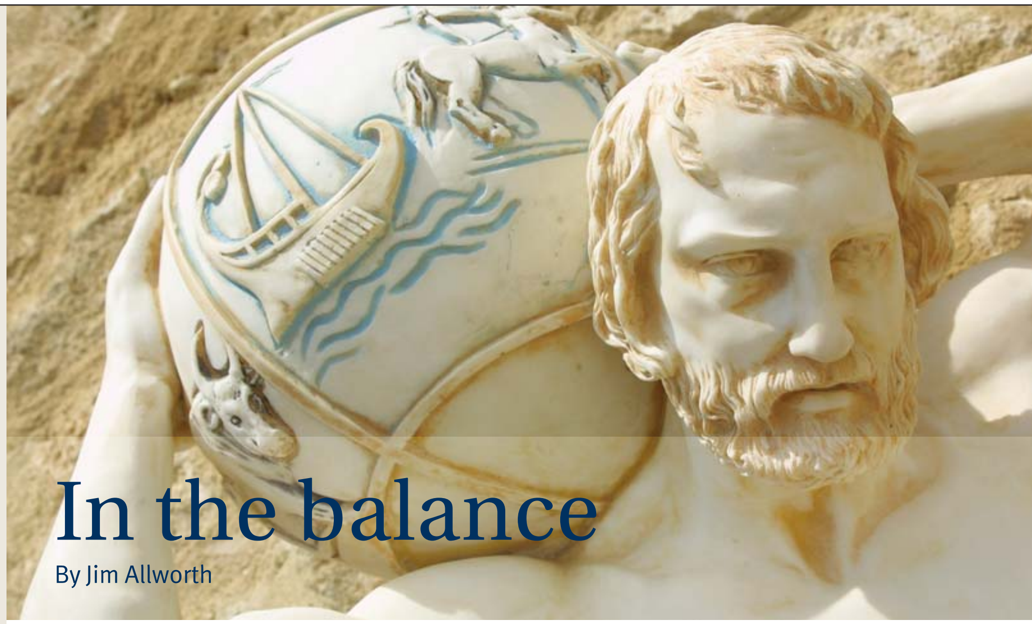
WEALTH MANAGEMENT review

A QUARTERLY PUBLICATION FOR OUR PRIVATE CLIENTS

JULY 2006

INSIDE

RBC Dominion Securities



In the balance

By Jim Allworth

The Canadian stock market generated a return of almost 10% in the first four months of this year, largely due to the spectacular performance of the basic materials and energy sectors (fully 47% of the value of the TSX Composite).

Since then, the market has given back much of that gain in a sharp and unsettling correction that has raised questions with many investors about the prospects for Canadian equities. We believe this provides a good opportunity to revisit our longer-term thesis for the stock markets.

THE YEAR AHEAD

Over the last two years, the U.S. Federal Reserve has raised short-term interest rates by 4% in an effort to cool down U.S. economic growth. Now, the Fed is finished raising rates, or is very close to doing so, and the question is whether these rate hikes will achieve the desired slowdown – or send the U.S. economy into an outright recession.

Although the answer won't be fully evident before mid-2007, if then, history strongly suggests the trajectory for both the U.S. and Canadian stock markets over the coming 12-15 months will depend very much on the outcome.

The historical experience of the past 65 years breaks neatly into two camps. When the U.S. has succumbed to recession – as it did following nine of the 16 Fed tightening cycles since the late '40s – then both the S&P 500 in the U.S. and the TSX in Canada have gone through a rocky 12 months (measured from the date of the final Fed rate increase). Typically, the averages have been down between 5% and 10% from that point, with the average stock faring worse than the broad indices.

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By contrast, looking at the seven instances when Fed tightening produced no worse than a slowdown in the rate of GDP growth, the median gain for both markets was 20%, with the average stock doing even better.

So, investors today are faced with a two-way risk particular to this moment in the monetary/economic cycle. If they run for cover but the U.S. avoids recession – as we expect it will – then they will have missed what could very well be an above-average year for stocks. But if investors choose to be excessively committed to equities and – against our expectation – the U.S. were to eventually slip into recession then such portfolios may well go through a challenging 12 months.

We think investors should position portfolios to take advantage of what we expect will be a good year for stock prices as U.S. (and Canadian) economic growth moderates toward a more sustainable long-term pace on either side of 3% per annum.

However, we also recommend that investors in the Canadian stock market factor in some added risks that pertain to this market in particular.

WHY NO U.S. RECESSION THIS TIME?

Here's what persuades us that the U.S. economy is not headed for recession:

1. The Fed's tightening policy was designed to moderate GDP growth – not crush it.

And that's what's been happening – from a 4.4% pace in 2004, to 3.8% last year, and toward an estimated 3.5% this year. We expect U.S. GDP to grow by 3% in 2007.

