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The Economy is Still Attempting to Regain its Sea Legs

Despite the challenges, there are factors that can help the economy navigate through rough waters.

One of the key goals for policymakers following the financial and credit crises was to create conditions for the U.S. economy to transition from an economy dependent on fiscal and monetary stimulus to an economy that could firmly stand on its own two feet.

However, despite aggressive stimulus measures, historically low interest rates, and the initial rebound out of the deep recession, the economy is still attempting to regain its sea legs. It has yet to transition to a self-sustaining recovery. Recently, some

U.S. leading economic indicators (data forecasting economic conditions three to six months from now) have stalled. Emerging market leading economic indicators — which tend to signal future global economic conditions — have already peaked.

The reality is that the United States and other developed economies are still in the midst of a lengthy deleveraging cycle. Many households remain in debt repayment mode or are preserving cash. Governments are beginning to confront expensive social safety net

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Defensive Equity Positioning is Warranted at This Stage of the Cycle

The Health Care and Energy sectors provide investors with potential opportunities.

Because the momentum of some leading economic indicators has stalled or peaked, we anticipate a shift toward defensive stock outperformance will occur in the months ahead. Historically, defensive stocks have outperformed cyclical stocks as leading indicators slide. Therefore, we recommend investors shift their equity allocations more toward defensive sectors at this stage of the economic cycle.

We're also cognizant that events related to Europe's debt challenges could eventually impact U.S. multinational companies' revenues and profits. Even if the current debt crisis is averted or forestalled, European nations are under pressure to cut government spending. While we agree that is the prudent approach to deal with the longer term challenges, it is not without economic consequences.

The good news is that the S&P 500's exposure to Europe is limited. Based on RBC Capital Markets' estimates, it's roughly 11.6% of total revenues. That level is not enough to kibosh earnings growth for the Index, from our perspective. However, it could constrain growth of sectors and companies more heavily exposed to Europe and the euro currency.

Even though the U.S. economy has yet to find its equilibrium level and the stock market faces challenges, we believe there are attractive opportunities in the Health Care and Energy sectors. They have been out of favor for the past year due partly to the economic cycle, which caused highly cyclical sectors

(Consumer Discretionary, Technology, and Industrials) to significantly outperform the S&P 500 during the initial recovery phase. At this stage, the Health Care and Energy sectors seem poised to benefit from a shift in the economic cycle. After leading indicators peak, the Health Care sector has historically performed the best among the 10 S&P 500 sectors. The Energy sector often outperforms the S&P 500 after global leading indicators peak at very high levels.

Both sectors are attractively valued, in our opinion. The Health Care sector is trading at a significant discount to the S&P 500 and is near its lowest level since 1980, as the graph below illustrates. It is at roughly the same level as it was during the Clinton health care reform initiative in the 1990s. The Energy sector is among the least expensive S&P 500 sectors, according to RBC Capital Markets' research.

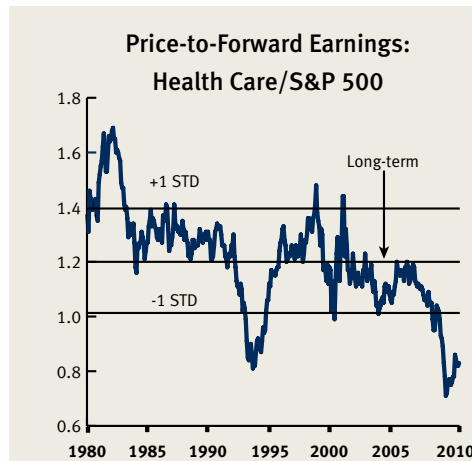
Furthermore, unique events impacted each sector. The passage of sweeping reform legislation created uncertainty for the Health Care sector. The Gulf of Mexico explosion and massive

oil spill contributed to the selloff in energy stocks.

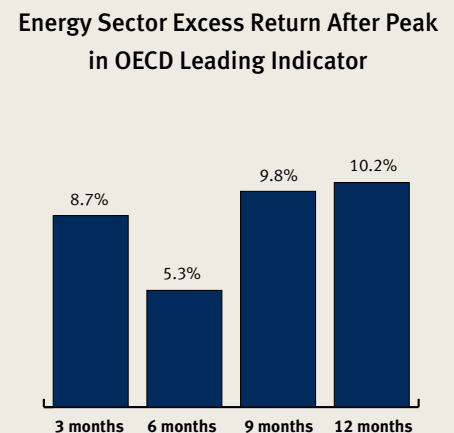
While the new health care overhaul could lower profit margins of some companies and carries significant potential liabilities for taxpayers and employers, we anticipate certain segments of the industry will benefit from the legislation. The key for investors is to find companies that can capitalize on higher health care usage rates but at the same time avoid price caps and/or taxes associated with the forthcoming regulations and reimbursement rules. We view the legislation as being a net positive for the biotechnology, clinical laboratory, diagnostic testing, drug distributor, and pharmacy benefit manager industries.

