

Market Navigator

A Quarterly Publication From the RBC Wealth Management Investment Committee

Second Quarter 2010



INSIDE THIS ISSUE

In Search of a Sustainable Growth Cycle 1, 4
“Recovery? What Recovery?”

EQUITY

Equity Investing in a Rising Interest Rate Environment 2
Sector and style shifts could occur when the Fed raises rates.

FIXED INCOME

Ready, Set,Hold! 3
The forecast from RBC Economics Research is that the Fed will begin tightening in the fourth quarter.

In Search of a Sustainable Growth Cycle

Clearly, there is a fissure between economic statistics and the economic realities of many individuals.

For more than six months, economic statistics have been indicating a recovery is unfolding. The stock market has been telegraphing it for the past year — that’s one reason it has rebounded so sharply since March 2009.

Yet many Americans, including some investors, have responded by asking, “Recovery? What recovery?”

To investors who have been pierced by the bursting of two bubbles in one decade — the technology bubble at the turn of the century and the credit bubble recently — it’s no wonder this economic recovery cycle would engender a dose of skepticism.

To Americans who are out of work and overloaded with debt or have lost their homes, an economic growth

rate of 5.9% in fourth-quarter 2009 didn’t change their circumstances.

Clearly, there is a fissure between economic statistics that indicate broad improvement in national trends and economic realities of many individuals.

At this stage, we believe the more relevant question facing investors is: will the statistical recovery become a self-sustaining, durable growth cycle?

Certain aspects of this recovery resemble normal patterns of previous cycles. Strong fourth-quarter 2009 growth occurred mainly because businesses slowed the pace of inventory liquidations compared to previous quarters. Consumer spending didn’t contribute much. Corporate earnings have rebounded sharply from low levels, although revenue growth has barely begun. Such patterns typically occur

Continues on page 4

Equity Investing in a Rising Interest Rate Environment

Following the recent rally, equity portfolios could currently hold allocations of highly cyclical sectors that may not be warranted if interest rates rise.

The extraordinary 72.3% rebound in the S&P 500 Index and similar surge in the Dow Jones Industrial Average during the past year have likely changed the composition of equity portfolios. As the market soared low-quality stocks led the move. Some sectors have roared back more than others, particularly Financials (+154.0%), Consumer Discretionary (+103.8%), and Industrials (+103.7%).*

In light of the rally, now is a good time to evaluate equity portfolios to determine if they can hold up to lingering uncertainties.

If the economic recovery progresses and a self-sustaining cycle ultimately unfolds, there is little doubt in our minds the Federal Reserve will raise interest rates.

Regardless of whether the Fed begins to raise interest rates later this year, early next year, or later, it is not too soon to consider the potential impact rate increases could have on equity investments.

In terms of the performance of the broader stock market, no two rate-hike cycles are the same. Since the post-inflation period of the 1970s and early 1980s, there have been four instances in which the Fed raised interest rates by 1.75% (175 basis points) or more. The stock market's reaction varied, as the table illustrates.

From a style and sector perspective, there has historically been a divergence in performance before and after a tightening cycle has begun, according to a study conducted by our research correspondent firm. Its research of the Russell 1000 Index since 1982 indicates the following:

- Growth stocks, including companies with earnings momentum, have traditionally outperformed during the quarter before the first rate hike.
- Value stocks, such as utilities and telecommunications companies, have

historically underperformed during the quarter before the first rate hike.

- Yet after the rate hike cycle has begun, style and sector performances tend to shift.
- Growth stocks have historically lost momentum and underperformed during the first quarter after a rate hike cycle has begun.
- However, companies that have sustained earnings momentum have historically outperformed during the same period. Value stocks have also outperformed in the past.
- Among sectors, energy has the best historical track record during the quarter after the first interest rate hike. More importantly, it has historically been the best-performing sector throughout the duration of previous rate-hike cycles.
- Highly cyclical industries, such as consumer cyclicals (which include retailers, autos, and home builders) and transportation, have traditionally underperformed during rate-hike cycles. The financials sector has also historically underperformed.

We recommend investors closely review sector and industry allocations and consider the performance divergences that could occur if the Fed embarks on a tightening cycle. Following the recent rally, portfolios could currently hold allocations of highly cyclical sectors that may not be warranted if interest rates rise. ■

* Performance data is from 3/9/09 through 3/18/10.

