



RBC DOMINION SECURITIES

Strategy-in-Brief: Summer 2009

EQUITY PORTFOLIO ADVISORY GROUP

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- *In the wake of a sharp and synchronized contraction in global economic activity, a moderation in the pace of decline has emboldened investors to return to risky assets. The unprecedented policy response and the apparent successful navigation through the worst of the U.S. financial crisis suggests that the Armageddon scenario is no longer on the table, although considerable challenges will confront policy makers in the years ahead.*
- *Superior fundamentals in relation to government finances, the financial system and the housing market serve to differentiate the Canadian landscape, but the inescapable trade links to the US have aligned Canada's economic trajectory with that of the US, on a lagged basis. The Bank Rate has been cut to 0.25% but the Bank of Canada has taken a cautious stance towards other non-conventional policies. This has had the unintended consequence of a significant appreciation in the Canadian dollar, which threatens to undermine certain sectors of the Canadian economy, suggesting that a more accommodative monetary stance may still be in order.*
- *Recent strength in equities has been corroborated by trends in other risky assets and moderating economic data, unlike numerous rallies witnessed over the past year. Growing confidence that these trends will extend into a period of economic growth suggest a less defensive investment bias is in order, although a period of consolidation in the markets is not out of the question.*

The Economy

<p>U.S.</p>	<ul style="list-style-type: none"> • The U.S. economy continued to contract at an annualized rate of -5.7% in Q1/09, just below the pace recorded in Q4/08. Consumer spending registered a modest gain of 1.5% supported by lower gas prices and mortgage refinancing. • Our 2009 GDP outlook stands at -2.7% with an improvement to 1% growth expected in 2010. Progress in the financial sector and the enormity of the policy response, which is only just beginning to have an impact, should support growth in the quarters ahead. • Unemployment now sits at 8.9%, with many commentators looking for a peak of 10% or more while measures of industrial capacity utilization remain near historical lows. While housing market affordability is at very supportive levels, the inventory overhang may overwhelm nascent improvements in the data.
<p>Canada</p>	<ul style="list-style-type: none"> • Superior fiscal, housing and financial market fundamentals have provided support to the Canadian economy but cannot overcome the significant trade exposure to the US. The decline in Canadian GDP accelerated from an annualized -3.7% in Q4/08 to -5.4% in Q1, following the US trajectory with a lag. • The 2009 outlook for Canadian GDP was downgraded slightly to -2.3%, rising to 1.2% for 2010 as low interest rates and global stimulus plans take hold. • The recent surge in oil and commodity prices is a positive for some sectors of the Canadian economy although the related run-up in the Canadian dollar, if sustained, would increase pressure on the beleaguered manufacturing sector.
<p>Europe</p>	<ul style="list-style-type: none"> • The Eurozone's poor economic performance continues with extremely weak GDP readings. • The UK continues to pay for its heavy reliance on the housing and financial sectors during the boom times. A large monetary and fiscal response has put the nation's AAA credit rating at risk. • European bank exposure to emerging Europe still poses a risk due to aggressive borrowing practices by eastern European consumers including foreign currency mortgages.

Asia	<ul style="list-style-type: none"> • The Japanese economy continues to feel pressure from a stronger Yen and plunging global trade. The recent decision by the Cabinet Office to upgrade its outlook on the Japanese economy for the first time in three years is a positive sign, however. • Chinese GDP was reported at 6.1% in Q1, deterioration from Q4's 6.8% and still below the 8% required for full employment. Purchasing Manager's Indices have moved back into expansionary territory, however concerns remain over the ability of the economy to sustain its pace of recovery without additional stimulus and more robust export demand.
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Monetary Conditions and Inflation

U.S.	<ul style="list-style-type: none"> • Though core inflation remains positive, headline inflation has fallen below zero on a year-over-year basis. Rising unemployment and low capacity utilization suggest that the economy would need to grow at a steady rate for a prolonged period before inflation becomes a concern. As such, short term interest rates are likely on hold at a range of 0%-0.25% for the foreseeable future, and the likelihood of additional Fed Treasury and mortgage purchases remains.
Canada	<ul style="list-style-type: none"> • The Bank of Canada has taken its benchmark rate to a record low of 0.25%, which it has committed to maintaining through early 2010. With administered rates essentially at their lower bound, quantitative easing is the next logical step if more monetary stimulus is required.
Europe	<ul style="list-style-type: none"> • CPI in the UK is still running in positive territory, but hasn't stopped the BoE from pulling out all of the stops monetarily. Rates are at 50bps and quantitative easing has been implemented, with the Bank recently increasing the amount and term of its government bond purchase program. • With rates at 1%, the ECB refinancing rate is the highest among its peers, with downward pressure likely. Recent comments suggests the ECB's Governing Council is not averse to further easing as CPI is below target at 0.6%. Quantitative easing has not been ruled out.
Asia	<ul style="list-style-type: none"> • Japanese rates remain on hold at 0.1% with deflation risks back to the forefront and a return of the "zero interest rate policy" possible if weakness persists. • China's money supply continues to expand, with M2 up 25.95% year on year while loans expanded 29.72%. The current one-year lending rate of 5.31% could be reduced further later this year if growth disappoints.

