current plan, private investors will "voluntarily" accept a cut in net asset value of about 80% on their holdings; state asset sales will be completed at the high valuations envisioned by the Greek government (and on time); and Greek GDP will stop shrinking next year and return to 2.3% growth in 2014. Assuming these and other stringent conditions are met, Greece would still need an additional €50 billion in bail-out aid by the end of the decade, on top of the €136 billion already promised through 2015,[2] before it can "achieve" a debt-to-GDP ratio of 120%. We are not holding our breath.

This is the view today. There are three longer-term implications given the way Greece's problems are being dealt with:

- The fact that the voluntary debt swap will essentially sanction a new class of privileged investors (the official sector) will likely dissuade many private investors from buying Greek debt when the country returns to the bond market.
- Other countries (read Ireland and Portugal) with heavy debt burdens will contemplate seeking Greek-style relief if they find austerity measures too difficult to stomach – the dreaded contagion effect.
- Europe, currently in recession, will enter a lengthy stage of mediocre growth.

As the new year begins, it's likely that long-term investors who are still holding European assets have so far had limited chances to unwind their holdings and are awaiting an opportunity to sell. We should not find comfort in the fact that the euro didn't decline below its historical average

EXHIBIT 10. Canadian Dollar vs. U.S. ISM Manufacturing Index



Source: Bloomberg

in 2011, despite the escalation of the Eurozone crisis. After all, 2011 was the year in which the ECB hiked rates twice, while the Fed embarked on a second round of quantitative easing. We could see a resumption in the euro's decline if and when investors are forced to liquidate. We expect the euro to fall to 1.20 by mid-2013 and plan to use euro rallies to sell the currency before the next expected leg down. We are quite confident that a number of factors can bring about such opportunities, e.g. positive data surprises amid heavy sentiment/positioning, excess liquidity after the second round of the LTRO, squabbles in the U.S. fiscal debate, possible post-election relief in France and any number of other headlines.

We have one other point to make about the euro. It is often noted that the Eurozone's collective fiscal health is better than that of the U.S., and that Europe has the means to solve its problems. While we agree with this statement, we don't believe that it will be relevant for currency markets until the prospect of a large, liquid Eurobond market to rival the U.S. Treasury market comes into view. That prospect is beyond our 12-month forecast horizon.

The Canadian dollar

On the surface, the Canadian dollar remains untarnished and some might say has even lagged the rally in commodities for no good reason. The Canadian story appears to be so much better than any other that supposedly Iceland is interested in adopting the "loonie" as its currency. Not the euro, not the greenback, not even the Norwegian krone, but the Canadian dollar. According to the Globe & Mail,[3] Canada has not seen such interest in its currency in 150 years. We note, however, that the loonie remains a good proxy for growth (Exhibit 10), which means that unless we expect an acceleration in global growth in 2012, the currency's upside is limited.

From a valuation standpoint, the Canadian dollar is about 20% overvalued (Exhibit 11), ranking it

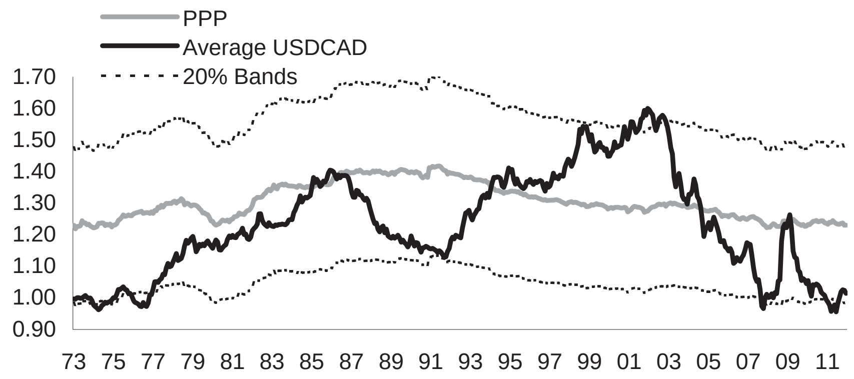
[2] Greece: Preliminary Debt Sustainability Analysis Feb. 15, 2012, tabled at the Eurozone FinMin meeting Feb. 20, 2012

[3] Globe &Mail, Mar. 2, 2012, "Iceland eyes loonie, Canada ready to talk"

among the most stretched major currencies based on purchasing power. Historically, upside from these levels is possible but does not last long, so it's an important factor in our forecast. On the other hand, while the Canadian dollar trades within the 0.98-1.02 range, the loonie is in line with shorter-term valuation models (Exhibit 12), which reflect the performance of U.S. equities, oil, and relative monetary policies.

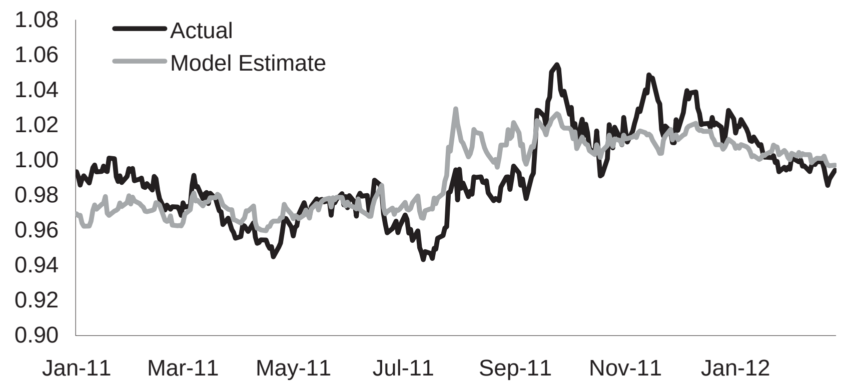
Delving deeper into the fundamentals, Canada has a current-account deficit after 20 years of surpluses. As long as Canada continues to attract portfolio inflows, this deficit is not a big cause for concern. However, portfolio inflows peaked five quarters ago, and continuity in that type of funding depends on how attractive Canadian bonds and equities (primarily bonds lately) appear to foreign buyers. The recent return to surplus in merchandise trade, which has benefited from the commodity rally, is already priced in and its positive effect should not be overestimated. Canada's terms of trade (the relationship between prices of exported goods and prices of imported goods) peaked in 2007 and sit 8% below that high, while the monthly average of the Canadian dollar is near 2007 levels. Additionally, it should be remembered that while Brent and West Texas crude prices are at their 2011 highs, the lagging prices of the Western Canada Select crude is more relevant for Canadian producers (Exhibit 13). Moreover, natural gas, which trades at historic lows, constitutes 19% of the Bank of Canada Commodity Index. As for the manufacturing side of exports, it has been shrinking over the past decade. Automotive exports, centred in Ontario and Quebec, have dropped to

EXHIBIT 11. USDCAD vs. Purchasing Power Parity



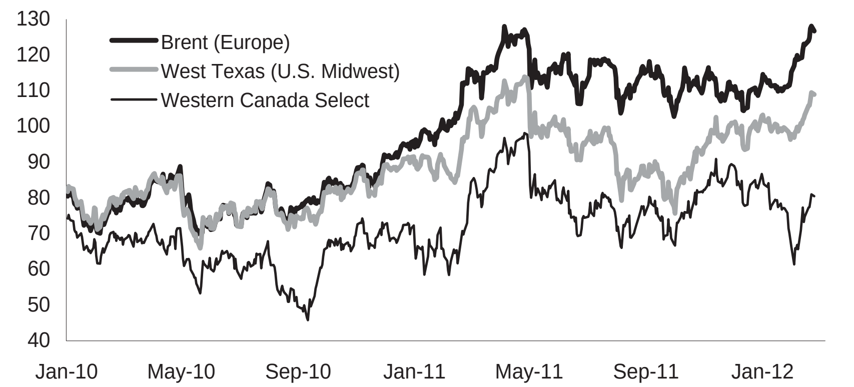
Source: RBC GAM, Bloomberg

EXHIBIT 12. USDCAD Short-Term Valuation Model
Daily Model Based on U.S. Equities, Oil, 2-Year Yield Spread



Source: RBC GAM, Bloomberg

EXHIBIT 13. Crude Oil Spot Prices



Source: Bloomberg

under 15% of total Canadian exports from 25%.