Period	# of Rate Hikes	Fed Funds When Hikes Began	Total Basis Points of Rate Hikes	S&P 500 6 mos Before First Rate Hike	S&P 500 Actual Return During Rate Hikes
6/30/04 - 6/29/06	17	1.00%	425	2.8%	11.6%
6/30/99 - 5/16/00	6	4.75%	175	11.4%	6.8%
2/04/94 - 2/01/95	7	3.00%	300	4.7%	0.1%
3/29/88 - 2/24/89	12	6.50%	325	-19.2%	10.4%
Averages			306	0.0%	7.2%

Data Source: RBC Wealth Management, Bloomberg L.P.

Ready, Set,Hold!

The forecast from RBC Economics Research is that the Fed will begin tightening in the fourth quarter.

It has been an interesting quarter in the fixed income markets, with sovereign risks in the European Union, concerns of higher rates and inflation yet to come, and ongoing financial issues with state and local governments combining to keep investors on edge. They take a backseat to the Federal Reserve, however, with each Federal Reserve Open Market Committee (FOMC) meeting taking on added importance in the march toward a shift in monetary policy. The forecast from RBC Economics Research is that the Fed will begin tightening in the fourth quarter, with Fed Funds closing the year at .75% and steadily raising rates through 2011 so that by year-end 2011 Fed Funds will be at 3.25%.

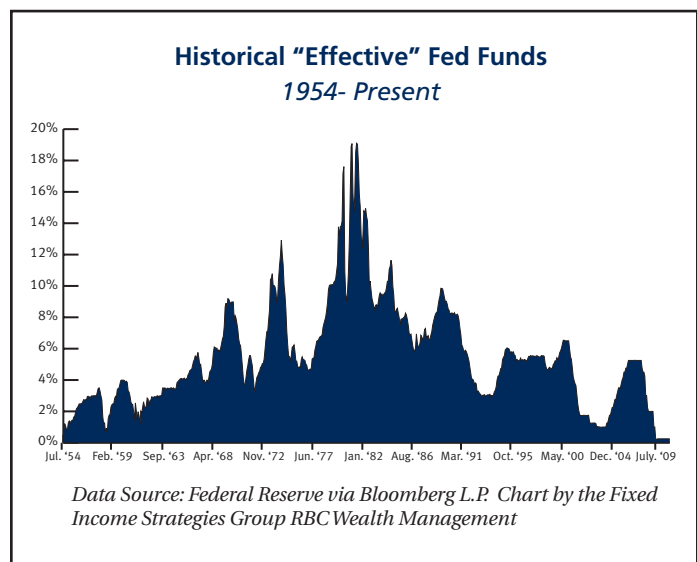
At the March 16 FOMC meeting, the Fed held policy steady, keeping its “extended period” language with regard to how long Fed Funds will be held at the current 0.00%-.25% range. Thomas Hoenig, President of the Kansas City Federal Reserve, has recently dissented over the use of this language due to signs of continued improvement in the economy. Nonetheless, “extended period” remains, and its inclusion (or exclusion) in future FOMC statements will be used by the market as a barometer to measure a change in Fed policy. The consensus seems to be that until unemployment begins to fall, the Fed will remain on hold, and this could be tested with the release of the March employment report as forecasts predict that Nonfarm Payrolls could increase by as much as 300,000. The point has also been made that the Fed doesn’t need to wait for a turn in employment — it is more important to move sooner rather than later in order to maintain control over the short-end of the yield curve.

The U.S. Treasury market is foreshadowing a Fed policy shift with the yield curve beginning to flatten. Currently the 2yr/30yr spread is 362 basis points (bps), almost 20bps tighter than the near historic wide levels set in mid-February. The 2-year T-note yield is higher by 20bps, while the yield on the 30-year T-bond is lower by 16bps. Additionally, the Fed Funds effective rate has begun to push higher toward the top of the current range. The “message” from the yield curve is then clear — the continued lack of inflationary pressures will anchor the

long end, while short rates rise in anticipation of the Fed tightening, which will result in a flatter yield curve. RBC Economics Research predicts the 2yr/30yr spread could be as low as 50bps by the end of 2011, with the 2-year T-note yield at 4.25% and the 30-year T-bond yield at 4.75%.

The forecast from RBC Economics Research is that the Fed will begin tightening in the fourth quarter, with Fed Funds closing the year at .75% and steadily rising rates through 2011 so that by year-end 2011 Fed Funds will be at 3.25%.