2. Even if the growth rate of consumer spending (two thirds of GDP) slows to 2% from today's 3.5% pace, the other one third of the economy, government spending and business capital investment, are unlikely to falter.

Those two components are growing at a combined rate of between 3% and 4%, driven by new government program spending and solid growth in corporate profits, coupled with unprecedented cash levels in corporate treasuries. The combined profile for the overall economy is one of moderating, not collapsing, growth.

3. If history is a guide, interest rates are not high enough to produce a recession.

Today the real fed funds rate (i.e., the fed funds rate minus the rate of inflation) stands at just 1%. Typically it has taken a real fed funds rate of more than 3%, usually in place for a year or more, before the U.S. economy has succumbed to recession. To get there, we think we'd need a much more aggressive Fed together with a sagging inflation rate (an unlikely combination).

WHAT WOULD CHANGE OUR MIND?

The last point above suggests what would shift our view toward the likelihood of recession – namely, if the Fed moved its target rate sharply higher, probably well beyond 6%. Such a move would require conviction on the Fed's part that Americans expect inflation to rise significantly above current levels on a sustained basis. Fed governors are worrying about this eventuality but – so far – do not see evidence it is occurring.

PUTTING IT TOGETHER

Here's what we recommend portfolio investors do to participate in the constructive equity environment we see unfolding over the coming 12 months, while acknowledging the particular challenges facing the Canadian market:

› Asset mix

For an all-Canadian portfolio we have reduced our recommended equity exposure from 55% (neutral) in a balanced portfolio to 50% (modest underweight). This still leaves a portfolio with fully half its assets committed to stocks but recognizes that Canadian shares remain aggressively valued even after correcting and in contrast to most other major stock markets. For a global portfolio, we continue to recommend a modest overweight for stocks.

› Sector exposure

Our longer-term outlook for commodities and resources, including energy, remains very positive. However, an interval of significant retrenchment within a long-term uptrend would not be unusual, especially following the speculative surge experienced by most commodities over the past several months. We recommend portfolios be modestly underweight in the energy sector – which has arguably been in a correction since the fall – and more significantly underweight in the materials sector (including metals and gold) for which the correction may have only begun. At the same time, opportunities exist to reduce risk through overweighting the more classically defensive sectors, such as financials, industrials, utilities and telecom services.

› International exposure

It may be especially timely to redeploy some portion of a Canadian equity portfolio into markets like the U.S., Japan, or the U.K., where shares are much more attractively valued. Any such realignment would mitigate to some degree the outsized exposure to the very volatile commodity and resource component that an all-Canadian portfolio inevitably features.

Please contact your Investment Advisor to discuss the suitability of these recommendations based on your specific situation. For more information about our current investment outlook, please ask for the summer issue of Portfolio Strategy Quarterly.

Jim Allworth is Vice Chair of the RBC Investment Strategy Committee.

Donating securities: new tax advantages

By Ian Fraser, MBA, CFRE

Recent tax changes can help you make the most of your charitable donations of securities such as publicly listed shares. In its May 2, 2006 budget, the federal government proposed the elimination of capital gains tax on donations of eligible securities to qualified registered charities. This change applies to donations made on or after May 2, 2006.

If you are considering how to give to charitable causes you care about, and you own securities that have appreciated significantly in value, you can benefit from this tax change.

Normally, you have to pay taxes on 50% of any capital gain when selling or otherwise disposing of assets like securities. To encourage charitable giving, the federal government reduced the capital gains inclusion rate on donations of securities to just 25% in 1997. This prompted a major increase in gifts of securities – from $69.1 million in 1997 to $200.3 million in 2000.

Building on this success, the federal government has now reduced the capital gains inclusion rate on gifts of securities to zero. When you donate appreciated securities, such as shares, directly to a charitable organization, you pay no tax on the capital gain. You receive a donation receipt for the full fair market value of your donation, entitling you to a generous tax credit.

HELPING YOU GIVE MORE

This tax break can substantially reduce the cost of your charitable donations and enable you to give more than you otherwise could. In the following example, donating shares with a fair market value of $100,000 only costs you $55,000 after the $45,000 tax credit, compared to $75,250 when you sell the shares first, then donate the proceeds.

TAKING ADVANTAGE OF THE TAX BREAK

This capital gains tax exemption applies when you donate shares directly to a qualified registered charity, or when you donate through a public foundation. However, the exemption does not apply when you donate to a private foundation or charitable remainder trust.

In these instances, the donated shares are considered sold – for tax purposes – even though you haven't actually sold them. This deemed sale results in capital gains tax at the normal 50% inclusion rate. In the example below, the tax would be $20,250, offsetting the donation tax credit you receive by nearly half.

While tax implications shouldn't be the only reason for choosing one way of giving to charity over another, it is an important factor to consider.