In recent months, the Canadian dollar has benefited from stronger U.S. growth data, higher commodity prices, rate cuts in emerging markets and geopolitical tension surrounding Iran's nuclear program. The negatives include the extreme overvaluation of the Canadian dollar based on purchasing power; the currency's high sensitivity to the possibility of a disorderly outcome in Europe; the near-record current-account deficit; the auto industry's loss of market share to cheaper production in Mexico; and the fact that monetary policy is on hold due to high household debt levels.

We believe the Canadian dollar is priced with little margin for safety and therefore vulnerable to this year's uncertain growth outlook. This limits the currency's upside, and we are comfortable forecasting a slight weakening over the next 12 months to 1.04.

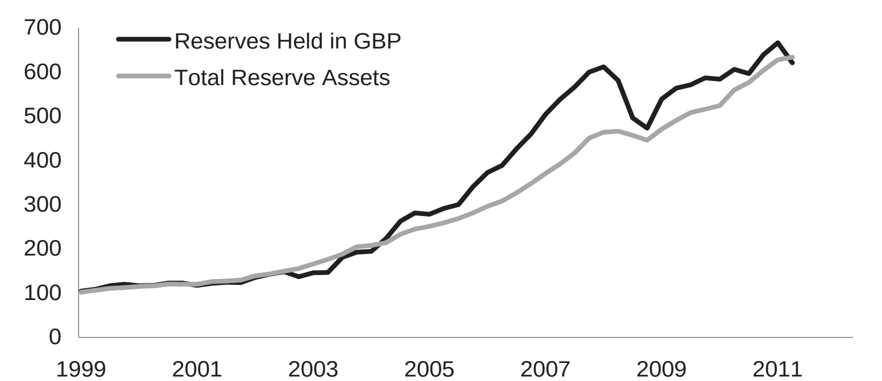
The Pound

Purchasing power parity is not currently useful in helping us predict the direction of the pound versus the euro or U.S. dollar. The U.K.'s combination of easy monetary and tight fiscal policies would suggest weakness for the pound, but irresponsible politics in the U.S. and the Eurozone are helping to support sterling for the time being. Moreover, a drop in inflation since the fall has resulted in higher real yields, and better-than-expected economic statistics are also shining a positive light on the currency (Exhibit 14). That growth improvement and a head-start on austerity measures led both the IMF and OECD to forecast an

EXHIBIT 14. G10 Data Surprises
Last 3 Months

Source: Deutsche Bank

EXHIBIT 15. GBP Reserves Keeping Pace With Total Reserve Growth
Indexed to 100 at Q1 1999



Source: IMF COFER Database

improving fiscal outlook. This relatively strong economic position and Britain's retention of the coveted AAA credit rating is reviving interest in the pound among foreign-exchange reserve managers who may need to diversify their currency flows (Exhibit 15).

For now, these positives make up for the negatives of slow growth, expectations of further quantitative easing, a widening current-account deficit and vulnerability to renewed stress in the global financial system. As a result, we expect limited change for the pound over our forecast horizon and possibly a slight bias to the upside beyond that. Our forecast is 1.60.

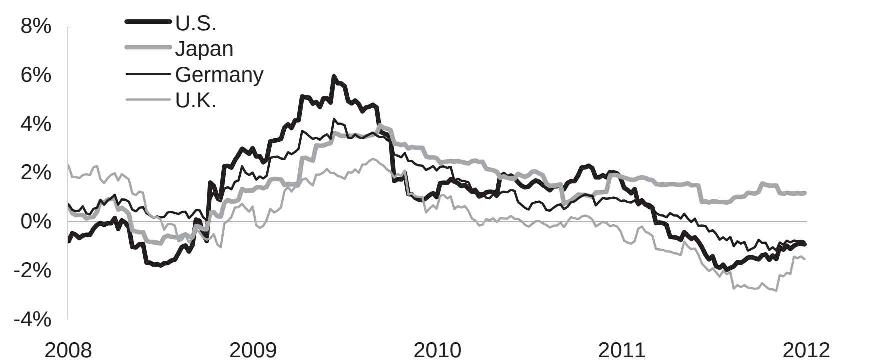
The Yen

The strength of the yen over the past few years surprised many investors, as the arguments for weakness had been ingrained. After all, Japan is the country with the highest public debt-to-GDP ratio of any major economy, the worst demographic profile over the next 40 years (Exhibit 7), aggressively competitive neighbouring economies and a decline in the current-account surplus. What escaped investors' collective attention was that most other economies were moving in the same direction, so Japan's relative position improved. The more that central banks in the developed world engaged in quantitative easing and promised to keep short rates low, the less "abnormal" Japan was. Also, with deflation entrenched, real rates exceeding 1% have been much more attractive than the negative real rates in the U.S. and Europe (Exhibit 16).

With short-term rates in the U.S. and Europe near those in Japan, Japanese investors such as insurance companies have been able to invest in higher-yielding foreign bonds, including U.S. Treasuries, and thereby lock in additional yield by hedging the currency. This has been a very popular trade. Hedge ratios at insurance companies spiked in 2008 and 2009, and have been slow to come down (Exhibit 17). Assurances from the Fed that rates will stay low through the end of 2014 have done nothing to discourage hedging by Japanese insurers. Why take on currency risk when you can earn a decent return without it? Until short-term interest rates start rising in other countries, the yen bulls have nothing to fear on this count.

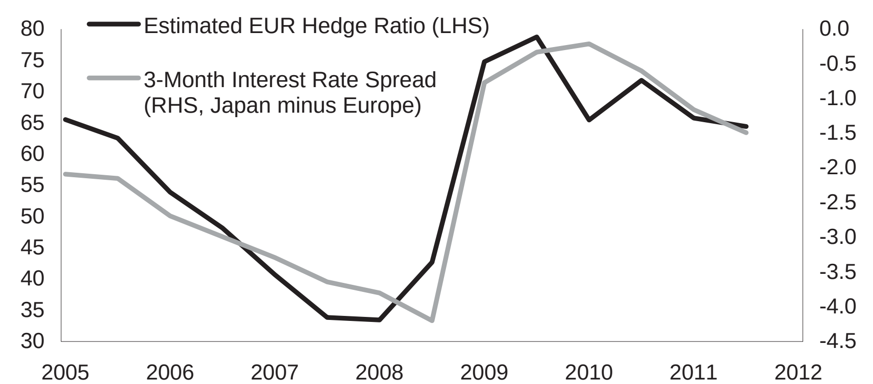
Even the recent trade deficit may carry less significance than first thought. That's because Japan's substantial stock of foreign investments generates a steady stream of investment income offsetting deterioration in the trade balance. The balance of payments picture therefore looks positive for the yen versus the U.S. dollar and the euro.

