THE GLOBAL INVESTMENT OUTLOOK

RBC GAM Investment Strategy Committee

SPRING 2017

Global Asset Management

THE RBC GAM INVESTMENT STRATEGY COMMITTEE

The RBC GAM Investment Strategy Committee consists of senior investment professionals drawn from across RBC Global Asset Management. The Committee regularly receives economic and capital markets related input from internal and external sources. Important guidance is provided by the Committee's regional advisors (North America, Europe, Far East), from the Global Fixed Income & Currencies Subcommittee and from the global equity sector heads (financials and healthcare, consumer discretionary and consumer staples, industrials and utilities, energy and materials, telecommunications and technology). From this it builds a detailed global investment forecast looking one year forward.

The Committee's view includes an assessment of global fiscal and monetary conditions, projected economic growth and inflation, as well as the expected course of interest rates, major currencies, corporate profits and stock prices.

From this global forecast, the RBC GAM Investment Strategy Committee develops specific guidelines that can be used to manage portfolios.

These include:

- the recommended mix of cash, fixed income instruments, and equities
- the recommended global exposure of fixed income and equity portfolios
- the optimal term structure for fixed income investments
- the suggested sector and geographic make-up within equity portfolios
- the preferred exposure to major currencies

Results of the Committee's deliberations are published quarterly in *The Global Investment Outlook.*

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EXECUTIVE SUMMARY

Sarah Riopelle, CFA
V.P. & Senior Portfolio Manager
RBC Global Asset Management Inc.

Daniel E. Chornous, CFA
Chief Investment Officer
RBC Global Asset Management Inc.

Leading economic indicators are at their best levels in several years, economic surprises have been overwhelmingly positive and corporate earnings continue to recover from their prior stumbles. Taken together, global economic signals remain quite strong by post-crisis standards. As a result, risk assets such as equities and corporate credit have performed well.

The biggest question on the minds of global investors relates to what the Trump administration will do in the next four years. There is still enormous uncertainty around precisely how U.S. public policy will play out. So far, optimists would appear to outnumber pessimists: equities have soared, the U.S. dollar has risen, bond yields have gone up and credit spreads have narrowed. It's important to recognize that his bout of market enthusiasm actually began well in advance of the election, but the political outcome provided a further springboard.

Faster economic growth, but we are not abandoning our "slow-growth" view just yet

Economic growth has improved in both developed and emerging markets, with most countries managing some improvement in recent months. Weighing the available evidence, we choose to celebrate this period of faster growth, but we assume that the current episode represents a fluctuation toward the high end of the post-crisis growth range rather than a permanent escape from the "slow-growth" environment. We continue to see a plethora of factors that will constrain economic growth going forward. We have moderately upgraded our 2017 growth forecasts this quarter but assume that some portion of the recent vigour will be shed into the second half of the year and into 2018.

Downside risks manageable

Risks to our outlook include the aging business and credit cycles, rising populist movements, higher interest rates, elevated Chinese debt loads and an ever-evolving and uncertain political landscape in the U.S. and Europe. We expect that the global economy will be able to move beyond these risks and continue to grow and possibly even accelerate, though still running at a pace below long-term historical norms.

U.S. dollar bull market keeps going

Six years into the U.S. dollar bull market, prospects for the greenback still look relatively bright. Many long-term factors are still supportive, while the other major currencies remain hampered by weaker growth profiles, less attractive interest rates and/or political uncertainty. Our forecast of single-digit gains for the U.S. dollar are tempered by what is likely the late stage of the bull market, but proposed Republican policies in the U.S could represent a shot in the arm for the greenback and further extend this period of dollar strength.

Trend to higher inflation continues

There is now clear evidence that the trend towards higher inflation is well afoot as the negative commodity shock has ended, thus removing a profound deflationary pressure. If economic growth is better than expected, inflation should logically rise even more quickly. Our inflation forecasts tend to be above the consensus, with some countries set to drift above their target levels.

All eyes on the Fed

Globally, many central banks are still focused on delivering prior quantitative-easing commitments. The one exception is the U.S. Federal Reserve which continues to press forward with its plan to nudge the fed funds rate higher. Improving U.S.

economic conditions, firming inflation and a strengthening labour market suggest a decreasing need for the extremely accommodative monetary policy that has been in place in the U.S. since the financial crisis. The Fed appears to be onboard with this logic, having raised its projections in December for the number of rates hikes in 2017 to three from the two forecast in September.

A popular topic of discussion in financial markets has been an expected shift from monetary stimulus to fiscal stimulus. A gradual decline in monetary stimulus is likely playing out, but there appears to be less new fiscal stimulus coming than popularly imagined. A key implication of these findings is to recognize that total government stimulus – monetary and fiscal policy combined – may actually be in slight decline. This is a reason to be cautious about expecting accelerating economic growth over the next few years.

Near-term pause in bond yields, but long-term direction is higher

The yield on U.S. 10-year Treasuries peaked at 2.65% in December and has been trading in a narrow range since then. Bond yields followed a similar pattern in other major regions, but to a lesser extent. The fact that yields have risen so rapidly since last summer has greatly reduced the valuation risk and, therefore, the need for a further near-term adjustment.

However, our fixed-income models continue to suggest that the long-term direction for yields is higher. The financial crisis has depressed real rates of interest to levels that are not likely to persist. The combination of both a bit more inflation and a higher real rate of interest would act as a headwind to fixed-income returns in general and pose a risk to sovereign-bond investors, in particular.

Stocks extend gains, earnings outlook brightens

Surprisingly strong economic data, surging consumer and business confidence, and better-than-expected earnings propelled stocks higher in the past quarter, with most major indexes delivering gains in the mid to high single digits. Emerging markets, European and U.S. equities rose the most, while gains for Japanese and Canadian stocks lagged. Although stocks have enjoyed a solid rally, we don't think that valuations are as stretched as some investors believe. Traditional price-to-earnings ratios, in particular, do not factor in interest rates and therefore may appear elevated when compared to history. Our own RBC GAM multi-factor model, which incorporates current levels of inflation, interest rates and corporate profitability, suggests U.S. stocks are actually a bit below fair value. However, we do recognize that stocks are not as cheap as they were, so a continued improvement in earnings is needed to fuel further equity gains. Fortunately, a recovery in profits is well underway. In fact, S&P 500 earnings exceeded analysts' forecasts in the fourth quarter and now appear to be accelerating. While there are risks that some of Trump's protectionist policies could have a negative impact on earnings, significant gains are also possible if large-scale corporate-tax cuts materialize and the economy accelerates.

Style rotation could be cause for concern in the near term

While our long-term view on equities remains positive, there are some current trends in the market that may be signalling near-term caution. The massive rotation in investment style leadership of 2016 has stalled so far this year. Since the start of 2017, growth has outperformed value and large caps have outperformed small caps, representing a lack of follow-through in 2016's style shift and, perhaps, a moderation in the positive outlook that rotation represented. Of course, this situation may simply indicate a pause within a longer-term move, or it could also be cause for concern if the trend deteriorates further. A sustained shift toward large-cap and growth leadership may foreshadow a slowdown in the economy and/or corporate profits in the quarters ahead.

Equity exposure slightly reduced

Our models continue to suggest that equities will outperform fixed income through the forecast horizon as well as over the longer term. A starting point of low yields, combined with our expectation that yields will rise, results in low or potentially negative returns over the years ahead. Prospective returns for equities are much more attractive. As a result, we have maintained our long-standing overweight exposure to equities and underweight position in bonds. That said, we have slightly reduced our exposure to stocks and allocated the proceeds to cash due to the uncertainty surrounding U.S. public policy and a variety of style and technical factors. For a balanced, global investor, we currently recommend an asset mix of 60% equities (strategic neutral position: 55%) and 38% fixed income (strategic neutral position: 43%), with the balance in cash.

ECONOMIC & CAPITAL MARKETS FORECASTS

ECONOMIC FORECAST (RBC GAM INVESTMENT STRATEGY COMMITTEE)

	UNITED STATES		CANADA		EUROPE		UNITED KINGDOM		JAPAN		CHINA		EMERGING MARKETS*	
	Spring 2017	Change from New Year 2017	Spring 2017	Change from New Year 2017	Spring 2017	Change from New Year 2017	Spring 2017	Change from New Year 2017	Spring 2017	Change from New Year 2017	Spring 2017	Change from New Year 2017	Spring 2017	Change from New Year 2017
REAL GDP														
2016A	1.60%		1.43%		1.68%		1.85%		0.99%		6.73%		4.98%	
2017E	2.25%	0.25	1.50%	N/C	1.75%	0.50	1.75%	0.25	0.75%	N/C	6.25%	0.25	5.25%	N/C
2018E	2.25%	N/C	1.50%	N/C	1.50%	N/C	1.50%	N/C	0.75%	N/C	5.75%	N/C	5.25%	N/C
CPI														
2016A	1.28%		1.41%		0.25%		0.65%		0.77%		2.12%		3.66%	
2017E	2.50%	0.25	2.00%	(0.25)	1.75%	0.25	3.00%	N/C	1.00%	0.50	2.50%	0.50	3.50%	0.25
2018E	2.25%	N/C	2.25%	N/C	1.75%	N/C	2.75%	N/C	1.00%	N/C	2.50%	N/C	3.25%	N/C

A = Actual E = Estimate *GDP Weighted Average of China, India, South Korea, Brazil, Mexico and Russia. Actual 2016 GDP uses estimates for Brazil and Russia.

TARGETS (RBC GAM INVESTMENT STRATEGY COMMITTEE)

	FEBRUARY 2017	FORECAST FEBRUARY 2018	CHANGE FROM NEW YEAR 2017	1-YEAR TOTAL RETURN ESTIMATE* (%)
CURRENCY MARKETS AGAINST USD				
CAD (USD–CAD)	1.33	1.44	N/C	(8.0)
EUR (EUR–USD)	1.06	1.00	N/C	(7.0)
JPY (USD–JPY)	112.73	115.00	N/C	(3.3)
GBP (GBP–USD)	1.24	1.15	N/C	(7.9)
FIXED INCOME MARKETS				
U.S. Fed Funds Rate	0.75	1.38	0.50	N/A
U.S. 10-Year Bond	2.40	2.50	0.25	1.5
Canada Overnight Rate	0.50	0.50	N/C	N/A
Canada 10-Year Bond	1.63	1.75	0.25	0.6
Eurozone Deposit Facility Rate	-0.40	-0.40	N/C	N/A
Germany 10-Year Bund	0.21	0.75	0.35	(5.0)
U.K. Base Rate	0.25	0.25	N/C	N/A
U.K. 10-Year Gilt	1.15	1.50	N/C	(2.1)
Japan Overnight Call Rate	-0.05	-0.10	N/C	N/A
Japan 10-Year Bond	0.07	0.10	0.10	(0.3)
EQUITY MARKETS				
S&P 500	2364	2525	175	8.9
S&P/TSX Composite	15420	16125	300	7.5
MSCI Europe	125	135	13	11.4
FTSE 100	7263	7550	450	8.1
Nikkei	19119	19975	975	6.2
MSCI Emerging Markets	936	1000	75	9.5

*Total returns are expressed in local currencies with the exception of MSCI Emerging Markets whose return is expressed in USD. Source: RBC GAM

RECOMMENDED ASSET MIX

Asset mix – the allocation within portfolios to stocks, bonds and cash – should include both strategic and tactical elements. Strategic asset mix addresses the blend of the major asset classes offering the risk/return tradeoff best suited to an investor's profile. It can be considered to be the benchmark investment plan that anchors a portfolio through many business and investment cycles, independent of a near-term view of the prospects for the economy and related expectations for capital markets. Tactical asset allocation refers to fine tuning around the strategic setting in an effort to add value by taking advantage of shorter term fluctuations in markets.

Every individual has differing return expectations and tolerances for volatility, so there is no "one size fits all" strategic asset mix. Based on a 40-year study of historical returns[1] and the volatility[2] of returns (the range around the average return within which shorter-term results tend to fall), we have developed five broad profiles and assigned a benchmark strategic asset mix for each. These profiles range from very conservative through balanced to aggressive growth. It goes without saying that as investors accept increasing levels of volatility, and therefore greater risk that the actual experience will depart from the longer-term norm, the potential for returns rises. The five profiles presented below may assist investors in selecting a strategic asset mix best aligned to their investment goals.

Each quarter, the RBC GAM Investment Strategy Committee publishes a recommended asset mix based on our current view of the economy and return expectations for the major asset classes. These weights are further divided into recommended exposures to the variety of global fixed income and equity markets. Our recommendation is targeted at the Balanced profile where the benchmark setting is 55% equities, 43% fixed income, 2% cash.

A tactical range of +/- 15% around the benchmark position allows us to raise or lower exposure to specific asset classes with a goal of tilting portfolios toward those markets that offer comparatively attractive near-term prospects.

This tactical recommendation for the Balanced profile can serve as a guide for movement within the ranges allowed for all other profiles.

The value-added of tactical strategies is, of course, dependent on the degree to which the expected scenario unfolds.

Regular reviews of portfolio weights are essential to the ultimate success of an investment plan as they ensure current exposures are aligned with levels of long-term returns and risk tolerances best suited to individual investors.

Anchoring portfolios with a suitable strategic asset mix, and placing boundaries defining the allowed range for tactical positioning, imposes discipline that can limit damage caused by swings in emotion that inevitably accompany both bull and bear markets.

1. **Average return:** The average total return produced by the asset class over the period 1977 – 2017, based on monthly results.
2. **Volatility:** The standard deviation of returns. Standard deviation is a statistical measure that indicates the range around the average return within which 2/3 of results will fall into, assuming a normal distribution around the long-term average.

GLOBAL ASSET MIX

	BENCHMARK POLICY	PAST RANGE	SPRING 2016	SUMMER 2016	FALL 2016	NEW YEAR 2017	SPRING 2017
CASH	**2.0%**	1.0% – 16%	3.0%	3.0%	3.0%	1.0%	**2.0%**
BONDS	**43.0%**	25.0% – 54.0%	37.0%	37.0%	37.0%	38.0%	**38.0%**
STOCKS	**55.0%**	36.0% – 65.0%	60.0%	60.0%	60.0%	61.0%	**60.0%**

Note: Effective September 1, 2014, we revised our strategic neutral positions within fixed income, lowering the 'neutral' commitment to cash from 5% to 2%, and moving the difference to bonds. This takes advantage of the positive slope of the yield curve which prevails over most time periods, and allows our fixed income managers to shorten duration and build cash reserves whenever a correction in the bond market, or especially an inverted yield curve, is anticipated.

REGIONAL ALLOCATION

GLOBAL BONDS	CWGBI* FEB. 2017	PAST RANGE	SPRING 2016	SUMMER 2016	FALL 2016	NEW YEAR 2017	SPRING 2017
North America	**39.2%**	18% – 44%	38.2%	37.0%	36.9%	38.1%	**44.2%**
Europe	**38.9%**	32% – 56%	39.9%	35.3%	34.4%	33.5%	**36.4%**
Asia	**22.0%**	17% – 35%	21.9%	27.7%	28.8%	28.4%	**19.5%**

Note: Past Range reflects historical allocation from Fall 2002 to present.

GLOBAL EQUITIES	MSCI** FEB. 2017	PAST RANGE	SPRING 2016	SUMMER 2016	FALL 2016	NEW YEAR 2017	SPRING 2017
North America	**61.8%**	51% – 61%	59.2%	60.2%	60.0%	60.3%	**60.8%**
Europe	**19.6%**	20% – 35%	22.2%	21.6%	20.5%	20.3%	**20.3%**
Asia	**11.3%**	9% – 18%	11.1%	10.8%	12.0%	11.9%	**11.4%**
Emerging Markets	**7.3%**	0% – 8.5%	7.5%	7.5%	7.5%	7.5%	**7.5%**

Our asset mix is reported as at the end of each quarter. The mix is fluid and may be adjusted within each quarter, although we do not always report on shifts as they occur. The weights in the table should be considered a snapshot of our asset mix at the date of release of the *Global Investment Outlook*.

GLOBAL EQUITY SECTOR ALLOCATION

	MSCI** FEB. 2017	RBC GAM ISC NEW YEAR 2017	RBC GAM ISC SPRING 2017	CHANGE FROM NEW YEAR 2017	WEIGHT VS. BENCHMARK
Energy	6.95%	5.85%	5.95%	0.10	85.6%
Materials	5.20%	4.52%	5.20%	0.68	100.0%
Industrials	11.21%	13.65%	13.21%	(0.44)	117.8%
Consumer Discretionary	12.31%	12.42%	14.31%	1.90	116.2%
Consumer Staples	9.69%	11.38%	9.69%	(1.69)	100.0%
Health Care	12.03%	10.32%	12.03%	1.71	100.0%
Financials	18.08%	17.82%	18.08%	0.27	100.0%
Information Technology	15.03%	17.05%	17.03%	(0.02)	113.3%
Telecom. Services	3.23%	1.31%	1.23%	(0.08)	38.1%
Utilities	3.09%	2.39%	1.09%	(1.29)	35.3%
Real Estate	3.16%	3.29%	2.16%	(1.13)	68.4%

*Citigroup World Global Bond Index **MSCI World Index

Source: RBC GAM Investment Strategy Committee

At RBC GAM, we have a team dedicated to setting and reviewing the strategic asset mix for all of our multi-asset solutions. With an emphasis on consistency of returns, risk management and capital preservation, we have developed a strategic asset allocation framework for five client risk profiles that correspond to broad investor objectives and risk preferences. These five profiles range from Very Conservative through Balanced to Aggressive Growth.

VERY CONSERVATIVE

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
Cash & Cash Equivalents	2%	0-15%	1.1%	2.0%
Fixed Income	78%	55-95%	73.7%	73.7%
Total Cash & Fixed Income	80%	65-95%	74.8%	75.7%
Canadian Equities	10%	5-20%	11.4%	11.2%
U.S. Equities	5%	0-10%	6.4%	6.8%
International Equities	5%	0-10%	7.4%	6.3%
Emerging Markets	0%	0%	0.0%	0.0%
Total Equities	20%	5-35%	25.2%	24.3%

	RETURN	VOLATILITY
40-Year Average	8.8%	5.5%
Last 12 Months	5.5%	2.9%

Very Conservative investors will seek income with maximum capital preservation and the potential for modest capital growth, and be comfortable with small fluctuations in the value of their investments. This portfolio will invest primarily in fixed-income securities, and a small amount of equities, to generate income while providing some protection against inflation. Investors who fit this profile generally plan to hold their investment for the short to medium term (minimum one to five years).

CONSERVATIVE

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
Cash & Cash Equivalents	2%	0-15%	1.1%	2.0%
Fixed Income	63%	40-80%	58.3%	58.3%
Total Cash & Fixed Income	65%	50-80%	59.4%	60.3%
Canadian Equities	15%	5-25%	16.5%	16.3%
U.S. Equities	10%	0-15%	11.6%	12.0%
International Equities	10%	0-15%	12.5%	11.4%
Emerging Markets	0%	0%	0.0%	0.0%
Total Equities	35%	20-50%	40.6%	39.7%

	RETURN	VOLATILITY
40-Year Average	9.1%	6.5%
Last 12 Months	8.2%	3.0%

Conservative investors will pursue modest income and capital growth with reasonable capital preservation, and be comfortable with moderate fluctuations in the value of their investments. The portfolio will invest primarily in fixed-income securities, with some equities, to achieve more consistent performance and provide a reasonable amount of safety. The profile is suitable for investors who plan to hold their investment over the medium to long term (minimum five to seven years).

BALANCED

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
Cash & Cash Equivalents	2%	0-15%	1.0%	2.0%
Fixed Income	43%	20-60%	38.0%	38.0%
Total Cash & Fixed Income	45%	30-60%	39.0%	40.0%
Canadian Equities	19%	10-30%	20.5%	20.2%
U.S. Equities	20%	10-30%	21.6%	21.9%
International Equities	12%	5-25%	14.3%	13.4%
Emerging Markets	4%	0-10%	4.6%	4.5%
Total Equities	55%	40-70%	61.0%	60.0%

	RETURN	VOLATILITY
40-Year Average	9.4%	7.7%
Last 12 Months	12.4%	3.7%

The **Balanced** portfolio is appropriate for investors seeking balance between long-term capital growth and capital preservation, with a secondary focus on modest income, and who are comfortable with moderate fluctuations in the value of their investments. More than half the portfolio will usually be invested in a diversified mix of Canadian, U.S. and global equities. This profile is suitable for investors who plan to hold their investment for the medium to long term (minimum five to seven years).

GROWTH

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
Cash & Cash Equivalents	2%	0-15%	1.0%	2.0%
Fixed Income	28%	5-40%	22.6%	22.6%
Total Cash & Fixed Income	30%	15-45%	23.6%	24.6%
Canadian Equities	23%	15-35%	24.6%	24.4%
U.S. Equities	25%	15-35%	26.7%	26.9%
International Equities	16%	10-30%	18.4%	17.5%
Emerging Markets	6%	0-12%	6.7%	6.6%
Total Equities	70%	55-85%	76.4%	75.4%

	RETURN	VOLATILITY
40-Year Average	9.6%	9.4%
Last 12 Months	15.4%	4.3%

Investors who fit the **Growth** profile will seek long-term growth over capital preservation and regular income, and be comfortable with considerable fluctuations in the value of their investments. This portfolio primarily holds a diversified mix of Canadian, U.S. and global equities and is suitable for investors who plan to invest for the long term (minimum seven to ten years).

AGGRESSIVE GROWTH

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
Cash & Cash Equivalents	2%	0-15%	1.0%	1.0%
Fixed Income	0%	0-10%	0.0%	0.0%
Total Cash & Fixed Income	2%	0-20%	1.0%	1.0%
Canadian Equities	32.5%	20-45%	32.2%	32.3%
U.S. Equities	35.0%	20-50%	34.9%	35.9%
International Equities	21.5%	10-35%	22.6%	21.5%
Emerging Markets	9.0%	0-15%	9.3%	9.3%
Total Equities	98%	80-100%	99.0%	99.0%

	RETURN	VOLATILITY
40-Year Average	10.2%	12.1%
Last 12 Months	21.3%	5.5%

Aggressive Growth investors seek maximum long-term growth over capital preservation and regular income, and are comfortable with significant fluctuations in the value of their investments. The portfolio is almost entirely invested in stocks and emphasizes exposure to global equities. This investment profile is suitable only for investors with a high risk tolerance and who plan to hold their investments for the long term (minimum seven to ten years).

CAPITAL MARKETS PERFORMANCE

Milos Vukovic, MBA, CFA
V.P. & Head of Investment Policy
RBC Global Asset Management Inc.

The U.S. dollar rose against the British pound and was flat versus the euro in the three months ended February 28, 2017, while falling against the yen and the Canadian dollar. The currency movements were relatively small, as the greenback increased 0.8% against sterling while declining 1.8% against the yen and 1.1% versus the loonie. For the latest 12-month period, the U.S. dollar climbed 12.2% versus sterling, extending its revaluation versus the British currency since the U.K.'s decision in June 2016 to leave the EU, and 2.7% against the euro. However, the U.S. dollar lost ground versus the Canadian dollar, falling 1.8%, and dropped 0.4% against the yen.

Global bond markets recorded modest gains during the latest three-month period as they reversed some of the losses recorded following the election of President Donald Trump. The Barclays Capital Aggregate Bond Index, a broad measure of U.S. fixed-income performance, gained 1.0%, while European bonds returned 0.4% in U.S. dollar terms as measured by the Citigroup WGBI – Europe Index. The Citigroup Japanese Government Bond Index gained 0.7%, and the FTSE TMX Canada Universe Bond Index, Canada's fixed-income benchmark, returned 1.5%.

Global equity markets recorded gains during the three-month period as the rally spurred by Trump's election kept its momentum. The S&P 500 Index rose 8.0% and the MSCI Japan gained 5.9%. The MSCI Germany climbed 11.0%, while the MSCI U.K. returned 7.6% and the MSCI France gained 6.5%. Over the 12-month period, the S&P 500 gained 25.0% and the MSCI Japan rose 20.3%. In Europe, the MSCI Germany returned 20.2%, the MSCI France gained 12.2% and the MSCI U.K. returned 10.8%, all in U.S. dollar terms. The S&P/TSX Composite Index rose 3.9% in U.S. dollar terms during the three months, compared with a 4.0% gain for the large-cap S&P/TSX 60 Index and a 5.5% return for the S&P/TSX Small Cap Index. For the 12-month period, the S&P/TSX benchmark index gained 25.5%. The MSCI Emerging Markets Index returned 8.9% during the three-month period and gained 29.5% over the 12-month period. Appreciation in emerging-market currencies was largely responsible for the gains.

The S&P 400 Index, a measure of the U.S. mid-cap market, rose 6.6% in the latest three-month period and 31.7% in the 12-month period, while the S&P 600 Index, a gauge of small-cap performance, rose 4.6% and 35.0%, respectively. The Russell 3000 Growth Index gained 8.7% during the quarter versus a 6.8% rise for the Russell 3000 Value Index. Over the 12 months, the Russell 3000 Value Index gained 30.0%, while the Russell 3000 Growth Index returned 22.8%.

All but one of the 11 global equity sectors recorded gains during the quarter ended February 28, 2017. The best-performing sector was Information Technology with a return of 11.0%, followed by Health Care, which rose 9.8% and Utilities with a 9.4% increase. The worst-performing sector over the three-month period was Energy, which fell 1.6%. Over the 12-month period, the best-performing sectors were Materials, Financials and Information Technology, and the worst-performing were defensive sectors such as Telecommunication Services, Consumer Staples and Utilities.

EXCHANGE RATES
Periods ending February 28, 2017

	Current USD	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
USD–CAD	1.3282	(1.12)	(1.08)	(1.83)	6.26	6.05
USD–EUR	0.9439	0.04	(0.64)	2.69	9.22	4.69
USD–GBP	0.8059	0.83	(0.68)	12.17	10.51	5.10
USD–JPY	112.3450	(1.80)	(3.88)	(0.36)	3.34	6.69

Note: all changes above are expressed in US dollar terms

CANADA
Periods ending February 28, 2017

	USD					CAD		
Fixed Income Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
FTSE TMX Canada Univ. Bond Index TR	1.47	1.93	3.80	(2.23)	(2.53)	0.33	1.89	3.89

U.S.
Periods ending February 28, 2017

	USD					CAD		
Fixed Income Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
Citigroup U.S. Government TR	1.02	0.89	1.49	2.63	2.23	(0.12)	(0.37)	9.06
Barclays Capital Agg. Bond Index TR	1.01	0.87	1.42	2.64	2.24	(0.12)	(0.44)	9.07

GLOBAL
Periods ending February 28, 2017

	USD					CAD		
Fixed Income Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
Citigroup WGBI TR	0.89	1.22	0.13	(0.60)	0.23	(0.25)	(1.71)	5.62
Citigroup European Government TR	0.44	0.24	(3.10)	(3.89)	0.29			
Citigroup Japanese Government TR	0.74	3.67	0.11	(0.58)	(3.81)			

CANADA
Periods ending February 28, 2017

	USD					CAD		
Equity Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
S&P/TSX Composite	3.91	2.16	25.54	(0.45)	1.08	2.74	23.24	5.78
S&P/TSX 60	3.98	2.26	26.05	0.55	1.84	2.81	23.74	6.85
S&P/TSX Small Cap	5.54	1.56	40.26	(3.03)	(3.68)	4.36	37.69	3.04

U.S.
Periods ending February 28, 2017

	USD					CAD		
Equity Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
S&P 500 TR	8.04	5.94	24.98	10.63	14.01	6.82	22.68	17.56
S&P 400 TR	6.63	4.34	31.73	9.64	13.83	5.43	29.31	16.50
S&P 600 TR	4.60	1.19	34.97	9.75	14.93	3.42	32.49	16.62
Russell 3000 Value TR	6.77	4.04	30.02	9.77	13.97	5.57	27.64	16.64
Russell 3000 Growth TR	8.73	7.39	22.77	10.06	13.67	7.51	20.52	16.95
NASDAQ Composite Index TR	9.43	8.22	27.81	10.58	14.45	8.20	25.47	17.50

Note: all rates of return presented for periods longer than 1 year are annualized

Source: Bloomberg/MSCI

GLOBAL
Periods ending February 28, 2017

	USD					CAD		
Equity Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
MSCI World TR *	7.77	5.25	21.26	5.20	9.41	6.16	18.56	11.68
MSCI EAFE TR *	7.94	4.37	15.75	(0.62)	5.16	6.32	13.18	5.50
MSCI Europe TR *	8.71	3.30	12.15	(3.13)	4.68	7.08	9.65	2.84
MSCI Pacific TR *	6.72	6.23	23.17	4.40	6.10	5.12	20.43	10.84
MSCI UK TR *	7.59	3.32	10.80	(4.12)	2.88	5.98	8.33	1.79
MSCI France TR *	6.52	0.96	12.15	(2.59)	5.26	4.92	9.66	3.41
MSCI Germany TR *	11.02	3.78	20.18	(2.58)	6.12	9.36	17.50	3.42
MSCI Japan TR *	5.90	4.88	20.29	5.70	7.19	4.31	17.62	12.21
MSCI Emerging Markets TR *	8.94	8.70	29.46	1.35	(0.37)	7.31	26.58	7.60

GLOBAL EQUITY SECTORS
Periods ending February 28, 2017

	USD					CAD		
Sector: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)	3 months (%)	1 year (%)	3 years (%)
Energy TR *	(1.61)	(5.07)	24.28	(6.30)	(1.85)	(3.09)	21.51	(0.52)
Materials TR *	7.63	6.02	35.91	0.54	1.05	6.02	32.88	6.74
Industrials TR *	6.47	5.53	23.72	5.57	9.97	4.87	20.97	12.07
Consumer Discretionary TR *	6.14	4.75	16.21	5.80	12.43	4.55	13.62	12.32
Consumer Staples TR *	9.26	6.10	8.80	7.41	10.30	7.62	6.38	14.03
Health Care TR *	9.79	8.10	10.73	5.61	14.24	8.15	8.26	12.11
Financials TR *	8.84	4.70	35.34	5.67	10.88	7.21	32.33	12.18
Information Technology TR *	11.00	9.47	31.35	13.32	13.55	9.34	28.43	20.30
Telecommunication Services TR *	6.51	0.53	4.66	2.84	8.18	4.92	2.33	9.17
Utilities TR *	9.35	4.75	9.84	4.17	6.31	7.71	7.40	10.59
Real Estate TR *	7.00	4.71	NA	NA	NA	5.40	NA	NA

* Net of taxes   Note: all rates of return presented for periods longer than 1 year are annualized   Source: Bloomberg/MSCI

GLOBAL INVESTMENT OUTLOOK

Broad strength continues

Eric Lascelles
Chief Economist
RBC Global Asset Management Inc.

Eric Savoie, MBA, CFA
Senior Analyst, Investment Strategy
RBC Global Asset Management Inc.

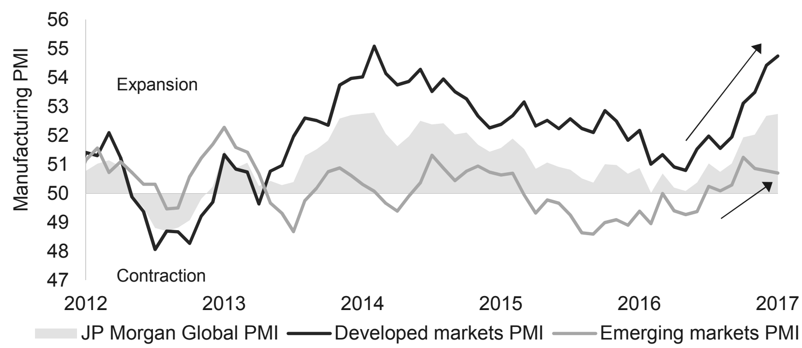
Daniel E. Chornous, CFA
Chief Investment Officer
RBC Global Asset Management Inc.

The positive macroeconomic signals that emerged in the second half of 2016 have continued to bloom in early 2017. Global leading economic indicators remain at their best levels in several years (Exhibit 1). Economic surprises have also been overwhelmingly positive and corporate earnings continue to recover from their prior stumbles (Exhibit 2). Accordingly, risk assets such as equities have performed well, enjoying remarkably little volatility in their upward trajectory.

The ascent of populist politics remains a highly contentious market consideration. In the short run, the U.S. election result has spurred a wave of optimism based on expectations of tax cuts and deregulation. It is possible that this optimism could produce a positive regime shift, enabling persistently faster growth even once the initial stimulus has expired. However, no less plausible is a darker scenario in which potent protectionist policies trip up economic growth.

