This Month’s Issue ... French Elections

France may soon elect a new president who has declared the Eurozone fiscal agreement is a “betrayal of French sovereignty and democracy.”

If Socialist candidate François Hollande is elected, and if the Parliament shifts to a left-wing majority, the region’s sovereign debt crisis could face its next challenge.

Financial markets are likely to express concern about any moves that would indicate less than full support for the fiscal compact.

— see page 6
**Global Overview**

**RBC’s Investment Stance**
When balancing the market’s catalysts (accommodative central bank policies and attractive valuations) with the lingering, persistent headwinds (below-trend growth, crude oil risks, and Eurozone uncertainties), we believe a “Neutral” stance remains justified for global equities. This translates into holding equities at a benchmark weighting in portfolios, or up to but not more than their long-term allocation. To take advantage of the modest improvement in leading indicators, we recommend adding exposure to economically sensitive sectors and trimming exposure to defensive ones.

For fixed income, we maintain an “Underweight” recommendation overall. Investment-grade corporate bonds still offer good value, and there are worthwhile opportunities in select regional sub-sectors. However, safe-haven government bonds are our least favored area.

### Global Asset Class View

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>View</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equities</td>
<td>=</td>
<td>Invested, but vigilant</td>
</tr>
<tr>
<td>Fixed Income</td>
<td>–</td>
<td>Unchanged</td>
</tr>
<tr>
<td>Cash</td>
<td>+</td>
<td>Maintain, but ready to allocate</td>
</tr>
</tbody>
</table>

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**Global Asset Class View Comment**

**Equities**
- **S&P/TSX:** 12,644 (+1.5%)
  - Equities: Neutral
  - Fixed Income: Underweight
  - Economy: Balanced, but uninspiring growth

**Fixed Income**
- **10-yr Cdn:** 1.99% (+9.8 bps)

**Cash**
- **S&P 500:** 1,365 (+4.1%)
  - Equities: Neutral
  - Fixed Income: Underweight
  - Economy: Stuck in a 2% GDP growth rut

**Equities**
- **Bovespa:** 65,811 (+4.3%)
  - 9-yr Govt: 11.33% (-11.5 bps)
  - Economy: Growth slowing toward 3%, inflation coming down

**Fixed Income**
- **FTSE 100:** 5,871 (+3.3%)
  - 10-yr Gilt: 2.15% (+17.9 bps)
  - Economy: Stuck in a 2% GDP growth rut

**Cash**
- **STOXX Europe 600:** 264 (+3.9%)
  - Equities: Underweight
  - Fixed Income: Underweight
  - Economy: Stuck in a 2% GDP growth rut

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**Equities**
- **S&P/ASX 200:** 4,298 (+0.8%)
  - 10-yr Govt: 3.98% (+25.5 bps)
  - Economy: Headed for 3% growth, capex leading the way
Financial Markets Commentary

The ECB’s massive loan program and improved economic data sparked a dramatic swing in sentiment and a strong rally in equities.

In reality, conditions on the ground for most major economies aren’t very different than they were throughout much of last year. Positive, but below-trend GDP growth seems poised to persist—unless of course crude oil spikes significantly higher.

The old Wall Street adage “Don't fight the Fed” has taken on a global twist. The Federal Reserve’s ultra-loose monetary policies, combined with aggressive actions by the European Central Bank (ECB) and Bank of England, not to mention the Bank of Japan’s surprise easing move, have elevated it to a new level: “Don't fight the major central banks.”

The original idea was born out of the observation in past cycles that equities tend to rally and government bond yields tend to decline, and then remain relatively low when the Fed implements highly accommodative monetary policies. When investors align portfolios with the Fed's strategies, they often benefit. But when they “fight the Fed,” it can be a losing proposition.

Don’t Fight the ECB

The new global take on this evolved when the ECB began flooding the region’s banking system with liquidity in December. Not only did European equities rally, but stocks across regions traded higher, including in February. Europe’s sovereign debt markets continued to stabilize last month, particularly in Italy and Spain, which had been under assault several times in 2011.

Since the ECB’s Long-Term Refinancing Operations (LTRO) began in December, it has lent the region’s banks a total of €1.02 trillion ($1.36 trillion) at a 1% rate for three years—a massive program in size and scope akin to a back-door quantitative easing strategy. RBC Capital Markets’ European fixed income strategists view this program as a success in that it should prevent a near-term banking crisis and could avert a sustained credit crunch in the region. However, it was never intended to be a one-stroke, final solution to end the sovereign debt crisis. “This can only be done via the cumbersome fiscal consolidation and structural reform process of the euro area sovereigns themselves,” our strategist wrote. Numerous hurdles remain.

Greece’s back-and-forth negotiation of its second bailout package garnered multiple front-page headlines in February but didn't move markets much. While we are encouraged a deal was finally struck—notwithstanding its considerable shortcomings—the Eurozone’s progress on many other fronts, including efforts to shore up the region’s banking system, make Greece’s fate less important to global financial markets than it was just six months ago.

Economic Improvement, but Still Below-Trend Growth

As the ECB threw everything but the kitchen sink at the financial system, the economy gained a little traction, and sentiment shifted from intensely negative to more overtly optimistic.

It’s important to put the economic data in perspective. The truth probably lies somewhere in the middle of the big October-to-February upswing in sentiment. Just as the overly negative assessment wasn’t accurate last fall, we doubt a highly optimistic viewpoint is appropriate today.
U.S. employment growth has picked up, and areas of the housing market have begun to thaw. Germany, Europe’s largest economy, and France, its second, have shown a few signs of life amid a regional downturn. Nonetheless, the recent rise in global leading economic indicators merely brought them back up to levels consistent with slow, below-trend growth. Global manufacturing activity is just barely giving expansionary readings. Most U.S. indicators are still well beneath what would normally occur during a typical recovery cycle. Further, the Eurozone economy remains vulnerable, particularly if politics were to thwart belt-tightening efforts and pro-growth reforms (see article on page 6).

**Crude Oil Threatens to Dampen Growth**

The rise in crude oil adds a new layer of uncertainty for global GDP growth in 2012. As tensions between Iran and the West have escalated, the North American crude oil benchmark (WTI) has climbed above $107 per barrel from the $95 per barrel average in 2011. The price of gasoline has risen 10% in the U.S. on a national basis and has surged 20%-30% on both coasts compared to one year ago. The European crude oil benchmark (Brent) has climbed to a new all-time high in euro and sterling terms. If prices remain elevated near current levels for a prolonged period, we believe the U.S. and global economies could absorb the hit, although growth would likely slow further. However, if tensions escalate and crude oil and gasoline were to spike, it could prompt a renewed debate about U.S. recession risks, deepen the European contraction, and constrain China’s (and Asia’s) energy-intensive economy.

In recent years, crude oil prices have not remained above US$100 per barrel for a prolonged period. This year, OPEC spare capacity should increase as flows from Libya return to the market and Iraq adds capacity. But neither of these developments would completely offset disruptions caused by a significant loss of Iranian production were that to materialize. (See our January article titled, *Oil Market Outlook*, for a deeper analysis of crude oil supply and demand dynamics.)