EXHIBIT 16. Real 10-Year Yields



Source: RBC GAM, Bloomberg

EXHIBIT 17. Estimated EUR Hedge Ratios for Japan Life Insurers



Source: Deutsche Bank

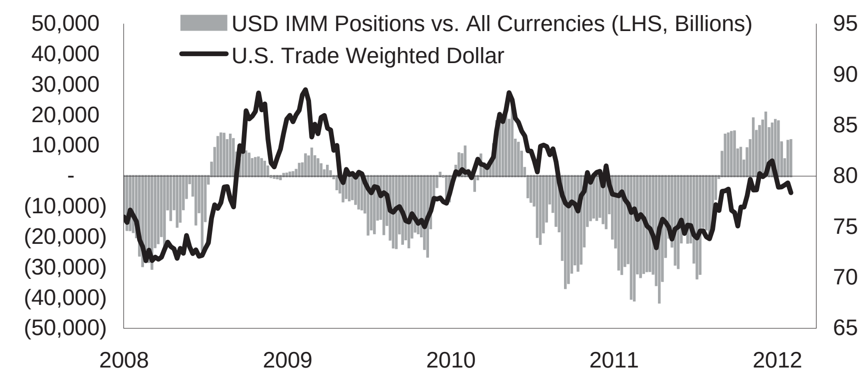
We sense, however, that the Bank of Japan has committed to preventing the yen from appreciating further. While direct interventions in currency markets are frowned upon by other G10 countries, the central bank's February 14 decision to increase quantitative easing and adopt an explicit inflation target bears the hallmarks of a copycat. It appears the BOJ has finally read the memo on the accepted rules of the central-banking game – and the market has taken notice. The yen has weakened 2.5% since the BOJ meeting, and while it's hard to expect dramatic weakness until interest-rate differentials become more significant, the risk of re-testing U.S. dollar lows against the yen has dropped. As a result, we move our 12-month target for a slow depreciation of the yen to 83 from about 80 currently.

Positioning – a short-term warning sign

Positioning is the third of our analytical tools after fundamentals and technicals. The downside of positioning as an indicator is that the foreign-exchange market is fragmented, making it hard to know what investors are betting on. What is easily and frequently observed is the segment of the market trading currency futures in Chicago, the so-called IMM positions (Exhibit 18). IMM is the acronym for the Chicago Mercantile Exchange's International Monetary Market, which deals with trading in currency and interest rate futures and options. Aggregates of speculative positions taken in major currencies each Tuesday are monitored by the market when they are released on Friday afternoons.

Unfortunately, IMM covers only a fraction of the foreign-exchange trading volumes – the majority is traded over the counter between banks. The OTC market does not have a central data-collection mechanism, so large dealers/custodians often find it useful to monitor and aggregate volumes transacted through them to get a snapshot of different segments of the market. We try to get access to as many of these reports as possible. Unfortunately, it happens frequently that what appears to be an extreme position on IMM has its opposite in another niche of the market, reducing the usefulness of positioning reports. It is only when we find that all surveys point in one direction that we take note. That does not happen often, but we did observe it through most of January and February when across all currency pairs and all data sources, the one common position was a euro short (Exhibit 19). That was enough to temper our bearishness in the short term, neutralize our positions and wait for a better opportunity. As we said earlier, we are quite confident that a number of factors will bring about such opportunities this year.

EXHIBIT 18. U.S. Dollar vs. IMM Positioning



Source: Commodity Futures Trading Commission, Bloomberg

EXHIBIT 19. Aggregate Investment Position in Currencies
January 31, 2011

	IMM	BARCLAYS	STATE STREET	TOKYOFX
GBP	Short	Neutral	Neutral	Neutral
CAD	Short	Very Long	Neutral	Neutral
EUR	Very Short	Very Short	Short	Short
JPY	Very Long	Very Long	Neutral	Neutral
AUD	Very Long	Very Short	Short	Short
CHF	Very Short	Neutral	Short	Neutral
NOK		Short	Very Short	Very Short
NZD	Very Long	Short	Neutral	Very Short
SEK		Very Short	Long	Long
USD	Long		Very Long	Long

Source: RBC GAM

Conclusion

While the risk of a disorderly default by Greece has decreased recently, it hasn't disappeared. The U.S. dollar remains a safe haven with an attractive valuation and the potential to eventually start trading based on the economy's brighter growth prospects. Our base case for the euro is a slow depreciation, but the possibility remains that there will be a fast decline that rattles markets.

However, positioning data suggests that negativity toward the euro is stretched, so we have been careful in the short term, while retaining a bias to sell rallies when the euro rises beyond 1.33. The Canadian dollar is near its long-term valuation extremes, but short-term valuations are neutral. We are watching the global growth outlook and are prepared to trade tactically, with a bias to buy U.S. dollars below parity. Our caution about the Canadian dollar is heightened by our view that during the next year a growth-negative fiscal shock appears more likely to occur than not. The pound should not have much downside now that growth in the U.K. is surprising on the upside, real rates have bottomed and the currency is recognized as a viable alternative for currency diversification. We prefer to hold the pound, adding to our positions on dips. As for the yen, the strong tendency for the Japanese to keep their money in yen and a smaller interest rate disadvantage support the currency, while the Bank of Japan's interventionism and intensified quantitative easing policy work against it. We don't expect a rapid depreciation, however, as long as the Fed is expected to anchor short-term rates. Our bias is to sell yen rallies. Finally, in an environment of lower risk appetite, it is particularly important to watch positioning, being wary when all available surveys show uniformity of opinion. While positioning can at times produce counter-trend rallies, we can use these to our advantage. Increased volatility, expectations of dollar-bottoming and the vulnerability of currencies to central-bank manipulation are all leading us to take more tactical positions and fewer strategic ones.

REGIONAL OUTLOOK – U.S.

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

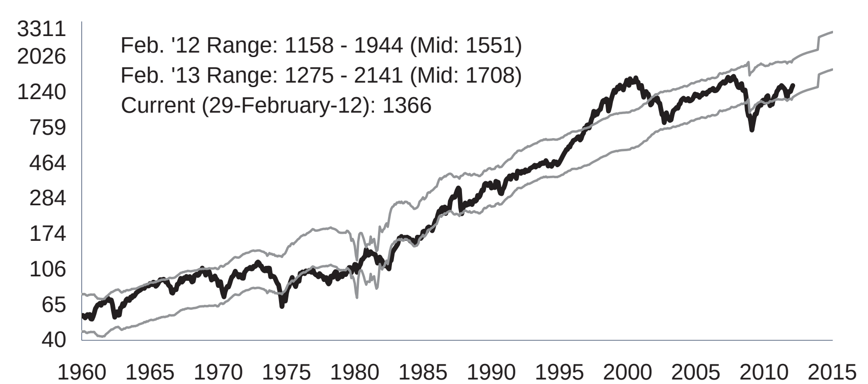
Brad Willock, CFA
V.P. & Senior Portfolio Manager
RBC Global Asset Management Inc.