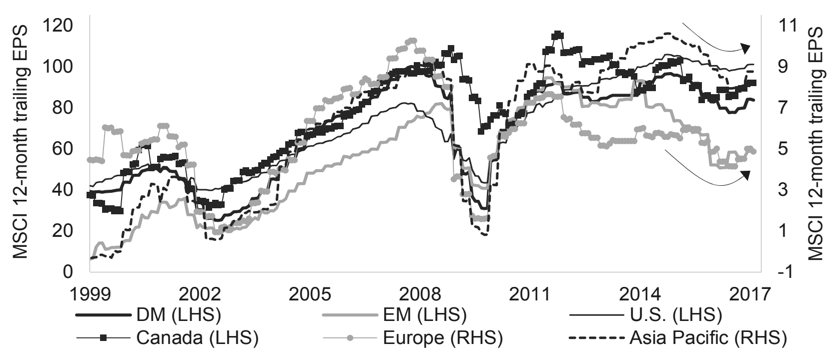
The fusion of positive momentum, strong macroeconomic signals and superior relative equity valuations leave us content to maintain a moderately overweight equity position. However, we have slightly reduced our exposure to stocks and allocated the proceeds to cash due to the uncertainty surrounding U.S. public policy, the fact that valuations are somewhat less supportive especially in the U.S. and a variety of technical factors. This adjustment furnishes ammunition should future market opportunities arise.

Exhibit 1: Global manufacturing cranking up



Note: PMI refers to Purchasing Managers Index for manufacturing sector, a measure for economic activity. Source: Haver Analytics, RBC GAM

Exhibit 2: Global corporate earnings rising



Note: Earnings per share (EPS) in U.S. dollars for developed markets (DM), emerging markets (EM), U.S. and Asia Pacific; euros for Europe; Canadian dollars for Canada. Source: MSCI, Bloomberg, RBC GAM

Parsing U.S. political change

The biggest question hanging over global investors today relates to what the Trump administration will do over the coming four years. So far, optimists would appear to outnumber pessimists: equities have soared, the U.S. dollar has risen, bond yields have gone up and credit spreads have narrowed (Exhibit 3).

It is very important to recognize that this bout of market enthusiasm began well in advance of the election, but the political outcome evidently provided a further springboard.

We continue to anticipate a blend of good and bad economic policies (Exhibit 4). The largest positive is the promise of extra fiscal stimulus, especially business-tax cuts that stand to disproportionately boost corporate earnings. The expectation of diminished red tape and the reality of higher business and consumer confidence are also material positives. The largest looming negative is the threat of new trade barriers. Other negatives include tighter immigration policy, higher interest rates and a stronger dollar.

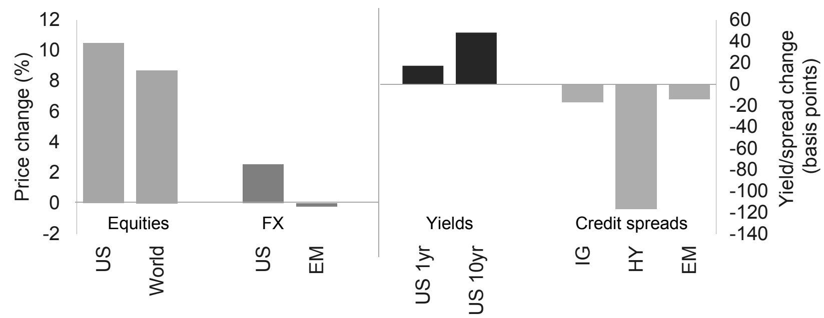
An early take on the Trump administration since the inauguration reveals a number of themes. The first is that there has been very little moderation of the views he espoused on the campaign trail, in contrast to the historical experience with other presidents. Thus, we are increasingly inclined to more fully price his various pledges into our economic and market outlooks.

Second, Trump's initial directives have been more focused on immigration than expected. Stricter border controls were always known to be part of his platform, including a much-discussed wall along the Mexican border. However, the number of proposals intended to shrink the pool of illegal immigrants is truly remarkable: 5,000 more border-control agents; 10,000 additional immigration officials; 100,000 members of the National Guard repurposed; the withholding of federal funds from "sanctuary cities" that shield illegal immigrants; and rule changes smoothing the deportation of longstanding illegal aliens rather than just recent arrivals.

The stakes are high. Eleven million people, or more than 3% of the U.S. population, are estimated to be illegal aliens. At a time when the unemployment rate is low, the loss of several million workers would impose a significant economic cost.

Third, the rise in confidence since the U.S. election (Exhibit 5) has been much more profound than expected. To the extent that this euphoria

Exhibit 3: Markets have high hopes for Trump policies



Note: Percentage change of S&P 500, MSCI World Index, trade-weighted exchange value of U.S. dollar and emerging market currencies since 11/8/2016. Basis point change of U.S. 1-year and 10-year yields; investment-grade, high-yield and EM credit spreads since 11/8/2016. Source: J.P. Morgan, Bloomberg, Haver Analytics, RBC GAM

Exhibit 4: Theoretical Trump economic effects

Effect	Drivers	Net effect
Positive	• Fiscal stimulus Tax cuts (+ + +) Infrastructure spending (+) Military spending (+) • Fewer regulations (++) • Higher confidence (++) • Dislodge special interests (+?)	• More economic growth in the short run
Negative	• Trade impediments (– – –) • Tighter immigration policy (– –) • Higher rates and dollar (– –) • Populism bad for growth (–) • High policy uncertainty (–?)	• Less economic growth in the long run • Net effect of short term and long term considerations is negative

Source: RBC GAM

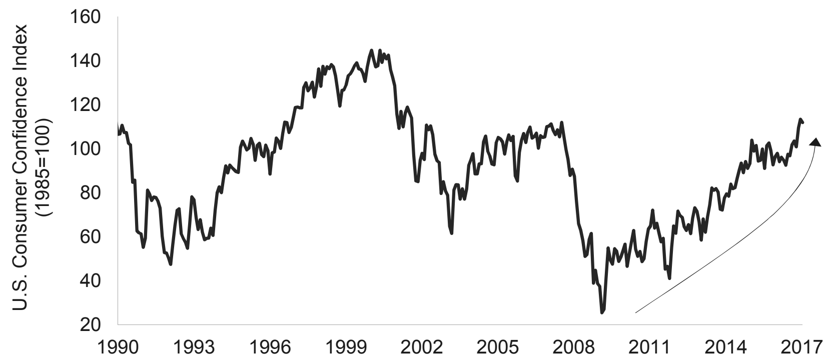
results in additional economic activity, it could create a virtuous circle that helps to lift economic growth out of the doldrums. We caution, however, that the prospect of reviving seemingly moribund business investment isn't quite as large an opportunity as it first seems once inflation distortions are eliminated (Exhibit 6).

Fourth, deregulation could help economic growth more than conventionally imagined. Although U.S. businesses already enjoy a laissez-faire economic environment by conventional metrics, there is no denying that proposed deregulation in the banking and energy industries would boost short-term profits for the affected parties, and a survey of small U.S. businesses shows that many feel their regulatory burden has increased significantly over the past decade (Exhibit 7). There is an opportunity to address that over the coming years.

Factoring these new considerations into the overall policy landscape guides us to a scenario of faster U.S. economic growth in 2017 and 2018, followed by slower growth thereafter. The GDP negatives eventually dominate the positives (Exhibit 8). A silver lining is that the aggregate effect of the policies should still be a net positive from a stock-market perspective given the outsized importance of corporate-tax cuts to that constituent.

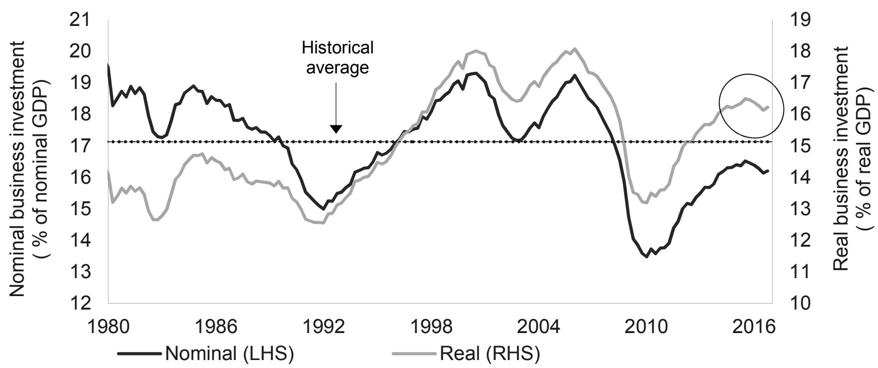
But there are two items missing from this discussion. One is a proper review of the forthcoming changes

Exhibit 5: Consumer confidence returns to pre-crisis levels



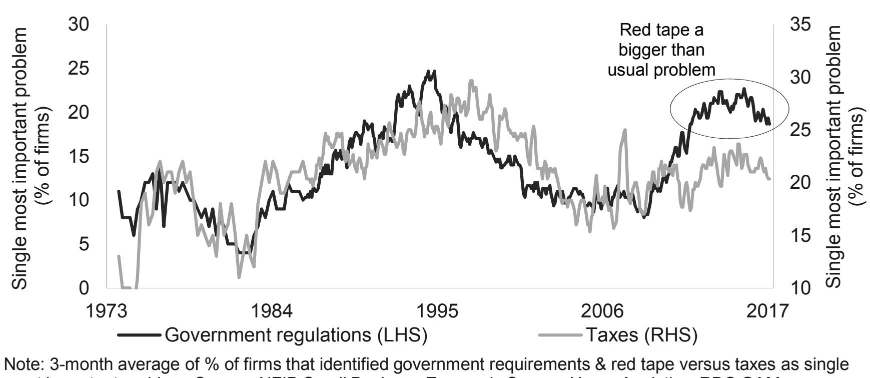
Source: The Conference Board, RBC GAM

Exhibit 6: Real U.S. business investment actually not low



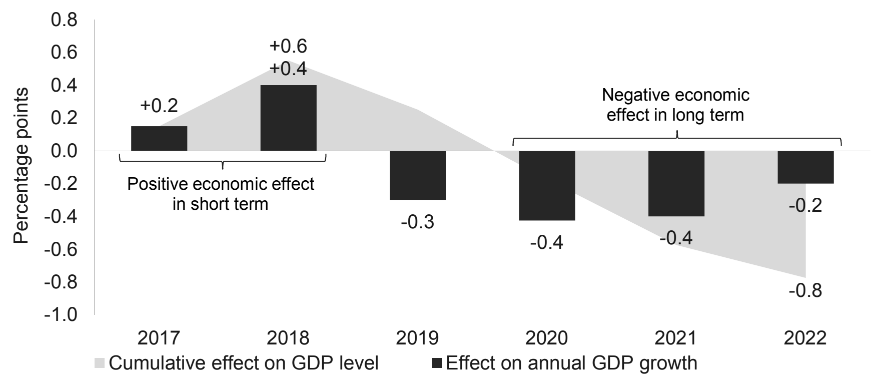
Note: Use of different scales to align historical averages. Source: BEA, Haver Analytics, RBC GAM

Exhibit 7: Government regulations squeeze U.S. small businesses



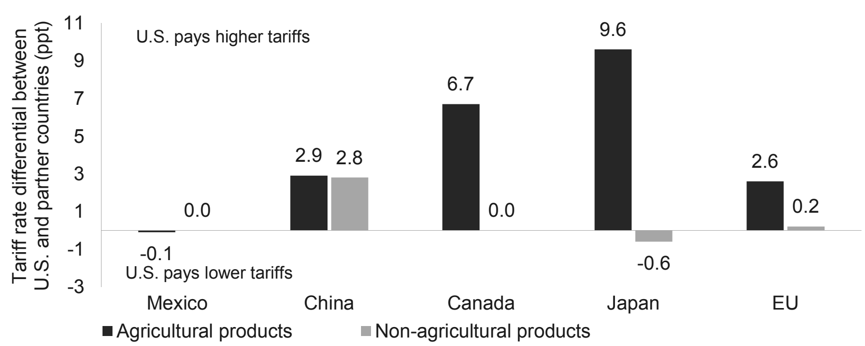
Note: 3-month average of % of firms that identified government requirements & red tape versus taxes as single most important problem. Source: NFIB Small Business Economic Survey, Haver Analytics, RBC GAM in U.S. trade policy. We cover that in the next section. The second is a confession: there is still enormous uncertainty around precisely how U.S. public policy will play out in the coming years. We have proffered our best guesses, but it is entirely conceivable that the net effect ends up being considerably better or worse.

Exhibit 8: Effect of Trump policies on U.S. GDP



Source: RBC GAM assumptions and calculations

Exhibit 9: U.S. gets bad tariff deal versus partners



Note: Difference between tariff rates U.S. pays on its exports to partner countries and rates partner countries pay on exports to U.S. Source: WTO/ITC/UNCTAD World Tariff Profiles 2016, RBC GAM

Understanding protectionism

The Trump administration is seeking to reclaim some portion of the country's lost manufacturing clout by imposing trade restrictions on foreign producers. Many questions remain about how this will play out.

First, will protectionist policies truly be implemented? After all, President Trump has occasionally talked about using the threat of tariffs as a bargaining tool rather than as actual policy, and ripe opportunities include demanding that Mexico and China reduce their export subsidies and import tariffs, which presently disadvantage U.S. firms (Exhibit 9). Nevertheless, we believe protectionist policies of some incarnation are the most likely scenario (with an 85% probability) given Trump's repeated referral to a coming "border tax."

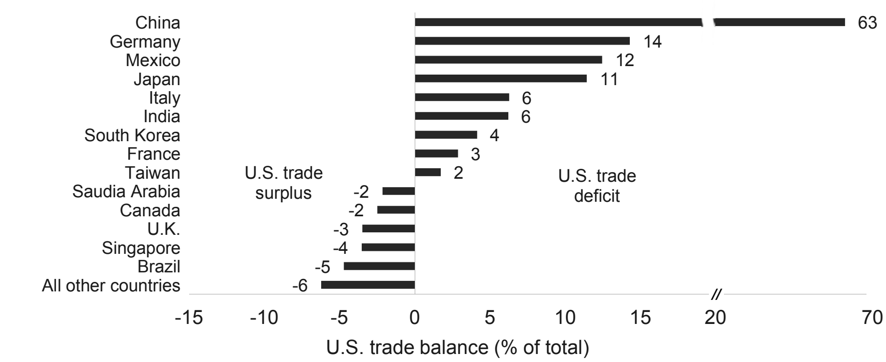
Second, when will such policies be pursued? While temporary anti-dumping measures could be implemented fairly quickly if levied at specific sectors in certain countries, more significant changes will take at least a few quarters and up to a few years to implement. As a result, we don't budget for any protectionist drag in 2017, instead assuming that it begins in 2018 and builds from there.

Third, what kind of protectionism will be pursued? The main buckets to choose among are some variation of a tariff (40% chance), a border-adjustment tax (30% chance) and non-tariff trade barriers (15% chance). These measures, in turn, could be applied to all countries, be focused on individual nations and/or be targeted at the sector level. The much-discussed border-adjustment tax bears superficial resemblance to a sales tax, but ultimately has qualities that make it akin to a tariff.

Fourth, how powerful would any protectionist measures be? This is another question with a wide range of plausible answers. Aggressive policy proposals including large tariffs of 45% on China and 35% on Mexico have been bandied about, but it is worth noting that if these represented the full extent of U.S. actions, the overall tariff level would “only” rise by 11 percentage points. A more likely option is a lower tariff rate applied broadly across countries. The border-adjustment tax option – effectively a 20% tax on imports – isn’t quite as trade-limiting as it first sounds since a rallying greenback would soften the blow, but it would still be significant. Given the alternative possibilities of non-tariff barriers or even no new trade impediments at all, our base-case forecast splits the difference by assuming the application of a 4% tariff universally.

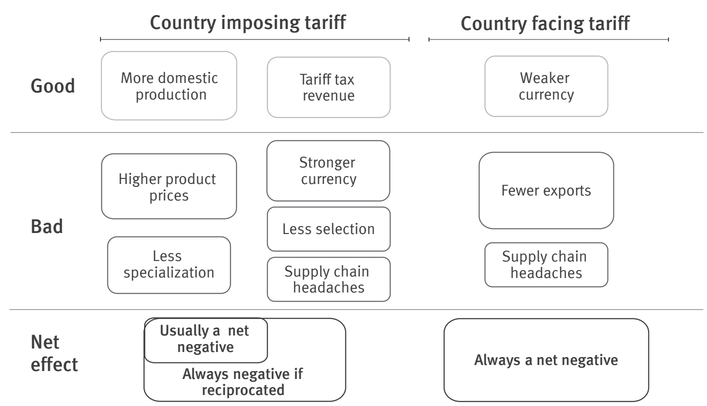
Fifth, who will the U.S. target with its protectionism? A simplistic argument would be those countries that trade most with the U.S. – with Mexico, Canada and China topping the list. However, this doesn’t capture the nuance of how the new U.S. administration thinks about trade. It isn’t so much that it rejects international trade as it takes a highly mercantilist stance, objecting to the countries that are most responsible for the large U.S. trade deficit. Through this lens, China should receive the overwhelming attention of trade negotiators given its responsibility for two-thirds of the U.S. trade deficit all by itself (Exhibit 10). Other notable culprits include Germany, Mexico and Japan. This squares well with recent U.S. trade rhetoric, and would leave Canada largely off the hook given a roughly balanced trading relationship with its large neighbour.

Exhibit 10: U.S. trade deficit with China tops the list



Note: Cumulative 12-month trade balance to Q3 2016. Source: Census Bureau, Haver Analytics, RBC GAM

Exhibit 11: Theoretical tariff considerations



Source: RBC GAM

Sixth, will affected countries retaliate against U.S. protectionism? It is possible they won’t respond for quite some time given the many steps necessary for a complaint to be made to the World Trade Organization, and for that organization to then judge that U.S. actions are illegal. However, we put our money on some sort of strategic retaliation that might lack the scope of U.S. protectionism but would be designed to maximize U.S. annoyance.

Finally, what sort of economic damage will this protectionism inflict? There is little dispute among economists that protectionism is an economic negative for all parties (Exhibit 11). There may be a few initial “wins” for the country imposing a tariff – mainly the promise of more domestic production and extra government tax revenue – but the reality is that the negatives accumulate quickly thereafter. For walled-off countries, the cost of imported products rise, the country's currency appreciates to the detriment of its competitiveness, productivity ebbs as the ability to specialize declines, supply-chain disruptions abound and the selection of products available for sale worsens. And that's all before other countries reciprocate with tariffs of their own, compounding the damage.

To provide a sense for the effect on GDP, an aggressive blanket tariff of 10% or a border-adjustment tax of 20% would both incrementally subtract somewhere between 1% and 2% from the level of U.S. economic output over time. Our own forecasting assumes a smaller tariff and thus a lesser hit of 0.7% to GDP.

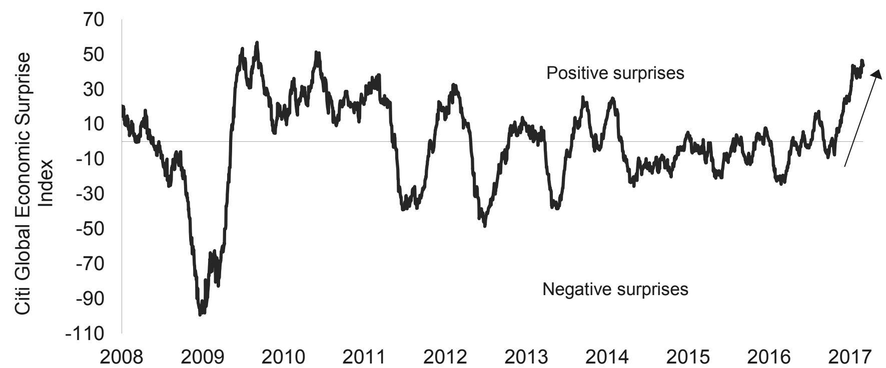
Weighing economic drivers

Global economic signals remain quite strong by post-crisis standards. A particularly impressive reading comes from the global economic surprise index, which shows that macroeconomic data has exceeded analysts' expectations by the largest margin in many years (Exhibit 12). Accordingly, consensus economic forecasts have started to ratchet higher (Exhibit 13).

The breadth of this economic uptick is considerable. Both developed and emerging-market leading indicators have improved, and most countries have managed some improvement in recent months.

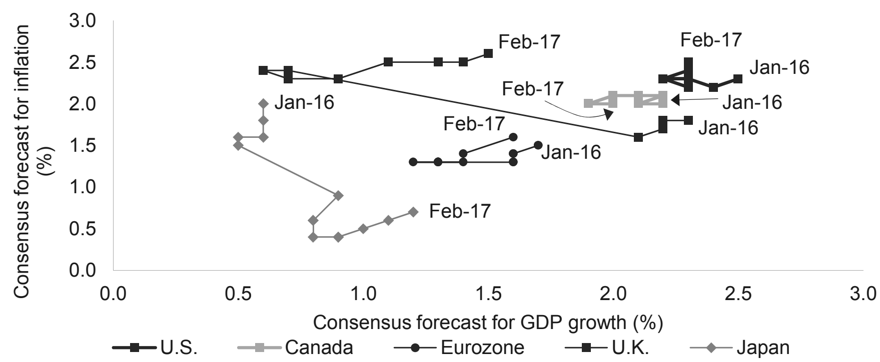
Why has growth improved? We dwell on two concrete explanations

Exhibit 12: Global economies doing better than expected



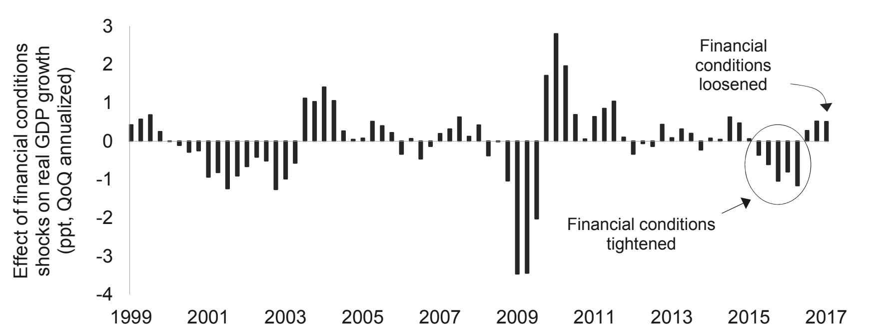
Source: Citigroup, Bloomberg, RBC GAM

Exhibit 13: Evolution of GDP and inflation forecast for 2017: developed markets



Source: Consensus Economics, RBC GAM

Exhibit 14: A recipe for economic growth: loose financial conditions



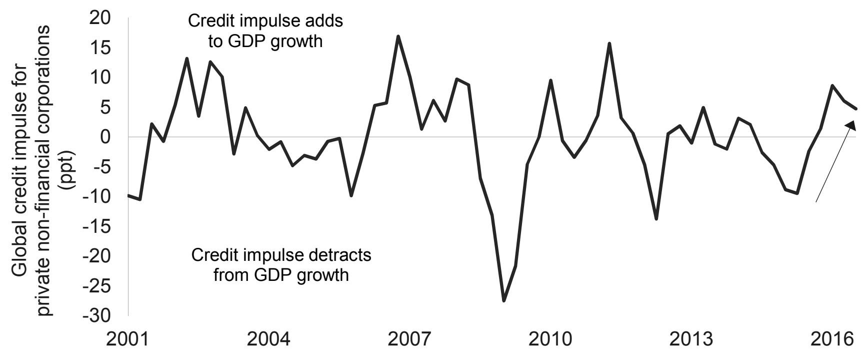
Note: 4-quarter cumulative effect of a quarter-over-quarter 100 bps change in Goldman Sachs U.S. Financial Condition Index on U.S. real GDP growth estimated using a bivariate VAR model. Source: Goldman Sachs, Bloomberg, RBC GAM and two speculative ones. The first concrete factor is that a previous bout of economic weakness in early 2016 was snuffed out as financial conditions improved (Exhibit 14). Relatedly, the global credit impulse is also now slightly positive (Exhibit 15). The unwinding of earlier weakness let economic growth revive to a normal pace.

The second concrete explanation is that optimism following the U.S. election has helped to supercharge growth. Whether the optimism is appropriate or misplaced is not the issue. For now, the optimism is undeniable, and this is encouraging more economic activity.

There are also speculative factors to consider. The first is that the U.S. acceleration may in part be artificial due to seasonal distortions. There has been a curious pattern in which U.S. growth is disproportionately inclined to accelerate over the second half of a calendar year, and then decelerate over the first half of the next year. There is thus the risk of a seasonal deceleration this year, though we can detect no evidence of this so far.

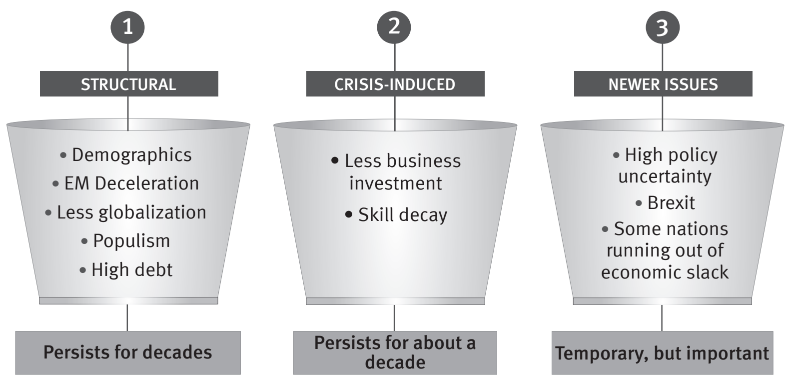
A second speculative factor is that the world could be starting to escape from secular stagnation – the malaise of inadequate demand that has plagued the post-crisis era. This is plausible from a chronological perspective in that past post-crisis malaises have tended to endure for no more than a decade. It is all the more conceivable given the recent jolt of confidence, which could elevate economic expectations to a sufficiently high plane that faster growth becomes self-sustaining.

Exhibit 15: Global credit impulse positive again...



Note: Credit impulse measured as year-over-year change in year-over-year percent change in credit outstanding. Source: IIF, RBC GAM

Exhibit 16: ... but there are many reasons for trend growth to be sluggish



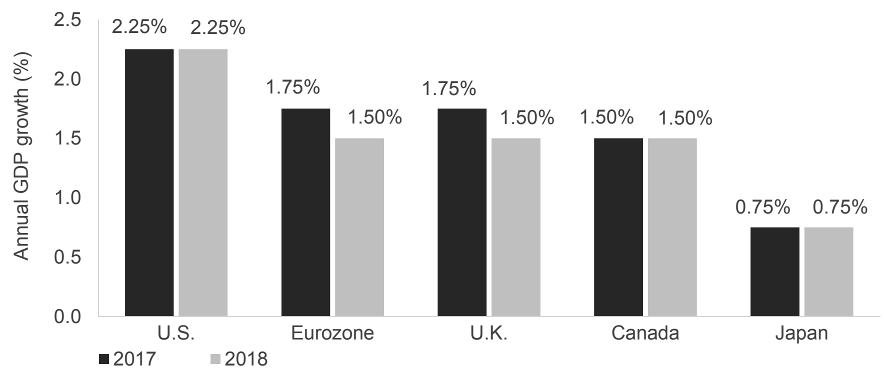
Source: RBC GAM

Weighing the available evidence, we choose to celebrate this period of faster growth and entertain the possibility that it could mark an upward regime shift. However, barring further evidence, we assume that the current episode represents a fluctuation toward the high end of the post-crisis growth range, rather than a permanent escape. Weighing on our mind is the plethora of factors that still constrain economic growth going forward (Exhibit 16).

We have moderately upgraded our 2017 growth forecasts this quarter but assume that some portion of the recent vigour will be shed into the second half of the year and into 2018 (Exhibit 17). Reasons for this assumption of subsequent tempering include:

- The fundamentally low speed limit on economic growth
- Higher borrowing costs that could exert a mild drag
- A Chinese economy that may slow somewhat given recent fiscal and monetary policy tightening
- The likelihood that the U.S. Federal Reserve (Fed) will tighten rates in response to additional fiscal stimulus
- The expectation that protectionism will start to weigh in 2018 and beyond.

Exhibit 17: RBC GAM GDP forecast for developed markets



Source: RBC GAM

Risks to our view

The best-laid plans often go awry. While the aforementioned factors and forecasts represent our best efforts on the subject, there is always the very real prospect that the world unfolds differently. Although the market currently ascribes a remarkably low level of uncertainty to the future, we think the risks are somewhat higher, making it important to consider alternative scenarios.

Exhibit 18: Downside risks: a constant evolution

Source: RBC GAM

For the bulk of the post-crisis experience, downside risks have easily dominated those to the upside. There are arguably still more of the former than the latter, but before venturing into the negatives it bears mentioning that there are some notable positive scenarios as well. One is that the economically "good" Trump policies are delivered with gusto while "bad" ones are avoided – a conceivable outcome given that the administration is dominated by business people inclined to maximize economic growth. Second, there is at least a sliver of a chance that the curse of secular stagnation is starting to ease, unlocking a more normal rate of economic growth.

Of course, there are still plenty of ever-evolving downside risks (Exhibit 18). We tend to focus on three big ones: the spectre of protectionism in an increasingly populist world, imminent European elections and an aging business cycle. We have already covered protectionism and other aspects of the populist platform in detail, and will get to European elections later in the document. That leaves the aging business cycle.

Let us be clear: we are not forecasting that the current economic expansion is imminently coming to an end (Exhibit 19). To the contrary, most classic recession measures signal a very low risk, including the fact that the yield curve is steepening (Exhibit 20). The risk is instead related to several other things. Chronologically, the economic expansion has now been in place for eight years, making it older than the average cycle. Although one cannot set one's watch to recessions, they do become somewhat more likely over time. A second factor is that there are a few signs that the credit cycle – a common dance partner for the business cycle – is itself aging. A third consideration is that the high level of U.S. policy uncertainty creates a world in which growth could be very good, but might be very bad. The latter, of course, means a higher recession risk.

There is also a spectrum of lesser downside risks that merit a moment's consideration. Higher interest rates are a risk given the extent to which borrowing costs have increased, with potential economic consequences. Debt hot spots are also significant given the high levels of leverage in certain markets, compounded by the increase in rates. Chinese risks have dimmed as the economy has stabilized and the credit market has proven resilient, but the country's economy could slip again and its debt levels remain precarious. Finally, international relations are a key economic and market risk at a time when relationships among the three military superpowers – the U.S., China and Russia – are in a state of flux.

Exhibit 19: Recession risk via non-traditional means

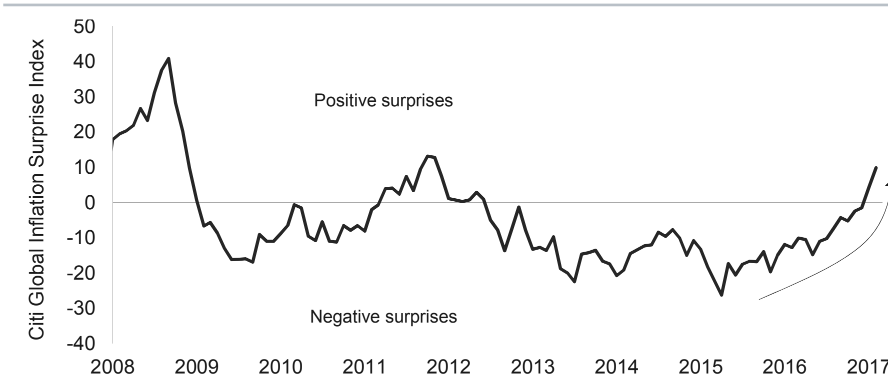
Traditional indicators	Other considerations	Variables to watch
• Most recession models blink green • Growth picking up • Financial conditions better • Yield curve steeper	• Expansion is old • Credit cycle aging • Trump uncertainty creates fat tails	• Degree of U.S. protectionism • Slope of yield curve • Financial conditions • U.S. unemployment rate • China shock

Source: RBC GAM

Exhibit 20: U.S. yield spreads have widened recently

Source: Federal Reserve Board, Reuters, Haver Analytics, RBC GAM

Exhibit 21: Global inflation surprises on the upside



Source: Citigroup, Bloomberg, RBC GAM

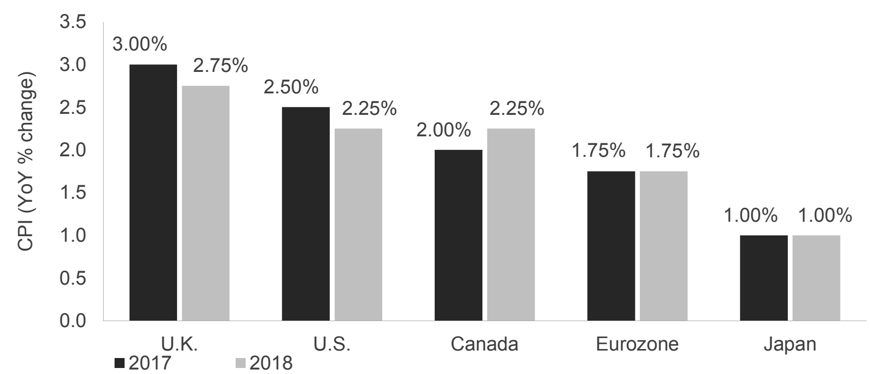
Inflation upward

We continue to bang the drum in anticipation of somewhat higher inflation. There is now clear evidence that the trend is well afoot (Exhibit 21). Our inflation forecasts tend to be above the consensus, with some countries set to drift above their target levels (Exhibit 22).