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### Market Scorecard

**Index (local currency)**

<table>
<thead>
<tr>
<th>Index (local currency)</th>
<th>Level</th>
<th>1 Month</th>
<th>YTD</th>
<th>12 Month</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>1,365.68</td>
<td>4.1%</td>
<td>8.6%</td>
<td>2.9%</td>
</tr>
<tr>
<td>S&amp;P/TSX Comp</td>
<td>12,644.01</td>
<td>1.5%</td>
<td>5.8%</td>
<td>-10.6%</td>
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<tr>
<td>FTSE 100</td>
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<td>Hang Seng</td>
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<td>Dow (DJIA)</td>
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<td>NASDAQ</td>
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<td>Russell 2000</td>
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<td>STOXX Europe 600</td>
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<td>German DAX</td>
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<td>Nikkei 225</td>
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<td>10.5%</td>
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<td>Straits Times</td>
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<td>Brazil Bovespa</td>
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**Commodities (USD)**

<table>
<thead>
<tr>
<th>Commodities (USD)</th>
<th>Price</th>
<th>1 Month</th>
<th>YTD</th>
<th>12 Month</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gold (spot $/oz)</td>
<td>1,696.85</td>
<td>-2.3%</td>
<td>8.5%</td>
<td>20.2%</td>
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<tr>
<td>Silver (spot $/oz)</td>
<td>34.68</td>
<td>4.5%</td>
<td>24.6%</td>
<td>2.3%</td>
</tr>
<tr>
<td>Copper ($/ton)</td>
<td>8,493.00</td>
<td>2.3%</td>
<td>11.9%</td>
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<td>Uranium ($/lb)</td>
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<td>Oil (WTI spot/bbl)</td>
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<td>8.7%</td>
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<td>Oil (Brent spot/bbl)</td>
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<td>12.2%</td>
<td>15.2%</td>
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<td>Natural Gas ($/mlnBtu)</td>
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<td>2.7%</td>
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**Bond Yields**

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<tr>
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<th>1/30/12</th>
<th>2/28/11</th>
<th>12 Mo Chg</th>
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<tbody>
<tr>
<td>US 2-Yr Tsy</td>
<td>0.293%</td>
<td>0.215%</td>
<td>0.680%</td>
<td>-0.39%</td>
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<tr>
<td>US 10-Yr Tsy</td>
<td>1.971%</td>
<td>1.797%</td>
<td>3.427%</td>
<td>-1.46%</td>
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<tr>
<td>Canada 2-Yr</td>
<td>1.097%</td>
<td>0.955%</td>
<td>1.844%</td>
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<tr>
<td>Canada 10-Yr</td>
<td>1.987%</td>
<td>1.889%</td>
<td>3.299%</td>
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<tr>
<td>UK 2-Yr</td>
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<td>0.357%</td>
<td>1.397%</td>
<td>-0.98%</td>
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<tr>
<td>UK 10-Yr</td>
<td>2.149%</td>
<td>1.970%</td>
<td>3.602%</td>
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<td>Germany 2-Yr</td>
<td>0.191%</td>
<td>0.158%</td>
<td>1.517%</td>
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<td>Germany 10-Yr</td>
<td>1.818%</td>
<td>1.787%</td>
<td>3.170%</td>
<td>-1.35%</td>
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**Currencies**

<table>
<thead>
<tr>
<th>Currencies</th>
<th>Rate</th>
<th>1 Month</th>
<th>YTD</th>
<th>12 Month</th>
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</thead>
<tbody>
<tr>
<td>US Dollar Index</td>
<td>78.74</td>
<td>-0.7%</td>
<td>-1.8%</td>
<td>2.4%</td>
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<tr>
<td>CAD/USD</td>
<td>1.01</td>
<td>1.3%</td>
<td>3.2%</td>
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<tr>
<td>USD/CAD</td>
<td>0.99</td>
<td>-1.3%</td>
<td>-3.1%</td>
<td>1.9%</td>
</tr>
<tr>
<td>EUR/USD</td>
<td>1.33</td>
<td>1.8%</td>
<td>2.8%</td>
<td>-3.5%</td>
</tr>
<tr>
<td>GBP/USD</td>
<td>1.59</td>
<td>1.0%</td>
<td>2.4%</td>
<td>-2.1%</td>
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<tr>
<td>AUD/USD</td>
<td>1.07</td>
<td>1.0%</td>
<td>5.1%</td>
<td>5.4%</td>
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<td>USD/CHF</td>
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<td>USD/JPY</td>
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<td>EUR/JPY</td>
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<td>EUR/GBP</td>
<td>0.84</td>
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<td>USD/SGD</td>
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<td>-3.5%</td>
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<td>USD/CNY</td>
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<td>USD/BRL</td>
<td>1.72</td>
<td>-1.7%</td>
<td>-8.0%</td>
<td>3.2%</td>
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</table>


Examples of how to interpret currency data: CAD/USD 1.01 means 1 Canadian dollar will buy 1.01 U.S. dollar. CAD/USD -1.9% return means the Canadian dollar has fallen 1.9% vs. the U.S. dollar during the past 12 months. USD/JPY 81.15 means 1 U.S. dollar will buy 81.15 yen. USD/JPY -0.8% return means the U.S. dollar has fallen 0.8% vs. the yen during the past 12 months.
French Elections: The Eurozone’s Next Challenge?

 › Upcoming elections in France appear likely to produce a new President and left-leaning Parliament. This potential change of power is important for France and also for the Eurozone within which it is the second-largest economy after Germany.

 › François Hollande, leader of the Socialist Party and possibly the next President of France, ominously has stated that the Eurozone fiscal compact is a “betrayal of French sovereignty and democracy.” He publicly said he would like to renegotiate the agreement.

 › If he follows through, this would present the very real possibility the sovereign debt crisis will “blow hot” again in the relatively near future, ushering in another episode of global financial market volatility.

 Possible Sweeping Change in France’s Political Landscape

 French voters will go to the polls to elect a president on April 22nd and again on May 6th if a run-off is necessary. Later in June it will choose the 577 Deputies of the National Assembly, also in two rounds, June 10th and 17th. For some months voter intention surveys have indicated a major shift to the left is likely. With the socialists already in control of the Senate, French power may well be completely in left-wing hands by summer.

 Socialist party candidate Mr. François Hollande is a favourite to beat Mr. Nicolas Sarkozy, the incumbent. For months, polls have given the former a constant lead of up to six percentage points in the first ballot. Recently that has narrowed, with the two running neck and neck in the first round. However, according to current polls, in a two-candidate, head-to-head run off on May 6th, Mr. Hollande’s margin of victory would be an overwhelming 56% to 45%.

 In addition to the high-profile Presidential elections, France also holds general elections for its National Assembly. The lower house and the Senate make up the Parliament. Votes in the National Assembly take precedence over those in the Senate. While members of the National Assembly are elected directly by the people, members of the Senate are elected by the representatives of local authorities.

 In the past two elections (2002 and 2007), voters have gone on to give the recently elected president a majority in Parliament, avoiding a situation where the President is confronted by an opposition National Assembly.

 If history repeats itself, a possible Hollande victory may well be sustained by the subsequent election of a left-wing majority in the National Assembly. Given the Senate went through a similar shift last year, François Hollande would preside with not only a left wing National Assembly, but also a leftist Senate, a sweeping change in the parliamentary power line-up.

 What Could Upset this Scenario?

