



Quarterly Strategy Report

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For Important Disclosures, see pages 10-11.

2010 Outlook

In the span of six months, the U.S. economy experienced one of the most dramatic swings in history. There's been a 9.2% swing in Gross Domestic Product (GDP). It registered -6.4% in the first quarter of 2009 and shot up to 2.8% in the third quarter. Corporate earnings have experienced a similar, sizable rebound.

The stock market soared as conditions improved, delivering one of its strongest rallies in such a short period of time since the 1930s.

As the calendar turns, there are a number of issues to consider about the investment environment.

The following pages provide our thoughts about the economy, stock market, and equity investment opportunities in 2010. In summary:

- The economy is likely to avoid a double-dip recession, but a “half-speed recovery” seems inevitable.
- Many excesses of the credit-bubble era still remain.
- The ongoing lethargy among the small business sector could be an economic headwind in 2010.
- There are a number of sovereign debt risks facing key regions of the world and one that very few strategists are talking about: Japan.
- It's too soon to fret about when the Federal Reserve will raise interest rates.
- But the mere anticipation of a Fed tightening cycle—even if it begins *later* rather than *sooner*—could impact the push and pull of financial markets.
- For the stock market, the so-called “easy” gains have been made.
- As RBC Capital Markets' chief institutional strategist put it, “It's now about hitting singles rather than home runs.”
- We anticipate modest gains for the stock market in 2010.
- Three potential market catalysts are: earnings growth, merger and acquisition activity, and money flows.
- Index hugging—just relying on broad-based exchange-traded funds or mutual funds that mimic the major indexes—is not likely to be as rewarding as it was in 2009.
- It's time to get tactical, move up the quality ladder, and strike a balance with sector allocations.

The State of the U.S. Economy

No Double Dip

Despite the sharp economic swing and extraordinary stock market rally, because of the high unemployment and underemployment rates, many Americans have not yet benefited from the economic rebound. Sentiment on Main Street is still rather negative. Chatter abounds about the current risks of a double-dip recession.

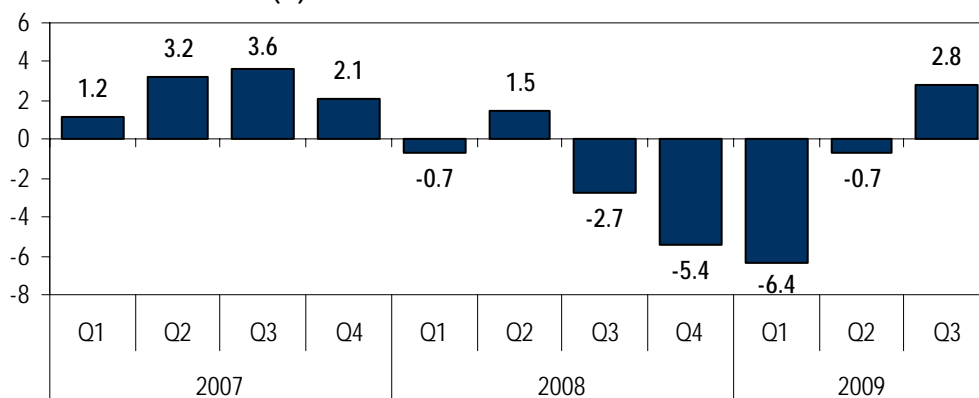
With all of the discussion about a potential double-dip, one would think they're common. In fact, they're not. Once a recession ends, the U.S. economy typically doesn't slide back into another one shortly thereafter—and we don't believe it will this cycle.

Forthcoming GDP data could show improvement due to inventory rebuilding, and other economic activity measures seem poised to rise. The worst of the “Great Recession” appears to have passed.

We anticipate the corporate sector will build on the momentum that began during the second half of 2009, which should make the economy less dependent on fiscal and monetary stimulus.

The U.S. economy is in far better shape today than it was just less than one year ago.