For the Energy sector, even though there are now regulatory and taxation risks associated with offshore drilling, we believe other factors outweigh these challenges and make the sector attractive for equity investors.

For more information, please request our *Quarterly Strategy Report*, titled: *Prevailing Over the Aftershocks*. ■



Source: RBC Capital Markets; data reflects ratio of Health Care Sector P/E to S&P 500 P/E.



Source: RBC Capital Markets, data is after OECD LEI peaks one standard deviation or more above its mean.

Interest Rates to Stay Lower for Longer

When the Fed begins to raise rates, it will be to begin removing the stimulus provided to the markets over the last three years and return Fed Funds to a more neutral level not to slow an overheating economy.

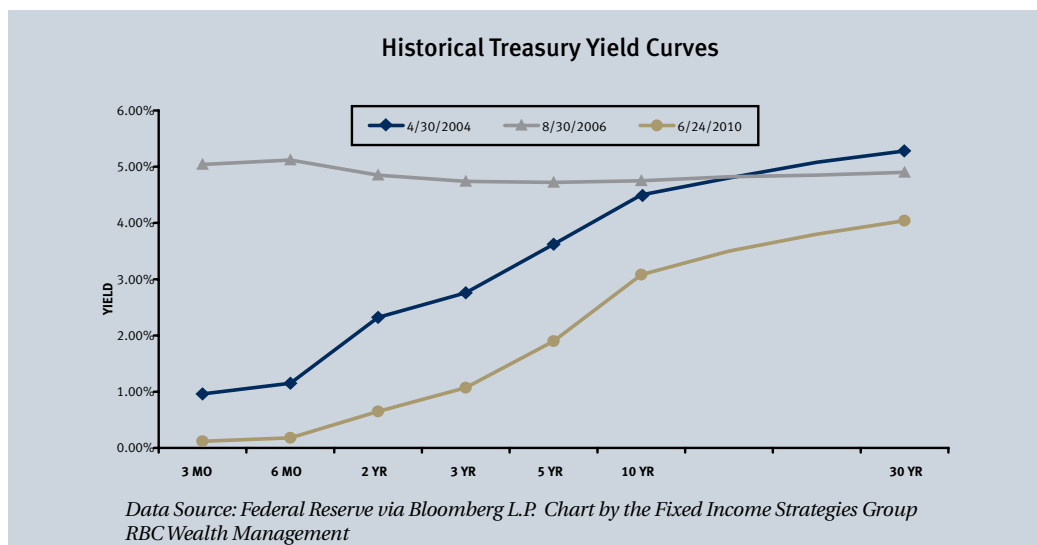
Interest rates moved lower across the curve during the second quarter, confounding consensus expectations. The Fed continues to loom large, but near-term market direction was hijacked by sovereign debt concerns in Greece, Spain, Portugal, and Ireland. This sparked a flight to a quality move into U.S. Treasuries, and yields are trading near their lows as the quarter ends.

To date, Federal Reserve policy has remained steady, but recent comments from Fed officials indicate the groundwork is being laid for the move to tighter monetary policy. However, with unemployment remaining stubbornly high, the housing market still soft, and economic growth hitting a plateau, analyst expectations are that the first Fed rate hike will be pushed into 2011. At the June FOMC meeting, policymakers voted to hold monetary policy steady, repeating that high unemployment, low inflation, and stable price expectations “are likely to warrant exceptionally low levels of the federal funds rate for an extended period.” Regardless of when the Fed begins to raise rates, it is important to realize the context within which they will be made. The purpose will be to begin removing the stimulus provided to the markets over the last three years and return Fed Funds to a more neutral level not to slow an overheating economy.

