The three elephants in the room

By Jim Allworth

Looking at current market valuations through the eyes of the proverbial visitor from Mars, there is a very compelling argument for boosting equity exposure right now. Stocks are cheap – full stop.

Most markets are trading well below their long-term average price-to-earnings (P/E) multiples, and consensus earnings forecasts for the coming year are mostly higher than the earnings about to be booked for 2011. That makes the forward P/E multiples even more appetizing.

The Martian visitor would also note that interest rates are low, on the face of it making stocks tastier still. In this interest rate and inflation environment, the S&P 500 should be trading at 17x earnings, not 13x. For Canada’s TSX it should be 16.4x, not today’s 14x. Looked at another way, the S&P currently offers a 2.2% dividend yield, and the TSX, 2.9% – in a world where cash earns nothing and 10-year government bonds in both countries pay just 1.85%. The stock market’s earnings yield, a truer measure of long-term returns, is a much fatter 8%.

Of course an observant Martian would notice interest rates aren’t just low, they’re very unusually low – 100 basis points or more below the prevailing rates of inflation. Might this very unusual interest rate picture tell us why stocks are so cheap?

This all brings us to the three “elephants” in the room:

1. The U.S. economy is forecast to grow by no more than 2%

This uncomfortably slow rate may leave the U.S. flirting with outright recession all year. We believe it will avoid recession, but the possibility can’t be ignored.

Recession or no recession is important from an earnings standpoint. Even slow GDP growth would likely deliver reasonable if restrained corporate earnings growth in 2012. But Europe’s percentage contribution to S&P earnings can reach up to the high teens. Europe is already in recession (see next elephant below), so smaller profits from the Continent would mean domestic earnings growth would have to make up the difference – a lot to ask given slow GDP growth, but not out of the question.

A recession would be another matter. S&P 500 earnings typically decline 20%-25%, on average, in recessions. Since July, the market has been adjusting to the prospect of slower earnings growth. At its worst moments in August and October, it was pricing in...
just a 50% probability of recession. If a recession is in the offing, then there is more market adjustment still ahead. Note: a U.S. recession is not in our forecast.

2. Europe is already in recession
Deteriorating business and consumer confidence and an increasingly dysfunctional banking system are the culprits. A resolution of the sovereign debt crisis would probably permit positive growth, but intense government fiscal austerity over the next several years severely limits any potential beyond that.

Just as in the U.S., recession in Europe typically means earnings don’t merely slow down, they decline – often significantly. Since peaking in the spring, major Eurozone bourses have corrected by about 10% more than markets elsewhere. Most of the damage was, understandably, attributable to banks; the rest to the prospects for a mild, short-lived economic downturn.

What has not been priced in, in our judgment, is a longer, deeper downturn even though the sovereign debt/banking crisis remains unresolved, and those more negative outcomes are still very much on the table.

3. The Chinese economy’s extended period of adjustment has become more difficult

Very tight monetary conditions designed to bring down inflation and rein in an incipient property bubble are working. But the resultant credit crunch is also taking a toll among small- to medium-sized manufacturers already suffering because of falling demand from their biggest customer – Europe – and a weaker order book in the U.S. Clearly there is room for the export picture to get worse before it gets better.

While there are plenty of growth levers left for policymakers to pull, and while we forecast a soft landing for China, the slowdown has already gone on longer than most were expecting six months ago. It is producing knock-on effects throughout the rest of Asia and especially for commodity producers around the world.

China has begun to ease monetary conditions, but it will be some time before there will be enough easing in place to reverse the slowdown already under way.

The dilemma facing investors

Valuations are extremely compelling, and if our forecasts are realized (a short, mild recession in Europe, slow growth but no recession in the U.S. and a soft landing in China), then stock markets have upside potential in 2012, especially in the U.S. and China.

However, the very low interest rates and depressed valuation of bank stocks everywhere suggest a less benign outcome: an unresolved crisis produces a deeper downturn for Europe, the U.S. slips into recession, and a worsening export picture makes the Chinese slowdown deeper and longer. Clearly, earnings and markets would then have further downside.

In Canada, GDP growth tends to more or less follow the direction set by the U.S. However, the sector make-up of the S&P/TSX does not look much like this country’s GDP mix. Financials, energy and materials, especially gold, are much more heavily represented in the market than in the economy. So for the market, the path of the U.S. economy is less important than the trajectory of Chinese growth (for commodities including energy) or the resolution of the Eurozone crisis (for bank and insurance valuations).