U.S. Gross Domestic Product (%)



Source: RBC Wealth Management, Bloomberg, Bureau of Economic Analysis

Of course headwinds still remain, which should be expected considering the severe seizure that occurred in the financial system and credit markets.

The structural challenges are among the reasons why RBC Asset Management's Chief Economist Patty Croft is anticipating, over time, a “**half-speed recovery**” will unfold—one that includes modest growth but isn't strong or sustainable enough to quickly erase the excesses of the past credit bubble era.

That's because when an economy is taken down by financial and credit crises, like the U.S. economy was last year, it has historically delivered lackluster growth.

It takes time for households to unwind the massive, lingering debt overhang that typically accompanies a credit bubble and for banks to begin lending at a healthy pace.

Until job growth improves by a meaningful degree, households pay down more debt, and credit conditions normalize, it's hard to envision strong GDP growth on a consistent basis.

Yet, those challenges are well known by many market participants.

One area of the economy that market participants have yet to fully consider, in our opinion, is the small business sector.

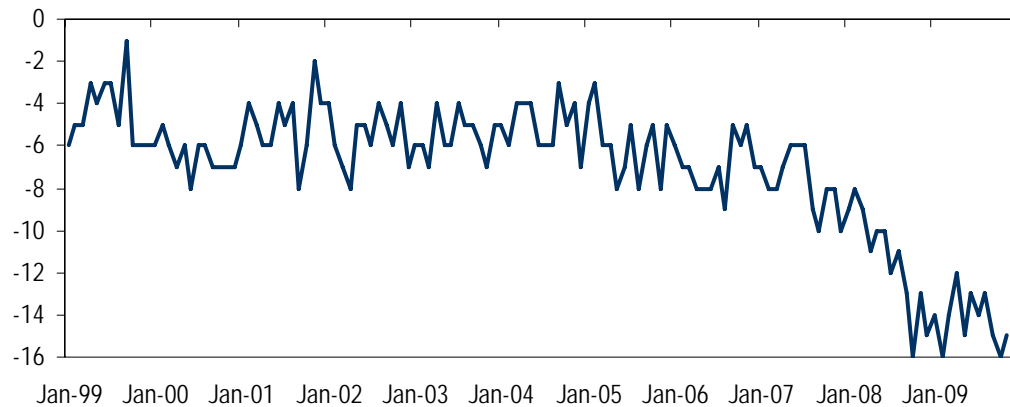
The ongoing lethargy among this sector could be an economic headwind in 2010. Even though many economic indicators have rebounded, it remains a drag on the broader economy.

This situation is notable because small business activity represents almost 1/5 of U.S. GDP and almost 1/3 of employment. Historically, it has been the most innovative sector.

Small business sentiment is still quite negative, according to the National Federation of Independent Business (NFIB). The organization's Optimism Index, which tracks the mood of small-business owners, has bounced off the lows reached earlier this year but is still at depressed levels.

The sector's views about credit market conditions are also at a very low level, as the graph below illustrates. RBC fixed income specialists anticipate this will be among the last sectors to experience improvement in credit conditions. Small business owners seem to agree.

NFIB Small Business Expected Credit Conditions



Source: RBC Wealth Management, Bloomberg, National Federation of Independent Business

Furthermore, as the calendar shifts to 2010, there are a number of sovereign debt risks facing key regions of the world. (The term "sovereign debt" refers to debt issued and backed by a government.)

While attention is currently focused on nations with small economies in Europe and Central America, **there's a much bigger sovereign debt issue lingering in the background: Japan.**

Russell Jones, global fixed income strategist at RBC Capital Markets, recently wrote, "... overall, Japan's fiscal and broader economic situation represents perhaps the greatest modern day macro policy conundrum of them all. Frankly, at this stage, it is difficult to see a way out."

That's because Japan's government is overloaded with debt. Its debt-to-GDP ratio is approaching 200%, the highest among major economies.