Interest Rates and Currencies

U.S.	<ul style="list-style-type: none"> • Government bond yields have risen as the flight to quality has unwound and focus turned to the ocean of U.S. Treasury supply. Rising 10-year rates have the potential to test the Fed's resolve and may lead to an increased commitment to its quantitative easing program. We are inclined to take a neutral to slightly negative view of the prospects for government bond yields over the next year. • Falling corporate bond spreads have offset the rise in government bond yields. Valuations remain attractive and investors continue to be drawn by equity-like returns. Increased default risk implies that diversification remains paramount. • In recent weeks the US dollar has weakened against most of its major trading partners as safe-haven assets fall out of favour. Concerns over the US fiscal position and foreign demand for US Treasury debt have also weighed on the currency.
Canada	<ul style="list-style-type: none"> • The Canadian dollar has staged an impressive rebound on the back of stronger commodities prices and a diminishing risk aversion. The recent move above \$US 0.90 probably exceeds what is justified by fundamentals, which could lead to concern at the Bank of Canada. • Given strong historical correlations, movements in Government of Canada bonds are likely to be influenced by Treasuries, though Canada's more benign supply picture should see GoC bonds outperform on a sustained backup in yields.

Earnings and Equity Markets

<p>U.S.</p>	<ul style="list-style-type: none"> • At \$52, recurring earnings for the S&P 500 have fallen below the peak from the previous economic cycle set in 2001 and are down some 40% from their 2007 high water mark. Over half of the S&P 500 constituents are exhibiting negative earnings momentum, however RBC CM's earnings estimate revisions index has begun to show improvement, particularly for companies in Telecommunications, Consumer Discretionary, and Information Technology sectors. • The recent rally in equity prices reflects the removal of a worst case scenario for the financial system and the revival of stocks that had previously been priced for bankruptcy. However stock prices are still significantly below their levels from a year ago, a reflection of the magnitude of the recent economic contraction, the fragile state of the US consumer, and the tentative nature of current signs of economic recovery. In addition, substantial challenges lie ahead related to large government deficits, ongoing household deleveraging, the unwinding of unconventional monetary policy, increased regulation, and potential future inflation pressures, all of which suggest that the start of a new secular bull market in equities may still be some ways off. • Nevertheless, the extent of fiscal and monetary stimulus heading towards our shores tilts the probabilities in favour of a period of economic growth towards the end of this year and into 2010. This will likely feed through to corporate earnings and equity valuations, providing opportunities for a reasonably attractive equity market returns, particularly in the face of still low interest rates. • Our technical analysis team notes the likelihood of a pause in the recent rally over the summer months. However, growing confidence in the predictive value of certain leading economic indicators and the knowledge that a majority of investors did not participate in the recent rally and hold sizeable amounts of cash leave us predisposed towards the possibility that any such pullback will be short lived. Accordingly, we would regard any pullback in share prices as an opportunity to add equity exposure with a six to twelve month view. • On a substantially longer-term view (5 years or more), the likelihood of a mean reversion to the long term trend in corporate earnings and equity valuations leaves substantial opportunity for investors with long time horizons. This stands in contrast to the recent decade in which equities underperformed both cash and bonds.
<p>Canada</p>	<ul style="list-style-type: none"> • The decline in TSX earnings is less advanced relative to the S&P 500 with Canadian earnings having peaked in Nov 2008 versus July 2007 for the US. That gap has begun to close, however consensus expectations still call for a further decline of roughly 21%. The RBC CM earnings estimate revision index remains negative but has taken a tentative turn up. On the basis of normalized earnings and longer term fair value models, the TSX is attractively priced but remains one of the developed world's more expensive markets. • Returns for the TSX are highly correlated to the S&P 500 and commodities prices. The resource-heavy composition of the TSX leaves implies a higher degree of leverage to additional signs of a firming global economic recovery, particularly amongst Asian economies which are significant consumers of commodities. In such an environment, Canadian stocks are likely to outperform. Conversely, a reversal back towards the levels of risk aversion witnessed in recent quarters would likely result in a period of underperformance for the Canadian market and the Canadian dollar.
<p>Europe and Asia</p>	<ul style="list-style-type: none"> • European equities appear more oversold than their North American counterparts, a reflection of the much slower approach adopted by the ECB and fiscal authorities.