There are several reasons for this strengthening inflation (Exhibit 23). The most powerful reason in the short run is that the negative commodity shock has ended, removing a profound deflationary pressure. For that matter, commodity prices have staged a partial recovery. The most important factor over the long run is that developed-world economies continue to tighten (Exhibit 24). This results in larger wage gains and higher price increases – both inflationary. Third, populism is known to be inflationary, most obviously via protectionist trade policies and immigration restrictions. Fourth, we anticipate a stronger U.S. dollar, implying declining currencies and thus additional inflationary pressures for most countries other than the U.S. Fifth, China has long been an exporter of deflation to the world. It seems less capable of sustaining this function in the future as globalization slows and the country's own inflation perks up (Exhibit 25).

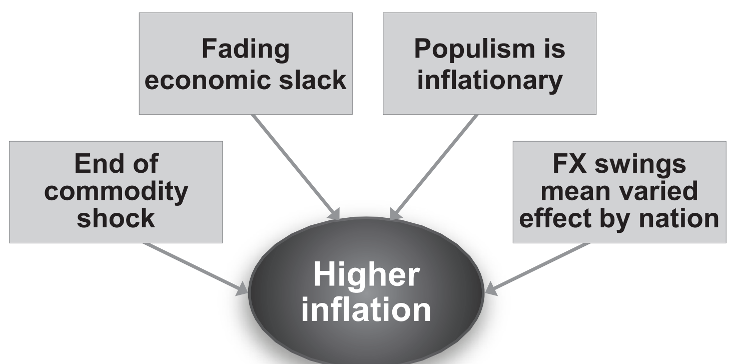
The combination of these factors should not translate into especially problematic inflation. But it does signal that low-inflation worries are

Exhibit 22: RBC GAM CPI forecast for developed markets



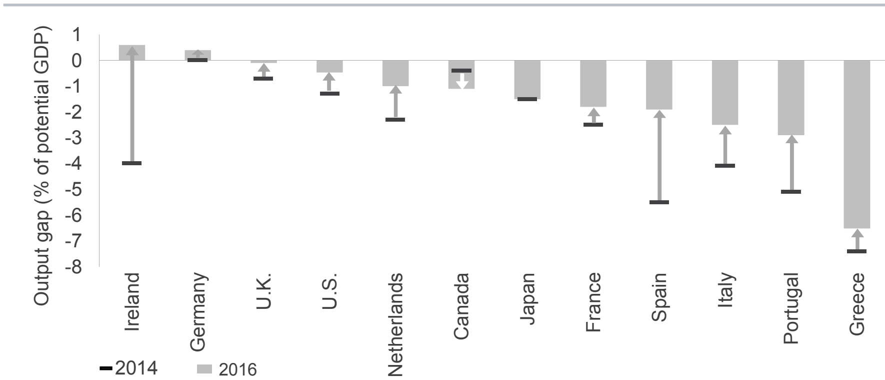
Source: RBC GAM

Exhibit 23: Deflation fears gone: Inflation pointing higher



Source: RBC GAM

Exhibit 24: Economic slack has shrunk in a number of countries



Source: IMF, Haver Analytics, RBC GAM

ending. Useful perspective is also gained by contemplating upside and downside growth scenarios. If economic growth is better than expected, inflation should logically rise even more quickly. Counterintuitively, the same could also be true of the downside risk. The biggest threat to economic growth is U.S. protectionism, which happens to be inflationary.

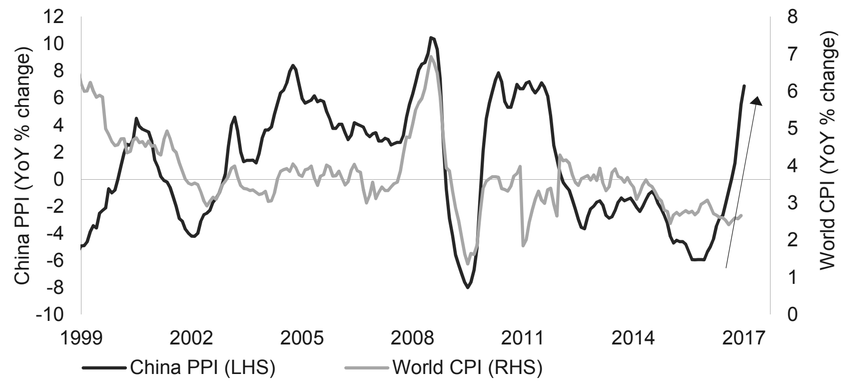
A subtle policy shift

A popular topic of discussion in financial markets has been an expected shift from monetary stimulus to fiscal stimulus. However, we find that this is overstated. A gradual decline in monetary stimulus is likely playing out. However, in our view there is less new fiscal stimulus coming than popularly imagined.

On the monetary side of the policy ledger, it is reasonably likely that the world is now edging past peak monetary stimulus. The Fed has been gradually tightening policy for more than a year, with an accelerated pace seemingly on track for 2017. The Fed's distended balance sheet could start to shrink as soon as next year.

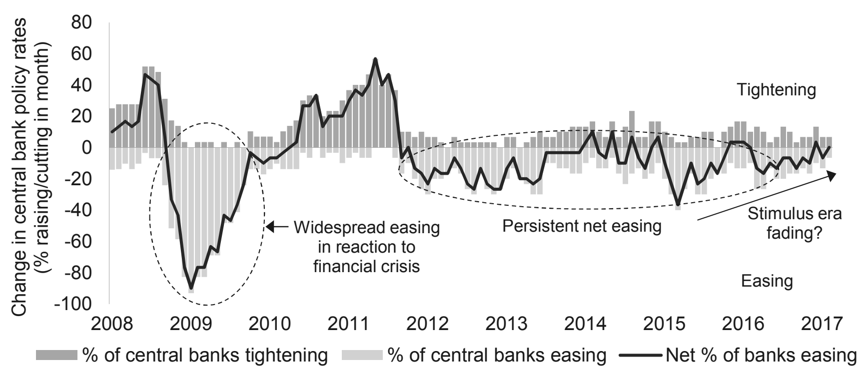
The evidence for peak monetary stimulus elsewhere is more subtle (Exhibit 26). The European Central Bank (ECB) is already starting to taper, with a further retreat expected in 2018. The Bank of England (BOE) appears set to allow its asset-purchase program to expire on schedule. Elsewhere, rising inflation and shrinking economic slack are prompting central banks to start backing away from their most extreme policy positions. For that matter, regardless of central-bank actions, the effective cost of borrowing has increased significantly.

Exhibit 25: Price pressures building in China



Source: CNBS, IMF, Haver Analytics, RBC GAM

Exhibit 26: Shifting monetary policy



Note: Based on policy rates for 30 countries. Source: Haver Analytics, RBC GAM

On the fiscal front, the recent U.S. policy pivot provides clear proof that fiscal stimulus is indeed on the rise in some jurisdictions. Canada has also scheduled significant fiscal stimulus for 2017. But, elsewhere, fiscal actions are harder to find. Although Japan announced another round of stimulus last year, the spending is smaller than previous iterations, leaving a net drag on growth. The U.K. recently scaled back austerity plans, but not to the point of generating an outright positive impulse. Globally, we compute a slightly negative fiscal impulse over the next few years (Exhibit 27). This could change if countries are emboldened by North American fiscal stimulus or if U.S.

protectionism obliges governments to prop up their economies, but that is merely speculation for now.

A key implication of these findings is to recognize that net government stimulus – monetary and fiscal policy combined – may actually be in slight decline. This is another reason to be cautious about expecting accelerating economic growth over the next few years.

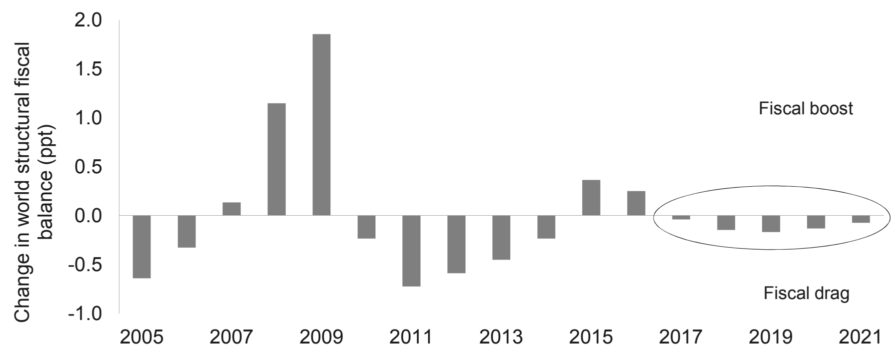
U.S. growth picks up

The U.S. has been a leading player in the recent economic revival. This is unsurprising given that post-election optimism is most relevant to the U.S. Important secondary metrics like the U.S. Beige Book provide further qualitative confirmation of the economic uptick. We have upgraded our own forecast for 2017 U.S. growth to 2.25%, a pace we believe can then be sustained into 2018. These are roughly on-consensus views, a shift relative to our prior below-market positions.

The key reason for this upward revision is the expectation of fiscal stimulus, which we figure will be worth an extra 0.2 percentage point of growth in 2017 and another 0.4 percentage point in 2018 (refer back to Exhibit 8).

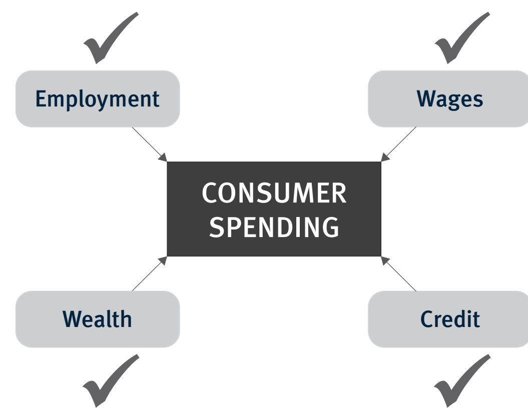
The U.S. consumer remains healthy, supported by constructive income, wage, wealth and credit trends (Exhibit 28). That said, we have our eyes on bank-credit standards as these are starting to become a bit less friendly (Exhibit 29).

Exhibit 27: Global fiscal stimulus to be less supportive



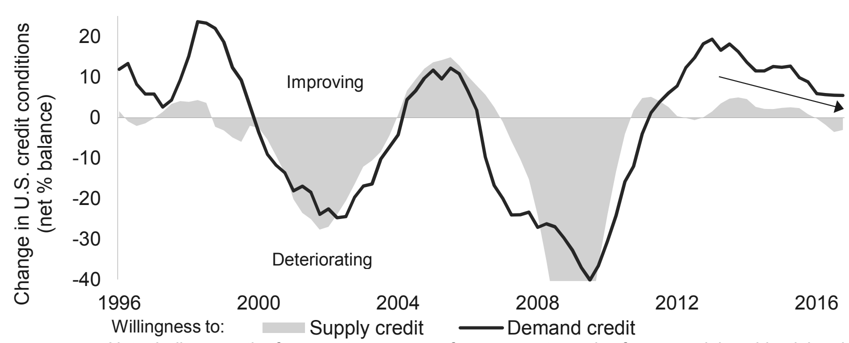
Note: Forecast from IMF World Economic Outlook, October 2016. PPP-based country GDP as share of world total used as weights. Source: IMF, Haver Analytics, RBC GAM

Exhibit 28: U.S. consumers in good shape



Source: RBC GAM

Exhibit 29: U.S. credit conditions have turned



Note: Indices are the four-quarter average of responses to a mix of commercial, residential and personal lending questions in the U.S. Senior Loan Officer Opinions Survey.
Source: Federal Reserve, Haver Analytics, RBC GAM

Whereas business investment has been a source of profound weakness in recent years, it may now be capable of a partial revival as confidence builds and the oil shock fades (Exhibit 30). The U.S. housing market continues to look capable of further improvement, even though mortgage rates have risen somewhat (Exhibit 31).

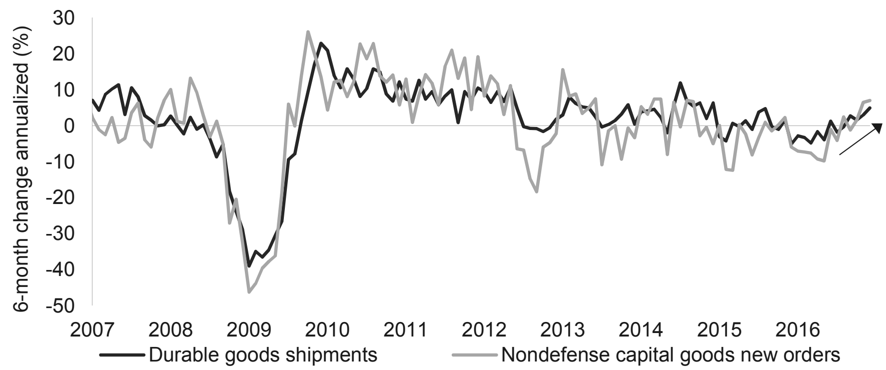
We look for the Fed to deliver several rate increases over the next 12 months, the heaviest lifting in many years (Exhibit 32). These rate increases are easily justified by the country's tightening economic conditions. Various measures of labour-market slack confirm this assessment (Exhibit 33).

It is conceivable that the Fed's priorities will change somewhat over the next year given the expected arrival of three new Fed governors and the prospect of a new Fed chief appointment in 2018. The implications are unclear. President Trump argued on the campaign trail that interest rates were too low, though he may now feel differently given the goal of boosting economic growth on his watch. The best that we can say is that any shift in U.S. monetary policy is likely to be toward a more rules-based approach, and also one that gives greater heed to the banking sector.

Better Britain

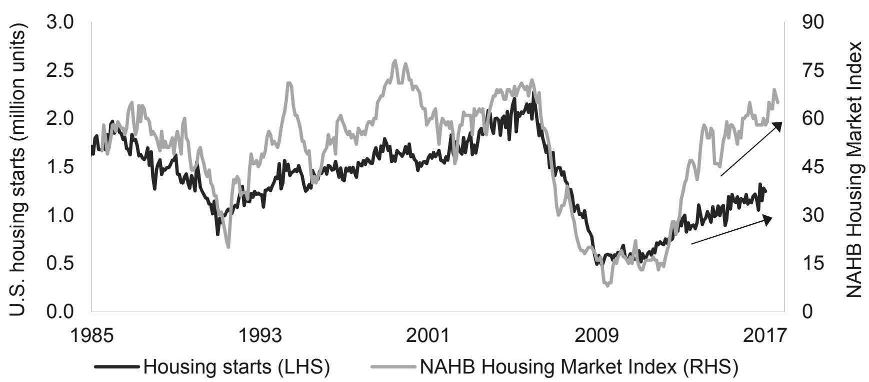
We stick with our above-consensus forecast for the British economy, looking for 1.75% growth in 2017 followed by a rate of 1.50% in 2018.

Exhibit 30: U.S. business investment improving



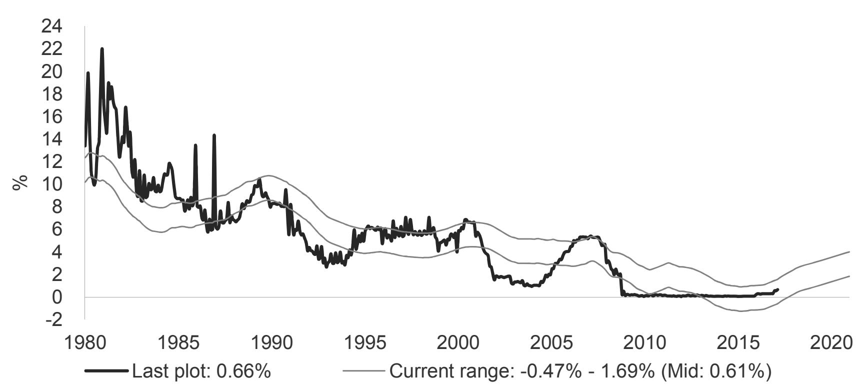
Note: New orders for nondefense capital goods exclude aircraft.
Source: U.S. Census Bureau, Haver Analytics, RBC GAM

Exhibit 31: U.S. housing market remains robust



Note: NAHB Housing Market Index in 6-month lead. Source: Haver Analytics, RBC GAM

Exhibit 32: U.S. fed funds rate
Equilibrium range



Source: Federal Reserve, RBC GAM

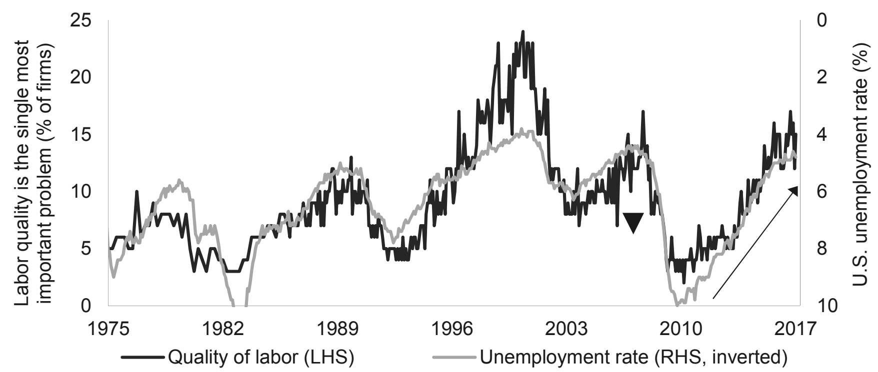
The simple reality is that whatever short-term damage has emerged from the Brexit vote last summer, the pound's subsequent weakness has largely compensated for that pain (Exhibit 34). The country's adjusted fiscal targets have also helped to reduce drag.

As a result, the British economy has managed to maintain its forward trajectory and the country's unemployment rate has continued to fall, now approaching normal cyclical lows (Exhibit 35). The BOE has upgraded its growth forecast and reduced the expected short-term drag from Brexit.

It is important to remember, however, that the U.K. has not actually left the EU yet. As such, the inefficiencies associated with a diminished flow of goods, services, people and capital have yet to take effect. Furthermore, economists generally agree that Brexit will reduce GDP over time, likely by a total of around 3% over the next decade (Exhibit 36).

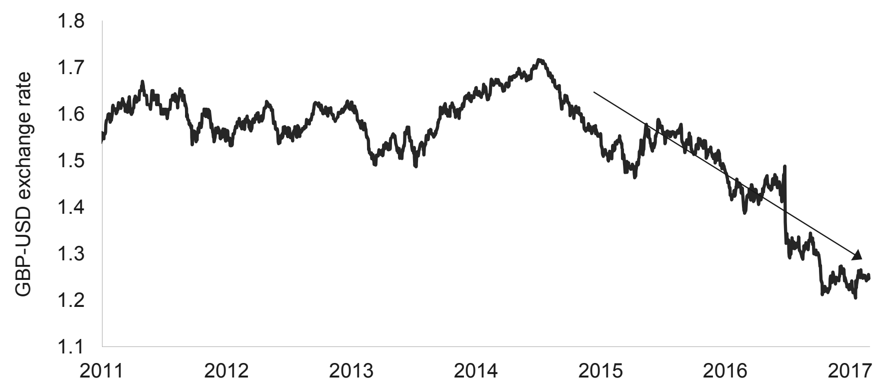
Brexit negotiations remain contentious. European nations seem to be hardening their stance, insisting not only that the exit be finalized before any subsequent trade arrangement is negotiated, but also that the U.K. make good on large financial obligations to Europe before the exit can be arranged. Suffice it to say that we continue to budget for a "hard" Brexit, meaning that the separation of the U.K. from the EU should be decisive.

Exhibit 33: Corroborating the tightening U.S. job market



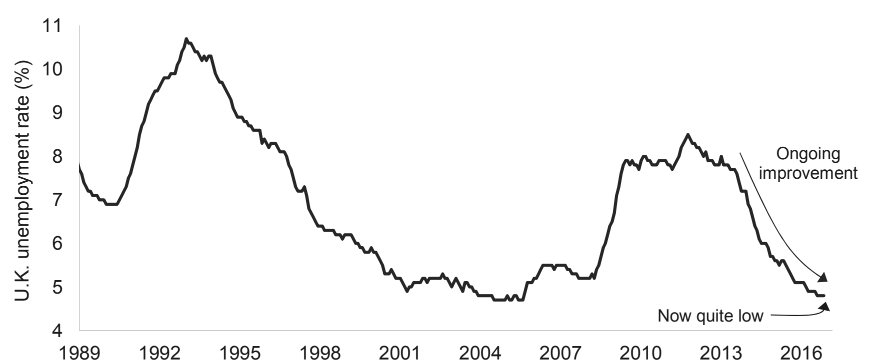
Source: BLS, NFIB Small Business Economic Survey, Haver Analytics, RBC GAM

Exhibit 34: British pound lends a hand by weakening substantially



Source: Reuters, Haver Analytics, RBC GAM

Exhibit 35: U.K. unemployment continues to fall



Source: Office for National Statistics, Haver Analytics, RBC GAM

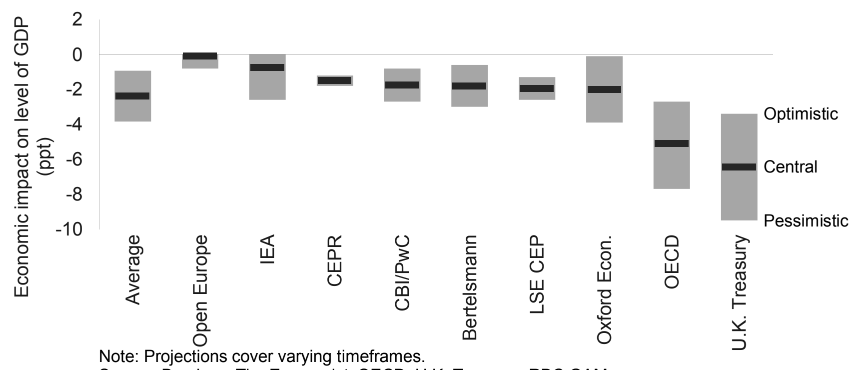
The combination of a weaker pound and an increasingly tight economy seems likely to heat up British inflation (Exhibit 37). In our forecast, the country's inflation rate rises all the way from subdued levels to a toasty 3.0%. Fortunately, the U.K. has experience and credibility in managing temporary flurries of inflation. The BOE won't get too fussed by this, though it is still on schedule to allow quantitative easing to expire and to start contemplating slightly tighter policy over time.

Eurozone economic revival

The Eurozone is another region for which we maintain an above-consensus economic forecast, anticipating 1.75% growth in 2017 followed by 1.50% in 2018. The logic behind this relatively cheery view is grounded in two things.

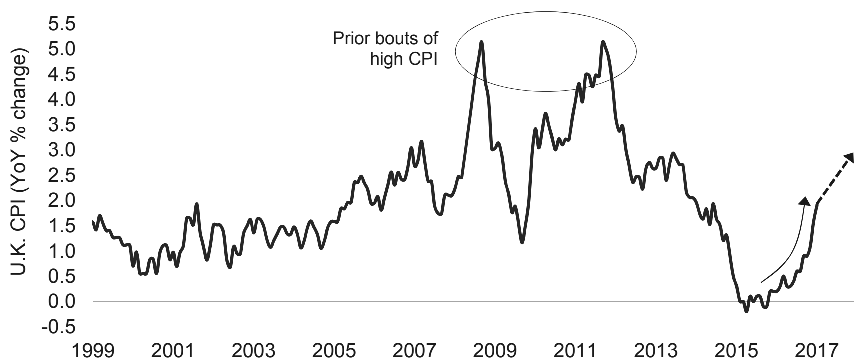
The first is that it has been useful throughout the post-crisis period to look to the U.S. as a leading indicator for the Eurozone. To the extent that the U.S. has made significant strides over the past several years, it seems conceivable that the Eurozone could manage a similar trick. The underappreciated Eurocoin index provides particularly clear evidence of Europe's economic acceleration (Exhibit 38). The continent's unemployment rate continues to fall (Exhibit 39). The region's credit impulse is nicely positive, the central bank has delivered ample stimulus and the softening euro has lent an occasional helping hand. The Eurozone isn't as exposed to the

Exhibit 36: Most models predict a substantial Brexit hit to GDP



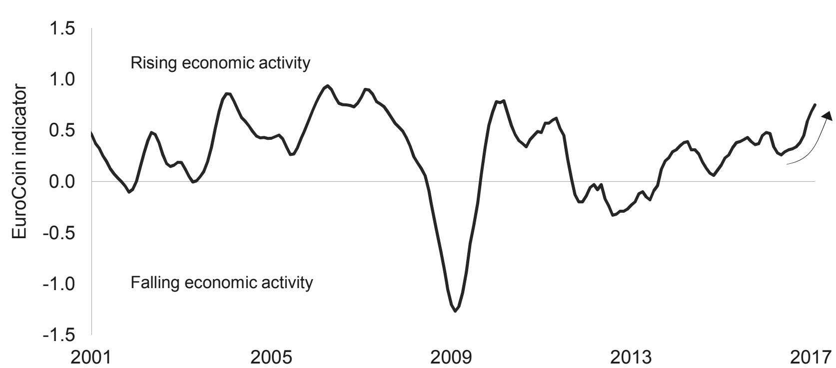
Note: Projections cover varying timeframes.
Source: Barclays, The Economist, OECD, U.K. Treasury, RBC GAM

Exhibit 37: U.K. inflation revving up again



Source: ONS, Haver Analytics, RBC GAM

Exhibit 38: Eurozone growth continues to improve



Source: Centre for Economic Policy Research, Haver Analytics, RBC GAM

U.S. protectionist threat as many other economies.

The second reason for optimism is that we expect the Eurozone to dodge another major populist victory. Although there is much to fret over – a subject discussed in the next section – the most likely scenario is a continuation of centrist policies.

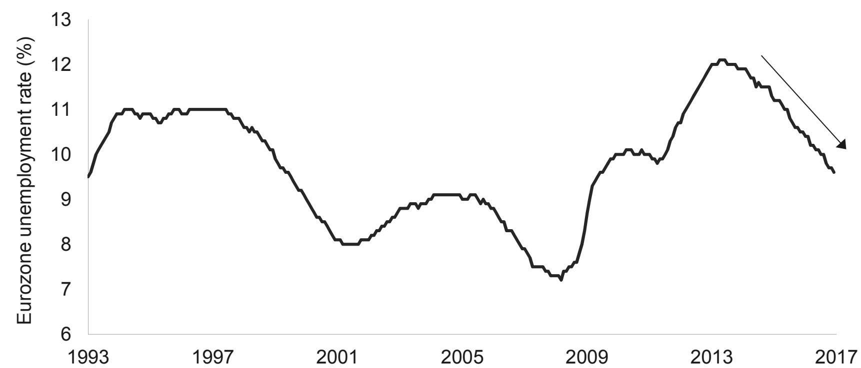
European inflation seems to be edging higher alongside its developed-world peers (Exhibit 40) and this has prompted the ECB to scale back its quantitative easing slightly. Further tapering seems likely in 2018. The fact that some Eurozone nations are now experiencing inflation above 2%, while others are mired in unusually low readings, could increase political infighting.

Eurozone political risks

Despite our prophecy that worst-case scenarios are avoided, European political risks are acute for three reasons. First, populist sentiment is strong in the region, with the majority of several countries' citizens believing they are better off outside the EU (Exhibit 41). Greece is no longer as central on the radar screen as it was, but it remains burdened by too much debt and considerable economic suffering (Exhibit 42).

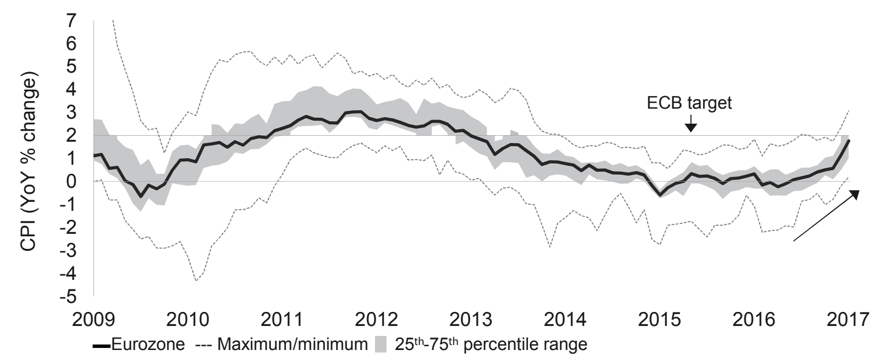
Second, there happen to be a large number of Eurozone elections coming in 2017. We have our eyes in particular on three, and a fourth might emerge. The Dutch election

Exhibit 39: Eurozone unemployment high, but declining appreciably



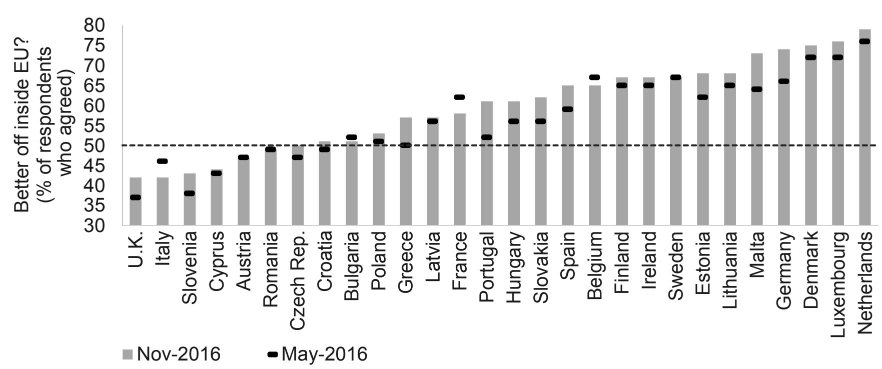
Source: Statistical Office of the European Communities, Haver Analytics, RBC GAM

Exhibit 40: Eurozone inflation rising en masse



Note: Range of YoY % change of headline CPI of individual Eurozone member countries.
Source: Haver Analytics, RBC GAM

Exhibit 41: Anti-EU sentiment prevalent



Source: European Commission Standard Eurobarometer 86 and 85, RBC GAM comes first in mid-March, followed by France in April/May and Germany in September. It is quite possible that Italy will call a snap election. In all cases, populist parties are polling better than they were in past years (Exhibit 43). The French and prospective Italian elections are particularly worth watching, as electorates in these countries are the mostly likely in our view to choose populist leaders.

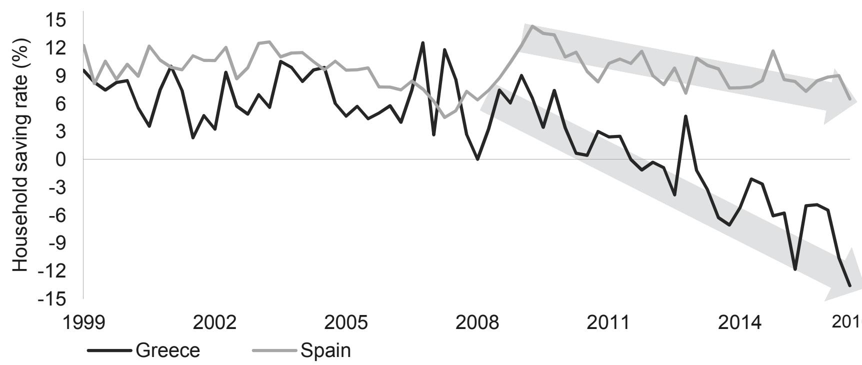
Third, populism could be especially consequential in Europe because the stakes are so high. The potential break-up of the Eurozone is a fairly unlikely scenario for the time being, but it is not a trivial risk over the longer run given the ramifications of such an outcome.

