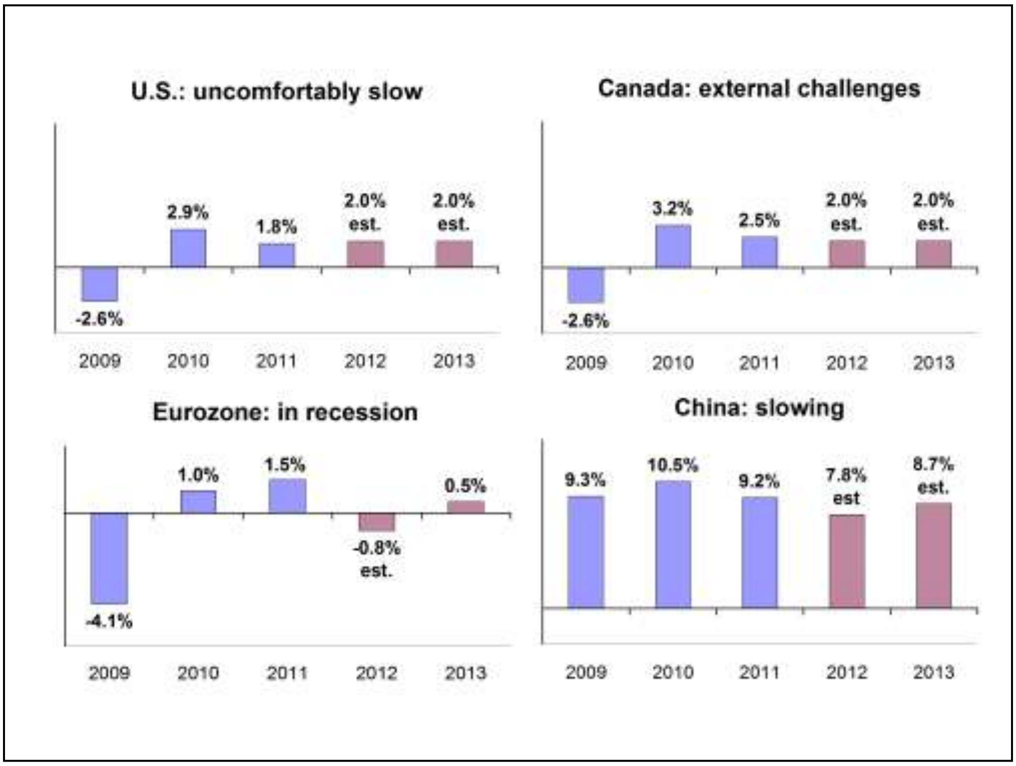
RBC Dominion Securities

Economic and Capital Markets Outlook

Summer 2012

Outlook

- ❑ Europe is in recession and the risks of the U.S. following suit should not be ignored.
- ❑ China's growth is slowing due to weaker trade and the effect of credit/policy crunch on housing and capital spending. The slowdown has already been deeper and longer than expected.
- ❑ Canada vulnerable to U.S. and China weakness, but still forecast to post best growth of any G8 economy (for now).
- ❑ Flight-to-safety bid has pushed bond yields to an artificially low level. Any improvement to crisis outlook could provoke a painful back-up in yields.
- ❑ Downward revisions to GDP growth estimates have reduced corporate earnings forecasts. Recession not yet factored in.
- ❑ Stocks offer compelling long-term value but could remain under pressure until the economic/earnings outlook stops deteriorating.



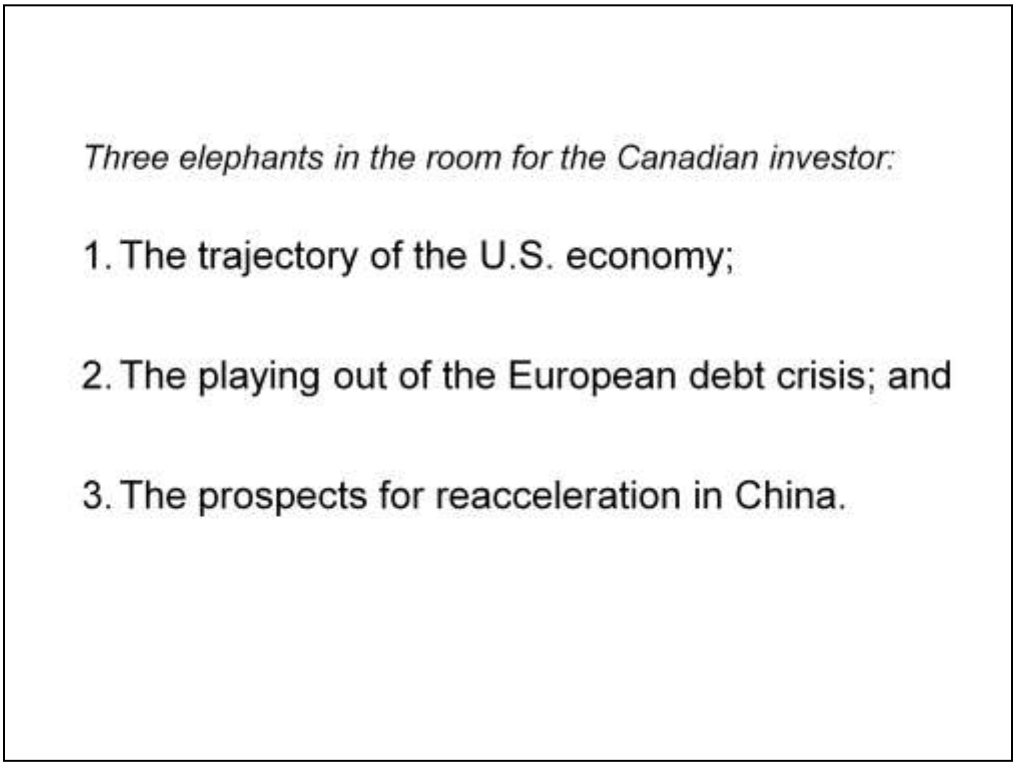
To begin let's check in on the economic backdrop:

The U.S. is growing at an uncomfortably slow rate of 2%, about half the 3% to 4% pace posted over more than a decade leading up to the financial crisis and the resulting recession.

The Canadian economy, as usual and understandably, is performing not too differently.

Most of Europe, including the U.K., besieged by the debt crisis, is in recession with only an anaemic recovery forecast for next year.

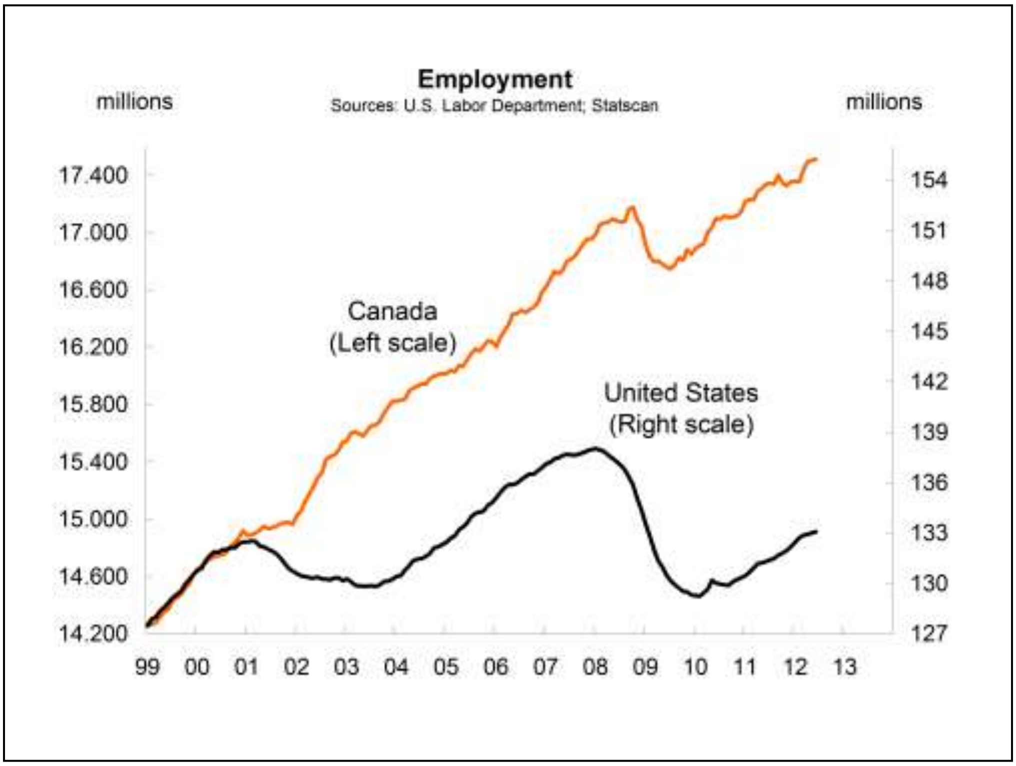
China's economy has been slowing by more and for longer than forecasters had been predicting even six months ago. Some reacceleration should arrive late this year.



From a Canadian investors standpoint there are three “elephants in the room.” All three will have at least as large an effect on the direction of Canada’s economy and the performance of financial markets over the next year or two as any purely domestic considerations. In order of importance today they are:

1. The forecast trajectory of the U.S. economy;
2. The playing out of the European debt crisis; and
3. The prospects for reacceleration in China.

To complicate matters further, all three are somewhat interconnected. Let’s start by looking at the prospects for the U.S. economy.