FOR MORE INFORMATION

Please contact your Investment Advisor to learn more about making the most of your charitable gifts.

Ian Fraser is Executive Director of the Charitable Gift Funds Canada Foundation, a registered public foundation that co-ordinates the RBC Dominion Securities Charitable Gift Program.

The tax benefit of donating shares

	Selling shares and donating cash	Donating shares before May 2, 2006	Donating shares on or after May 2, 2006
Value of donation	$100,000	$100,000	$100,000
Original cost	$10,000	$10,000	$10,000
Capital gain	$90,000	$90,000	$90,000
Taxable capital gain	$45,000	$22,500	$0
Tax on capital gain	$20,250	$10,125	$0
Donation tax credit	$45,000	$45,000	$45,000
Net tax savings	**$24,750**	**$34,875**	**$45,000**

Assumes marginal tax rate and donation tax credit of 45%. Marginal rates and donation tax credits vary between provinces.

Improving your account statements

Look for the following new features on your RBC Dominion Securities account statements over the next few months.

› FOREIGN EXCHANGE RATES

The exchange rate used to convert U.S. dollar denominated assets held in your Canadian Dollar Account will now be printed on your statement.

› DESIGNATED BENEFICIARIES

If you have designated a beneficiary for your registered account, you will see the beneficiary listed at the top right-hand corner of your statement. In the event you have more than two beneficiaries designated, you will see “Multiple” on your statement. Please note that due to regulatory reasons, this change is not applicable to Quebec-based residents.

› SPOUSAL RSP INDICATOR

If you have a spousal registered account, your statement will identify the spousal account at the top right-hand corner of the statement.

For more information about these new features, please contact your Investment Advisor.

Always prepared

At RBC Dominion Securities, we maintain disaster recovery and business continuity plans to ensure our ability to continue doing business during disruptions, while minimizing any impact to our clients. These plans are not only good business practice, they are also mandated by the Investment Dealers Association of Canada (IDA).

Our plans are designed to protect the economic well-being of our clients, as well as the resources we rely on to deliver our services: our employees, information and other assets.

In planning for potential business disruptions, we study various scenarios, such as disruptions affecting a single building, a large region or the entire country. Our plans are structured in such a way that we can resume critical operations during most types of disruptions through, for example, back-up technology systems in alternate locations. Client accounts are also safeguarded and accessible at a basic level during most disruption scenarios.

We continue to review, revise and test our recovery strategies. Since these strategies contain confidential and proprietary details, we cannot make them public. However, the IDA will begin to audit these plans, and we are making ours available to the IDA for review.

INTEREST RATES APPLIED TO ACCOUNT BALANCES*

As of June 22, 2006 our interest rates are as follows:

Credit balances	Canadian dollar accounts	US dollar accounts
Under $10,000	1.25%	2.25%
$10,000 – $24,999	1.50%	2.35%
$25,000 – $49,999	1.75%	2.85%
$50,000 – $59,999	2.25%	3.10%
$60,000 – $99,999	2.50%	3.50%
$100,000 and over	3.00%	3.75%
Debit balances	**Canadian dollar accounts**	**US dollar accounts**
Under $10,000	8.00%	10.25%
$10,000 – $24,999	7.75%	10.00%
$25,000 – $49,999	7.50%	9.75%
$50,000 – $99,999	7.25%	9.50%
$100,000 and over	7.00%	9.25%

Registered accounts

All credit balances 0.50% All debit balances 8.00%

The interest rates that will be in effect for debit balances in cash and margin accounts fluctuate with prime as follows:

Debit balances	Canadian dollar rates†	US dollar rates†
Under $10,000	$CDN Prime + 2.00%	$USD Prime + 2.25%
$10,000 – $24,999	$CDN Prime + 1.75%	$USD Prime + 2.00%
$25,000 – $49,999	$CDN Prime + 1.50%	$USD Prime + 1.75%
$50,000 – $99,999	$CDN Prime + 1.25%	$USD Prime + 1.50%
$100,000 and over	$CDN Prime + 1.00%	$USD Prime + 1.25%

†Based on prime rates as of June 22, 2006.
$CDN Prime= 6.00% and $USD Prime= 8.00%. Rates are subject to change.

*RBC Financial Group retains the right to change interest rates on a discretionary basis. A committee comprised of individuals representing various authorities within RBC Dominion Securities administers these interest rates. These rates are adjusted from time to time based on various factors, including, but not limited to, competitive analysis, Bank of Canada and other bellwether rates, and/ or cash rates. Interest amounts less than $5 are neither charged nor paid on regular accounts and interest amounts less than $1 are neither charged nor paid on special product accounts. Rate changes of less than 1% will be processed on the 22nd of the month. The average daily cash balance for the month determines the tier that will be used to establish the rate.

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