Japan: slow growth but tight economy

We have scaled back our Japanese growth forecast, maintaining a below-consensus stance with predictions of 0.75% growth in both 2017 and 2018. Our caution reflects two things. First, we have come to the realization that Japan's speed limit simply hasn't increased very much despite the best efforts of Prime Minister Abe's structural reforms. Second, Japan stands to be among the more targeted countries in the coming U.S. protectionist push given its large trade surplus with the U.S. (refer back to Exhibit 10) and its emphasis on the auto industry.

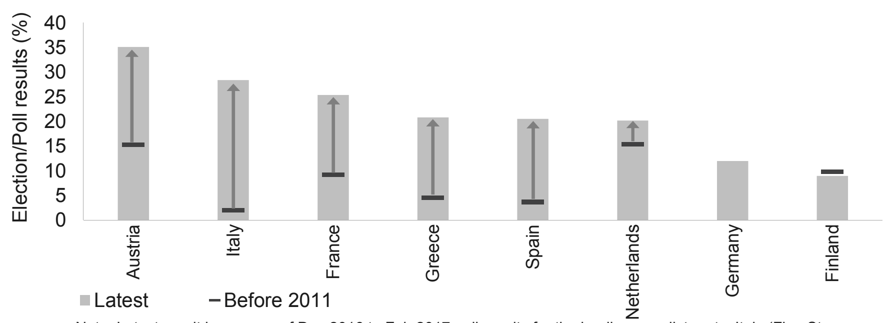
To be clear, Japan's economy continues to grow and has managed a string of entirely decent quarters

Exhibit 42: Substantial dissaving in Greece



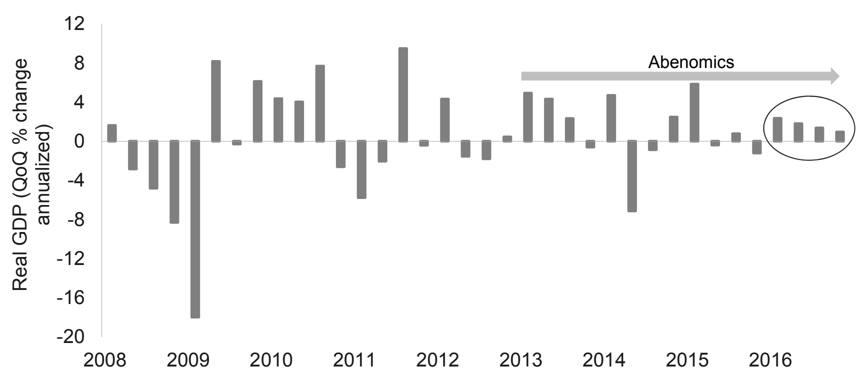
Source: Statistical Office of the European Communities, Haver Analytics, RBC GAM

Exhibit 43: Populist parties in Europe gaining traction



Note: Latest result is average of Dec 2016 to Feb 2017 poll results for the leading populist party: Italy (Five-Star Movement), France (National Front), Greece (Syriza), Netherlands (Party for Freedom), Germany (Alternative für Deutschland), Finland (Finns Party). 2016 election results shown as latest for Austria (Freedom Party) and Spain (Unidos Podemos). "Before 2011" data based on results from elections held just before 2011. No data for Alternative für Deutschland before 2011 as party was foundrd in 2013. Source: Wikipedia, RBC GAM

Exhibit 44: Japanese economy manages to stay afloat



Source: Cabinet Office of Japan, Haver Analytics, RBC GAM recently (Exhibit 44). And although the country's absolute rate of economic growth is underwhelming – a clear indictment of supply-side reform efforts – demand-side stimulus has largely succeeded in closing the country's output gap. As a result, Japan's labour market is as tight as it was during the country's early-1990s heyday (Exhibit 45). Japanese bank lending is also ticking along more quickly than usual (Exhibit 46).

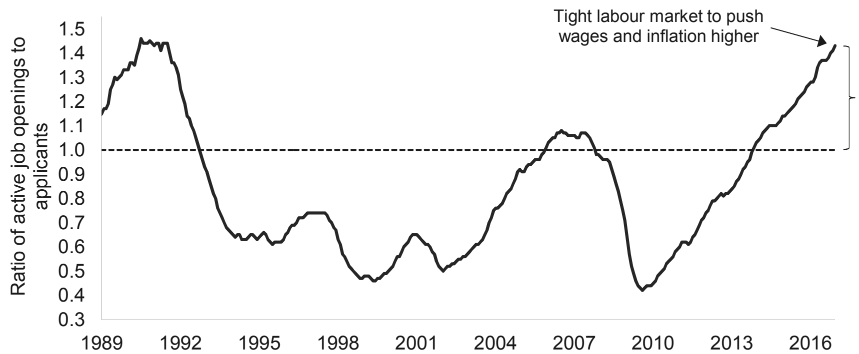
We anticipate 1.0% Japanese inflation in each of the next two years. On the one hand, this is much better than the slight deflation sustained in 2016, thanks in large part to a softer yen and a stronger economy. On the other hand, this forecast remains well shy of the Bank of Japan's (BOJ) 2.0% inflation goal. Given the sizeable wedge that is likely to persist, the BOJ will be among the most reluctant of the major central banks to back away from extreme monetary stimulus.

Emerging-market revival

After five years of decelerating growth, emerging-market economies finally bottomed last year and have since managed to accelerate modestly (Exhibit 47). Leading indicators have also moved higher. These are welcome developments.

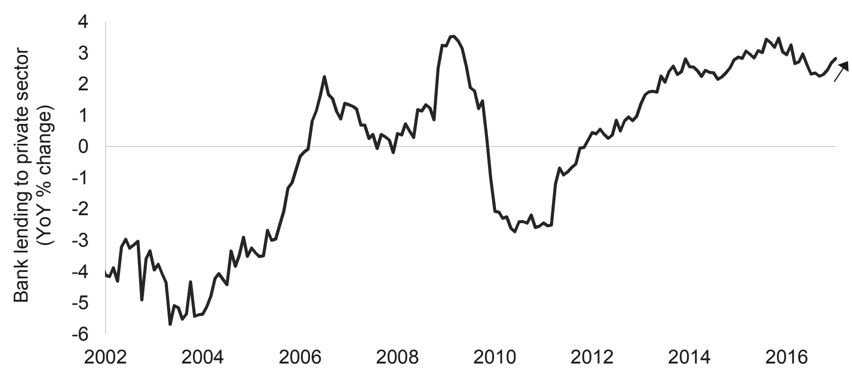
However, four caveats are necessary. First, the rebound is not especially forceful. Growth is improving, but only to the standards of a few years ago. It is hardly on par

Exhibit 45: Japan's labour market getting tighter



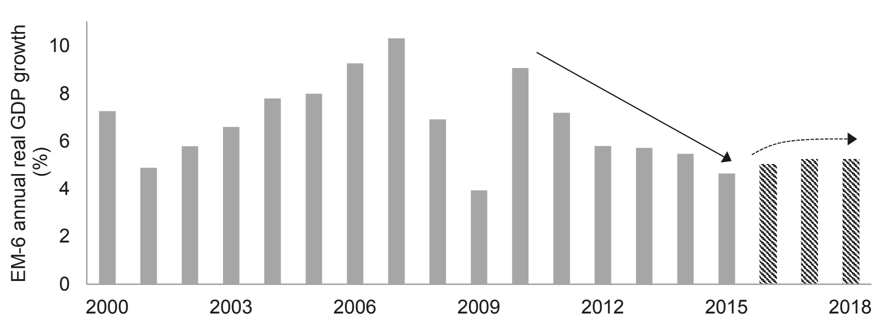
Source: MHLW, Haver Analytics, RBC GAM

Exhibit 46: Japanese bank-lending growth turns higher



Source: Bank of Japan, Haver Analytics, RBC GAM

Exhibit 47: EM growth to pick up from 2016 onward



Note: EM-6 includes Brazil, China, India, Mexico, Russia and South Korea.
Source: Haver Analytics, RBC GAM

with the mid-2000 salad days for emerging markets.

Second, the emerging-market recovery is narrowly based (Exhibit 48). It is essentially a story of resource-exporting nations escaping from recession now that the commodity shock has ended. Other countries are generally continuing on their prior trajectory, or even slipping slightly.

Third, we expect China, which accounts for about one-third of global economic growth, to decelerate over the coming years.

Fourth, emerging markets are particularly vulnerable to U.S.-dollar strength and higher bond yields. This is because they often finance themselves in U.S. dollar-denominated debt, their indebtedness has grown significantly over the years and emerging-market investors tend to be flighty. We believe these threats are manageable given repeated demonstrations of resilience on the part of emerging markets over the past decade, and thus that faster aggregate growth can prevail. But there is a risk to that view.

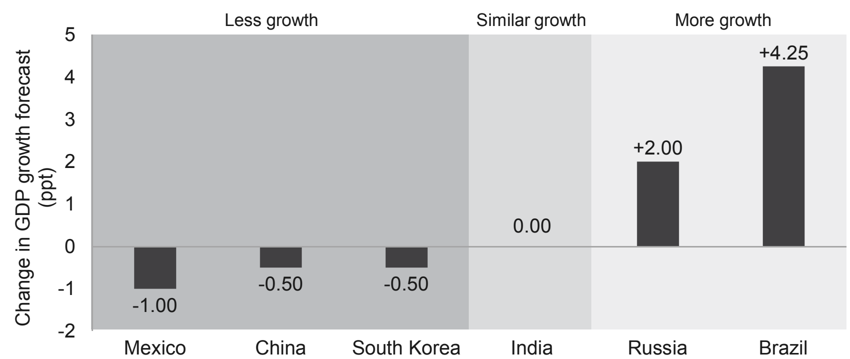
Where does this leave us on emerging markets? We continue to look for slightly better emerging-market growth (Exhibit 49). Of course, the outlook varies significantly by country, with key differentiators including whether a country is a resource exporter (helping much of Latin America), is delivering important reforms (a positive for India, China, Argentina, Mexico and Brazil), has succumbed to credit excesses (a negative for China in particular), enjoys particularly good competitiveness (frontier markets lead the charge; China has lost ground) and finally whether it risks being disproportionately affected by U.S. protectionism (Mexico, China and South Korea are the major emerging-market economies toward the top of the list).

China to dip again

China remains the linchpin of global growth. After several years of steady deceleration, it managed to stabilize its growth rate over the past year thanks to better global demand and government stimulus (Exhibit 50).

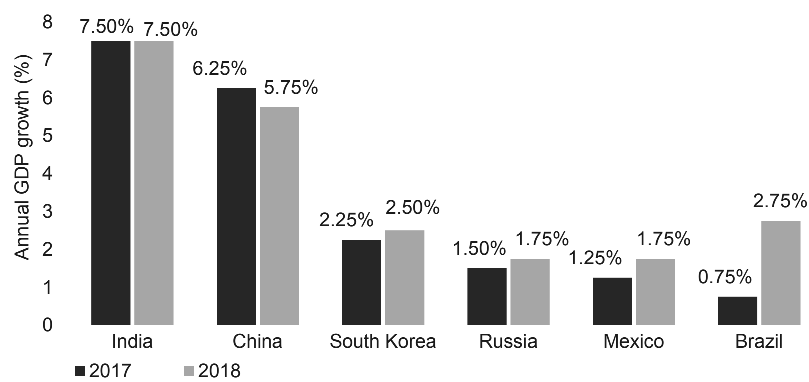
However, we believe that the country will revert to a slowing trend and forecast 6.25% growth in 2017 and 5.75% in 2018. This is hardly a disaster in that the country is still

Exhibit 48: Mixed outlook for emerging-market growth in 2017



Note: Difference in latest RBC GAM GDP forecast for 2017 and 2016. Source: RBC GAM

Exhibit 49: RBC GAM GDP forecast for emerging markets



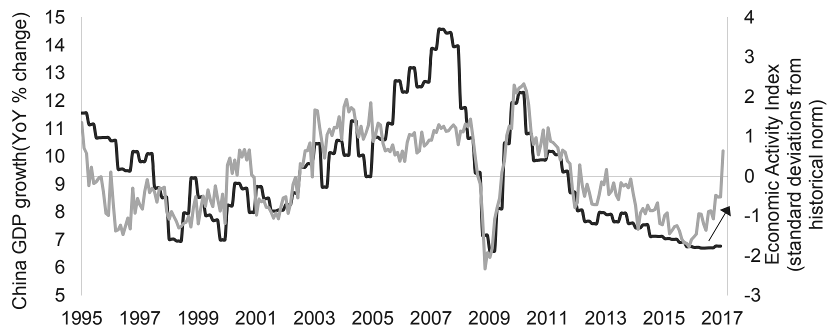
Source: RBC GAM

growing quickly on an absolute basis and will be a much safer place if it stops trying to sustain unnaturally fast growth.

The central logic beneath this diminishing forecast is that China has lost a great deal of competitiveness given wage gains that outpaced productivity gains; its exports will not enjoy as many tailwinds now that globalization is fading and U.S. protectionism is rising; and the economy has been artificially propped up by government support. On this last count, there is now evidence that government support is starting to unwind. Government spending growth has recently slowed dramatically (Exhibit 51). The People's Bank of China has increased borrowing costs, while a new tax was imposed on auto purchases and tighter lending standards were recently implemented for home buyers.

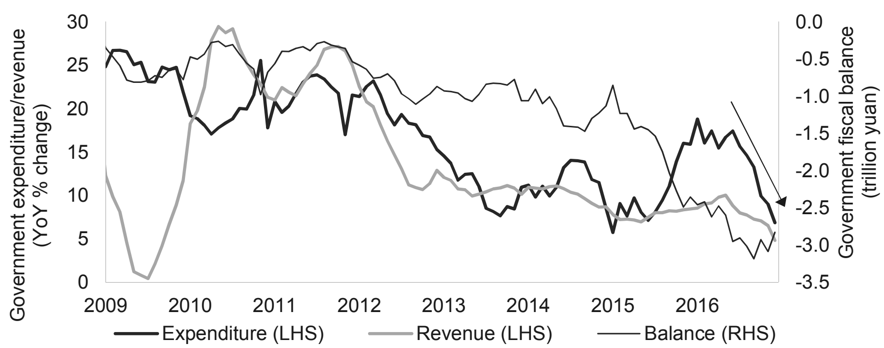
Furthermore, the government of President Xi Jinping is installing reformers tasked with fixing some of China's lingering excesses, the most pressing of which is the country's debt. China's debt problems are largely the result of easy money, a housing boom and artificially high growth targets. The danger of a debt blowup in the near term has arguably fallen over the past year as the country mopped up local-government debt excesses and because higher inflation makes debt-servicing easier. That said, we continue to look for eventual pain on this front.

Exhibit 50: China has managed an economic revival for now



Note: Index constructed using sixteen proxies for real economic activity in China.
Source: Bloomberg, Haver Analytics, RBC GAM

Exhibit 51: Chinese government fiscal support fading



Note: Rolling 12-month total of China's general government expenditure, revenue and fiscal balance. Source: Ministry of Finance of China, Haver Analytics, RBC GAM

Canadian revival faces new threats

Canada has managed a sprightly economic revival over the past few months, with our composite leading indicator surging from a substantially subpar position to slightly above normal (Exhibit 52).

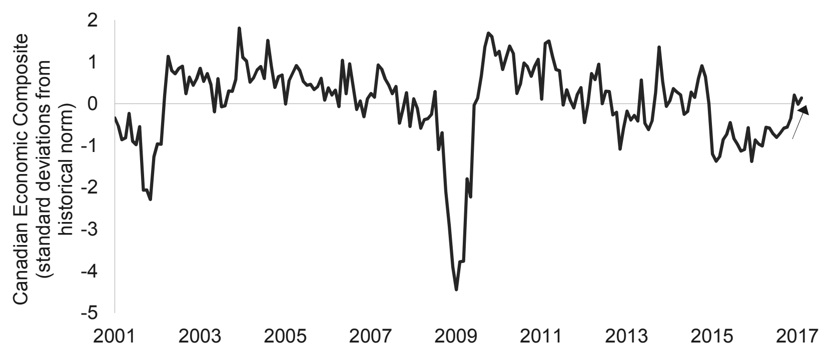
The country's prior struggles were intertwined with the global oil shock, which has now faded nicely. The oil market continues to normalize, with 2017 set to be the year in which global supply and demand return to balance even if oil inventories require some additional time to settle (Exhibit 53). So far, a larger fraction of last autumn's announced OPEC production cuts have been delivered than expected, though the quota reductions promised by certain non-OPEC oil producers have not been as faithfully delivered. More will be learned at the next OPEC meeting in June.

Thanks to higher commodity prices, the profound regional divergences that underpinned Canada's economic slowdown are rapidly narrowing (Exhibit 54). According to our proprietary estimates, resource-exporting Alberta has rebounded sharply in recent months, substantially bridging the gap with export-oriented Ontario. However, we do not expect Alberta to take the lead as oil prices are still too low for a substantial revival in business investment.

A further help for the Canadian economy is the significant fiscal stimulus the federal government is delivering. The new European trade deal is also helpful, as is the prospect of additional free trade among the country's provinces, but these add only minutely to growth. The Bank of Canada maintains a considerable amount of monetary stimulus with a policy rate of just 0.50% and doesn't seem to be in a hurry to move off of that perch.

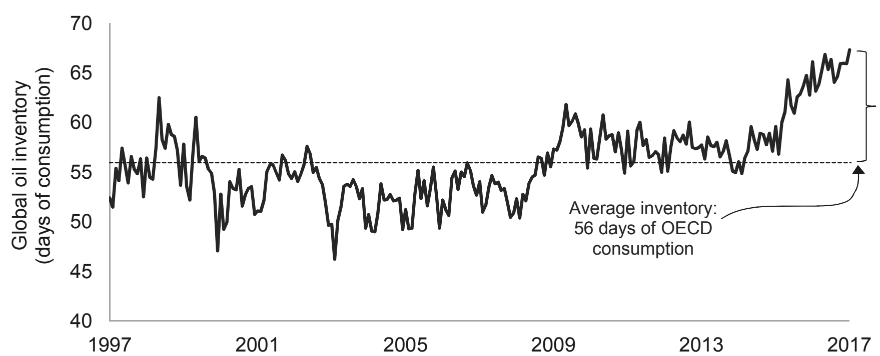
The Canadian dollar has softened over the past few years, and we anticipate a further shift lower. This is starting to become visible in the country's real trade balance (Exhibit 55), though is not yet apparent in the nominal numbers.

Exhibit 52: Canadian economic signal has strengthened



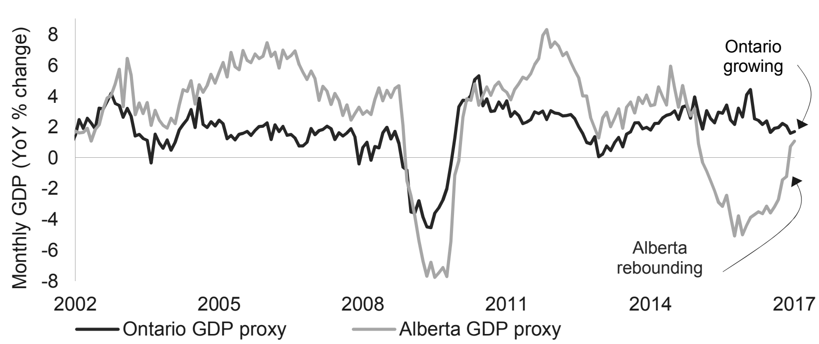
Note: Composite constructed using four leading indicators from surveys on Canadian businesses. Source: CFIB, Haver Analytics, RBC GAM

Exhibit 53: Global crude-inventory level still elevated



Note: Global oil inventory reflects OECD commercial crude stock and consumption. Historical average since 1997. Source: EIA, RBC GAM

Exhibit 54: Ontario in decent shape; Alberta in recovery mode



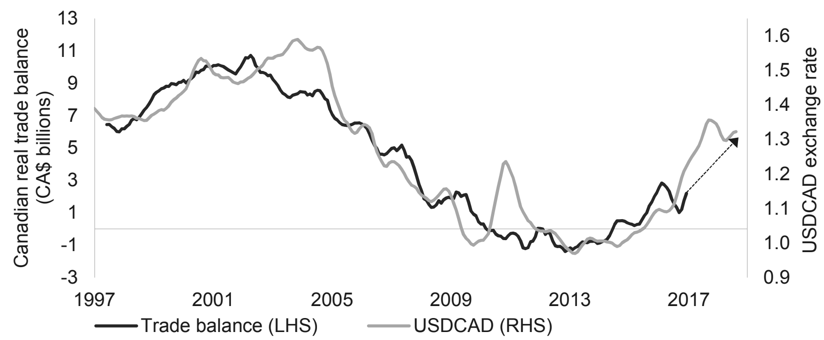
Note: Monthly provincial GDP estimated from available monthly economic variables, combined via principal component analysis and then regressed against annual provincial GDP. Source: Haver Analytics, RBC GAM

However, having finally exited the oil shock, Canada now faces two new threats: U.S. policy changes and a dangerous domestic housing market. For these reasons, we continue to anticipate below-consensus economic growth of 1.5% in both 2017 and 2018.

There are many ways in which the Trump administration could affect Canada (Exhibit 56). Several are good, but the negatives dominate. The most prominent threat is the prospect of trade barriers. The prospect of declining U.S. corporate tax rates and looser environmental standards would also put Canada at a disadvantage. The positives are less powerful but include Trump's support for the Keystone XL oil pipeline, a weaker Canadian dollar and stronger U.S. demand in the short run. The considerable uncertainty around U.S. policy changes adds uncertainty to the Canadian outlook, too.

Canada's housing market is mutating in a number of interesting ways. Vancouver's previously red-hot market is clearly cooling – a welcome development, though one that also detracts from short-term growth. On the other hand, Toronto has accelerated sharply, and this is starting to cause concern among residents and politicians to the point that regulatory measures may be taken. Given the recent increase in mortgage rates, high household-debt levels and the wave of macroprudential tightening already underway, we budget for some economic drag from a cooling Canadian housing market over the next few years.

Exhibit 55: Canadian real trade balance could improve further



Note: 6-month moving average of Canadian real trade balance of all merchandise goods. 6-month moving average of USDCAD exchange rate in 19-month lead. Source: Bank of Canada, Statistics Canada, Haver Analytics, RBC GAM

Exhibit 56: Some Canadian considerations under Trump

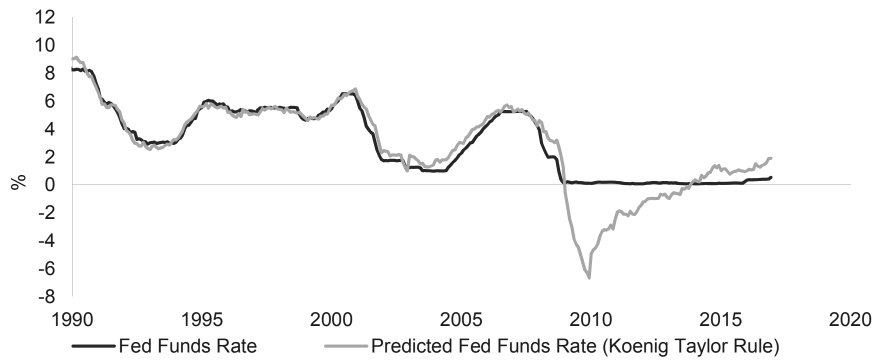
Good for Canada	Bad for Canada
Faster short-term U.S. growth	Slower long-term U.S. growth
Weaker Canadian dollar	Higher interest rates
Keystone XL pipeline	Protectionism / fewer exports
Better quality/more immigrants	Tax wedge opens to Canada's disadvantage
Less competition from Mexico and China	Environmental wedge opens to Canada's disadvantage
Greater motivation to pen foreign trade deals	Must meet NATO spending obligations?
Numerous positives, but negatives probably dominate	

Source: RBC GAM

Higher interest rates are appropriate

Although many of the world's major central banks are still focused on delivering prior quantitative-easing commitments and using low or even negative interest rates to stimulate their economies, the Fed continues to press forward with its plan to nudge the fed funds rate higher. Improving U.S. economic conditions, firming inflation and a strengthening labour market suggest a decreasing need for the extremely accommodative monetary policy that has been in place in the U.S. since the financial crisis. The Fed appears to be onboard with this logic, having raised its projections in December for the number of rates hikes in 2017 to three from the two forecast in September. Supporting the view that rates should be moving higher is the Koenig-Taylor Rule, which estimates a suitable level for the fed funds rate given measures of economic growth, inflation and unemployment. The rule first hinted that rates should be above zero in early 2014, around the time that the Fed began to taper its quantitative-easing program, and the indicator has been moving gradually higher since then as the outlooks for growth and inflation have firmed (Exhibit 57).

Exhibit 57: Koenig-Taylor Rule and fed funds rate



Source: Federal Reserve Bank of Dallas, RBC GAM

While the Fed has hiked interest rates twice since the end of QE – in December 2014 and again in December 2015 – this model suggests that as many as five more rate hikes may be warranted to achieve full employment and price stability. Rather than focusing on the exact timing of the next rate hike, investors should consider whether the Fed is moving too slowly. In our view, current conditions support higher interest rates now, and it would be a policy mistake to put off further tightening. We expect the Fed to hike three times over the next 12 months.

Bond yields take a breather

At current levels, yields in the developed world remain historically low and are below our modelled estimate of equilibrium in all major regions (page 44). The yield on 10-year Treasuries peaked at 2.65% in December and has been trading in a narrow range ever since. The idea that Trump administration policies would generate a bit more inflation was quickly reflected in fixed-income markets after the U.S. election, greatly reducing the need for further near-term adjustment in bond prices. Other major fixed-income markets followed a similar pattern as Treasuries, but with a lesser magnitude.

Our fixed-income models continue to suggest that the long-term direction for yields is higher and, while the post-U.S. election jump alleviated valuation concerns in the near term, risks are still tilted to the upside. Exhibit 58 disaggregates our bond-equilibrium model into its components of an inflation premium and real rate of interest. Our forecasts suggest that the inflation premium embedded in the model could contribute another 50 basis points to nominal yields over the next year, with no further advance over the longer term. The other source of upward pressure on nominal yields is from the real rate of interest, which is generally influenced by the pace of economic growth. This portion of the model was dragged to extraordinarily low levels following the financial crisis and has remained low for a host of structural reasons (aging demographics, high sovereign-debt levels, global savings glut, slowing productivity growth, etc.). However, following a positive turn in many of the economic indicators that we monitor and the election of President Trump, there seems to be at least a small chance that the pessimistic post-crisis view of the global economy may be in question and that economic growth could rise to historical averages. A sustained economic expansion would force the real rate of interest higher as investors demand a positive after-inflation return on their fixed-income investments. The combination of a bit more inflation and a higher real rate of interest would act as a headwind to fixed-income returns in general and pose a risk to sovereign-bond investors, in particular.

The financial crisis has depressed real rates of interest to levels that are not likely to persist and, following a 35-year bull market in bonds, the outlook for fixed-income returns is somewhat uninspiring. The steady decline in interest rates since the 1980s has provided a massive tailwind for bond returns (Exhibit 59). Through the great bull market, the 10-year Treasury generated annual returns averaging 8%. It is difficult to imagine a scenario where those kinds of returns will be achieved on a sustained basis. Our model assumes that the real rate of interest on 10-year Treasuries reverts to its 40-year trailing average over the coming five years. With this in mind and assuming that yields eventually move to our modelled level of equilibrium, U.S. 10-year government bonds would generate a total return of 0.55% per year through February 2022. To observe the impact of varying real-interest-rate assumptions, we tested scenarios where real rates reverted to their 10-year and 100-

Exhibit 58: U.S. 10-year bond yield
Fair-value estimate composition

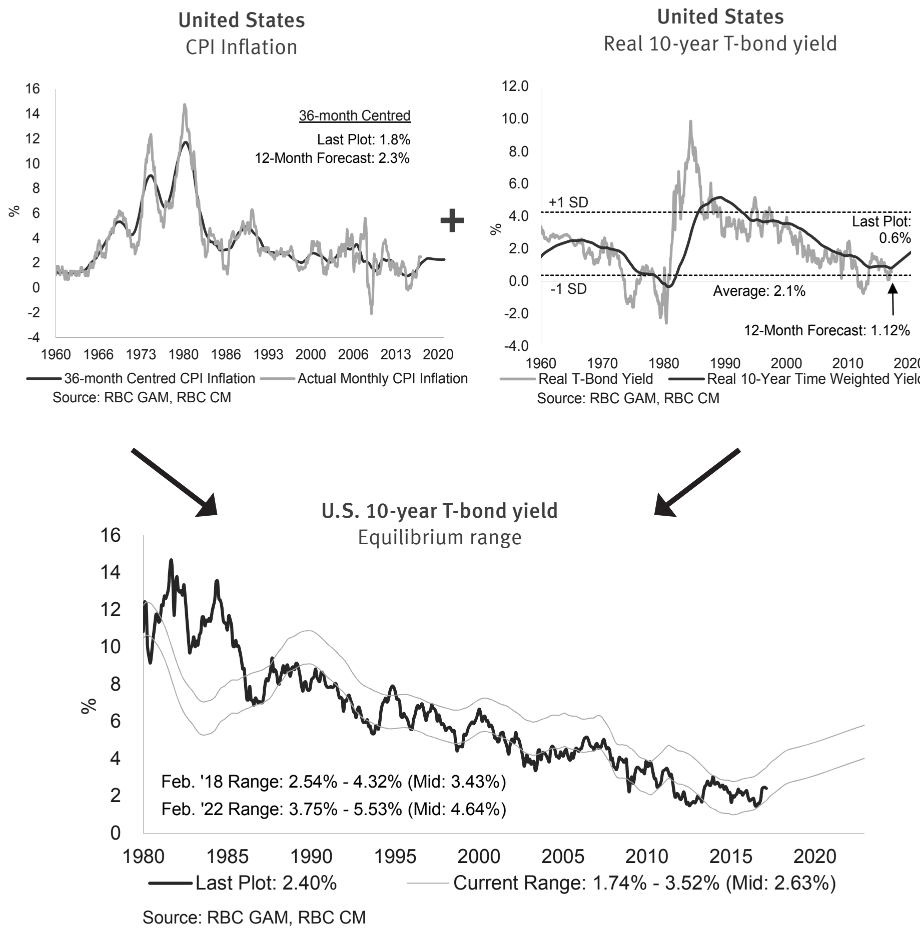
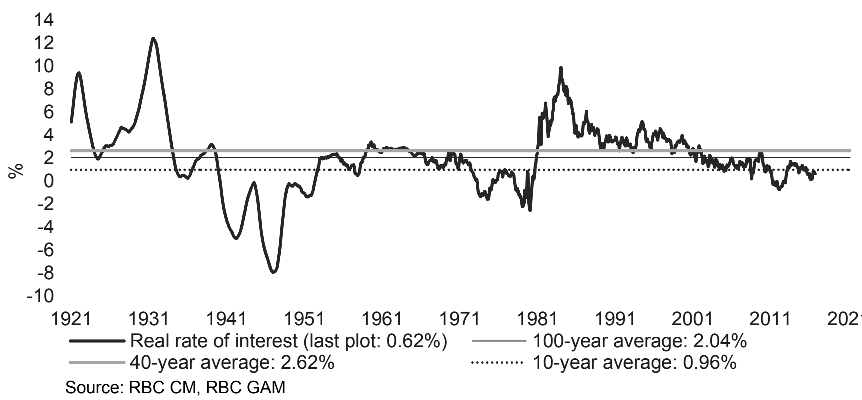


Exhibit 59: U.S. real yield
U.S. 10-year bond yield – 36-month centered YoY CPI



year trailing averages (Exhibit 60). Using the 10-year trailing average for the real yield of 0.95%, the total-return forecast for 10-year Treasuries rises to 1.72% per year over five years. Using the 100-year trailing average of 2.04% for the real yield, the total return would be 0.95% per year over the same period. Crucially, none of the outlined scenarios result in particularly attractive sovereign fixed-income returns going forward.

