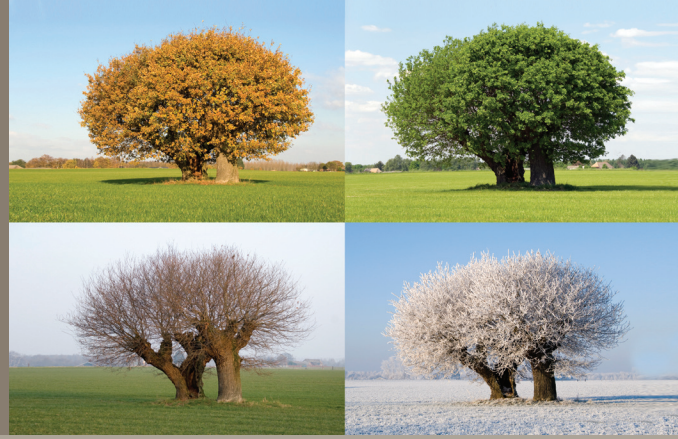


Understanding the Economic and Stock Market Cycles



Why sitting on the sidelines can mean missed opportunities

After one of the longest running economic expansions in the modern era, we find ourselves in the midst of a recession. Headlines show rising unemployment, lower consumer sentiment and rising foreclosures. Yet despite the gloomy economic news, the market is actually presenting opportunities to buy high-quality stocks and investment-grade corporate bonds at very low valuations. To make sense of the negative headlines and potential opportunities, it is useful to look at the interaction and differences between the economic and stock market cycles.

A refresher on the economic cycle

The “economic cycle” is the long-term pattern of alternating periods of economic growth and decline. Growth periods are expansions of the economy or “booms,” similar to what we experienced from 2002 to 2008. Periods of decline are contractions of the economy or “recessions,” similar to the conditions we are experiencing currently in 2009. The highest point of a boom is called a “peak”; the lowest point of a recession is called a “trough.” The expansions and contractions of the economy are measured, and announced in the headlines, by changes in Gross Domestic Product (GDP).

Understanding leading and lagging indicators

Newspaper and media reports today are full of what can be a bewildering array of economic statistics. Making sense of these can be a challenge for many investors. There are some basic principles that can help you understand how they affect you and your investments. Economists look at leading indicators to determine where the economy is heading, and to estimate the degree of expansion or contraction in the next phase of the economic cycle. They look at lagging indicators to confirm what has already happened in the economy, and to measure where we are in the current economic phase. Listed below are some of the most commonly cited indicators.

Leading indicators. These indicators tend to move *before* the economy follows suit, as they did in 2008.

- 1 **Stock market** — The decline in the S&P/TSX Composite Index and other world indices in September 2008 suggested that a period of economic weakness would follow, which we started experiencing in December 2008.
- 2 **Housing starts** — The number of new houses under construction began declining in September 2008.
- 3 **Consumer sentiment** — The Conference Board of Canada publishes the results of a survey called the Confidence Index, which hit an 18-year low in fall 2008, indicating an oncoming recession.

Lagging indicators. These indicators confirm what has already happened to the economy.

- 1 **Unemployment rate** — Canada experienced record job losses in January 2009 as unemployment hit 7.2%, well above its recent low of 5.8% in January 2008.
- 2 **Interest Rates** — Interest rates tend to be low during a recession to promote business and consumer spending. The Bank of Canada decreased its interest rate to an historic low of 0.50% in March 2009.
- 3 **Business spending** — Businesses are cutting their spending in anticipation of a decrease in demand for their goods and services. In a recent Bank of Canada Business Outlook Survey, investment in machinery and equipment was expected to be significantly reduced for the first time since 2001.



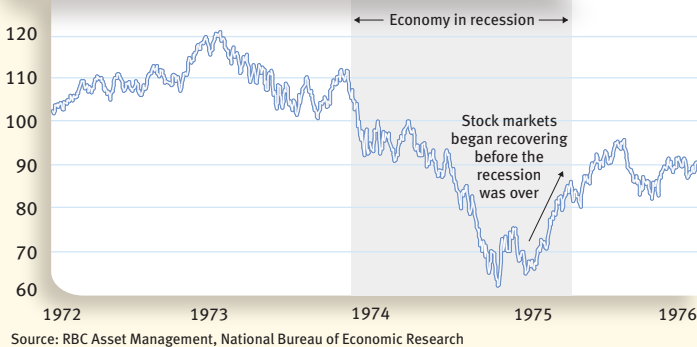
A closer look at the stock market as a leading indicator

Making investment decisions based on what the markets did yesterday or last month is like trying to drive while looking in the rear-view mirror. This is because stock markets are forward-looking: their valuations reflect expected future earnings. Given their tendency to lead the rest of the economy, history has shown that stock markets will often turn upward while their respective economies are still in recession, as illustrated below.

- › In the recession of the mid-1970s, stock markets began to recover soon after reaching their lows in December 1974. Economic conditions, however, did not show signs of recovery until April 1975.

- › In the recession of the early 1980s, stock markets began to recover after hitting their lows in August 1982, but their related economies did not recover until about four months later.