UNITED STATES RECOMMENDED SECTOR WEIGHTS

	RBC INVESTMENT STRATEGY COMMITTEE FEBRUARY 2012	BENCHMARK S&P 500 FEBRUARY 2012
ENERGY	12.0%	12.2%
MATERIALS	3.4%	3.4%
INDUSTRIALS	11.8%	10.8%
CONSUMER DISCRETIONARY	2.4%	3.4%
CONSUMER STAPLES	11.5%	10.9%
HEALTH CARE	11.0%	10.8%
FINANCIALS	11.0%	11.5%
INFORMATION TECHNOLOGY	13.1%	14.1%
TELECOMMUNICATION SERVICES	21.8%	20.1%
UTILITIES	2.0%	2.9%

Source: RBC GAM

S&P 500 EQUILIBRIUM
Normalized Earnings and Valuations



Source: RBC GAM

U.S. markets have experienced a significant rebound since the drubbing they took in the fall of last year. During the past three months, the S&P 500 is up about 10%, and roughly 25% from the lows of early October. Investor sentiment has perked up thanks to better economic data in the U.S., some progress toward fiscal union in Europe and more aggressive action from the European Central Bank (ECB). As a result, market volatility has declined by over 50% since the fall, and stock correlations – the degree to which stocks tend to move in the same direction – has fallen too, reinforcing the positive sentiment and driving valuations higher. While the laundry list of long-term structural concerns remains, the odds of a catastrophic credit event in Europe have been significantly reduced and the outlook for the markets has improved as a result.

Key to the better outlook was the ECB's introduction of the Long-Term Refinancing Operation (LTRO), which provides European banks with unlimited liquidity and dramatically reduces the likelihood of a Lehman-like credit event and/or financial-system meltdown. Since the introduction of the LTRO, financing costs in Europe have come down for most governments and banks. In the U.S., stock-market valuations have expanded by roughly one and a half multiple points, daily volatility has fallen by almost a third and individual stock correlations have dropped 15% to 20%. Clearly, the LTRO program has been successful at reducing perceived systemic risk over the short to intermediate term.

Markets have been prodded higher not only by the ECB's engagement, but also by improvement in the U.S. economy. Regional and national surveys of economic activity have risen for five straight months after hitting their lows in October. Forward-looking components of the surveys regarding new orders and expectations of future activity suggest that the strength should continue at least into early spring. In addition, it is important to note that surveys of many emerging-market economies and many other developed-world economies are improving too, which suggests a boost for S&P 500 company earnings. Further gains in global and U.S. business activity seem likely over the next few quarters, as inflationary pressures appear to be receding in the emerging world and central banks there ease monetary policies.

Although the level of economic growth remains below trend, the uptick in activity is generating positive change in U.S. employment and housing markets. Unemployment insurance claims hit a cycle low, lay-off announcements are falling, the average number of hours worked in the manufacturing sector rose to a 20-year high, and surveys suggest that companies intend to boost hiring. While house prices are still declining in aggregate, the pace is moderating, and the declines are concentrated in a handful of states where the crisis was the worst. In these states, sales of foreclosed homes account for about half of total transaction volume and have dramatically skewed the aggregate price data lower. In contrast, for the U.S. as a whole, sale prices for non-distressed homes are down only 1% or so in the past year. In addition, the rental market has tightened, and record-low mortgage rates have boosted the attractiveness of rental units to investors, particularly in the distressed market. The housing sector, 6½ years after the peak in prices and sales, is no longer a drag on the economy.

The past year has been quite remarkable for U.S. equity markets, which are roughly unchanged despite a 10% rise in corporate profits, and 20% gains in both free cash flows and dividends. The Utilities sector and other sources of perceived stability are priced as a sure thing, while stocks leveraged to economic growth trade as if their earnings and cash flows were unsustainable. Despite the rally we have seen since the October lows, stocks are cheaper now than they were a year ago. Housing, employment and consumer confidence are stronger than at this time last year, and inflation is lower, but investors are sceptical.

During the past three months, cyclical sectors have led the market higher as the economic data has improved. What is different this time is that the Financials sector has led the pack, due to the success that the ECB has had with the LTRO in improving financial conditions in Europe and the U.S. The healthier employment and housing markets also bolster the outlook for U.S. banks. Given our expectation that the data will continue to impress into the spring and perhaps early summer, our portfolios are generally positive on the outlook for economically sensitive sectors such as Materials and Industrials. Our view is less sanguine for some sectors that are viewed as defensive, including Utilities.

The U.S. economy has been improving, and it appears that the developing world is about to become a tailwind for the global economy as inflation recedes, monetary policy eases and domestic economies accelerate. This brighter outlook for the developing world makes us more likely to add to the cyclical bets in our portfolio. However, the possibility of a disorderly default by Greece must be reckoned with and suggests that the prudent strategy is to remain positioned moderately bullish until the Greek bailout situation has been resolved. In addition to Greece, major risks to a further market advance include: a hard landing in China, which seems unlikely in the intermediate term; a worsening of the economic slowdown in Europe; and continuing political discord in Washington, which makes progress on the U.S. debt and deficit seem impossible. However, the biggest near-term risk to the market is a sustained rise in the price of gasoline. In previous cycles, the tipping point for the economy appears to have been a gasoline price of roughly US$4.00 a gallon, compared with about US$3.60 a gallon in late February. Perhaps with employment improving and natural gas prices down considerably, the tipping point is a bit higher. Employment and housing are the keys to a sustainable recovery, but if gasoline prices rise too quickly, the market advance may sputter.

REGIONAL OUTLOOK – CANADA

Stuart Kedwell, CFA
Senior V.P. & Senior Portfolio Manager
RBC Global Asset Management Inc.

Improvements in near-term economic data in the U.S., coupled with successful liquidity injections in Europe and some easing of monetary conditions in emerging markets, buoyed global equity markets in recent months. Although the S&P/TSX Composite Index participated in this move with a 4.3% gain, the Canadian benchmark lagged its global peers and was well off the pace of the S&P 500. The lacklustre performance of gold stocks held back the index, and the Financials sector trailed its global counterparts. The performance of the Energy sector did not match the 7% rise in the price of West Texas crude. Finally, the index's larger-capitalization stocks again lagged the broader market during the quarter, as they have for much of the past 18 months.

The Canadian dollar increased 3% during the quarter, but continues to underperform many of the performance factors with which it has traditionally had high correlations. With a forecast for moderating economic growth, we continue to believe that the strength of the Canadian dollar versus the U.S. dollar has largely run its course. We expect 2% growth from the Canadian economy in 2012, similar to the level expected in the U.S. Canada's housing market is the subject of much debate, yet hangs in, while the employment picture is characterized by surveys showing businesses intend to hire even as momentum in the number of actual new jobs begins to wane.