In Jones' view, a day of reckoning could be looming. He said, "Japan's lost decade threatens to become a lost generation ... a sovereign downgrade seems to be only a matter of time."

These issues are reminders that the unintended consequences of decades of bad policy decisions by central bank and government leaders could echo for years.

At the very least, the sovereign debt vulnerabilities facing Japan and other nations could be a headwind for financial markets in 2010 and beyond.

The Fed Still Pulls the Strings

The potential for a “half-speed recovery” is a key reason we believe it’s too soon to fret about when the Federal Reserve will begin to raise interest rates.

Nevertheless, the topic will likely gain momentum as the year progresses.

The Fed is a key part of the equation for 2010 because its actions during the financial crisis, along with other central banks around the world, played a significant role in jumpstarting the U.S. and global economies. And their actions could ultimately result in unintended consequences.

So as central banks decide when to exit the stage, market participants will attempt to gauge the impact. The mere anticipation of a Fed tightening cycle—even if it begins *later* rather than *sooner*—could impact the push and pull of financial markets.

In recent history, major Fed tightening cycles haven’t been terribly damaging to the stock market but did serve as a headwind.

Since the late 1980s, there have been four major interest rate-hike cycles that have lasted 10 months or more, wherein the Fed has raised rates by 175 basis points (1.75%) or more.

On average, the S&P 500 delivered an annualized return of 6.3% during those cycles. The peak annualized return was 11.4% and the low was 0.1% (the return was essentially flat).

More relevant to investors in the near-term—since the beginning of the rate hike cycle doesn’t seem like it will occur during the first half of 2010—is the performance that occurred *before* previous tightening cycles actually began. On three of the four occasions, the S&P 500 traded higher, the table below shows. But it lost a lot of ground prior to the 1988-1989 tightening cycle.

Major Fed Tightening Cycles Since the Late 1980s

Period	# of Rate Hikes	Fed Funds Rate When Hikes Began	Total Basis Points of Rate Hikes	S&P 500 Return 6 mos Before First Rate Hike	S&P 500 Actual Return During Rate Hikes	S&P 500 Annualized Return During Rate Hikes
6/30/04 - 6/29/06	17	1.00%	425	2.8%	11.6%	5.6%
6/30/99 - 5/16/00	6	4.75%	175	11.4%	6.8%	8.2%
2/04/94 - 2/01/95	7	3.00%	300	4.7%	0.1%	0.1%
3/29/88 - 2/24/89	12	6.50%	325	-19.2%	10.4%	11.4%
Averages			306	0.0%	7.2%	6.3%

Source: RBC Dain Rauscher, Bloomberg

Many economists and fixed income strategists, including those at RBC, are currently forecasting the Fed will wait to begin its tightening cycle until the latter part of 2010, at the earliest. And the debate has barely begun as to whether it would be a modest or major tightening cycle in duration and magnitude.

Regardless of when the Fed begins to raise interest rates, it has already indicated it will remove some of its stimulus programs in 2010, which is a *de facto* tightening strategy, albeit one with fewer teeth than rate hikes.

Inflation trends are among the key determinants of the Fed’s interest rate policy. While inflation has perked up recently from a very low level, RBC economists are not forecasting an inflation surge in 2010. However, they acknowledge it is a longer-term possibility. To read about inflation risks in the context of the explosive expansion of the Fed’s balance sheet, see our report, *Insights on Inflation*, published in October 2009.

Fiscal Headwinds are Building

Often times, issues that could emerge over the longer term aren't reflected in current economic data or swings in financial markets. From our perspective, that's the case with a time bomb that is ticking in Washington D.C. and elsewhere. That time bomb is the fiscal debt burden.

For the past decade, and because of seeds that were sewn much longer before that, the nation has fallen into a state of fiscal neglect.

U.S. fiscal debt is roughly 85% of GDP—not nearly as high as Japan's 200% rate—but is projected to rise sharply as baby boomers age and as Medicare, Medicaid, Social Security, and other so-called entitlements overwhelm the system.

