



GLOBAL INSIGHT – 2014 OUTLOOK

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GLOBAL INSIGHT – 2014 OUTLOOK

2014 OUTLOOK – PAGE 3

The calendar is turning from the “year of the markets” to the “year of the investor.” As investors come to grips with the new reality, stronger global growth and no threat of a U.S. recession should create opportunities in equities.

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FIXED INCOME – PAGE 12

Panicky headlines aside, the rate normalization process will likely play out over several years, not months.

EUROPE – PAGE 17

Growth should remain fragile, uneven, and vulnerable to shocks. Equity returns should be worthwhile nonetheless.

CANADIAN EQUITIES – PAGE 22

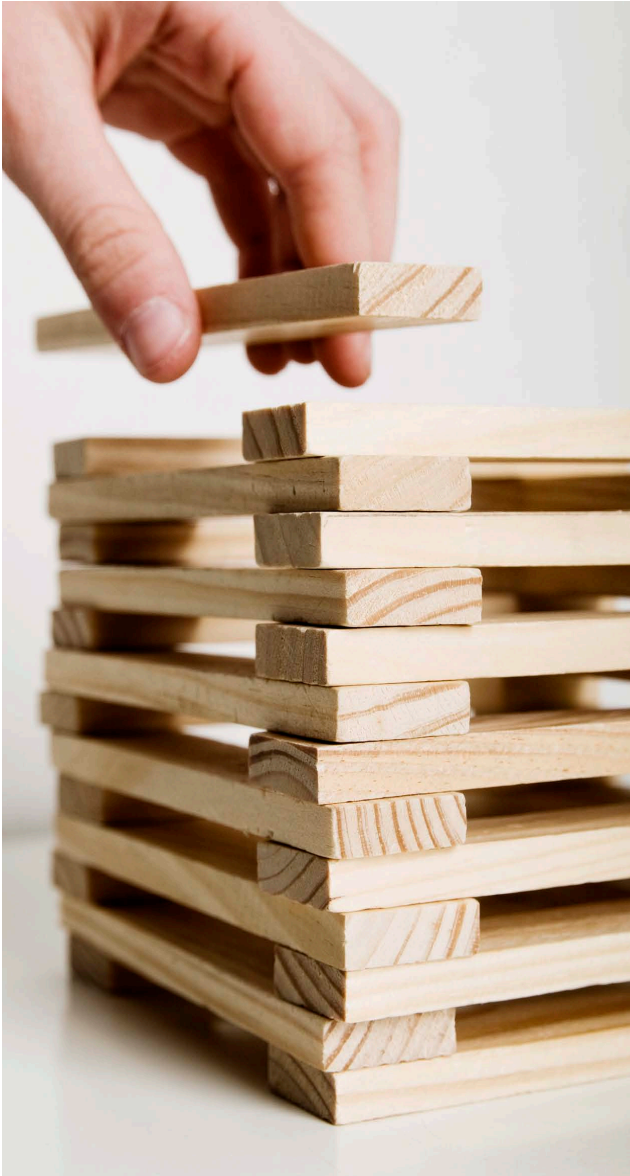
The tide is still headed out; stay underweight Canadian equities.

EMERGING MARKETS – PAGE 25

The slowdown looks set to reverse, but not all emerging markets are created equal.

U.S. “TIGHT OIL” – PAGE 31

The U.S. energy revolution has picked up dramatically, and ought to contribute to a larger global oil surplus in 2014.



2014 OUTLOOK

It's the Economy ... Again

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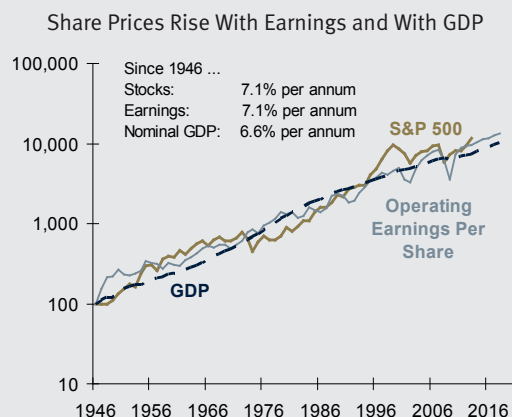
2013 looks to have been the “year of the markets”—it featured a powerful advance in equity share prices set beside a painful back-up in bond yields (and corresponding slump in bond prices). We are dubbing 2014 “the year of the investor,” who we expect to spend some considerable time and energy coming to terms with the new reality in both markets.

There is one overarching fact underpinning our expectations for stock and bond performance in 2014:

Most economies are doing better than they were a year ago. Underlying conditions suggest they should be able to hold onto those gains or improve further in 2014 and probably beyond. Most importantly, it is very unlikely the U.S. will fall into or even approach recession in the next 12-18 months.

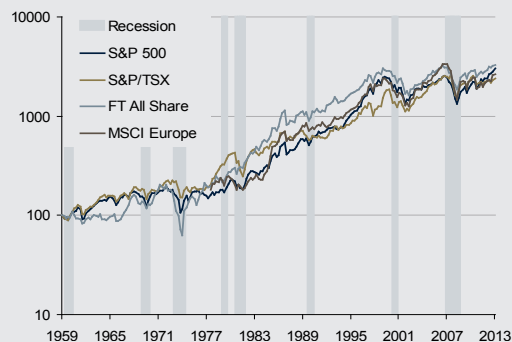
That's it. If one can subscribe to that view, the basic shape of the investment returns landscape falls into place—most stock markets will deliver positive returns and bond yields will move somewhat higher.

The Economy Determines Share Values



Source - Standard & Poor's, U.S. Department of Commerce, RBC Global Asset Management

U.S. Recessions and Bear Markets Go Hand in Hand



Source - RBC Capital Markets, U.S. Department of Commerce

“Positive returns” for stocks doesn’t necessarily mean a re-run of 2013’s big double-digit advance. Likewise higher bond yields don’t have to arrive by way of a 10-week, rates-up-110-basis-points debacle like the one bond markets contended with this past summer. But putting aside the precise path markets eventually take to achieve these returns, we believe investors should be looking for opportunity in the equity market while approaching bond and fixed income markets cautiously.

THE ECONOMY TELLS THE TALE

Stocks don’t go up (or down) by magic. They move in concert with the perceived underlying earnings power of the companies that make up the market. Since the end of World War II, the S&P 500 has risen at a compound annual rate of 7.1% per annum. Over the same span of 67 years, the profits of S&P 500 companies have grown at exactly the same rate—7.1% per annum. And it didn’t take a crystal ball to predict how much those earnings were going to grow. They grew somewhat faster than the nominal growth rate (i.e., the growth rate before adjusting for inflation) of the U.S. economy, which averaged 6.6% per annum.

Data for British and Canadian stocks are available from the late ‘50s onward and for major continental European stocks from the late ‘70s. All seem to bear out the long-term linkages between economic growth, earnings growth, and the advance of share values in the stock market.

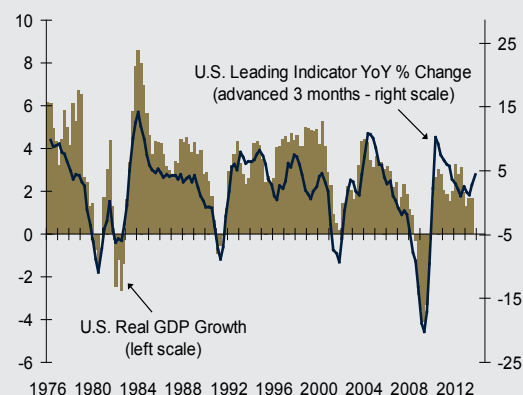
Over a reasonable time span, say three to five years, if you got the economy right, chances were you got the stock market right. Of course, on the way to compiling that 7.1% per annum record (10.6% per annum including dividends) the S&P 500, and all equity markets, suffered a number of very serious retrenchments—2000/2002 down 50% and 2007/2009 down 57% come immediately to mind—along with punishing bear markets in 1946, 1957/1958, 1969/1970, 1973/1974, and 1981/1982. And, although not nearly so drawn out, the market plunges around the Cuban missile crisis of 1962, the stock market crash of 1987, and the Far Eastern financial meltdown of 1998 are not easily forgotten. It is a testament to the strength and persistence of the long-term advance in equity values we have been describing that all those setbacks and quite a number of others are incorporated in that 7.1%-per-annum 67-year upward march.

BEWARE RECESSIONS

All “bear markets” since WWII have occurred around the time of downturns in the economy and in corporate earnings. It seems that recessions—particularly U.S. recessions—are sure-fire killers of bull markets. The bear markets that recessions induce are as painful as they are because earnings are usually falling at the same time investors are rapidly losing confidence in the future.

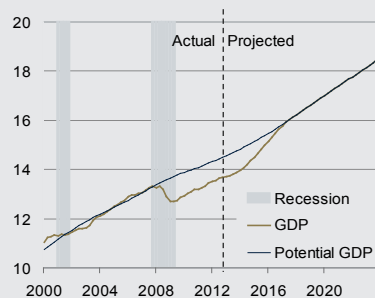
Today, not only is the U.S. nowhere near recession but most developed economies are growing while indicators of industrial and commercial health are improving just about everywhere. Reliable leading

No Recession in Sight



Source - U.S. Department of Commerce, Conference Board

Catch-Up Growth Phase May Be About to Kick In



Note: Potential GDP is the Congressional Budget Office's estimate of the output the economy would produce with a high rate of use of its capital and labor resources.

Source - RBC Wealth Management, Congressional Budget Office, National Bureau of Economic Research

indicators are suggesting the U.S. expansion will have legs at least through next year.

All U.S. recessions since World War II have been preceded by a period of “tight money” when credit becomes expensive and harder to get. Today, the Fed remains committed to a zero-interest-rate policy (see article page 12) and a growing percentage of banks are indicating an interest in making new loans. Any onset of restrictive credit conditions that could produce an economic and earnings downturn looks some way off, certainly beyond 2014.

With no U.S. recession in sight, investors in most developed economy stock markets will be free to evaluate equities principally in terms of their long-term earnings potential. And that, as we stated earlier, tends to be linked to the pace of economic growth. If developed economies like the U.S., Canada, the U.K., Germany, and Japan can grow even at a moderate pace, as seems likely, then it would be reasonable to expect corporate earnings to grow at least that fast if not faster.

That would argue, persuasively we think, that higher stock prices lay ahead.

RISKS ARE TO THE UPSIDE

There is another possible growth scenario that we commented on back in March. It is the Congressional Budget Office (CBO) long-term forecast for the U.S. economy, first published in August 2012, tweaked in February 2013, and still operative. It called for U.S. GDP growth to sag to just 1.6% in 2013, weighed down by tax increases and

government spending cuts. But starting in mid-2014, as the fiscal drag diminishes, it forecasts the U.S. economy will kick into a higher gear, embarking on a three-and-a-half year run of much faster growth, averaging 4% per annum, eating through the economy's excess capacity along the way, and regaining its long-term trajectory in the first half of 2017.

Were the U.S. economy to perform as the CBO expects (note that consensus forecasts are for much more moderate growth in the neighbourhood of 2.6%-3.0% per annum), it would be very good news, raising tax revenues, shrinking the federal deficit even faster while boosting state surpluses as well as jobs growth and, in all likelihood, kicking off an upswing in capital spending.

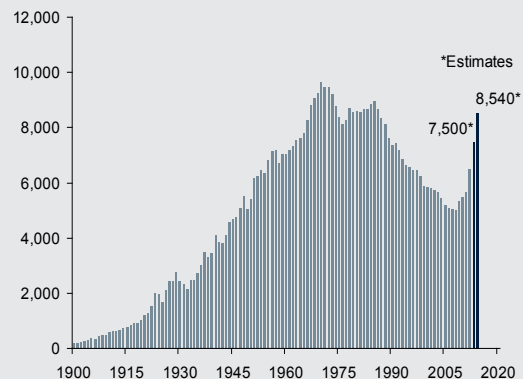
The three catalysts we identified last March as most likely to drive such a ramp up in U.S. GDP growth, have emerged more fully into mainstream awareness:

1. Energy development is growing strongly.

(See article on page 31.) The International Energy Agency asserts shale oil development is ramping up so quickly, the U.S. will become the world's largest oil producer by the end of 2015, two years ahead of previous estimates. So far, this has produced a 66% increase in employment in the extractive industries. But, the impact will eventually extend to construction of infrastructure for gathering, shipping storage, and processing as well as to related services.

Soon to Be the World's Largest Producer

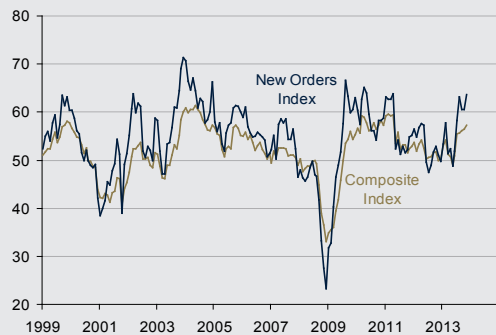
U.S. Crude Oil Production - Barrels per Day (000's)



Source - U.S. Energy Information Administration

Manufacturing On a Roll

ISM Manufacturing Index



Source - Institute for Supply Management

In the past 5 years, domestic consumption of oil has fallen by about 2 million barrels per day, while U.S. production has grown by 3 million barrels per day. Surging U.S. production has helped keep a lid on world energy prices, leaving more discretionary spending dollars in the pockets of consumers in America and everywhere. The 5 million barrels per day of foreign oil that has been displaced has done wonders for the U.S. balance of payments with more to come.

