



Quarterly Strategy Report

Private Client Research Group

Minneapolis, MN
(612) 371-7280

New York, NY
(212) 703-6105

San Francisco, CA
(415) 445-8536

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For Important Disclosures, see pages 7-8.

Prevailing Over the Aftershocks

Following the earthquake that struck financial markets in late 2008 and early 2009, initially economic growth surged and stock markets soared.

However, after an earthquake occurs, aftershocks tend to roll though the landscape. Recently, financial markets have experienced the first meaningful aftershock since the big earthquake. Risks associated with Europe’s debt crisis jolted global equity markets in May. The U.S. stock market fell 8.2% that month, as measured by the S&P 500 Index.

Europe’s fiscal challenges have the potential to create more volatility for the stock market and other aftershocks could surface if the U.S. economy weakens.

At this stage of the cycle, we believe investors can more effectively prevail over additional aftershocks if equity allocations are defensively positioned.

Economic Conditions

- **The U.S. economy has yet to transition to a self-sustaining recovery cycle.**
- **Momentum has slowed as the deleveraging process continues.**
- **Higher taxes and events in Europe are potential destabilizing forces, but other factors could counterbalance them.**
- **Corporate cash levels, the U.S. banking system, and China should provide stabilizing influences.**

One of the key goals for policy makers following the financial and credit crises was to create conditions for the U.S. economy to transition from an economy dependent on fiscal and monetary stimulus to an economy that could stand on its own two feet.

As the stimulus programs were implemented and interest rates were kept historically low, leading economic indicators and growth surged, as did the stock market. The unprecedented measures led the U.S. economy out of a deep recession.

However, despite the stimulus measures, the economy has yet to transition to a self-sustaining recovery. Recently, some U.S. leading economic indicators (data forecasting economic conditions three to six months from now) have lost momentum or peaked. Emerging market leading economic indicators—which tend to signal future global economic conditions—have already peaked.

U.S. Economy: Attempting to Find its Equilibrium Level

Stabilizing Forces	Destabilizing Forces
<ul style="list-style-type: none"> ◆ Low interest rates ◆ U.S. and global economies expanding ◆ Personal net worth has risen ◆ Corporate profits growing ◆ Capital spending rebound ◆ Businesses rebuilding inventories ◆ Small business sentiment improved ◆ Consumer confidence improved 	<ul style="list-style-type: none"> ◆ European debt crisis; slower European growth ◆ U.S. leading economic indicators stalling ◆ Employment conditions remain weak ◆ Deleveraging persists ◆ Bank lending still sluggish ◆ Housing market fragile; foreclosures rising ◆ Higher taxes and high deficits ◆ Increased regulation

Source: RBC Wealth Management, RBC Asset Management

The reality is that the U.S. and other developed economies are still in the midst of a lengthy deleveraging cycle. Many households remain in debt repayment mode or are preserving cash. Governments are beginning to confront expensive social safety net and public pension system liabilities that have built up over decades. The deleveraging process could persist for quite some time, creating volatility and potential aftershocks for financial markets.

Employment and housing market conditions remain fragile. U.S. private sector job growth has improved modestly but lags previous post-recession periods. Filings for unemployment benefits remain stubbornly high and are little changed since the beginning of the year. The pace of home sales improved meaningfully, and home values stabilized when federal tax credits were offered as incentives. Yet since the tax credits expired, housing activity has weakened and seems vulnerable to slowing further.

These and other measures indicate to us it could be difficult for the U.S. economy to gain traction and build on the strong 5.6% Gross Domestic Product growth that was recorded during fourth-quarter 2009. The economy is still growing but seems unable to put together a string of strong growth quarters as typically occurs during early recovery phases.

Events in Europe add an additional layer of uncertainty. The risks have little to do with specific nations, per se. After all, Greece's economy is roughly the size of the state of Washington's. The financial risks center on the potential vulnerabilities of Europe's banking system and its exposure to sovereign and consumer debt of weaker European nations, and potential economic headwinds.