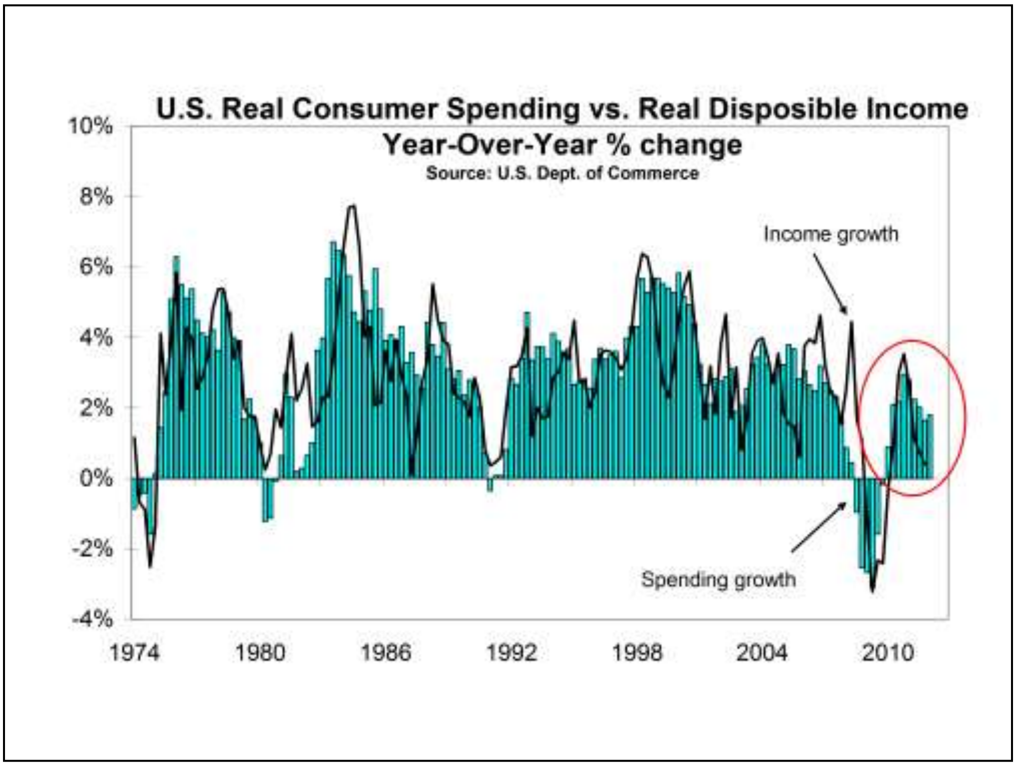
The U.S. is the world's largest economy. At 25% of global GDP it is more than twice as large as either China or Japan. It is a very large customer of many other economies including Canada, China, Japan, Korea, as well as most of Latin America including Brazil. Because of those linkages, how the U.S fares is extremely important for the rest of the world.

The U.S. lost some 9 million jobs in the recession. So far much less than half of those have been recovered. While the private sector has created 4.2 million jobs since early 2010, government has shed half-a-million million workers.

This very slow improvement in the employment picture has had a negative effect on American consumer attitudes, household income growth, and spending. With more and perhaps deeper government cuts coming this year and next it may hard for this picture to improve meaningfully for some time yet.

By contrast, Canada lost proportionally less than half as many jobs in the recession as the U.S. (425,000) and as of June had recovered all of them and an additional 335,000 on top of that.

As global growth slows further and fiscal stimulus is withdrawn over the next two years job creation in Canada is likely to slow also.

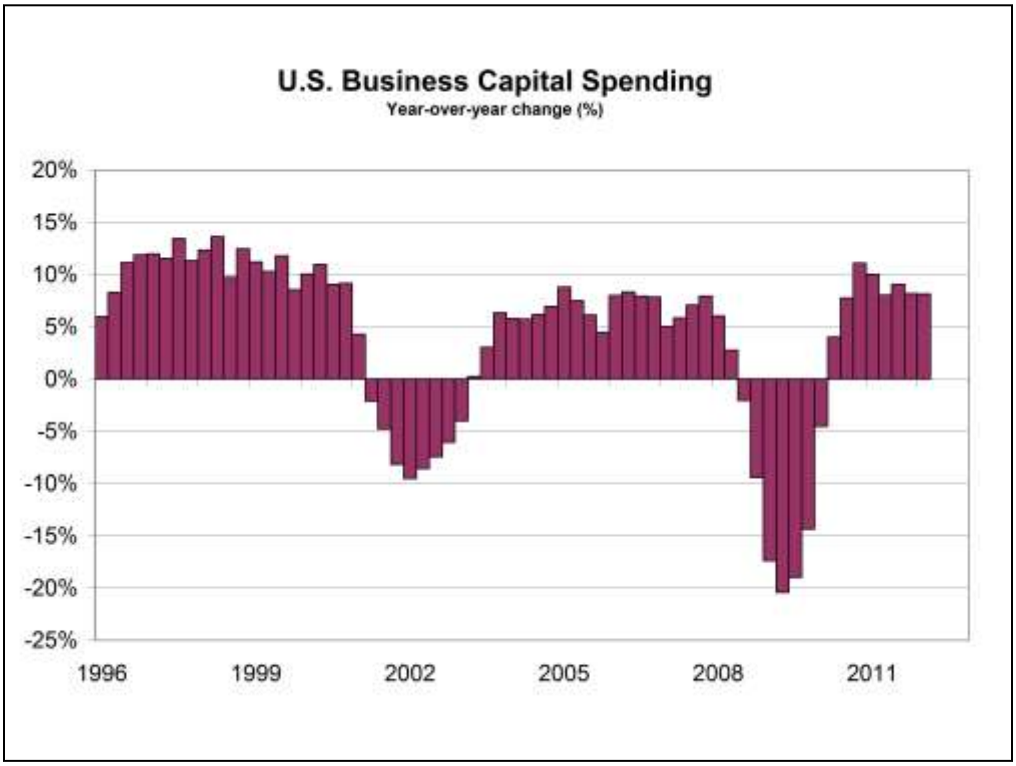


At 70% of GDP, consumer spending is the most important economic component of the American economy. While household spending has held up better than feared over the last few quarters, this chart reveals just how anaemic growth in spending (the turquoise bars) has been compared with past cycles.

Meanwhile, real disposable income growth (the dark line), the fuel that drives spending, has been growing more slowly than spending. That's mostly because average weekly earnings have been declining in recent quarters.

That means consumers have managed to keep their real spending growing only by cutting back on savings, which they have done in each of the past four quarters.

But unless something quickly changes for the better - i.e., job growth speeds up (a challenge), inflation drops further (maybe), housing returns to health (not fully in 2012), confidence is restored (Europe, gov't cuts, etc.) – then consumer spending will be hard pressed to contribute as much to U.S. growth in 2012 as it did last year.

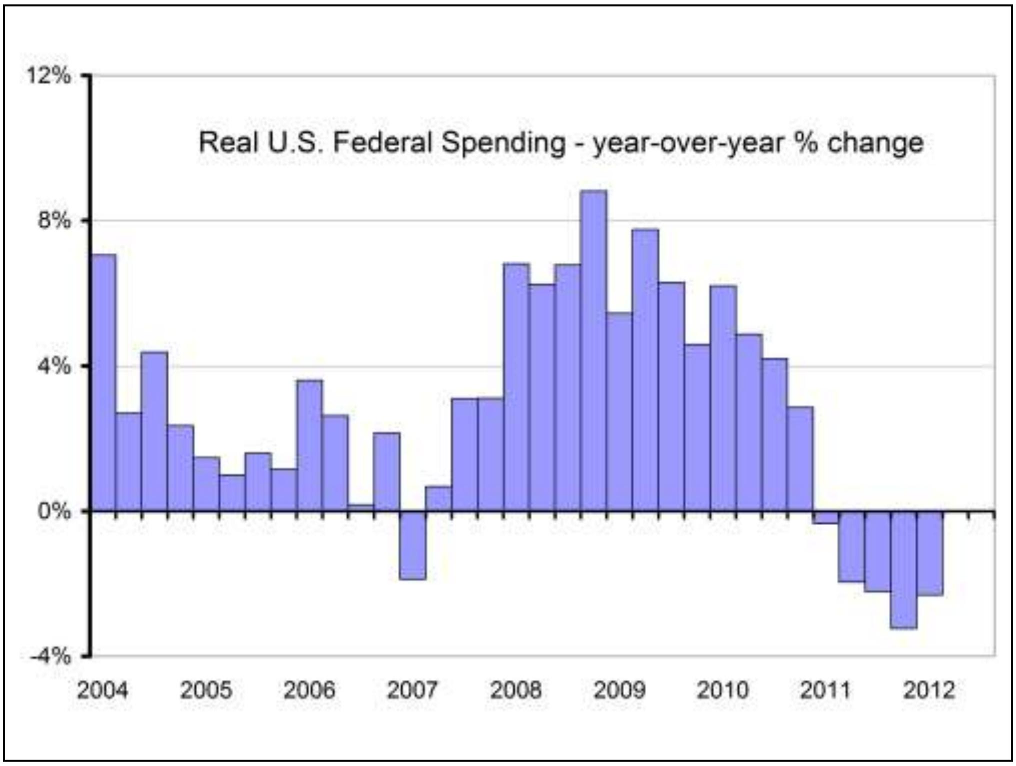


If the consumer can't be counted on to go on running down savings to keep household spending growing, then a lot of the heavy lifting in 2012 and in 2013 will have to be done by business capital spending. Capex has already been pretty robust this cycle aided in part by tax incentives. However these were recently cut in half by Congress for the coming year.

The good news is that corporations in the U.S. (and in Canada, Europe, and Asia) are in great shape. Profits are at record highs and so are margins. Companies are awash with cash and have very low net debt and many have managed to lock in very low debt service costs on the debt they do have.

So companies for the most part are financially very capable of growing their capital spending vigorously. However the sixty-four dollar question is "Will they?" Especially given that Europe is in recession while growth in the U.S., Canada, and China is slowing.

Capex growth in Q2 was likely markedly slower than in either Q1 or Q4, but some leading indicators or future spending have improved recently.