Fear of higher rates continues to drive many investors to the short end of the yield curve in an effort to play defense, thinking that when rate hikes occur, the result would

be a parallel shift higher across the curve. We feel, however, the yield curve will experience what’s called a “Bear Flattener.” In this environment short rates rise faster than long rates, resulting in a flattening of the yield curve. Short rates would rise as the Fed tightens monetary policy, while sluggish economic growth coupled with low inflation anchor the long end of the curve near current levels. When the Fed last tightened, from June 2004 through August 2006, fed funds increased 4.25% (to 5.25% from 1%). At the beginning of this tightening cycle the 2yr/30yr Treasury spread was approximately 300 basis points (bps.) At the conclusion, the spread had narrowed to 17 bps — the 2-year T-note yield increased 270 bps to 5.03%, but the yield on the 30-year T-bond fell 9 bps to 5.20%. Similar flattening moves were seen across other sectors, such as investment grade corporate and municipal bonds. The current 2yr/30yr spread is 340 bps, so an increase in fed funds to 2.50% — the RBC Forecast for fourth-quarter 2011 — would narrow that spread only to approximately 100bps, near the historical average.

We continue to recommend investors extend out on the curve to capture higher incremental yields rather than earn low rates in money market alternatives. Portfolio structure, ladders, or barbells, provide the best hedge against future events, and high-credit quality investments should be used to build the core portfolio. The municipal bond sector remains under pressure, and we recognize the risks, but we feel the predictions of the demise of the municipal bond market are incorrect. The risks emphasize the need to focus on underlying credit quality and structure. RBC Wealth Management’s recent white paper report, titled: *Preparing for a New Tax Environment*, describes how the issuance of Build America Bonds has contributed to a supply/demand imbalance which could only worsen due to increased tax rates on the highest income earners. In our view, this dynamic should provide support to the long end of the muni curve, and we continue to recommend munis as an attractive investment alternative. ■



The Economy is Still Attempting to Regain its Sea Legs *Continued*

and public pension system liabilities that have built up over decades. The deleveraging process could persist for quite some time, creating volatility and headwinds for financial markets.

Employment and housing market conditions remain fragile. U.S. private sector job growth has improved modestly but lags previous post-recession periods. Filings for unemployment benefits remain stubbornly high and are little changed since the beginning of the year. The pace of home sales improved meaningfully, and home values stabilized when federal tax credits were offered as incentives. Yet since the tax credits expired, housing activity has weakened and seems vulnerable to slowing further.

These and other measures indicate to us it could be difficult for the U.S. economy to find its equilibrium level and build on the strong 5.6% Gross Domestic Product growth that was recorded during fourth-quarter 2009. The economy is still growing but seems unable to put together a string of strong growth quarters as typically occurs during early recovery phases.

Events in Europe add an additional layer of uncertainty. The risks have less to do with specific nations, per se. After all, Greece's economy is roughly the

size of the state of Washington's. The financial risks center on the potential vulnerabilities of Europe's banking system and its exposure to sovereign and consumer debt of weaker European nations, and the related economic consequences of austerity measures.

The European debt crisis is a wake-up call for governments to cut spending. High government debt levels in Europe, Japan, and the United States could provide additional headwinds for financial markets over the longer term if they are not dealt with credibly and soon. However, even though spending cuts are prudent, they could bring near- and mid-term economic risks. As governments initially cut spending — which European countries and U.S. states and municipalities are beginning to do — economic growth could be constrained and modest deflationary pressures could be extended over a longer period.

Yet despite these lingering headwinds, there are factors that can provide stabilizing influences and help the economy navigate through rough waters, including:

- Many U.S. corporations are sitting on a pile of cash and have healthy balance sheets. Cash levels have risen sharply since the financial crisis unraveled in late 2008.

Liquid assets are currently 6.2% of total assets, the highest level since 1965. While capital spending has risen recently, companies certainly have more room to expand product and service offerings and invest in productivity. As risk aversion dissipates, we believe cash-rich companies will boost capital spending.

- The U.S. banking system is on firmer ground. It has weathered its greatest challenge, in our opinion. It now sits on a more stable foundation and has little exposure to the current sovereign debt challenges in Europe. We do not believe the U.S. banking system is at risk of unraveling if the European debt crisis worsens.
- China's economy is still growing at a healthy pace. This is spurring Asian growth and can help counterbalance a potential slowdown in Europe. Even though inflation in China has risen and the property market seems bubbly, the economy appears poised to contribute to global growth in the near term. The government's recent decision to revalue the yuan currency and delink it from a hard peg against the U.S. dollar is also supportive of growth. China is the most important swing factor for the global economy, in our view. ■



RBC Wealth Management*

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