



RBC DOMINION SECURITIES

Strategy-in-Brief: Fall 2009

EQUITY PORTFOLIO ADVISORY GROUP

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- *The global economy is in the midst of a synchronized recovery in trade and the manufacturing sector, driven by strong fiscal stimulus and a rapid depletion of inventories. Sustainability of the recovery remains a concern and relies upon improvement in the corporate sector leading to higher employment and resumption of growth in consumer spending. While taking their foot off the gas pedal in relation to Quantitative Easing, central banks remain committed to maintaining a supportive monetary policy stance. Fiscal stimulus too will remain a key economic driver in the year ahead. Longer term headwinds suggest that the recovery may prove to be less robust than would historically be expected after a recession of such severity.*
- *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. Rising commodity prices have spurred strength in the Canadian dollar which threatens to undermine certain sectors of the Canadian economy, suggesting that The Bank of Canada will likely hold the Bank Rate at 0.25% for some time.*
- *Despite universal expectations of a pullback, equity prices have marched steadily higher and may continue to do so, although at a slower pace. The prospect for normal returns in an environment of low interest rates and zero returns on cash leaves us biased towards equity outperformance in the year ahead, although the risks just beyond our forecast window remain elevated.*

The Economy

- **US**
 - The pace of economic contraction slowed dramatically from -5.7% in Q1 to -1.0% in Q2 aided by government expenditures, net exports and increasing manufacturing activity, following an unprecedented inventory drawdown. Our outlook is for growth approaching 2% for the remainder of 2009, bringing the 2009 rate to -2.8%, and a modest 2.2% for 2010. Fiscal stimulus will play an important role in 2010 with only 10-15% of stimulus funds spent so far.
 - The US housing market has seen encouraging signs with sales and home prices rising modestly from very low levels and unsold inventories falling, even while foreclosures continue at a high pace.
 - A surge in unemployment of 4.8 percentage points so far in 2008/2009 looks set to moderate, with the rate likely peak near 10% later this year. Sustainability of the recovery rests with the consumer who, after being a net drag so far, will likely increase consumption by a modest 1.8% next year as the growth in the household savings rate abates.
 - Despite the outlook for positive growth, the recovery is set to be less robust than would traditionally be expected following a recession of the depth experienced over the past year.
- **Canada**
 - GDP rose for the first time in June at +0.1%, having fallen by -3.4% in Q2 and -6.0% in Q1. With outsized trade exposure to the US, Canadian GDP tends to follow the US with a lag. Business capital investment continues to be a net drag on output. However, a sound banking system has provided effective transmission of lower interest rates into the economy, spurring a rebound in housing and consumer activity. GDP growth should pick up to +2% in Q3 and +2.4% in Q4 and outpace the US modestly in 2010. Unemployment, at 8.7% is likely to peak at 9.2% by the end of year.
 - Rising oil and commodity prices are a positive for some sectors of the Canadian economy although the related run-up in the Canadian dollar increases pressure on the beleaguered manufacturing sector.
- **Europe** - Typically a laggard, Eurozone GDP data surprised to the upside with positive German and French GDP due to rising industrial exports and major auto incentives. A moribund consumer and the lapsing of these incentives leaves the strength of the recovery in question, although improved business sentiment bodes positively for future employment.

➤ **Asia**

- Export-oriented Emerging Asian economies, amongst the hardest hit in the downturn, are leading the recovery. Q2 GDP rose at over a 12% annual rate as exports rebounded and a consumer sector unencumbered by the excesses of many Western nations forged ahead.
- In Japan, surging exports and increasing confidence amongst manufacturers lie in contrast to a sluggish household sector which remains dependent upon government stimulus, likely to be continued under a newly elected government. Unemployment recently hit an all time high of 5.7%.
- Chinese GDP growth remains on track for 8% in 2009 and 9% in 2010. The rate of bank lending and investment has eased from a blistering pace. Retail sales, housing activity, and a modest recovery in exports support the fundamental outlook.

Monetary Conditions and Inflation

- **US** - Though core inflation remains positive, headline inflation has fallen below zero on a year-over-year basis. High unemployment and low capacity utilization mean the economy would need to grow at an improved rate for a prolonged period before inflation becomes a concern. Traditionally, the Fed has avoided raising policy rates until a positive employment trend has become established. Short term interest rates are likely on hold at a range of 0%-0.25% for the foreseeable future, although an improving growth outlook implies a reigning in of non-conventional policy.
- **Canada** - 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. CAD strength, and its potential drag on the economy, has kept discussion of quantitative easing alive, but it remains a low probability as other central banks reign in their QE activities.
- **Europe** - At 1%, the ECB refinancing rate is the highest among its peers, although recent upside GDP surprises likely remove the possibility of further cuts. Rates are expected to stay level into 2010.

