

# Take Note

Spring 2009

For clients, associates and friends of,

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## MUTUAL FUNDS:

### *A HIVE OF ACTIVITY*



One of the questions clients have been asking most often is: "Should they be doing something different with their mutual funds in the context of the recent economic and market meltdown?"

When they look at their statement they see the same mutual fund name month after month and assume that no changes have been made.

Keep in mind that each mutual fund is made up of a basket of stocks (and other investments). We have selected these funds for your portfolio because they fit with your risk tolerance and because we believe that they will provide good long term returns over time.

Each of the fund managers for these mutual funds is following a discipline that is focused on buying the best stocks at the best time for the best value. For example the RBC Canadian Dividend fund which has had historically strong performance has in the last year traded 31% of its holdings to improve performance.

Of the approximately 40 stocks that were held in the portfolio at the first of the year the managers would have replaced

12 stocks with ones which they felt were capable of performing better in this market at this time.

Some mutual fund companies have gone further and have replaced 100% of their positions within a 1 year time frame. Another favourite of ours because of its strong investment discipline, LifePoints, has traded 30-50% of the positions in the portfolios over the last year.

Beneath each single unchanging name of a mutual fund company there is a dedicated hive of analysts who are working extremely hard, buying and selling stocks, bonds and other investments to produce the best possible returns.

## Spring Seminar:

### **TAX EFFICIENT INCOME AND THE TAX-FREE SAVINGS ACCOUNT**

Thursday, May 7th  
@ 12 NOON

IN RBC DS BOARDROOM

RSVP'S CALL JENNIFER

613-549-3497

Light snacks will be served.

# Commentary from the RBC Trend and Cycle Analysts: Spring 2009: "Everybody into the Pool"

In the first week of April, our **Trend and Cycle** analysts noted a few technical levels or trigger points that would support the case for an extension of the current market upturn. On April 9th and 10th, six significant markers were struck, paving the way for a round of buying. (1) The VIX index, the standard measure of stock market volatility, is showing a narrower band each day, dropping from swings of 80 points daily last November down to nine points currently. (2) American financial stocks have turned positive on better earnings reports, especially from Wells Fargo last Friday. (3) Copper, a bellweather commodity for the global economy, has moved close to its 200-day moving average of \$2.29 per pound. (4) Gold, which trades inversely to the broad stock market, has declined from \$1007.70 per ounce in February to \$895 today. (5) The yield on the U.S. 20-year bond index has also been rising from around 2.7% to 2.95%. (6) Finally, the Canadian dollar has risen to the \$0.82 level from a low of \$0.77 as recently as January.

We believe the broad indices could push another 10% to 12% higher over the next 3 to 5 weeks. The next resistance level for the TSX (now 9300) would be 9505 and then 10200. The S&P 500 Index (now 854) would see resistance at 875 and 943. We should bear in mind that this rally is within the context of a bear market and will not lead permanently to safe ground just yet. Longer term, we still believe the risk window remains open until mid-year in 2010. Between now and then, we will treat the market as a series of intermediate trades and focus primarily on weekly data.

The enthusiasm for parking cash in GICs appears to be waning and there is a marked underperformance for the defensive sectors of the economy such as Utilities, Telcos and Staples. On the

other hand, Metals, Energy and Technology have shown signs of strength as they are favorite proxies for the economy's recovery. Both Financials and Energy are showing early intermediate upturns. We recommend that investors place cash to work with a regular investment program so that market participation is maintained at all times.

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**Patricia Croft, Chief Economist for RBC Asset Management**, is less pessimistic in her recent outlook for the global economy. She says there are still risks with defaults in commercial mortgages and higher unemployment rates yet to come. However, the fiscal and monetary stimulus has been unprecedented. Recorded global losses to date have been \$2,083 billion but the stimulus added into the system has been even larger at \$2,292 billion. Even China and India have eased massively to boost their economies. Interest rates are now at their lowest levels in history. Canada's overnight rate is 0.5%, the U.S. is 0% to 0.25%, Britain is at 0.5% and the European Central Bank is at 1.5%. The recent meeting of the G-20 leaders recognized that fiscal policy must be aggressive, coordinated, flexible and timely. Today's fight is against deflation even if the world faces inflation in two years when the fiscal stimulus will have to be unwound.