2. Manufacturing is enjoying a resurgence.

Manufacturing output in the U.S. is back at an all-time high. China and the U.S. both produce about 18% of all world manufactured goods. However, the U.S. accomplishes this with about 12 million workers, whereas the Chinese manufacturing workforce is thought to be north of 100 million. This speaks to the productivity gulf that separates the U.S. and most developed economies from younger emerging ones.

Other factors than productivity are helping U.S. manufacturing:

- The U.S. (trade-weighted) dollar is down 6% from 2010 levels. Against China's renminbi, the decline is 18%. A cheaper dollar has made U.S. exports more competitive and imports less attractive at home.
- Wages in low wage countries are under upward pressure. In China, faced with growing dissatisfaction, the government unilaterally forced many high-profile

manufacturers to raise hourly pay rates. Wages have been rising faster than labour productivity, eroding China's cost advantage in the process.

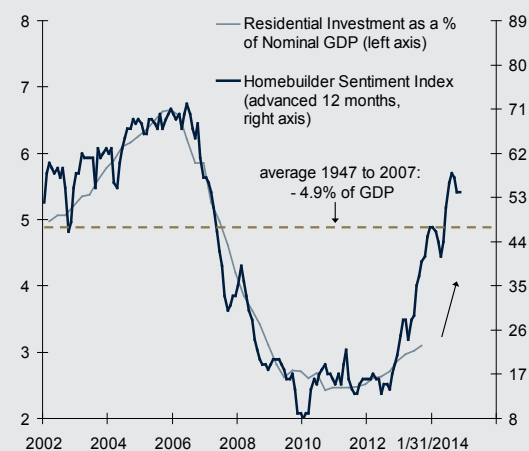
- Shale gas drove North American natural gas prices from a peak of \$14 per mmbtu in 2008 to a low of \$2 in 2012. Even at today's \$4 per mmbtu, North American manufacturers enjoy a significant cost advantage over their European and Asian counterparts where gas ranges between \$11 and \$15 per mmbtu.

The narrowing cost disadvantage at home, high transportation costs, as well as the complexity of dealing at great distances within jurisdictions where laws, property rights, and regulations are very much in flux, has slowed the rush by U.S. manufacturers to move production offshore. Many companies have or are considering returning at least some production to the United States. A number of high-profile American and non-American corporations have indicated their next increment of added capacity will be located in the U.S., especially if the output is intended for American consumers.

3. The housing recovery continues to build.

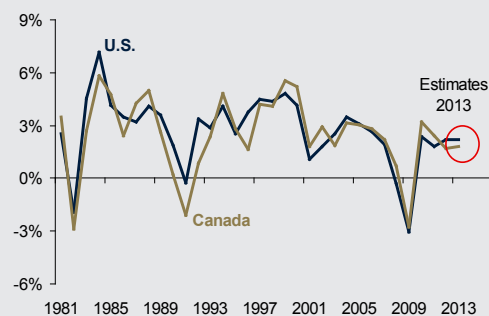
Residential fixed investment (housing construction) accounted for just 2.4% of GDP at the beginning of 2011. By the end of the third quarter of 2013, it had reached 3.1% of GDP, on its way back, we believe, to its 50-year, pre-crisis average of 4.5%-5.0% by 2017/2018.

Housing Construction Adding to Growth



Source - National Association of Homebuilders, U.S. Department of Commerce

U.S. and Canada Real GDP – Joined at the Hip



Source - U.S. Department of Commerce, Statistics Canada

Housing starts, which averaged 1.5 million for 50 years prior to 2008, and just 600,000 between 2009 and 2012, are now running around 900,000. November housing permits breached the one million mark for the first time since 2008, up 100% off their recession lows. Employment in the sector is building. While still approximately 21% below their 2006 peak, home prices have risen for 20 straight months and most markets cite a shortage of homes for sale as a major contributing factor.

Housing's health has a big impact on consumer attitudes. Confidence hit 30-year lows twice in a three-year span: once in the depths of the recession in 2009 and again in late 2011 as house prices were hitting bottom. Thereafter, confidence rose along with house prices until the prospect of rising mortgage rates and the congressional standoff brought readings down off what had been six-year highs. Despite this moderation, consumer sentiment remains very much in positive territory, yet well short of the extremes.

All these catalysts—surging oil production, a revitalised manufacturing outlook, and the housing recovery—were not on the market's radar two years ago, and forecasts which included them, had there been any, would have been sceptically received. Today, they are acknowledged but their sustainability is not widely accepted. It appears at least plausible that each could make even greater contributions to U.S. GDP growth in each of the next two years and perhaps beyond.

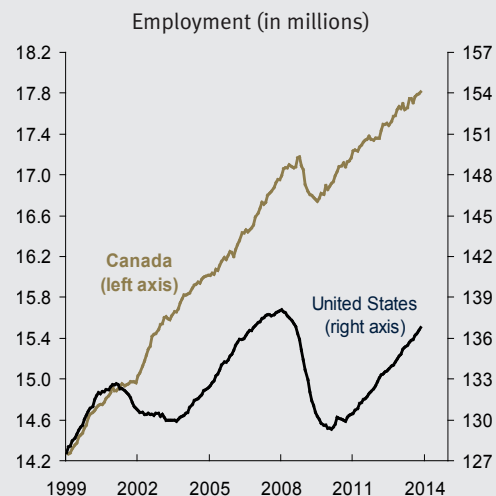
GOOD NEWS FOR EVERYBODY

A period of catch-up U.S. growth would be very good for economies beyond the United States. Imports of goods and services from the rest of the world into the U.S. are running at \$2.8 trillion per annum—a figure larger than the GDP of either France or the U.K., not much smaller than the entire German economy (the world's fourth-largest), and twice the value of all Chinese exports. If U.S. GDP growth were to move closer to 4% per annum from today's 1.8%, then imports would also grow perhaps at an even faster rate, providing a welcome boost everywhere.

Canada is the United States' largest trading partner. With exports totalling approximately 30% of GDP and with about 73% of its exports destined for the U.S., Canada's pace of economic growth has moved pretty much in lock step with that of the U.S. over at least the past 35 years (see chart). The correlation between the two has been even tighter since 2003, with Canada performing almost identically to the U.S. going into and coming out of the recession and locked in the same 1.5%-2.5% growth rut since 2009.

Canada's failure to outperform the U.S. on a GDP basis for the past several years is surprising because the country did dramatically better on so many of the economic fronts that have provoked much policy soul searching in the U.S.—e.g., no financial institution collapsed nor was bailed out by the government nor forced into a distressed merger; there was no sustained real estate downturn; less than half as many jobs were lost (proportional to

Canada's Better Job Growth Hasn't Translated to Better GDP Growth



Source - U.S. Labor Department, Statscan

the size of the economy) than in the U.S.; there has been strong job growth all through the recovery; no fiscal cliff; no extreme austerity and the federal government expects to be in surplus by 2015.

It seems highly likely a faster pace of U.S. growth will produce a comparable pick-up for the Canadian economy. And for Mexico. And for several Latin American countries. Not to mention the economies of China, Japan, and greater Asia, as well as the U.K. and most European economies.

GLOBAL ECONOMIES ARE IMPROVING ...

Many of these regions are already doing better. China's growth rate appears to be stabilising in the 7%-8% range. The jury is still out on Japan's Abenomics experiment, but so far, inflation, growth, and corporate profits all seem to be moving in the right direction.

The eurozone economy pulled out of recession in the second quarter and stayed out in the third but almost entirely due to a comparatively strong German economy. Unemployment remains near all-time highs above 12%, and the European Central Bank suggests it may get worse before it gets better. Banks in the region remain mostly unwilling and/or unable to lend, which leaves the ability of the euro area to stay out of recession an open issue.

By contrast, the U.K. economy left recession behind a year ago. In the third quarter, GDP grew at a 3.2% annual rate. The fourth quarter looks to be even better. The Bank of England felt comfortable enough

to amend its "funding for lending" scheme in order to take some steam out of the real estate market. Unemployment has fallen from its high-water 8.4% rate in early 2012 to 7.6% in October. Further declines appear likely.

A growing global economy led by the U.S. and most of the developed economies is likely to be accompanied by growing corporate profits. The long-term linkages that have existed between economic growth, earnings growth, and the growth of share values in all major markets suggests the next several years could be a potentially rewarding period for equity investors.

BONDS IN TRANSITION

If the U.S. and global economies pick up speed in 2014, whether at a moderate pace or something more, we believe bond prices will come under pressure again as yields follow growth higher.

Bond investors have benefitted from an extraordinary, multi-decade bond bull market which began in the early 1980s and probably ended when yields bottomed and prices peaked in summer 2012.

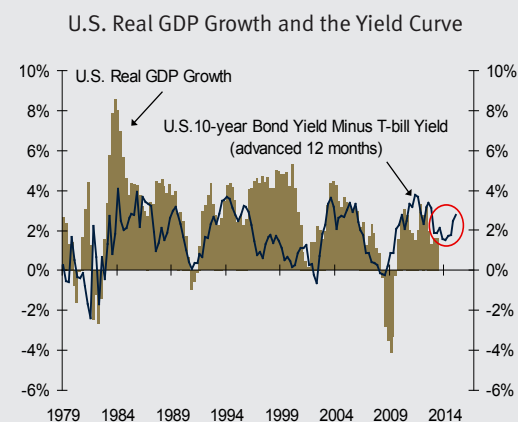
With the decline in yields likely having run its course, the bond market seems set to work through a transitional phase. The need for a "safe haven" has diminished as the crisis has receded. In our judgment, bond yields are only part way through an upward adjustment that will bring them back to a level where investors are adequately compensated for the risks of future inflation. Investors should work to shift out of a longstanding bull market

"Normalized Rates" Means Higher Rates



Source - Federal Reserve, RBC Dominion Securities

No Recession In Sight: The Most Reliable Long-Term Leading Indicator Points to Faster Growth Next Year



Source - U.S. Department of Commerce, Federal Reserve

mindset and look to adjust portfolios for new realities and more moderate returns.

PORTFOLIOS NEED ADJUSTMENT

The days of sub-2% 10-year Treasury, Canada, and Gilt yields are probably behind us. With better U.S. and global GDP growth in 2014, yields of 3% or more could be on the horizon even though major central banks have vowed to keep short-term, benchmark interest rates pegged at or near the floor for some considerable time.

Despite 10-year government bond yields rising more than 100 basis points since mid-2012, many bond portfolios are not yet set up for the possibility yields could rise another 50-75 basis points in the next year if growth picks up only moderately.

For 2014, we recommend defensive positioning, favouring shorter maturities, liquid issues, and selective credits in mispriced sectors. We maintain our longstanding below-benchmark recommendation for fixed income exposure, which corresponds with our Underweight rating.

Volatility associated with bond markets ebbing and flowing could present opportunities at times. Rallies should be viewed as opportunities to reposition portfolio holdings. That said, any sell-offs that become overdone may create attractive tactical plays in some country-specific sectors (e.g., U.S. municipals, Canadian preferreds, emerging market debt, etc.).

Most importantly, investors should look beyond the absolute yield on an individual security and consider the relative risks in this unique interest rate environment.

(For an extensive discussion of the U.S. bond market and Fed policies, see the article on page 12.)

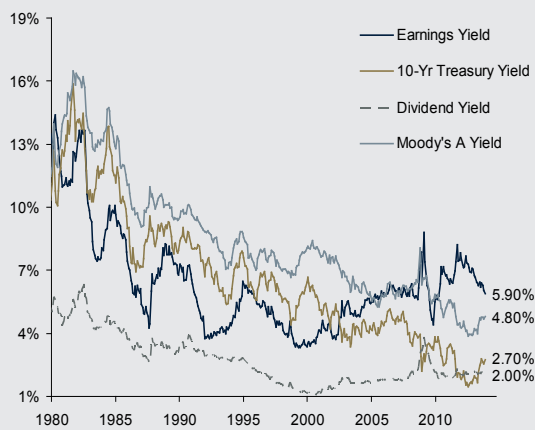
WHAT TO WORRY ABOUT

It's easy, and often the best advice, to say, "Relax and trust in the long-term." But the last few years have provided ample evidence that mere mortals will find (need) something to worry about from time to time.

As noted, it is important to stay alert to the potential for any economic downturn intense enough to turn corporate earnings lower and sap investor confidence in the viability of the long term. Almost always that would include a U.S. recession. At the moment the prospects for a U.S. recession to arrive on the scene in the next 12-to-18 months are very low. Most indicators of economic health are pointing toward a continuation of positive economic growth in the months and quarters ahead, some to an acceleration of that growth.