The municipal bond market continues to deal with changing dynamics. The financial distress felt by state and local governments is widely publicized. Lesser known, however, is the growing impact of the Build America Bond (BAB) program. BABs were introduced one year ago, and the government subsidy paid to municipalities allows them to issue taxable BABs cheaper than they can issue traditional tax-free bonds. This has reduced the supply of new tax-free issues, and the resulting supply crunch in the primary and secondary tax-free muni market has driven spreads through normal historical averages. The BABs program was initially set to expire at the end of 2010, but with its success, it likely will be made permanent and expanded to other sectors of the muni market. As a result, for investors in tax-free munis, the current dynamics of reduced supply and tighter spreads may persist for some time. ■



In Search of a Sustainable Growth Cycle *Continued*

during the early stage of a recovery cycle. They do not trouble us.

Other aspects of this recovery period are abnormal. Bank lending is still contracting at an unusually high rate. Small business owners find it difficult to obtain financing and are pessimistic about current conditions and future prospects. Consumer confidence is tepid at best and is lagging previous recovery periods. Some leading economic indicators (data that tend to forecast economic activity in the next three to nine months) have already peaked and lost momentum since the beginning of the year. These aspects do concern us.

Additionally, monetary and fiscal policies are far beyond normal bounds. The Federal Reserve's balance sheet remains very bloated, and politicians have yet to craft a credible plan to cut federal spending. In our view, these challenges need to be confronted soon. The Fed has already begun to remove some of the emergency liquidity measures it implemented during the crisis period.

However, it should not be surprising that all conditions necessary for a long-term recovery have yet to materialize. We view the current statistical recovery as a positive first step in that direction. The U.S. economy has made significant progress during the past year. It is not yet experiencing a self-sustaining growth cycle and has some less-than-desirable contours, but it's recovering nonetheless.

The housing market and employment conditions could be among the key determinants of whether a self-sustainable recovery unfolds.

From our perspective, the housing market remains vulnerable. The nascent improvements that began during the latter part of 2009 have lost momentum. Another wave of so-called shadow inventory, which includes foreclosures and distressed properties, still lurks in the background.

The success or failure of the 2010 spring and summer home-selling seasons should reveal whether the initial housing rebound was the beginning of a healing process or just a mirage. At the very least, housing market headwinds could stunt hopes for a robust economic rebound in 2010, RBC Capital Markets' fixed income specialists recently said.

Even though employment conditions are currently weak, we believe the worst of the jobs recession is over. RBC economists anticipate the negative trend in non-farm payrolls could soon turn positive.

However, given a 9.7% unemployment rate, a 16.8% rate of unemployed and discouraged workers (the U6 rate), and a fragile small business sector, another "jobless-recovery" could occur similar to the post-2001 recession period. Back then, employment conditions improved, but at a slower pace than typical post-World War II recovery periods. This go-around, job growth will need to be stronger than the post-2001 cycle for a long-term economic upswing to manifest.

As investors consider the composition of portfolios, we recommend weighing the lingering economic uncertainties and vulnerabilities. There could be bumps and detours along the path toward a long-term, sustainable growth cycle. ■

RBC Correspondent Services and RBC Advisor Services, divisions of RBC Capital Markets Corporation, member NYSE/FINRA/SIPC, provide custody services for accounts managed by your Investment Professional. The referenced product or service is available through that relationship.

The Market Navigator is a service provided to you. The information contained in this report has been compiled by RBC Wealth Management (RBC WM) from sources believed to be reliable, but no representation or warranty, express or implied, is made by Royal Bank of Canada, RBC WM, its affiliates or any other person as to its accuracy, completeness or correctness. All opinions and estimates contained in this report constitute RBC WM's judgment as of the date of this report, are subject to change without notice and are provided in good faith but without legal responsibility. This report is not an offer to sell or a solicitation of an offer to buy any securities. Every province in Canada, state in the U.S., and most countries throughout the world have their own laws regulating the types of securities and other investment products which may be offered to their residents, as well as the process for doing so. As a result, the securities discussed in this report may not be eligible for sale in some jurisdictions. This report is not, and under no circumstances should be construed as, a solicitation to act as securities broker or dealer in any jurisdiction by any person or company that is not legally permitted to carry on the business of a securities broker or dealer in that jurisdiction. This material is prepared for general circulation to clients and does not have regard to the particular circumstances or needs of any specific person who may read it. To the full extent permitted by law neither RBC WM nor any of its affiliates, nor any other person, accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. No matter contained in this document may be reproduced or copied by any means without the prior consent of RBC WM. Additional information available upon request. Copyright © 2010 by RBC Wealth Management, a division of RBC Capital Markets Member NYSE/FINRA/SIPC. All rights reserved.