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Davidson Professional Wealth Management

of RBC Dominion Securities

Market Commentary

December 9th, 2011

Professional Wealth Management Since 1901

RBC Dominion Securities

Still cleaning up after the party

In retrospect, the 1980's, the 1990's and the first half of the 2000's was one hell of a party! As interest rates declined, consumers and politicians, among others, became increasingly comfortable taking on debt. The belief was that ever higher levels of debt could be justified as long as economies and household income continued to grow. At some point, a "good thing" turned into "too much of a good thing", and the debt bubble that eventually resulted became well-entrenched in developed economies, promising to take years to sort out.

As 2011 draws to a conclusion, we find ourselves working through the messy details of a complex deleveraging process. Eurozone debt is in the spotlight right now, with the challenges of US mortgage and government debt being ever present. I, for one, would be among the most surprised if these was addressed in just a few short years. The bubble took close to 25 yrs to build, and it will take several years to work off, presenting challenging conditions all the while.

With expectations for economic growth and capital market performance being very low right now, there is a reasonable chance that 2012 will end up being a more satisfying and prosperous year for investors. For those of you who recall, in early 2009 pessimism reigned supreme. But, by the end of the year, North American equity markets had rallied strongly by between 28% and 40%.

Based on valuation models, the RBC Investment Strategy Committee is indicating a preference for equities over bonds.

We readily acknowledge that equity market targets and 10 yr government bond yields have been extremely difficult to forecast, given the heightened level of concern over sovereign finances and their potential impact on economic growth. While the inputs to the various valuation models we use lead us to expect one thing, in the short term, events, combined with investor psychology, often dictate something different.

In spite of the heightened level of concern, the RBC Investment Strategy Committee is forecasting modest levels of growth over the next 12 months.

Real GDP	Forecast 2011	Change	Forecast 2012	Change
United States	1.75%	N/C	2.00%	(0.50)
Canada	2.25%	(0.25)	2.00%	(0.50)
Europe	1.50%	(0.50)	0.00%	(1.50)
United Kingdom	1.00%	(0.25)	1.00%	(1.00)
Japan	-0.50%	N/C	2.25%	(0.50)
Emerging Markets*	6.75%	N/C	6.50%	N/C

CPI	Forecast 2011	Change	Forecast 2012	Change
United States	3.00%	0.25	1.75%	N/C
Canada	2.75%	N/C	2.00%	(0.25)
Europe	2.50%	N/C	1.50%	(0.25)
United Kingdom	4.25%	N/C	2.50%	0.25
Japan	-0.25%	(0.50)	0.25%	N/C
Emerging Markets*	6.50%	0.50	5.50%	0.25

RBC Investment Strategy Committee - Capital Markets Forecasts

Central Bank Policy Rates	30-Nov-11	Forecast Nov-12	Change	1 Year Est. Total Ret.%
United States	0.25	0.25	N/C	N/A
Canada	1.00	1.00	(0.50)	N/A
Europe	1.25	0.50	(1.00)	N/A
United Kingdom	0.50	0.50	N/C	N/A
Japan	0.10	0.10	N/C	N/A

Equity Markets	30-Nov-11	Forecast Nov-12	Change	1 Year Est. Total Ret.%
S&P 500	1247	1375	50	12.4
S&P/TSX Composite	12204	13500	N/C	13.5
MSCI Europe	1276	1400	(100)	14.6
FTSE 100	5505	5750	N/C	8.5
Nikkei	8630	9750	(750)	15.3

10-Year Government Bonds	30-Nov-11	Forecast Nov-12	Change	1 Year Est. Total Ret.%
United States	2.05	3.00	(0.25)	(3.7)
Canada	2.15	3.00	(0.50)	(3.4)
Germany	2.28	3.00	(0.50)	(2.6)
United Kingdom	2.31	2.75	(0.50)	0.6
Japan	1.07	1.50	N/C	(1.2)

Currencies	30-Nov-11	Forecast Nov-12	Change	1 Year Est. Total Ret.%
CDA per US	1.02	1.04	0.02	(1.5)
US per Euro	1.34	1.25	N/C	(6.2)
Yen per US	77.61	80.00	(5.00)	(3.5)
US per Pound	1.57	1.60	(0.04)	2.7

* GDP Weighted Average of China, India, South Korea, Brazil, Mexico and Russia.

