

Quarterly Review & Outlook

December 31, 2010

Summary

The global economy continues to struggle in the aftermath of the credit crisis, but the recovery is gaining traction. Unprecedented amounts of fiscal and monetary relief kick-started and sustained the upswing, and the passage of time has allowed a great deal of healing from the events of 2008-2009. Recent U.S. economic data releases have dampened fears of a fall back into recession. Europe, now in the thick of a banking crisis (the latest development in the credit crisis that began with the peak in the U.S. housing market in 2006), is posting surprisingly solid data in its core economies. And aside from Japan, Asia and the emerging world continue to pump out gains well in excess of the largest economies. Still, with the crisis bubbling up with alarming frequency and intensity, the forecasting environment remains murky. The business-cycle upswing that began in the spring of 2009 seems likely to sustain its muted and tentative pace through mid-2011, gaining strength from a new round of quantitative easing (QE2), a slowly improving jobs market, and growing incomes and profits.

Excerpted from the RBC Investment Strategy Committee's Global Investment Outlook - New Year 2011 edition

Recovery Gaining Traction but Risks Persist

Since the full scale of the crisis was revealed in early 2009, we have looked for a “half-speed” recovery. In a world where U.S. and developed-world growth runs at 2.5%-3.0% or below, it will often feel like we are on the cusp of a slip back into recession – indeed, the perpetual threat of a double dip will define this period.

Headwinds to North American growth are still strong, including the sovereign-debt crisis in Europe, credit, housing and employment. Macroeconomic issues in Europe are likely to slow improvement in global credit channels through 2011, while still holding the potential to morph into much broader threats to financial institutions, governments and the global economic recovery. The domestic housing market has weakened in recent months, suggesting that the stability that

appeared earlier this year was more a function of government support than of a market finding equilibrium. The U.S. employment picture remains depressed and the elevated unemployment rate is an obstacle to a faster recovery. With fiscal conditions already stressed and short-term interest rates near zero, unconventional policy in the form of QE2 has appeared as the Fed tries to achieve its dual mandate of price stability and full employment.

Europe remains in a state of flux and the fiscal crisis is far from over. The limits of monetary union without fiscal integration are being tested, and markets are waiting for a clear long-term strategy for cleaning up the mess. We expect Europe to eventually right itself, and a continued recovery in the U.S. and strong growth in China provide the Eurozone with breathing room to work through



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its debt problems. Ireland's fiscal shortfall alone is insufficient to cause North American investors great concern. However, the Irish problem travels with a host of related issues that present real challenges for European credit markets, and therefore the broader financial markets. Contagion remains a risk, but a review of indicators that gauge stress within financial markets beyond European bank and sovereign debt suggest the crisis remains contained so far.

A Story of Two Dollars

Markets have interpreted the Fed's extended use of easy monetary policy, most recently in the form of QE2, as a sign that the U.S. is committed to devaluing the dollar. In our view, the key question is: against which currencies? Currencies of the major U.S. trading partners – developed markets with floating currencies – have already absorbed the lion's share of the dollar's decline since 2002 and trade imbalances with these trading partners have moderated. On the other hand, emerging market countries, most of which fix their currencies to the dollar, are responsible for the majority of the U.S. trade deficit. As long as they peg their currencies, these countries are effectively importing a Fed monetary policy that is inappropriate for growth rates that are faster than in the developed world. Since any moves to weaken or remove the currency pegs will face strong political opposition in emerging markets that undertake such steps, we can expect that the dollar's decline against these currencies will take some time. However, we are confident that the revaluations will happen as it becomes clear that it is in the best domestic interest of emerging markets, which need tools in their fight against inflation. Developed market currencies either have their own set of problems (the euro, for example), or are overvalued against the dollar based on purchasing power and further appreciation is, therefore, unlikely. For those with a longer-term time horizon, dollar weakness against major currencies should be bought.

Short Rates to Remain Low

Short rates remain at rock-bottom levels. That this degree of monetary ease is becoming a semi-permanent feature of policy across the developed world is a constant reminder that conditions are far from "normal" despite the recent improvement in economic indicators. With QE2 in full force, the Fed is a long way from tightening policy. Recent record

low U.S. inflation readings reinforce this view. We will be watching for signs that the trillions in global monetary and fiscal stimulus are pushing inflation expectations up, but there is as yet little evidence of that. Eventually, as the sense of crisis gradually abates and the economy generates sustained forward momentum, the potential for rate hikes will appear. We believe QE2 will work to boost asset prices, spur consumer spending and boost inflation expectations, so we have penciled in a small rise in our forecast for short-term interest rates one year from now.