However, other market setbacks, short of full-blown bear markets, can take a toll on portfolios and erode investor resolve. For example, if bond investors became spooked by the prospect for better-than-expected GDP growth, the 50-to-75 basis-point increase in bond yields we expect to unfold over the next 12-to-18 months might instead be compressed into a much shorter time frame. If at the same time

U.S. Equity Valuations Still Attractive



Source - Federal Reserve, Standard & Poor's, Moody's, RBC Global Asset Management

the stock market was running higher, the valuation advantage offered by the earnings yield on stocks over the interest rate paid by high-grade corporate bonds—so lavish at 3.8% back in May and already down to a much skinnier 1.1% today—might be compressed even further, perhaps to zero.

That wouldn't be the end of the world. Over most of the past 35 years the earnings yield of blue-chip stocks has been well below the interest yield on investment grade corporate bonds (and below 10-year government bond yields for that matter). However the speed of that change between relative expected returns might be enough to send equity buyers to the sidelines and usher in a period where stocks moved sideways to down rather than relentlessly higher.

It is entirely possible, even likely, such a change in market momentum shows up sometime in the coming year. We would recommend investors treat any such market retrenchment with respect if it arrives. Corrections almost always reach deeper and last longer than investors expect or are prepared for.

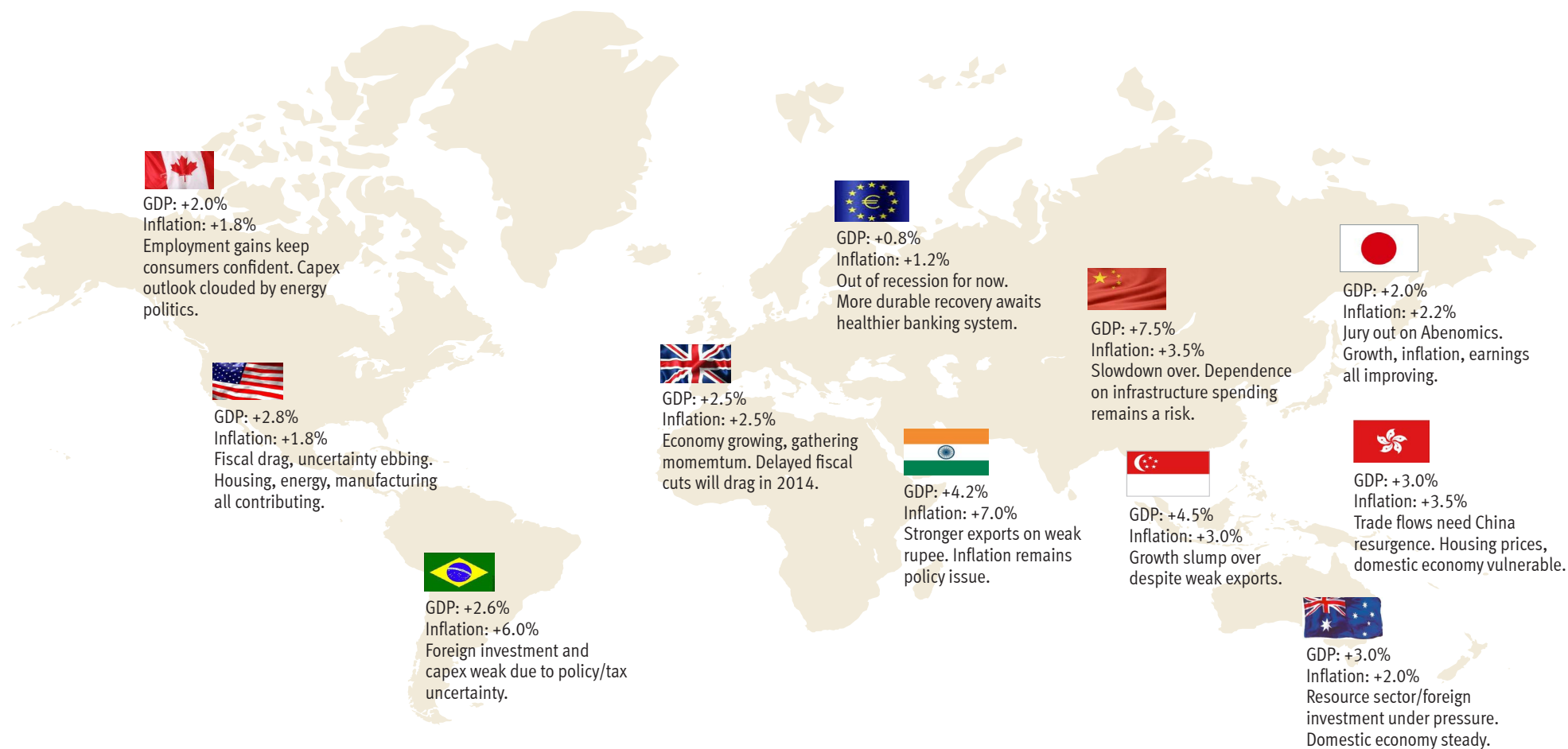
THE ROAD TO “NORMAL”

Rather than regarding equity markets as simply “up a long way off their 2011 lows” we are more inclined to characterize them as once again tracking the prospective, long-term earnings power of businesses in a world where crisis is ebbing, most economies are growing, and the U.S. economy, the world's largest is regaining its stride. China's growth rate appears to have stabilized at a satisfactory and more

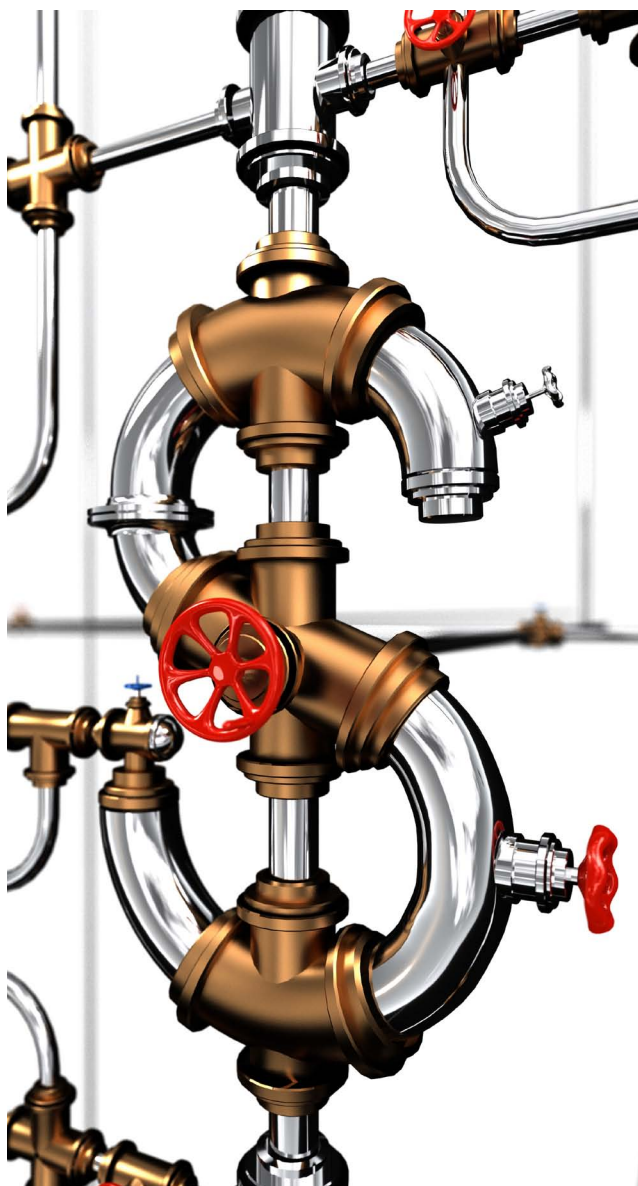
sustainable level. Europe is not out of the woods but is making important structural progress. Canada and the U.K. look to be keeping pace with the U.S.

All this speaks to further progress back toward a more normally functioning economic world. One in which corporate earnings grow at a pace dictated by economic growth, most stock markets deliver positive returns measured over the full year and bond yields move somewhat higher.

REGIONAL FORECASTS FOR 2014



Source - RBC Global Asset Management, RBC Wealth Management, RBC Dominion Securities



FIXED INCOME INVESTING IN 2014

Interest Rate Normalization – A Long-term Process

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2014 should be a year in which the interest rate normalization process, with its beginnings in the “taper tantrum” of summer 2013, continues. However, it is important for investors to consider the context of rate movements because panicky headlines could be far too prevalent. The impact of the Great Recession is still felt and, as a result, our outlook has the Federal Reserve remaining accommodative, the economy improving, but not yet delivering robust growth, and the rate normalization process playing out over several years, not months.

The U.S. economy and investment climate have improved, and the crisis mentality, so predominant in recent years, has begun to fade. However, markets will continue to deal with the fact that growth has not yet managed to break out of its subpar rut, as well as monetary and fiscal policy uncertainty. All in all, this serves as a reminder that while the Great Recession is in our collective rear-view mirror, its impact upon the economy and interest rates is still being felt.

THE FEDERAL RESERVE WHERE THE RUBBER MEETS THE ROAD

We expect Janet Yellen to be confirmed as Fed chair by the Senate. Even as she takes the helm in early 2014 and a number of regional banks see new leadership, the Federal Reserve has said it will continue its open-ended commitment to do what is necessary to boost the U.S. economy. The much-anticipated tapering of its latest large-scale asset purchase program or QE3 will begin, and due

Unemployment – An Important Indicator But Not the Only Indicator



Source - Bloomberg, data through November 2013

to its perceived diminished returns, it is unlikely another QE will be initiated. Instead, the Fed will be relying more upon a process of providing “forward guidance” (in other words, the Fed’s forecast) for the economy and interest rates.

FED TAPERING AND DATA DEPENDENCY

Over the course of the last few months, markets have come to understand and believe the Federal Reserve will, at some point, commence tapering its monthly Treasury and mortgage-backed securities purchases, currently running at \$85 billion per month combined. At the same time, however, markets have seemingly been unable to fully understand the tapering process could be uneven and driven by the data (“data dependent”).

The market’s intense, single-minded focus on employment has been a distraction. Data dependency is *not* unemployment dependency. It is a focus on various metrics of economic activity and performance including employment, inflation, GDP growth and make-up, as well as fiscal policy discussions in Washington, D.C., and the level of mortgage rates.

In our opinion, tapering will begin in 2014, possibly as soon as the January Federal Open Market Committee (FOMC) meeting, but more likely at the March meeting. We expect it to conclude in late 2014. There is a widely held assumption that, once started, tapering will proceed in steady-paced, even increments. However, we believe it will be anything but, as data dependency could make the process

subject to fits and starts. It is not inconceivable tapering could extend into early 2015. Finally, it is important to remember that tapering is not tightening; this will only come when the Fed begins to move away from its zero interest rate policy (ZIRP).

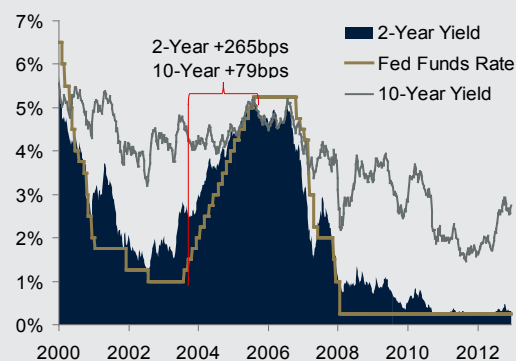
WILL THE REAL UNEMPLOYMENT RATE PLEASE STAND UP?

Much has been made of the Fed’s 6.5% unemployment rate threshold and what will happen once reached. The Fed has long maintained 6.5% is a target, not a trigger, and that once hit, it would not necessarily signal an immediate tightening in monetary policy. The official unemployment rate (U3) stands at 7.0%, a significant improvement from a high of 10.0% in October 2009, and given current trends in monthly payroll growth, there is the distinct possibility the 6.5% threshold could be achieved in 2014. As a result, market participants began to imagine they could see the first rate hike on the horizon.

There are, however, some important things to consider. First, much of the recent improvement in the unemployment rate has come from people leaving the labor force, discouraged over the lack of job prospects. This ongoing reduction in the labor force participation rate has allowed Fed officials to become more nuanced in their discussion, suggesting that with participation so low, the underlying employment rate is actually higher than the current official rate, somewhere in

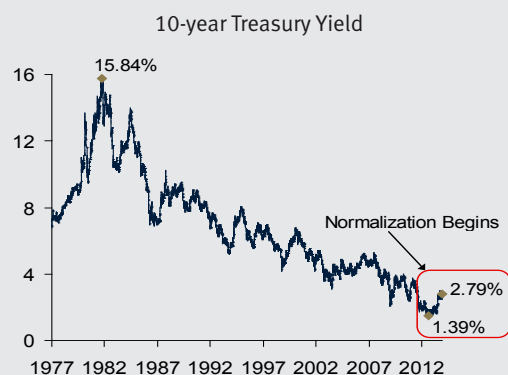
When ZIRP Eventually Ends, 10-Year Yields Won't Necessarily Move in Lock Step

Periods of rising short-term rates do not automatically translate to rising 10-year yields.