The expected levels of government debt vs GDP reflect the debt bubble that has built up over the last 20 or so years. In this respect, Canada looks very good relative to a number of its developed-world peers.

In setting on the course of deficit spending so many years ago, politicians and economists believed that their economies would grow, keeping debt levels in check. Without adequate growth, tax increases and / or spending cuts eventually become necessary.

Global Gross Debt/GDP Ratios with IMF Forecasts

	United States	Canada	France	Germany	Italy	Japan	United Kingdom
2008	71.2	71.3	67.5	66.3	106.3	195.0	52.0
2009	84.6	83.4	78.1	73.5	116.1	216.3	68.3
2010	91.6	84.0	84.3	80.0	119.0	220.3	77.2
2011	99.5	84.2	87.6	80.1	120.3	229.1	83.0
2012	102.9	83.1	89.7	79.4	120.0	233.4	86.5
2013	105.6	81.0	90.3	77.9	119.7	238.0	87.4
2014	107.5	78.5	89.8	75.8	119.3	242.4	86.5
2015	107.5	78.5	89.8	75.8	119.3	242.4	86.5
2016	109.4	75.6	88.5	73.8	118.7	246.7	84.4
Prior Peak	83.2	101.0	77.4	72.5	121.8	217.6	68.2
Anticipated Deficit/GDP Ratio for 2011	-10.8	-4.6	-2.3	-6.0	-4.3	-10.0	-8.6

Source: IMF

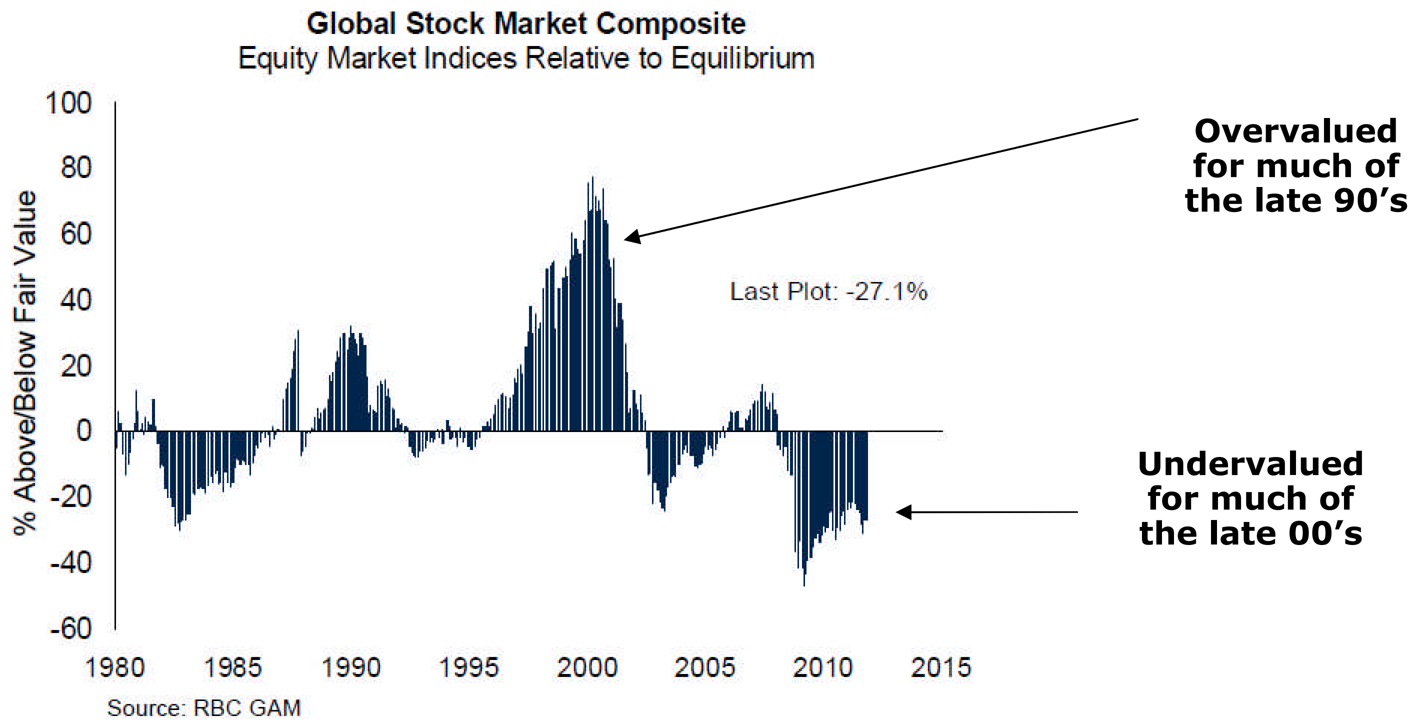
One of the most obvious symptoms of the times is the ultra-low prevailing interest rates. This is largely a result of central bank activities as well as investors' concerns relating to equities and their preference for bonds at almost any yield. While this is good for debtors, it's incredibly hard on lenders and savers. As you can see from the left hand column in the table below, bond yields for 10 year government bonds are near or even below 2%. All other fixed income securities are priced compared to the prevailing levels for these benchmark bonds.