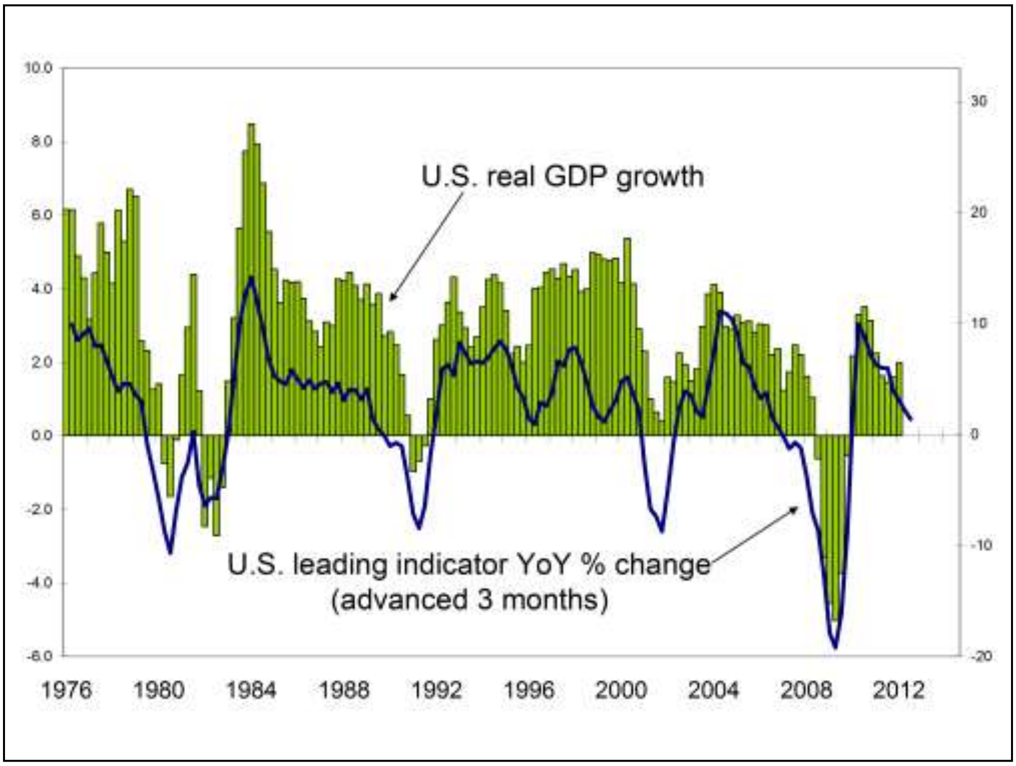


Government spending – or lack of it – is now a headwind for the U.S. economy. U.S. federal spending surged in 2009 and 2010 in an effort to moderate the economic downturn. That stimulus has already started to be withdrawn with more cuts expected this year and possibly much deeper ones for 2013.

When Congress failed to reach agreement last summer about how or when to rein in the U.S. budget deficit, it accepted a temporary *status quo* and "kicked the can down the road" until the end of this year following the election.

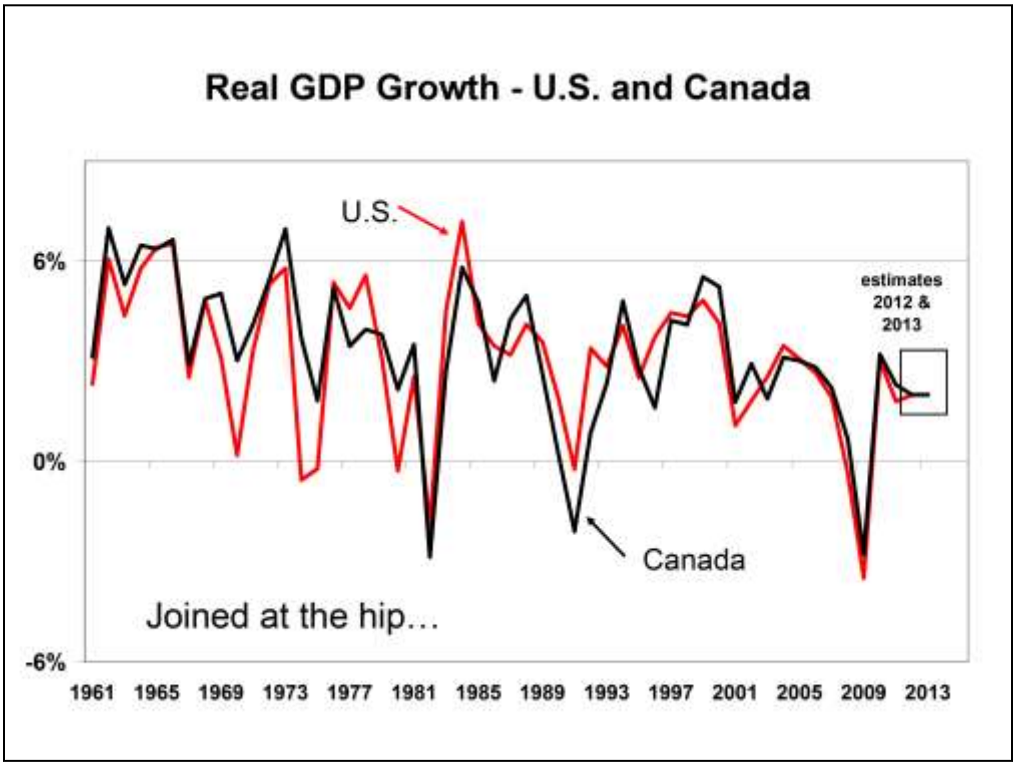
If there is no agreement by the end of December then in January both the Bush tax cuts for high income earners and the Obama payroll tax cut will expire and automatic deep spending cuts will kick in. This is the so-called "fiscal cliff"' and if left unattended it will carve 3.8% out of GDP next year.

Our GDP growth estimate for next year is 2%. It assumes that two-thirds of these fiscal measures are pushed out beyond 2013 and that the resulting 1.3% drag on the economy is more than made up for by growth in consumer spending and capital investment. If nothing is done and all the provisions are allowed to expire then a U.S. recession in 2013 becomes likely.



Despite the potentially weaker spending outlook for all the sectors of the economy, so far the Conference Board's much-watched index of leading indicators is **not** signalling that a U.S. recession is imminent. Usually it registers negative readings (that is, falls below the zero line on this chart) several quarters before the economy actually contracts.

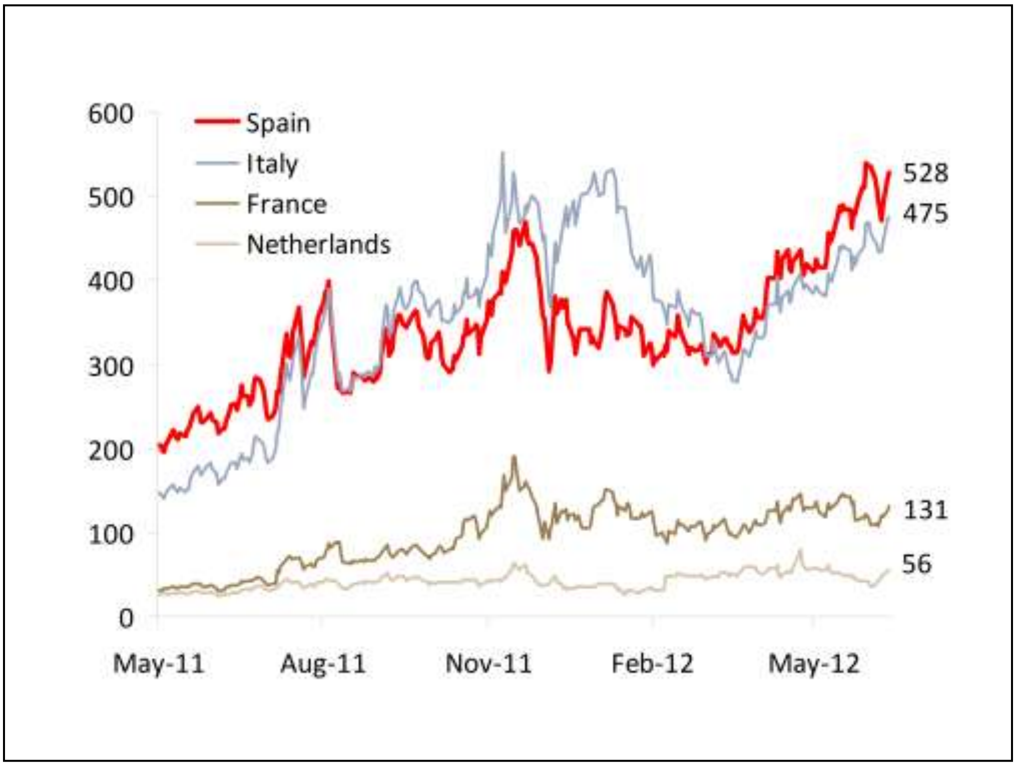
However, with capital spending perhaps set to slow, government cutting spending, and the consumer underpowered and uncertain, the possibility of the U.S. slipping into recession in 2013 can't be entirely ruled out. Especially if the "fiscal cliff" is not addressed or if a negative shock to the banking system were to be delivered by a worsening of the European situation.



Canadians would like to think their economic fate lies in their own hands. However, the history of the last 50 years, shown in this chart, suggests otherwise.

Canada may be able to outperform (or underperform) the U.S. economy in any given year but clearly the direction of growth is determined by the trajectory of the U.S. economy.

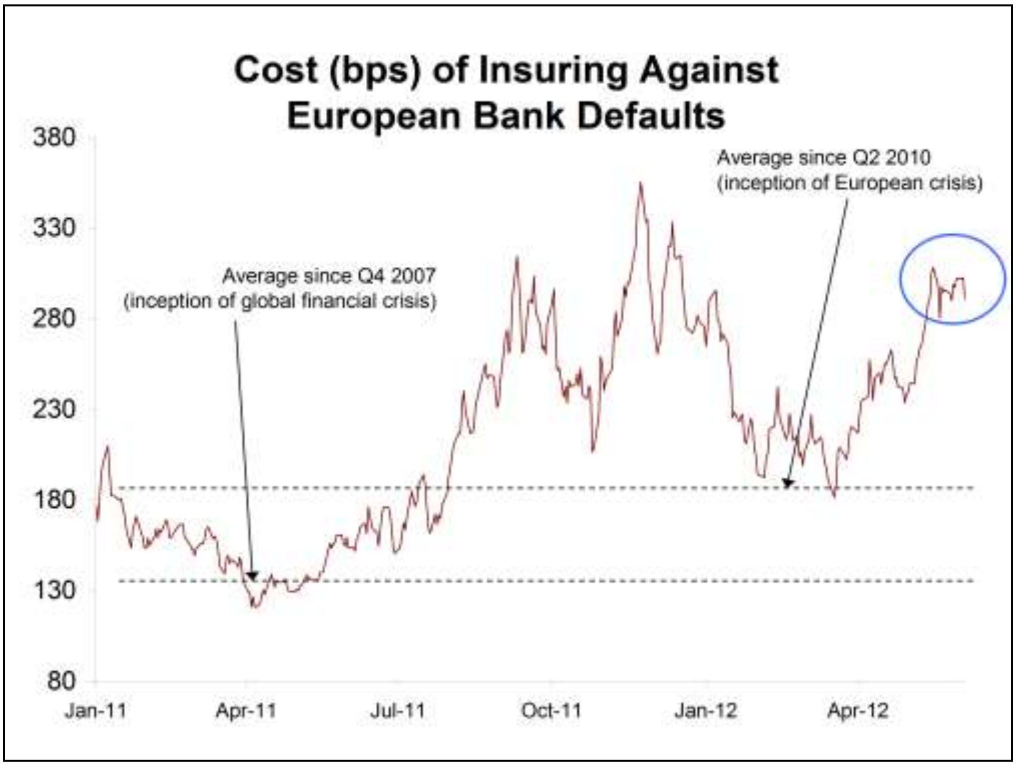
We forecast an extended period of below-potential growth for the U.S. with the outside possibility of a recession thrown in for good measure. If the historical “close fit” pictured above holds, the prudent expectation would be for similar outcome in Canada.



