

Market Navigator

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That was Then, This is Now

The economy is in rough shape, but it's not as bad as previous crises.

Recessions normally raise anxieties among investors and can jolt investment strategies. Unfortunately that's par for the course. However, this recession has sparked a severe and extreme degree of fear and pessimism — understandably so considering the economic, housing market, and portfolio damage that has occurred. Among the greatest fears for investors is whether this recession and financial crisis will morph into something more incendiary. We are frequently asked: “Will the recession turn into a depression?” Or: “Is the country headed into a long period of Japanese-style deflation and stagnation?”

There are similarities between this crisis and those two periods. Currently, the U.S. economy is caught in a negative feedback loop. The crisis — which initially

manifested itself most acutely in the financial sector, housing market, and credit markets — has morphed into broad economic weakness. That weakness has further constrained the financial sector as more borrowers have defaulted on a myriad of loans. The additional financial sector stress has since ricocheted back onto the U.S. economy and has infected the global economy. This cycle is at risk of repeating. Also, the threat of deflation — which is a key characteristic of the Depression and Japan's challenging period — does exist in the U.S. economy today. If deflation takes root, conditions could worsen.

However, there are important distinctions between today's crisis and the Great Depression and the Japanese deflation period that we believe investors should heed. First, the approach to fighting the current crisis has involved significantly more financial resources and creative policy

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A Roadmap for Recovery

While 2009 could be bumpy, watch for the sign posts that could provide hints about the recovery.

As we consider equity investing in 2009, it's difficult not to envision the stock market tethered in some way to the economic and credit market issues that still linger. But that doesn't mean 2009 will be a replay of 2008. After all, the market has already factored in multiple unprecedented events, the near-collapse of the global financial system, and a host of negative economic data.

Now that this bear market has crossed over a historic threshold — the biggest bear of the post WWII era — a question on the minds of many investors is: “When will the stock market recover?” Of course, anyone who says they know the answer hasn't been investing for very long. That being said, there will be sign posts on the road to recovery that could provide hints along the way.

We believe a key catalyst for a rally would be the upturn in leading economic indicators, which would occur before GDP growth officially recovers. The indicators haven't turned yet, but when they do, the stock market could rally, as it has during previous bear market cycles. The implementation of a fiscal stimulus package could help the indicators improve. If such a rally is to be sustained, the turn in leading economic indicators would need to be durable — meaning the economy would need to be on the path toward a healthy, long-term recovery, not just a short-term growth spurt.

Corporate earnings trends are another sign post. We anticipate profits will continue to deteriorate during at least the first half of the year, which has yet to be fully factored into Wall Street analysts' estimates, in our opinion. While analysts have cut estimates quite significantly during the past six months due to the credit crisis, they still need to slash estimates further to factor in the global recession. As estimates come down to more reasonable levels, equity investors will be better able to separate the real values from the value traps.

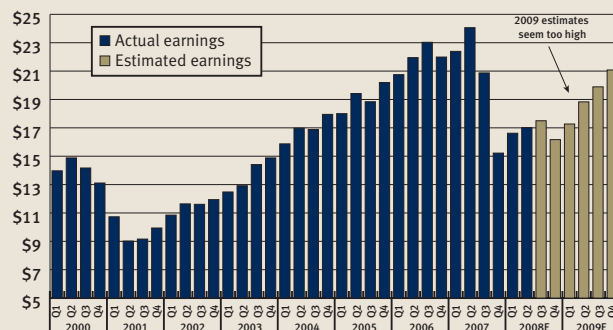
Even though these and other sign posts are ahead, the market needs the assistance of “time and price” in order to reach them. The stresses in the financial system and

the economic vulnerabilities won't be solved overnight because the fallout from this crisis has been extreme. Furthermore, the stock market and corporations are confronted with not just U.S. economic challenges, but global economic challenges. We believe the market's performance will be dependent on the time it takes for the global credit markets to heal, for the global economy to become less murky, and for active investors to regain confidence.

When we refer to “price,” we're referring to the stock market's valuation — or the amount investors are willing to pay for corporate earnings. The market isn't what we would characterize as expensive on a price-to-earnings basis. However, because the earnings estimates are so uncertain (and are likely too high), it is still difficult to value individual equities and the market as a whole.

Also, the risk of deflation makes the valuation issue more complicated. In the past, periods of sustained deflation have wreaked havoc on stock valuations, sending them into the single digits, and have been very damaging to the balance sheets of companies with high debt levels. That is one reason we believe it is so important that policy makers achieve their goal of fighting off deflation sooner rather than later. ■

Quarterly S&P 500 Earnings Estimates from Wall Street Analysts



Source: RBC Wealth Management, Standard & Poor's, FactSet, Thomson Financial

Focus on What You Know ... With an Eye to the Future!

With an eye to the future however, it is also imperative that investors adhere to the core tenets of fixed income investing...

2008 was a year that we will long remember with many extraordinary, unprecedented, and hitherto unimaginable events occurring in the global credit markets. Capping off this memorable year was the move by the U.S. Federal Reserve to reduce its target overnight rate, Fed Funds, to a range of 0.00-.25% and the plunge in U.S. Treasury rates to historical lows.

The volatile market conditions played no favorites, with all sectors outside of U.S. Treasuries experiencing losses. This proved to be extremely unsettling to fixed income investors who typically buy and hold, expecting their bonds to provide stability during volatile market conditions. Losses of 10-40% across fixed income sectors however left many questioning the wisdom of this strategy, and at the same time causing a great deal of consternation. Indeed, the cataclysmic shifts in the financial landscape left many investors wondering if their bonds, a majority of which are fundamentally sound, would even mature at par! With that kind of fear building in the market, is it any wonder then that short-term T-bills traded at negative yields at one point?