 Marine Le Pen, the extreme-right Front National leader, currently garners 17% of the voting intentions and, thus, is not an insignificant player. To be sure, voting intentions could be understated because there is still a stigma attached to declaring oneself a supporter of the Front National despite the fact that Mrs. Le Pen has disavowed and forced out an anti-Semitic fringe from her party. Mrs. Le Pen harbours nationalistic sentiments and campaigns in favour of a euro exit.
Alternatively, Mr Sarkozy could make an unexpected come back in the run-off polls, as he did in the first ballot surveys. Having decided to launch his campaign less than 70 days before the first ballot, he still has to deploy the full strength of his electoral machine. But with a disapproval rating of 68%, he would be the first president in the Fifth Republic to be that unpopular and re-elected.

Finally, Mr. Hollande, as President, could fail to achieve an absolute left-wing majority in the National Assembly. In this case, he would have to join forces with centre Members of Parliament to form a majority.

At the present time, the polls still favour an outcome that would see Mr. Hollande defeat Mr. Sarkozy in the run off on May 6th and preside with a leftist Parliament.

What Would President François Hollande Do?
Despite the prospect of a left-wing victory, Mr. Hollande is not presenting a traditionally left-wing platform. Early this year, he committed to reduce the budget deficit to 3% of GDP by 2013, in line with the current government's target, and to eliminate the deficit by 2017, only a year later than Mr. Sarkozy's pledge. This would be no small achievement given the country has not balanced its books in over 35 years.

Hollande has made a number of promises that play to his audience, including the proposed hiring of some 60,000 new teachers, banker bashing, and the reversal of Mr. Sarkozy's pension-age reform to take it back to 60 from 62. He remains quite vague about his economic model. As a former party boss who has never held a ministerial position, a track record is clearly lacking.

Higher Taxes Are in the Offing
Higher taxes seem certain. This is preferred by both presidential candidates as the way to finance their respective programmes. Mr. Hollande favours taxes on salaries, wealth, businesses, banks, and financial income. Mr. Sarkozy suggests raising the VAT rate to 21.2% from 19.6%. Markets and rating agencies have found this disappointing because an exclusive focus on raising taxes suggests an unwillingness to tackle the inefficiencies of the French state. Raising taxes forever does not appear a viable long-term solution for an already heavily taxed economy.

France Needs to Grow
Clearly the French economy would be helped by more growth. But this is a very tall order. Despite running an uninterrupted string of deficits for more than thirty years—presumably designed to stimulate the economy—French GDP growth has averaged just 1.8% per annum since 1987. Germany did no better over the same interval but did manage a very costly re-unification along the way. Both trailed the U.K. at 2.3% per annum and the U.S. at 2.6%.

Over the same time span, France's balance of payments and trade accounts both went from positive into negative territory, while competitiveness eroded and export growth lagged behind its peers. It seems unlikely contemplated tax increases will set any of these on a more positive trajectory.

The Opportunity of a New Mandate
One key issue for France will be whether the new President tackles the labour market. Mr. Sarkozy has suggested emulating some German labour reforms, but what he has suggested so far have been rather timid measures—mostly some lowering of the “social charges” paid by employers. He has stopped short of calling for any alteration of the 35-hour work week.

One would hope, given the precedent being established by both Spain and Italy, two heavily indebted countries that are both implementing wide-ranging labour reforms, that this might give the French President some “cover” to go down the
same path. However, it is clear any move in this direction would produce a strong response from an electorate accustomed to the traditions of a high-spending state.

What exactly François Hollande would do if he were to be elected remains far from clear. Former President François Mitterand—initially voted in as a Socialist—moved decidedly more to the centre two years after being elected when the government was forced to adopt tough policies to combat inflation and allow France to remain competitive within the European Monetary System. This precedent, still fresh in the minds of the French, might give Mr. Hollande the opportunity to pursue a more pragmatic, less doctrinaire, path.

**What About Hollande and the Debt Crisis?**

Mr. Hollande has made it clear he believes the Eurozone fiscal compact, agreed to last year, as it stands is not in the best interests of France or the Eurozone and he will seek to renegotiate. What’s more, the directions he wishes to take—closer fiscal union, more pro-growth fiscal policies, more proactive support and participation by the European Central Bank, and the issuance of Eurozone bonds backed by all member governments—are all decidedly not favoured, or even contemplated, by Germany, the Netherlands, or some others.

These directions, however, are in line with where Italy’s new Prime Minister, Mario Monti, would like to see policy head and presumably Spain as well, not to mention several other highly stressed “ peripherals.” But however much the new French president will be able to speak for France, he (she) will not be able to speak for the Eurozone. France may argue for reopening negotiations, but it can’t force unwilling partners to agree. It’s important to remember German Chancellor Angela Merkel (and others) faces her own elections early next year.

**How Would Markets React?**

President Nicholas Sarkozy and Chancellor Merkel, while often disagreeing profoundly, worked to resolve those differences in private, consistently presenting a united front in public. They have used their very considerable combined authority to lead the efforts to resolve the region’s sovereign debt crisis. Mr. Hollande has no established working relationship with the Chancellor, and given his intentions toward the fiscal compact, his election is likely to usher in a period of renewed market skepticism and concern.

We do not expect any precipitate action on the part of the new government once it is in place. France has a lot to lose in any renewed upswelling in the crisis. French banks and institutions are thought to be among the largest external holders of Italian government debt and also have material exposure to Spanish debt. Any resurgence in the crisis would likely see those two countries’ bonds come under considerable pressure once again—both are facing very large refundings over the course of the year.

French bonds, too, as they did last October/November, would likely suffer painful collateral damage as might the country’s credit rating.

Global equities, it goes without saying, would not escape unscathed, in our opinion.

Of course, with the elections behind, Mr. Hollande, like many before him, would be confronted by the realities and limitations of power. The platform promise to rewrite the compact is likely to turn into an effort to amend and improve it rather than an outright repudiation.

Markets are likely to express concern about any move that would indicate less than full support for the fiscal compact and any perceived fracturing of German/French solidarity. However, there would be a very big difference in intensity between the reaction on the one hand to a French refusal to play ball and on the other to a pragmatic effort to strengthen the Eurozone’s response to what is still an unresolved crisis.
Global Equities

Markets Need Time to Digest Recent Gains

Stock markets gained ground in February, climbing higher on the strength of some modest recovery/stabilization of global leading economic indicators. This persuaded investors a U.S. or global downturn was less likely than had been feared, even as a Eurozone recession seemed certain.

Also important, especially for markets with heavy commodity exposure, was the decision by the Peoples’ Bank of China to lower bank reserve requirements for the second time in three months. This was taken as a sign more easing measures would follow and the economy would avoid a hard landing.

The Greek debt deal and the extension of the payroll tax cut and unemployment benefits in the U.S. were expected and would have affected markets only if they hadn’t happened.

On the negative side of the ledger, Q4 GDP in the Eurozone and U.K. contracted quarter-on-quarter. Real disposable income barely grew in the U.S. In recent weeks, a number of central banks have lowered their growth forecasts for 2012.

This same downward adjustment of already modest growth expectations is also playing out on the earnings front. For example, last summer the consensus estimate for this quarter’s S&P 500 Index earnings peaked at $26.50 per share. It has fallen steadily and today is down to $23.90 with no sign it has reached bottom. Full-year 2012 earnings estimates peaked in 2011 at around $113 and have since fallen to less than $105 per share (our own estimate sits at $101). Europe has understandably witnessed an even deeper retrenchment of earnings expectations.