The Eurozone crisis has taken centre stage again. Three small economies – Greece, Ireland, and Portugal – have had to be bailed out by Europe and the IMF because they were incapable of ever repaying their very large debts. They and all other European countries have undertaken programs of austerity – i.e., cutting spending and raising taxes – to bring down their debt to GDP to sustainable levels.

This austerity has pushed the region's fourth largest economy, Spain, into a very painful recession – unemployment is running close to 24%. Markets are worried Spain will have to be bailed out too.

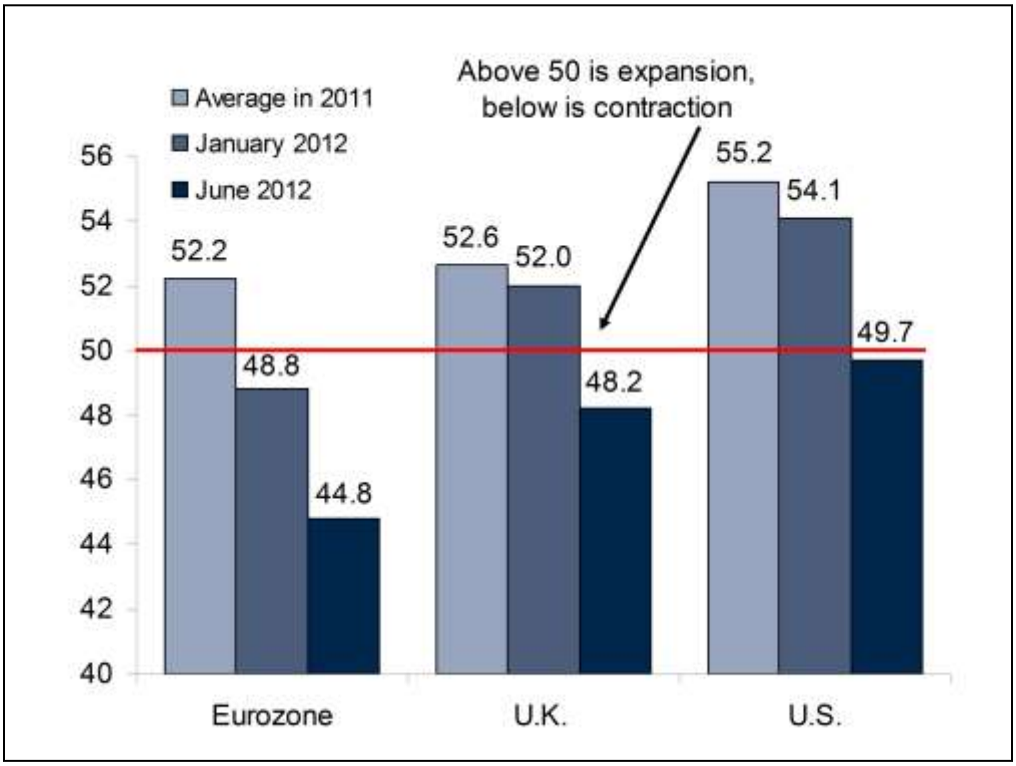
This chart shows the spread, expressed in basis points, between the borrowing costs having to be paid by Spain, Italy, France, and the Netherlands and that for the region's top credit, Germany. Clearly borrowing costs for both Spain and Italy have risen very steeply since March.



Much of Europe's sovereign debt is owned by European banks. The market's biggest worry is that sovereign debt problems will turn into a banking crisis, one where banks everywhere become less willing to lend to European banks that own the affected debt and then eventually to any other bank anywhere that is thought to have exposure to those European banks.

A seizing up of the inter-bank lending market is what followed the Lehman collapse in 2008 and produced a sharp global economic slowdown.

This chart shows that the cost of buying insurance against default by European banks has risen sharply over the last couple months back up to where it was at the end of last year just before the region's long-term refunding operation was introduced to give banks access to cheap government funding.



The sovereign debt crisis and the inability of European governments to take decisive and effective steps to resolve it has sapped business and consumer confidence across the Eurozone. The region is in recession and leading indicators like the one pictured here suggest it is going to get worse before it gets better.

The U.K., which is a member of the European Union but not of the Eurozone, is also in recession. It has very strong trade and financial ties with Ireland, one of the worst affected economies, and sends half its exports into the Eurozone.

Neither the U.S. nor Canada does that much in the way of direct trade with Europe, so a European recession by itself would not be enough to produce one in North America. But if the recession now underway were to worsen the European banking crisis, that could tighten monetary conditions everywhere enough to further weaken an already fragile global economy.

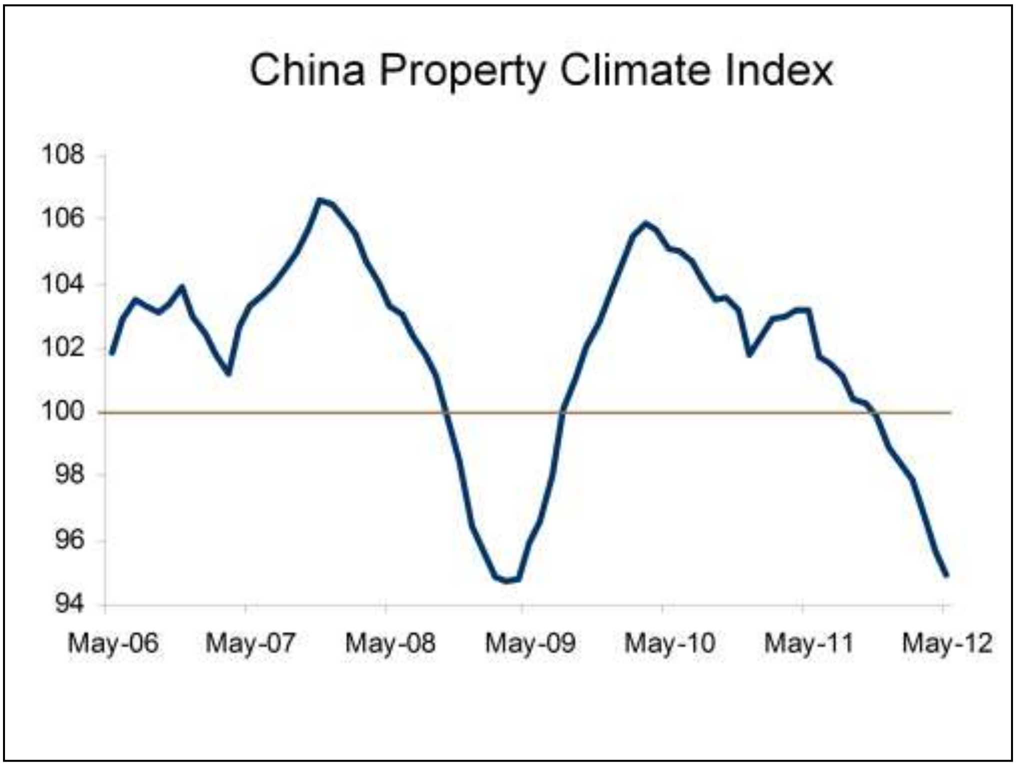
The prospect for a reacceleration of Chinese growth over the next year or two could be the deciding factor that determines whether Canada does a little bit better than the U.S. or a little bit worse.

While China continues to post GDP growth numbers that most other countries can just dream of, it has been slowing down nonetheless – from over 10% in 2010 to just 9.2% last year and a projected 7.8% in 2012.

China's is an extremely commodity intensive economy – the country consumes just about 40% of every industrial commodity and more than 10% of the world's crude oil. Hence whether China is slowing down or speeding up has become the most important factor in determining the direction of global commodity prices. This in turn makes it very important to Canada's large energy, mining, and fertilizer industries and to the outsized resource and commodity sectors of Canada's stock market.

In the process of China slowing down – from a very high growth rate to merely a high one – the need to adjust inventories of raw materials has put downward pressure on many commodity prices since last spring.

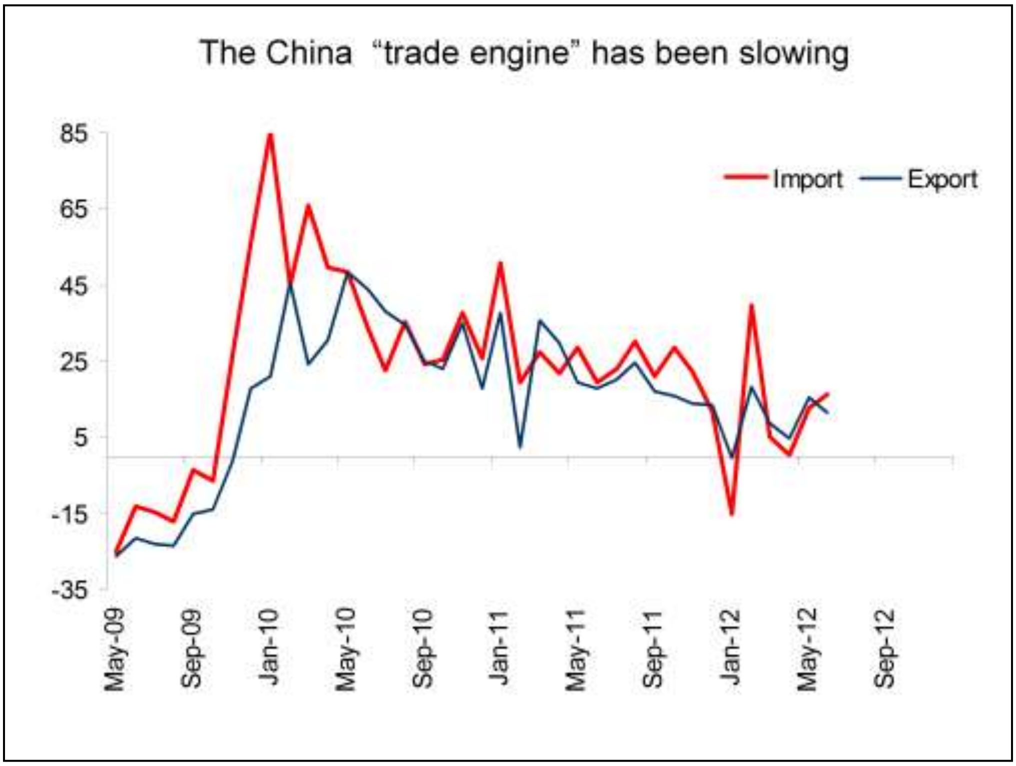
China's leading indicator of industrial activity has been oscillating between readings of "contraction" and "expansion", suggesting this period of commodity inventory adjustment may have further to run.