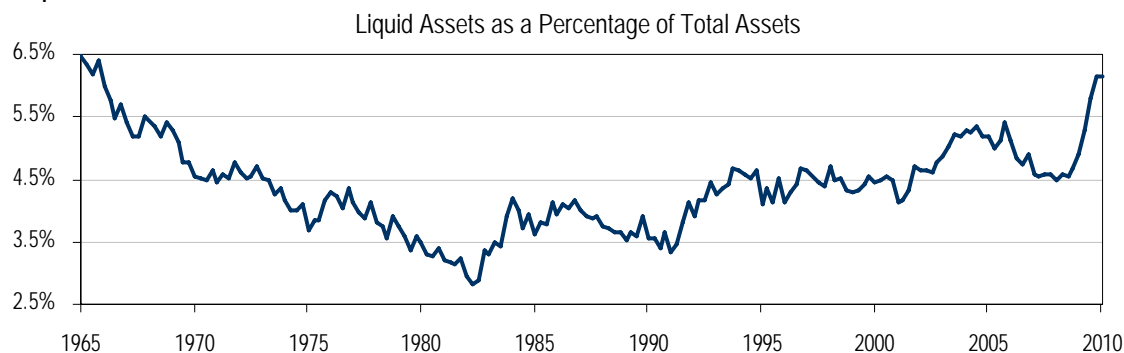
The European debt crisis is a wake-up call for governments to cut spending. High government debt levels in Europe, Japan, and the United States could provide additional headwinds for the stock market over the longer term if they are not dealt with credibly and soon.

However, even though spending cuts are prudent, they could bring near- and mid-term economic risks. As governments initially cut spending—which European countries and U.S. states and municipalities are beginning to do—economic growth could be constrained and modest deflationary pressures could be extended over a longer period.

Yet despite these lingering aftershocks and challenges, there are factors that can provide stabilizing influences: 1) corporate cash levels are very high, 2) the U.S. banking system is on firmer ground, and 3) China's economy is still growing at a healthy pace.

First, many U.S. corporations are sitting on a pile of cash and have healthy balance sheets. Cash levels have risen sharply since the financial crisis unraveled in late 2008. Liquid assets are currently 6.2% of total assets, the highest level since the mid-1960s, as the graph below illustrates. While capital spending has risen recently, companies certainly have more room to expand product and service offerings and invest in productivity. As risk aversion dissipates, we believe cash-rich companies will boost capital spending.

Corporate Balance Sheets are Flush with Cash



Source: RBC Wealth Management, Credit Suisse, Federal Reserve Board of Governors; data is through the first quarter 2010

Second, the U.S. banking system has weathered its greatest challenge, in our opinion. It now sits on a more stable foundation and has little exposure to the current sovereign debt challenges in Europe. We do not believe the U.S. banking system is at risk of unraveling if the European debt crisis worsens.

Third, China's economy continues to grow, which is spurring Asian growth and can counterbalance headwinds in Europe. Even though inflation in China has risen and the property market seems bubbly, the economy appears poised to contribute to global growth in the near term. Its recent decision to revalue the yuan currency and delink it from a hard peg against the U.S. dollar is also supportive of growth. China is the most important swing factor for the global economy, in our view.

Stock Market Strategy: Use Defensive Measures to Prepare for Additional Aftershocks

- **U.S. equity allocations should be more defensively positioned at this stage of the cycle.**
- **U.S. economic and European debt-related headwinds could begin to weigh on corporate profits and could further pressure equity valuations.**
- **We recommend tilting exposure toward defensive stocks versus cyclical stocks.**

Because some global and U.S. economic indicators have recently begun to stall in momentum and others seem to have peaked, we anticipate a shift toward defensive stock outperformance will occur in the months ahead.