Equities rally across the board

Surprisingly strong economic data, surging consumer and business confidence, and better-than-expected earnings propelled stocks higher in the past quarter, with most major indexes delivering gains in the mid to high single digits. Emerging-market, European and U.S. equities rose the most, while gains for Japanese and Canadian stocks lagged. Although stocks have enjoyed a solid rally in the recent quarter, they remain below our estimate of fair value in all the major regions that we track (page 45). U.S. equities are slightly below our modelled estimate of fair value, but Europe, Canada and emerging markets are much cheaper on this basis. In aggregate, our global composite equilibrium situates stocks at levels that have represented attractive entry points in the past, though we recognize that valuations have risen meaningfully since this bull market began (Exhibit 61).

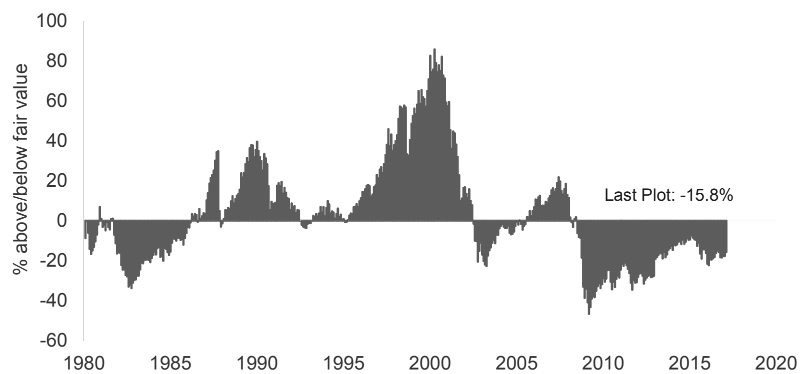
Many investors attribute the stock market's recent buoyancy to

Exhibit 60: Testing the impact of varying real-interest-rate assumptions
U.S. 10-year T-bond

Trailing average window (years)	Trailing average real rate of interest	Mid point of equilibrium in Feb 2022	Total annual return forecast to Feb 2022
10	0.96%	3.22%	1.72%
40	2.62%	4.64%	0.55%
100	2.04%	4.15%	0.95%

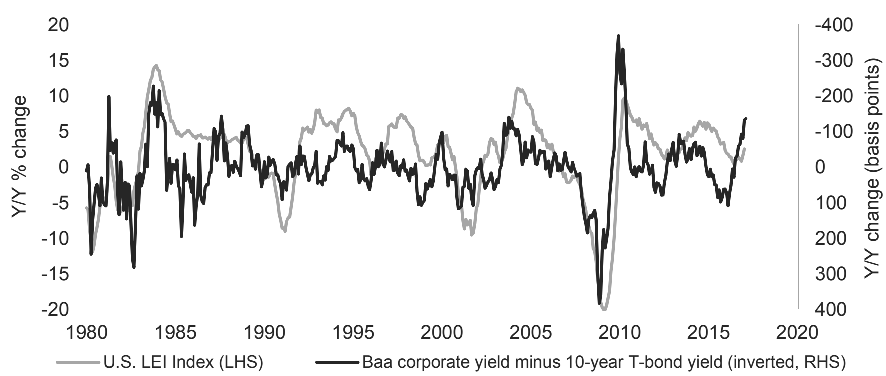
Source: RBC CM, RBC GAM

Exhibit 61: Global stock-market composite
Equity market indexes relative to equilibrium



Source: RBC GAM

Exhibit 62: Corporate-bond spread and U.S. leading economic indicators



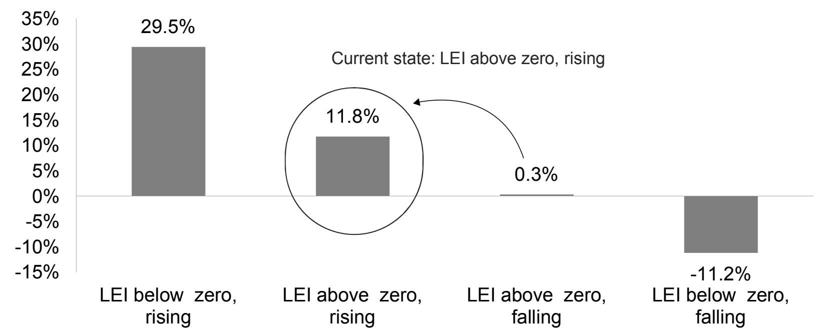
Source: The Conference Board, RBC GAM, ISI

Trump's pro-growth agenda but, in fact, leading economic indicators (LEI) turned up and credit spreads began to narrow many months prior to the U.S. election. Exhibit 62 plots the year-over-year change in investment-grade corporate credit spreads against the year-over-year change in the U.S. LEI. Notice that the narrowing in credit spreads that started in February 2016 was later confirmed by a turn higher in the LEI in the summer. Improvement in the LEI is meaningful because stocks have returned an annualized average of 11.8% in periods where the LEI is positive and rising as it is now, compared with just 0.3% when the LEI is positive but falling, which was the case prior to the start of the latest rally (Exhibit 63). The fact that credit spreads are narrowing is also important because an environment where stocks and credit markets move in sync is generally positive for risk assets (Exhibit 64).

Valuations are not a barrier to equity returns

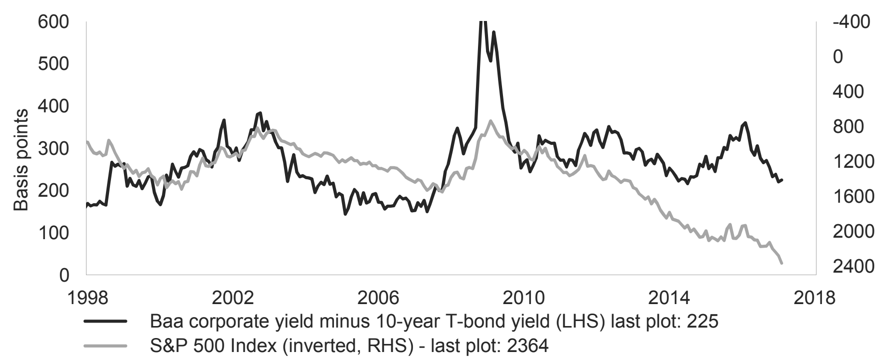
We don't think that the rally over the past year has stretched valuations as much as some investors believe. Exhibit 65 plots a valuation composite made up of eight metrics that we monitor and, while it has certainly risen over the past year, it has not reached levels that we would consider a barrier to future equity gains. It's worth noting that not all of the underlying indicators posit the same conclusion. Exhibit 66 plots the latest values of the components that make up the composite in terms

Exhibit 63: Average annualized equity returns sorted by LEI phase
S&P 500 Index



Note: based on rolling monthly periods back to January 1960. The year-over-year change in the Conference Board Leading Economic Index was used as the basis for above/below zero, and the month-over-month change was used as the basis for rising/falling. Source: Wolfe Trahan & Co., Bloomberg, RBC GAM

Exhibit 64: Corporate-bond spread and S&P 500



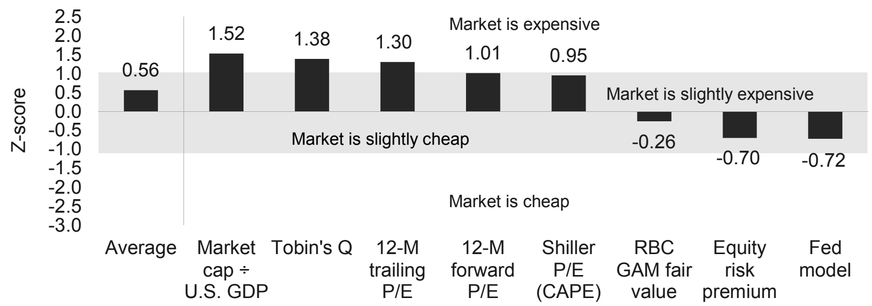
Source: RBC GAM, ISI

Exhibit 65: S&P 500 Index
Simple average of valuation metrics

Notes: Historical data from Jan 1956 for 12-M Trailing P/E, 12-M Forward P/E, Equity risk premium, Shiller P/E, Tobin's Q and Fed model. Historical data from Mar. 1956 for market cap ÷ U.S. GDP. Historical data from Jan 1960 for RBC GAM fair value. The r-square figures used for the weighted composite are based on the relationship of each valuation indicator with S&P 500 10-year returns. Source: Haver Analytics, RBC CM, RBC GAM of standard deviation from their long-term average. Some valuation metrics suggest the market is expensive and others argue the market is at least moderately cheap. The key difference between these opposing measures is whether historically low interest rates are incorporated into the specific calculation. Traditional price-to-earnings ratios, in particular, do not factor in interest rates and therefore may appear elevated when compared to history. Our own RBC GAM fair-value model, a multi-factor model which incorporates interest rates, inflation and corporate profitability, suggests U.S. stocks are actually a bit below fair value.

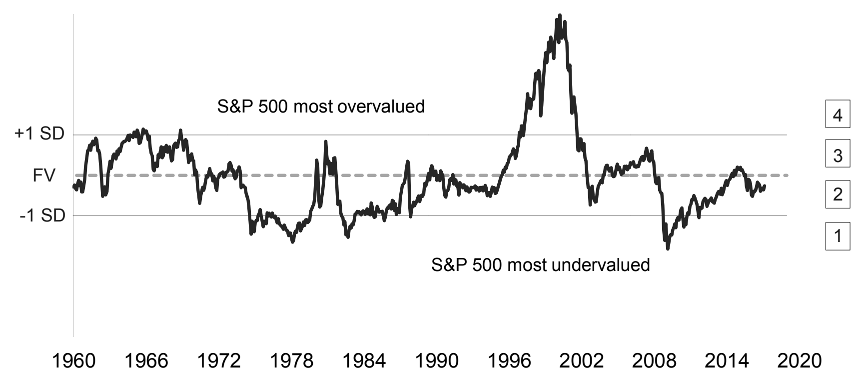
Stocks have historically delivered attractive returns when valuations are situated below our modelled estimate of fair value. Exhibit 67 plots a version of our S&P 500 equilibrium band that has been standardized, or stretched sideways, so that the midpoint of the band is represented by the dotted line running horizontally through the centre of the chart. We separated the chart into four buckets and calculated performance statistics over one-year time frames based on where the market was at the start of the measurement period (Exhibit 68). The S&P 500 is currently in Bucket 2 – lodged between equilibrium and one standard deviation below fair value. In this zone, the S&P 500 has, on average, generated the second-best returns, the highest frequency of positive monthly outcomes and the lowest

Exhibit 66: S&P 500 Index
Normalized valuation metrics, as at February 2017



Notes: Historical data from Jan 1956 for 12-M Trailing P/E, 12-M Forward P/E, Equity risk premium, Shiller P/E and Fed model. Historical data from Mar 1956 for market cap ÷ U.S. GDP. Historical data from Jan 1960 for RBC GAM fair value. Source: Haver Analytics, RBC CM, RBC GAM

Exhibit 67: Standardized S&P 500 fair-value bands



Source: Haver Analytics, RBC GAM

Exhibit 68: S&P 500 Index
Return prospects by valuation zone

Valuation	Data set (Bucket)	1-year average return	Batting average^	1-year average return in win*	Max loss	1-year return STD
(S&P 500 most overvalued)	4	(0.7%)	50.0%	14.8%	(27.5%)	17.0%
1 SD Above	3	3.4%	62.1%	13.0%	(41.4%)	15.6%
Equilibrium	2	12.0%	85.5%	16.0%	(44.8%)	13.8%
1 SD Below (S&P 500 most undervalued)	1	14.7%	80.2%	19.9%	(12.8%)	16.3%

*Win = Periods where returns are above 0%. ^Batting average = Incidence of winning in any given period. Source: RBC GAM volatility in subsequent one-year forward periods.

Earnings accelerate

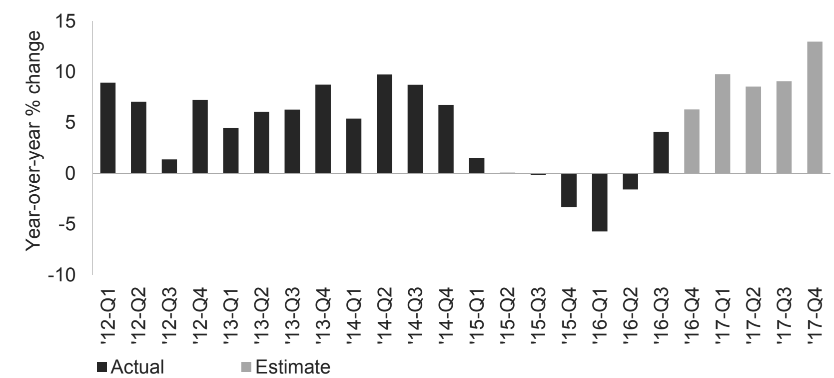
Recognizing that stocks are not as cheap as they were even several quarters ago, the fuel for further equity gains is likely to come from higher earnings and, fortunately, a recovery in profits is well underway. In fact, S&P 500 earnings exceeded analysts' estimates in the fourth quarter and now appear to be gathering additional momentum. The stabilization in the price of oil has been the key variable that has allowed corporate profits to resume their upward trajectory. Exhibit 69 shows a table of the dollar change in S&P 500 earnings per share coming from each of its underlying sectors, blended with estimates where actual data is not yet available. Notice that in 2015 and 2016, the Energy sector was the most significant drag on earnings and one of just two or three of the 11 sectors to have a negative impact. Looking ahead to 2017, analysts expect earnings to grow more quickly as the headwind from energy turns into a tailwind, and as all sectors contribute positively (Exhibit 70). While there are risks that some of Trump's protectionist policies could have a negative impact on earnings, significant gains are also possible if large-scale corporate-tax cuts materialize and the economy accelerates.

Exhibit 69: S&P 500 earnings per share
Yearly $ contribution to index by sector

Sector\Year	2014	2015	2016F	2017F
Technology	▲$2.53	▲$2.43	▲$0.44	▲$3.12
Financials	▲$1.45	▲$0.16	▲$0.29	▲$2.49
Health Care	▲$1.97	▲$2.01	▲$1.62	▲$0.94
Cons. Disc.	▲$0.70	▲$1.69	▲$1.61	▲$1.11
Industrials	▲$1.32	▲$0.43	▼$(0.09)	▲$0.88
Cons. Stpls.	▲$0.24	▲$0.06	▲$0.42	▲$0.58
Energy	▼$(0.00)	▼$(7.76)	▼$(3.79)	▲$4.04
Utilities	▲$0.22	▲$0.04	▲$0.18	▲$0.00
Telecom	▲$0.33	▲$0.37	▲$0.04	▲$0.05
Real Estate	▲$0.30	▲$0.31	▲$0.13	▲$0.21
Materials	▲$0.21	▼($0.25)	▼$(0.00)	▲$0.39
S&P 500	▲$9.27	▼$(0.51)	▲$0.84	▲$13.80
S&P 500 ex-Energy	▲$9.27	▲$7.24	▲$4.63	▲$9.76

Note: actual data for 2015 and prior, consensus estimates for 2016 onward. Based on a bottom-up aggregation of current index constituents. For real estate companies, funds from operations was used in place of earnings. Source: Bloomberg, RBC GAM

Exhibit 70: S&P 500 Index earnings per share
Quarterly earnings % change from same quarter in prior year



Source: Thomson Reuters, RBC GAM

The upside scenario for stocks

Assuming the economy and financial markets avoid negative shocks and earnings materialize as we expect, further gains for stocks are ultimately likely. To gauge the potential upside for the S&P 500, we consider consensus estimates in the context of our modelled equilibrium price-to-earnings ratio – the ratio historically consistent with current and expected levels of inflation, interest rates and corporate profitability (Exhibit 71). If the market trades at an equilibrium P/E of 18.6 and earns the current consensus top-down estimate of US$132.00 per share, the S&P 500 would reach 2455.60 by year-end and deliver a total return of 5.5% from the close on Feb 28, 2017. The same math applied to 2018 top-down estimates of US$147.00 would generate an S&P 500 Index reading of 2734.60, which would generate a total return of 19.3% over the next 22 months, or a compound annual return of 10.1% for the period.

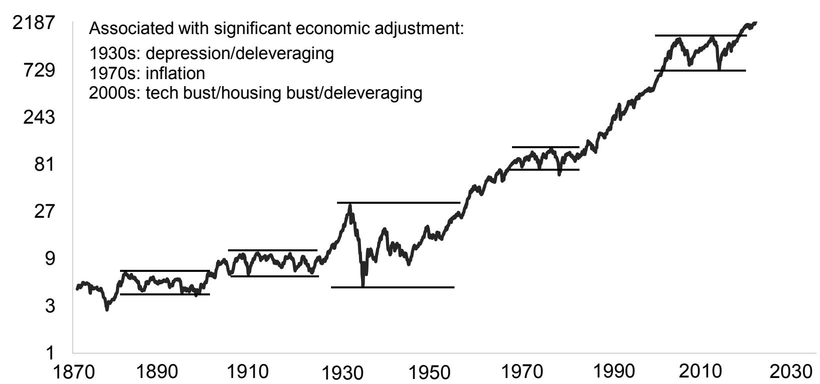
A look at long-term market trends since 1870 also suggests that the bias for equities is higher. Exhibit 72 shows that markets can go for decades without sustained upside progress, but these 'lost years' are usually followed by substantial moves higher. The early-2000s bear market began with the collapse of the technology bubble in 2000 and was followed by the global financial crisis in 2008-2009. The rally since the financial crisis led the S&P 500 to break decidedly above its pre-crisis peak and has

Exhibit 71: Earnings estimates and alternative scenarios for valuations and outcomes for the S&P 500 Index

		Consensus			
		2017 Top down	2017 Bottom up	2018 Top down	2018 Bottom up
	P/E	$132.0	$129.5	$147.0	$144.9
+1 Standard Deviation	22.9	3018.9	2960.6	3362.0	3314.2
+0.5 Standard Deviation	20.7	2737.3	2684.4	3048.3	3005.0
Equilibrium	18.6	2455.6	2408.2	2734.6	2695.8
-0.5 Standard Deviation	16.5	2173.9	2131.9	2421.0	2386.6
-1 Standard Deviation	14.3	1892.3	1855.7	2107.3	2077.3

Source: RBC GAM

Exhibit 72: Range-bound markets & cyclical bull phases
S&P 500 –1870-2017



Source: RBC GAM, Robert J. Shiller

Exhibit 73: U.S. secular bull markets

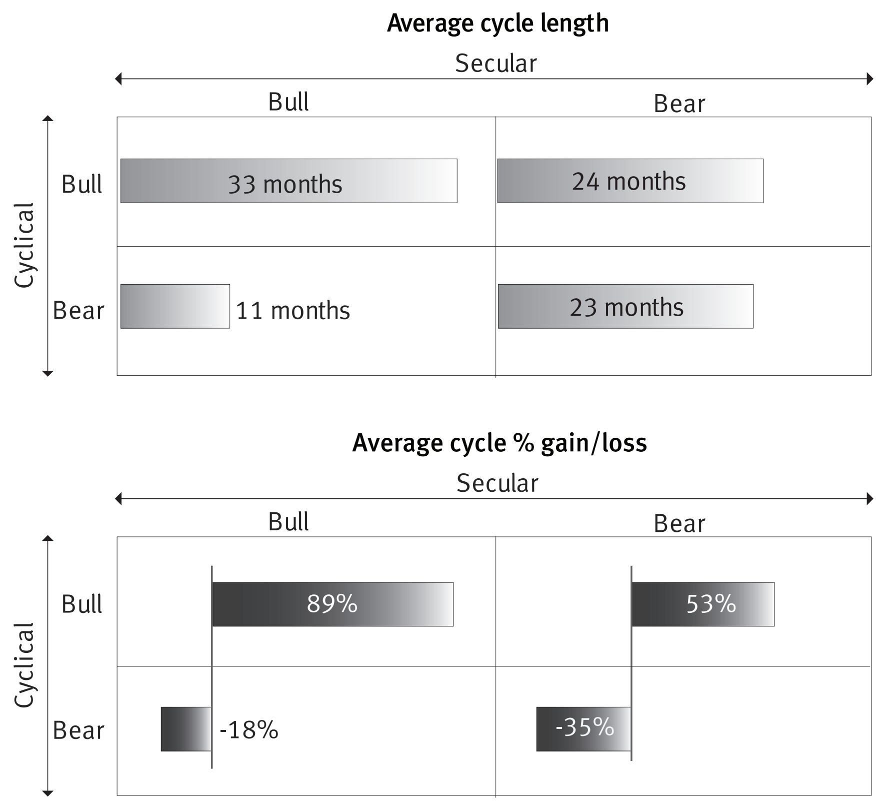
Secular bull market began	Secular bull market ended	Duration (years)	S&P 500 at cycle start	S&P 500 at cycle end	S&P 500 cycle % change
August 1896	September 1906	10.1	3.8	10.0	163%
August 1921	September 1929	8.1	6.5	31.3	385%
April 1942	November 1968	26.6	7.8	108.4	1282%
February 1978	August 2000	22.5	87.0	1517.7	1644%
Average		16.8			869%
Median		16.3			834%
Current cycle February 2009	?	8.0?	735.09	2363.64?	222%?

Note: uses Robert Shiller's historical U.S. stock market data since January 1870. Data based on monthly closing prices. Source: Robert J. Shiller, RBC CM, RBC GAM continued, opening up the possibility that we are in a secular bull market that began in 2009. Some analysts may argue that the equity rally is becoming extended, but at eight years, the current cycle is less than half the age of the average secular bull, and the tripling in stocks from their 2009 lows is meagre compared to average gains of greater than nine-fold for secular bull markets (Exhibit 73). The fact that we may be in a secular bull market is important because rallies are considerably longer and produce significantly more upside compared with rally phases during secular bear markets (Exhibit 74). Moreover, corrections in secular bull markets are half as deep and half as long relative to those in secular bear markets, and should be considered buying opportunities.

Style rotation loses thrust

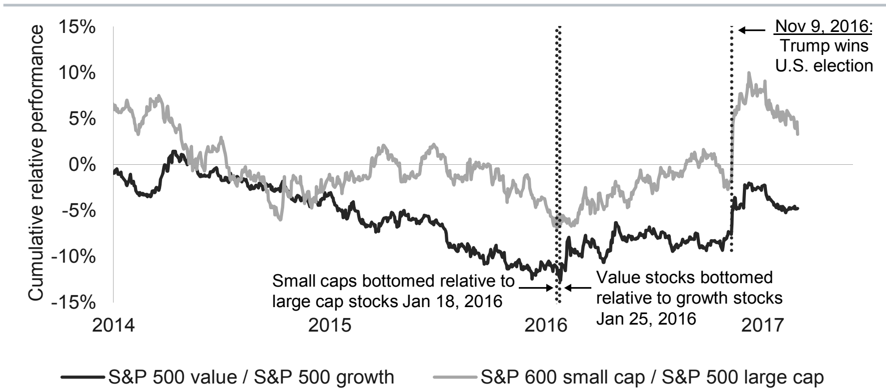
While our long-term view on equities remains positive, there are a variety of market trends that may signal a need for near-term caution. The massive rotation into small-cap and value stocks of 2016 has given up ground so far in 2017. As stocks rallied through 2016, we pointed out that the emergence of value and small-cap stocks predicted improvement in economic data and corporate profits, and those expectations ultimately came to fruition. This position was based on the fact that investors frequently turn to value stocks when economic growth is about to accelerate because they offer a cheaper way to capture earnings growth.

Exhibit 74: U.S. equity-market cycle statistics



Note: uses Robert Shiller's historical U.S. stock market data since January 1870. Data based on monthly closing prices. Source: Robert J. Shiller, RBC CM, RBC GAM

Exhibit 75: Relative style performance



Source: Bloomberg, RBC GAM

However, since the start of 2017, growth has outperformed value and large caps have outperformed small caps, representing lack of follow-through in 2016's style shift and, perhaps, a moderation in the positive outlook that rotation represented (Exhibit 75). Of course, this situation may simply indicate a pause within a longer-term move, or it could be cause for concern if the trend deteriorates further. A sustained shift toward large-cap and growth leadership may foreshadow a slowdown in the economy and/or corporate profits in the quarters ahead.

Asset mix – maintaining overweight equities and underweight bonds

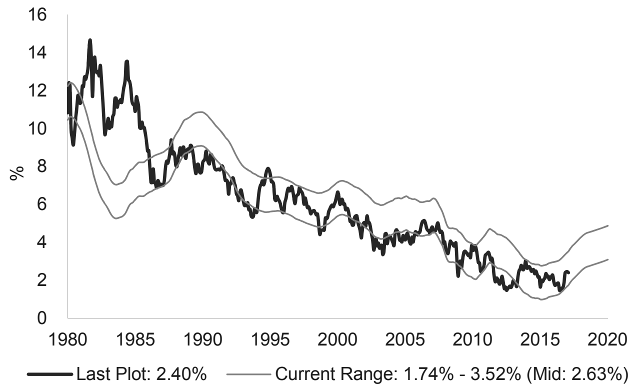
The macro backdrop for risk assets continues to improve given healthier economic data, firming inflation, rising consumer and business confidence, and accelerating corporate profits. Monetary-policy normalization is warranted under these conditions and a gradual increase in short-term interest rates likely won't derail the bull market in stocks. Risks to our outlook include the aging business and credit cycles, rising populist movements, higher interest rates, elevated Chinese debt loads and an ever-evolving and uncertain political landscape in the U.S. and Europe. We expect that the global economy will be able to absorb these risks and continue to grow and even accelerate, though still run at a pace below long-term historical norms.

Our outlook for sovereign fixed-income returns is uninspiring. As the domestic and global economies move ahead and painful memories of the financial crisis fade with the passage of time, real interest rates are likely to climb toward their long-term norm dragging nominal yields along. We expect government bonds to deliver low single-digit returns for an extended period, as coupon income is offset by falling bond prices. Equities, though, benefit from a growing economy through increasing corporate profits and dividend payments. A sustained expansion, even if slow, should encourage higher equity prices and keep the bull market in stocks alive. We expect stocks to generate mid to high single-digit returns through the forecast horizon.

We have maintained our long-standing overweight exposure to equities and underweight position in bonds. That said, stocks have had a significant run, valuations have moved higher, and the constructive style shift over the past year appears to have stalled. For these reasons we have trimmed our equity weight by one percentage point and allocated the proceeds to cash. For a balanced, global investor, we currently recommend an asset mix of 60% equities (strategic neutral position: 55%) and 38% fixed income (strategic neutral position: 43%), with the balance in cash.

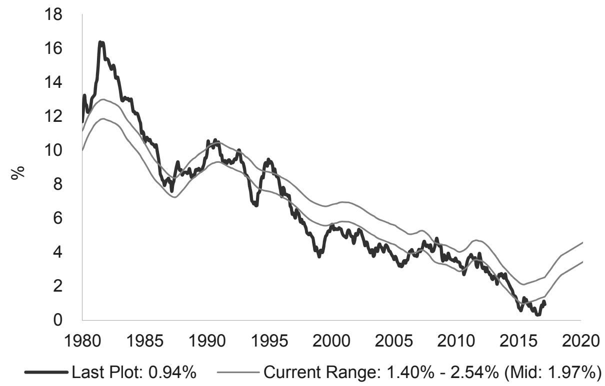
GLOBAL FIXED INCOME MARKETS

U.S. 10-Year T-Bond Yield
Equilibrium range



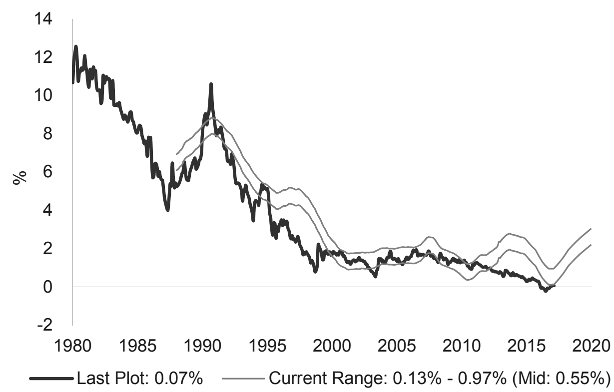
Source: RBC GAM, RBC CM

Eurozone 10-Year Bond Yield
Equilibrium range



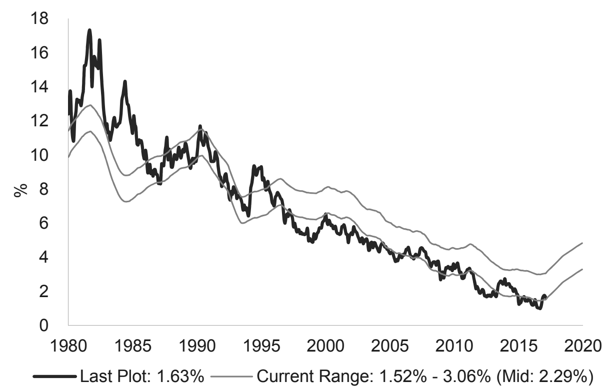
Source: RBC GAM, RBC CM

Japan 10-Year Bond Yield
Equilibrium range



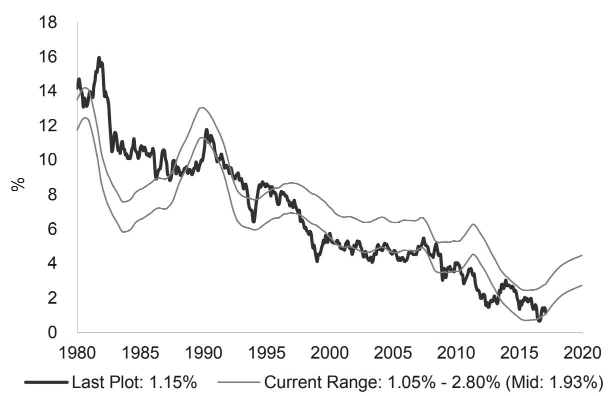
Source: RBC GAM, RBC CM

Canada 10-Year Bond Yield
Equilibrium range



Source: RBC GAM, RBC CM

U.K. 10-Year Gilt
Equilibrium range

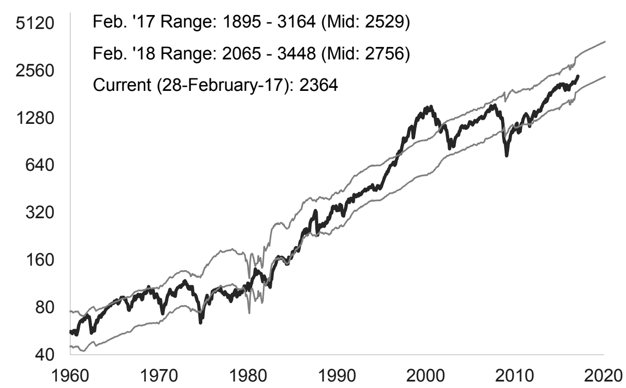


Source: RBC GAM, RBC CM

"Yields in the developed world remain historically low and are below our modelled estimate of equilibrium in all major regions."