Elected politicians of both political parties have layered billions upon trillions of dollars of debt onto the backs of current and yet-to-be-born taxpayers.

While this issue seems to be gaining interest among voters of widely divergent political stripes, there is little evidence the population at large is prepared to take the tough medicine necessary to make fiscal conditions healthy again.

This problem spans beyond the U.S. federal government. It is occurring within many states and municipalities. And it spans across borders to the United Kingdom, Japan, and many other nations.

Just like U.S. household finances recently hit a wall because of excessive borrowing during the past decade, governments could ultimately hit a wall if spending is not curtailed and retirement and healthcare entitlements are not reduced.

Financial markets may not have to contend with these issues in 2010 or even the year after that. But at some point, we believe the risks could emerge to the forefront if U.S. politicians, policy makers, and the population at large don't quickly confront reality.

Equity Investment Opportunities in 2010

Not much can top the stock market's performance since March of 2009. The S&P 500 Index and other broad measures staged one of the strongest rallies in history in such a short time span.

The S&P 500 has climbed 62.0% from the March low through December 17, 2009. Every sector of the market rallied. The Financials, Information Technology, and Materials sectors have been particularly strong since March. The rally provided more than enough gusto for the broad stock market indexes to achieve a double-digit return year. The S&P 500 was on tap to close up more than 20% for the year as of this writing.

There are Potential Catalysts Ahead ...

The "easy" gains have been made, in our view. As RBC Capital Markets' Chief Institutional Strategist Myles Zyblock put it, "It's now about hitting singles rather than home runs."

There are a number of catalysts that could lift the market further in 2010, in our opinion. While we're not anticipating the market to move as swiftly and as briskly as it did throughout much of 2009 and there could be bumps along the way, we believe the market has the capacity to move up modestly over the course of the year. Three potential catalysts are visible at this stage: earnings growth, merger and acquisition activity, and money flows.

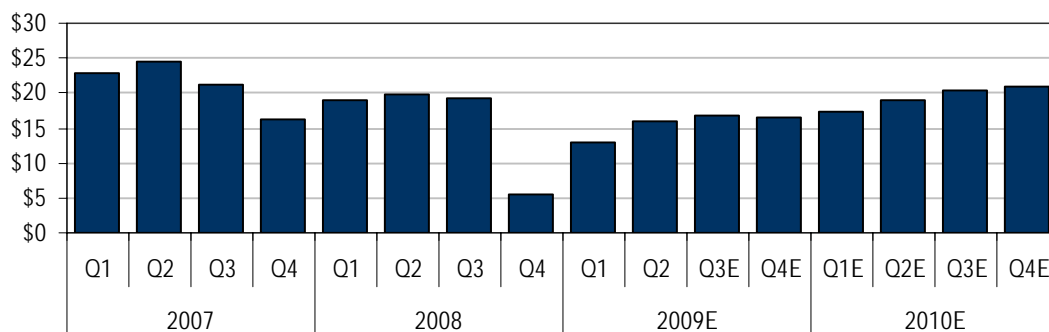
Catalyst #1: Earnings Growth

Despite economic challenges, corporations could provide robust earnings growth in 2010. They have cut operating expenses to the bone and should reap the rewards as sales improve.

Earnings forecasts among corporate executives and analysts have moved up meaningfully compared to six months ago, but we don't view current expectations as being totally out-of-bounds.

Wall Street analysts are collectively forecasting S&P 500 earnings of \$77.48 in 2010. That would represent growth of roughly 24.6% compared to 2009. While that could be a challenging level to reach, it is possible if the economy delivers a couple of above-average quarters. Also, keep in mind the 2010 earnings forecast is still well below the peak earnings of \$84.56, which occurred in 2007.

S&P 500 Corporate Earnings



Source: RBC Wealth Management, Thomson Financial. Beginning in the third-quarter of 2009, the data represents the consensus forecast of Wall Street analysts (third-quarter 2009 earnings have yet to be finalized).