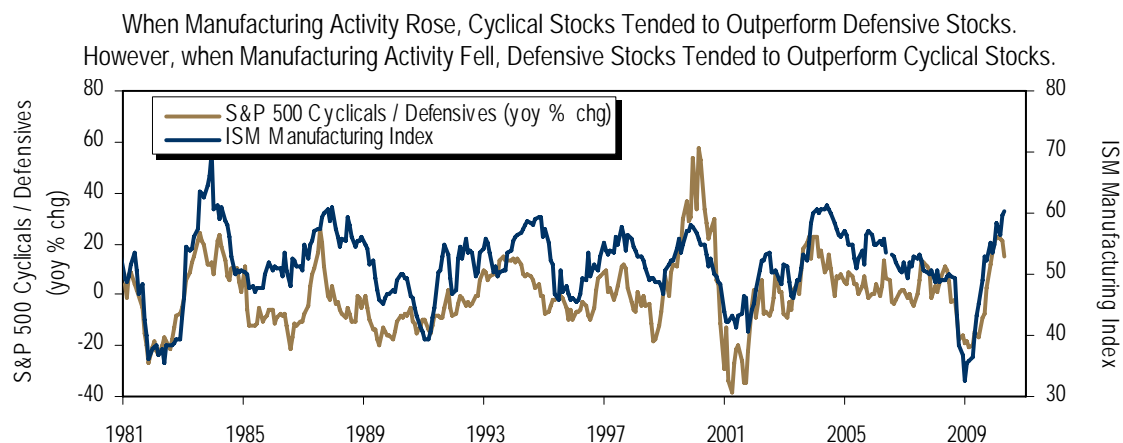
Consider the relationship between one of the key leading economic indicators—manufacturing activity—and the performance of cyclical and defensive stocks. The graph below illustrates that when manufacturing activity declines (when the blue line trends lower), defensive stocks tend to outperform cyclical stocks (the gold line also trends lower). The opposite tends to occur when manufacturing activity rises. Cyclical stocks tend to outperform defensive stocks.

U.S. manufacturing activity rose sharply off of very depressed levels in 2009. The broader stock market rallied along with it, and cyclical stocks outperformed defensive stocks by a wide margin. That pattern is typical during early recovery phases.

However, U.S. manufacturing activity recently began to lose momentum. From January through May, the ISM Manufacturing Index bounced within a range of 56.5 to 60.4 (any reading above 50.0 indicates expansion in the manufacturing sector).

While the Index may not drop below 50.0 in the near term, we believe it could have already experienced its peak when it reached 60.4 in April, or at the very least could be near its peak. If manufacturing activity loses ground in the months ahead, defensive stocks could outperform cyclical stocks, as they have in prior cycles.

Key Relationship: Manufacturing Activity and the Performance of Cyclical and Defensive Stocks



Source: RBC Capital Markets; the gold line represents a ratio of the performance of cyclical-to-defensive stocks

We're also cognizant that events related to Europe's debt challenges could eventually impact U.S. multinational companies' revenues and profits. Even if the current debt crisis is averted or forestalled, European nations are under pressure to cut government spending. While we agree that is the prudent approach to deal with the longer term challenges, it is not without consequences.

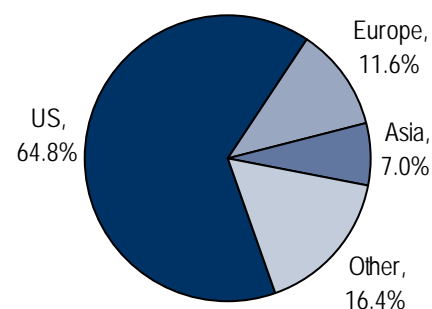
Most European economies never fully recovered from the credit crisis of 2008 and early 2009. Similar to the United States, Europe has yet to shift into a self-sustaining growth cycle. Therefore, cutting spending at this stage could impact the European economy negatively over the near and mid term.

The good news is that the S&P 500's exposure to Europe is limited. It's roughly 11.6% of total revenues, based on RBC Capital Markets' estimates. That level is not enough to kibosh earnings growth for the Index, from our perspective. However, it is enough to register as a potential aftershock facing U.S.-based multinationals. It could constrain revenue growth of sectors and companies that are more heavily exposed to Europe. Additionally, the recent rally in the U.S. dollar (up 17.2% versus the euro year-to-date) could pose headwinds for companies that rely on significant export revenue.

The table below illustrates the Materials sector has roughly 22.2% of revenue from Europe, which we view as meaningful. Six sectors have between 10.7% and 14.9% exposure.

