

Private Client
Strategies & Insights

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The Slow Climb Toward Prosperity

We anticipate economic growth will be anemic until consumers and the Financial sector clean up their balance sheets.

The U.S. economy and American consumers have faced multiple challenges during the past year, including the bursting of the housing market bubble, the credit crisis, and high energy and food prices. As a result, economic growth has been quite sluggish and far below the economy's long-term potential. In order for the economy to climb back toward prosperity and deliver solid growth on a sustained basis, we believe investors will need to endure a slow process in which consumers and the Financial sector clean up their balance sheets.

Consumer debt expanded rapidly during the past 10 years. While much of the excess debt was due to the housing bubble, non-mortgage debt also mounted. Consumer credit, excluding loans secured by real estate, has risen 94% since 1998, according to Federal Reserve data. In the aftermath of the housing bubble and credit crisis, many consumers are being confronted with a period of forced debt reduction and restraint. The government's stimulus package has provided a short-term boost, but we view that as only a temporary phenomenon. When the stimulus impact wanes,

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Tug-of-War

We believe it is prudent to implement an investing strategy based on careful style, sector, and stock selection rather than focusing primarily on the broad indexes.

The stock market has been pulled and strained in numerous ways in 2008, including during the second quarter. At times it felt like a tug-of-war, with the market on one side and macro forces on the other side; and the macro forces have been unwilling to let go of the rope. The market has been impacted by economic headwinds, energy and food price shocks, and the weak housing market. The fact that the Financial sector is only partially through its transition out of the credit crisis also weighed on the broad U.S. stock indexes during the second quarter.

Furthermore, historically stock prices have been driven in part by corporate earnings growth and the prices (or valuations) investors are willing to pay for that earnings growth. Both of these components have been under pressure recently and could remain so in the near-term, in our opinion.

Corporate earnings growth prospects for the balance of 2008 seem rather muted, not solely because of the lingering distress within the Financial sector, but also because profit margins are being constricted due to high energy and food prices. Thus far, companies have not been able to fully pass along higher input prices to their customers. They've absorbed a portion of the higher food and energy costs, so profit margins have been squeezed. As a percentage of Gross Domestic Product, corporate profits were near record levels in mid-2006 (when oil was at \$74 per barrel) and have slowly rolled over since then as the price of oil has spiked. We believe profit margins will continue to be constricted until the oil and food

price shocks recede and the economy grows a faster pace.

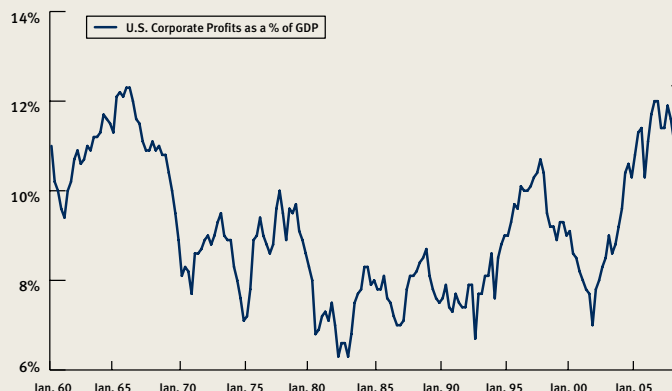
Investors' concerns about future inflation levels have also weighed on stock prices and valuations, in our opinion. Historically, the higher the rate of consumer inflation, the less investors are willing to pay for stocks on a price-to-earnings basis. For example, the stock market tends to have a tougher time advancing when consumer inflation is persistently above 5%. Even though widespread inflation hasn't broken out in all areas of the U.S. economy, consumer inflation recently rose 4.2% on a year-over-year basis because of the spike in crude oil and higher food prices. Until the inflation overhang lifts, we believe institutional investors will be cautious about equity valuations.

The upcoming presidential election is another factor that could impact the stock market. Investors seem nervous about potential tax code changes on dividends and capital gains. Regardless of who is elected, we believe tax rates are likely to rise for

many investors and taxpayers in the upper-income brackets.