➤ **Asia**

- Japanese rates remain on hold at 0.1% as the economy grapples with accelerating deflation, and significant excess economic capacity.
- In China, concern that bank lending, the primary vehicle for delivering fiscal stimulus, was contributing to a potential stock market bubble has led to a reigning in of short term loan activity. However, benign inflation (-1.7% in June, 1.5% forecast for 2009), and concerns over the longer term sustainability of the recovery leaves policymakers disposed to maintaining their current pro-growth stance at least until Q2 next year, at which time policy rates may commence a gradual march higher.

Interest Rates and Currencies

➤ **US**

- 10-year Treasuries have remained in a 3%-4% range near calculated fair value given an outlook for low inflation and steady policy rates for the foreseeable future. Excess supply poses only a modest threat given a higher US savings rate. As the recovery progresses, asset flows out of bonds into more risky assets should push yields above the 4% range.
- Narrowing corporate bond spreads have offset the rise in government bond yields. Although the lion's share of gains is likely behind us, corporate bond valuations remain attractive given that the apparent stabilization in profitability bodes well for a moderation in expected default rates.
- Long term fundamentals remain poor for the US dollar given large budget deficits and bond issuance; however, this has been reflected in an already significant decline in the currency to date. A strong negative correlation with equity prices leaves room for some US dollar recovery in the event of a pullback in equity markets.

➤ **Canada**

- For the Canadian dollar, levels at or above \$US 0.90 probably exceed what is justified by fundamentals in the near term, leaving the currency vulnerable to any softening in optimism regarding the economic outlook and equity markets.
- 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 any sustained backup in yields. A strong currency may also threaten the economic outlook, leading to a longer period of low rates from the Bank of Canada, which would also be supportive of Government bonds.

Earnings and Equity Markets

➤ **US**

- At \$44, recurring earnings for the S&P 500 have fallen below the peak from the previous economic cycle set in 2001 and are down some 51.5% from their 2007 high water mark. However, while the momentum of actual reported earnings

remains neutral, RBC CM's earnings estimate revisions index has turned up and is in positive territory for the first time in two years. Consensus estimates for forward 12 month earnings has troughed and is now rising, standing currently at \$65 while RBC CM projects calendar 2010 and 2011 index earnings just below consensus at \$70 and \$84. Earnings growth is the dominant driver of returns for investment horizons of one year and beyond. From this perspective, current expectations remain well below the 2007 peak of \$91, but provide ample support for equity markets from current levels.

- In recent months, equity markets have travelled a substantial distance from pricing in the bankruptcy of the financial system, to pricing in the first tentative signs of recovery. We look for further equity strength, although prospects from here are much more modest, with a target of 1,150 for the S&P 500 one year out. Our view rests on three considerations: (i) leading economic indicators and massive fiscal stimulus still in the pipeline suggest there will be upside economic surprises in the quarters ahead, (ii) we are in the part of the cycle where earnings improvements tend to exceed forecasts, leading to increased confidence, lower risk premiums, and rising valuations, and (iii) the combination of low inflation, zero returns on cash, large cash holdings, and ample liquidity argue we remain in a sweet spot for risky assets. Ironically, while most investors remain focused on the risk of a double-dip recession and its impact on earnings visibility, a greater impact on equity markets would be felt from rising inflation and interest rates. This could happen if the economy were to recover too strongly/quickly combined with a Lazarus-like resuscitation of the US banking system causing central banks to abruptly reverse policy course. Given the huge amount of economic slack and ongoing consumer and financial deleveraging this remains a low risk scenario. We regard the current environment as a cyclical bull market within a potential secular bear.
- Technically, the S&P 500 is now nearly 2 standard deviations above its 200-day moving average, suggesting an inevitable slowing in the pace of gains. Many investors have waited for months (in vain) for some pullback to provide a more appealing entry point. Historical seasonal patterns highlight the potential for underperformance in September and October and our technical analysts indicate that a risk window for correction remains open. While history suggests any pullback could range from between 5% to as much as 20%, from a 12-month perspective, the trend is still up, and as yet is showing no real signs of longer-term deterioration.
- 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 past decade in which equities underperformed both cash and bonds.