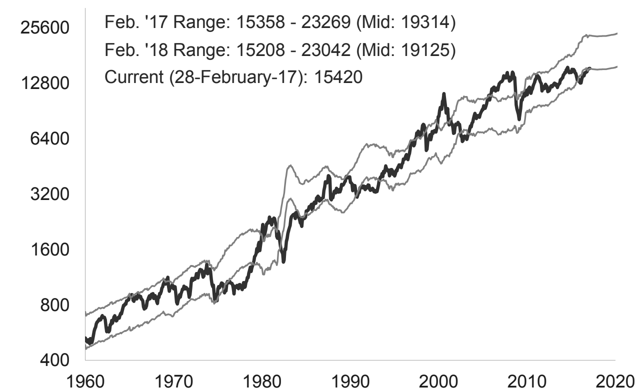
GLOBAL EQUITY MARKETS

S&P 500 Equilibrium
Normalized earnings and valuations



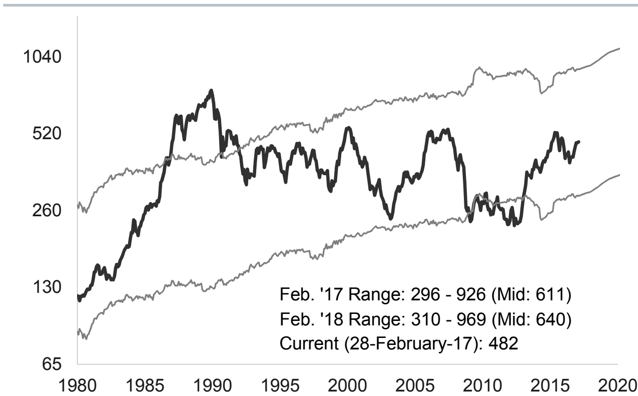
Source: RBC GAM

S&P/TSX Composite Equilibrium
Normalized earnings and valuations



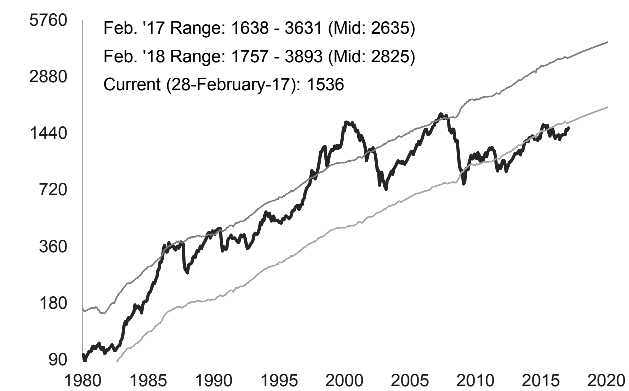
Source: RBC GAM

Japan Datastream Index
Normalized earnings and valuations



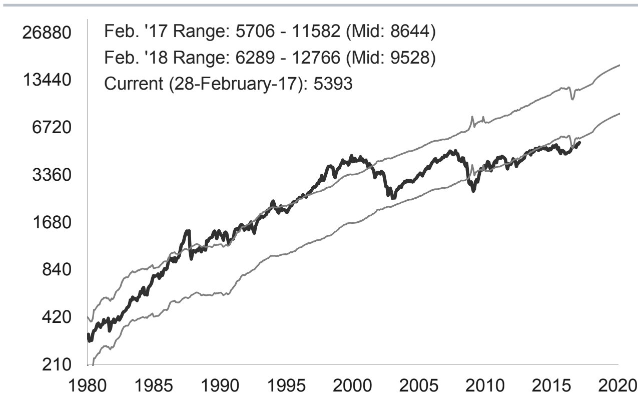
Source: Datastream, Consensus Economics, RBC GAM

Eurozone Datastream Index
Normalized earnings and valuations



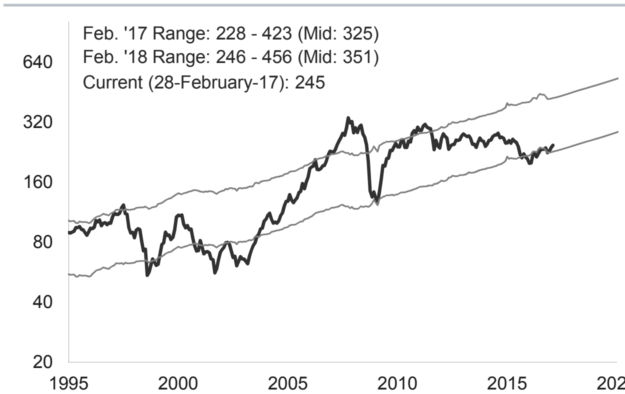
Source: Datastream, Consensus Economics, RBC GAM

U.K. Datastream Index
Normalized earnings and valuations



Source: Datastream, Consensus Economics, RBC GAM

Emerging Market Datastream Index
Normalized earnings and valuations



Source: Datastream, RBC GAM

GLOBAL FIXED INCOME MARKETS

Soo Boo Cheah, MBA, CFA
Senior Portfolio Manager
RBC Global Asset Management (UK) Limited

Suzanne Gaynor
V.P. & Senior Portfolio Manager
RBC Global Asset Management Inc.

Exhibit 1: 10-year yield has largely fluctuated between 2.30%–2.60% since the election of President Trump

Source: Bloomberg

Market view

The current era of relatively predictable fixed-income returns is coming to an end. After a decade of monetary-policy dominance, bond yields will, in our opinion, be increasingly driven by more traditional influences: fiscal policy; the rate of global economic growth; inflation; and politics, meaning the success or failure of the populist wave that appears to be sweeping the West. Forecasting bond yields in this highly complex environment will be much more challenging than was the case in the recent period of central-bank supremacy and relatively weak economic growth and inflation. The uncertainty associated with this new regime leads us to double our range of probable total-return forecasts over the next 12 months to between -4% and +6% from the -2% to +3% range that has been in effect since the financial crisis.

The yield on the 10-year U.S. Treasury bond increased significantly in the weeks after the presidential election amid expectations that fiscal stimulus and regulatory rollbacks would bolster economic growth. The 10-year yield has fluctuated between 2.30% and 2.60%, up from 1.82% the day before the election and as low as 1.35% in July 2016 (Exhibit 1).

The arguments for higher bond yields

The global economy is experiencing a cyclical recovery regardless of the political noise, and its performance should remain the key driver of fixed-income markets over the next 12 months. U.S. data releases have been strong and the employment picture continues to improve, leading many investors to prepare their portfolios for reflation. We believe that Trump's loosening of financial regulations should re-ignite the animal spirits that went missing after the 2008 financial crisis, creating self-sustaining economic growth. Corporate America will likely invest and hire more, pushing up the cost of capital and inflation.

Aiding this momentum will be an administration stocked with business-minded department heads and White House advisors. Trump has appointed Steve Mnuchin, a former Goldman Sachs executive, as Treasury secretary and billionaire investor Wilbur Ross to head the Commerce Department. Gary Cohn, the recently departed Goldman Sachs president, is Trump's top economic counsellor. These appointments help to validate the optimism towards streamlining regulations and promoting business investment.

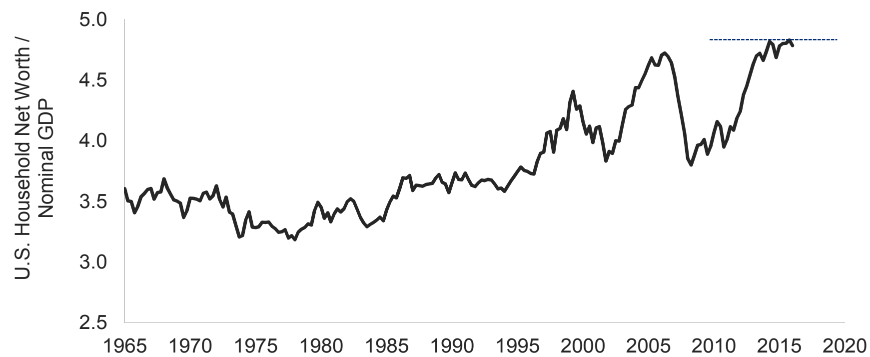
A tight labour market is another source of economic optimism and will foster inflationary pressures as higher wages embolden consumers to spend more. A higher-inflation, faster-growth environment would be a departure from the slow-growth mindset that has prevailed since 2012.

Assuming that the government spending materializes as advertised and stokes economic growth, we would expect yields to be pulled higher by competition for capital between Treasury bonds and businesses and individuals seeking loans. Here's why: capital must be financed either from abroad and/or with domestic savings, and administration proposals aimed at reducing imports would increase the importance of domestic savings as a source of capital. Domestic private savers as a group tend to demand higher compensation for loans than foreign entities, potentially leading to higher rates as growth quickens.

In the upbeat economic scenario, we would expect the U.S. Federal Reserve (Fed) to be much less cautious with monetary tightening, and benchmark rates could rise at a much faster rate than the once-per-annum experience of 2015 and 2016. The yield curve would flatten rapidly were the Fed to raise rates at a pace that is faster than any rise in longer maturities.

In addition to entertaining interest-rate increases, the Fed will have to examine how and whether it can reduce the US$4.2 trillion of bonds that it holds, 57% of which is invested in U.S. Treasuries. Fed officials have indicated they might start the process of shrinking the balance sheet if economic growth is sufficiently strong. We do not believe, however, that they will get very far as interest rates would likely increase and force a pullback to avoid weakening the economy. Moreover, capital rules introduced after the financial crisis require banks to hold excess reserves, and would make it difficult for the Fed to pare its balance sheet. We expect the Fed to telegraph any intention to trim its bond assets to avoid a scare that could rapidly drive up interest rates.

Exhibit 2: U.S. economic growth cannot disappoint if asset prices are to remain high



Source: Bloomberg

The case for higher yields suggests that the U.S. Treasury 10-year yield could rise to between 3.00% and 3.50% over the next 12 months, and in the process pull up yields of other developed-market bonds. A scenario of self-sustaining U.S. economic growth would enable the European Central Bank (ECB) and the Bank of Japan (BOJ) to scale back their bond purchases and allow bond yields to rise globally.

The arguments for lower yields

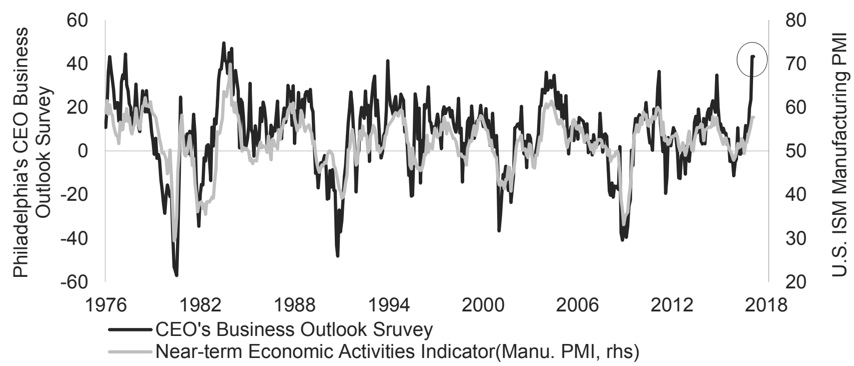
Factors that could drive government yields lower are risks emanating from somewhat elevated valuations for stocks and non-government bonds, as well as a contrarian interpretation of some economic data. Higher valuations expose riskier assets to the impact of disappointing economic growth or earnings shortfalls, in which case investors might abandon riskier assets for the safety of government bonds.

One sign of this situation is today's historically high reading of U.S. household net worth as a percentage of GDP (Exhibit 2). Moreover, S&P 500 price-to-earnings multiples are at their highest in 15 years. Another telling point: the Federal Reserve Bank of Philadelphia's CEO business-outlook survey for January reached its most optimistic level since the early 1980s. The survey tends to correlate with purchasing managers' indexes, an indicator of near-term economic performance, and together they send a cautious contrarian signal (Exhibit 3).

Since the election of President Trump, investors have been increasing exposure to riskier assets, seemingly ignoring their risks, among them the possibility that the president and Republican lawmakers are unable to agree on regulatory and fiscal legislation.

Another argument against higher yields is the possibility that higher inflation does not materialize. After all, the increase in inflation that has taken root over the past 12 months was due more to the overall rise in commodity prices than the inflationary impact of a sustainable expansion, and inflation is therefore likely to be limited if oil prices remain near current levels. The earlier period of monetary-policy dominance coincided with falling commodity prices, and this disinflationary environment touched off one of the biggest equity rallies in history as valuations surged. For now, with inflation and bond yields rising and commodities prices firm, investors still think equity prices are headed higher, this time because of expectations that revenues are about to accelerate. Are stock investors too optimistic? If so, a prudent portfolio approach is to start acquiring government bonds as insurance against a pullback in riskier assets.

Exhibit 3: Peak in business optimism is usually followed by a near-term peak in economic activity



Source: Bloomberg

Investors should also keep in mind the disinflationary experience of Japan in recent decades, and in recent years the failure of Japanese policymakers to achieve their 2% inflation target even with massive fiscal stimulus and years of easing by the BOJ. Like Japan, the U.S. economy is still highly indebted and low interest rates have helped keep the banking system afloat. Like Japanese Prime Minister Abe, Trump is a fan of deregulation to spur growth, but we remind investors that such policies have yet to bear much fruit in Japan.

More generally, increases in inflation-adjusted yields will be limited by aging populations, with their preference for saving; huge accumulations of bonds by central banks; and the generally low-capital nature of investment, all of which will continue to keep a lid on how high bond yields can go. Our research and Japan's experience suggest that when private and government indebtedness are high, real interest rates must stay low for an extended period. The Fed's determination to go slow on interest-rate increases means that it will likely continue to err on the side of caution and, as things stand, we expect the U.S. central bank to raise rates two times in 2017, one fewer than the median of Fed member forecasts.

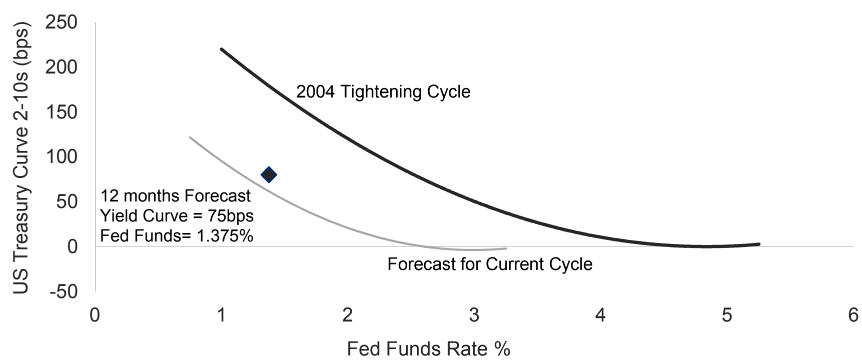
All these arguments suggest that global rates could remain trapped within the ranges established over the past five years, with investors earning coupons.

In sum, bond bears are sure to be warmed by the likelihood that volatility will be higher than it has been for many years as investors struggle to adjust their expectations to the unfolding political and economic uncertainties. For bond bulls, the longevity of the rally will offer comfort that things will continue as they have. While monetary policy may not get as much attention, the size of the Fed's balance sheet will be impossible to ignore. As a result, the bearish case is restrained, with the outlook for Treasury yields to be 50 to 100 basis points higher. The bull case is 50 to 80 basis points lower. We find ourselves at an inflection point, and the range of possible yields is now wide enough that we are uncomfortable taking an aggressive view on where rates are headed.

Direction of rates

We anticipate higher-than-normal volatility in bond markets. Investors are torn between the promise of faster economic growth, on the one hand, and uncertainty created by the Trump administration and the possibility of additional populist victories in Europe, on the other. We assign a slightly higher probability to the bear case but acknowledge the uncomfortably meaningful odds of the bullish one.

Exhibit 4: Yield curve is expected to flatten to 75bps from 120bps currently



Source: RBC GAM

We are raising all bond-yield forecasts slightly and expect most central banks to be more open to tighter policy as economies firm. We expect the Fed to extend its nascent efforts to boost rates in the next 12 months and assume the ECB will most likely scale back bond purchases after German elections in September. The BOJ is likely to increase its yield target on 10-year Japanese government bonds (JGBs) if the Fed and the ECB deliver on tightening, while Bank of England (BOE) policy will rest more on the need for preparations to withdraw from the EU. The Bank of Canada (BOC) is the most likely to stay sidelined because the Canadian economy faces a possible cooling of the domestic housing market and protectionist efforts in the U.S.

U.S. – We expect the Fed to deliver three hikes in the fed funds rate over the next 12 months. The Fed will be assessing the potential for the expected Trump fiscal-stimulus package and regulatory reforms to stoke inflation. In any event, the U.S. central bank will be cautious in its tightening. Investors also should not be unduly alarmed by Trump's choices for Fed vacancies since we believe that new members will be under pressure to focus on the Fed's twin mandates of inflation and jobs. To ignore economic reality would risk sending the U.S. economy into a tailspin.

A year from now, we expect the yield curve to have flattened as policy rates continue to rise. Our model suggests that the gap between 2-year and 10-year Treasuries will narrow to 75 basis points over the next 12 months from 120 basis points currently (Exhibit 4). We peg the 10-year yield forecast at 2.50%, based on the average of the midpoint of the bull and bear cases. The fed funds rate will rise to 1.375% from about 0.66%, in our view.

Germany – European political concerns and the ECB bond-purchase program remain the factors holdings down bund yields. The Dutch and French will hold general elections in the spring and Germany in the autumn. Italy could call for an election sometime after Easter. A flare-up in European politics and renewed questions about whether the EU can survive over the long term are likely to dominate investor concerns. In that case, German bunds would benefit from a flight to safety, while spreads in other markets would widen in a sign of investors' nervousness.

Our assumption is that anti-EU sentiment subsides after the busy election season. At this point, the brightening economic outlook will take centre stage and the ECB could well start to reduce the pace of bond purchases, probably beginning in 2018. We expect European inflationary pressures to ebb as long as energy prices do not increase much from current levels. Low wage growth, high unemployment and economic slack will also conspire to keep inflation low. We expect ECB policymakers to keep the benchmark deposit rate at negative 0.40%, and our forecast for the 10-year bund yield increases to 0.75%, 0.35% higher than our previous forecast.

Japan – The BOJ may become more flexible in its current policy, which centers on controlling the yield curve, as Treasury yields rise and the ECB prepares to pare the pace of bond purchases. The BOJ is currently targeting the 10-year JGB yield near 0% with total annual purchases of 80 trillion yen (US$700 billion). With prospects for global growth shifting higher, we expect the BOJ to keep its official target on the 10-year JGB at 0.00%, but to allow it to stray higher to 0.10%. We maintain our deposit-rate forecast at negative 0.10%.

Canada – The outlook for the Canadian economy has improved over the past 12 months, due in part to the increase in oil prices above US$50 a barrel. The economy's prospects will likely be restrained, however, by high household debt and soaring prices for residential real estate. In Vancouver, stricter mortgage rules and a new sales tax on purchases by non-residents have slowed that market somewhat, but Toronto sales and prices continue to rise to record levels. The cordialness of the recent meeting between Prime Minister Trudeau and President Trump has led many investors to believe that Canada may end up avoiding some of the U.S. president's protectionist policies, which in any case seem aimed mainly at Mexico and China.

INTEREST RATE FORECAST: 12-MONTH HORIZON

Total Return calculation: February 28, 2017 – February 28, 2018

U.S.

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	1.38%	1.75%	2.00%	2.50%	3.10%	1.4%
Change to prev. quarter	0.50%	0.30%	0.15%	0.25%	0.05%	
High	1.88%	2.75%	3.00%	3.25%	3.75%	(2.8%)
Low	0.38%	0.75%	1.00%	1.50%	2.20%	7.2%
Expected Total Return US$ hedged: 1.57%						

GERMANY

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	(0.40%)	(0.10%)	0.20%	0.75%	1.30%	(3.86%)
Change to prev. quarter	0.00%	0.00%	0.05%	0.35%	0.40%	
High	0.00%	0.65%	0.80%	1.25%	1.60%	(7.50%)
Low	(0.40%)	(0.50%)	(0.25%)	0.00%	0.50%	3.65%
Expected Total Return US$ hedged: (2.09%)						

JAPAN

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	(0.10%)	(0.10%)	(0.05%)	0.10%	0.95%	(1.02%)
Change to prev. quarter	0.00%	0.00%	0.00%	0.10%	0.35%	
High	0.00%	0.10%	0.10%	0.25%	1.10%	(3.06%)
Low	(0.10%)	(0.10%)	(0.10%)	(0.10%)	0.50%	4.56%
Expected Total Return US$ hedged: 0.93%						

CANADA

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.50%	0.90%	1.15%	1.75%	2.40%	1.57%
Change to prev. quarter	0.00%	0.00%	0.15%	0.25%	0.40%	
High	1.00%	1.50%	1.70%	2.25%	2.75%	(2.02%)
Low	0.25%	0.25%	0.50%	1.00%	1.75%	7.97%
Expected Total Return US$ hedged: 1.81%						

U.K.

	3-month	2-year	5-year	10-year	30-year	Horizon return (local)
Base	0.25%	0.60%	1.00%	1.50%	2.25%	(4.42%)
Change to prev. quarter	0.00%	0.00%	0.00%	0.00%	0.05%	
High	0.50%	1.00%	1.75%	2.50%	3.00%	(13.17%)
Low	0.00%	0.00%	0.25%	0.50%	1.40%	7.41%
Expected Total Return US$ hedged: (3.16%)						

Source: RBC GAM

However, any “tweaks” to the NAFTA trade agreement would bear watching.

Demand from international investors has helped buoy Canadian bonds in recent years as Canada is one of the few countries with a AAA rating. Japanese purchases reached a record in 2016, totaling more than the previous 10 years combined. Since late last year, however, demand has fallen off because of rising hedge costs. The uncertainty surrounding U.S. policy adds to the reasons that the BOC will almost certainly be sidelined for another year. BOC Governor Stephen Poloz has even said a rate cut is “on the table” if economic risks materialize. As is usually the case, we expect longer-term bond yields to move in the same direction as their U.S. counterparts, but at a slower pace.

Our 12-month forecast for the BOC policy rate is unchanged at 50 basis points. However we have raised our forecast for the 10-year government bond to 1.75% from 1.50% given the rise in U.S. rates.

U.K. – Following Brexit, the BOE faces the worst economic scenario among the major developed economies. A weak currency is leading to higher inflation and businesses are delaying investments amid uncertainty about the U.K.’s relationship with its biggest trading partner, the EU. Further significant softening in investment sentiment, economic activity and consumption could prompt the BOE to deliver another round of easing in 2018. For the time being, we expect the BOE to keep its policy rate at 0.25%, and our 10-year gilt yield forecast stays at 1.50%.

Regional preferences

We are changing our regional recommendation to overweight U.S. Treasuries by five percentage points and underweight German bunds and JGBs by 2.5 percentage points each. The optimistic scenario is generally priced into Treasuries, while bunds and JGBs should play catch up.

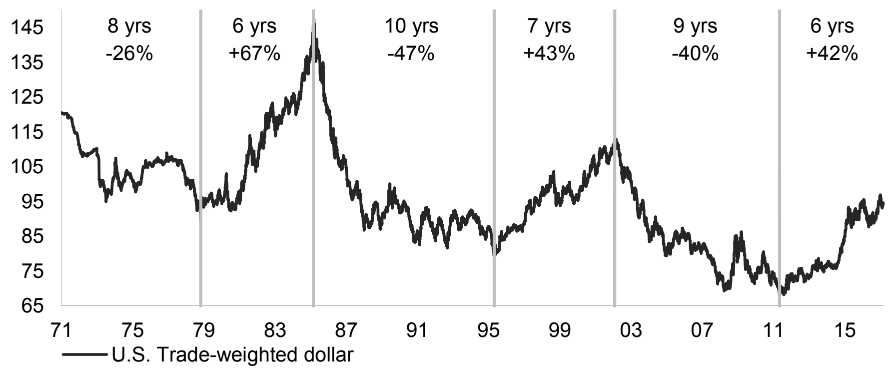
CURRENCY MARKETS

Dagmara Fijalkowski, MBA, CFA
Head, Global Fixed Income & Currencies
(Toronto & London)
RBC Global Asset Management Inc.

Daniel Mitchell, CFA
Portfolio Manager
RBC Global Asset Management Inc.

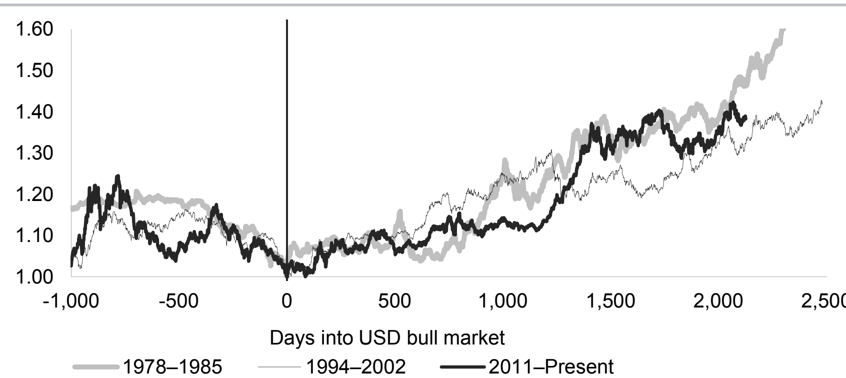
Taylor Self, MBA
Analyst
RBC Global Asset Management Inc.

Exhibit 1: U.S. trade-weighted dollar index



Source: U.S. Federal Reserve

Exhibit 2: U.S. dollar bull markets



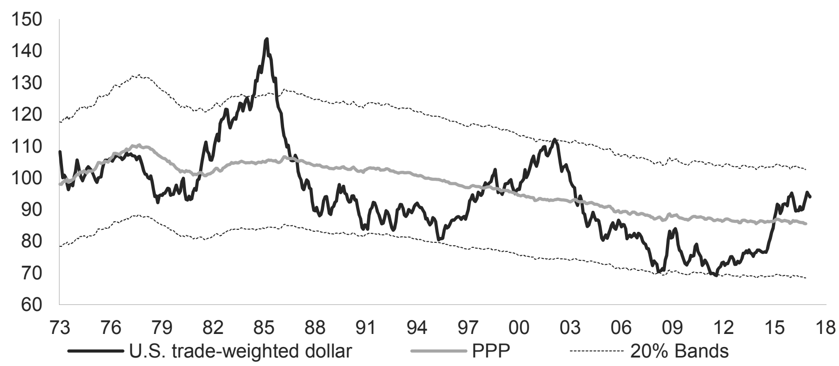
Source: Bloomberg, RBC GAM

The U.S. dollar bull market remains in full swing. Since the greenback bottomed in mid-2011, many factors have contributed to its upward path, several of which are still in place today even as the long-term cycle matures. Moreover, other currencies remain hampered by domestic factors: weaker growth profiles, political uncertainty and easier monetary policy. Our forecasts for the greenback call for modest, single-digit gains versus other developed-market currencies.

The two previous bull markets lasted six and seven years, and the increases were 67% and 43% from bottom to top, respectively (Exhibit 1). Bull markets are traditionally supported by stronger levels of economic growth and higher interest rates in the U.S. than abroad – two elements that are still supportive today. Compared with past cycles, the experience since the dollar bottomed in 2011 looks remarkably familiar (Exhibit 2). A long bottoming process started in May 2011, followed by phases of a steady appreciation, a furious rally and more recently, the establishment of a comfortable range. The current stage seems to be nearing its end with the trade-weighted dollar rising above the consolidation range.

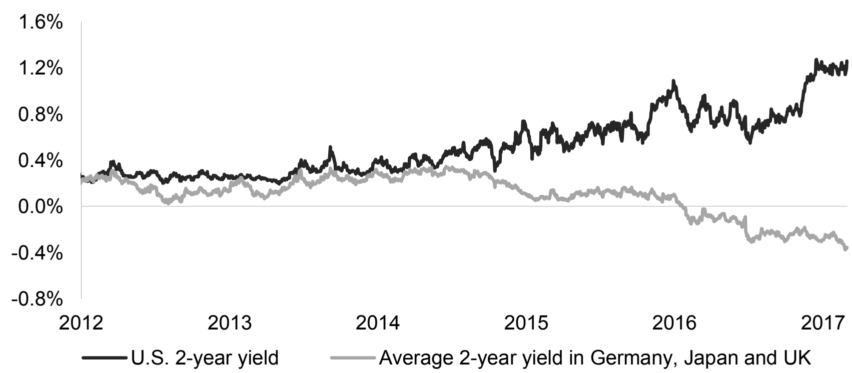
Cycles help dictate our strategic bias on the U.S. dollar over longer time periods, while tactical risks to the U.S. dollar may come in and out of focus. At the moment, we are wary of several short-term risks to further greenback strength: the failure of economic data to continue surpassing expectations, an improvement in economic growth abroad and the possibility that vacant seats on the U.S. Federal Reserve's (Fed) monetary policy board will be filled by dovish members. However, it is longer-term fundamentals that drive our forecasts for the direction of exchange rates over the coming year. And it is these fundamental factors – valuations, relative monetary policies and demand for U.S. dollars – that we believe will remain supportive for the greenback this year.

Exhibit 3: U.S. dollar purchasing power parity



Source: RBC GAM

Exhibit 4: Wider interest-rate differentials
U.S. versus other developed countries



Source: RBC GAM, Bloomberg

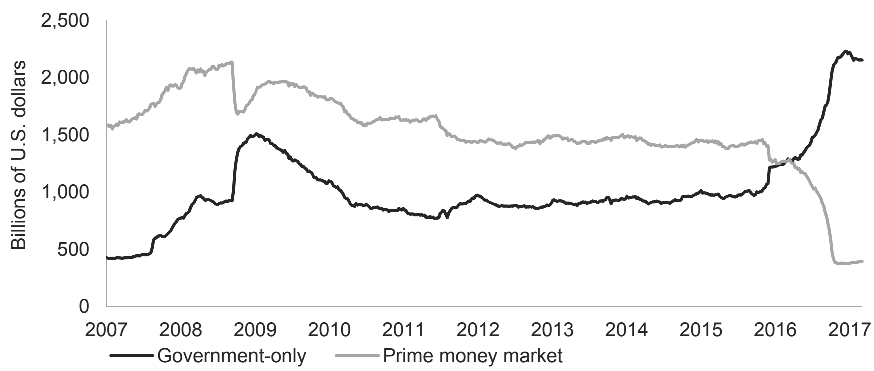
While our valuation models suggest the U.S. dollar is about 10% overvalued, we should note that the greenback is correcting from an extremely undervalued position. Valuations can be estimated in a variety of ways. Our favoured measure is the simple purchasing power parity model, which evaluates whether a basket of goods is attractively priced in one country relative to another. The model assumes that both consumers and corporations setting up production facilities will seek to acquire goods and services as cheaply as they can. Theoretically, a country with a cheaper overall basket of goods should experience higher demand for its currency and thus a strengthening of the exchange rate until price parity exists between goods in both countries. In reality, factors such as tariffs and transportation costs mean that significant deviations from the “parity” exchange rate are required for broad shifts in purchasing to occur. A 20% deviation from fair value has historically marked that level (Exhibit 3). Based on purchasing power parity, most currencies tend to travel from one extreme to another over the course of several years, passing through fair value along the way. Given the U.S. dollar’s current valuation, it will be necessary for the greenback to continue strengthening for the global procurement and purchasing patterns to shift.

While economic growth in the developed world has improved, the U.S. economy continues to outshine its peers. As a result, we believe that monetary-policy divergence will continue, with the Fed gradually raising rates at the same time that almost every other developed-market central bank holds interest rates near crisis lows. This is reflected in widening interest-rate differentials (Exhibit 4) in the face of the continued quantitative easing being conducted by the European Central Bank (ECB), Bank of Japan (BOJ) and Bank of England (BOE).

Finally, demand for U.S. dollars is rising, while supply is being constrained by several changes in the structure of the market. Being the world’s primary reserve currency, the U.S. dollar is used extensively by foreigners as a unit of account, a means of exchange and a store of value. In the Eurodollar market, an immense amount of borrowing and lending occurs in U.S. dollars outside American borders, and this market relies on a sufficient supply of U.S. currency to function properly. Plentiful liquidity helps keep interest rates low and grease the wheels of commerce and lending.

Conversely, a lower global supply of dollars can cause a tightening of financial conditions and raise the cost of borrowing. Money-market fund reforms last fall resulted in a US$1 trillion reduction in the amount of widely-available dollar funding (Exhibit 5) that has historically supplied the Eurodollar market, and tighter U.S. financial regulation has made it more expensive for U.S. banks to make loans abroad. Supply could be further dented by a proposed corporate U.S. tax holiday, which would encourage multi-national firms to bring home a growing pile of profits earned abroad. In sum, there is a growing disparity between the global supply and demand for dollars, the result of which should be a higher cost of funding and further yield support for the greenback.

Exhibit 5: Changing composition of money markets



Source: I.C.I.

Beyond these three slow-burning supports for the U.S. dollar is a fourth: policies proposed by Congressional Republicans could be a very powerful force in currency markets. Deregulation, fiscal spending, tax policy and profit repatriation all have the potential to boost economic growth or increase the attractiveness of the U.S. as an investment destination. Of particular relevance are plans to introduce border-adjustable taxation (BAT), a policy that could dramatically alter the way U.S. corporate tax is paid. Under these plans, American companies would be taxed on the value of goods imported, providing incentives for U.S. firms to move manufacturing back home. This matters for currency markets because the introduction of BAT would immediately make foreign goods far more expensive than domestic alternatives, and currencies would weaken against the U.S. dollar to restore competitiveness. There is, of course, disagreement as to whether BAT can be enacted. President Trump is wary of its complexity while others in the White House are more supportive of the plan. Our forecasts reflect this uncertainty and conservatively assume that the U.S. dollar is set to gain 5% to 10% versus other developed-market currencies over the next 12 months, as traditional drivers put upward pressure on the greenback and bold policy choices by the new U.S. administration serve to extend the cycle. Some estimates suggest that BAT could cause the greenback to strengthen by 10%-15% over a short period, an upside risk to our forecasts.