S&P 500 Estimated Revenues: Geographic Breakdown

Sector	% US	% Europe	% Asia	% Other
Information Technology	47.0	14.9	17.2	21.0
Materials	48.7	22.2	11.9	17.1
Energy	58.0	12.3	2.7	27.0
Consumer Staples	59.9	13.7	5.0	20.7
Industrials	61.8	14.0	8.1	16.1
Health Care	62.4	14.7	5.4	17.5
Consumer Discretionary	73.4	10.7	3.5	12.4
Financials	83.1	4.9	3.9	8.1
Utilities	97.0	0.4	0.1	2.5
Telecommunications	98.0	0.0	0.1	2.0
S&P 500 totals	64.8%	11.6%	7.0%	16.4%



Source: RBC Capital Markets; data reflects estimates of revenue exposure based on an analysis of historical company data from 2008 and 2009. The "other" category includes Latin America. S&P 500 totals are capitalization weighted.

Even though the U.S. economy has yet to find its equilibrium level and the stock market faces challenges, we believe there are opportunities in defensive sectors such as Health Care and Energy.

Sector Spotlight: Health Care

- **Prospects for this defensive sector seem poised to change for the better.**
- **Some segments of the industry could actually benefit from health care reform legislation.**
- **Additionally, the Health Care sector has historically outperformed all other sectors after a key leading economic indicator has peaked.**
- **The sector's valuation is cheap on a historical basis.**

Two factors have held back the Health Care sector since the market bottomed in March 2009:

1) the passage of health care legislation, and 2) the economic cycle, which favored cyclical sectors over defensive sectors. However, we believe the sector's prospects are poised to change for the better.

Even though the passage of health care reform legislation could lower profit margins of some companies and carries significant potential liabilities for American taxpayers and employers, we anticipate certain segments of the Health Care sector will benefit from the new laws and regulations. After all, since when has the federal government created a new subsidy for a service and demand for that service dropped? With health care insurance mandated and insurance subsidized with taxpayer funds, the overall use of health care services and products seem poised to rise, in our opinion.

The key for investors is to find companies that can capitalize on higher health care usage rates but at the same time avoid price caps and/or taxes associated with the forthcoming regulations and modified Medicare and Medicaid reimbursement rules.

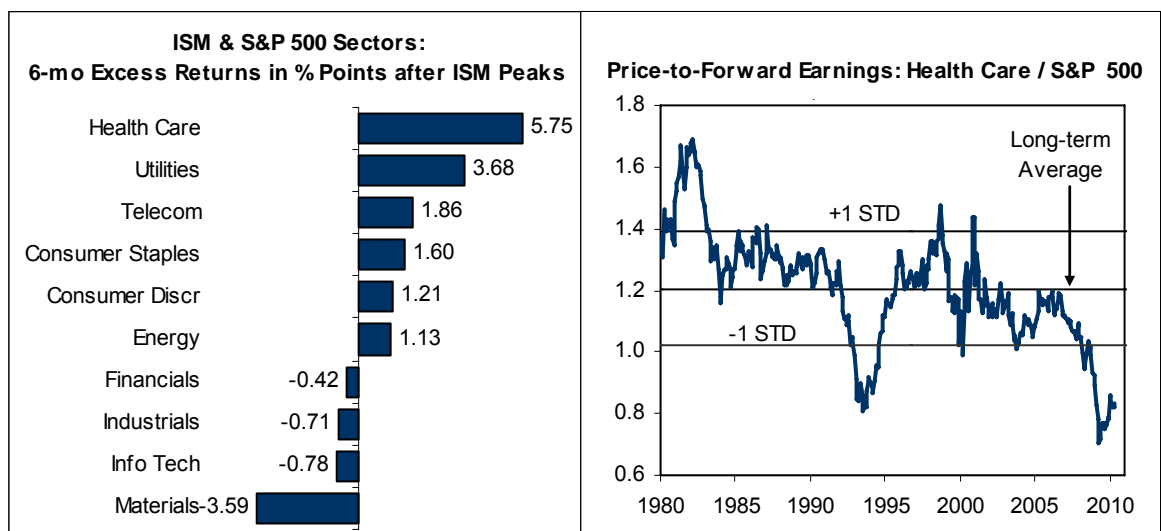
While some health care companies face obstacles related to the new legislation, including managed care companies, not all companies will, in our opinion. We view the legislation as being a net positive for the biotechnology, clinical laboratory, diagnostic testing, drug distributor, and pharmacy benefit manager industries. The biotechnology industry should benefit from provisions that make it difficult for generic companies to gain approval for biogeneric or biosimilar drugs. The other segments should benefit from higher utilization rates due to the influx of newly insured patients.