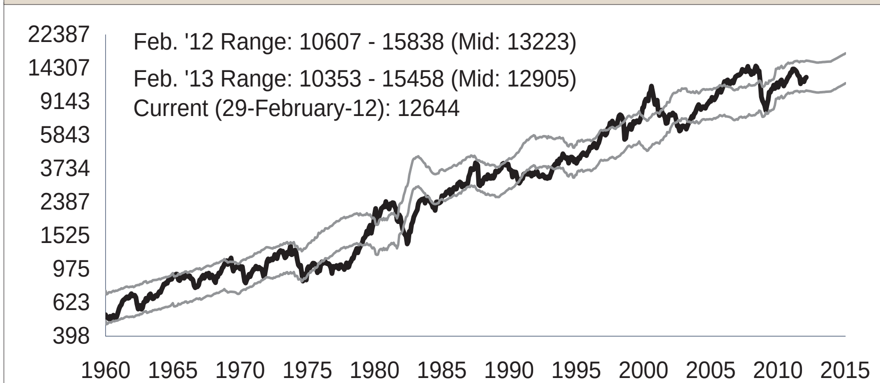
After a period in which bullish sentiment has increased markedly, equity markets have surged and the focus has been on good news. It is difficult to suggest that headwinds will not re-emerge as part of the debate in the next few months. That said, for intermediate-term investors, the Canadian stock market is attractively valued based on our estimates of normalized earnings capacity. Dividend yields, free-cash-flow generation and corporate balance sheets are in good shape and reasonable returns are forecast, particularly relative to fixed income. In Canada, we highlight the difference in valuation between the largest 60 companies and the broader market. For years, the valuation of one has been in lockstep with the other. More recently, however, valuations

CANADA RECOMMENDED SECTOR WEIGHTS

	RBC INVESTMENT STRATEGY COMMITTEE FEBRUARY 2012	BENCHMARK S&P/TSX COMPOSITE FEBRUARY 2012
ENERGY	27.0%	27.1%
MATERIALS	21.5%	21.7%
INDUSTRIALS	6.5%	5.6%
CONSUMER DISCRETIONARY	1.5%	1.9%
CONSUMER STAPLES	4.5%	4.1%
HEALTH CARE	3.0%	2.6%
FINANCIALS	1.0%	1.5%
INFORMATION TECHNOLOGY	29.0%	29.4%
TELECOMMUNICATION SERVICES	2.0%	1.3%
UTILITIES	4.0%	4.8%

Source: RBC GAM

S&P/TSX COMPOSITE EQUILIBRIUM
Normalized Earnings and Valuations



Source: RBC GAM

of the larger companies have lagged, opening up an interesting opportunity.

Price-to-earnings multiples in the banking group rallied off levels that were at the low end of the trailing 10-year range. The sector was led by Royal Bank of Canada, as capital-markets conditions rebounded and the bank's valuation moved from average back to its normal premium. Fixed-income markets re-opened across Europe this past quarter following the easing of liquidity concerns, driving new government issuance and related trading. Recent results have reminded investors that normalized trading revenues, while maybe not as high as the first quarter of this year, are also not likely to be as low as those of the third and fourth quarters of last year. Consumer asset growth and the housing market, coupled with net-interest-margin pressures, remain key issues for the domestic businesses of the banks. Nevertheless, returns on equity have proven resilient and the spread of these returns relative to those available from a 10-year bond remain attractive. Current dividend yields and modest payout growth should combine to provide satisfactory total returns.

The insurance industry has been weighed down by the growing consensus that interest rates will remain low for a long period of time. While the impact of low rates on earnings power could persist for five or so years (as changes in the ultimate reinvestment rate grind through the income statement), we believe the group has enough capital and earnings capacity to weather this storm. From a portfolio standpoint, given the interest rate sensitivity of other sectors like utilities and real estate and our belief that the likelihood of additional equity capital is low, the insurance companies provide some portfolio protection against a rise in interest rates.

As investors focus on the slowing momentum of China's economic growth, the likelihood of valuation multiples expanding in the Materials sector is low. Yet, at current commodity prices, free-cash-flow generation in the sector will be significant. We think the use of this cash flow will be a key deciding factor in the performance of the sector over the intermediate term. Gold stocks lagged bullion during the quarter. A number of gold companies continue to struggle from both a capital investment and operational standpoint. As the volatility in the price of gold has ratcheted upwards, gold companies, by and large, have struggled to match bullion on up days, and tended to underperform on down days.

The Telecommunication Services sector continues to offer investors reasonable dividend yield against a backdrop of low growth and discussions about future outlays for capital investments in a competitive environment. The behavior of new entrants and clarity around the rules governing the upcoming wireless-spectrum auction remain the key points for investors' consideration.

The Energy sector continues to trade below levels implied by forward prices. Regional price differences have been elevated this year, and operating and capital-cost inflation continues to be a concern. Neither is likely to disappear in the near term. On the natural gas front, new drilling is finally beginning to slow in response to a very warm winter and some weakening in natural-gas liquids pricing. With an abundance of natural gas in North America and a ridiculously low energy equivalent when compared to oil, the market is waiting for a concrete and sustainable demand response to help prices. Chemicals producers, which use natural gas as feedstock, and liquefied natural gas export terminals, are two key areas of our research efforts.

REGIONAL OUTLOOK – EUROPE

Michael Joynson
Portfolio Manager
RBC Asset Management UK Limited

After a difficult 2011, this year has started off on a more optimistic note for investors. Among the factors contributing to the more positive outlook are a steady improvement in U.S. economic news, increasing evidence that emerging-market interest rates are coming down, signs of stabilization in some European economic indicators, and the apparent removal of near-term liquidity risks in the Eurozone. Internal market dynamics have reflected this increased, albeit fragile, optimism with a rapid rotation in recent weeks away from the defensive stocks that performed so well in 2011, towards the more cyclical, value-biased areas of the market, including Financials.

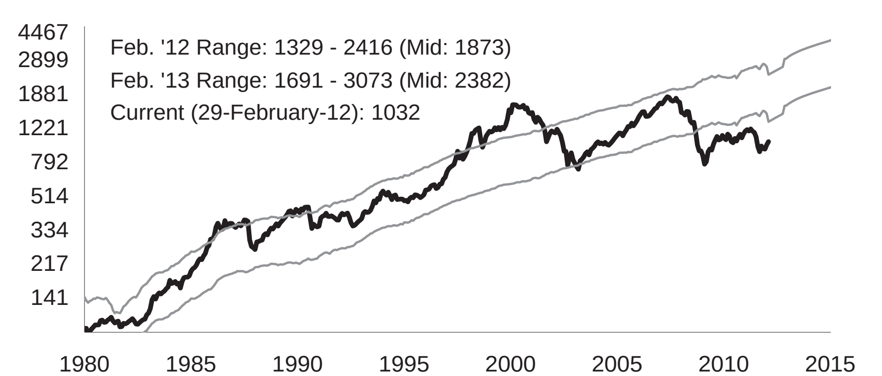
Fiscal austerity, restrained bank lending and rising unemployment continue to weigh on many domestic European economies. From an equity-market perspective, however, a re-acceleration of global economic momentum and the implementation of the Long-Term Refinancing Operation (LTRO) by the European Central Bank mean the risk of a self-perpetuating spiral into deep recession and financial dislocation has, for now at least, been avoided. So long as this remains the case, equity markets will favour stocks exposed to stronger global growth. Unfortunately, the more favourable global growth environment will not be felt evenly across the region. In fact, faster growth will likely exacerbate growth differentials rather than narrow them, with Scandinavia and Germany benefiting at the expense of southern Europe.