Besides weak export growth, another important factor in China's economic slowdown has been its tight monetary policy, designed to defuse a painful bout of inflation, combined with tough regulations aimed at damping down real estate speculation. Since late last year real estate prices have been receding across much of the country.

Two years ago China watchers were worried house prices were rising too quickly. Now that prices are falling in most cities they are afraid the government will have trouble stopping the decline.

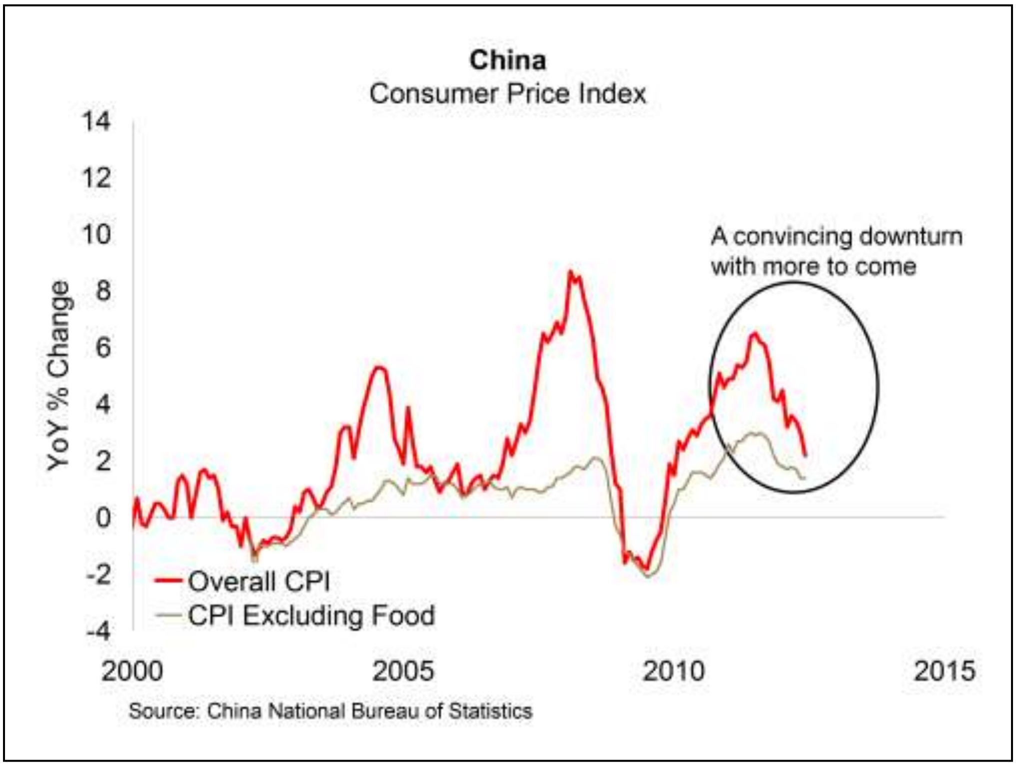
Because there remains pent-up demand for housing and because, compared to most housing markets, China's uses comparatively little leverage, we believe the decline will not be self-reinforcing. Increasing affordability and the eventual easing of second home purchase regulations should bring the housing market and prices into equilibrium reasonably quickly.



Export growth has been slowing but remains positive. Most of the slowdown has been due to weak exports into Europe, China's largest customer – partly because of weak European demand due to the recession and partly because European banks have been pulling back from providing trade finance.

As long as Europe remains in recession, both problems are likely to get worse. However stronger demand from the rest of Asia is taking up some of the slack.

An American recession – not in our forecast but a possibility – would add to China's export challenges.

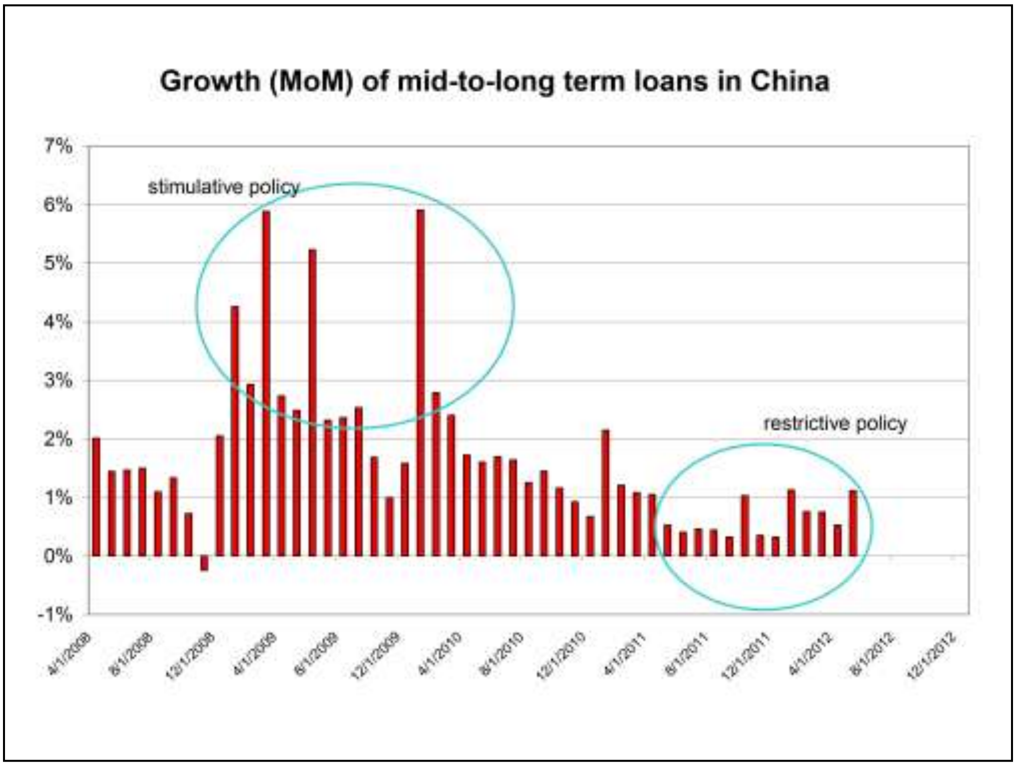


Inflation, particularly food inflation, has fallen dramatically since last summer.

This could be an important source of future stimulus for China's economy particularly because food comprises about a third of the Chinese household budget versus just 12% in North America. Reining in food prices boosts consumer confidence and leaves more ammunition for discretionary spending.

Policy tightening appears to be over and more substantial steps toward easing are widely expected for 2012. However, we believe policymakers are prepared to allow GDP growth to moderate further rather than risk rekindling price pressures by reversing course too quickly.

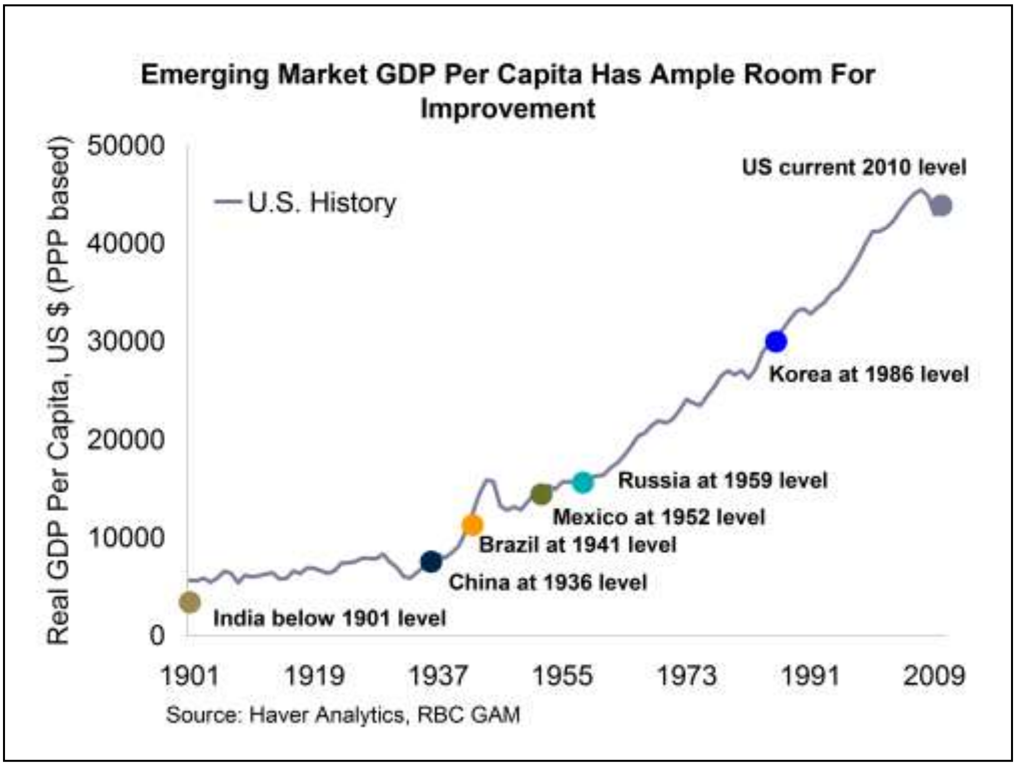
To the extent that any eventual revival of Chinese growth prospects translates into stronger demand for commodities, it is likely to have a positive effect on the Canadian economy and an even bigger one on the Canadian stock market. That said, we believe reacceleration of the Chinese economy is still some ways off.



