



MARKET OUTLOOK

*Provided by the RBC Investment Strategy Committee
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Equities and confidence have been trending higher since the start of 2012 on the back of favourable economic data. Not only has the economy rebounded, but memories of last summer’s crippling U.S. political dysfunction are beginning to fade, and Europe has managed a series of deft policy manoeuvres that have dialled back the intensity of its crisis. The upward trend is clear in confidence, employment, consumer credit, purchasing managers’ indexes, credit spreads and stock prices. And yet a degree of caution remains advisable. The rollercoaster ride that was 2011 reminds us that even the most promising of beginnings can be derailed by adverse – and oftentimes unforeseeable – developments. Moreover, levels of sustainable economic growth may simply not be very impressive in the present era.

Improved economic data, but risks remain

Consensus economic forecasts have responded to this barrage of good cheer by starting to flutter higher. Our own estimates are mostly unchanged, or even slightly weaker, relative to a quarter ago. With this publication, we introduce our 2013 forecasts. On the whole, they correspond to the view that 2013 will be reminiscent of 2012, with the expected continued application of the fiscal handbrake and a lingering financial crisis-induced hangover.

Europe remains a focal point for global markets, and our biggest worry. We can say with reasonable confidence that one-fifth of the global economy (the Eurozone) will be in recession in 2012. Interest rates are still enormously stimulative, but fiscal austerity is beginning to bite, and we expect big cuts in government spending to stifle growth in peripheral Europe, slicing about a percentage point off U.S. economic growth, and lesser amounts elsewhere. Perhaps most tellingly, economic forecasts still call for weaker growth in 2012 than in 2011, which was itself weaker than 2010. Europe has bought itself some breathing room by introducing several major initiatives, but we remain cautious about near-term prospects simply because much work remains to be done. Our long-term outlook has always been relatively benign: no failure of a large bank; no default by a large country (though smallish Greece and Portugal are another matter); and the survival of the euro in its current form. All of this is in the best interest of Europe, achievable, and ultimately likely.

The U.S. has enjoyed an impressive economic rebound since the fall. Two festering wounds of past dysfunction – the housing market and the job market – have begun to heal. The U.S. housing market is clearly in transition. We endorse the view that it has mostly stopped deteriorating and may even begin a modest rebound. However, a more ebullient move higher remains unlikely, despite improvement in some measures of sales activity. A big development over the past several months has been surging U.S. job creation. Employment gains have materially exceeded expectations and put the unemployment rate on track for a showing that was expected to take the better part of a year to achieve.

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China remains a concern as it has clearly lost a step over the past year. But the Chinese economy now looks to be stabilizing, thanks in large part to policymakers who have taken full advantage of the window afforded by falling inflation to deliver further monetary stimulus and to prop up the precariously positioned housing and local debt markets. We continue to look for a Chinese soft landing in the near term. But credit excesses can only be solved with yet more credit for a finite period before bigger problems emerge. We fear a harder landing for China later this decade.

The dollar finds support

As for currency markets, the U.S. dollar remains a safe haven with an attractive valuation and the potential to eventually start trading based on the economy's brighter growth prospects. The long-term case for a higher dollar is also supported by a gradual improvement in the U.S. current-account deficit and stronger demographics. The country's relatively young population will boost the size of the labour force down the road, increasing the odds that U.S. workers can generate sufficient tax revenue to service high debt levels. Europe does not enjoy such support. We believe that a weaker euro is an integral part of the solution to the problems in the peripheral Eurozone. Now that the ECB has been adding liquidity in ever larger amounts and ever longer maturities, the single currency no longer enjoys the central-bank support that propped it up in 2011.

Mild inflation and low short rates ahead

Across most of the world, inflation remains reasonably well-behaved. Commodity prices are again rising, presenting an upside risk to inflation, but consumer food prices are turning down, providing some offset. There is certainly the chance of a whiff of extra inflation at some point down the road as the economy recovers and central bankers prove reluctant to tap on the brakes given prior traumatic experiences. But this is not a near-term prospect.

Global policy rates remain low as central banks deliver significant doses of unconventional stimulus with an eye towards stimulating economic growth. The Fed has articulated a plan to keep interest rates unchanged through 2014. In turn, the short end of the yield curve should remain extremely low for at least a few years to come. Other major central banks are unlikely to act much more quickly.

Upside risks to bond yields longer term, but flat in the near term

Policymakers appear committed to suppressing longer-term interest rates, at least in the near term. As a result of this, and the fact that risk aversion should remain elevated given fears about Europe and China risks, yields are unlikely to sprint higher in the near term. Should Europe deteriorate or another shock materialize, it is conceivable that U.S. 10-year yields could fall through their autumn 2011 levels.