Now, most markets look less attractive on a valuation basis than they did a few months ago when stock prices were lower and estimated forward earnings were higher. At the same time, economic surprise indexes and investor sentiment surveys are registering a high level of optimism.

Investor optimism in the face of below-potential economic growth and the earnings challenges noted above suggest to us stock markets may need to spend some time digesting the gains they have already posted this year. Although over the Greek debt hurdle for now, forthcoming elections in France (see page 6) and Greece, together with very large debt refundings looming for Italy and Spain among others, could bring Eurozone issues back to the front burner in the near future.

Our stance has not changed: we recommend a “Neutral” exposure to stocks—that is, portfolios should contain up to but not more than their long-term target allocation to equities.

<table>
<thead>
<tr>
<th>Global Asset Class View</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset Class</td>
</tr>
<tr>
<td>Equities</td>
</tr>
<tr>
<td>Fixed Income</td>
</tr>
<tr>
<td>Cash</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Region</th>
<th>Weighting</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>Neutral</td>
</tr>
<tr>
<td>Canada</td>
<td>Neutral</td>
</tr>
<tr>
<td>Continental Europe</td>
<td>Underweight</td>
</tr>
<tr>
<td>U.K.</td>
<td>Neutral</td>
</tr>
<tr>
<td>Asia (ex Japan)</td>
<td>Neutral</td>
</tr>
<tr>
<td>Japan</td>
<td>Overweight</td>
</tr>
</tbody>
</table>
We maintain a “Neutral” recommendation (benchmark allocation) for U.S. equities. Even though economic momentum is subdued, attractive valuations and accommodative central bank policies are catalysts for 2012.

Because leading indicators have risen from the danger zone, we would add exposure to economically sensitive sectors at the expense of defensive ones.

**Market Developments**
The large-capitalization S&P 500 delivered its strongest February performance in 14 years (+4.1%). Small-cap stocks have outperformed since the October 3 low (Russell 2000 +33% vs. S&P 500 +24%). Mid-cap stocks have also surged (S&P 400 +31%). While we favor large-cap stocks for long-term holdings due to their valuation advantage and lower volatility, we doubt small- and mid-caps have peaked. At roughly 15x forward earnings estimates, the Russell 2000’s valuation is slightly below its long-term average. If it were to drift up to 17x-18x, where it has run into trouble during this cycle, we would trim positions.

Eurozone stabilization has caused volatility to decline sharply. So far this year, the S&P 500 has moved up or down 1% or more in only four sessions. In 2011, the index moved by that magnitude 46% of the time.

S&P 500 earnings appear to have risen 9.2% year over year during Q4, and profit margins remained high. However, momentum slowed. Year-over-year revenue growth slipped to 6.9% from 10.6% the previous quarter. The positive-to-negative earnings surprise ratio dropped to 2.8, below the 3.5 long-term average. Moreover, analysts continue to trim their forward earnings estimates (see chart).

**Portfolio Recommendations**
- To better align portfolios with the modest improvement in leading indicators, increase exposure to economically sensitive sectors: Financials, Industrials, and Technology.
- We upgraded Financials to “Overweight” in mid-February, the first time RBC Capital Markets has granted the sector this rating since December 2009. The ECB’s actions have significantly decreased contagion risks for U.S. banks. If employment continues to improve, lending activity should increase over time and ultimately translate into stronger organic earnings growth.
- In addition to favoring dividend-growth companies in “Overweight” sectors, we still like dividend payers/growers in Health Care, Energy (including Master Limited Partnerships), and Real Estate Investment Trusts.
- Decrease exposure to Consumer Staples (downgraded to “Neutral”). Valuations are quite stretched compared to the S&P 500.

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**S&P 500 Index vs. Earnings Revisions**

Source: RBC Dominion Securities Quantitative Research; data through 2/29/12
Equities: Canada

Neutral (=)

We maintain a “Neutral” recommendation (benchmark allocation) for Canadian equities. Attractive valuations and accommodative central bank policies could be catalysts for worthwhile returns in 2012.

Heavy exposure to Financials (~30% of market weight) as well as Energy and Commodities (~50%) gives the Canadian stock market exaggerated exposure to the three factors of most concern to investors: sub-par growth in the U.S., the ongoing slowdown in China, and the European debt crisis.

All three are capable of improving over the coming 6-to-12 months, but any one of them, particularly Europe, could deteriorate in a way that would have an out-sized negative affect on the S&P/TSX.

Market Developments

The Canadian broad average is up nearly 6% for the year. While a marked improvement over the prior 10 months—when it fell more than 15%—the S&P/TSX continues to lag most other global indices.

The heavyweight Energy sector has strengthened along with the Iran-induced oil price surge but not as much as it would have were it not for the very weak outlook for natural gas.

Financial stocks have gone nowhere as Europe has blown hot and cold. Canadian banks have limited direct exposure to Southern Europe; however, concerns Europe could ignite another broader global banking crisis weighs heavily on Financial sector valuations from time to time.

Metal stocks, including gold issues, after a dismal last four months of 2011 (down more than 20%) have rallied this year on the strength of the first signs of monetary policy easing in China. While we think there is more policy easing to come, we expect the reacceleration of Chinese economic activity that will produce sustainably higher commodity prices is still some way off.

Portfolio Recommendations

- We have become less constructive on gold stocks, because the sharp rise in oil prices is likely to begin to eat into operating margins.
- We have increased our recommended weighting in Industrials to “Overweight” from “Underweight” to reflect a somewhat more positive North American macro-economic backdrop. Canadian industrials have significant exposure to mining and energy, where capex levels are expected to remain relatively high.
- While we continue to advocate a focus on dividend payers and growers, we note yield-hungry investors have bid up many high-quality issues to levels that are no longer attractive. We are “Underweight” Utilities.

<table>
<thead>
<tr>
<th>Sector View</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Consumer Staples</td>
<td>+</td>
</tr>
<tr>
<td>Financials</td>
<td>+</td>
</tr>
<tr>
<td>Industrials</td>
<td>+</td>
</tr>
<tr>
<td>Telecommunication Services</td>
<td>+</td>
</tr>
<tr>
<td>Consumer Discretionary</td>
<td>=</td>
</tr>
<tr>
<td>Health Care</td>
<td>=</td>
</tr>
<tr>
<td>Materials</td>
<td>=</td>
</tr>
<tr>
<td>Energy</td>
<td>-</td>
</tr>
<tr>
<td>Information Technology</td>
<td>-</td>
</tr>
<tr>
<td>Utilities</td>
<td>-</td>
</tr>
</tbody>
</table>

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Equities: Continental Europe

Underweight (-)

- Supported by synchronised liquidity from central banks and anticipation of the second €500bn Long Term Refinancing Operation (LTRO), European equities continued to rally in February.
- The signing of the elusive second Greek bail out and signs of resilience in economic momentum in the Eurozone were also supportive.
- Despite improving fundamentals and modest valuation levels, asymmetric risk remains. We remain “Underweight.”

Market Developments

Undeterred by news of protests in Greece and higher oil prices, markets advanced for most of the month. Cyclicals, banks, and autos in particular, rallied most.