Catalyst #2: Mergers & Acquisitions

Merger and acquisition activity perked up in 2009 and should play an even bigger role in 2010. The cost-cutting cycle has largely run its course, and organic growth may be challenging considering economic headwinds still linger. Now that the worst stage of the credit crisis has passed, the corporate sector—which is flush with cash—could utilize M&A to a greater degree in order to boost revenue and earnings growth over the longer term.

So far much of the recent M&A activity has represented marriages of convenience—companies in duress coming together or distressed companies being swallowed up by healthier ones. In 2010, we believe M&A deals will be more strategic in nature—companies that are in healthy financial positions acquiring rivals or smaller companies with the goal of improving existing product lines or expanding into new areas.

Historically there has been a loose correlation between M&A activity and the market's performance. When M&A activity rose, the stock market tended to trade higher, and vice versa.

Catalyst #3: Money Flows

Individual investors mostly stayed away from the equity market in 2009. Many equity positions were sold into the abyss of the massive downturn that occurred previously. Other investors who chose to ride out the storm sat on their positions without adding additional exposure to stocks. Money flowed fast and furiously into the bond market in 2009 as investors searched for safety.

Historically, strong equity market rallies—even those that are only cyclical in nature—haven't ended until individual investors jump in with both feet.

In our view, money would likely flow back into stocks before the rally fully runs its course. Increased money flows from individual investors would be a catalyst for the market to trade higher. But after that happens, the music may stop.

What about the market's valuation?

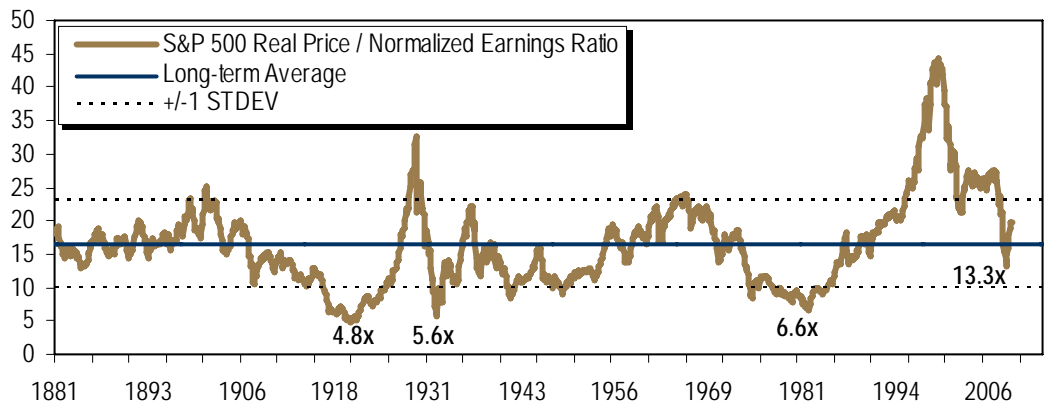
The market's valuation (price-to-earnings ratio) is not currently a catalyst, in our view.

The easy valuation expansion has already occurred. In retrospect, the market was relatively attractive for a very brief period in March 2009. Since then, as the stock market has soared in price, it has become more expensive from a price-to-earnings perspective.

Based on our favorite valuation measure, the market is currently trading at 19.9 times trailing earnings, which is above the long-term P/E average of 16.3, an average compiled since the late 1800s (shown in the graph below). This P/E measure has been constructed by Professor Robert Shiller of Yale University. It uses a 10-year, trailing earnings model that adjusts for inflation.

Even though the market is overvalued according to the Shiller model, it is not at a level that would cause us alarm. It has not yet reached one standard deviation above average. P/E ratios can reside at above-average levels for long periods of time before they begin to impact asset prices negatively. Furthermore, this Shiller valuation measure is among the most conservative we consider. There are other valuation measures which have merit that indicate a more attractive valuation picture.