EUROPE RECOMMENDED SECTOR WEIGHTS

	RBC INVESTMENT STRATEGY COMMITTEE FEBRUARY 2012	BENCHMARK MSCI EUROPE FEBRUARY 2012
ENERGY	11.8%	11.9%
MATERIALS	10.4%	10.3%
INDUSTRIALS	12.1%	10.8%
CONSUMER DISCRETIONARY	3.6%	4.6%
CONSUMER STAPLES	9.2%	8.5%
HEALTH CARE	13.4%	13.2%
FINANCIALS	11.9%	11.9%
INFORMATION TECHNOLOGY	18.3%	19.3%
TELECOMMUNICATION SERVICES	4.0%	2.9%
UTILITIES	5.3%	6.5%

Source: RBC GAM

EUROZONE DATASTREAM INDEX EQUILIBRIUM
Normalized Earnings and Valuations



Source: Datastream, Consensus Economics, RBC GAM

The trough in industrial sentiment has coincided with a bottoming-out in analyst pessimism. While earnings estimates continue to be scaled back, the pace of change has waned. We still consider earnings risks to be to the downside. However, current valuations imply that stock markets should not be hurt too much by further cuts to earnings estimates, so long as they are not material.

European stock valuations should continue to underpin the market, both on an absolute basis and relative to other equity markets and asset classes. The MSCI Europe trades at just 10.6 times the consensus estimate for 2012 earnings, a 10% discount to global equities. Robust corporate cash flows and low payout ratios should support returns to shareholders through stock buybacks and/or dividend growth. Europe's prospective 2012 dividend yield of 4.2% looks extremely competitive in the context of the low returns available from cash and fixed-income assets.

The 20% rise in European equity markets from their lows last year and the sharp rotation back to cyclical stocks, show that investors are now taking a more optimistic view. This has been warranted given the policy response we have seen and the improvement/stabilization in many economic indicators. Where equity markets go from here is harder to call, and the risks remain significant. The global economic recovery is fragile, and much of Europe remains mired in recession. Although the threat of a disorderly Eurozone break-up has receded, sovereign-debt issues remain, and the LTRO is a stop-gap measure for the banks, not a permanent solution. Consequently, we expect equity markets to remain volatile, but underpinned by reasonable valuations. Any upside will be predicated on further improvement in the macroeconomic outlook, which would also support further style rotation toward higher-risk assets.

To reflect a less pessimistic outlook, we are moving toward a more balanced portfolio. We are reducing exposure to sectors offering dependable growth, which performed strongly in 2011, and re-investing the proceeds in companies exposed to a re-acceleration of global growth. Exposure within sectors remains skewed towards the stronger economies of northern Europe.

Within the Consumer Discretionary sector, our preference is for niche consumer-services-related companies with market-leading positions. With the macroeconomic backdrop stabilizing, we have bought back into media and increased exposure to autos. Our focus in the Consumer Staples sector is on tobacco stocks, which offer attractive valuations, excellent dividends, good capital discipline and strong operations. We also like companies that make food ingredients.

The Energy sector still trades at a substantial discount to the overall market and offers attractive dividend yields. Valuations in the sector reflect oil prices significantly below current levels. Our preference is for oil-services providers, which should continue to benefit from a significant increase in capital expenditures by the oil majors, as well as smaller exploration and production companies.

In Financials the outlook for banks remains challenging. The sector is being regulated to a degree that eats into capital returns, and the days of mid-teen returns on equity are now past. In many cases, balance sheets remain impaired, and we expect loan growth to be muted. However, we have selectively increased our bank exposure as valuations reached highly stressed levels, while the LTRO appears to have solved the sector's liquidity problems for now. Exposure to insurers has also been raised.

Against a still uncertain macroeconomic backdrop, the Health Care sector's strong balance sheets, robust cash flows, low earnings volatility and increasing focus on capital returns is an attractive combination. We have been adding to capital-goods companies in the Industrials sector. While this sector bore the brunt of the cuts to earnings estimates in the second half of 2011, the situation seems to have stabilized recently.

Within the Information Technology sector, we view software companies as stocks that benefit from the increased corporate spending that tends to take place later in the economic cycle. Expectations remain relatively low and management teams are demonstrating a higher degree of capital discipline. Balance sheets in this sector are strong.

We have been increasing our weighting in the Materials sector, as the global economic picture looks more robust, and valuations reflect a less positive picture than we expect. Our preference in the Telecommunication Services sector is for cable operators. We see excellent cash generation from this industry, and prospects for higher shareholder returns. The Utilities sector has performed poorly for some time. We believe that many companies in the sector face higher taxes imposed by governments seeking ways to bolster their revenues.

REGIONAL OUTLOOK – ASIA

Yoji Takeda
Director & V.P.
RBC Investment Management (Asia) Limited

Global investors have been returning to Asia against the backdrop of improving markets in Europe and the U.S. Over the near term, we believe global stocks could rally ahead of the U.S. presidential election, and that monetary easing in China could provide further impetus for higher stock valuations in a period of discounted equity prices. However, the global situation is fragile, and any hiccups in Europe could quickly unwind valuation gains.

Among Asian markets, Japan may present the biggest opportunity for surprises to the upside, as it has long underperformed. With the yen stabilizing, export profits should recover from the depressed levels of 2011. Taiwan has also underperformed, largely because of concerns about the outcome of the recent presidential election and excessive product inventories, but the economy should recover as these obstacles have largely passed. Hong Kong-listed Chinese stocks could also take flight, as the Chinese government gradually eases monetary policy to achieve a soft landing. China's easing should support the export-tilted stock markets of Australia and South Korea.

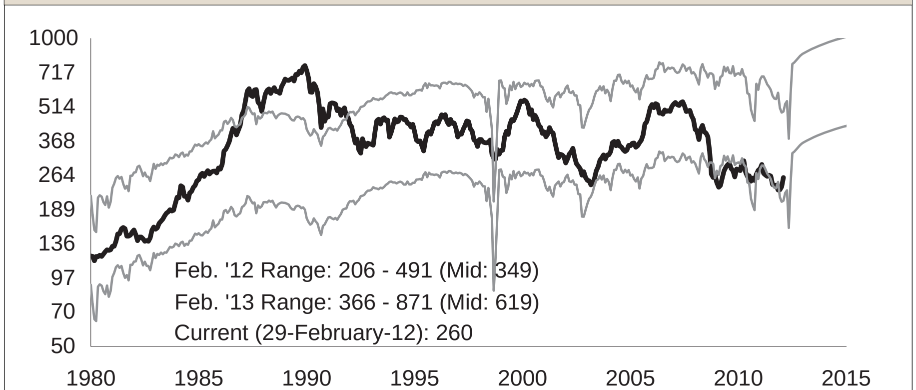
Asian economies and equity markets have responded well to looser monetary policies in China and elsewhere. While earnings reports may remain weak in the near term, equity markets have largely discounted any short-term profit weakness. Fortunately, inflationary pressures have quieted in the last few months.