➤ **Canada**

- 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. Consensus earnings expectations for 2010 have started to turn up, but are still some 7% below current levels, suggesting some tough quarters ahead.
- Returns for the TSX are highly correlated to the S&P 500 and commodities prices. Assuming a 10% gain in commodities prices and a return to positive economic growth in Canada and the US, our 12 month target for the TSX lies at or about 12,000.
- On the basis of normalized earnings and longer term fair value models, the TSX is reasonably priced but remains one of the developed world's more expensive markets. The resource-heavy composition of the TSX 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. Eurozone equities have fallen the furthest below our estimate of long term fair value.

Asset Allocation


In our view the odds favor continued outperformance of equities as an asset class over the next 12 months, although the overall return prospects are much lower than what has recently been delivered. For risk-oriented and agile investors, we would regard any softness in markets near term as opportunities to add exposure so long as leading indicators on the economy continue to point to continued economic expansion.

For conservative investors with a longer term investment horizon, we would note that while valuations over a 5-year or longer horizon are compelling, the sustainability of the current economic recovery is by no means assured and substantial risks remain, suggesting that investors should be at their long term strategic asset weightings, but need not chase this market.

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

Global Portfolio – Stocks 60%, Bonds 35%, Cash 5%

Sector Strategy

	 CANADA	 U.S.
Financials	Market Weight – Underlying environment remains challenging, as credit losses are likely to persist in the next several quarters. However, Canadian banks have for the most part demonstrated strong ability to earn through the crisis. Poor earnings quality continues to weigh on the lifecos. Thus, Focus List remains more heavily weighted toward banks than insurers.	Market Weight – The underlying environment remains challenging but recent trends suggest slowing in pace of credit losses may be on the horizon while revenue has been supported by robust capital markets and expanding net interest margins. 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	Underweight – Sector reduced to UW from MW for current quarter. Competition amongst existing players has intensified, while new wireless entrants have begun to enter the market and could further erode competitive landscape.	Underweight – The wireless landscape remains very competitive with smaller incumbents offering aggressive pricing alternatives. Furthermore, consumers remain diligent with respect to their wireless plans despite continued growth in smartphone sales.
Utilities	Underweight – Defensive characteristics should be supportive of 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. Focus List is currently weighted more toward economically sensitive stocks and thus Utilities are maintained at UW.	Underweight – Sector offers attractive attributes such as above average dividends yields and relative earnings resiliency. However, power demand remains weak and sector could lag in a global economic recovery.
Consumer Staples	Underweight – Sector offers investors stable growth and strong balance sheets. While Focus List is more heavily geared toward the more economically sensitive sectors of the market, the relative underperformance of Staples has made valuations more compelling than the recent past.	Market Weight – Sector offers strong international growth opportunities and relative stability. 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 the US consumer remains under pressure, upside potential in share prices remains as signs of stabilization of economic and consumer confidence in the US continue to emerge.
Healthcare	Underweight – Investors should look to US market for more broad-based group of names.	Market Weight – Overhang of healthcare reform could persist through the fall although risk may be reflected in valuations. Favour companies with less exposure to potential legislation and those that continue to see relatively good earnings trends.
Industrials	Overweight – Committee believes that the likelihood of a second half economic recovery has grown considerably. Sector offers strong economic leverage and OW is maintained.	Market Weight – Sector offers exposure to global economic recovery. Favour early cycle exposure as well as international end markets where activity has shown signs of reaccelerating.
Technology	Overweight – Sector increased to OW from MW because of strong relative performance and sensitivity to an economic recovery. Look to US for some exposure as it has more diverse names.	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	Overweight – Sector raised to OW from MW. While inventories remain elevated, especially for natural gas, the expected economic recovery could boost NA and European demand. Further, significant supply reductions could begin to show up late in the year, creating a supply/demand imbalance, which could quickly erode inventories.	Market Weight – 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	Overweight – Sector raised to OW from MW. While base metal stocks have staged a strong recovery, significant upside remains should global economic recovery play out as expected. Fertilizer stocks continue to offer compelling long-term valuations, while gold is entering strong seasonal demand period.	Overweight – The outlook for the sector has improved on the back of a reacceleration in global leading indicators. Favour more cyclical areas of the sector that offer leverage to improving economic activity, both domestically and overseas.

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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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Rating	RBC Capital Markets		Investment Banking Serv./Past 12 Mos.	
	Count	Percent	Count	Percent
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HOLD [SP]	528	45.91	94	17.80
SELL [U]	81	7.04	5	6.17

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