Long-Term S&P 500 Valuation: 1881 – 2009



Source: Professor Robert Shiller of Yale University, RBC Capital Markets, RBC Wealth Management.
 Note: This data is a monthly series with the S&P 500 price as of 12/17/09 used to calculate the valuation for December 2009.

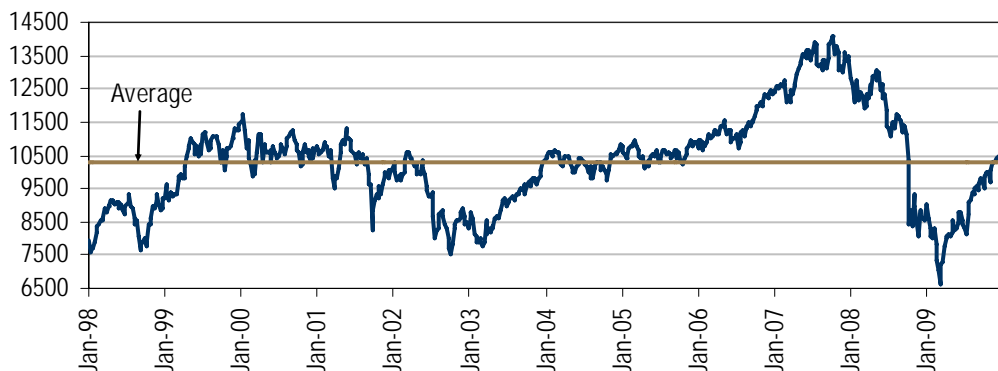
Is it a Bull Market, a Bear Market—or Both?

Even though those potential catalysts and others could boost stock prices in 2010, we continue to believe the market is residing within a longer-term, secular bear-market cycle.

On the face of it, the term “secular bear market” sounds pretty dismal because it represents a long-term period in which stocks deliver disappointing returns. And, reality is, that’s what the market has experienced for the past decade.

When the “Dow 10,000” baseball caps were first being waved on the floor of the New York Stock Exchange, it was March of 1999. Recently, because of the recent surge in stock prices, the Dow has moved just beyond that level again. It’s gone just about nowhere over a long period of time. Currently, it’s right back to the average level since 1998.

Dow Jones Industrial Average 1998-2009



Source: RBC Wealth Management, Bloomberg; weekly data series through 12/11/09

The questions on the minds of many investors are: Does the market's recent advance represent one more rally that will ultimately fade away? Or is this rally the start of something new and better—such as a new long-term secular bull market cycle?

Our assessment is that the market still needs time to work off the economic excesses that flourished during the past 10 years. In other words, we don't think the secular bear market has ended, and we do think it could continue to linger.

While we are optimistic that the recent rally will be extended in 2010 because corporate earnings fundamentals are poised to improve and economic conditions are healing, it could take more time for a full-fledged new secular bull cycle to begin.

But it's important to recognize the market has already endured many years of this challenging cycle. Secular bear markets do eventually come to an end, and there are frequently attractive investment opportunities during such periods.

The market has already experienced two extraordinary rallies within this secular bear period; one from 2003-2007, and the current rally which began in March 2009 (which we anticipate will continue into 2010). These sharp rallies are commonly known as "cyclical bull" moves.

So to answer the initial question: Is it a bull market, a bear market—or both? We believe it's both—a cyclical bull within a secular bear phase.

Therefore, we recommend investors take advantage of the recent rally by implementing the following strategies:

- **Get Tactical**

In 2009, anyone who hugged the major equity indexes was able to enjoy the sharp rally that occurred. As the economy began to rise out of the pit, much of the money that was thrown at the market by institutions was non-discriminating and broadly allocated among investments that mimicked indexes such as the S&P 500 (large-capitalization stocks), the S&P 400 (mid-cap stocks), and the S&P 600 (small-cap stocks).