Patricia is watching the signs for change such as American house prices and stabilizing trends in construction. She wants to see the signs of demand for transported goods revealed in the Baltic Dry Shipping Index. The stock market itself is a leading indicator as is the expansion in the money supply and these are both trending higher. Commercial loans and credit are also expanding once again. Moreover, the preconditions for a market rally are in

place: there is a high level of cash parked in treasury bills and money markets, investors have capitulated, U.S. housing inventories have peaked and are now moving down and we have passed the trough in economic momentum.

In conclusion, with pessimism rampant, the turning point has been reached. Equity markets look very attractive with prices unusually low. Corporate bonds represent a remarkable risk/reward opportunity in Canada, particularly financial debt. Lower oil prices coupled with massive policy response have placed a floor under the global economy. This all sounds rosy; however, there are still problems to work out. It will take time to work through the deleveraging and weak employment cycle. Unemployment may rise to 9% or higher. The consumer is tapped out and fearful. Overall, it will take a long time for confidence in the financial system to be restored.

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The Canadian economy is very dependent on strong price performance in commodities, basic materials, energy and precious metals. Global deflation is the current peril and so there is a universal weakening in demand for the goods that Canada produces in such abundance. Thus, the Canadian equity market has been oversold relative to its historic growth trend. From June 2008 to March 9, 2009, the TSX lost 51% of its market value. However, it has since regained 21% in little more than a month. The low Canadian dollar is helping to encourage sales of basic goods. Investor expectations are unusually low and these recent positive earnings reports have been spurring a rally. For instance, Enbridge increased its earnings per share by 86% between 2007 and 2008 while it increased its

dividend by 12%. SNC Lavalin recently announced an increase in earnings of 9% and it increased its dividend by 25%. These companies are not unique as most of the companies on the RBC DS Focus list are also announcing solid profits this quarter. Dividend yields have never been higher.

We reiterate our opinion from the Winter Newsletter when we wrote that “much of the risk has been removed from the stock market and, no matter

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what the future portends, buying stocks today is less risky than it was six months ago in Canada or a year ago in the U.S. Because equity prices are dynamic and eventually there is a regression back to the mean or average point, it is a fair assumption that stocks will tend to move upward from here.” We believe that all investors should be positioned to take advantage of even a mild recovery by deploying small amounts of cash into the market regularly.

So what does the future hold? We expect that the consumer price index, along with the gross domestic product, will still be negative for 2009. However, there should be some response to the stimulus in 2010 with GDP growing at 1%. Government capital spending on infrastructure has been announced for the coming months. The Obama government has provided another \$720 billion of stimulus to the financial sector including home mortgages. The Federal Reserve Board is using quantitative easing in which government bonds and mortgage-backed securities are purchased off the market at competitive rates. This is driving long-term interest rates lower, thereby pushing the conventional mortgage rate to its lowest level in forty years and spurring a massive increase in new mortgage applications. Commercial loan rates are the lowest in history with the prime rate in Canada at 2.5% and 3.25% in the U.S. This will stabilize the housing and commercial loan markets and eventually restore consumer confidence.

**Jim Allworth, Vice-President and Director of RBC Dominion Securities**, says that lack of clarity in the outlook is a great concern to all investors but we still favour stocks over bonds and hold a below-normal exposure to fixed income, particularly to government debt. The current RBC asset allocation range suggests 15% in

short-term interest accounts, 25% in bonds of two to ten years duration and 60% in common stocks. Stocks globally appear very attractively valued by historical standards. Growing confidence in the authorities’ willingness and ability to finance the system will eventually displace fear and risk aversion. This will create a meaningful countertrend rally in the next few weeks although it may take considerably longer for the market to become confident that the economy is on the road to full recovery.