ASIA RECOMMENDED SECTOR WEIGHTS

	RBC INVESTMENT STRATEGY COMMITTEE FEBRUARY 2012	BENCHMARK MSCI PACIFIC FEBRUARY 2012
ENERGY	2.7%	2.8%
MATERIALS	11.6%	11.6%
INDUSTRIALS	18.0%	16.5%
CONSUMER DISCRETIONARY	2.6%	3.6%
CONSUMER STAPLES	14.7%	13.9%
HEALTH CARE	6.3%	6.2%
FINANCIALS	4.4%	4.6%
INFORMATION TECHNOLOGY	28.0%	29.3%
TELECOMMUNICATION SERVICES	8.4%	7.7%
UTILITIES	3.2%	3.9%

Source: RBC GAM

JAPAN DATASTREAM INDEX EQUILIBRIUM
Normalized Earnings and Valuations



Source: Datastream, Consensus Economics, RBC GAM

As a result, policymakers have room to ease monetary policy further and bolster fiscal spending. However, Asian governments will loosen monetary policy only gradually, so it may take some time for inflationary expectations to come down significantly.

Asian markets also will be driven this year by regional politics. A leadership change in China is slated for October and, in South Korea, parliamentary elections in April and a presidential ballot in December are on the horizon. Taiwan's presidential election was won by the pro-China incumbent. We expect that Chinese government policies will become incrementally more supportive for the economy in the run-up to the change in governance.

In spite of some concerns late last year, China appears to have largely achieved a soft landing. January CPI fell to 4.3% from 6.5% year over year, while fourth-quarter GDP growth slowed to 8.9% over the same period. To help effect the slowdown, the Chinese government unexpectedly cut reserve requirements for banks in December to allow for faster loan growth. We expect additional easing this year to improve liquidity and government-driven investment, albeit on a smaller scale than in 2008 and 2009. That said, we are unlikely to see aggressive easing as long as the leadership transition goes smoothly. A big issue that investors feared last year, namely an explosion in local-government debt, has been addressed to a large degree by the federal government. After all, China has deep pockets and strong tax-revenue growth to provide financial assistance to troubled parts of the economy.

Investors made their way back to Japanese stocks and other higher-risk assets only after they had returned to many other Asian markets. Since current market valuations in Japan have barely risen from historical lows, even as the European situation stabilized, Japanese stocks may be able to catch up with gains in other markets. Japan will probably be one of the fastest growing developed economies in 2012, thanks to significant spending on rebuilding projects after last year's earthquake and related tsunami. The outlook is particularly positive for sectors whose earnings were hurt in the past year by the unprecedented natural disasters and strong yen. Exporters of manufactured products such as autos, machinery and electronic components should report much better profits for fiscal 2012, while domestic construction and housing-related companies should benefit from a $180 billion supplementary reconstruction budget. Japanese corporate profits are expected to increase by more than 20% in 2012, the highest among developed markets, albeit off a low base in 2011. Valuations in the Financials sector should rise from deep discounts relative to the market, as stronger capital positions will make it easier for banks to improve their earnings. Japanese growth in 2013, however, will depend largely on demand from exports in other Asian nations and the U.S. One major uncertainty in Japan is politics. The government of Prime Minister Yoshihiko Noda is trying to push through a rise in the consumption tax to 10% from 5% starting in 2014, together with social-security reform and spending cuts. These proposals are facing major opposition. Failure of this legislation could damage the credibility of the Japanese government's debt-financing program, which may result in a cut to the country's credit ratings.

In Taiwan, the victory of the incumbent president, Ma Ying Jeou, in the January elections should produce better relations with China. In addition, production of technology-related products is expected to recover, after bottoming during the first quarter, following an unusually large inventory build-up of flat panel TVs and PCs. To support a recovery, Taiwan's government plans to increase fiscal spending, as monetary policy is already relatively loose. These factors should support the market, which trades at a relatively low valuation.

South Korea's economy faces slower external demand and weak domestic consumption. Last year, the country's automotive and technology companies benefited from Japan's supply-chain problems after the earthquake. This year, the challenge will be for the current government to maintain growth-friendly policies at a time when the more socialistic opposition is gaining in popularity. The outcome will depend largely on demand from China and the U.S.

The strength of Australia's stock market will depend mainly on two factors: Chinese demand for raw materials, and the response of fiscal and monetary authorities to weak growth outside the mining industry. The Materials sector, particularly iron ore and coal exports, should continue to do well as China achieves a soft landing. However, the domestic economy remains under pressure due to household deleveraging and weak consumption. A combination of falling inflation and rising unemployment will likely push the Reserve Bank of Australia to cut interest rates. The government's fiscal position remains healthy, which should enable it to boost spending as needed. Exporters of manufactured goods would benefit from lower interest rates, assuming the Australian dollar weakens as rates decline.

REGIONAL OUTLOOK – EMERGING MARKETS

Philippe Langham
Senior Portfolio Manager
RBC Asset Management UK Limited

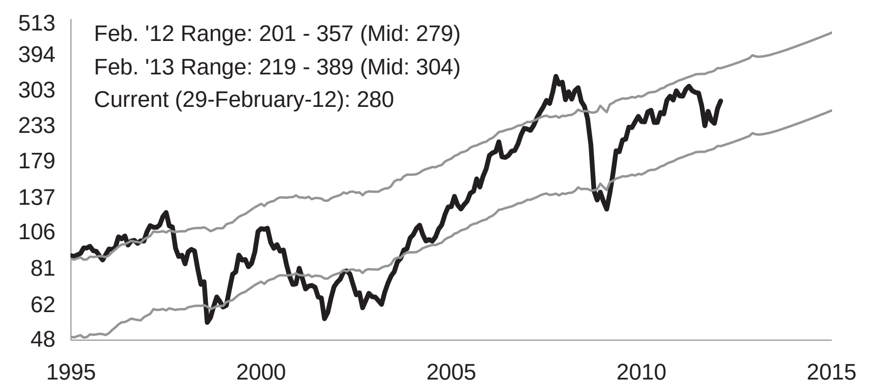
Developing-market economies accounted for over 80% of global growth in 2011, and over the last decade have been the main force behind global growth, helping contribute to the outperformance of emerging markets during that time. However, in 2011, emerging markets underperformed developed markets by 13% in U.S. dollar terms due primarily to concerns over inflation and investors' lower appetite for investment risk.

We expect emerging markets to continue posting growth that is superior to that in developed markets, helped by much healthier balance sheets, greater policy flexibility and rapidly growing populations. Economic expansions in the developed world will continue to be constrained by high government debt loads and efforts by consumers to lower their debt levels. The longer-term case for emerging markets based on faster economic growth and superior profitability remains intact.

In addition to the underlying structural support for emerging markets, the case for outperformance resuming in 2012 is supported by very attractive valuations, looser monetary policies, an improvement in earnings momentum and signs of a pick-up in global industrial growth.

The valuation case for emerging markets has become more attractive in the past 12 months. With earnings estimates still being cut by analysts, the best guide to valuations is the trailing price-to-book ratio. Emerging markets started the year trading at 1.58 times their book value, near previous lows (with the exception of the Asian crisis), when a low of 1.0 times was reached. History suggests that there is a very strong probability of a positive 12-month return at these valuation levels. Emerging-market equities look particularly cheap relative to bonds. The disconnect between bonds and equities is symptomatic of expectations that deflation will take hold, which seems highly unlikely in emerging markets.