Economic data pointed to a stabilisation of the Eurozone. Real GDP fell by 0.3% from Q3 to Q4, a better result than many had feared. German GDP fell by 0.2%, Italian GDP by 0.7%, more than double the pace of Spain (-0.3%), but less than the steep decline seen in Portugal (-1.3%). French GDP bucked the trend, up a welcome 0.2%.

Spanish labour reforms were announced by the new government. Aimed at improving the flexibility of the labour force, these reforms might result in yet more social unrest and possibly still higher unemployment. They do, however, set the stage in the medium to long term for an economic recovery.

Corporate earnings reports for Q4 have been underwhelming. With some 40% of companies reporting, 42% beat, and 14% hit the consensus forecast, while 44% missed, making this (so far) the worst earnings season in three years.

The elusive Greek bail-out package worth €130bn was finally agreed upon. With an initial 53.5% haircut on €200bn of private market debt, the terms of the deal aim to get debt/GDP to 120% by 2020. Despite the bailout, better macro-economic data than hoped for, and a system flush with liquidity, we remain “Underweight” the region. The Greek deal clearly lowers the probability of an immediate default, but substantial hurdles remain: Greek elections in April, relentless supervision by the Troika (EU, IMF, and ECB), and large refunding in May and August. Even if Greece navigates these successfully, a debt-to-GDP ratio of some 120% is probably not sustainable.

Granted Europe is now better prepared for any Greek default down the road, but effects of such an event can’t be quantified. Who owns credit default swap derivatives and how many is not known, so the potential chain reactions can’t be predicted.

Upcoming French elections (see article on page 6) will refocus investor attention on the solidarity (or lack of it) among the stronger Eurozone nations and may raise the prospect that prior agreements could come undone.

We prefer to remain “Underweight.”

Portfolio Recommendations

- We recommend confining exposure to resilient European companies with a sustainable market position, global sales, exposure to growing regions or industries, and that are protected by high barriers to entry. A strong balance sheet is an absolute prerequisite.
Equities: United Kingdom

Neutral (=)

Economic data releases were refreshingly encouraging over the month, leading many to believe a technical recession may be averted.

Markets rose, supported by synchronised central bank action.

We recommend a “Neutral” exposure to U.K. equities.

Market Developments
Thanks to synchronised policy action from central banks, U.K. equity markets continued to rally. Once again, FTSE 100 gains were dwarfed by those of the smaller-cap-heavy FTSE 250. Greater risk appetite was evident in sector performance, with Industrials, Support Services, and Financials leading, while Health Care and Telecoms lagged.

Economic data releases were encouraging. Manufacturing and services PMIs surprised early in the month, pointing to upside risk to the 0.1% Q1 GDP growth forecast. In addition, the first read on the Q4 GDP expenditure breakdown suggested consumption had returned to growth, having fallen for the previous five quarters. Furthermore, despite fears of a European slowdown, net trade seems to have made a strong contribution to growth. The data gives substance to the idea that a technical recession, much talked about at the end of last year, may well be avoided.

Public finance numbers have also come in slightly better than expected. Public sector net borrowing, excluding financial interventions, recorded a surplus of £7.8bn versus the £6.3bn expected. So far this fiscal year the government has borrowed £93.4bn, or 73.6% of the revised full-year forecast of £127bn. In the absence of negative shocks in February and March, borrowing at the end of 2011-12 should come in at the original £122bn forecast presented last March.

U.K. consumer inflation slowed from 4.2% y/y in December to 3.6% y/y in January, in line with expectations and partly reflecting the fading of the January 2011 VAT hike effects. Looking ahead, RBC Capital Markets expects that downtrend to continue over the next few months as inflation heads back towards the Bank of England’s 2% target.

News in the labour market was not as heartening. The unemployment rate was in line at 8.4% in Q4. However, full-time employment continued to fall, albeit at a slower pace.

The quantitative easing (QE) programme was extended by £50bn, as expected. Given the current outlook, RBC Capital Markets believes the Monetary Policy Committee is likely to stop its QE programme after this round of purchases is completed by the end of April.

Portfolio Recommendations
- We continue to favour companies with relatively high exposure to North American customers and relatively low exposure to European ones. In addition, we look for companies with solid market positions, high barriers to entry and exposure to growing regions or industries, and a strong balance sheet.
Asian equities began 2012 strongly following particular weakness in the second half of 2011. However, most regional economic data points to below-trend growth. Surging energy prices are becoming challenging. The largest Asian economies rely on oil imports. We maintain our “Neutral” stance on equities in Asia ex-Japan and our “Overweight” stance on Japan.

While the slowdown in the Chinese economy is currently unfolding in a controlled manner, it remains unclear when the rate of growth will stabilize. However, our base case still calls for a soft landing. We forecast 2012 Chinese GDP growth of 8.3%, moderate appreciation in the Chinese currency, and the benchmark lending rate to remain unchanged at 6.56%.

Monetary policy has remained tight in China. A multitude of measures to control property prices remain firmly in place. The month-over-month decline in property prices, which began late in 2011, has continued into 2012. Investors remain concerned with how a slowdown in property prices would affect local government revenues and, in turn, the ability for local governments to repay large accumulated debts. That noted, the debt burden of China’s central government relative to the size of the economy remains low by international standards.

Equity valuations are low. Equity performance over a 12-month time horizon has historically been favourable at these valuation levels when central banks have started easing.

Market Developments
Asian equity indices rallied in February as the threat of an imminent European credit crunch receded. Central banks in the region are no longer tightening. They are either on hold, as in Australia, New Zealand, South Korea, and China, or loosening policy, as in Indonesia and Thailand. Many central bank statements have referenced the weak global growth environment as an impediment to domestic growth, although the tone of statements has improved recently.

China
Chinese economic data is pointing to a soft landing for the economy. However, while the rate of the slowdown has been even and controlled, there is yet no indication when it will end. Economic leading indicators are providing mixed messages.

China’s central bank, the People’s Bank of China, reduced the required reserve ratio (RRR) for the country’s biggest banks by another 50 basis points. The move helps to ease particularly tight credit conditions, enabling banks to lend an additional USD$60 billion equivalent. However, at 20.5%, the RRR remains close to historic highs, with no sign of any imminent cut in Chinese interest rates. We forecast continued, moderate easing in the RRR in the first half of this year with the Chinese benchmark lending rate remaining unchanged at 6.56%.

Chinese house prices continue to fall. In the government’s most recent survey of property prices across China, prices were either lower or the same in all 70 cities. This was the first time prices had...
failed to rise in any of the surveyed cities during this tightening cycle. It is likely the downturn in Chinese property will continue throughout 2012 and remain a source of concern for investors.

**ASEAN Region & Australia**

The Asian Dollar Index, composed of 10 regional currencies, rose by 0.6% in February following a 1.7% increase in January. The Thai baht rallied 2.2%, the Malaysian ringgit rose 1.8%, and the Singapore dollar rose 1.1%. The Indonesian rupiah was slightly weaker during the month.

The decision by the Reserve Bank of Australia (RBA) to keep its benchmark interest rate unchanged at 4.25% surprised investors who had been expecting a rate cut. The RBA noted global economic conditions had improved on balance while the country’s inflation was within the target range. While it is unlikely rate cuts will occur in the short term, we do forecast 50 basis points of easing to 3.75% by the end of 2012. We forecast 2012 GDP to grow by 3.4%.