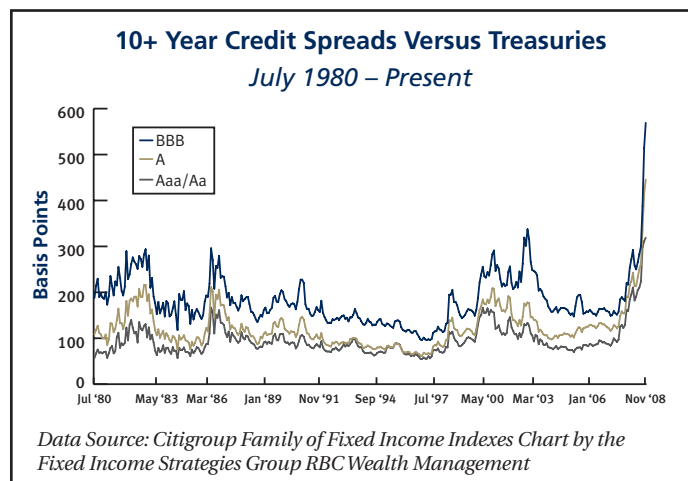
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Focusing on what we know, these themes are likely to play out in the near-term:

1. Volatile, unsettled market conditions will persist well into 2009; possibly beyond.
2. GDP growth will be considerably below trend, negative at times, through this period.
3. Unemployment will continue to rise.
4. Deflationary pressures, not inflation, will be the issue for the Fed.
5. The Fed will likely hold rates at current low levels.
6. The yield curve will flatten with long rates, 10 years and 30 years, likely falling below 2%.
7. The Fed and the Treasury will continue to take aggressive measures to stabilize the economy.

Once the global financial markets stabilize new challenges will arise, and forecasts for what might transpire run the gamut from: the Treasury market is a bubble waiting to burst, the Fed's huge infusion of liquidity will result in hyperinflation, and we will experience a repeat of the unsuccessful 0% interest rate policy of Japan. Investors need to consider these issues, but remember we are in uncharted waters and forecasts are just that.

Going forward, the challenges will continue to be great leaving investors wondering what their course of action should be. First and foremost it is important not to panic; a thorough portfolio review should be the first step. This will identify problem securities. So far, our experience has shown that investors own many bruised and battered, but fundamentally sound issues, with only few rating an outright "sell." In those cases, swaps can be recommended to generate a tax loss, improve credit quality, move up in the capital structure, or take advantage of a shift in the yield curve. Once the "state of the portfolio" is known, it's time to focus on the tremendous opportunities, the best in years. Yield spreads for credit sensitive sectors such as high quality, investment grade corporate and municipal bonds are at historically wide levels, private label mortgage-backed securities offer the potential for equity-like returns, and secondary preferred issues provide attractive yields with the potential for capital appreciation. With an eye to the future however, it is also imperative that investors adhere to the core tenets of fixed income investing — diversification, quality, and liquidity — while using sound strategies such as barbells and ladders. ■



That was Then, This is Now *Continued*

measures early on in the process. For example, during the early days of the Depression, policy makers actually raised interest rates and taxes, which was precisely the wrong thing to do. In Japan, the central bank waited years to act. The Japanese property bubble burst in 1989, but the country's central bank didn't loosen the money supply until 1995 and didn't really begin expanding the money supply to a significant degree until 2001, more than a decade after deflation began to choke the economy. In stark contrast, the Federal Reserve's actions during the past few months have surpassed what it took Japan 12 years to implement.

Second, we view the conditions of the previous crises as more ominous. During the Great Depression, unemployment reached 25% because banks were allowed to fail en masse (and there was no deposit insurance at the time) and businesses went under at a rate we cannot even fathom. While we anticipate current unemployment conditions will deteriorate and could climb into the double digits and business failures will mount, we do not believe they will reach Great Depression-like proportions. The U.S. banking system, as fragile as it may be, has far more foundational structures in place to keep it standing. Also, if the Obama administration implements a significant stimulus package, it should help employment conditions from becoming unhinged and could lessen the impact of the downturn.

Furthermore, in Japan, the magnitude of the property bubble was more extreme because land prices rose almost three times higher than U.S. home prices did during our

recent bubble. As a consequence, Japanese land prices ultimately fell 80% from peak to trough. So far, U.S. home prices have fallen roughly 20% from the peak on a national basis. While we anticipate home prices could fall further, we do not believe the national average price will collapse.

These are among the reasons we don't anticipate this recession will deteriorate into something as severe as the Great Depression or the Japanese deflation period. However, the reality is, the current crisis will continue to test the mettle of policy makers and investors in 2009. The final chapters of this saga have yet to be written. There are still many economic vulnerabilities and uncertainties because of the fragile state of the credit markets, U.S. consumer balance sheet, and global economy. The economic disruptions could be more severe than the recessions of the early 1980s and mid-1970s. U.S. investors are accustomed to 3%-4% Gross Domestic Product growth — that's considered "normal" economic activity. So, if a deep recession occurs with GDP activity of -5% or more, it would be quite a burden to many Americans.

Although we view some of the monetary and fiscal policy responses as necessary, undoubtedly, there will be unintended consequences later. The policy programs have brought the nation into uncharted territory. Finally, even if the U.S. and global economies stabilize in 2009, we believe it will be very challenging for the Fed and Treasury Department to determine how and when to unwind their interventionist tactics. ■



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