EMERGING MARKET DATASTREAM INDEX EQUILIBRIUM
Normalized Earnings and Valuations



Source: Datastream, RBC GAM

Inflation in emerging markets appears to have peaked, as food prices have begun to stabilize and most emerging markets have started the next cycle of monetary easing. While we have already started to see some monetary easing in China, it is likely that Beijing will begin to loosen restrictions on residential property as the year progresses. This could have a substantial impact on demand. These trends are clear positives for emerging-market equities, which suffered for much of last year on concerns over inflation and associated fears that interest rates would increase. There is much more room to lower rates in emerging markets than in developed ones, where rates are already extremely low. This environment of loose monetary policy is no doubt good for industrial growth. In addition, low short-term rates in developed markets, and the prospect of further unconventional monetary easing, lend support to the positive liquidity backdrop.

The global industrial cycle tends to have a significant impact on emerging-market performance. Leading indicators have been heading downwards for the past eight months, and we still expect growth rates in the developed world to stay muted for a considerable period. However, as we enter 2012 there are signs that some of these indicators are stabilizing. A decline in earnings momentum in emerging markets appears to be bottoming over the past two months, and analysts are starting to raise their earnings estimates for emerging markets more quickly than they are for companies in developed markets.

In terms of sector positioning, we retain our preference for companies that benefit from domestic growth. The Financials and consumer sectors stand out as the main beneficiaries of this theme.

The Consumer Discretionary sector will benefit from the shift in emerging markets from exports to domestic demand. Rising incomes, easier access to credit, increasing urbanization and positive demographics all support this theme.

We also have an overweight in Consumer Staples and are very bullish on the long-term prospects for the sector. The combination of low penetration levels for essentials (particularly in India and China), a rising young population, an expanding middle class and changing lifestyles will continue to drive staples consumption. The rising desire of emerging-market consumers to trade up to higher-quality and/or luxury products will also be a key theme. This trend will especially be the case in China, where volume growth will be slower than the past five years, and "premiumization" will be an important driver of revenue and margins. Furthermore, the sector has defensive characteristics and its companies generally have strong balance sheets and high free-cash-flow generation.

Concerns about weak economic growth, the deleveraging of European banks and the speed of recent credit growth in China and Brazil have recently dogged the Financials sector. However, we are now more comfortable that the current global macroeconomic headwinds have been priced in. Financials have been the strongest sector coming out of the last three slowdowns, and with monetary policy now easing and credit cycles bottoming, we think it makes sense to own quality financial-services companies that have underperformed. The long-term structural growth story for emerging-market banks is very strong. We expect to see fast and profitable growth in the banking industry because consumer credit is still at a very early stage of development; balance sheets are strong because emerging-market banks generally rely heavily on deposits, which are stickier than commercial paper and other types of funding; emerging-market banks are generally well capitalized and relatively underleveraged; they have strong earnings power with high returns on assets and equity; and current valuations ignore the longer-term potential of these markets.

The Information Technology sector is trading at a wide discount to its average multiple of the last decade, indicating scepticism about the sustainability of the industry's earnings. While technology companies tend to perform best late in the business cycle, demand may be broadening out because many products have become indispensable. There is also the potential for technology to be a prime beneficiary of any pick-up in capital expenditures, as U.S. job growth has strengthened in recent months.

In the current macroeconomic environment, we believe that it makes sense to retain a bias toward high-quality companies with high and predictable cash flows. With global growth showing signs of accelerating and valuation multiples at attractive levels, it is also important to remain cognizant of value.

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 $250 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. & 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.

MEMBERS

ERIC LASCELLES
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.

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.

MARTIN PALECZNY, CFA
V.P. & SENIOR PORTFOLIO MANAGER
RBC GLOBAL ASSET MANAGEMENT INC.

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 RILEY, FSCI
HEAD, DISCRETIONARY INVESTMENT MANAGEMENT
RBC WEALTH MANAGEMENT UK & TRUST

George has over 30 years experience in the Financial sector. He was appointed Head, Discretionary Investment Management, British Isles in 2010 and Managing Director of RBC Investment Solutions (CI) Limited in 2011. In 2006 he was appointed Head of the Global Investment Solutions group for RBC Wealth Management, International after moving from RBC (Suisse) where he had been the Chief Investment Officer since 2002. He is a Fellow of the Chartered Institute for Securities & Investment. Prior to joining RBC, George worked with Lloyds Bank International, in their trust business in the British Isles and Monaco. He joined RBC in 1988.

JASON STORSLEY, CFA
PRESIDENT & CEO
RBC DIRECT INVESTING INC.

Jason joined RBC Direct Investing on Feb. 1, 2009, and is responsible for developing strategy, growing assets under administration, and expanding revenue and market share. He was previously head of RBC AM's institutional investment-management business and Director of Global Equity Research. Jason's career at RBC Financial Group dates from 1998, when he joined RBC DS. In 2001, he moved to the Fixed Income Portfolio Advisory Group, where he was in charge of structuring portfolios for high-net-worth clients and formulating trade recommendations. Jason was elevated to Vice President in 2003, when he assumed leadership of the portfolio advisory group, and the retail bond sales and trading desks.

GLOBAL EQUITY HEADS

Ray Mawhinney	Senior V.P. & Senior Portfolio Manager, U.S. & Global Equities RBC Global Asset Management Inc.
Yoji Takeda	Director & V.P., Asian Equities RBC Investment Management (Asia) Limited
Dominic Wallington	Chief Investment Officer & Chief Executive Officer RBC Asset Management UK Limited
Phil Langham	Senior Portfolio Manager, Emerging Markets RBC Asset Management UK Limited
Paul Johnson	V.P. & Senior Portfolio Manager, Global Equities RBC Global Asset Management Inc.

GLOBAL EQUITY ADVISORY COMMITTEE

Chris Beer, CFA	V.P. & Senior Portfolio Manager, Canadian & Global Equities RBC Global Asset Management Inc.
Cameron Hurst	Associate Portfolio Manager, U.S. Equities RBC Global Asset Management Inc.
Stuart Morrow, CFA	Manager & Senior Analyst, Global Equity Research (Financials & Consumer Discretionary) RBC Global Asset Management Inc.
Martin Paleczny, CFA	V.P. & Senior Portfolio Manager, Asset Allocation & Derivatives RBC Global Asset Management Inc.
Cameron Scrivens	V.P. & Senior Portfolio Manager, U.S. Equities (Health Care & Technology) RBC Global Asset Management Inc.
Robert Silgardo, CFA	Senior Analyst, Global Equities (Telecommunications & Technology) RBC Global Asset Management Inc.
Janice Wong, CA, CFA	Senior Analyst, Global Equities (Industrials & Utilities) RBC Global Asset Management Inc.

GLOBAL FIXED INCOME & CURRENCIES ADVISORY COMMITTEE

Soo Boo Cheah, MBA, CFA	Senior Portfolio Manager, Global Fixed Income & Currencies RBC Global Asset Management Inc.
Dagmara Fijalkowski, MBA, CFA	Head, Global Fixed Income & Currencies (Toronto and London) RBC Global Asset Management Inc.
Suzanne Gaynor	V.P. & Senior Portfolio Manager, Global Fixed Income & Currencies RBC Global Asset Management Inc.
George Riley, FSCI	Head, Discretionary Investment Management RBC Wealth Management UK & Trust.

A NOTE ON FORWARD-LOOKING STATEMENTS

RBC Global
Asset Management