In 2010, index hugging—relying on just broad-based exchange-traded funds or mutual funds that mimic the major indexes—is not likely to be as rewarding, in our opinion. We anticipate the investment environment will be more challenging as sector and individual stock performances diverge.

Institutional investors are likely to become more discriminating about stock valuations, revenue growth, cash flows, and industry opportunities.

Sector, style, and stock nuances are likely to arise, which begs for a more tactical strategy by individual investors. By "tactical" we mean shifting a portion of equity exposure that is allocated toward broad index-mimicking investments into other areas of the market that have the potential to outperform the major indexes in 2010.

- **Move Up the Quality Ladder**

One area of the market where we see potential for outperformance is the category of quality stocks. Companies with impressive cash flow, strong balance sheets, effective management teams, high credit ratings, industry-leading positions, and solid revenue growth prospects for the economic recovery period represent what we would define as "quality."

What's interesting about this category is that "quality" during one economic cycle may not represent "quality" during the next. Many investors assume their stock portfolios are filled with quality companies. That may have been the case at one point, but as time wears on and economic conditions change, some companies stumble. Their balance sheets deteriorate, revenue trends no longer resemble what they once did, and management teams change.

Furthermore, low-quality stocks had fantastic returns during 2009 and represented the bulk of the outperformance. We believe their dominant run has come to an end. Earnings quality

is likely to face greater scrutiny in the coming quarters, and many low-quality stocks may not meet the challenge.

Now is the time to upgrade stock portfolios by examining current equity positions (including funds) to determine whether there are lower-quality holdings that can be jettisoned and replaced with higher-quality equity holdings.

Within the quality area, dividend-paying stocks represent one of our favorite sub-categories and have for some time. Companies that have a long history of dividend growth are particularly attractive. Dividend-paying stocks will likely gain favor in 2010, in our view, as investors seek higher-risk assets than bonds but still want a steady stream of income to counterbalance equity market volatility. For more information about dividend-paying stocks, see our report, *Dividends Still Matter*, published in October 2009.

- **Strike a Balance**

Sector exposure is just as important, if not more important, than stock selection when it comes to equity portfolio performance. That's because while there are a number of attractive stocks at any given time, if a stock's sector is out of favor, they aren't likely to outperform the market and may not even perform well.

Currently, we recommend striking a balance among sectors. We continue to believe cyclical sectors will outperform the market in the near-term, such as Industrials, Information Technology, and Consumer Discretionary. Throughout much of the rally since mid-March, we have recommended overweighting these sectors, and we continue to do so.

However, as the year progresses, we anticipate performance will shift toward defensive categories. From a technical standpoint, the Health Care, Telecommunications, and Utilities sectors are already beginning to look attractive. These sectors also provide dividend opportunities. We believe it is now appropriate for individual investors to begin building positions in defensive sectors—before the institutions gravitate toward them.

Sector Recommendations: First-Quarter 2010

Sector	S&P 500	RBC CM's Current Stance*	RBC CM's Previous Stance*
	Weighting 12/17/09		
Consumer Discret.	9.7%	Overweight	Overweight
Industrials	10.5%	Overweight	Overweight
Info. Technology	19.1%	Overweight	Overweight
Energy	11.7%	Market Weight	Market Weight
Financials	14.0%	Market Weight	Overweight

Sector	S&P 500	RBC CM's Current Stance*	RBC CM's Previous Stance*
	Weighting 12/17/09		
Health Care	13.0%	Market Weight	Market Weight
Materials	3.5%	Market Weight	Market Weight
Consumer Staples	11.6%	Underweight	Underweight
Telecom. Services	3.2%	Underweight	Underweight
Utilities	3.8%	Underweight	Underweight

Source: RBC Capital Markets

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Rating	Count	%	Investment Banking Services Provided During Past 12 Months	
			Count	%
Buy (TP/O)	584	49.49	176	30.14
Hold (SP)	521	44.15	122	23.42
Sell (U)	75	6.36	4	5.33

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