In the longer term, however, our view remains that bond yields will eventually climb, perhaps sharply.

Ultimately, the economy will normalize and valuations within capital markets will line up with the interest and growth rates that prevail in the economy. In that scenario, government bonds

are highly vulnerable to capital losses as investors decide that the probability of a return to crisis conditions has diminished. In fact, current yields are only sustainable in the event that tail risks emerge or economic growth is dramatically reduced for an extended period of time.

Investor confidence improves resulting in strong gains for equities

Stocks markets around the world have rebounded sharply from their autumn 2011 lows, mainly due to improved investor sentiment, as the pessimism that infected risk assets last fall has lifted. The diminishing risk of contagion spreading from Europe to the global financial system, and the low risk of a near-term U.S. recession are two factors supporting the market's advance. Some investors are questioning how much higher equities can go in the near term given the macroeconomic risks that are still apparent in Europe. Our view remains one of cautious optimism.

The long-awaited expansion in valuations appears to be emerging. Now that P/E ratios have moved higher, further equity-market gains may place valuations in a range that investors have been uncomfortable with since 2008. We still think this is possible, however, as the market remains well below fair value.

Alternatively, if valuations cannot advance from here, higher profits will be needed to drive stock gains. There is a rising hurdle rate on future profits because earnings have exceeded expectations for many quarters, and this earnings performance has been driven by cost cuts that will be increasingly difficult to replicate. While not impossible, this would require another surge in productivity growth, or a much stronger economy than we currently project.

Remain modestly overweight stocks, underweight bonds

Our recommended asset mix remains unchanged. The opportunity for patient investors to reap the benefits of normalization in stocks and bonds remains enormous and compelling. Moreover, these potential gains are not predicated on a return to above-average economic growth. Even relatively sluggish growth of 2% or so, accompanied by modest but positive profit growth and some further easing of investor risk aversion, would be sufficient to deliver extremely attractive relative returns for equity investors over the longer term. That said, we are reluctant to raise our equity overweight at this time, as we feel that stocks are vulnerable to a retracement or period of consolidation over the coming months. However, maintaining a cash reserve will allow us to act on opportunities as they present themselves amid a potentially volatile macroeconomic environment. Any reasonable longer-term view that assumes even a modest pace of continued economic expansion continues to argue for an underweight position in fixed income. For a balanced global investor, we recommend an asset mix of 57.5% equities (benchmark: 55% within an allowed range of 40% to 70%), 35.0% bonds (benchmark: 40% within an allowed range of 30% to 60%), with the balance of 7.5% in cash.

MANAGING THE ASSET MIX IN THE RBC MANAGED PORTFOLIOS

Building an investment portfolio involves numerous decisions about asset allocation, geographic exposure, and the ongoing adjustment of both. As an investor in the RBC Managed Portfolios, you can be confident that your investment is vigilantly monitored to keep you on track as you progress toward your financial goals.

Helping ensure that the RBC Managed Portfolios are positioned to take advantage of opportunities while mitigating risk is a continuous process. The Portfolio Manager relies on the research conducted by the RBC Investment Strategy Committee (RISC), a team of investment experts from across RBC who provide extensive analysis of the global economy, capital markets, currencies, sectors, and bonds.¹ Armed with the RISC outlook, the Portfolio Manager monitors, revises, and rebalances the asset mix (allocation to cash, bonds, and stocks) to position the portfolios to respond to market conditions and seize potential future opportunities.

Equity diversification

Within the equity component of your portfolio, the allocation to specific geographic regions is also monitored to ensure an appropriate level of exposure to a diverse range of investment opportunities, be they in Canada, the U.S. or beyond these two countries. As the overall equity weight changes over time, the portion committed to each of these regions is considered and adjustments are made in line with the RISC perspective.

A closer look at 2011

For example, as 2011 progressed, RISC concluded that the increased volatility in equity markets was going to continue.

This outlook guided the Portfolio Manager to adjust the asset mix of the portfolios throughout the year so that both equity and fixed-income exposure decreased with the proceeds allocated to cash, helping protect the RBC Managed Portfolios from the short-term volatility that equity markets were experiencing. Exposure to international equities accounted for the largest reduction within equities as uncertainty continued to weigh on Europe.

Constant Vigilance Unlocks Timely Opportunities

At least as important as these high-level asset mix changes is the daily monitoring that enables the Portfolio Manager to act on short-term opportunities.

Last September, for example, a positive trend in global equity markets carried the equity weight in the RBC Balanced Investment Profile up to 58.5% from the target allocation of 57.5% that was set in August. Believing that the rally would be short-lived, RISC recommended rebalancing the equity allocation back to 57.5% with the proceeds moving to cash. This was a positive move for investors as markets gave back gains later in the fall.