Remain vigilant

This is not the time to put investment portfolios on autopilot. We continue to watch reliable leading indicators, which are generally consistent with our base-case forecasts for the major economies and corporate earnings.

We recommend a neutral exposure to stock markets coupled with a high level of vigilance. In 2012, probably in the first half, we expect this two-scenario dilemma will be resolved in one direction or the other, and in a way that pushes us off our neutral stance.

For a fuller look at what might be in store in 2012, ask for our special 2012 Outlook edition of Global Insight.

Jim Allworth is co-chair of the RBC Global Portfolio Advisory Committee.
Easing the burden of being an executor
By Sandy Nicolaou

At some point in your life you may be asked to be the executor\(^1\) of a friend’s or relative’s Will. While it is usually considered an honour, it can also be a complicated undertaking to settle an estate according to the deceased’s wishes – one that can seem overwhelming when you’re also grieving.

Acting as an executor means being responsible for an often lengthy, intensely detailed task list that bears with it not only the burden of ensuring a loved one’s last wishes are carried out, but legal liability as well. Your overall responsibility as an executor is to administer the estate according to the deceased’s final wishes as expressed in the Will and according to the law.

It may take about 18 months to settle even a simple estate, and the executor has to complete as many as 70 different tasks and duties. This includes finding and, if necessary, probating the Will, protecting and distributing assets, and paying outstanding debts and taxes. You will also have to prepare a final accounting for the beneficiaries of the estate.

### Five things you must know if you are an executor

1. Understand the scope of the task you are being asked to perform, and assess whether you have the time and resources to perform it, before you start acting as executor. If you determine you don’t have the time, knowledge or resources, you will not be forced to act, but you must renounce your executor duties very early on, before you get involved in the estate.

2. Keep the lines of communication open with all parties involved in the estate. A big source of frustration can be unrealistic expectations about what a beneficiary will receive, and how quickly all the necessary tasks can be completed and assets distributed.

3. Stay organized. Keep all aspects of the estate completely separate from your own documents and funds, and be meticulous with your record-keeping. You will need it later when it comes time to do things such as prepare tax returns and account to the beneficiaries of the estate.

4. Remember that you are a fiduciary, meaning that you will be held to the highest level of trust and integrity. You must always act in the best interests of the beneficiaries of the estate, and if things go wrong, you have personal liability to them.

5. Above all else, know when to seek qualified professional advice.

---

\(^1\) In Quebec, “liquidator”, in Ontario, “estate trustee with a will.”

---

Services for executors

Very few people who accept the honour of being an executor are prepared to simply walk away from it, even if they need or would prefer some assistance. If you have agreed to be an executor and are feeling overwhelmed by the duties involved, are unsure how to proceed, or simply lack the time required to carry out your duties, RBC\(^\circ\) can provide assistance and support.

RBC Estate & Trust Services has been meeting the estate needs of Canadians for more than 100 years. Estate and trust professionals are skilled in the intricacies of estate administration and can provide assistance – as much or as little as your personal situation requires. They are also sensitive to the complexities of family dynamics, and their compassion and professionalism can make estate settlement much easier on you.

Estate and Trust Professionals are employees of The Royal Trust Company or Royal Trust Corporation of Canada.
The condensed executor checklist

Here are some of the many duties an executor can expect to carry out:

**Preliminary steps**
- Locate the Will and review for specific instructions concerning the funeral. Assist with funeral arrangements, if required.
- Obtain multiple original copies of proof-of-death certificate (most organizations that you will deal with as executor require original documentation).
- Ensure the family’s immediate financial needs can be met.
- Communicate with family and beneficiaries to gather information and set expectations.

**Probate the Will (if necessary)**
- Apply for probate or instruct a solicitor to apply for probate.
- Pay probate taxes to the provincial government as determined.
- Obtain copies of Grant of Probate to deal with estate assets.

**Gather and safeguard estate assets**
- Verify that adequate insurance is in place to protect assets.
- Notify banks and institutions where the deceased held accounts or had other dealings.
- Create an inventory of estate assets and value the estate.
- Open an estate account to deposit income, pay expenses, and transfer assets and any balances.

**Administer estate**
- Close out bank and investment accounts, clear safety deposit boxes and collect insurance proceeds.
- Manage the investments considering the suitability of specific investments.
- Pay all debts and settle all legitimate claims.
- Prepare and file income tax returns (including any outstanding returns from previous years, if not yet filed). Pay all income taxes owing. Obtain tax clearance from Canada Revenue Agency.
- Keep beneficiaries up to date on estate progress.