10-Year Government Bond Yields
RBC GAM Forecasts and Equilibrium Levels

	RBC Global Asset Management			Equilibrium Level	
	Current (%)	Forecast (%)		Forecast (%)	
	Yield 30-Nov-11	Forecast Nov-12	Total Return (Local Curr.)	Equilibrium Nov-12	Total Return (Local Curr.)
United States	2.05	3.00	-3.7	3.77	-9.0
Canada	2.15	3.00	-3.4	4.52	-14.9
Germany	2.28	3.00	-2.6	4.73	-15.5
U.K.	2.31	2.75	0.6	4.46	-14.2
Japan	1.07	1.50	-1.2	2.38	-8.9

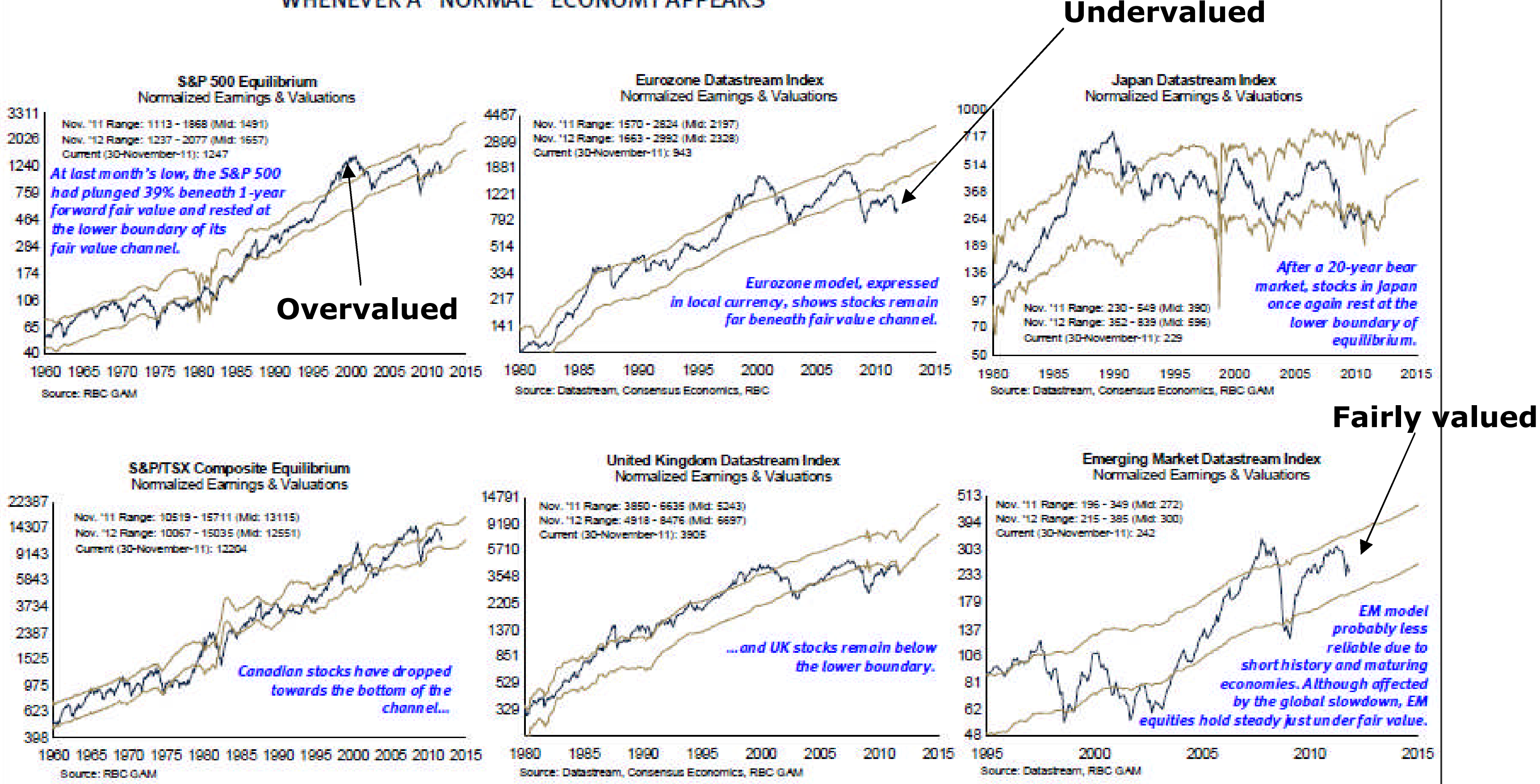
Source: RBC GAM

Valuation models that are used for indicating whether an asset market is attractive or unattractive (as illustrated on this page and the next) provide very little guidance as to the timing of investment in those markets. Furthermore, based on how they are calibrated, they provide their most useful guidance when economic and investment conditions are "normal".



Although still far above the massive discount to fair value evident in the spring of 2009, our GDP-weighted index of global stock market valuations has fallen back to levels that appeared only during the deep bear markets of 1981-1982 and 2007-2009.

EQUITY MARKETS: MAJOR EQUITY MARKETS STILL SHOW SUBSTANTIAL RISK PREMIUMS/SOLID TOTAL RETURN PROSPECTS WHENEVER A "NORMAL" ECONOMY APPEARS



Fair value is the minimum price level consistent with mild inflation/low interest rates in an environment of economic growth. Above-average price appreciation remains a possibility in an environment where 'normalcy' is restored. Moreover, opportunity exists as valuations in the biggest markets still lie below their minimum expected levels. Corrections are always a possibility and valuations will not limit the risk of damage of systemic shocks, but the outlook for equity market returns is generally superior when stocks lie below fair value at the bands' midpoint.