Policymakers have lowered bank reserve requirements three times since December and have recently lowered the one year lending rate twice by a total of 56 basis points, the first rate cuts in this easing cycle.

For the immediate future a great deal hinges on the government's willingness to ease further, perhaps more aggressively.

The tightening of the past two years produced a big slowdown in money supply growth and bank lending. The easing cycle now underway will be judged as taking hold once lending, especially mid-to-long-term lending, picks up in a sustained way. Watch this space!

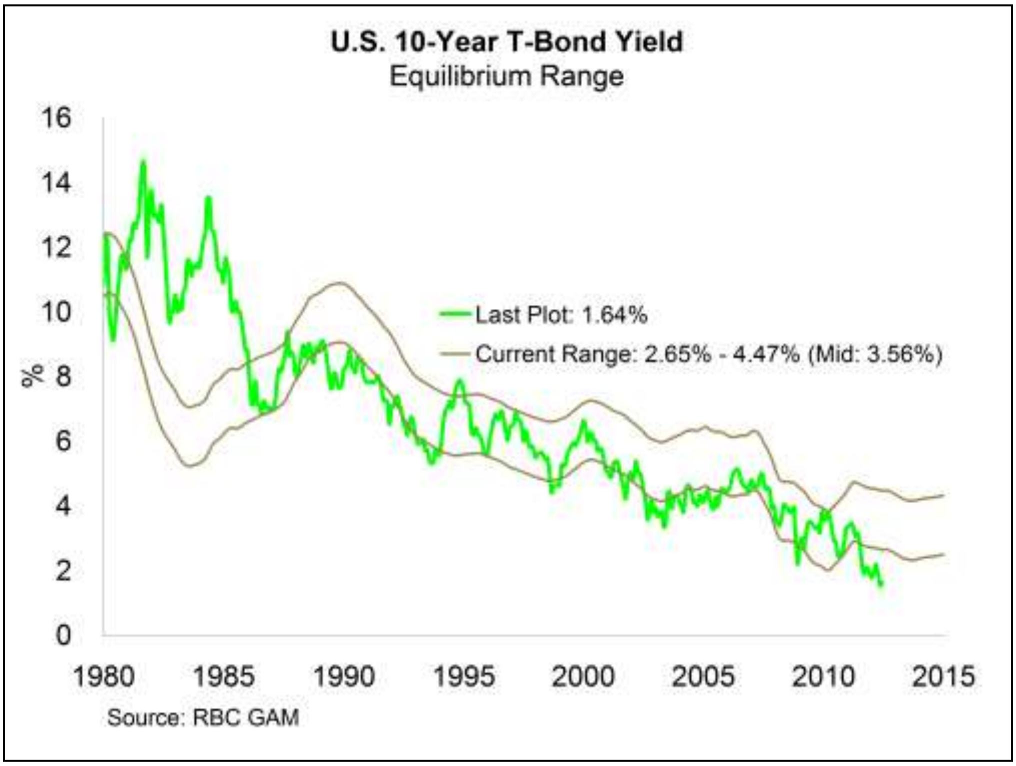


Short term concerns notwithstanding, the long term outlook for China and several other emerging economies looks bright.

This chart shows that despite giant strides made by fast growing economies like China, Brazil, and India over the past 20 years or more, they are all still rather a long way back of the U.S. (and other developed countries) when compared on a GDP per capita basis.

While there is no guarantee that these emerging economies will follow the path set by GDP per capita in the U.S. over the past century it seems likely that they will make some significant gains.

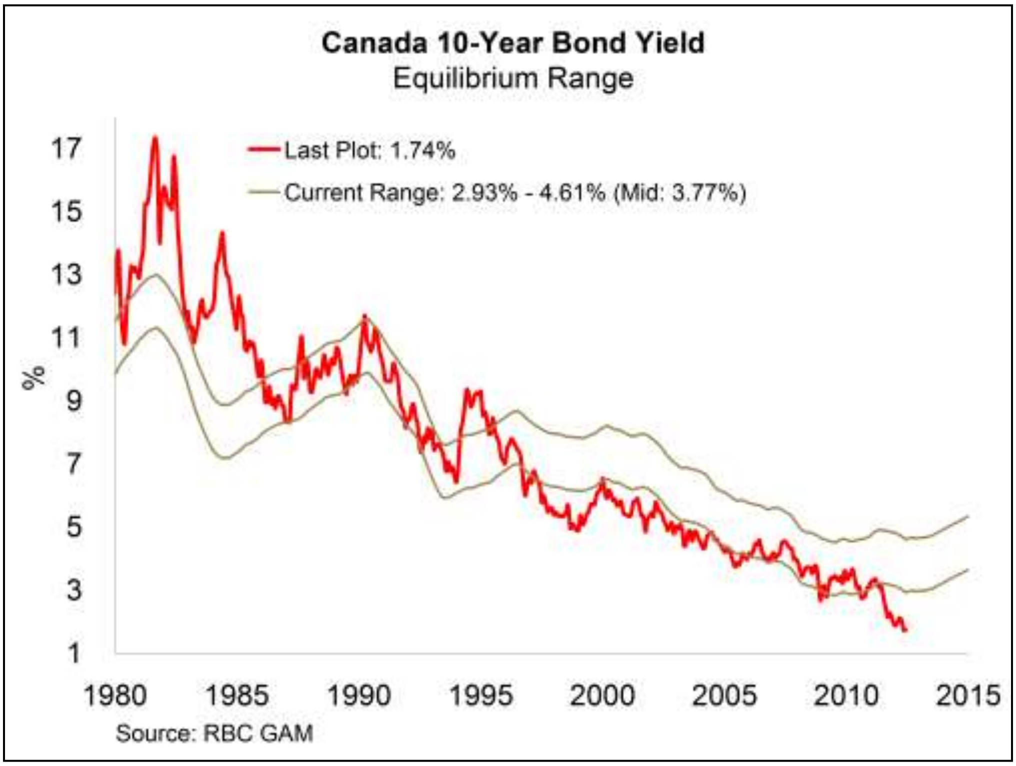
That should make the global economy much more balanced and also much more competitive.



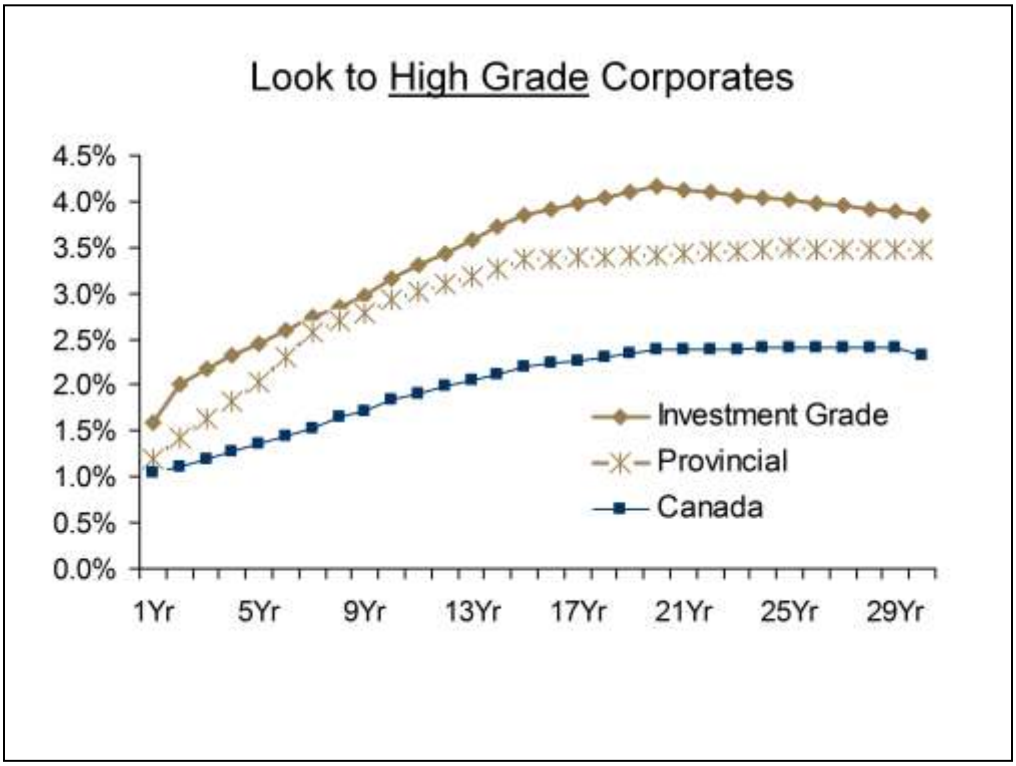
The European debt crisis has provoked a “flight to safety” that has seen immense amounts of capital flood into U.S. Treasury bonds and Canada bonds as safe havens. That has pushed bond yields to artificially low levels. So low that Treasuries are yielding almost half a percentage point less than the latest rate of inflation. Usually it would be the other way around, with bonds yielding 1% to 2% more than inflation.

The crisis is far from over. Rapidly ebbing inflation and a longer, deeper recession in Europe, now combined with a softer-than-expected U.S. economy, suggest the much-feared “normalization” of bond yields that would result if the crisis were resolved won’t be nearly as extreme as it would have been six months ago and will likely be pushed further out into the future. Nonetheless, ultra-low coupons that are still below today’s rate of inflation make it hard to recommend meaningful new long-term commitments to government bonds.

On the other hand, if the crisis continues to blow hot, government bonds offer the best protection against deeper than expected declines in equity prices.