Source - RBC Wealth Management, Bloomberg

30-Year Bond Bull Market Ends, Normalization Begins



Source - RBC Wealth Management, Bloomberg; data through 11/21/13

between the official rate and the much-broader full unemployment rate (U6), which stands at 13.2%. Second, two very senior Federal Reserve economists published papers proposing the unemployment rate threshold be lowered to 5.5%. So far this isn't a widely held view, only Minneapolis Federal Reserve President Narayana Kocherlakota had previously suggested this, but it hasn't been dismissed outright either. This combined with the stature (at the Fed) of the authors who proposed it, suggests it will be given consideration, and we believe it will find its way into Fed policy in 2014. The net effect would be to further push out the date when the Fed would begin considering raising short-term interest rates. With the Fed removing some pressure from the monetary gas pedal, lowering the employment threshold, in our opinion, would enable ZIRP to remain in place for the foreseeable future.

FORWARD GUIDANCE ON RATES LOST IN THE TAPER TANTRUM

The Fed's non-tapering announcement at the September 2013 FOMC meeting surprised the markets. All but ignored, however, was the forward guidance (the Fed's forecast) provided for interest rates and economic growth. Growth was revised lower and Fed policymakers said current policy (ZIRP) will likely be maintained until late 2015 if not into 2016. Furthermore, the rate guidance suggested short-term interest rates would rise to just 2% by the end of 2016, and were unlikely to hit the Fed's perceived neutral rate of 4% until at least 2019. For additional perspective, if the employment threshold

is lowered to 5.50% as suggested in the two Fed papers referenced earlier, the first rate hike may not occur until 2017!

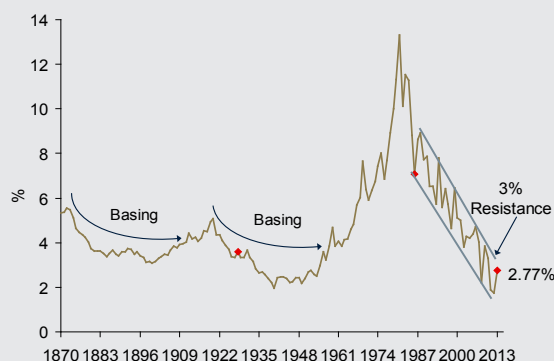
RATE NORMALIZATION IS COMPLICATED: CONTEXT AND PERSPECTIVE RIP 30-YEAR FIXED INCOME BULL MARKET IS A BEAR ON THE DOORSTEP?

If one is to believe Federal Reserve officials and prominent money managers, 2013 marked the year in which the 30-year bond bull market ended. What a strong run it was—the 10-year Treasury yield fell from a high of nearly 16% in 1982 to a low of approximately 1.40% in 2012 (see lower chart). The start of the tapering discussion in May proved to be the last call for the bull. To the surprise of many, the eventual end arrived with a bang, not a whimper.

While we agree with the view the great bond bull market has ended, and we mourn the demise of our long-term bullish friend, we do not think a new bear market is imminent. We have already had a glimpse of what the normalization process will look like. As with tapering, it should be an uneven process driven by the economic data, subject to fits and starts. Since hitting 3.00% in early September, the 10-year yield has averaged 2.70%, and our expectation is it will maintain this level at least into the first quarter of 2014 and the start of tapering.

Nor should the Federal Reserve's role in managing the normalization process be ignored, witness the September FOMC meeting where a "tightening in financial conditions" (read: rising mortgage rates)

140-Year History of 10-Year Yields – Past Periods of Normalization Took Years



A very long-term perspective can help to put the near-term fears regarding interest rates into perspective. A typical chart pattern is for big declines to be followed by long neutral periods, which we have seen develop on only two other occasions with the interest rate trend over the past 140 years. We expect the big decline in rates over the past 20 years to also evolve into a long bottoming process where rates could remain in a low range for a period that is measured in years. The 3.0% level on the 10-year treasury yield is the resistance level that could mark the top of a range for the foreseeable future.

— BOB DICKEY, RBC WEALTH MANAGEMENT TECHNICAL ANALYST

Source - RBC Wealth Management, RBC Capital Markets, RBC Global Asset Management, data through 11/29/13

was cited as the reason to postpone tapering. To us, the message from the Fed has been that interest rates needed to rise from the extremely low, safe-haven yields at the worst of the European debt crisis, to a level more appropriate for an economy that is growing, albeit at a slow and sluggish pace, with no recession in sight. The other part of that message, though, was that with economic growth still running at below-potential rates and inflation not an issue, a 3.00% 10-year yield was too high. In our opinion, rates will move higher, or normalize, but over a period of several years not months.

HISTORICAL PERSPECTIVE ON RATES

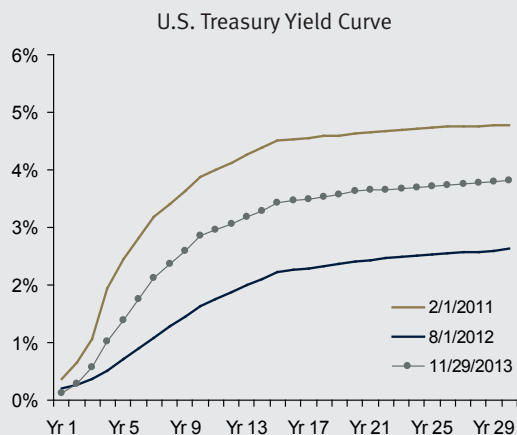
As they say, a picture is worth a thousand words. The chart provides another look at the 30-year bond bull market, but in the context of 140 years of interest rate history. This view reveals that in the past, after there has been a severe economic downturn with its origins in the financial sector, before interest rates begin a significant new upward phase they have typically put in a significant basing period lasting years. There should be no argument the recent Great Recession originated in the financial sector, and we think consensus opinion would say it was the most severe downturn since the Great Depression of the 1930s. During the post-Depression era, while yields moved up almost immediately off the 1940 lows, they did not develop any further serious upward momentum until the early 1950s. As we continue to exit from the Great Recession, we expect rates to go through a comparable multi-year bottoming pattern.

Market activity since late 2011 indicates this bottoming phase has begun. That said, it is our opinion below-normal rates could persist for at least another three years, given an accommodative Fed concerned with setting the economy on a strong sustainable growth track, a U.S. economy which, while showing signs of improvement, is still struggling to grow at over a 2% annual rate, ongoing global economic issues, and persistently low inflation.

RATES WILL RISE: LOOK TO 2011 FOR DIRECTION

In spring 2011, global economic conditions were on a firmer footing—GDP growth in the U.S. was near 3%, and expectations were high that trend growth of 3.5% was not far away. Sovereign debt concerns in Europe had yet to surface in a big way, although issues in Greece were beginning to percolate to the surface. China's economy had not yet begun its sharp slowdown.

In early 2011, 5-year Treasuries peaked at 2.40%, 10-year yields hit 3.75%, and 30-year yields reached 4.70% before each collapsed to their 2012 lows of 0.54%, 1.38%, and 2.45%, respectively. Since mid 2012, conditions in the U.S. have improved, and conditions in the other members of the “big three” (Europe and China) have begun to stabilize or improve recently as well. However, clearly it will take time for conditions to heal completely, and ongoing global challenges make it likely this will play out over a number of years. Currently, yields are approximately 100 basis points below 2011 levels,

2011 Provides Near-Term Guidance

Source - Bloomberg; data through 11/29/13

and assuming continued slow and steady progress for the U.S. economy, coupled with the end of QE3 and continued economic progress in Europe and China, we believe these levels represent reasonable rate targets for the next 12-18 months.

INVESTOR GUIDANCE FOR 2014:**FOCUS ON QUALITY AND MANAGE DURATION RISK**

The move to ever-lower rates and the related double-digit bond portfolio total returns which transpired over several consecutive years fostered a sense of complacency among investors. Some forgot investing in bonds entails risk. To access higher yields and achieve those eye-popping total returns, many investors reached outside of their investment comfort zones, assuming more credit risk or extending portfolio durations. The swift and sharp upward adjustment of yields in recent months has provided a stark reminder of the risks. Going into the new year, given our expectation that rates will gradually rise as economic conditions improve, it is still appropriate for investors to review portfolios, to address any variances from established investment guidelines.

We continue to believe the best opportunities are in credit, but recent spread tightening going into year end argues for caution. The volatile illiquid markets of last summer amidst the tapering discussion was largely driven by the reduced ability (or willingness) of global bond dealers to commit capital to support the markets, mostly in response to higher regulatory capital requirements. These concerns vanished

following the Fed's non-taper decision, causing spreads to tighten once again. However, in our view, expectations for a start to tapering in the new year could trigger renewed volatility. We recommend investors be selective, keeping some "dry powder" available for future purchases.

Managing risk—credit, interest rate, and duration—plays an important role in our "selectivity" recommendation. In our judgment, all the forgoing discussion favors focusing on quality, investment-grade issues while limiting duration to the intermediate maturities. That said, we expect the year to present opportunities to take advantage of higher yields when they materialize or special situations provided by market dislocations in credit sectors such as preferreds, emerging markets debt, or within the U.S., the municipal bond universe.



EUROPE – BACK ON THE MAP

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2013 marked the fading of the eurozone's existentialist crisis. With better governance and with the ECB committed to the role of lender of last resort, the chances of a eurozone breakup have receded markedly. Against this backdrop, returns in European equity markets were very strong in 2013. In 2014, while probably less spectacular, returns should be worthwhile nonetheless.

CRISIS RECAP

The eurozone crisis, which erupted in 2009, was due to deficient governance on the part of the national governments themselves and from within the financial sector. The crisis revealed a chronic lack of competitiveness and also deep structural weaknesses affecting the region's flexibility and growth potential. The absence of resolution mechanisms ensured that uncertainty spiralled out of control. What action would authorities take, if any? Would the people of each country endure the social stress needed to deal with past imbalances and create more-flexible economies? Would they

reject these policies and opt for their respective country's exit from the eurozone? This all conspired to create a storm of a political, financial, and economic nature where the very survival of the European Monetary Union (EMU) was questioned. Only two outcomes were deemed possible by observers—the eurozone would be dismantled or a “United States of Europe” would have to be formed.

ROLLING UP THEIR SLEEVES

The crisis' turning point occurred in 2012 with the announcement the European Central Bank (ECB) would intervene in sovereign debt markets to an

unlimited extent. The undertaking to form a banking union further calmed nerves. With these measures in place, concerns about sovereign solvency and the EMU's survival abated, allowing policymakers to focus on improving the sustainability of the eurozone instead of fighting fires. Their vision was not one of a "United States of Europe." Rather, it was the original one of a loose federation of sovereign countries with a common currency, but with the addition of risk and burden sharing agreements that would enable countries in trouble to receive timely support. To achieve this vision, with a resolve that surprised the most sceptical observers, policymakers worked on strengthening the European Union's architecture, implementing fiscal austerity, and pushing through structural reforms.

STRENGTHENING THE EUROZONE ARCHITECTURE

To improve the region's framework and build a stronger base for financial stability, policymakers opted for a two-pronged approach, taking measures to improve both governance and burden sharing (see table).

First, policymakers aimed to improve governance related to fiscal, economic, and banking policies. To fiscal targets, they added well-articulated medium- and long-term objectives for debt levels. For a more-efficient monitoring of imbalances building up in countries, policymakers set up a mechanism to alert authorities to potential challenges. Finally, to limit the involvement of taxpayers in bank bailouts, policymakers initiated discussions on a banking union.

Measures to Improve Governance and Burden Sharing

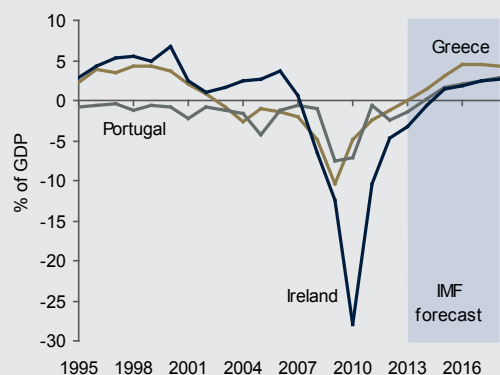
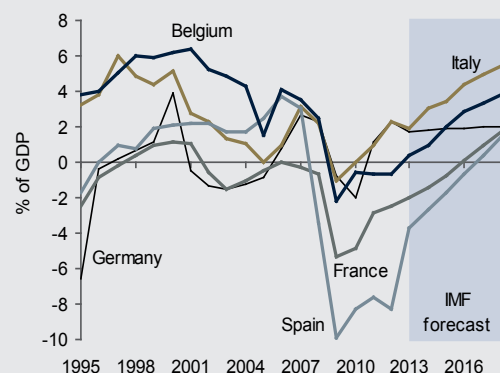
	Measure	Why?	What Has Been Done?	What Remains To Be Completed?	Stage
GOVERNANCE	Fiscal Policy Planning	To improve the regional governance of fiscal policy	The Stability and Growth Pact (SPG), which laid out the eurozone's fiscal rules pre-crisis, was supplemented by the Fiscal Compact whereby the 3% of GDP deficit limit included in the SPG is now part of a more clearly articulated set of medium- and long-term set objectives.		Completed
	Economic Imbalances Monitoring and Surveillance	To more efficiently monitor imbalances in the economy	A procedure for monitoring macroeconomic imbalances was set up, giving countries the responsibility to take specific corrective steps once imbalances are flagged by the European Commission.		Completed
	Banking Union	To avoid involvement of taxpayers in banking crises	The ECB will take over as the single supervisor in the autumn of 2014 and will use a single rule book on prudential requirements, supervising 130 banks and overseeing national supervisors who will oversee the rest.	Creation of a single bail-in procedure determining how the burden of resolving bank failures is to be shared, to what extent are liabilities bailed in, the amount of flexibility in the process, and the extent of the involvement of national resolution funds financed by the banks.	Discussions are advanced but inconclusive
BURDEN SHARING	Risk and Burden-Sharing Mechanisms	To deal with liquidity and solvency risks for sovereign and banks	Liquidity support for sovereigns is provided by the European Stability Mechanism and Outright Monetary Transactions. Liquidity support for banks, comes from the ECB, including unlimited liquidity at very low rates over long horizons and against a broad pool of collateral.	Proposal of financial support in exchange for reforms. Common fiscal capacity for absorbing country-specific shocks.	Initial outline provided; discussion at very early stages

Source - Royal Bank of Canada Investment Management (UK) Ltd.