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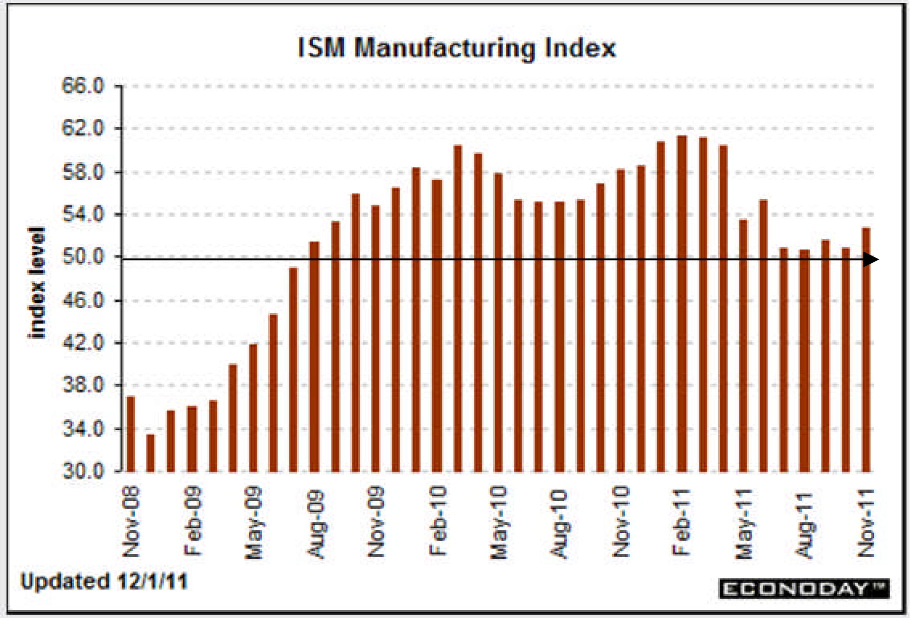
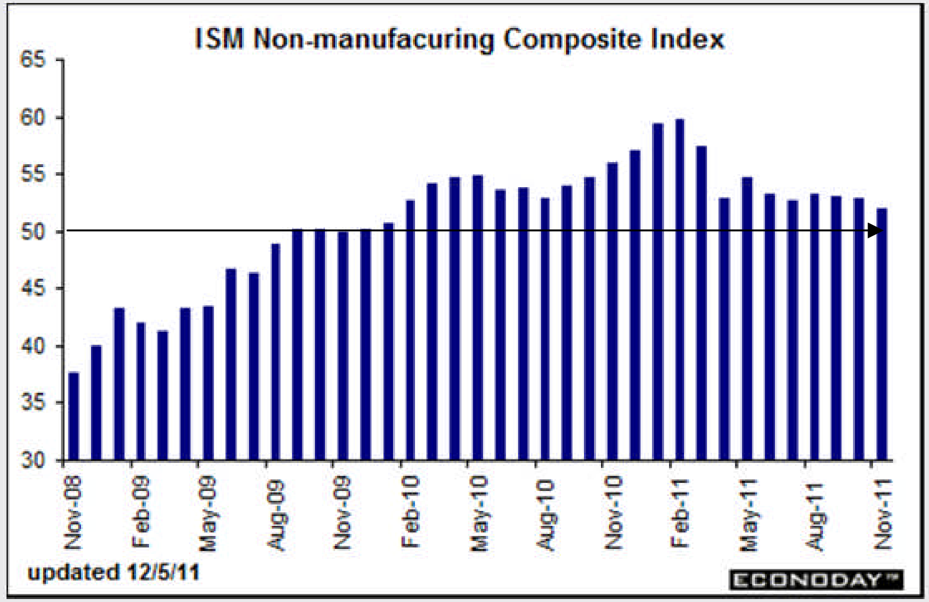
The charts below indicate that the US economy is still growing, although at a slower pace than this time last year. Despite all of the negative headlines the US economy has remained remarkably resilient and offers hope that the US may skirt recession. This bodes well for equity investors assuming Europe's problems are contained.



Data Source: Haver Analytics



Data Source: Haver Analytics

The ISM manufacturing index (formerly known as the NAPM Survey) is constructed so that any level at 50 or above signifies growth in the manufacturing sector. A level above 43 or so, but below 50, indicates that the U.S. economy is still growing even though the manufacturing sector is contracting. Any level below 43 indicates that the economy is in recession.