Because of these challenges, the market's tug-of-war with the macro forces will persist in the near term, in our opinion. We believe it is prudent to implement an investing strategy based on careful style, sector, and stock selection rather than focusing primarily on the broad indexes. Beneath the surface of the S&P 500 Index, we do see opportunities. We recommend investors increase exposure to quality growth stocks. As profit margins come under pressure, we believe quality growth stocks will be afforded higher relative valuations and could deliver better returns than value stocks. Additionally, RBC Wealth Management's proprietary portfolio, the Guided Portfolio Large Cap, includes stocks that we view as attractive based on fundamental, quantitative, and technical criteria, and its holdings emphasize our sector preferences. For more information about our perspective on the market, please request our *Quarterly Strategy Report* titled, *Tug-of-War*. ■

U.S. Profit Margins Could Decelerate Further



Source: RBC Capital Markets, Bureau of Economic Analysis

Sell Bonds in May and Go Away — Missed Opportunities will Result!

Selling and going away will result in missed opportunities and investors should look to corporate bonds for attractive yields.

One often hears the saying “sell in May and go away” applied to the equity markets, and taken at face value it could have applied to the U.S. Treasury market this past quarter. While offering a sense of security, selling and going away would also result in missed opportunities.

Early on, the overriding concern in the financial markets continued to be the state of the U.S. economy. The Fed was expected to ease monetary policy at its next FOMC meeting, and in late April, the Central Bank didn't disappoint, easing by another 25 basis points. By this time, however, market sentiment had already begun to change with the odds of a near-term recession fading and financial market pressures easing. This change was never more evident than in the Treasury market where the massive flight to quality began to reverse. By the end of quarter the 2yr/30yr spread had narrowed to approximately 190 basis points from over 300 basis points.

A 40% spike in oil prices, coupled with upward pressure on commodity prices in general, caused inflation expectations to change dramatically and with it the outlook for short-term interest rates. On the surface, the Federal Reserve appears to have shifted its focus from the economy to inflation and publicly seems to have adopted a more hawkish stance with Fed Chairman Bernanke himself leading the charge. Public perceptions have shifted from Fed policy being “on hold” to anticipating a series of rate hikes at upcoming FOMC meetings.

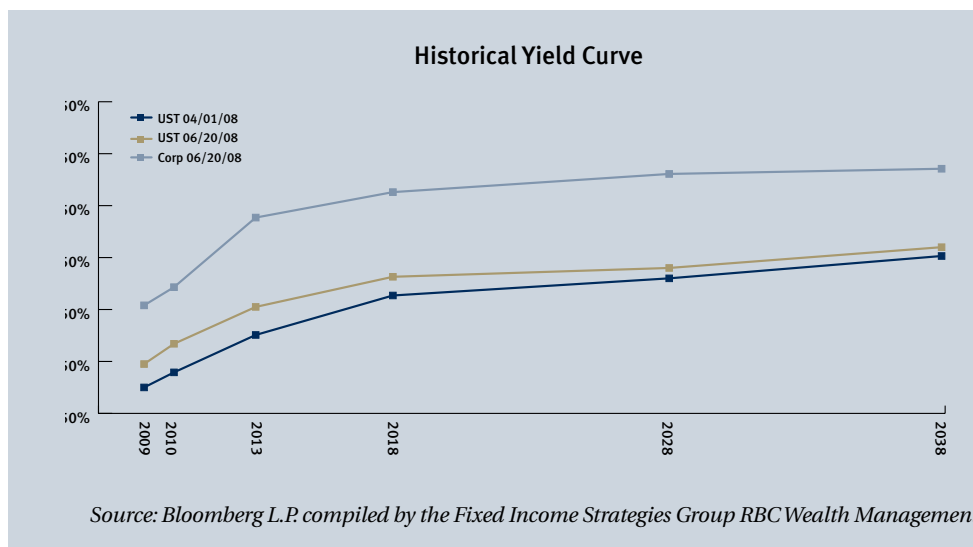
Rather than follow the crowd though, investors should take note of comments such as “...not so

much actual inflation, but rather the expectations of accelerating prices” in the daily *Fixed Income News*, and “we believe it's premature to bet on a tightening cycle for three reasons...” in the most recent *RBC Investment Strategy Weekly*. The message here is that the change in Fed tone may be more “jawboning” rather than a signal of imminent rate increases. For the record, RBC's base case view that slowing growth and moderating inflation will have the Fed easing in early 2009 remains intact.