S&P 500 Index Rebound During The 1974-1975 Recession



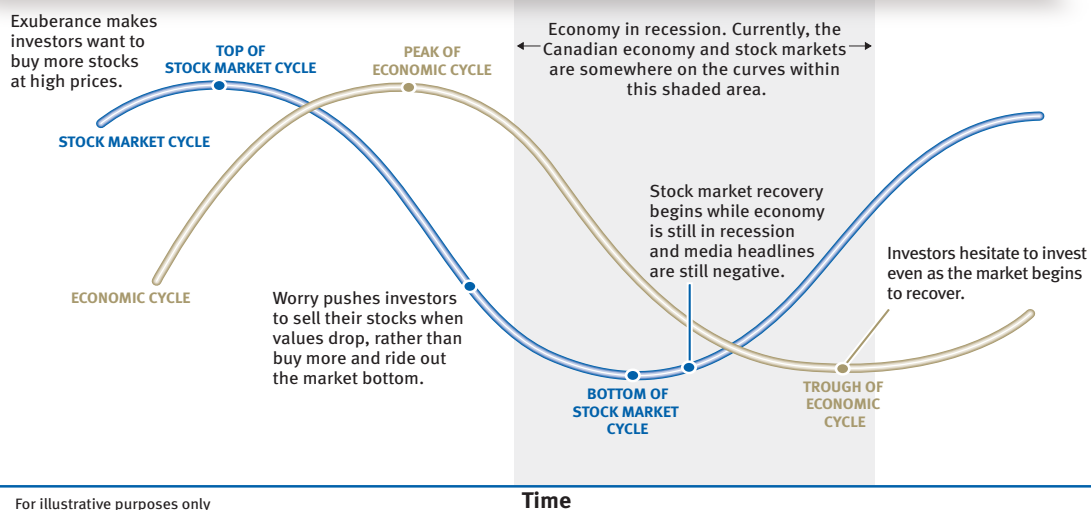
S&P 500 Index Rebound During The 1981-1983 Recession



How does this lag affect investors?

The lag between the stock market cycle and the economic cycle creates a challenge for investors, as strong emotions at both peaks and troughs push people into buying high and selling low — exactly the opposite of what they should be doing.

The Stock Market And The Economy: How The Two Cycles Are Related



What does this mean for investment portfolios?

Based on the S&P/TSX Composite Index for the 10 years ending December 31, 2008, those who stayed invested through the full economic cycle earned 5.3%. Those who tried to time the market by buying and selling often did not do as well. Sitting on the sidelines waiting for the market to recover and missing just the 10 best trading days produced a return of only -0.8%. Missing the 30 best and 50 best trading days earned returns of -7.7% and -12.7% respectively.

Massive government intervention poised to make a difference

Through the use of monetary and fiscal policies, governments aim to stimulate the economy during recessions and to moderate growth when the economy is expanding too rapidly. Listed below are some of the aggressive actions governments worldwide are taking to limit the effects of the current recession.

Government Actions Aimed At Stimulating The Economy

MONETARY POLICY

How governments and central banks control the money supply and interest rates.

POSSIBLE ACTION

Raise or lower interest rates

Increase or decrease the money supply

ACTION TAKEN RECENTLY

The Bank of Canada overnight rate has been decreased to its historic low of 0.50%. The central banks of many countries around the world have also reduced their rates.

The U.S. and the U.K.'s quantitative easing strategies (i.e., printing new money to inject into the system) are underway. The Bank of Canada has hinted at this as a possible future policy, if and when necessary.

DESIRED EXPANSIONARY OUTCOME

Low borrowing costs will stimulate the economy by enabling businesses and individuals to access loans that increase spending.

More money flowing through the economy improves liquidity and credit conditions, and in turn encourages more business and consumer spending.

FISCAL POLICY

How governments adjust their spending and taxation to influence the economy.

POSSIBLE ACTION

Increase or decrease spending on government programs

Raise or cut taxes

ACTION TAKEN RECENTLY

Of the \$40B of fiscal stimulus introduced by Canada's federal budget in January 2009, about \$27B is allocated to spending programs. The U.S. and other countries have also committed billions to their fiscal spending packages.

Of the \$40B of fiscal stimulus introduced by Canada's federal budget in January 2009, about \$13B is in tax cuts. The U.S. has similarly instituted tax cuts in its economic stimulus bill.

DESIRED EXPANSIONARY OUTCOME

Government spending will create jobs and counter the drop in corporate and consumer spending, and meet its objective of stopping the economy from contracting into a deeper recession.

Tax cuts provide families with more after-tax dollars to spend on consumer goods, and businesses with more money to spend on payroll, operations and equipment needed to grow.

Stick with your long-term plan

In Canada, the impact of government actions should begin to be felt over the next several quarters. At RBC Asset Management Inc., we believe that the economic recovery will commence in late 2009 or early 2010, and that the stock market will bottom before then. History has shown us that "sitting on the sidelines" while economic news continues to be negative often results in missing a

significant upturn in the market. This lesson provides a compelling argument for exploring some of the many investment opportunities that exist currently in the marketplace, particularly in light of the aggressive government policies aimed at minimizing the effects of this recession. Understanding the difference between the stock market and economic cycles, and the time lag that often occurs between them, is vital to avoiding the inclination to abandon your long-term investment plan until the headlines announce that the economy is improving.

Talk to your advisor about why now may be the time to move out of money market funds into long-term funds that are well-positioned to capture the market upswing when it occurs.



RBC Asset Management®

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