The ISM non-manufacturing survey does not compile a composite index like its manufacturing cousin. The business activity index, which is actually akin to the production index in the manufacturing survey, is widely followed as the key figure from this survey

Markets go through alternating bull and bear phases, as show below. Bear markets can be profitable, but require different investment strategies and more nerve than do bull markets.

Long-Term Market Cycles 1920-2011

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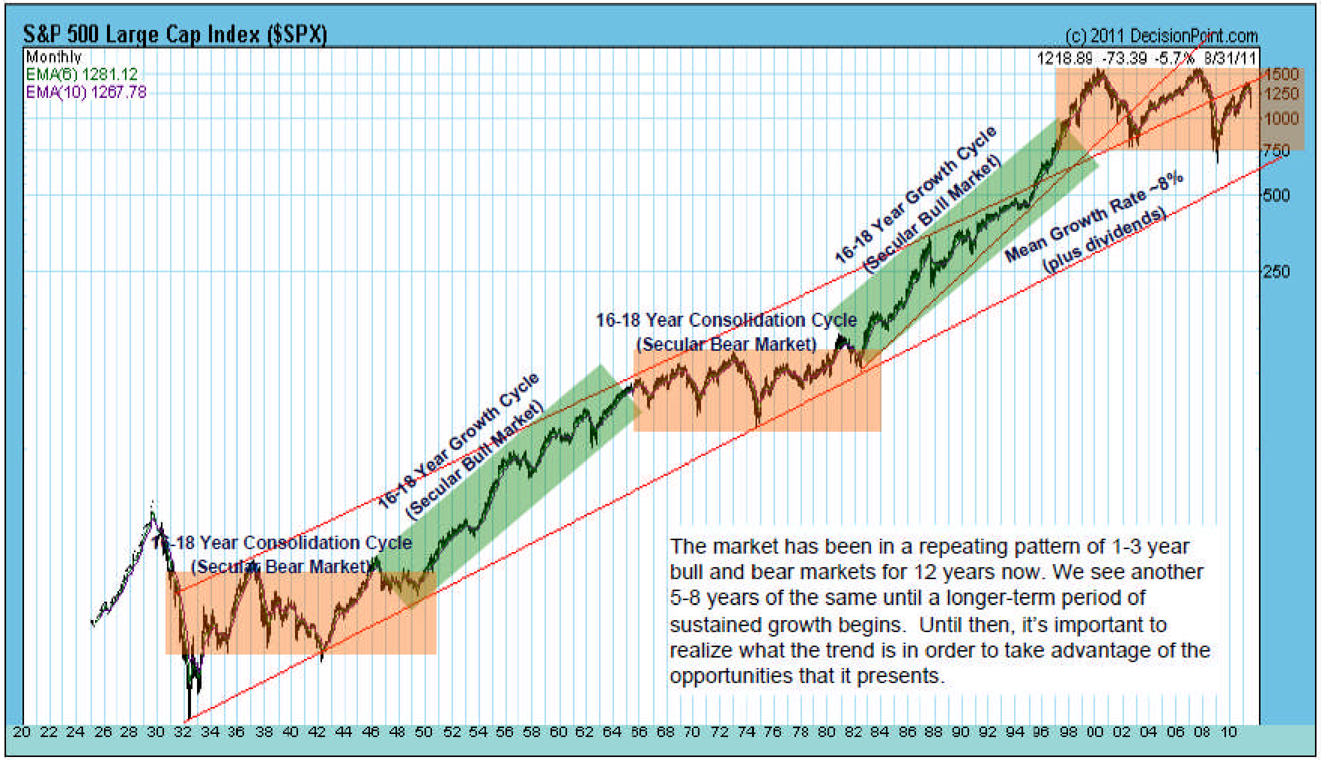

Chart courtesy of Decisionpoint.com and RBC Wealth Management

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