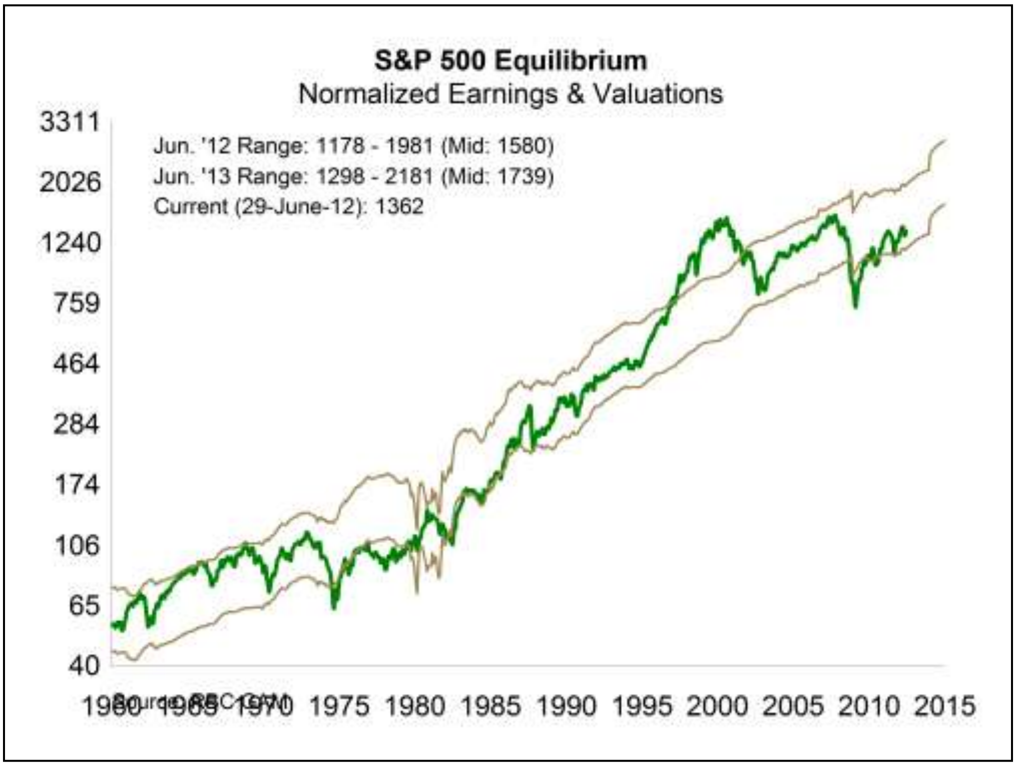
The same unrewarding equation faces investors in Canadian government bonds.



For those investors who intend to hold bond positions to maturity we believe better value can be found today in the high-grade corporate sector and among selected provincial issues.

However, this sector could also produce mark-to-market losses in the shorter term if the crisis and the global economic outlook were to worsen.

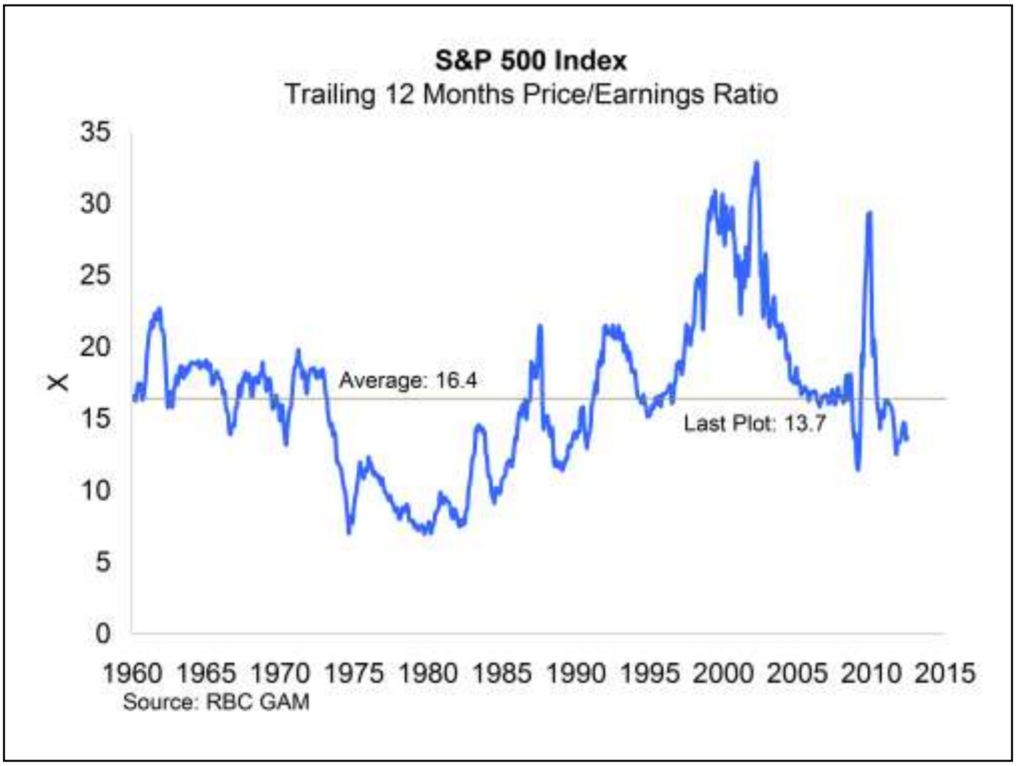
Given the ongoing search for yield, we caution investors to remain selective and to avoid overweighting any one sector.



Turning to the stock market, this model looks at how American stocks are valued in relation to their earning power, taking into consideration the outlook for interest rates and inflation. 'Fair value' would be at the mid-point of this band.

The index today is a long way below what we calculate to be fair value and even further below what this model projects fair value will be one year from now.

On this basis then, large-cap, blue-chip American stocks as represented by the S&P 500 are quite undervalued.

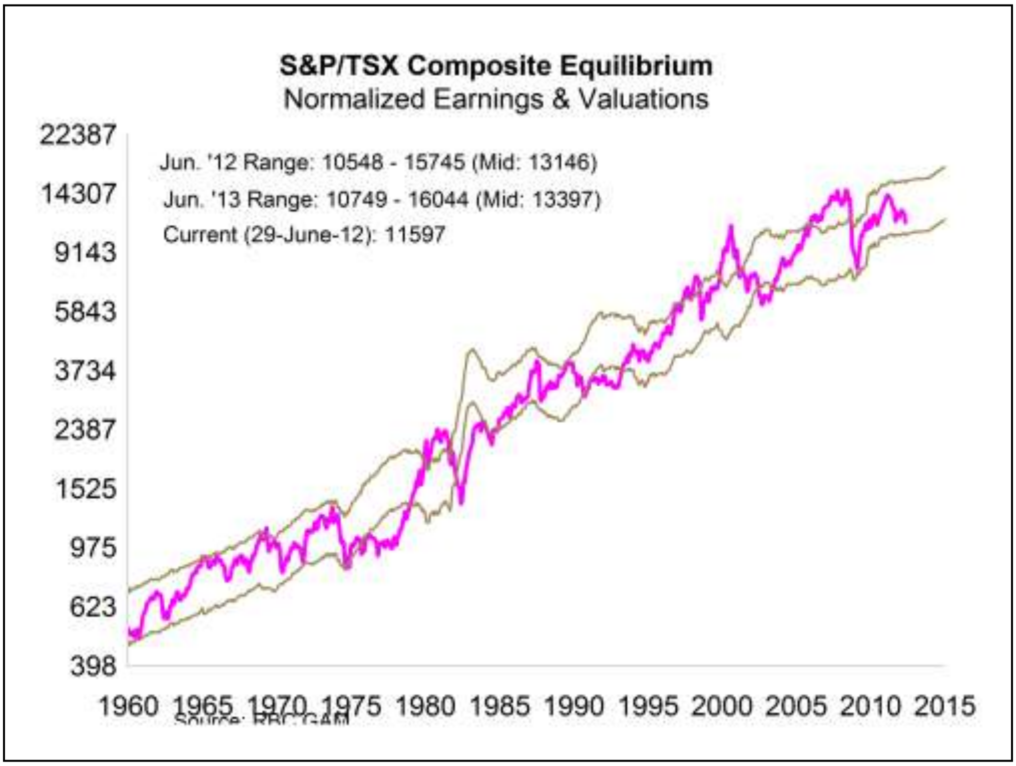


Price-earnings ratios are a more familiar way of judging market valuation for most investors.

This measure is sending the same message as "fair value": stocks are quite cheap in relation to their latest 12 months reported earnings and to next year's estimated earnings.

Earnings for the year just ended were $98 for the index up from $85 a year earlier. For 2012 we estimate S&P 500 earnings per share will grow to $101.

So the market is trading at an attractive 13 times estimated earnings. Back in the years leading up to the recession the market consistently traded at between 15 and 17 times earnings – and that was half the 32 times earnings posted at the market peak in 2000.



Looked at the same way the Canadian market is more fully valued than its American counterpart. On a price/earnings ratio basis the TSX is trading at 14.4 times this estimated year's earnings versus 13X times for the S&P.

Part of the difference is explained by the fact that Canadian bank stocks account for a larger proportion of the TSX by value than American bank stocks comprise of the S&P 500 (30% versus 16%). And Canadian banks are judged to have stronger balance sheets, cheaper more stable deposit bases, as well as better dividends and dividend prospects than do most American banks.

However, in our view, even after adjusting for this the TSX is still expensive relative to the S&P 500. That's because its sector make up is more concentrated and more risky.

China sensitive

TSX Sector Weights

Energy	26.7%
Materials	21.5%
Industrials	5.8%
Cons Disc	4.1%
Cons Staples	2.7%
Health Care	1.5%
Financials	29.6%
Info Tech	1.3%
Telecom Svc	5.0%
Utilities	1.9%
	100.0%

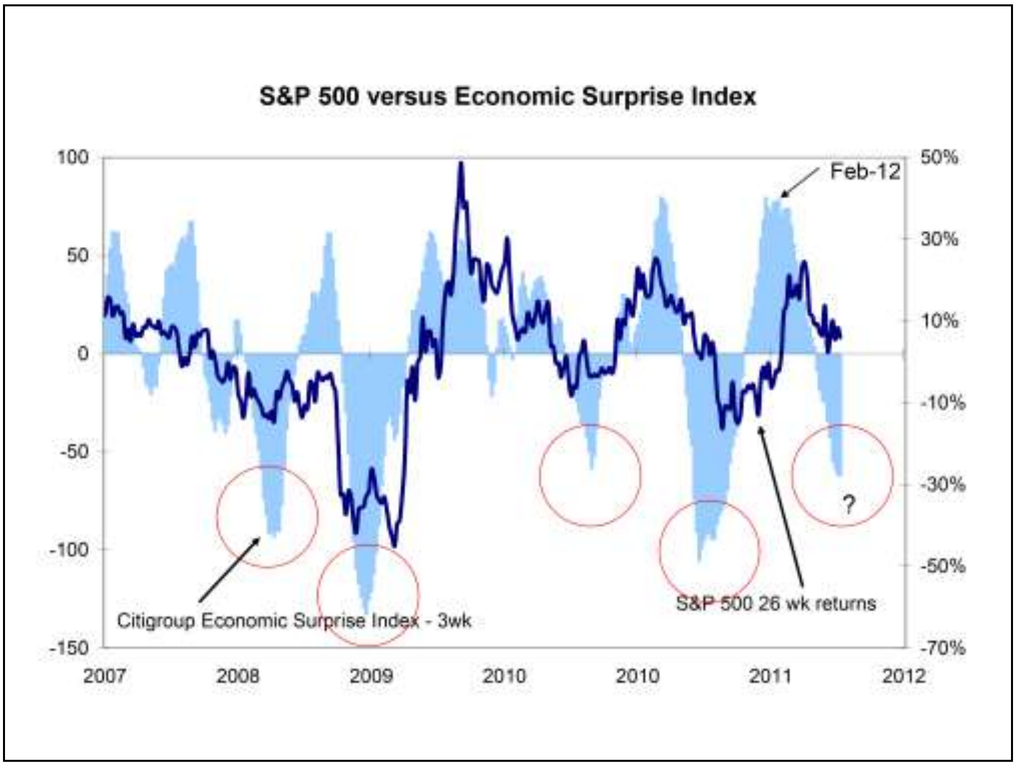
Euro crisis sensitive

The Canadian stock market looks very different from the Canadian economy in make up. Almost 80% of the value of the TSX index is comprised of just three sectors – energy, materials, and financials. But those three sectors account for less than 40% of Canada's GDP.