The euro

We expect the euro to weaken over the next 12 months, eventually reaching parity with the U.S. dollar. Policy divergences between the Fed and the ECB will continue to tilt the outcome in favour of euro weakness. In addition, heightened political risks in 2017 will weigh on the value of the currency.

Underpinning our weaker-euro stance is the assumption that the ECB will continue to provide substantial monetary stimulus. The ECB's bond-purchase program should continue through the end of 2017. ECB President Mario Draghi has said he remains particularly attuned to downside economic risks in contrast to a more optimistic Fed, which we expect to raise interest rates gradually over the next year.

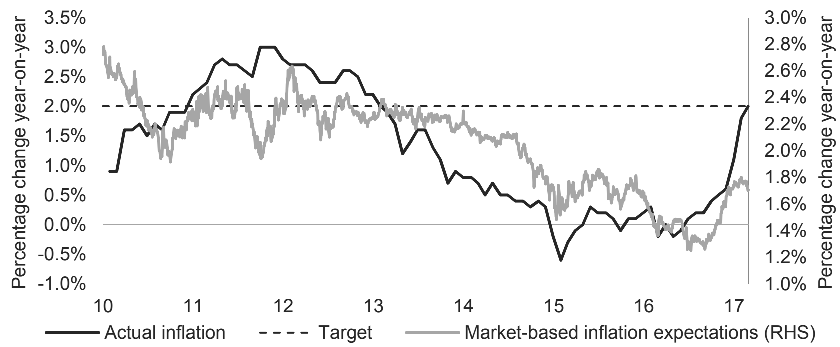
An important consideration for the ECB is the lacklustre outlook for inflation in the Eurozone. While headline inflation approached the ECB's target of 2% in January, this mostly reflects the end of year-on-year declines in energy prices. Meanwhile, core inflation is low and stable, indicating modest upward pressure on prices. In addition, while inflation expectations have risen, they have done so only modestly and remain well below the ECB's 2% target and expectations from a few years ago (Exhibit 6).

If the price of oil remains near current levels, the impact of higher energy prices should retreat quite quickly, leaving the ECB facing a tepid inflation outlook once again. The ECB has stated that it will not worry about the temporary impact of higher headline inflation due to energy prices as long as underlying measures of core inflation remain contained.

Another reason for the ECB to keep policy accommodative is the uneven performance of European economies. While Germany's economy exhibits almost no slack, major economies such as France, Italy and Spain have substantial idle capacity (Exhibit 7). We expect that the ECB will err on the side of easier monetary policy to aid the fortunes of these economically weaker members of the Eurozone.

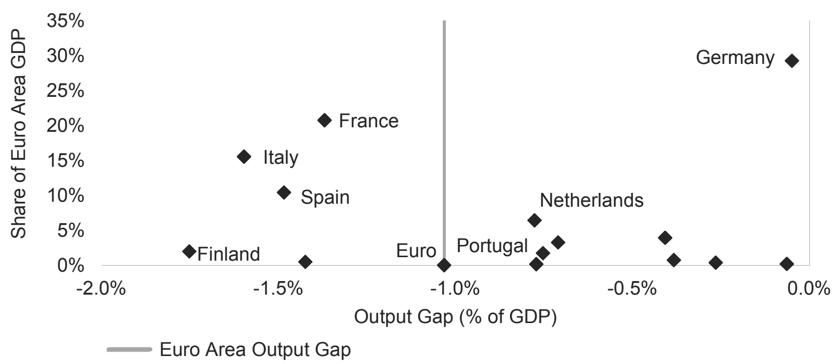
The benefits of ECB easing and accelerating global growth could be lost on Europe if political uncertainty does not abate (Exhibit 8). Europe is saddled with a busy 2017 political calendar, with general elections scheduled in the Netherlands, France and Germany. The possibility of early elections in Italy also exists. The impact of political risk will be

Exhibit 6: Eurozone inflation and expectations



Source: Bloomberg, RBC GAM

Exhibit 7: Output gaps are still large in key Eurozone countries



Source: European Commission

threefold. First, reform efforts could founder as politicians defer hard policy choices to improve their election odds. Second, consumer confidence and business investment will take a hit, impairing growth. Finally, the value of the euro will be weighed down by a higher political-risk premium.

These political risks and subdued inflation suggest that the ECB will maintain its accommodative policy stance. The continued monetary easing will stand in stark contrast to the gradually increasing rates that we expect from the Fed, and this should result in a weaker euro.

The pound

The British pound has fallen 15% versus the U.S. dollar since the Brexit vote in June, and we believe sterling has further to fall. While the more dire growth predictions have not come to fruition, inflation has accelerated to a three-year high due to higher energy prices and substantial pass-through from the pound's depreciation (Exhibit 9). The BOE has indicated that it will accept a prolonged period of above-target inflation in order to offset an expected weakening of economic activity. The robust consumer spending that followed the referendum was likely driven by individuals completing major purchases before expected price increases. Going forward, we expect higher inflation to reduce the purchasing power of households and uncertainty surrounding EU exit negotiations to undermine business investment. The combination of slower growth and faster inflation bodes ill for the pound's fortunes.

Uncertainty regarding what the U.K.'s relationship with the EU will look like after exiting will also weigh on the pound. The U.K. government has prioritized control over its borders, a position that may come at the cost of losing preferential access to the EU as an export market. The disruption is already being seen in the financial-services industry, a major contributor to the U.K. economy, as several large employers consider relocating personnel to Frankfurt or Paris.

Faced with the loss of access to the EU's single market, the U.K.'s attractiveness as an investment destination has almost certainly been impaired. Moreover, domestic businesses are more likely to hold off on major investments as long as the exact nature of the U.K.-EU relationship is up in the air.

Exhibit 8: Eurozone political uncertainty and business investment

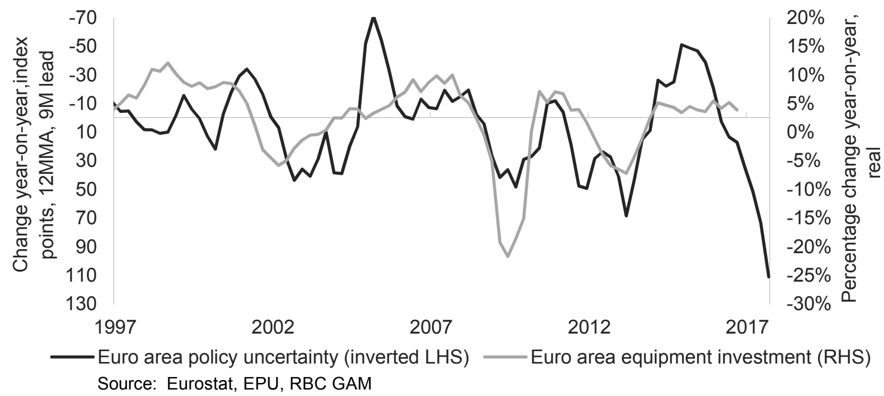
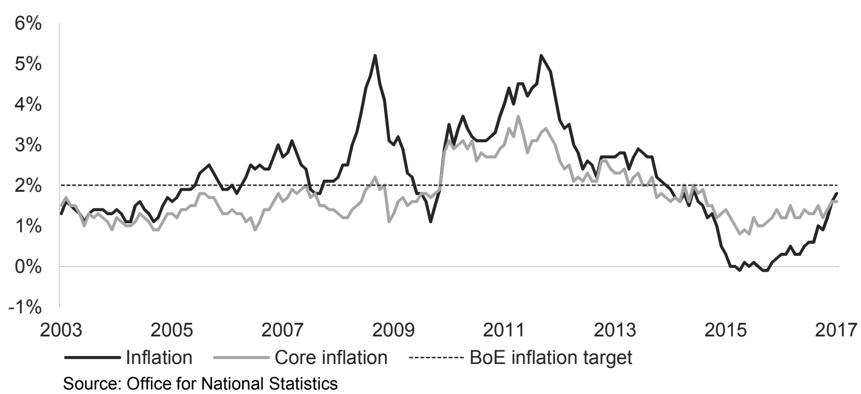


Exhibit 9: U.K. measures of inflation



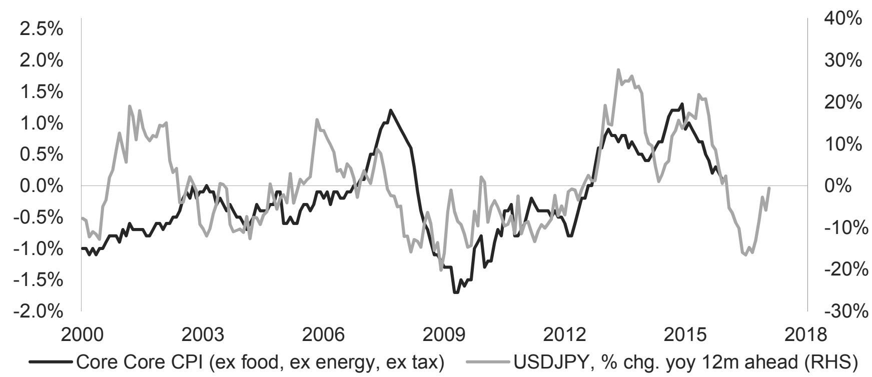
With the backdrop of the unappealing prospects of lower economic growth and rising inflation, the U.K. must contend with a current-account deficit that ranks among the largest in the world. Prior to the Brexit referendum, the U.K. had managed to easily finance its current-account deficit due to its relative attractiveness vis-à-vis Europe. However, much of the deficit is relatively insensitive to currency movements and the arguments for investing in the U.K. have weakened, so a further decline in the pound may be needed to restore greater balance. We expect the pound to extend its decline to 1.15 against the U.S. dollar over the next year.

The yen

We expect the BOJ, similarly to the ECB, to continue supplying substantial monetary stimulus for some time. That's because better-than-expected Japanese economic activity has been due to improved exports rather than a domestic demand-led cyclical upturn. Meanwhile, the inflation picture for Japan remains decidedly dour. We do not expect the BOJ to change its policy stance as long as inflation remains below target – and the evolution of the yen suggests that this could be some time coming (Exhibit 10).

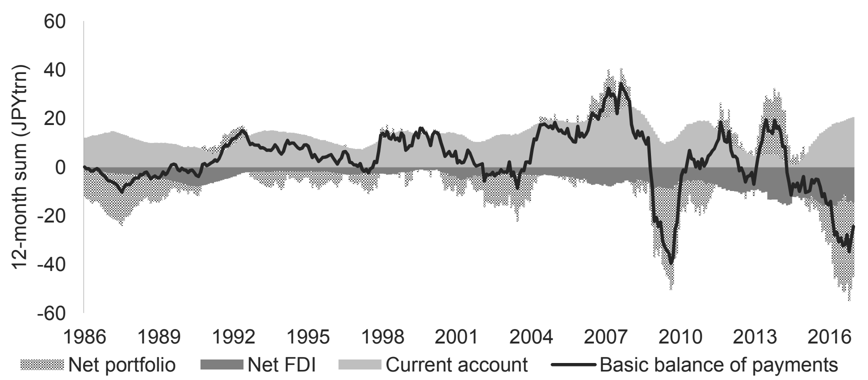
The BOJ last year shifted policy to focus on targeting the yield on the 10-year Japanese government bond, a policy known as "yield-curve control" (YCC). Under YCC, the 10-year yield is targeted at 0%, plus or minus 10 basis points. While the BOJ has so far kept earlier commitments to expand its asset holdings by 80 trillion yen (US$700 billion) per year, the credibility of the new program has become the overriding concern for market participants. As we highlighted in the last *Global Investment Outlook*, the net effect of the BOJ's framework has been to lower the volatility of JGBs and increase the relevance of monetary-policy divergence for yields and currency values. With the Japanese yield curve relatively constrained, movements in the yen have become a function of U.S. interest-rate changes. Indeed the yen has strengthened almost to pre-election levels as longer-term U.S. interest rates have fallen. This appreciation creates difficulties for the BOJ, which will now find it harder to stimulate inflation at all, let alone reach the 2% target. We believe the BOJ will need to maintain accommodative policy for some time in order to achieve its target.

Exhibit 10: Japan inflation impulse from currency movements



Source: BOJ, Bloomberg, RBC GAM

Exhibit 11: Japan's basic balance of payments



Source: BOJ, Ministry of Finance, RBC GAM

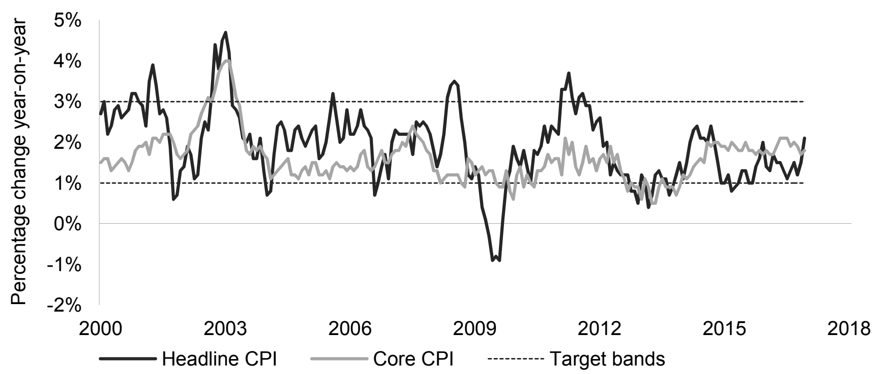
Meanwhile, we expect capital outflows from Japan to continue apace. This is important, as these outflows need to offset a sizeable current-account surplus (Exhibit 11). These flows will represent M&A activity by Japanese firms looking for growth abroad and domestic investors seeking higher returns in foreign assets as the BOJ continues to buy substantial amounts of JGBs. In addition, rising political risks in Europe may lead Japanese investors to reroute their funds to U.S. bonds.

As long as these outflows continue, we expect small depreciation of the yen, limited by the fact that the currency is already cheap.

The Canadian dollar

We expect that the loonie will also lose ground over the next year versus the dollar. For one thing, the Bank of Canada (BOC) is likely to keep interest rates unchanged due to a lacklustre economic outlook, while the Fed extends its round of gradual rate increases. Oil prices, while higher than a year ago, are not high enough to encourage fresh investment in the oil-dependent parts of the economy, and the Canadian housing market is reaching lofty levels, with the pace of activity unlikely to be sustained. What is more, the currency is not weak enough to boost Canadian non-energy exports. Overall, we believe the Canadian economy is set up for an extended period of relatively poor performance versus the U.S., and this will result in a weaker loonie.

Exhibit 12: Canada headline and core inflation



Source: Bank of Canada

While inflation has recently risen in large part due to higher energy prices, weak core inflation (Exhibit 12) suggests that there remains substantial slack in the economy. Moreover, overall gains in the labour market have been impressive, but the details behind them are decidedly less so. Since 2015, the bulk of the jobs added by the Canadian economy have been part-time positions. Wage growth has also left much to be desired. In stark contrast to the U.S., where we are seeing increased signs of a tight labour market, there is little evidence that the same dynamics are forming in Canada.

The underlying weakness in Canadian employment numbers can be explained by the situation in both oil and non-energy manufacturing. The rise in global oil prices over the past year has not been enough for high-cost Canadian oil-sands producers, which have had to reduce their reserve estimates because projects are not economically viable at current prices. While prices are high enough to cover marginal costs and keep existing production online, there will be fewer new projects that require capital and labour.

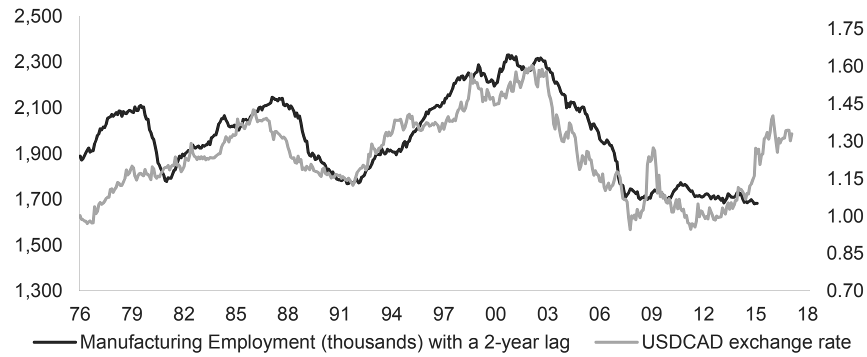
The state of affairs in non-energy manufacturing is not much better, with the decline in the value of the loonie failing so far to spur a significant surge in manufacturing activity (Exhibit 13). After several years of remarkable Canadian-dollar strength, coupled with the global financial crisis, much of Canada's manufacturing capacity has disappeared. A weaker loonie cannot provide opportunities for businesses to capitalize on new-found export competitiveness when those businesses no longer exist. Much of the production has either closed or moved to more competitive countries such as Mexico. It is important to note that as much as the Canadian dollar has weakened from its 2007 highs against the greenback, the Mexican peso has weakened much more (Exhibit 14). It will take several years of pronounced weakness in the loonie for businesses to commit to producing in Canada.

In addition to these pre-existing conditions, there are now new factors potentially eroding Canada's attractiveness as an investment destination for manufacturing. They include the increase of U.S. protectionism under President Trump and reductions in U.S. tax rates, which would eliminate the tax advantage that Canadian companies now enjoy. What is more, Canada has relative high electricity costs and stricter environmental regulations, which also figure in where businesses decide to locate. There is some hope that Canada will avoid some of the more destructive impact of U.S. trade protections if they come to fruition. However, it seems premature to bank on a renaissance for Canadian manufacturing, even with a much lower loonie, as long as President Trump is promising to renegotiate NAFTA and to aggresively promote U.S. industry.

The final consideration for our outlook is housing. While concern over the continued surge in prices for residential real estate and in household debt may keep the BOC from cutting its policy rate further, it is also true that any slowdown in the housing market would represent another headwind for the economy. The current torrid pace of housing price gains will inevitably cool either of its own volition or via the impact of increased macroprudential measures. This is not a trivial issue for the economy, as housing-related activity accounts for around 15% of GDP. In addition, as mortgage rates begin to rise, following higher bond yields, demand for housing will slow and force consumers to spend more on debt servicing and less on other goods and services.

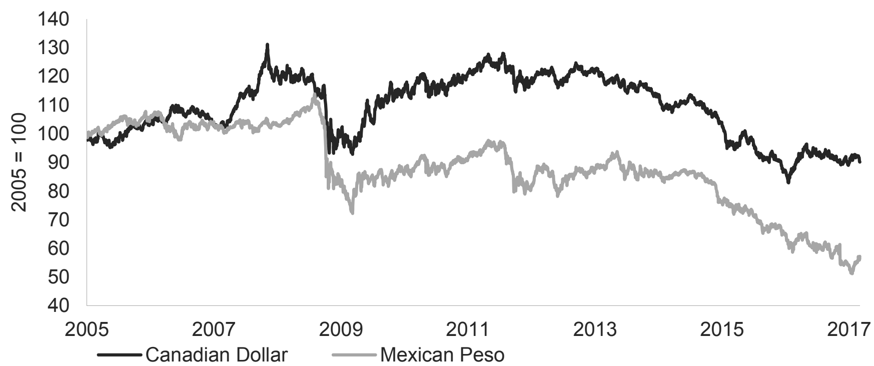
In sum, we expect the gap between the U.S. and Canadian economies to continue to grow. Cognizant of the challenges and differences described here, the BOC will likely remain on hold as the Fed continues to hike interest rates. Widening interest rate differentials will contribute to the attractiveness of the dollar. Our forecasts call for further weakening of the loonie.

Exhibit 13: Canada manufacturing employment and the exchange rate



Source: Bank of Canada, StatsCan, RBC GAM

Exhibit 14: Canadian dollar and Mexican peso versus the U.S. dollar



Source: RBC GAM, Bloomberg

Conclusion

With almost six years of U.S. dollar appreciation behind us, it's only natural that we continuously question the rationale for further strength in the greenback. We note that, until recently, the bulk of the strength was fueled by external rather than domestic drivers, including at various times: fiscal tightening in Europe; the European sovereign-debt crisis; a reduction in Chinese stimulus; Abenomics and a switch to negative rates by the ECB and the BOJ. Currencies are a relative game, and the U.S. dollar had been winning mostly due to the failures of others. Within the last couple of years, domestic factors have come to the fore, such as improvement in the U.S. labour market and the related normalization of Fed policy. The already dollar-bullish setup was given a potential shot in the arm by the U.S. presidential election, with many of the Republican proposals expected to boost the economy's growth potential, competitiveness and therefore, demand for the U.S. dollar. As a result, our forecasts may turn out not to be bullish enough. They are, however, tempered by our recognition of the later stage of the cycle and by uncertainty concerning proposed U.S. economic and foreign policies.

EUROPE: INVESTING IN PERIODS OF POTENTIAL POLITICAL CHANGE

"Everything needs to change so everything can stay the same"

Giuseppe Tomasi di Lampedusa – The Leopard

Dominic Wallington
Head, European Equities &
Senior Portfolio Manager,
RBC Global Asset Management (UK) Limited

Recently we were asked for our thoughts on political developments in Europe. Our custom is generally to invoke the stock-market aphorism "stocks are not the market and the market is not the economy" when talking to investors in our funds. Another way of making the same point is to say "listen to the businesses, not to the headlines." Too much equity-investor time is taken up looking at the ever-changing macro and trying to fit portfolios into world views that tend to be difficult to discern and to time. Our team's approach is built on an understanding that it is the job of corporate-management teams to mediate and offset the external problems that find their way into the news. Also, many of the businesses that we look at are highly international and not particularly affected by local economics or politics. There are always tensions between the prerogatives of government and business interests, but the political assumption for more than a generation has been that the best way to help the economy is to help the companies within it.

All of these things tend to add up to the business environment exhibiting a stability that astonishes those who look at the news and market movements. We practice an educated agnosticism towards the idea that big events are relevant to investment but sometimes we need to turn our attention to unfolding themes.

In the U.K. and the U.S., we have witnessed political events that demonstrate the remarkable flexibility of democracy. Subsequently, markets are generally at higher levels and so, yet again, it has appeared to be wise not to react to big macro events. As a whole, business growth and profitability have not been affected by Brexit and Trump and the market has recognised this. Our concern is that we believe similar political changes could occur in Europe and for similar reasons. The difference is that, in our view, the EU possesses less dexterity to deal with change than the U.K. and the U.S. Democracy can operate at a national level, but the technocratic body that is the EU might not be able to accommodate the change that results.

The new energy in European politics may prove fragmentary, with individual countries seeking greater sovereignty in response to the demands of their domestic populations. At the same time, there may be a growing understanding that European integration has stalled, perhaps terminally. While predictions are very difficult to make, our conclusion is that there are clear risks to the EU project and that the process is unlikely to follow a linear chain of events. The forces currently rippling across the intricate intersection of politics and markets are, nevertheless, long term in nature and need to be thought about.

If events unfold in this way – and there is the potential that to do so doesn't require populist parties taking power but merely garnering levels of support that surprise market participants – parts of the long-lived EU Institutional framework could be at risk. The implications of this would be more substantial than those associated with the changes that have recently taken place in the U.K. and the U.S.

The constancy of change is a given, and this universal theme has been recognized in many of the world's religious texts and great works of art. What is important is acceptance and incorporation of this fact. If Europe does see political change, then it is possible that it will be accompanied by policy that is reflationary in nature, especially in Southern Europe. Investors may anticipate this and we may therefore ultimately witness a more extended style change in European equity markets towards weaker, more lowly rated companies. The thinking will be that the operating environment will become easier for them. This would not necessarily work to our advantage because we tend to invest in the companies that excel in any environment.

We believe, however, that the companies we specialize in are the best at coping with the more generalized issue of change, irrespective of how it might manifest itself. It could be economic, political, structural or technological. The quality of management teams in these types of companies tends to be very good but they also generally exhibit built-in sustainable advantages that make them more robust. LVMH is not the same company as the one founded by Louis Vuitton in 1854, but the longevity of the brand is very instructive in terms of understanding how LVMH might fare if the European political landscape does change. Having survived the Long Depression of 1873-1890 and numerous political changes and wars both in the 19th century and, most substantially, in the 20th century, the brand and the group have prospered on the global stage. Whatever happens to the political landscape in Europe, LVMH will continue. If change does come to Europe we shall not be surprised by it but, having anticipated its possibility, we will still respond by listening to the businesses and not watching the headlines.

REGIONAL OUTLOOK – U.S.

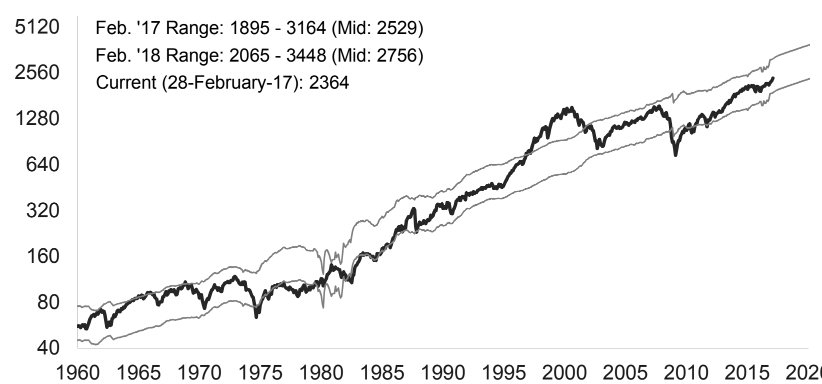
Brad Willock, CFA
V.P. & Senior Portfolio Manager
RBC Global Asset Management Inc.

UNITED STATES RECOMMENDED SECTOR WEIGHTS

	RBC GAM INVESTMENT STRATEGY COMMITTEE February 2017	BENCHMARK S&P 500 February 2017
Energy	6.00%	6.67%
Materials	2.85%	2.85%
Industrials	12.30%	10.22%
Consumer Discretionary	12.05%	12.05%
Consumer Staples	8.35%	9.35%
Health Care	13.25%	14.02%
Financials	16.00%	15.00%
Information Technology	23.50%	21.52%
Telecommunication Services	1.40%	2.40%
Utilities	2.00%	3.11%
Real Estate	2.30%	2.81%

Source: RBC GAM

S&P 500 EQUILIBRIUM
Normalized earnings and valuations



Source: RBC GAM

The U.S. stock market surged higher over the past three months, extending the rally that began a little over one year ago. In the quarter ended February 28, 2017, the S&P 500 returned 8.0%, setting a new high on the second-to-last day of the period. Much like the previous quarter, the period featured aggressive rotation between sectors as investors weighed the likelihood of the individual elements of President Trump's legislative agenda. In the previous quarter, the shares of all cyclical sectors outperformed the market as investors focused on the potential pro-growth policies of the new administration. However, in the most recent quarter, the only cyclical sectors to outperform were the Information Technology and Financial sectors while the other outperformers, Utilities, Consumer Staples, Health Care and Real Estate, are all regarded as less cyclical. We believe the move can be attributed to the realization that tax reform, regulatory changes, the potential for a massive infrastructure bill and the replacement of Obamacare will take time, and in the end may not live up to the early post-election expectations.

Since the election, the S&P 500 is up almost 12% and while some of the market's advance must be attributed to the anticipation of pro-growth policy action, the fundamentals are also doing their part to drive the market higher. Surveys of U.S. economic activity are at a six-year high and the new-orders and inventory components indicate that production should keep improving. The housing-market recovery continues at a measured pace with home prices rising 5.6% year-over-year and sales of new and existing homes up about 2% to 3% from last year. Mortgage rates have increased by 0.5% to roughly 4% since last summer and we are watching data on demand for new mortgages to monitor the state of housing. To date, the housing cycle appears intact but rising rates and higher house prices will act as headwinds for the market unless income growth can act as an offset. The pace of U.S. job growth is slowing as is typical later in the business cycle, but the economy still created an average of 182,000 new jobs per month over the past six months. Wage growth is currently running at a 2.5%-3.0% rate. However, if economic activity continues to improve this year and next, wage growth could top 4% and inflation would likely become a problem for the economy and markets. As a result of the robust jobs market, retail sales are up roughly 5% from last year. Not all retailers are doing well, as many bricks-and-mortar retailers continue to lose market share to online retailers like Amazon. In addition, Walmart is cutting prices to re-establish its reputation as the retailer offering the lowest prices as competition intensifies. Restaurants, entertainment, discounters and home-improvement retailers have fared much better than department stores, apparel retailers and grocers.

Corporate fundamentals are also supporting the market. After three years of essentially flat earnings, we expect the S&P 500 to generate roughly 7% profit growth in 2017. The oil-price drop from mid-2014 until early 2016 plus a 20% rally in the trade-weighted U.S. dollar over a similar period depressed the earnings of the Energy sector and large multinationals. The negative effects of the stronger U.S. dollar and oil prices started to wane in 2016's third quarter, when earnings rose about 4% and then accelerated to roughly 7% in the fourth quarter. In the current quarter, the U.S. dollar is no longer a headwind, as it is flat versus last year, and the price of oil is about double what it was. These shifts should help the earnings of multinational firms, particularly companies with large foreign sales in the Information Technology and Health Care sectors. In addition, slightly higher interest rates and lower loan losses should help the Financials sector. First-quarter earnings could grow about 10%, with 75% coming from the Energy, Financials and Information Technology sectors.

Looking forward, our base case assumption is that the economy continues to improve somewhat and that interest rates slowly rise through 2017. Earnings estimates in this scenario are roughly US$132 for 2017 (+6.5%) and US$143 for 2018 (+8.3%), although high levels of global uncertainty make us much less confident of our 2018 forecast. The key for the base case scenario is that the Trump administration and Congress make tangible progress toward achieving their goals with respect to tax reform, deregulation and repatriation of foreign earnings after first repealing and replacing the current health-care law. If Congress is successful, we expect the benefits of executing the Trump agenda to impact 2018 earnings, but it is very hard to know by how much. A drop in the corporate tax rate could boost earnings by US$10-US$15, but there could be offsets depending on how the government finances the tax cut. For example, if the cut is financed with a border-adjustment tax or BAT, half of the benefit could be erased. Additionally, a BAT would likely slow GDP growth and result in an increase in the U.S. dollar, which would further reduce S&P earnings. In our bearish scenario, a bigger-than-expected slowdown in economic activity would be caused by rising mortgage rates; higher gasoline prices; further gains in the U.S. dollar; weaker-than-expected Chinese economic growth; and stringent protectionist policies by the Trump administration. A significant delay or watering-down in tax reform would also be a likely negative for stock-market returns. In a bullish scenario, the Trump administration would pass its full agenda without a BAT, thereby encouraging an increase in bank lending to small business, increased capital investment by the corporate sector and a bump in spending on defense and infrastructure. In this scenario, corporate earnings and stocks would likely go much higher.

At the moment, the S&P 500 trades at roughly 17 times 2018 expected earnings. Clearly, much has to go right to justify current stock prices. For the stock market to hold up and move higher, 'animal spirits' will need tangible evidence in the form of increased economic activity and better-than-expected corporate earnings. Otherwise, confidence and optimism will fade and so will stock prices. For now, given the high level of expectations and therefore increased likelihood of disappointment, we have slightly reduced the risk level within our portfolios.

REGIONAL OUTLOOK – CANADA

Stuart Kedwell, CFA
Senior V.P. & Senior Portfolio Manager
RBC Global Asset Management Inc.

The S&P/TSX Composite Index hit an all-time high in the most recent quarter, and the benchmark's total return of 21% in 2016 made it among the best-performing global equity markets. Notwithstanding this strength, the 3.9% index return in the latest three months lagged the S&P 500 Index. The Canadian dollar's 1% advance versus the U.S. dollar was underwhelming given stronger Canadian economic data and a 9% rise in the price of West Texas Intermediate crude. Investors were preoccupied with persistent concerns about the unabated surge in prices for Canadian residential real estate, the failure of manufacturing to take the reins from energy as the driver of Canadian economic growth and expectations that interest-rate increases in Canada are likely to lag the U.S.