Australian Prime Minister Julia Gillard comfortably won a leadership ballot against former Prime Minister Kevin Rudd. Mr. Rudd resigned his position as Foreign Minister in the ruling Labour Party to fight for the leadership.

**Japan**

The Bank of Japan (BoJ) increased the size of its asset purchase program by the equivalent of approximately USD$125 billion and will purchase long-term Japanese government bonds. At the same time as short-term interest rates in the U.S. rose, investors were also left to consider if Japan’s 2011 trade deficit would be a one-time event. The Japanese yen weakened to over USD/JPY 80. Even so, we remain bullish on the yen. The BoJ forecasts 2% GDP growth for fiscal-year 2012, which begins in April.

**Portfolio Recommendations**

- **General:** We have an “Overweight” benchmark weighting on Japan. We have a “Neutral” benchmark weighting on Asia (excluding Japan). However, we are cognizant that regional economic leading indicators may be bottoming. There could be an opportunity to consider an “Overweight” position later in the first half of the year if the stabilization in the regional economy is confirmed.

- **Countries:** We prefer Japan—lowest valuation in Asia, trading at 1.0x book value; Indonesia—strong domestic consumption theme and oil exporter; Australia—high dividend yield. Chinese equities may be inexpensive at these levels, but we await confirmation that the country’s economic momentum is bottoming.

- **Sectors:** We prefer defensive, non-cyclical sectors but would selectively add to cyclical stocks in portfolios as the economic data stabilizes.

- **Style:** We prefer large-capitalization names, supportive dividends.
Global Fixed Income

High-Grade Corporates Still Worthwhile

Despite some improvement in leading indicators, a Greek debt deal, acknowledgement the ECB’s LTRO program was a success, two bank reserve cuts in China, an extension of tax cuts and unemployment benefits in the U.S., and enough (marginally) better-than-expected economic data to push the economic surprise index up to unsustainably high levels—in other words, all the things that have sent equity investors into a tizzy and stock indexes 5%-10% higher—despite all these, high-grade government 10-year yields have barely budged. German, American, and Canadian 10-year yields are all sitting near 2%, well below current inflation rates. The “safe haven” trade is still on.

Even accepting the negative gap against inflation rates could conceivably get filled in of its own accord, i.e., by inflation rates continuing to fall, it seems clear the Eurozone crisis remains at front of mind for fixed income investors.

And no wonder. Forthcoming elections in France (see page 6) and Greece and a referendum in Ireland may put to the test the commitment of Eurozone members to agreements already signed. Also, the fact the region looks to be headed for (or already in) recession is very likely to complicate and draw out the crisis.

While it is not quite the “hot button” item it was last fall, the Fed has not ruled out the deployment of QE3 if U.S. growth falters and in any event has pushed out any beginnings of “rate normalization” to 2014. The Bank of England and the Bank of Japan have both enlarged existing QE programs. The prospect of collecting only very low yields, knowing that at any time and without warning an improvement in the European crisis could push bond rates back up to or above the inflation rate, makes it hard to recommend any new commitment to high-grade sovereign bonds, including Treasuries.

High-grade corporates continue to offer better value, particularly because the improvement to the economic backdrop that would permit government yields to move back above the rate of inflation would also argue for a narrowing of the yield advantage still available.

Buoyed by low default rates and spreads above historical averages, the high-yield sector is worth looking at for those who can accept the substantially higher risks. However, a pick-up in default rates due to a downturn in the U.S. economy would reduce the attractiveness of this asset class.

Global Asset Class View

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>View</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equities</td>
<td>=</td>
<td>Invested, but vigilant</td>
</tr>
<tr>
<td>Fixed Income</td>
<td>–</td>
<td>Unchanged</td>
</tr>
<tr>
<td>Cash</td>
<td>+</td>
<td>Maintain, but ready to allocate</td>
</tr>
</tbody>
</table>
Fixed Income: Canada

Canadas
- Government bond yields moved higher in February on signs of continued progress in addressing Europe's debt problems.
- Bank of Canada Governor Mark Carney reiterated the current policy interest rate of 1% is consistent with inflation returning to its 2% target. Future interest rate hikes are forecasted well into 2013.
- Barring a return of recessionary economic data, yields on government bonds could rise over the course of the year.

U.S. Treasuries
- In February, strength in U.S. economic numbers and slow progress in the Eurozone sent yields to their highest levels in three months.
- The Federal Reserve's commitment to its monetary policy stance and ongoing purchases of long-dated securities is supportive of a “lower-for-longer” rate environment and a flatter yield curve.
- Even with the up-tick in Treasury yields, with current rates of inflation and low rate environment, we still see better opportunities in credit-sensitive sectors.

Provincials & Agencies
- Both provincial and agency bonds outperformed federal government bonds in February, yet all sectors saw negative total returns on the month.
- New issuance was robust in February with Canada's provinces taking advantage of the absolute low interest-rate environment.
- For conservative investors looking to maximize return, we favour provincial bonds for government bond exposure due to their relatively higher yields and strong credit ratings.

Corporates
- Investment-grade credit spreads were moderately tighter in February, yet asset-class returns were positive despite the rise in government bond yields.
- Corporate refinancing and deleveraging efforts will continue to minimize default risk and cause spreads to tighten further.
- We believe corporate bonds will outperform government bonds on a relative basis, but investors need to be selective. Some sectors offer better value, and it is important not to overweight one sector (i.e., Financials) in search of yield.
- High-yield bonds have performed well this year; high-yield spreads are back to long-term averages.
- Valuations remain attractive on a spread basis and default rates are expected to stay low, but the absolute low level of yields reduces the opportunities somewhat. We feel risk-oriented investors should focus on the upper tier of the high-yield asset class.

Preferreds
- Preferred share prices were volatile in February when an increase in attractively priced new-issue activity applied downward pressure to secondary market pricing.
- The new issue activity is likely to continue as corporations look to minimize their financing costs on both new and existing funding initiatives.
- The absolute low level of yields is unlikely to deter taxable investors due to the tax-advantaged income and high-quality issuers offered in the space.
- The capital structure subordination and poor liquidity of preferred shares make lower quality issues more susceptible to price volatility but also provide opportunity for above-average returns for investors willing to assume the additional risk.
Recent improvements in global manufacturing Purchasing Managers’ Indices have been encouraging for economically sensitive commodities.

Over the longer term, sustained growth in commodity-intensive economies—like China and India—together with constrained supplies, would suggest constructive market conditions.

In the near-term, the risk of more European volatility or disorderly sovereign default could lead to significant declines in all risky assets.