More important in the present situation, these three sectors are highly sensitive to volatile factors playing out elsewhere in the world.

Banks and lifeco's, already under pressure from the Eurozone crisis, would weaken further if that situation worsened.

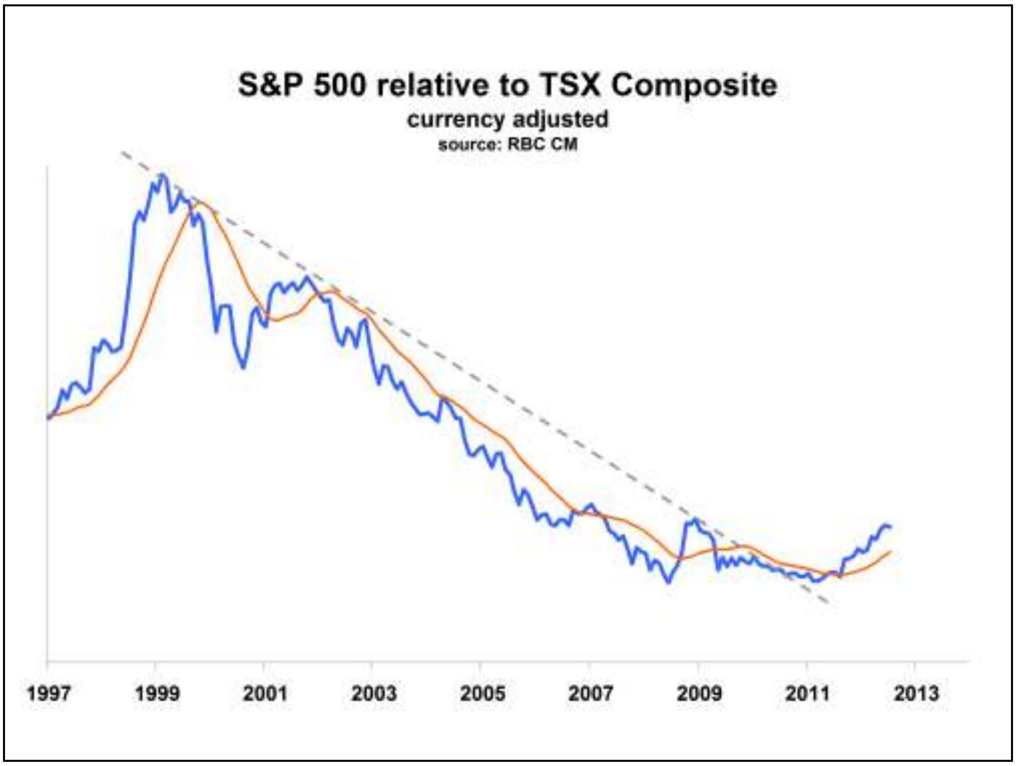
Energy and materials are vulnerable to any renewed downturn in global growth, especially one that featured a longer and harder landing for China.



In recent years the stock market has swung betweens extremes of optimism and pessimism. A few months of better-than-expected data on employment, income growth, inflation, housing, etc., convinces investors even more good news is on the way and they bid share prices up in anticipation. But a few months of worse-than expected data convinces them a recession is just around the corner driving stocks lower.

The economic surprise index measures which way the economic data has been running – ahead of expectations or below. It peaked in Jan/Feb and has been trending sharply lower ever since. It is already deeply in negative territory although it could certainly go lower still. The stock market rolled over in April as concerns rose the American economy was slowing more than expected.

The correction since April has already taken some risk out of the stock market. Pessimism has replaced optimism among a growing number of investors. Were the tide of economic data to turn higher, it would likely produce a worthwhile advance in share prices. That would be especially true if it was accompanied by any improvement in the European debt crisis.



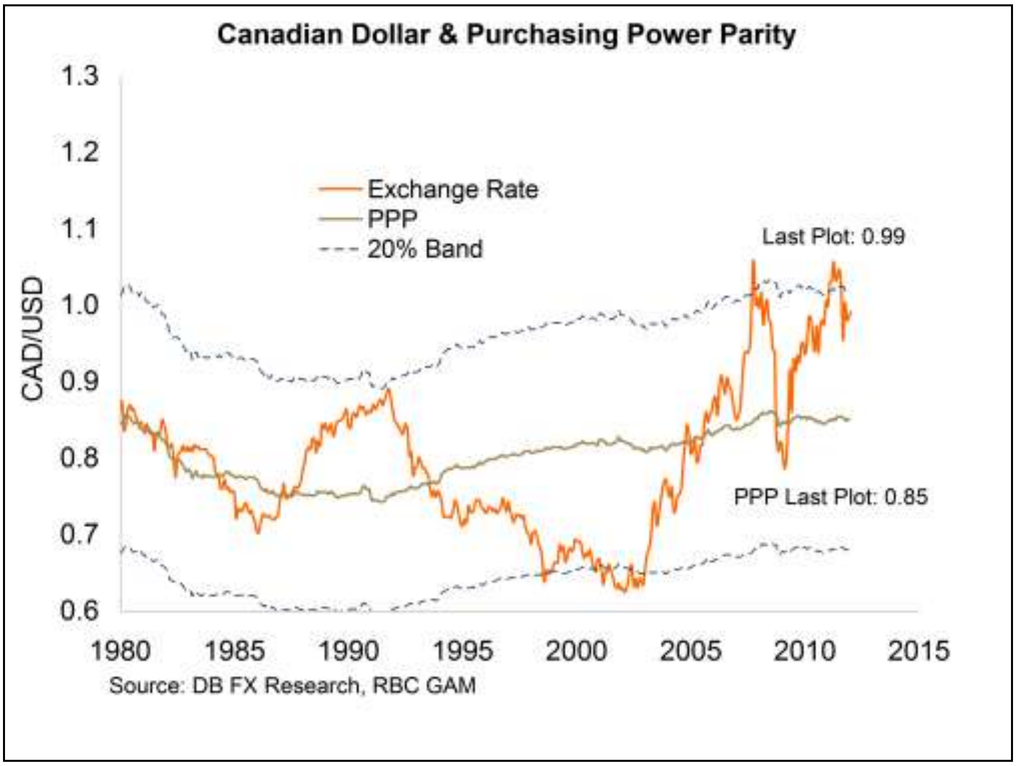
Looking beyond near-term cyclical concerns, a well established, longer-term trend appears to be undergoing a sea change. For over a decade American large cap stocks have dramatically underperformed Canadian ones.

Two related factors have accounted for this: the heavy preponderance of commodity-driven sectors in the Canadian market, accounting for almost 50% of its value, and the sustained run of super-charged growth by a commodity hungry Chinese economy.

With China gearing down to a target growth rate (7%-9%) three or four percentage points slower than what it achieved since 2000 and the U. S. now growing at only half speed and Europe in recession, it seems likely commodity consumption and pricing is going to have to suffer through a challenging and much less dynamic interlude. That new more difficult phase has been underway since early last year.

What was an advantage for the Canadian market and earnings is turning into a headwind in a slow growth environment.

Add to this the fact that the TSX's much larger financial sector (30% versus just 16% for the S&P 500) will continue to be held hostage by the Eurozone crisis and you have the ingredients for a trend change – one that sees the S&P begin to outperform the TSX.



Not only did the TSX outperform the S&P from 2000 until last year but the very strong Canadian dollar made the experience even more rewarding. We think that this strong Canadian dollar trend has also run out of steam.

In 2002 the loonie was more than 20% undervalued versus the U.S. dollar. Today it is almost 20% overvalued. History suggests it is difficult for the Canadian dollar to sustain itself for very long more than 20% either side of its purchasing power parity with the greenback.

That in turn suggest that any gains made by a Canadian investing in U.S. stocks in the period ahead of us are unlikely to be eroded or eaten up by any adverse strengthening of the Canadian currency.

Take-aways

- Recommended portfolio stance is
  “neutral” with “vigilance”.
- Not yet prepared to “look over the valley”
  - it still might turn out to be a chasm.
- Let indicators reach more pessimistic
  extremes.
- Canada’s tailwinds may be turning into
  headwinds.
- Add U.S. exposure.

Because stocks are very attractively valued while bonds offer unacceptably current low returns as well as plenty of risk, we would like to be able to recommend an over-weight commitment to equities. However we find ourselves constrained by the recognition that the Eurozone crisis might still jolt North America from slow growth into recession and prolong China’s economic slowdown.

It’s also possible that if Congress fumbles the “fiscal cliff” the U.S. could head into recession without any help from Europe.

Were that to happen, today’s price/earnings ratios would no longer look so attractive and stocks might be vulnerable to an additional period of retrenchment.

While that is not our forecast we rate the probability of it occurring at about 30%, high enough that it needs to be acknowledged.

We recommend a “neutral” exposure to stocks – that is, portfolios should contain up to but not more than their long term target allocation to equities. We also counsel vigilance since we expect many present uncertainties will be resolved over the next few months or weeks in a way that forces us off our neutral stance in one direction or the other.

Longer term, investors should consider adding U.S. equity exposure to portfolios.