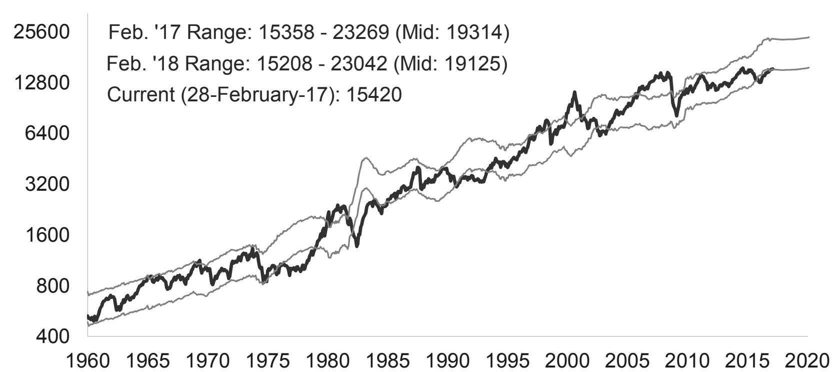
Financial stocks continued their strong global move higher, and the Canadian Financials sector was no exception as it outpaced the S&P/TSX. Canadian banks accounted for about 25% of index earnings in 2016, and shares of gold producers also performed well, although they ended the three-month period well off their highs. Shares of lumber and copper producers also performed strongly, as did the underlying commodities.

CANADA RECOMMENDED SECTOR WEIGHTS

	RBC GAM INVESTMENT STRATEGY COMMITTEE February 2017	BENCHMARK S&P/TSX COMPOSITE February 2017
Energy	20.25%	21.16%
Materials	11.50%	12.21%
Industrials	11.00%	8.90%
Consumer Discretionary	5.00%	5.01%
Consumer Staples	3.25%	3.66%
Health Care	0.00%	0.57%
Financials	37.25%	35.18%
Information Technology	3.25%	2.72%
Telecommunication Services	4.00%	4.72%
Utilities	2.00%	2.82%
Real Estate	2.50%	3.04%

Source: RBC GAM

S&P/TSX COMPOSITE EQUILIBRIUM
Normalized earnings and valuations



Source: RBC GAM

The Energy sector held back index returns. Offsetting oil-price gains were worries that inventories were still too high even after OPEC production cuts and uncertainty about what President Trump's border-adjustment tax would mean for the sector.

Our expectations for economic growth around the world continue to be modest. Our forecast for 2017 growth now sits at 2.25% for the U.S. and 1.50% for Canada. We have increased our U.S. CPI estimate to 2.50% for 2017 and note that markets are now forecasting more interest-rate increases in 2017 from the U.S. Federal Reserve than they were before the election.

For the S&P/TSX, estimates for 2017 earnings are now about $914 and the early read on 2018 is near $1,040. These forecasts are a considerable uptick versus 2016 and reflect returns on equity for the index that are consistent with the longer-term average. Importantly, these earnings forecasts are dominated by substantial earnings improvement in the Materials and Energy sectors. The forecast earnings increase in the Energy sector accounts for almost half of total forecast 2017 profit growth and almost a third for 2018. This assumes the price of oil makes its way to the mid-US$60s as current prices are still 20% below marginal-cost levels. Aside from the commodity sectors, expectations for the remainder of the earnings pool are healthy and generally in line with historical levels. Currently the valuation of the S&P/TSX is moderately lower than that of the S&P 500. This seems justified given the energy-price forecast and the outsized contribution of financial-company earnings to the overall profit pool. Stocks in the Financials sector have typically garnered a lower valuation than the broader market.

After a period of very strong share-price performance, bank valuations on a forward price-to-earnings basis are approaching the highest levels since the financial crisis. Returns on equity are stable, capital levels are strong and the outlook for solid single-digit earnings growth remains in place. While the direction of valuations is tough to predict, the banks continue to offer investors attractive dividend yields and payout hikes in line with earnings growth, making them solid total-return investments. Going forward, the focus for investors will be on credit provisions, which are very low relative to history. The performance of the banks' capital markets and wealth-management divisions, coupled with the relative contributions of non-domestic earnings, will likely be key differentiators of performance.

The share prices of insurance companies initially surged last fall with the rise in interest rates but have since consolidated as fourth-quarter earnings did not meet expectations. That said, we continue to believe that higher interest rates will benefit both the earnings and capital levels of insurers. Many insurance companies have large wealth-management businesses and exposure to attractive Asian markets that are growing quickly. In a stable-to-gradually rising interest-rate environment, insurers could continue to outperform.

Valuations in some sectors that have traditionally had very stable cash flows are at the top end of historical ranges. The Telecommunication Services, Utilities and Real Estate sectors struggled in the latest quarter and will continue to face headwinds should interest rates rise. The reasons are that the growth in these types of businesses may not offset the rise in future interest costs, as well as the higher discount rate applied to the cash flows. One area that interests us is grocery stores, where valuations have recently been pressured by concerns about falling food prices and their negative impact on profit margins. We believe the worse of this trend will have passed by this summer.

Oil prices are difficult to forecast in the short run, but remain below our estimate of marginal cost. While OPEC's decision last year to cut production was no doubt a positive, the mechanism of the cuts has left longer-dated prices below levels that would trigger major new projects. We continue to believe that large companies with long-life reserves and strong balance sheets are set to deliver attractive levels of free cash as crude prices return to the marginal cost of production. In the shorter term, however, the potential impact of any border-adjustment tax on the sector will weigh on performance. We note that the Canadian Energy sector is integrated with the broad North American refinery industry and plays an important role in American gasoline prices. It is therefore possible that this area would not be included under such a tax.

REGIONAL OUTLOOK – EUROPE

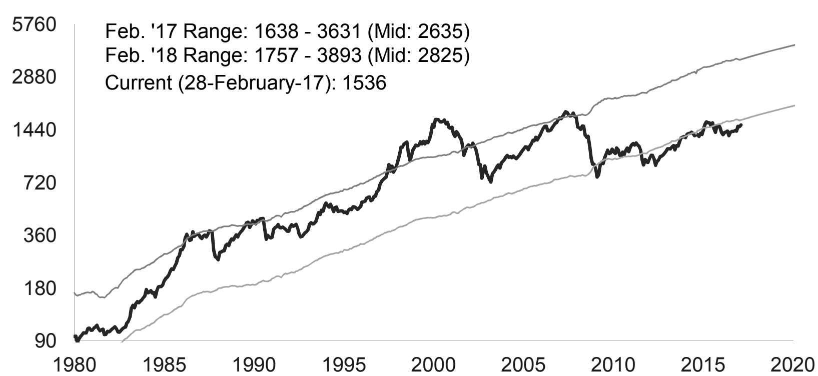
David Lambert
Senior Portfolio Manager
RBC Global Asset Management (UK) Limited

EUROPE RECOMMENDED SECTOR WEIGHTS

	RBC GAM INVESTMENT STRATEGY COMMITTEE February 2017	BENCHMARK MSCI EUROPE February 2017
Energy	6.12%	7.12%
Materials	8.90%	8.42%
Industrials	15.00%	13.02%
Consumer Discretionary	12.50%	10.75%
Consumer Staples	14.00%	14.06%
Health Care	12.22%	13.09%
Financials	19.50%	20.28%
Information Technology	5.42%	4.38%
Telecommunication Services	3.00%	4.09%
Utilities	2.50%	3.43%
Real Estate	0.85%	1.35%

Source: RBC GAM

EUROZONE DATASTREAM INDEX EQUILIBRIUM
Normalized earnings and valuations



Source: Datastream, Consensus Economics, RBC GAM

Evidence that the Eurozone economy ended 2016 on a firmer footing can be found in business-confidence measures that exceeded pre-Brexit levels, the purchasing managers' index at a 5½-year high and business expectations that were at their most optimistic since measurements began in 2012. The improvement reflects faster global growth and has so far outweighed the negative impact of uncertainty around Italy's banking system. We caution that this backdrop is framed in the context of federal elections scheduled later this year in the Netherlands, France and Germany.

Political risk continues to be widely eschewed by investors and business people because the outlook for corporate earnings and economic growth appears to be brightening. That said, the potential for disruptions to closer European integration and the euro itself would increase if far-right politicians such as Geert Wilders in the Netherlands and Marine Le Pen of France win elections or otherwise extend their influence. We see the greatest risk to stability in France, where polls suggest that Le Pen, leader of the National Front, will make it to a probable May 7 run-off vote, giving her a shot at the presidency on an anti-euro, EU-skeptic ticket.

How do we manage political risks from a European equity perspective? Principally, we stick to our core discipline of concentrating on companies with superior or improving business models. We have long talked about the benefits of companies that have good competitive positions, generate consistently high returns, have low capital intensities and demonstrate progress expanding their asset bases. These are the key ingredients for compounding shareholder value over time, and our goal is to identify such companies. However, we are also aware that equity markets go through cycles and phases that can favour certain styles and companies.

The macro indicator that we rely on has been improving for most of 2016 and recently turned positive. The improvement suggests that the "recovery" phase of the market in which we have been for the past year (a move higher in the indicator from depressed levels) may be transitioning to a new phase (the "boom" phase).

The "recovery" phase of the cycle has always been the phase where our core investment philosophy struggles given our preference for consistent and high returns on capital and low capital intensity. It has always been the part of the cycle when stock rotation is heaviest and is often the most difficult time for active management to outperform.

However, the transition we are expecting is a time when a number of higher-risk names should maintain good performance given expectations of faster revenue and earnings growth. Indeed, the early indications are that year-over-year European earnings in the fourth quarter of 2016 will gain about 10%, and analysts are raising year-over-year profit expectations in Europe for the first time since 2011.

It is in this environment that the "recovery" phase, a period of outperformance for value versus growth and of low-quality, higher-risk stocks, may be yielding to the "boom" phase, a period where we typically still see a preference for higher-risk, lower-quality stocks, but where the bias for value stocks tends to dissipate. In the "boom" stage, rising momentum – the combination of revenue and earnings upgrades coupled with a faster rate of change in share prices – becomes a more important driver of equity markets.

During the "recovery" phase, we added mid caps and a number of "lower-quality" companies whose operations were showing progress. One of the big sources of improving returns in some of these lower-quality companies has been a pickup in revenue. A general rise in revenues after several years of stagnation would lead to particularly large profit gains for companies with large fixed investments because faster top-line growth increases returns on capital as more revenue falls directly to the bottom line. Expectations that revenues will accelerate has been bolstered to a degree by investor anticipation that the impetus for economic growth is shifting to fiscal stimulus from the massive monetary stimulus in place for almost a decade. President Trump's promise to boost spending on infrastructure is a prime example.

This development is a definitive positive for regional stock markets and economies. We would expect that, as the "boom" phase for stocks progresses, companies whose valuations fall or flat-line, but that exhibit strong operations, will provide buying opportunities. Assuming that fiscal stimulus is the new order of the day, we would expect to boost holdings of companies with strong prospects for revenue increases. Generally speaking, we have seen European equities outperform global stocks over the past three months, and we will need earnings momentum to remain robust for this trend to continue.

At the sector level, Industrials stocks have been performing best. Our preference within the sector has been for companies offering consistent growth and returns that are high and stable, and/or are demonstrating good operational momentum. However, we have been focusing on companies in more cyclical areas of the Industrials sector over the past three months, such as capital-goods manufacturers. Our Industrials exposure tends to be skewed to mid-cap stocks because they account for a relatively high portion of the stocks in the sector.

Similar to the Industrials sector, Materials stocks have been robust, driven predominantly by rising commodity prices. We have been adding to the sector through a combination of construction-related exposure and mining. We think the outlook for copper is better than it is for other metals, and that earnings for many mining companies will benefit from the revenue increases that these higher prices should generate. Our long-term preference is in specialty chemicals and niche areas of enzymes and flavours and fragrances, where we see high barriers to entry and good growth.

The rotation into more cyclical areas of the market has been funded by reducing exposure to defensive areas of the portfolio where valuations have become richer, including health care, tobacco and beverages.

REGIONAL OUTLOOK – ASIA

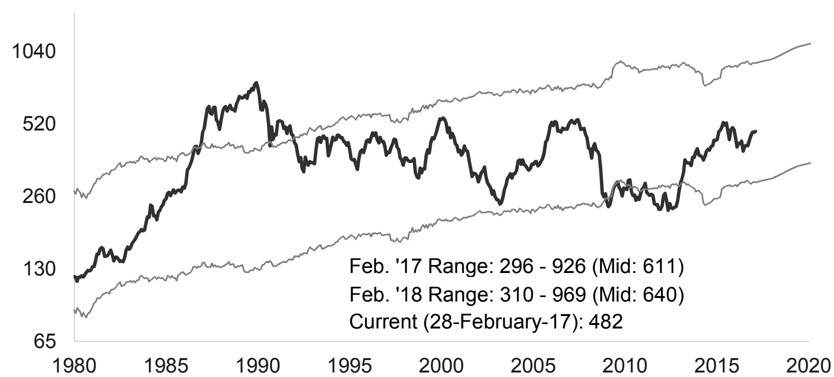
Mayur Nallamala
Head & Senior Portfolio Manager
RBC Investment Management (Asia) Limited

ASIA RECOMMENDED SECTOR WEIGHTS

	RBC GAM INVESTMENT STRATEGY COMMITTEE February 2017	BENCHMARK MSCI PACIFIC February 2017
Energy	2.25%	2.99%
Materials	6.25%	6.82%
Industrials	12.75%	12.66%
Consumer Discretionary	14.00%	12.91%
Consumer Staples	8.00%	6.15%
Health Care	6.00%	4.93%
Financials	21.50%	22.47%
Information Technology	19.50%	17.59%
Telecommunication Services	3.00%	5.02%
Utilities	2.00%	2.81%
Real Estate	4.75%	5.64%

Source: RBC GAM

JAPAN DATASTREAM INDEX EQUILIBRIUM
Normalized earnings and valuations



Source: Datastream, Consensus Economics, RBC GAM

Asian stock markets have been rallying since the election of Donald Trump in early November as investors discount his tough rhetoric on tariffs and trade protectionism. It is difficult to determine how much of the regional stock-market strength is due to pledges by Trump to lower taxes, cut regulation and boost infrastructure spending, and how much should be attributed to a broader cyclical recovery in Asia. Increased Chinese government spending in the months preceding the U.S. election has helped produce improved economic data, making China a key contributor to the region's quickening economic expansion.

We are increasingly cautious given the large number of policy unknowns that stem from unpredictable U.S. leadership. President Trump has persisted in his trade rhetoric since the inauguration and we believe that economies whose exports to the U.S. significantly exceed their imports have the most to be concerned about – primarily the industrial exporters of northern Asia. The more-domestically driven economies of South Asia are less exposed to exports, but rising protectionism would hurt all of them given the trade linkages that exist among regional economies.

Australia's equity market has been a notable outperformer, driven by a continued rally in base-metals producers and renewed investor interest in financial-services stocks. The commodities story remains closely tied to China. Political developments in Asia will remain in the headlines in 2017, with Indian election results being tabulated this month. Later this year, South Korean will hold elections and a Chinese Communist Party Congress will take place.

Japan – Japan's stock market has so far managed to hold onto its significant post-U.S.-election gains, confounding investors who expect a recent strengthening of the yen to crimp profits. President Trump has made pointed comments on currency and trade indicating that tensions remain with Japan, the closest U.S. ally in the region. The impact of geopolitical sideshows such as

North Korea's missile tests muddy the waters when it comes to predicting how the trade issues will transpire. We believe that Trump will direct much of his energy at his country's trade relationship with China, but there's no guarantee that Japan will emerge unscathed.

The Japanese economy is being bolstered by continued accommodative fiscal and monetary policies. Economic growth for 2017 is projected to be 1.0%. Even with the yen's recent reversal, the currency remains weak enough to support corporate profits and inflation continues to undershoot the Bank of Japan's (BOJ) 2.0% inflation target. Wage growth and increased female participation in the workplace are positive labour-market trends.

While the BOJ will likely continue easing, the scale of this policy may diminish, so the yen and equity-market trends may be more subject to external forces than in the past few years. Prime Minister Abe has made progress toward lowering unemployment to 3%, achieving 2.5% wage growth and promoting Japan as a tourist destination. Moreover, real estate prices across Japan are rising for the first time since 1992, which is a welcome development for consumer spending.

The outlook for the yen remains critical for corporate profitability and capital expenditures. While the BOJ would like to maintain a weak yen, geopolitical shocks or slower-than-expected economic growth could lead to a strengthening of the currency, threatening corporate earnings.

Abe's political position remains strong and he continues to push forward with longer-term structural reforms. Stimulus packages continue to focus on infrastructure projects and subsidies for child care and elderly care, which should help stimulate economic growth over the next two years. Investment returns may get a boost from a gradual improvement in corporate governance.

China, Taiwan, South Korea – The outlook for other major North Asian economies is similar to Japan's. China, Taiwan and South Korea are also at risk from more protectionist trade policies given their large trade surpluses with the U. S. An initial step by Trump to fulfill his campaign promises to get tough on trade could come in the form of a declaration that China is a currency manipulator. Such a step could push down the renminbi in the face of recent attempts by the Chinese government to support the currency's value against rising capital outflows.

In China, the government appears to be achieving a better balance between economic growth and structural reform. Larger-scale economic reform is more likely to be pushed back to 2018, as the old guard of the Communist Party will be replaced in November 2017. Economic restructuring is likely to have a negative impact on growth, and so any significant reforms will need to be accompanied by a reduction in growth targets. Foreign-exchange reserves are, for now, sufficient to offset periodic concerns about currency outflows. China's debt-to-GDP ratio of 270% is among the highest of the emerging markets and remains a concern because corporate debt is rising fast. Other risks include an overheated property market and a sharp devaluation of the renminbi. The launch of a program making it easier for foreign investors to trade stocks listed on the mainland (Shenzhen-Hong Kong Stock Connect) in December is the latest achievement in China's quest to gain stature and influence in global financial markets.

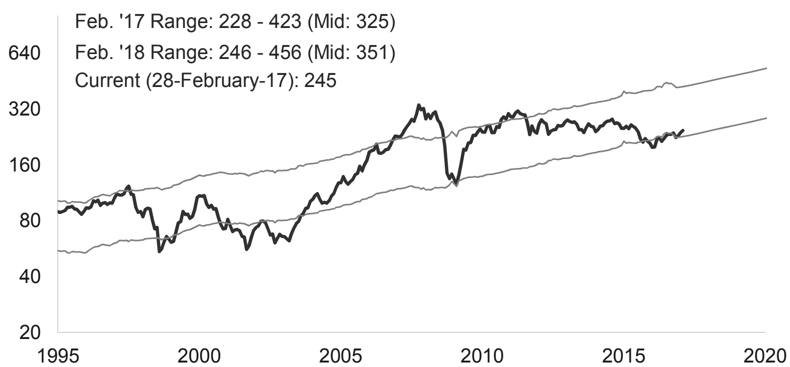
India remains Asia's fastest-expanding emerging economy with a growth rate of 6.8%. The Reserve Bank of India kept interest rates unchanged, as expectations of higher inflation were offset by the negative economic impact of the government's controversial decision late last year to remove large currency bills from circulation. The winter parliamentary session has been disrupted by that decision, pushing back the timeline for implementation of a valued-added tax.

Australia – Improving commodity prices, driven in part by Chinese demand, is a tail-wind for the Australian economy. However, the government continues to rebalance the economy so that it relies less on mining and more on housing construction, services and household consumption. Australian financial stocks have rebounded as both capital concerns and fears of a real estate bubble have abated. Australia's AAA credit rating may be downgraded, given the country's sizeable budget deficit and multiple changes in political leadership over the past decade.

REGIONAL OUTLOOK – EMERGING MARKETS

Philippe Langham
Head & Senior Portfolio Manager,
Emerging Market Equities
RBC Global Asset Management (UK) Limited

EMERGING MARKET DATASTREAM INDEX EQUILIBRIUM
Normalized earnings and valuations



Source: Datastream, RBC GAM

Emerging-market equities outperformed their developed-market counterparts by 3.3 percentage points in 2016 (8.6% versus 5.3%), the first time that emerging markets have led in six years. Last year's emerging-market recovery could have been bigger, but was curtailed by the U.S. dollar rally and bond sell-off triggered by Donald Trump's presidential victory in November.

While the stronger dollar and rising bond yields remain concerns, there are several positive factors that should support emerging-market performance over the medium term. First, commodity prices have been increasing, which along with rising yields supports the view that global growth can accelerate. Second, there is a powerful case that the rally of the U.S. dollar will persist only against currencies of other developed markets as valuations for emerging-market currencies are cheap, and because many emerging markets have high real interest rates and strong current accounts. Third, both earnings and relative emerging-market growth look set to improve from cyclically low levels driven by improved productivity and structural reforms. Finally, the valuation case for emerging-market equities is strong, particularly relative to developed markets, following the significant underperformance of the past six years.

While emerging-market equity performance has been relatively flat overall in recent years, there have been clear winners and losers in terms of sectors and individual companies. In this environment, we believe that active fund management should include consideration of opportunities outside of the benchmark if investor returns are to be satisfactory.

It appears that we have reached the stage where monetary-policy options, especially in the developed world, have been exhausted and that future stimulus will be increasingly focused on fiscal policy. While the recent focus on fiscal policy and infrastructure has largely been in developed markets, emerging markets also have a substantial need for infrastructure improvement. Importantly, many emerging-market countries now have sufficient fiscal capacity and more reform-friendly governments, meaning that we are likely to see fiscal stimulus play an increasingly important role in emerging markets as well. The positive outlook for infrastructure has led to increasing expectations that commodities will keep strengthening. Commodity prices have been on the rise since the beginning of 2016, after slumping in previous years, due to optimism over the potential for faster economic growth and increased infrastructure spending. However, the potential impact of such improvements and other fiscal stimulus in developed markets needs to be put in context. The US$1 trillion that Trump has proposed spending over 10 years equates to the amount that China spent in *just the first eight months of 2016*. What happens in China is the key driver for commodity prices.

We are seeing important positives for the Chinese economy as there is a clear transition happening away from investment-driven growth towards a consumption-led expansion, and a strong commitment to reforms and crackdown on corruption by the Chinese government. Furthermore, private enterprises are becoming increasingly important for China's economy, which is positive because it puts pressure on the Communist Party to improve the country's economic, social and legal structures, and to increase the quality and availability of education, health care and environmental protections. However, there are also noteworthy risks for the Chinese economy, particularly due to the rapid build-up of risky credit since the global financial crisis and from overcapacity in a number of industries. Going forward, it is therefore important that credit growth slow and that it be of higher quality. It is also necessary that the Chinese leadership address excess capacity in the economy by continuing to implement reforms.

Emerging markets have traditionally been strongly associated with commodities, but this connection has receded somewhat in recent years. Indeed, overall emerging-market exposure to commodities is not significantly higher than it is in developed markets, although there are still many individual emerging markets that depend on commodities. In this regard, the key point is that emerging markets have become much more domestically oriented over the past decade. Significantly, since 2015 the aggregate market capitalization of the consumer sectors in emerging markets has exceeded that of the resource sectors.

Expectations of a pickup in global growth have led to a sharp rotation out of income-producing equities and the powerful outperformance of cyclical issues and stocks with low valuations. While we have increased our exposure to the more economically sensitive parts of the market, we are wary of companies whose returns are not likely to be sustainable. Cyclicals by their nature can rarely sustain durable returns and will often experience painful reversals when a cycle turns. Nonetheless, we believe there is a strong case for avoiding the most expensive parts of the market, which have become crowded and where valuations have become increasingly stretched in recent years. In terms of defensive equities, we feel it is important to distinguish between mature high-yielding sectors such as Telecommunication Services and Utilities, where we are cautious, and Consumer Staples, which have stable, rising earnings and strong pricing power, and tend to produce very high long-term returns. While growth can appear pedestrian when economic growth accelerates, the fall in valuations of many defensive stocks in 2016 increased the attraction of Consumer Staples in our view. Increasing protectionism is also a concern. Trump's policies are still not clear but a key aim seems to be efforts to bring manufacturing back to the U.S. This reinforces our emerging-market emphasis on stocks that depend on domestic demand.

The relative performance of emerging markets has been diverging and we believe that countries that embrace structural reforms will end up winners. We are particularly positive on the outlook for India, whose business environment is improving amid tax and regulatory reforms and which offers a good choice of high-quality companies that trade at attractive valuations. We like specific stocks in the Philippines, South Africa and Chile. We are less optimistic about markets in China, South Korea and Russia. China's debt represents a significant risk. While valuations in South Korea and Russia are attractive, corporate governance is poor and we can find better opportunities elsewhere.

RBC GAM INVESTMENT STRATEGY COMMITTEE

Members

Daniel E. Chornous, CFA

Chief Investment Officer
RBC Global Asset Management

Chair, RBC GAM Investment Strategy Committee

Dan Chornous is Chief Investment Officer of RBC Global Asset Management Inc., which has total assets under management of $393 billion. Mr. Chornous is responsible for the overall direction of investment policy and fund management. In addition, he chairs the RBC Investment Strategy Committee, the group responsible for global asset-mix recommendations and global-fixed income and equity portfolio construction for use in RBC Wealth Management's key client groups including retail mutual funds, International Wealth Management, RBC Dominion Securities Inc. and RBC Phillips, Hager & North Investment Counsel Inc. He also serves on the Board of Directors of the Canadian Coalition for Good Governance and is Chair of its Public Policy Committee. Prior to joining RBC Asset Management in November 2002, Mr. Chornous was Managing Director, Capital Markets Research and Chief Investment Strategist at RBC Capital Markets. In that role, he was responsible for developing the firm's outlook for global and domestic economies and capital markets as well as managing the firm's global economics, technical and quantitative research teams.

Stephen Burke, PhD, CFA

Vice President and Portfolio Manager
RBC Global Asset Management

Stephen is a fixed-income portfolio manager and Head of the Quantitative Research Group, the internal team that develops quantitative research solutions for investment decision-making throughout the firm. He is also a member of the PH&N IM Asset Mix Committee. Stephen joined Phillips, Hager & North Investment Management in 2002. The first six years of his career were spent at an investment-counselling firm where he quickly rose to become a partner and fixed-income portfolio manager. He then took two years away from the industry to begin his Ph.D. in Finance and completed it over another three years while serving as a fixed-income portfolio manager for a mutual-fund company. Stephen became a CFA charterholder in 1994.

Dagmara Fijalkowski, MBA, CFA

Head, Global Fixed Income & Currencies
(Toronto and London)
RBC Global Asset Management

As Head of Global Fixed Income and Currencies, Dagmara leads a 25-person team in Toronto and London with about $50 billion in assets. In her duties as a portfolio manager, Dagmara oversees several bond funds and manages foreign-exchange hedging and currency-management programs. Dagmara chairs the Fixed Income Strategy Committee. She is also a member of the Investment Policy Committee, which determines asset mixes for balanced products, and the RBC Investment Strategy Committee. In 2016, she was appointed to the RBC GAM Executive Committee. Dagmara, who began her investment career in 1994, holds an MBA from the Richard Ivey School of Business in Canada and a Master's degree in economics from the University of Lodz in Poland. Dagmara is a CFA charterholder.

Stuart Kedwell, CFA

Senior Vice President and
Senior Portfolio Manager
RBC Global Asset Management

Stu began his career with RBC Dominion Securities in the firm's Generalist program and completed rotations in the Fixed Income, Equity Research, Corporate Finance and Private Client divisions. Following this program, he joined the RBC Investments Portfolio Advisory Group and was a member of the RBC DS Strategy and Stock Selection committees. He later joined RBC Global Asset Management as a senior portfolio manager and now manages the RBC Canadian Dividend Fund, RBC North American Value Fund and a number of other mandates. He is co-head of RBC Global Asset Management's Canadian Equity Team.

Eric Lascelles

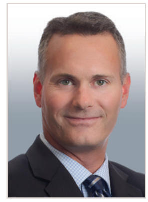
Chief Economist
RBC Global Asset Management

Eric is the Chief Economist for RBC Global Asset Management Inc. (RBC GAM) and is responsible for maintaining the firm's global economic forecast and generating macroeconomic research. He is also a member of the RBC GAM Investment Strategy Committee, the group responsible for the firm's global asset-mix recommendations. Eric is a frequent media commentator and makes regular presentations both within and outside RBC GAM. Prior to joining RBC GAM in early 2011, Eric spent six years at a large Canadian securities firm, the last four as the Chief Economics and Rates Strategist. His previous experience includes positions as economist at a large Canadian bank and research economist for a federal government agency.

Hanif Mamdani

Head of Alternative Investments
RBC Global Asset Management

Hanif Mamdani is Head of both Corporate Bond Investments and Alternative Investments. He is responsible for the portfolio strategy and trading execution of all investment-grade and high-yield corporate bonds. Hanif is Lead Manager of the PH&N High Yield Bond Fund and the PH&N Absolute Return Fund (a multi-strategy hedge fund). He is also a member of the Asset Mix Committee. Prior to joining the firm in 1998, he spent 10 years in New York with two global investment banks working in a variety of roles in Corporate Finance, Capital Markets and Proprietary Trading. Hanif holds a master's degree from Harvard University and a bachelor's degree from the California Institute of Technology (Caltech).



Martin Paleczny, CFA

Vice President and
Senior Portfolio Manager
RBC Global Asset Management

Martin Paleczny, who has been in the investment industry since 1994, began his career at Royal Bank Investment Management, where he developed an expertise in derivatives management and created a policy and process for the products. He also specializes in technical analysis and uses this background to implement derivatives and hedging strategies for equity, fixed-income, currency and commodity-related funds. Since becoming a portfolio manager, Martin has focused on global allocation strategies for the full range of assets, with an emphasis on using futures, forwards and options. He serves as advisor for technical analysis to the RBC GAM Investment Strategy Committee.

Sarah Riopelle, CFA

Vice President and
Senior Portfolio Manager
RBC Global Asset Management

Since 2009, Sarah has managed the entire suite of RBC Portfolio Solutions, including the RBC Select Portfolios, RBC Select Choices Portfolios, RBC Target Education Funds and RBC Managed Payout Solutions. Sarah is a member of the RBC GAM Investment Strategy Committee, which sets global strategy for the firm, and the RBC GAM Investment Policy Committee, which is responsible for the investment strategy and tactical asset allocation for RBC Funds' balanced products and portfolio solutions. In addition to her fund management role, she works closely with the firm's Chief Investment Officer on a variety of projects, as well as co-manages the Global Equity Analyst team.

William E. (Bill) Tilford

Head, Quantitative Investments
RBC Global Asset Management

Bill is Head, Quantitative Investments, at RBC Global Asset Management and is responsible for expanding the firm's quantitative-investment capabilities. Prior to joining RBC GAM in 2011, Bill was Vice President and Head of Global Corporate Securities at a federal Crown corporation and a member of its investment committee. His responsibilities included security-selection programs in global equities and corporate debt that integrated fundamental and quantitative disciplines, as well as management of one of the world's largest market neutral/overlay portfolios. Previously, Bill spent 12 years with a large Canadian asset manager, where he was the partner who helped build a quantitative-investment team that ran core, style-tilted and alternative Canadian / U.S. funds. Bill has been in the investment industry since 1986.

Brad Willock, CFA

Vice President and
Senior Portfolio Manager
RBC Global Asset Management

Brad Willock, who joins the RBC Investment Strategy Committee this quarter, came to RBC Financial Group in May 1996 after receiving a Bachelor of Commerce degree with distinction from the University of Calgary. Prior to that, he earned a Bachelor of Science degree from the University of British Columbia and represented Canada at the 1992 Barcelona Summer Olympics in volleyball. Brad joined RBC Global Asset Management Inc. in July 2002 and is a Senior Portfolio Manager and CFA charterholder. He manages the RBC U.S. Dividend Fund, the equity portion of the RBC $U.S. Income Fund as well as the U.S. equity sleeve of the RBC Balanced Growth & Income Fund.

GLOBAL EQUITY ADVISORY COMMITTEE

- **Philippe Langham**
  Head & Senior Portfolio Manager,
  Emerging Market Equities
  RBC Global Asset Management (UK) Limited
- **Brad Willock, CFA**
  V.P. & Senior Portfolio Manager,
  North American Equities
  RBC Global Asset Management Inc.
- **Mayur Nallamala**
  Head & Senior V.P., Asian Equities
  RBC Investment Management (Asia) Limited
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  V.P. & Senior Portfolio Manager,
  Asset Allocation & Derivatives
  RBC Global Asset Management Inc.
- **Dominic Wallington**
  Head, European Equities &
  Senior Portfolio Manager,
  RBC Global Asset Management (UK) Limited

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- **Dagmara Fijalkowski, MBA, CFA**
  Head, Global Fixed Income & Currencies
  (Toronto and London)
  RBC Global Asset Management Inc.
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  Senior Portfolio Manager,
  Global Fixed Income & Currencies
  RBC Global Asset Management (UK) Limited
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- **Eric Lascelles**
  Chief Economist
  RBC Global Asset Management Inc.

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Global Asset Management

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