We recommend that clients add to positions in high quality, dividend-paying stocks. Cash distributions will support the portfolio value while we await a change in sentiment, which could swing around quickly and without much warning. In fixed income, we recommend fairly short maturities in taxable accounts so that liquidity is available for better opportunities. High grade corporate bonds and mortgage-backed securities are offering very attractive yields versus government bonds. At the moment, the yields on corporate debt have been relatively high. Monetary easing should help to lower borrowing rates on corporate debt thus boosting capital values. As confidence is restored, the wide spreads between government bonds and commercial debt will likely narrow, thereby providing investors with a positive advantage.

Since our last Newsletter, we have pushed out our estimate for recovery in the general economy to 2010. However, the stock market will lead the economic recovery by a few months. We are forecasting that there will be no growth in the Canadian economy in 2009 and only mediocre expansion of 1% in 2010. Nevertheless, stocks were sold off to an extreme level of pessimism and should rebound somewhat in the remainder of this year.

# Fixed Income - A Couple of Opportunities?

## Government - Corporate Bond Switch - A Timely Idea

As we all struggle through this severe recession and market downturn, we should be asking ourselves what strategies might allow us to take advantage of this period in the economic cycle. Most of you will have a certain percentage of your portfolios in fixed income. The amount and type of fixed income you hold will be dependent on your personal risk tolerance, need for income etc.

Since last fall, 2008, when the stock markets took a tumble, there has been a "flight to safety" as stocks were sold off and Government bonds and treasuries were bought. This drove up the prices and lowered the yields on Government bonds. Since October, 2008, the 10 year Government of Canada bond yield has fallen from about 3.70% to about 2.70%. These yields are not justifiable in a normal economic environment and as the economy improves, there is a significant likelihood that Government bond prices will fall.

Over the same time period, prices on investment grade corporate bonds have fallen, driving up the yields on this class of fixed income. The reason these yields

have risen is the default risk associated with a struggling economy. When our economy improves, and this default risk is reduced, the credit spreads on these corporate bonds will be reduced and there will be gains to be made.

We don't recommend large exposure to corporate bonds, but this is the time period when investment grade corporate bonds offer above average returns and investors are adequately compensated for the risks.

For those clients holding high quality Government bonds, you may be interested in selling them to capture the capital gain and move the proceeds over to investment grade corporate bonds that are trading at reduced prices. If you don't hold any Government bonds, you can take advantage of this corporate bond opportunity with new money purchases.

As an example to help clarify this trade, the AAA-rated Government of Canada 4.5% June 1, 2015 bond has increased in price from September 30, 2008 @ \$106.12 to April 3, 2009 where it is trading at \$114.75 giving a yield to maturity of only 1.9%. At the same time, you can purchase a Manulife 6.7% June 30, 2012 @ \$95.74 for a yield of 8.2%. This will provide better income and a

capital gain at maturity in return for accepting additional risk that Manulife will not default on its interest payments. (Note: prices and instruments used as examples from available inventory at date of writing)

This may be the time for you to consider investment grade corporate bonds for no more than 10% of your fixed income portfolio. Please call us to discuss since this example will not necessarily be appropriate for every investor.

## Real Return Bonds - Cheap Inflation Protection

Another fixed income opportunity is in **Real Return Bonds** (RRB). RRBs feature principal and coupons that are indexed to inflation, providing certainty of future purchasing power. Because of the very low inflation levels lately, these securities have fallen in price and there has never been a better time to own inflation protection. Although we currently read about deflation being the #1 problem, there are many forecasts of rising inflation once this recession is over. Governments around the world are printing money trying to stimulate the economy and this stimulus is likely to increase future inflation. Two investments that offer exposure to RRBs are the TD Real Return Bond Fund and the Barclay's iShares ETF (XRB).



\*\*Rates [and/or yields] as of 04/01/2009. Rates [and/or yields] are subject to change and availability. This information is not investment advice and should be used only in conjunction with a discussion with your RBC Dominion Securities Inc. Investment Advisor. This will ensure that your own circumstances have been considered properly and that action is taken on the latest available information. The information contained herein has been obtained from sources believed to be reliable at the time obtained but neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers can guarantee its accuracy or complete-

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