Commodity Forecasts

<table>
<thead>
<tr>
<th>Commodity</th>
<th>2012E</th>
<th>2013E</th>
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</thead>
<tbody>
<tr>
<td>Oil (WTI $/Bbl)</td>
<td>100</td>
<td>106</td>
</tr>
<tr>
<td>Natural Gas ($/mmbtu)</td>
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<td>4.75</td>
</tr>
<tr>
<td>Gold ($/oz)</td>
<td>1,800</td>
<td>1,800</td>
</tr>
<tr>
<td>Copper (US$/lb)</td>
<td>3.75</td>
<td>4.00</td>
</tr>
<tr>
<td>Potash (US$/tonne, Midwest)</td>
<td>558</td>
<td>551</td>
</tr>
<tr>
<td>Ammonia (US$/tonne, Tampa)</td>
<td>485</td>
<td>365</td>
</tr>
<tr>
<td>Corn (US$/bu)</td>
<td>6.51</td>
<td>6.20</td>
</tr>
<tr>
<td>Wheat (US$/bu)</td>
<td>6.69</td>
<td>7.18</td>
</tr>
</tbody>
</table>

Source: RBC Capital Markets forecasts (oil, natural gas, gold, copper, potash & ammonia), Bloomberg consensus forecasts (corn, wheat)

Gold
- Low real interest rates appear supported for some time, with the Federal Reserve expecting rates to remain “exceptionally low” into 2014.
- Macro uncertainty in Europe continues.
- While jewelry and industrial demand weakened slightly in 2011, both remained largely flat despite markedly higher gold prices.
- Gold ETF demand rose 7% in 2011, following growth of 20% in 2010.
- Central bank buying drove significant market demand, rising to net purchases of 440 tonnes in 2011, up from 77 tonnes in 2010. This compares to total gold demand from all sources of 4,067 in 2011.

Energy
- Oil prices are up on tensions between western nations and Iran that have flared up following a November report from the International Atomic Energy Agency that stated Iran may be actively developing a nuclear weapon. The U.S. has imposed new financial sanctions that block dealings with Iran’s central bank, and European Union countries have decided to ban Iranian oil imports starting July 1, 2012. Iran has responded by threatening to prevent shipping through the Strait of Hormuz. Roughly 20% of the world’s crude oil shipments travel through this passageway.
- For natural gas, continued growth in industry-wide U.S. domestic production, combined with an abnormally warm winter have led to U.S. storage levels dramatically above the 5-year average.

Copper and Industrial Metals
- Improvement in global leading economic indicators and a solid Q4 GDP result in China have supported recent copper prices.
- The global supply/demand balance for copper has been in deficit for two years; however, this is expected to shift to a mild surplus for 2012 when several large mine expansions come on-stream.

Corn and Agricultural Commodities
- For potash, weak demand and higher inventories have led to major producers announcing production curtailments. Potash Corp. recently extended its cutbacks to March 31, which translates to 15% of the company’s production capacity for the year. Inventories in China remain high, and India has recently proposed further reductions to its fertilizer subsidies. Despite demand weakness, the supply response has led to solid price support.
- Ammonia prices have declined sharply due to aggressive pricing from producers in the Middle East.
- Corn and soybean prices remain up from year-end lows on heat and drought concerns in South America.
- Wheat prices remain strong on concerns extremely cold weather conditions may reduce crop yields in Russia. However, ample global stocks limit the upside on prices.
Currencies

Key Viewpoints: Major Currencies

We moderated our bearish forecast on the euro at the start of this year based on our view that sentiment was already extremely negative on the currency and an uncontrolled default or Eurozone exit by Greece was unlikely.

Our proprietary model for the euro implies current valuations already reflect an extremely poor outlook for the Eurozone (see chart). While we still expect the currency to grind lower through year-end, we don’t expect a collapse.

The yen sold off precipitously during February, but we are not backing away from our contrarian house view the yen will strengthen against the dollar through the end of 2012.

On February 13th, the Bank of Japan (BoJ) expanded the size of its asset purchase fund from ¥20 trillion to ¥30 trillion. This increase in Japan’s quantitative easing program caused a drop in Japan Government Bond (JGB) yields and accelerated the decline in the yen that started at the end of January.

We would fade this move for two reasons. First, we believe the widening spread between Japanese and U.S. 2-year interest rates is approaching a natural limit. If the Fed is to be believed, short-term U.S. rates are on hold near zero until 2014, and Japanese interest rates should remain at similar levels. Second, although the Japanese trade balance has deteriorated this year, we do not expect a sustained external deficit for at least five years. Until then, the natural domestic demand for yen should continue to support the currency.

Over the short term, positioning is not extreme, and there may be scope for further mild yen weakness approaching Japan’s fiscal year end. However, we view further yen weakness as an opportunity to buy.

Commodity-Based Currencies

We still expect the Canadian dollar to outperform its Australian and New Zealand counterparts this year, but only slightly.

The Canadian dollar has benefitted from the “NAFTA trade” and its association with the comparatively strong U.S. economy, but gains are slowing as the price of oil begins to reflect supply risks instead of demand gains. The Aussie dollar has strengthened in 2012 on speculation that the RBA’s easing cycle is over. But we see several risks to this view, including subdued conditions in the non-mining sector.
<table>
<thead>
<tr>
<th>Country</th>
<th>Currency</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.</td>
<td>USD</td>
<td>U.S. economic data is improving, but high unemployment and fiscal concerns remain.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>We forecast the dollar index (DXY) to rise 2% to 80.0 by Dec 31, 2012.</td>
</tr>
<tr>
<td>Japan</td>
<td>JPY</td>
<td>Poor trade data and QE has hurt the yen, but we maintain the sell-off is temporary.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>We forecast the JPY to rise 14% vs. USD to 71.0 by Dec 31, 2012.</td>
</tr>
<tr>
<td>Switzerland</td>
<td>CHF</td>
<td>The SNB has both the will and firepower to intervene to defend the EUR/CHF floor.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>We forecast the CHF to fall 9% vs. USD to 0.99 by Dec 31, 2012.</td>
</tr>
<tr>
<td>Australia</td>
<td>AUD</td>
<td>The RBA may not be done easing, especially if growth slows at resource customers.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>We forecast the AUD to fall 2% vs. USD to 1.05 by Dec 31, 2012.</td>
</tr>
<tr>
<td>China</td>
<td>CNY</td>
<td>Soft domestic data and EZ export markets suggest flat near term before gains continue.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>We forecast the CNY to rise 3% vs. USD to 6.10 by Dec 31, 2012.</td>
</tr>
<tr>
<td>Brazil</td>
<td>BRL</td>
<td>High interest rates should still attract fund flows, but intervention is a risk.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>We forecast the BRL to fall 1% vs. USD to 1.72 by Dec 31, 2012.</td>
</tr>
<tr>
<td>Eurozone</td>
<td>EUR</td>
<td>Shorts have been squeezed out on Greek “progress.” Expect slow decline, no collapse.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>We forecast the EUR to fall 5% vs. USD to 1.27 by Dec 31, 2012.</td>
</tr>
<tr>
<td>U.K.</td>
<td>GBP</td>
<td>Likely to keep semi-haven status due to fiscal progress, but may lag in risk-on rally.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>We forecast the GBP to end flat vs. USD at 1.59 by Dec 31, 2012.</td>
</tr>
<tr>
<td>Canada</td>
<td>CAD</td>
<td>In a holding pattern, but should still benefit from the global (and NAFTA) risk-on trade.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>We forecast the CAD to end flat vs. USD at 1.00 by Dec 31, 2012.</td>
</tr>
<tr>
<td>New Zealand</td>
<td>NZD</td>
<td>Interest rates unlikely to fall further, light positioning argues for gains versus AUD.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>We forecast the NZD to fall 2% vs. USD to 0.82 by Dec 31, 2012.</td>
</tr>
<tr>
<td>South Korea</td>
<td>KRW</td>
<td>Vulnerable to negative EZ headlines, but 2012 GDP growth near 3.5% should attract buyers.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>We forecast the KRW to rise 11% vs. USD to 1025 by Dec 31, 2012.</td>
</tr>
<tr>
<td>Mexico</td>
<td>MXN</td>
<td>Easing of risk aversion should allow MXN to make up lost ground. Valuation cheap.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>We forecast the MXN to rise 6% vs. USD to 12.25 by Dec 31, 2012.</td>
</tr>
</tbody>
</table>