The ECB will assume the role of Single Supervisor to the banking sector in 2014, after an Asset Quality Review (AQR) and stress tests are performed on eurozone banks. The AQR should ease the difficulty of comparing across national boundaries as

regulatory definitions vastly differ across the region. For example, while full details are still to be revealed, there are suggestions that the rules for non-performing loans (NPLs) will be harmonised. The AQR may also apply a risk weighting to sovereign

Primary Balances are Improving



Source - Haver Analytics, International Monetary Fund (IMF), World Economic Outlook (WEO), RBC Capital Markets

paper which currently carries a zero risk weight, or no risk. In effect, the AQR and the stress tests could be game changers for the banking sector if they are constructed in such a way as to improve visibility and confidence in the banking system. In turn, we believe a healthier banking sector more willing to lend would clearly improve growth prospects.

With these measures, governance of fiscal and economic policies should be better assured, while a banking union would streamline the banking sector.

Second, policymakers set out to build mechanisms for risk and burden sharing to enable the system to deal with liquidity and solvency risk of sovereigns and banks.

FISCAL AUSTERITY

In addition to setting up a reinforced framework for the monetary union, countries undertook the task of bringing government debt-to-income ratios down to levels that can be sustained over the long term via substantial austerity programmes. Most countries, except France, Spain, and Ireland, are now close to achieving breakeven before interest expense, or a “primary balance.” All things being equal, once a country achieves a primary balance, its public sector debt no longer accumulates faster than its economy is growing. This is a necessary milestone that must be reached on the way to first stabilising and then reducing a country’s debt-to-GDP ratio. Clearly, the more countries able to transition to primary surplus from primary deficit, the less-precarious the region’s fiscal and political outlook.

STRUCTURAL REFORMS

A long list of structural reforms has also been enacted to enhance labour flexibility and growth potential. It is not clear whether these are having a positive impact at this stage. Eurozone unemployment levels have not improved much, but are stabilising, if at lofty levels. Moreover, business surveys suggest there has been little improvement in the efficiency of eurozone economies. The World Economic Forum’s (WEF) *Global Competitiveness Report*, based on a survey of 13,000 business decision makers conducted in 2009 and again in 2013, suggests there has been only limited progress over recent years, Germany excepted.

There has been some progress in some areas, however. The weak demand caused by austerity is putting pressure on unit labour costs in some countries, with Italy and France the notable exceptions.

BETTER, IF SUBDUED, PROSPECTS

Prospects for the region have improved from where they were 18 months ago, but remain challenging. Policymakers have done much to strengthen the stability of the system, but comparatively little to promote growth and address the high unemployment situation. Reforms are progressing only slowly, and we believe austerity will continue to be the order of the day for some time. The eurozone returned to growth in 2013 with much fanfare, but given the continued burden of austerity and a banking sector still unwilling (and in some cases unable) to lend, any future growth is likely to be

Overall Efficiency and Labour Market Efficiency Rankings

	Overall Efficiency Rank	
	2009	2013
Germany	7	4
France	16	23
Ireland	25	28
Spain	33	35
Portugal	43	51
Italy	48	49
Greece	71	91
U.S.	2	5
U.K.	13	10
Total Number of Countries	133	144

	Labour Market Efficiency Rank	
	2009	2013
Ireland	22	16
France	67	71
Germany	70	41
Spain	97	115
Portugal	103	126
Greece	116	127
Italy	117	137
U.S.	3	4
U.K.	8	5
Total Number of Countries	133	144

Source - World Economic Forum's *Global Competitiveness Report* (2009-2010 and 2013-2014)

moderate, fragile, and uneven. RBC Capital Markets economists have pencilled in a mere 1% for 2014 eurozone GDP growth.

Bailout programme countries Greece and Portugal will continue to receive support for some time. For Greece, an identified funding gap in the programme remains a key unresolved issue. Ultimately, we expect Greece to require a third package of support. There will also be pressure on the country to reach the International Monetary Fund's 110% debt-to-GDP ratio target by 2022 from the current 175% ratio. Portugal is expected to enter a new programme when its existing one ends in 2014. Ireland is the only periphery country positioned to exit its programme successfully at the end of 2013.

In Spain, the post-crisis adjustment effort is proceeding, with key reforms beginning to bear fruit. While this implies continued weakness domestically, exports are already tipping the balance towards growth. Italy remains a potential problem. Should its debt fail to decline to the degree markets expect and if rolling over maturing Italian debt becomes difficult, the newly installed stability buffers of the region could be tested. The consequences could be disruptive, as Italy is the world's third-largest global sovereign bond issuer as measured by total outstanding debt.

Political stress is unlikely to leave the region entirely. The social stress of austerity has been apparent with the rise of non-mainstream parties in many countries. With these parties' popularity increasing

as economic growth has declined, we would expect national political tensions to ease only once these economies stabilise. The European political center remains committed to the monetary union.

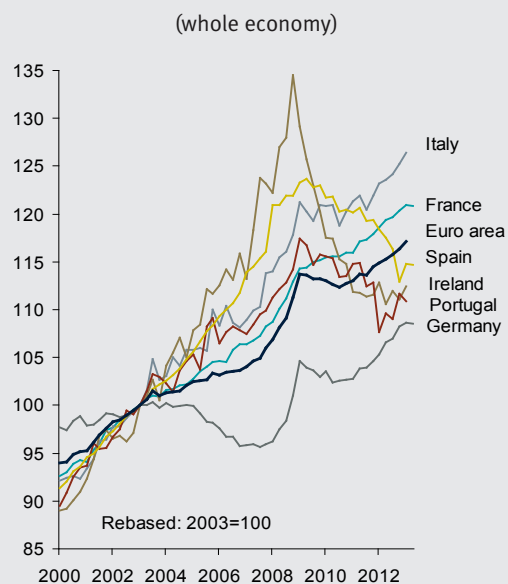
With growth subdued and inflationary pressures very low, the ECB will likely be under pressure to loosen monetary policy further to help mitigate the stress of tight fiscal policies. RBC Capital Markets economists expect the ECB to be on hold until 2016, though there remains the possibility of further cuts in the refinancing rate, currently at 0.25%, if macroeconomic data softens or financial conditions tighten. The central bank recently even suggested it would not rule out negative interest rates.

Alternatively, the ECB may also elect to launch a new Long-Term Refinancing Operation (LTRO). An LTRO is a tool used by the ECB to ease the liquidity pressure on banks, and lower bond yields for sovereign borrowers. The maturity of a 3-year LTRO in 2015 is being regarded by the market as an approaching cliff. This is weighing on market confidence and already contributing to higher forward rates for 2015 than would otherwise be the case. A new LTRO would not only remove the financing cliff, but would also provide much-needed funding access during the upcoming Asset Quality Review process for the banking sector.

EQUITIES MARKET LEADERSHIP TO OSCILLATE

Last year, we stressed the view that it is important to differentiate the macro situation of the region with the microeconomic performance of the corporate

Nominal Unit Labour Costs



Source - Haver Analytics, RBC Capital Markets

sector. We very much stand by that view. Europe offers a wealth of world class, well-run companies. The corporate sector is in good health and the equity market remains attractively valued with price-to-earnings ratios of 13.6x and 12.1x based on 2014 and 2015 consensus earnings estimates, respectively.

Europe's discount to the U.S. market has narrowed, but remains wider than historical norms. Now that it has rerated, we would expect European equity markets to move largely in line with corporate earnings growth.

Over the past few years, the strategy of investing in quality European companies with a global footprint has been the clear winner. During that period, resilient, high-quality growth stocks, many with international platforms, have led the market. Going forward, we believe the demarcation of market leadership may not be as clear cut. There were signs of this oscillation during summer 2013. A growing number of positive economic surprises in Europe provoked a flow of optimistic rhetoric from the corporate sector. In response, domestic European stocks, many of which had been trading at distressed valuation levels, rallied.

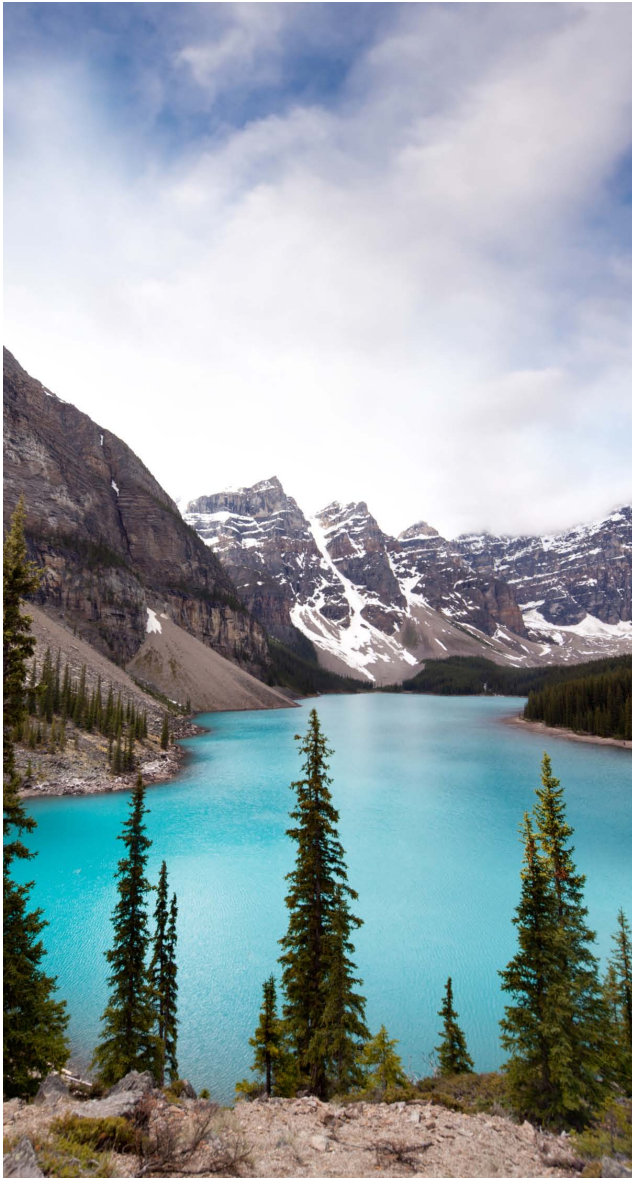
Going forward, we expect the eurozone recovery to be fragile. The economy is likely to encounter periods where it surprises on the upside and others when it disappoints. Accordingly, we would expect market leadership to oscillate between value and quality stocks. Indeed, the summer rally of value

stocks has stretched so far that in the short term, it looks as though it has run its course. Moreover, the pace of positive economic momentum has faded and has not been translated into better earnings.

Against this backdrop, we continue to recommend core holdings of good, quality European companies with a global footprint and ideally with visible earnings momentum. To guard against market leadership oscillation, we would also suggest portfolios include some domestic value stocks, preferably those with restructuring potential. These would benefit not only from enhanced demand driven by a potential European recovery, but also from cost cutting or portfolio improvements.

CONCLUSION

Many challenges remain, but the political commitment of policymakers has so far confounded sceptics. With better governance and with the ECB committed to the role of lender of last resort, the chances of a eurozone breakup have receded markedly. The year 2013 marked the return to growth for the region, although that growth will remain fragile, uneven, and vulnerable to shocks. Returns in European equity markets were very strong in 2013. In 2014, while probably less spectacular, returns should be worthwhile nonetheless. Equity market leadership was clearly in the hands of good, quality companies with an international platform over the past few years. Going forward, we would expect market leadership to oscillate between those stocks and domestic, cyclically orientated companies.



CANADIAN EQUITIES

The Tide is Still Headed Out

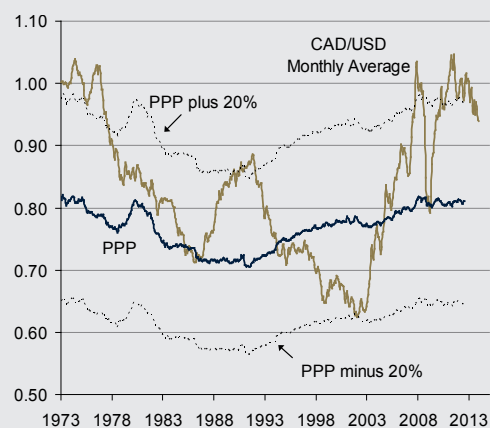
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For more than ten years the Canadian equity market outran most of its global peers, driven by its heavyweight energy and resources sectors as well as the superior performance of its outsized financials sector. That tide turned abruptly two years ago. Since then the S&P/TSX has been a notable laggard. Many of the factors that had contributed a decade of strong outperformance have since become headwinds that are likely to keep the TSX underperforming most other markets for some time yet.