Rather than follow the crowd though, investors should take note of comments such as “...not so much actual inflation, but rather the expectations of accelerating prices” ... “we believe it's premature to bet on a tightening cycle for three reasons...”

The previous issue of *Strategies & Insights* highlighted the opportunities in the municipal bonds whose ratios to Treasuries were greater than 110% across the curve. Opportunities have

lessened as these ratios are now at or near 5-year averages of 80-95%. On the other hand, investment-grade corporate bond yield spreads are at their widest levels in 5 years. Major financial companies offer the highest yields, with spreads to Treasuries of 100-900 basis points, but the desire to avoid ongoing credit issues, coupled with the fact that investors already own many of these names, makes it necessary to look to non-financials for diversification. In doing so, the yield give-up depending upon the issue and its perceived credit risk, can be as narrow as 75-125 basis points, and current yields on non-financial names are: 5yr-5.00-5.50%; 10yr-5.20-6%; and 25yr-5.70-6.60%. It is our view that investors should look to corporate bonds for attractive yields, but in doing so should diversify their portfolios away from financials (and in most cases give up little in yield), stay with solid investment grade credits, and look to extend out on the curve to lock in attractive coupons and yields. ■



The Slow Climb Toward Prosperity *Continued*

many Americans will once again be confronted with credit card bills, student loans, auto loans, and home equity lines of credit that need to be paid. Wealthier Americans' balance sheets are as strong as they've been in decades, but many lower- and middle-income Americans now have little capacity to spend discretionary income or add more debt, which has reduced their ability to drive the economy forward.

The situation has been exacerbated because consumers are being squeezed between two forces that rarely occur simultaneously. On the one hand, there is meaningful inflation in goods we need every day, like gasoline and food. The United States is now spending almost as much on energy as a percentage of disposable income as it did during the oil crisis of the early 1980s.¹ On the other hand, severe deflation (falling prices) has occurred in Americans' most important asset — residential real estate. We believe home prices will continue to drop until supply and demand come into balance, which may not occur until 2009 or later. The combination of inflation in one part of the economy and deflation in another has contributed to the lowest levels of consumer confidence since the early 1980s.

Despite these challenges and the likelihood that headline consumer and producer inflation could rise further, we do not anticipate the economy will slump into a period of extreme malaise similar to what occurred in the 1970s and early 1980s. There are a few important distinctions between then and now:

- Employment is sturdier than it was in the 1970s. Even though the job market is still vulnerable to further deterioration, we don't believe it will approach the dire situation that occurred in the mid-1970s and early 1980s when the unemployment rate rose to 9% and almost 11%, respectively.
- Wage inflation has been nonexistent during the current cycle and should remain muted as long as the economy is sluggish, in our opinion. Wage inflation was the fuel behind the oil-induced inflation spiral of the 1970s.
- While Americans' expectations about future inflation have risen, they are relatively tame compared to previous inflation outbreaks. This point is critical because when inflation expectations rise dramatically, inflation rates tend to follow suit. Currently, inflation expectations are still tame enough

to prevent an inflation spiral, in our view.

- Interest rates are much lower today compared to the 1970s when the 10-year Treasury yield averaged 7.3% and compared to 1981 when the yield peaked at 15.8%. Low interest rates are currently providing many consumers with a much-needed life raft and an opportunity to pay down debt.

These are some of the reasons we do not anticipate the economy will relive the 1970s and are optimistic about its long-term prospects. However, we believe investors' patience will be tested in the near term. The deleveraging process could take time — more time than investors have become accustomed to in this fast-paced internet era. U.S. economic activity should be constrained for the balance of 2008 and into 2009, in our opinion. The slow climb back toward prosperity will likely be accompanied by anemic Gross Domestic Product growth well below the 3.5% historical trend rate until consumers and the Financial sector begin to get their balance sheets in order. ■

¹ Credit Suisse, *The implications of higher oil/food prices*, May 21, 2008.



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