Source: RBC Capital Markets and RBC Wealth Management
Key Forecasts

**U.S.**

- Real disposable income growth barely grew in Q4. Second-half consumer spending was fueled by savings draw-down. Confidence recently improved due to better jobs and housing data. Inflation receding, but gas prices squeezing discretionary spending.
- Fiscal drag to become more pronounced, but the extension of the payroll tax cut and unemployment benefits lightens the burden for 2012.
- Business capital investment was a bright spot all last year, but leading indicators of capex are mixed, new orders weak. Tax incentives for 2012 have been cut in half.
- Muddle through at 2% GDP growth, but slow growth makes economy vulnerable to external shocks from Europe, oil, geopolitics, etc. Recession not in our forecast, but can’t be entirely ruled out.

**Central Bank Rate**

<table>
<thead>
<tr>
<th>Today</th>
<th>1-year Out</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.25%</td>
<td>0.25%</td>
</tr>
</tbody>
</table>

**Inflation**

<table>
<thead>
<tr>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012E</th>
<th>2013E</th>
</tr>
</thead>
<tbody>
<tr>
<td>-0.3%</td>
<td>1.6%</td>
<td>1.8%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Canada**

- Employment growth prospects have become less certain. Canada lost jobs in 3 of the last 6 months; may start to weigh on confidence. Inflation ebbing; wage growth so far keeping pace with prices. Longer term, substantial build-up of household debt has left consumer too exposed to future rate increases.
- Weak U.S. growth and a more drawn-out slowdown in China will make for more challenging export performance.
- Government stimulus finished; spending cuts coming this year and next.
- Capex heavily skewed toward energy. Cross-border pipeline politics and weak natural gas prices could be a drag.

**Central Bank Rate**

<table>
<thead>
<tr>
<th>Today</th>
<th>1-year Out</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.00%</td>
<td>1.00%</td>
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</table>

**Inflation**

<table>
<thead>
<tr>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012E</th>
<th>2013E</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.3%</td>
<td>1.8%</td>
<td>2.9%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- FOMC committed (sort of) to no rate hike before mid-2014. Fed has readied new asset purchase program (QE3) targeted at mortgage-backed securities, but likely won’t be introduced until economy softens again.
- European concerns have repeatedly driven Treasury yields below 2%. A Eurozone solution would quickly push them back up toward 3%, but fast-falling inflation and the prospect of QE3 would limit the upside.

- The Bank of Canada (BoC) lowered its growth forecasts out to and including 2013, citing substantial global headwinds including a longer, deeper European downturn. Expectations for a rate hike mid-2012 have come off the table. Possibility of a rate cut if inflation threat wanes and global growth falters.
- An end to the flight-to-safety bid would drive Canada bond yields sharply higher with no contemplated BoC QE program to provide an offset.

Source: RBC Investment Strategy Committee and RBC Capital Markets
### Global Insights

**Eurozone**

- **GDP**: GDP contracted in Q4, including in Germany. Region probably already in recession. Promise of deep austerity cuts to come, and inability to end the crisis weighing on confidence. Spending weak; capex intentions uncertain.
- **Rate cuts won’t have traction before second half, and not then if banks, under pressure to raise capital, choose to do so by shrinking loan books.**
- **Weakening currency should help core countries; peripheral outlook grim.**

**Central Bank Rate**

- **Today**: Various interest rates.
- **1-year Out**: Various interest rates.

**Inflation**

- **U.K.**: U.K. economy continues to slowly weaken. GDP contracted in Q4. Consumer squeezed by inflation, but real consumer spending increased for the first time in five quarters. Capex spending fell by almost 3%.
- **Trade was a bright spot in Q4, but half of exports go into the Eurozone—at risk as Europe slips into recession. Heavily exposed to Ireland in both trade and finance. Recession hard to avoid if Europe downturn worsens.**
- **Inflation fell sharply to 3.6% in January (from 5.2% in September and 4.2% in December). Last year’s VAT increase has started to fall out of the calculation, and utility rate increases will do the same this summer. Bank of England forecasts a reading below 2% by year end.**

**Central Bank Rate**

- **Today**: Various interest rates.
- **1-year Out**: Various interest rates.

**10-year Rate**

- **U.K.**
  - **Today**: Various interest rates.
  - **1-year Out**: Various interest rates.

- **Germany**
  - **Today**: Various interest rates.
  - **1-year Out**: Various interest rates.

- **Italy**
  - **Today**: Various interest rates.
  - **1-year Out**: Various interest rates.

- **Spain**
  - **Today**: Various interest rates.
  - **1-year Out**: Various interest rates.

**Source:** RBC Investment Strategy Committee and RBC Capital Markets

**Key Forecasts**

- The ECB cut rates by 25 bps at each of President Draghi’s first two meetings. Now on hold. Inflation now below 3% and likely headed toward 2% over the year. More rate cuts feasible if economy weakens further.
- December decision to give banks 3-year access to ECB funding has removed risk of area banks slipping inadvertently into a funding crisis. It has bought time and substantially lowered Spanish, Italian, and French 10-year yields.
- Big loser from “closer fiscal union” or “Eurobond” solution would be German bunds.
- Inflation ebbing takes the Bank of England (BoE) off the hot seat. Will continue balancing ultra-tight, austerity-driven fiscal policy with very accommodative monetary policy. No rate change before 2013. New round of QE approved in October has since been increased.
- Gilts benefitting from flight-to-safety bid and the BoE's extended and enlarged QE program. An end to both would herald a back-up in yields.
China

Economy slowing, exports weaker, especially to Europe. Exports now flat year over year, but January affected by New Year holidays.

Credit crunch taking a toll on small-to-medium manufacturers and property developers. Real estate markets cooling off.

Gov’t fiscal policy supportive, especially via affordable housing construction. Consumer spending growing at double-digit rates.

Inflation unexpectedly ticked higher in January to 4.5% (from 4.1%) under influence of lunar New Year. Moderating trend likely to re-establish itself in February.

Tightening over. More easing to arrive over 2012. However, policymakers appear willing to allow GDP growth to moderate further rather than risk rekindling price pressures by reversing course too quickly.

Our forecast is a “soft landing,” but any reacceleration is some ways off.

Japan

Reconstruction and restart of the auto sector produced the promised V-shaped recovery from the earthquake-induced downturn, but industrial production has faded following the summer spurt. GDP shrank by 0.6% in Q4. Currency strength has become a drag on trade.

Growth in first half likely to be respectable against easy comps, although effect of supply disruptions from Thai flooding a wildcard. Second half will need stronger demand from China.

Retail trade and machinery orders both ticked higher in Q4. However, lacklustre domestic demand together with a more challenging export environment in 2012 suggest growth will quickly subside into the 2.0% +/- 0.5% range. Inflation not a factor.
Research Resources and Important Information

Research Resources
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