While the overall asset mix of your RBC Managed Portfolio is designed to align with your specific investor profile, the day-to-day management of this asset mix is working to help keep your investment on track.

Target asset mix for the RBC Balanced Investment Profile

	Cash	Bonds	EQUITY REGIONS			Total Equity
			Canadian Equity	U.S. Equity	International Equity	
Benchmark	5%	40%	20%	20%	15%	55%
January 2011	2.5%	37.5%	21.8%	22.2%	16.0%	60.0%
March 2011	2.5%	36.5%	22.2%	22.6%	16.3%	61.0%
May 2011	5.0%	36.5%	21.2%	21.9%	15.5%	58.5%
June 2011	5.0%	35.0%	21.6%	22.5%	15.9%	60.0%
August 2011	7.5%	35.0%	21.2%	21.6%	14.8%	57.5%
November 2011	7.5%	35.0%	21.1%	22.0%	14.5%	57.5%

The prevailing trend in the direction of the allocation to each asset class is shown above. Tactical changes may have temporarily moved counter to this trend as a result of the RISC outlook at the time.

¹The most recent investment outlook of the RBC Investment Strategy Committee (RISC) may be seen at <http://funds.rbcgam.com/investment-insights/investment-outlook>

Quarter In Review

The opportunity for patient investors to reap the benefits of a normalizing environment for stocks and bonds remains compelling as equities and confidence have been trending higher since the start of 2012. The rollercoaster ride that was 2011, however, reminds us that even the most promising of beginnings can be derailed by adverse – and oftentimes unforeseeable – developments. Based on our outlook, we remain overweight equities and underweight fixed income relative to our benchmarks.

WHAT HAPPENED IN WORLD MARKETS LAST QUARTER	HOW YOUR MONEY IS BEING MANAGED BASED ON OUR OUTLOOK
Fixed Income Policymakers worldwide continued to appear committed to suppressing longer-term interest rates, at least in the near term. Current bond yields are only sustainable in the event that risks emerge or economic growth is dramatically reduced for an extended period.	Our view remains that while bond yields are expected to remain low in the near term, as current threats to the economy begin to fade, yields will eventually climb, perhaps sharply. In that scenario, government bonds are highly vulnerable to capital losses and, as a result, we remain modestly underweight fixed income.
Canadian Equities Canadian markets gained this past quarter, benefiting from improvements in near-term economic data in the U.S., coupled with successful liquidity injections in Europe. However, the S&P/TSX Composite Index lagged its global peers' performance as gold stocks held back the index. The S&P/TSX Composite Total Return Index rose over 4% this quarter.	Overall, we remained overweight Canadian equities this past quarter. We have reduced exposure to Financials while increasing exposure to Information Technology. We have increased our overweight exposure to Industrials and remain overweight Consumer Discretionary and Consumer Staples relative to our benchmark. We remain underweight Materials, Health Care and Telecom.
U.S. Equities The U.S. has enjoyed an impressive rebound as the housing and job markets have begun to heal. Although the level of economic growth remains below historical averages, investor sentiment has improved thanks to better economic data. The S&P 500 Total Return Index increased by almost 10% in C\$ over the period.	Overall, we have increased exposure to U.S. equities. We moved from market weight to overweight positions in Industrials and Consumer Staples while remaining underweight Health Care and Utilities. Our overweight positions in Consumer Discretionary and Information Technology have been slightly reduced. We have reduced our exposure to Financials.
International Equities Europe continues to remain the largest concern as it could be headed for recession in 2012. China is also worth watching as it has clearly lost a step over the past year; however, the economy now looks to be stabilizing. Asian markets have responded well to looser monetary policies in the region. Among these markets, Japan may present the biggest opportunity for surprises to the upside, as it has long underperformed. The MSCI EAFE Index and the MSCI Emerging Markets Index returned 8% and almost 12%, respectively, in C\$.	Overall, we remain underweight international equities and have reduced our position further. In Europe, we have increased our exposure to the Utilities and Financials sectors but remain underweight our benchmark. We have moved from overweight to underweight in Energy and have reduced our overweight positions in the Consumer Staples and Consumer Discretionary sectors. In Asia, we reduced our overweight positions in the Consumer Discretionary and Consumer Staples sectors. We have moved our underweight position in Materials to market weight and increased our overweight position in Industrials.

Requirements for Redemptions. You can instruct your advisor to sell some or all of your units at any time. This is called a redemption. Redemptions will only be permitted in certain minimum amounts, as described in the simplified prospectus. Your advisor must send your redemption request on the same day it is received. Redemption requests are handled in the order in which they are received. Redemption requests specifying a forward date or specific price will not be processed. Your redemption will not be processed until your advisor has received all documentation. Please contact your advisor for further information.

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