For nearly a decade, the S&P/TSX outperformed most global indices and especially the S&P 500. Following the bursting of the technology bubble, the S&P/TSX returned 75% over the next 9 years vs. 12% for the S&P 500. Magnifying this period of outperformance was the sharp rise in the Canadian dollar (see chart on following page), which made Canadian equity investments doubly profitable for non-Canadian investors or, put the other way, lowered even further U.S. equity returns

for Canadian investors. The root causes of this outperformance were many, but the main were: 1) China's entry into the World Trade Organization and the resultant impact this had on that country's economy and global commodity demand; 2) the Canadian housing boom and the impact this had on both the domestic economy and loan growth for the Canadian banks; and 3) the decline in global bond yields and the impact this had on the valuations of dividend-paying stocks.

Canadian Dollar in U.S. Dollars
versus Purchasing Power Parity (PPP)



Source - RBC Global Asset Management, Bloomberg

While these somewhat intertwined forces did not go away following the global financial crisis, they may have passed an inflection point. China continues to grow at 7% to 8%, but this is a notable downshift from the 10%+ levels that prevailed just a few years ago. For an emerging economy the capital investment share of its GDP typically plateaus in the 30%-35% range and then gradually declines to around 25% or lower, but for the Chinese economy that share reached nearly 50% in the wake of the global financial crisis. Most observers agree current levels are extreme and for the Chinese economy to remain healthy on a go forward basis, this investment share will need to decline, perhaps precipitously. Investment-led growth is more demanding of commodities than consumption-led growth. As the consumption share of the economy rises and the investment share declines, China's economy will become more balanced and its growth trajectory more stable; however, as a consequence commodity demand will wane to some degree.

Meanwhile, Canada's housing market remains healthy and in relative balance despite a couple of pockets of potential instability, notably condo markets in Toronto and Vancouver. However, the robust growth of the past decade appears to have slowed in response to a series of more restrictive mortgage qualification rules introduced by the federal government. Most metrics that measure valuation and affordability are still within historic bands; however, they have begun to push toward

upper bounds in several important markets, which suggest the next five to seven years could see a slowing in market growth. In that event loan growth would also slow, presenting a headwind for the Canadian economy as well as potentially for bank stock valuations.

Lastly, while bond yields remain low by historic standards, a shift has occurred in the past year. With most major central banks pursuing aggressive monetary policies designed to re-inflate the global economy, most investors have begun to worry when, not if, long-term bond yields would normalize further. This has eroded the valuation equation for high-yielding common stocks—as yields rise, valuations compress.

Regardless of which of these causes played what role and how much of an impact each had, in early 2011, the near decade-long period of outperformance for the Canadian market abruptly ended. Since then, the S&P/TSX has been one of the worst-performing indices globally, underperforming the S&P 500 by more than 40% over a two-and-a-half stretch. And while significant underperformance has already occurred, there is reason to believe that this relative trend could continue for some time to come. It's worth noting the Canadian dollar peaked only a few months after the equity market and has fallen by 10% to date over some two-and-a-half years. This has made the S&P/TSX underperformance relative to the S&P 500 even more painful to experience.

S&P500 Relative to TSX (currency adjusted)



Source - RBC Capital Markets, LLC

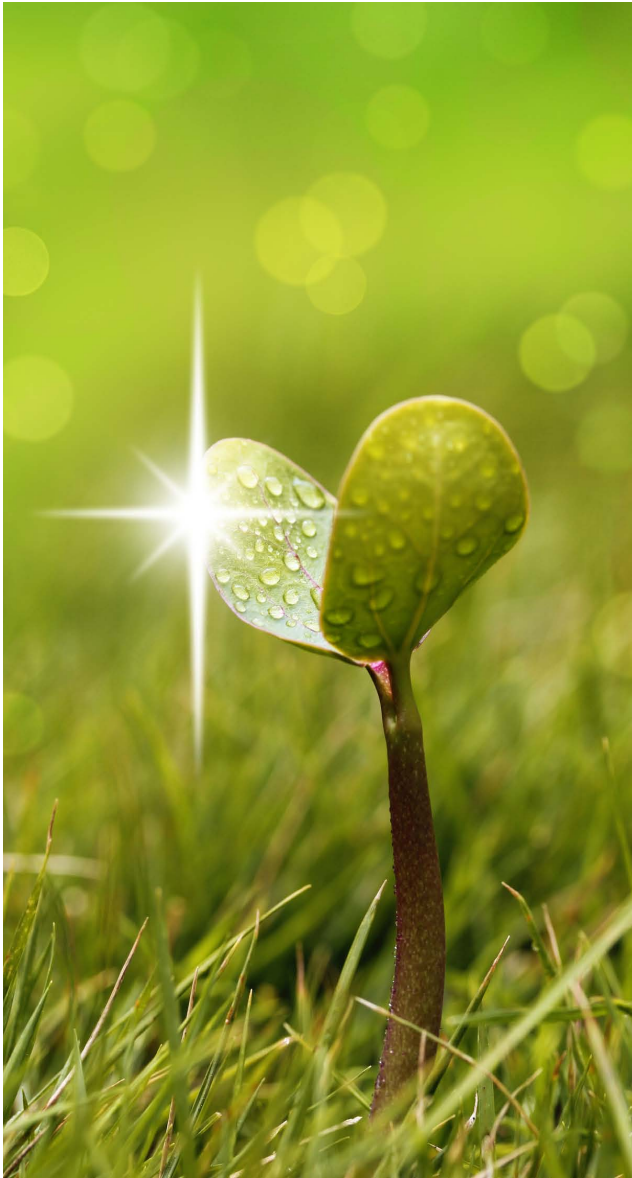
FORCES STILL IN PLACE

Supply/demand balances for many commodities appear likely to remain in surplus for several more years. While there will likely be periods in which commodity stocks (currently 26% of the S&P/TSX) perform well, history has shown that sustainable outperformance is unlikely until these supply excesses are worked off. Further, the sharp growth in U.S. oil and gas production that looks likely to continue at least through the end of the current decade (see article on page 31), potentially puts a cap on energy prices. Thus, while the Canadian oil and gas producers (20% of the index) are trading at compelling valuations relative to historic norms, their ability to generate significant multiple expansion in the face of energy prices that are likely to be contained, may prove difficult. Similarly, the housing market, while unlikely to suffer a significant setback is also unlikely to generate significant returns over the next several years as measures of affordability and valuation are approaching extreme levels. As mentioned, this is likely to weigh on loan growth, which not only negatively impacts the bottom line of the Canadian banks (25% of the index), but also the momentum of the domestic Canadian economy.

STAY UNDERWEIGHT CANADA

Against this backdrop, we continue to recommend that investors underweight Canadian stocks in the context of a global portfolio. The commodity-heavy nature of the S&P/TSX makes sustainable

outperformance unlikely until supply/demand balances normalize, which may take several years. Further, while we remain confident that the Canadian housing market will avoid a sharp correction, we believe that the most likely outcome is a slowdown, as the market grows into some of the sharp gains of the past several years. Layer on top of this our cautious view on interest rates and the potential negative impact this could have on high-yielding common stocks, we believe the likelihood of continued relative underperformance is high enough to warrant an overall Underweight recommendation.



EMERGING MARKETS

Equities Have Underperformed for Three Years – We Assess the Outlook

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Over the past few years, emerging markets (EM) have developed at a slower pace. Economic growth slowed from 6.2% in 2011 to 4.9% in 2012, and is forecast by the International Monetary Fund (IMF) to come in at 4.5% for 2013. It is likely no coincidence that slowdown has run parallel to several years of underperformance of EM equities versus those in developed markets (DM), although the reality is more complex given some of the unusual developments in DM over the period such as rock-bottom interest rates and unprecedented monetary stimulus. But these growth averages for emerging economies taken as a whole hide mixed economic fortunes and market dynamics among countries. As events of 2013 demonstrated, not all EMs are created equal.

2013 EM results varied greatly, from 1.2% and 1.5% growth for Mexico and Russia, respectively, up to 7.6% for China. For 2014 the IMF forecasts EM growth will improve to 5.1% versus a 3.6% forecast for global growth—a number which by itself is already positively impacted by the EM component. More importantly, it signals a change in direction, something investors would normally notice.

The pattern of the slowdown in EM growth over the past three years has been similar to the slowdown in DM growth. But the rate of decline has been faster. EMs are generally more leveraged to exports and manufacturing. Muted demand from developed economies has an amplified effect on emerging ones. However, the reverse is also true. The pick-up in the DM growth forecast for 2014 should boost

Snapshot of Global Growth: 2011 – 2014

	2011	2012	Projections	
			2013	2014
World Output	3.9	3.2	2.9	3.6
Advanced Economies	1.7	1.5	1.2	2.0
United States	1.8	2.8	1.6	2.6
Euro Area	1.5	-0.6	-0.4	1.0
Japan	-0.6	2.0	2.0	1.2
United Kingdom	1.1	0.2	1.4	1.9
Canada	2.5	1.7	1.6	2.2
Other Advanced Economies	3.2	1.9	2.3	3.1
Emerging & Developing Economies	6.2	4.9	4.5	5.1
Central & Eastern Europe	5.4	1.4	2.3	2.7
Commonwealth of Independent States	4.8	3.4	2.1	3.4
Russia	4.3	3.4	1.5	3.0
Excluding Russia	6.1	3.3	3.6	4.2
Developing Asia	7.8	6.4	6.3	6.5
China	9.3	7.7	7.6	7.3
India	6.3	3.2	3.8	5.1
ASEAN-5*	4.5	6.2	5.0	5.4
Latin America & the Caribbean	4.6	2.9	2.7	3.1
Brazil	2.7	0.9	2.5	2.5
Mexico	4.0	3.6	1.2	3.0
Middle East, North Africa	3.9	4.6	2.3	3.6
Sub-Saharan Africa	5.5	4.9	5.0	6.0
South Africa	3.5	2.5	2.0	2.9

*Indonesia, Malaysia, Philippines, Thailand, and Vietnam

Source - International Monetary Fund

demand for EM exports. As things stand, the DM growth outlook will turn from a headwind to a tailwind for the emerging world in the coming year.

LONG-TERM POTENTIAL

With three years of underperformance by EM equities in mind, it behooves us to remind ourselves why EMs are still a fundamentally important consideration for investors. Simply put, by 2030, 60% of global economic activity may be in these countries. The right chart shows how U.S. per-capita GDP has increased over the past century. Some of the largest EMs are then placed on this U.S. curve to gauge their relative development. Of course, there is no guarantee these countries will continue to move upward along the trajectory the U.S. experienced. But, we believe the potential is evident.

SUMMER 2013

Because of low yields in developed economies, investors have looked elsewhere, including emerging markets, for higher-yielding securities. The “taper tantrum” (see article on page 12) this past summer had an immediate impact on emerging markets and their economies. Currencies declined against the U.S. dollar in 15 countries, with higher-yielding currencies the hardest hit. The Indonesian rupiah and Indian rupee declined by more than 15%, while the Brazilian real and Turkish lira were not too far behind.

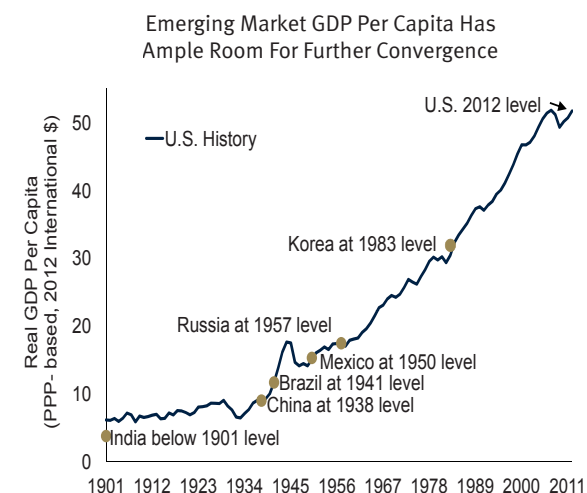
Emerging markets equities battled under successive waves of funds flowing out of the region. This had already begun in March 2013, but spiked in June,

when the reaction to tapering peaked, and did not end until October. To put this in perspective, these seven months of consecutive funds outflows from emerging market equities occurred over an even longer stretch than was seen in the turbulence of the second half of 2008 during the global financial crisis.