Return to Economic Normalcy a Threat to Bond Markets

Since early October, yields on 10-year T-bonds have risen almost 90 basis points. Even in this challenging macroeconomic environment, we think we've seen the lows in long-bond yields in most major developed countries. While bond yields are justified by current economic conditions, a return to economic normalcy, whenever that occurs, remains a critical threat to the bond market.

Equity Valuations Remain Attractive

Corporate profits, a crucial element of bull markets in equities, remain healthy. Aggressive cost-cutting through the recent recession and initial steps of the recovery established significant operating leverage as revenues began to improve. In addition, by many measures, companies have healthier balance sheets and greater access to cheap credit than they have had in decades. As a result, corporate executives are showing a high level of confidence in their companies' future earnings potential. Today's powerful earnings environment might be less compelling if investors had already incorporated it into expectations, pushing market valuations up sharply in anticipation. As long as valuations reflect an economic environment more depressed (and more risky) than it actually is, there is an opportunity to capture attractive gains as valuations normalize.

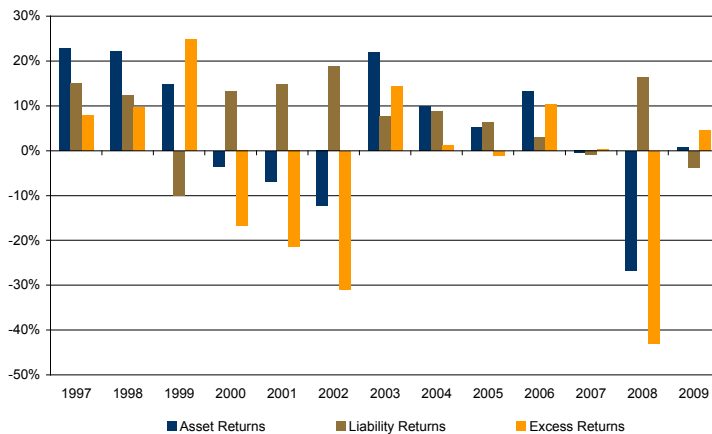
In the Spotlight



Liability Driven Investing (LDI)

Over the last half of the 20th century, the investment management industry witnessed a significant increase in equity allocations, inclusion of low/negatively correlated asset classes and a proliferation of risk management tools aimed at maximizing return while managing asset-only diversification over the long term. While asset-only performance may have yielded superior results against benchmarks and/or peer-universe managers, conventional practices failed to recognize the obligations or liabilities the assets were intended to fund. Conventional practice did not measure – and thus did not manage the biggest risk in the plan – interest rate risk. For a typical pension plan, the significant mismatch between assets and liabilities resulted in extreme fluctuations in funded status and excess returns (i.e., asset returns less liability returns) as shown below.

Assets vs. Liabilities: 1997-2009



Source: RBC GAM Research. Asset returns determined from a portfolio of 60% S&P 500, 30% Barclays Capital Aggregate and 10% EAFE, rebalanced monthly. Estimated liability returns were developed using a AA corporate yield curve. This hypothetical illustration is shown for illustrative purposes only. Past performance is no guarantee of future results.

The Immediate Challenge

Pension plans are facing significant deficits and pension reform in most countries resulting in these challenges:

- More rapid funding of deficits
- Increased funding, balance sheet, and potential P&L volatility
- Valuation based on a yield curve (e.g., versus a flat rate such as 8.5%)
- Proposed change in pension accounting
- Mark-to-market pressures that can increase volatility

The Solution

LDI is a client-driven, solutions-oriented mindset; it is not a product orientation. At RBC GAM (US), we have a number of professionals with actuarial and investment consulting backgrounds who understand the various liability measures impacting clients. With this specialized expertise, and detailed understanding of the liabilities, we are able to partner with you and your advisor to develop and manage custom-tailored investment solutions geared to your specific risk and return objectives.

Firm Update

New Employees

RBC GAM (US) is pleased to announce the addition of the following employees to our team:

Steph Gunderson

Client Service Associate

Saravan Vivek

Business Systems Analyst

David Fake

Quantitative Analyst

Theresa Alewine

Chief Compliance Officer

William Dillon

Proposal Writer

Carolyn King

Accounting Manager

RBC GAM (US): A History of Consistent Growth

Assets Under Management (\$ Billions)



*Preliminary as of 12.31.10

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