Asset Allocation



Longer term risks abound for the economy and financial markets, leaving many unanswered questions; however the removal of the worst case scenario for the financial markets is prompting a return to evaluating risky assets on the basis of their earnings potential.

While the path of risky asset prices from here is unlikely to parallel their recent surge and may be subject to a period of consolidation, **it is our view that the highly defensive posture advocated in recent quarters is no longer warranted, suggesting a move towards a slightly above benchmark stance as opportunities present themselves in the months ahead.**

All-Canadian Portfolio – Stocks 60%, Bonds 30%, Cash 10%

Global Portfolio – Stocks 60%, Bonds 35%, Cash 5% - For a global portfolio, the potential for more monetary easing and the adoption quantitative easing initiatives within the Eurozone warrant a slight bias towards fixed income positions over cash.

Sector Strategy

	 CANADA	 U.S.
Financials	Overweight – Systemic risk factors have been reduced, but the underlying environment remains challenging, as credit losses are likely to continue to rise in the next several quarters. Commercial real estate is still deteriorating, which could weigh heavily on those banks with larger exposures. Poor earnings quality continues to weigh on the lifecos, so an underweight position is maintained.	Market Weight – Systemic risk factors have been reduced, but the underlying environment remains challenging, as credit losses are likely to continue to rise in the next several quarters. Clarity with regards to capital adequacy was achieved by the stress tests, and as a result the focus of investors has shifted to the normalized earnings potential.
Telecom Services	Market Weight – Strong free cash flow and balance sheets should limit need to access credit markets. Wireless, which has been a driver of strong results in both Canada and the US, continues to slow, as increased competition and changing consumer behavior weighs on companies.	Market Weight – The wireless landscape is becoming more competitive with smaller incumbents offering competitive wireless alternatives. There have been signs that consumers are being more diligent with respect to their wireless plans.
Utilities	Underweight – Defensive characteristics should be supportive to stocks, while regulated business models better insulate them in a difficult credit environment, as many of the companies can pass on higher borrowing costs to customers.	Market Weight – Sector still offers attractive attributes such as reasonable valuations, earnings resiliency, and relative safety. Continue to favor regulated companies with favourable regulatory backdrops.
Consumer Staples	Market Weight – Sector offers investors stable growth and strong balance sheets, but valuations remain above their historic norm.	Underweight – Potential for reacceleration of input costs could limit margin expansion, volumes facing risk of greater private label competition.
Consumer Discretionary	Market Weight – Favor media companies over more consumer focused businesses. Canada offers limited opportunities and we would recommend investors consider US alternatives.	Overweight – While US consumer remains under pressure, upside potential in share prices remains as signs of economic stabilization in the US continue to emerge.
Healthcare	Underweight – Investors should look to US market for more broad-based group of names.	Underweight – Overhang of healthcare reform could persist through the summer, and as a result exposure to the sector has been reduced. Favour companies with less exposure to potential legislation and those that continue to see relatively good earnings trends.
Industrials	Overweight – Stocks look attractively valued with the potential to benefit from a recovery in economic activity and increase in infrastructure spending.	Underweight – Near-term consensus estimates have become too optimistic for the majority of this sector, and the Committee is skeptical that there will be a reacceleration of industrial production in the short-run.
Technology	Market Weight – Profitability metrics show significant resiliency; valuations are improving but remain elevated relative to the rest of the market.	Overweight – Evidence emerging of stabilization in demand trends, consequently, looking to position the sector towards companies with a higher degree of cyclicity in their end markets.

Energy	Market Weight – The outlook for both oil and natural gas are mixed in the near-term, as inventories remain well above normal. Significant amounts of existing and planned production have been shelved (some permanently), which could potentially cause prices to spike higher in the future when demand returns. Favor oil focused names over gas focused.	Overweight – The outlook for crude oil has improved, driven by early signs of stabilization in the global economy and OPEC's compliance to stated production cuts. The outlook for natural gas is more mixed, as inventories remain well above normal while demand in the US remains muted.
Materials	Market Weight – Favor precious metals and fertilizer equities because of their lower cyclicality and favourable supply/demand dynamics. USD weakness, powerful policy stimulus and hopes of a global recovery offer support. Continue to recommend gold exposure as part of portfolio.	Market Weight – Gold and gold-leveraged equities provide needed stability to the portfolio in the current environment. USD weakness, powerful policy stimulus and hopes of a global recovery offer support.

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Top Pick (TP): Represents best in Outperform category; analyst's best ideas; expected to significantly outperform the sector over 12 months; provides best risk-reward ratio; approximately 10% of analyst's recommendations.

Outperform (O): Expected to materially outperform sector average over 12 months.

Sector Perform (SP): Returns expected to be in line with sector average over 12 months.

Underperform (U): Returns expected to be materially below sector average over 12 months.

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			Count	Percent
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