EM EQUITY FUNDS FLOW

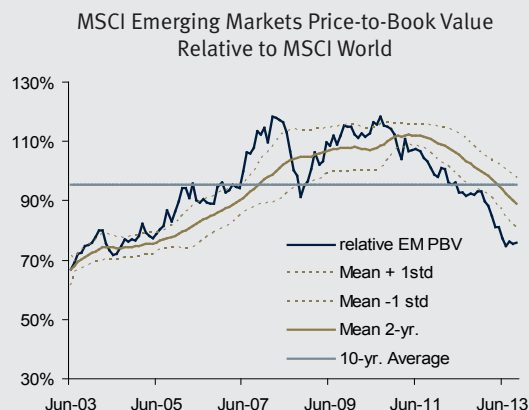
There is no single explanation for why certain EM markets were more severely impacted than others during the summer of 2013. Attention has focused on factors including current account deficits, fiscal deficits, inflation, and the size of foreign exchange (FX) reserves. Market factors were also important,

Emerging Economies: Long-Term Potential



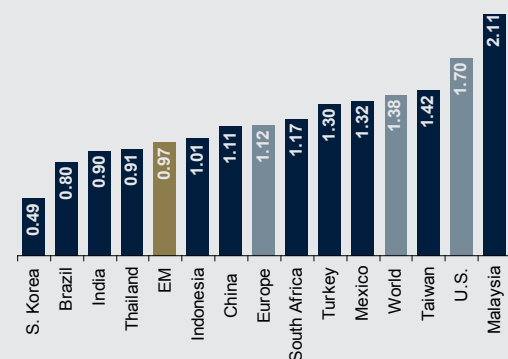
Source - RBC Global Asset Management and Haver Analytics

Attractive Long-Term Valuation Relative to Developed Markets



Source - RBC Global Asset Management and FactSet

Forward PEG Ratio of Select Equity Markets



Source - RBC Dominion Securities Inc. and FactSet

such as capital controls, liquidity, and market size. Smaller markets are more at risk from adverse fund flows than larger markets. For example, North Asian markets were much less impacted than those in South and Southeast Asia. Generally, North Asian countries run current account surpluses, have sizeable FX reserves, and inflation is not currently a problem. Market size is also bigger.

As surprising as the speed and depth of the sell-off in May and June was the subsequent rally. By the end of October, equities losses had been erased. The concern at the time of the sell-off was really about whether the markets were signaling that a significant deterioration in economic fundamentals was about to take place in EM, or that the market drop itself might even cause such an economic dislocation. In any event, this so far has proven not to be the case. The episode did lead to policy tightening in several EMs as currencies fell, but credit growth has remained strong across EM. In our view, the bigger concern for EM in 2014 is not whether the U.S. 10-year yield will rise to 3% or 3.5%, but whether DM growth and demand pick up.

VALUATIONS ARE ATTRACTIVE

Valuations—Aggregate: EM equities are inexpensive on both an absolute and a relative basis. RBC Global Asset Management notes that the current price-to-book (P/B) value multiple of approximately 1.5x for EM equities compares favourably to the long-term average of 2.0x. Relative to MSCI world equities, EM equities trade at a 25% discount in terms of price-to-

book value. This is the biggest discount in close to 10 years.

Valuations—Countries: One useful measure compares valuation to growth. The bottom chart shows 2013 price-to-earnings (P/E) ratios divided by forecast earnings growth (G) in 2014. (This is the forward PEG ratio.) Lower ratios, where an investor pays less for growth, are more attractive than higher ratios, where the price for growth is higher. A ratio of 1.0 is an approximate dividing line between cheap and expensive. South Korea, Brazil, India, and Thailand all have a forward PEG ratio of less than 1.0. Malaysia is the most stretched at 2.1. The whole of EM has a forward PEG ratio of slightly less than 1.0, compared to Europe at 1.12, global equities at 1.4, and the U.S. at 1.7.

EM EQUITIES: 2014 OUTLOOK

2013 was a disappointing year for EM investors (the third consecutive year of poor relative performance). However, this should be set in context. EM equities outperformed by a wide margin coming out of the recession. Looking back further, EM equities still have the upper hand in terms of performance over the past decade.

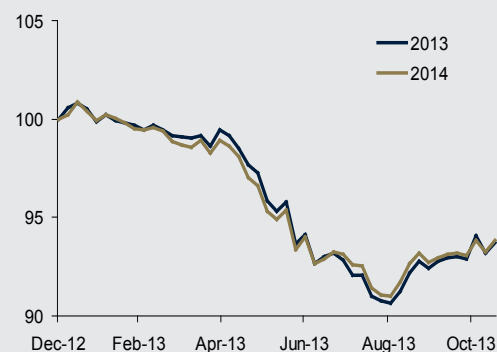
The sizeable performance shortfall of the past few years between EM equities and the developed markets is unlikely to be repeated in 2014. Equities in the U.S. and Japan were particularly strong in 2013. It was also the third consecutive year in which EM economic growth slowed; however, that growth slowdown is set to reverse in 2014 with the

Emerging Market and Developed Market Equities Relative Performance



Source - Bloomberg

MSCI Emerging Markets 2013 and 2014 Earnings Revisions



Source - RBC Global Asset Management and FactSet

change in direction potentially acting as a catalyst for EM equities. Further, there is a silver lining to the EM cloud: expectations have been set lower, earnings forecasts have been revised downwards for 2014 and 2015, and EM equity valuations are increasingly attractive relative to DM. In other words, notwithstanding concerns over tapering, the bears have been wandering around the EM woods for quite a while.

CONCLUSION

Three important items we believe emerging markets investors should watch in 2014 are growth in developed markets, global bond yields, and the outlook for China.

An improvement in DM growth would bode well for EM, given their cyclical index composition. IMF growth data for advanced economies have declined sequentially from 1.7% in 2011, to 1.5% in 2012 and just 1.2% in 2013. However, this growth rate is forecast by the IMF to almost double in 2014 to 2.0% as Europe swings from recession to expansion and the U.S. economy improves. Operating leverage is higher in EM, and margins are lower. Just as the reduction in DM growth had an amplified impact on EM growth over the past three years, the reverse would also be true. Beneficiaries of this would be countries more exposed to global growth, such as tech-heavy South Korea, Taiwan, and China.

Global bond yields may continue to rise as developed market growth improves and the

Federal Reserve begins to remove stimulus. We believe the point of maximum stimulus from U.S. monetary policy will soon pass. QE has morphed from a blessing to a curse for EM, making life more complicated for emerging markets bond investors. It is difficult to see how this process will be positive for EM funds flow after the experience of 2013, although we do not expect the same dramatic reaction. Risks are higher for those emerging markets that have been the target of carry trades or are deficit countries with high inflation and volatile currencies. Brazil, India, Indonesia, and Turkey may be vulnerable again. North Asian markets are more stable in this regard.

China is the largest EM economy, the single biggest contributor to both EM and global growth, and the largest weighting in the MSCI EM equity index. As the world's largest exporter, China also sits at the centre of the global supply chain for many goods, sucking in raw materials and components across EM, from iron ore in Brazil to phone parts from Taiwan, and exporting finished products. China also forms an ever-larger portion of final demand. Leading indicators for the Chinese economy are neutral to positive and growth seems to have stabilized. In a scenario of better global growth, risk may actually lie to the upside for Chinese growth in 2014, something that is little discussed.

Please see Country Insights on following pages.

MSCI Emerging Markets Overview

Region	Weighting in MSCI EM Index	Economic Output (US\$bn)	Three Largest Equity Sectors Per Market		
China	19.0%	8,358	F (40%)	E (15%)	T (11%)
South Korea	15.9%	1,130	IT (37%)	D (18%)	F (14%)
Brazil	11.7%	2,253	F (29%)	E (17%)	M (17%)
Taiwan	11.0%	474	IT (52%)	F (18%)	M (12%)
South Africa	7.5%	384	F (27%)	D (22%)	T (14%)
India	6.2%	1,842	F (24%)	IT (21%)	E (12%)
Russia	6.2%	2,014	E (57%)	F (18%)	T (9%)
Mexico	5.1%	1,178	S (26%)	T (22%)	M (17%)
Malaysia	3.8%	304	F (29%)	I (12%)	T (12%)
Thailand	2.5%	366	F (38%)	E (21%)	M (12%)
Indonesia	2.4%	878	F (35%)	D (17%)	S (14%)
Turkey	1.7%	789	F (52%)	S (13%)	I (13%)
TOTAL	93.0%	19,970			

D: Consumer Discretionary IT: Information Technology
E: Energy M: Materials
F: Financials S: Consumer Staples
I: Industrials T: Telecommunications

Source - World Bank, Bloomberg

COUNTRY INSIGHTS

We provide a brief outlook for three of the BRIC countries (Brazil, India, and China), as well as Indonesia, a major growth economy in Southeast Asia.

BRAZIL

Outlook: The IMF forecasts 2.5% growth in 2014, the same as 2013. Monetary policy continues to have a tightening bias. Despite this, the Brazilian real has been weakening and was one of the worst-performing currencies in EM in 2013, declining by 15.2% (as of December 6). The path of the real in 2014 is far from certain, in our view. Inflation is high but stable. The presidential election in October 2014 will impact longer-term decision-making by the government during the year.

Markets: Brazilian equities are inexpensive at 10x 2014 forecast earnings. However, earnings forecasts are already optimistic with the consensus forecasting 16% earnings-per-share growth. Tightening monetary policy and a weakening currency are a negative combination, although exporters, such as mining companies, may benefit from the latter.

CHINA

Outlook: The IMF forecasts 7.3% growth in 2014. Chinese Premier Li Keqiang believes China has entered a “medium- to high-speed” growth period, defined as 7.0%-7.5%. Structural concerns remain, such as local government debt levels and

credit growth. The housing market was strong in 2013. The important Third Plenum meeting, in November 2013, provided greater clarity on the policy agenda. Reform areas range from increasing land rights to further financial market liberalization to changes in the one-child policy, all of which boost consumption. The Communist Party elevated the role of markets in the economy to “decisive” from “fundamental.” We think this is a milestone development. Implementation is now key. The inflation outlook is benign. The chance of benchmark interest rate increases is low. The renminbi should continue to appreciate. China's FX reserves are now more than US\$3 trillion. Improved growth in the U.S. and Europe would be a positive for China. China's key risk is a failure to slow excessive credit growth.

Markets: Credit is tight, and yields are rising. Spikes in short-term yields may continue and could become larger as the authorities squeeze liquidity. The currency is stable and strong. Equity earnings are forecast to grow by 9% in 2014; but, there is a wide range across sectors. Consensus earnings forecasts have been largely unchanged during 2013, while most Asian countries have experienced negative revisions. Investors may continue to focus on “new China” sectors, such as internet, consumer, insurance, and clean energy. We believe structural concerns are priced into the big banks stocks, where P/E ratios are lower than dividend yields.

“In 1988, there were just 10 countries in the MSCI Emerging Markets Index, representing less than 1% of world market cap. Today the MSCI Emerging Markets Index covers over 800 securities across 21 markets and represents approximately 11% of world market cap.”

– MSCI Research, as of October 2013

INDIA

Outlook: The IMF forecasts 5.1% growth in 2014. This would be a positive change in direction. However, high inflation and twin deficits will remain challenges in 2014. Interest rates will likely continue to increase. The currency weakness in summer 2013 did moderate thereafter. The rupee declined by 12.6% against the U.S. dollar (as of December 6) versus 22% at its nadir. There is a general election in May. Obtaining a majority in the Lok Sabha, the lower House of Parliament, will be hard for any current coalition, let alone individual party, to achieve. But this is nothing new.

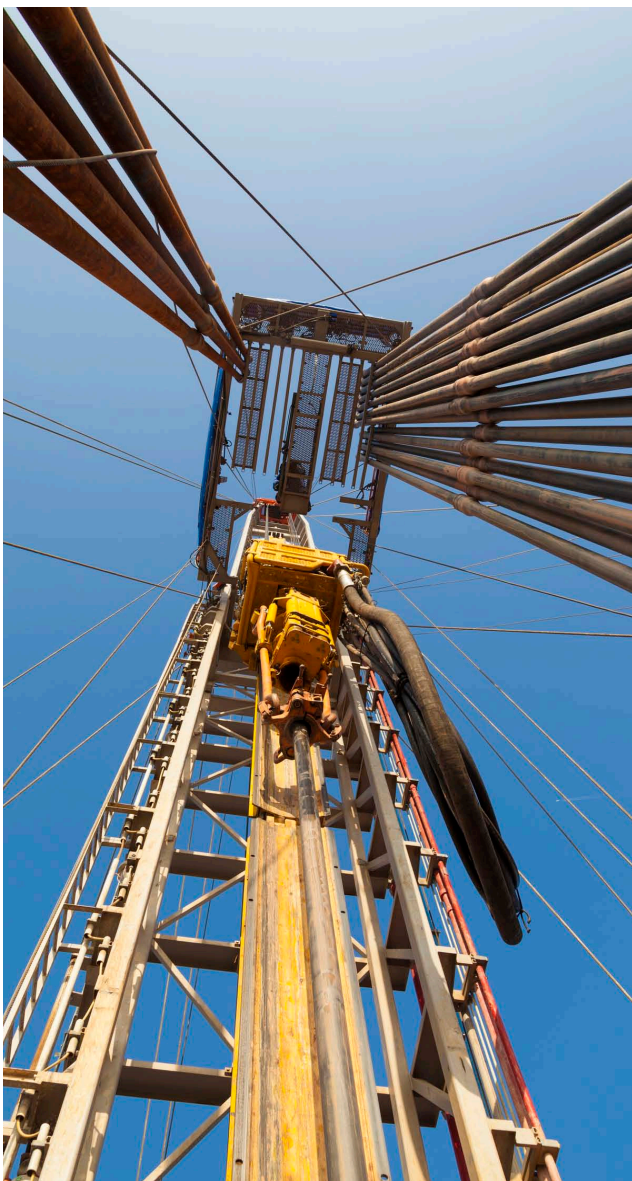
Markets: Fed policy will be more important than the election. The rupee appears to have stabilized for the time being. Equity valuations are undemanding, but it is hard to identify catalysts beyond a weaker currency, which benefits exporters and U.S. dollar-earners. The current 17% earnings growth forecast by the market may be optimistic. However, the information technology sector, the second-largest MSCI index weighting at 21%, may benefit from the lower rupee.