**Distribute estate**
- Initiate sale of assets and transfer of titles.
- Pay legacies, other bequests and residue of estate, obtaining receipts from each respective beneficiary after all outstanding debts and taxes have been paid.
- Prepare a final accounting of all assets, liabilities, expenses and distribution of assets for beneficiaries.
- Have each adult beneficiary approve the accounting and sign a release.

Please contact your Investment Advisor for more information on RBC’s executor services, or to receive a copy of our executor guidebook, which includes a comprehensive checklist of duties.

Sandy Nicolaou is Vice President, RBC Estate and Trust Services.

### INTEREST RATES APPLIED TO ACCOUNT BALANCES*

As of December 22, 2011 our interest rates are as follows:

<table>
<thead>
<tr>
<th>Credit balances</th>
<th>Canadian dollar accounts</th>
<th>US dollar accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>All credit balances</td>
<td>0.10%</td>
<td>0.10%</td>
</tr>
<tr>
<td>Debit balances</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Under $10,000</td>
<td>5.00%</td>
<td>5.00%</td>
</tr>
<tr>
<td>$10,000 – $24,999</td>
<td>4.75%</td>
<td>5.25%</td>
</tr>
<tr>
<td>$25,000 – $49,999</td>
<td>4.50%</td>
<td>5.00%</td>
</tr>
<tr>
<td>$50,000 – $99,999</td>
<td>4.25%</td>
<td>4.75%</td>
</tr>
<tr>
<td>$100,000 and over</td>
<td>4.00%</td>
<td>4.50%</td>
</tr>
<tr>
<td>Registered accounts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>All credit balances</td>
<td>0.10%</td>
<td>0.10%</td>
</tr>
<tr>
<td>All debit balances</td>
<td>5.00%</td>
<td>5.50%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Debit balances</th>
<th>Canadian dollar rates†</th>
<th>US dollar rates†</th>
</tr>
</thead>
<tbody>
<tr>
<td>Under $10,000</td>
<td>CAD Prime + 2.00%</td>
<td>USD Prime + 2.25%</td>
</tr>
<tr>
<td>$10,000 – $24,999</td>
<td>CAD Prime + 1.75%</td>
<td>USD Prime + 2.00%</td>
</tr>
<tr>
<td>$25,000 – $49,999</td>
<td>CAD Prime + 1.50%</td>
<td>USD Prime + 1.75%</td>
</tr>
<tr>
<td>$50,000 – $99,999</td>
<td>CAD Prime + 1.25%</td>
<td>USD Prime + 1.50%</td>
</tr>
<tr>
<td>$100,000 and over</td>
<td>CAD Prime + 1.00%</td>
<td>USD Prime + 1.25%</td>
</tr>
</tbody>
</table>

Based on Royal Bank prime rates as of December 22, 2011. CAD Prime = 3.00% and USD Prime = 3.25%. Rates are subject to change.

† Based on Royal Bank prime rates as of December 22, 2011. The interest rates that will be in effect for debit balances in cash and margin accounts fluctuate with Royal Bank prime rate as follows:

- Under $10,000: CAD Prime + 2.00% USD Prime + 2.25%
- $10,000 – $24,999: CAD Prime + 1.75% USD Prime + 2.00%
- $25,000 – $49,999: CAD Prime + 1.50% USD Prime + 1.75%
- $50,000 – $99,999: CAD Prime + 1.25% USD Prime + 1.50%
- $100,000 and over: CAD Prime + 1.00% USD Prime + 1.25%

RBC Wealth Management

This newsletter is not intended as nor does it constitute tax or legal advice. Readers should consult their own lawyer, accountant or other professional advisor when planning to implement a strategy. 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 completeness. This report is not and under no circumstances is to be construed as an offer to sell or the solicitation of an offer to buy any securities. This report is furnished on the basis and understanding that neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers is to be held in any responsibility or liability whatsoever in respect thereof. The inventories of RBC Dominion Securities Inc. may from time to time include securities mentioned herein. Using borrowed money to finance the purchase of securities involves greater risk than a purchase using cash resources only. Should you borrow money to purchase securities, your responsibility to repay the loan as required by its terms remains the same even if the value of the securities purchased declines. RBC Dominion Securities Inc.*, Royal Trust Corporation of Canada, The Royal Trust Company and Royal Bank of Canada are separate corporate entities which are affiliated. *Member-Canadian Investor Protection Fund. RBC Dominion Securities Inc., Royal Trust Corporation of Canada and The Royal Trust Company are member companies of RBC Wealth Management, a business segment of Royal Bank of Canada. © 2011 Royal Bank of Canada. All rights reserved.