INDONESIA

Outlook: The IMF forecasts 5.5% growth in 2014, citing slower investment, weaker commodity demand from other emerging markets and tighter financing conditions as reasons for its reduced forecast. The rupiah and bond yields were significantly impacted by the tapering discussion. Rupiah declined by 23% against the U.S. dollar

in 2013 (as of December 6). Accordingly, interest rates were increased several times. The currency is weak and inflation elevated, although inflation may moderate in 2014. There is a parliamentary election in April and a presidential election in July. The current president must step down. Political uncertainty is no help.

Markets: Slowing growth, high inflation, higher interest rates, and a volatile currency are headwinds for Indonesian equities and bonds in 2014. Indonesian markets will receive unwanted attention as tapering unfolds. Consumption growth may slow under tougher macro conditions. Consumer stocks are nearly one-third of the MSCI Indonesia equity index. Financials are also one-third. Loan-to-deposit ratios are already high, implying slower loan growth and/or tighter lending margins for banks. The Jakarta Composite is trading at the higher end of its historical forward P/E ratio. Earnings downgrades in those two sectors would stretch valuations. Despite the weakness in equities in 2013, the Index is up more than 370% since the low in 2008.



U.S. “TIGHT OIL” – IT’S A GUSHER!

MARK ALLEN – TORONTO, CANADA
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Last year, we wrote with some enthusiasm about the potential of U.S. shale oil to add a significant new source of supply in the coming years. (“Shale oil” has become the generic term for oil found in “tight” rock formations.) Shale oil’s high-cost nature and nascent stage of development then seemed unlikely to have an immediate impact on global market conditions. However, U.S. expansion has continued to surprise to the upside and is showing little sign of abating. International Energy Agency predictions of the U.S. becoming the world’s largest oil producer have moved up by two years to 2015. Perhaps as soon as the second half of 2014, we will see the U.S. overtake Russia as the world’s second-largest oil producer. More importantly, we now see the impact of U.S. shale oil as becoming meaningful in size and contributing to a likely surplus for next year.

INTRODUCTION

Should shale oil development continue at its current pace, the United States could overtake Russia as the world’s second-largest producer of oil and liquids by this time next year.

Shale oil development is so rapid that production growth from the U.S. appears sufficient to single-handedly accommodate all one million barrels per day of incremental demand growth globally this

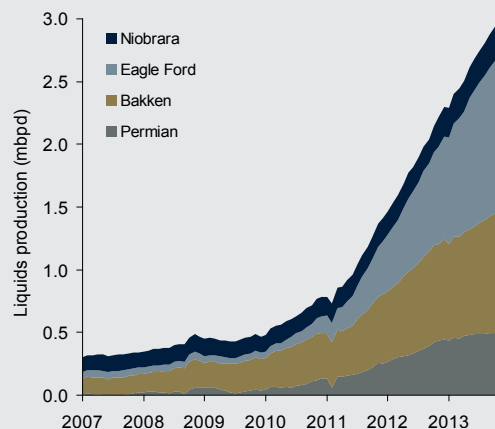
year. With the price of oil, like all commodities, determined by changes in supply and demand at the margin, U.S. shale oil is turning heads.

U.S. SHALE OIL UPDATE

The shale oil revolution constitutes a game changer for North American supply dynamics, in our opinion, and is making an ever-increasing impact on the world stage.

U.S. Shale Oil Liquids Production

(2007 – Present)



Source - U.S. Energy Information Administration

Note: In an attempt to isolate tight oil from conventional vertical production, the above excludes base Permian production of 0.8 mbpd as of January 2007.

Only a few years ago, U.S. production was thought to be in steady decline, having peaked in the 1970s. From its low point in 2008 to the present, total U.S. crude oil and liquids production has soared to 10 million barrels per day (mbpd) from approximately 7 mbpd. This energy renaissance has been fuelled by growth from four shale oil plays: Bakken (now about 10% of total U.S. oil and liquids production), Eagle Ford (about 12%), Permian (about 13%), and Niobrara (about 3%). Collectively, these four plays have accounted for the lion's share of nationwide growth.

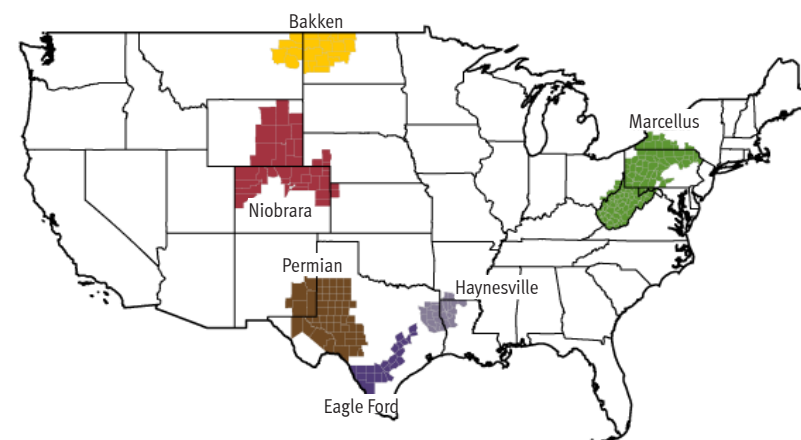
The pace of production growth from these plays has accelerated in the past two years as operators learn to drill more efficiently and effectively with longer lateral well lengths and increased stage counts when fracking. The past 12 months have seen an incremental +0.8 mbpd delivered to the market, while in the past 24 months, the additions have totalled an incremental +1.6 mbpd. The standout performer has been the Eagle Ford which alone accounts for roughly half of this growth.

With U.S. production forecast by RBC Capital Markets to reach 10.9 mbpd in 2014 and 11.4 mbpd in 2015, the United States is set to surpass Russia (10.9 mbpd in 2014 and 2015) as the world's second-largest producer some time in the

second half of next year. Production from the world's largest producer, Saudi Arabia, varies from year to year and may well come in below 10 mbpd in 2014 depending on what is required to manage the global market. Saudi Arabia claims to have capacity of 12 mbpd, which might be attainable by the U.S. in 2015 or 2016.

Resource estimates would suggest there is much shale (or tight) oil left to be exploited in the United States. Remaining reserves and undeveloped resources are estimated by Advanced Resources International to exceed 47 billion barrels, including: Bakken (14.7 billion barrels), Eagle Ford (13.6 billion), Permian (9.7 billion), and Niobrara (4.1 billion). While the presence of these huge resources has been known by geologists for decades, it has

Key Tight Oil and Shale Gas Plays



Source - U.S. Energy Information Administration

While the growth in U.S. production is impressive, it must be put into context within the global oil market. At about 3 mbpd of production, U.S. tight oil is still just 3% of global supply.

taken a sustained period of high oil prices for development in size to become economically viable. Tight oil development, however, remains at an early stage, and one key concern is that the initial sweet spots of these plays may be exploited early, leading to a peaking of production in the future. With individual wells showing production declines of 60%-75% in the first year, new and prolific drilling locations will be required to keep this oil renaissance alive.

BALANCING GLOBAL SUPPLY AND DEMAND

GLOBAL SUPPLY

While the growth in U.S. production is impressive, it must be put into context within the global oil market. At about 3 mbpd of production, U.S. tight oil is still just 3% of global supply.

U.S. supply growth of +1.0 mbpd in the last year is substantial even on the world stage; however, global declines driven by aging fields of 4-6 mbpd (excluding the U.S. and Libya) have been the norm in recent years. The industry is on a constant treadmill and effectively needs to replace production equivalent in size to that of Saudi Arabia about every two years just to stay even!

Looking ahead, RBC Capital Markets believes four nations will anchor net supply additions next year: the U.S. (+0.8 mbpd) driven by tight oil, Canada (+0.3 mbpd) driven by oil sands, Brazil (+0.2 mbpd) driven by offshore pre-salt deposits, and Iraq (+0.2 mbpd) driven by renewed investment.

GLOBAL DEMAND

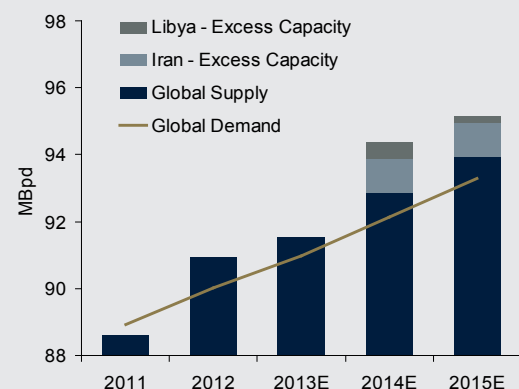
Global demand has been expanding at about 1% in recent years, with moderate declines in the Organisation for Economic Co-operation and Development (OECD) countries being offset by 2%-3% growth in non-OECD markets. Despite a long period of sustained high oil prices, the expansion of emerging market demand has remained robust. The lasting driver of this demand growth appears to be industrialization and the growing vehicle fleet fostered by urbanization in emerging markets. Most notable of these have been China and the Middle East, which represent about one-third and one-fifth, respectively, of total worldwide demand growth for this year.

MARKET BALANCE

Comparing expected global demand of 92.1 mbpd next year with expected supply of 92.9 mbpd delivers a 0.8 mbpd surplus, according RBC Capital Markets estimates. This surplus is comparable to the 2012 experience, and roughly double the level observed this year.

However, these forecasts exclude unused capacity of about 1.0 mbpd in Iran and about 0.5 mbpd in Libya, which is expected to be tied up for political reasons. With Iran making progress on its relationship with the P5+1 nations (United Nations Security Council + Germany) and Libyan politics a wild card, we could be surprised with a larger global surplus should either of these situations improve, or should U.S. shale oil accelerate faster than we expect.

Global Supply and Demand Outlook



Source - RBC Capital Markets, RBC Wealth Management

OPEC attempts to manage oil prices by controlling its output, thus an important measure of market balance is OPEC spare capacity. OPEC's effective spare capacity has ranged in recent years from a tight almost 1.5 mbpd in July 2008 when oil prices reached \$147 per barrel to a loose 5.0-5.5 mbpd in late 2009 and early 2010, when oil prices were \$70-\$85 per barrel. Effective OPEC spare capacity is expected to increase to 3.7 mbpd in 2014 according to RBC Capital Markets and could easily move into a four-handle level if higher-than-expected volumes from Iran, Libya, or the U.S. were to elicit more aggressive production curtailment from Saudi Arabia, the swing producer.

COULD U.S. SHALE OIL IMPACT GLOBAL OIL PRICES?

Another year of high oil prices is drawing to a close, supporting the thesis that at a nascent stage, U.S. tight oil might not have a significant impact on global oil prices.

Uncertainty around Middle East and North African volumes is likely to continue and may mask the impact of additional U.S. tight oil supply in 2014. However, surprises in this region have been the norm in recent years, and we would expect these surprises to be the primary driver of oil prices—in one direction or the other—in the near term.

According to RBC Capital Markets estimates, absent new Middle East tensions, OPEC effective spare capacity is poised to reach about 4 mbpd by 2015 as the U.S., Canada, Brazil, and Iraq continue to drive global supply increases. Should Iran's 1 mbpd of

spare capacity return to market in that timeframe, even looser conditions would likely materialize.

In the longer run, we believe North American supply additions will be determined by free market forces. If a supply surplus too large for OPEC to manage were to play out, we would expect U.S. spending to be cut back. In 2009, for instance, when oil prices averaged \$62 per barrel, Bakken drilling dropped by 60% peak to trough, and was down 25% on average for the year.

Our national research correspondents estimate that most U.S. tight oil plays deliver reasonable economic returns at approximately \$50-\$70 per barrel, while some require \$80+ per barrel. Given steep initial well declines and a U.S. exploration and production model that works on a cash in/cash out basis, we would expect U.S. supply growth to adjust relatively quickly should oil prices approach breakeven levels.

CONCLUSION

U.S. shale oil volumes continue to rise rapidly and are starting to meaningfully contribute to looser market conditions. We expect steady demand growth, geopolitical turmoil, and strong growth primarily from U.S. shale oil and Canadian oil sands to keep oil in the \$75-\$100 per barrel range in the near term.

A major supply disruption or fear thereof in the Middle East would likely be required to drive prices higher in the near term. For prices to fall below this range, it would most likely require a change in outlook for global economic growth, more specifically, for China.

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