We believe Health Care stocks would also benefit if a shift takes place in the economic cycle. The sector is among the most defensive because health care consumption tends to be less impacted by slowing economic momentum than other sectors.

After leading indicators peak, the Health Care sector has historically performed the best among the 10 S&P 500 sectors. For example, it has the best performance track record six months after the peak in the ISM Manufacturing Index, as the chart below on the left illustrates.

Additionally, we view the sector's valuation as attractive. The Health Care sector is trading at a significant discount to the S&P 500. The sector's forward price-to-earnings ratio is 0.83 of the S&P 500's price-to-earnings ratio. Historically, it has traded at a premium of 1.2 versus the S&P 500, on average, since 1980. The graph below on the right illustrates the Health Care sector's valuation relative to the S&P 500 is near its lowest level since 1980 and is at roughly the same level as it was during the Clinton health care scare in the 1990s.

Health Care: An Attractive Defensive Sector



Source: RBC Capital Markets. Data in the left chart represents sector returns in excess of S&P 500 Index returns after each peak in the ISM Manufacturing Index since 1980.

Sector Spotlight: Energy

- **The Energy sector typically outperforms after global leading economic indicators peak.**
- **The sector's valuation is inexpensive.**

Recently much of the trading in Energy stocks has been highly influenced by the Gulf of Mexico explosion and massive oil spill and the related impact of the deep-water offshore drilling moratorium.

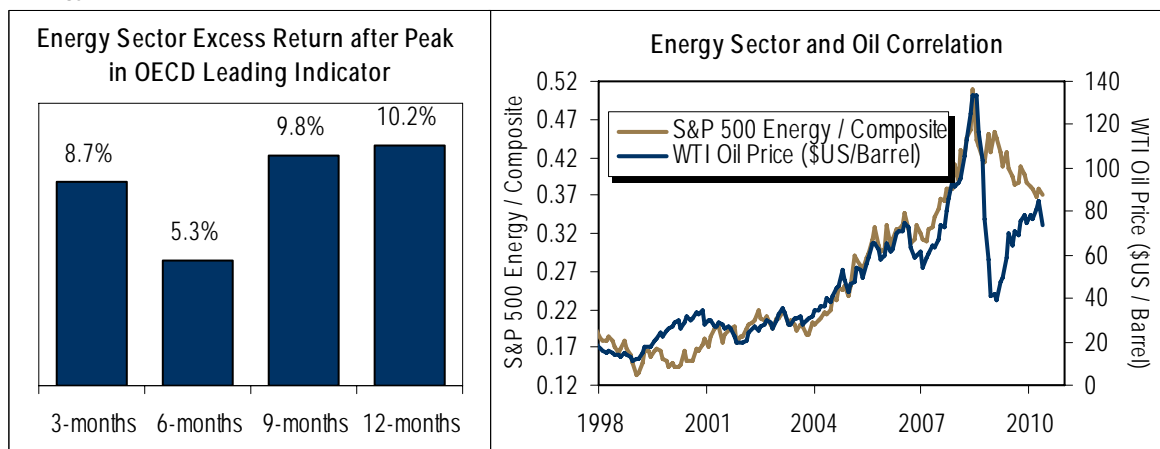
Even though there are now regulatory and taxation risks associated with offshore drilling, we believe other factors outweigh these challenges and make the sector attractive for equity investors. The Gulf-spill selloff in energy stocks has created an attractive buying opportunity, in our assessment.

RBC Capital Markets' institutional strategist Myles Zyblock upgraded the sector May 19. His research indicates the Energy sector "often outperforms the S&P 500 in the 9-12 months after the global leading indicators peaks from an elevated reading."

Following the massive fiscal and monetary stimulus thrown at developed and emerging economies after the financial crisis, the OECD's global leading economic indicator has become rather elevated on a historical basis. It has risen to more than 1.5 standard deviations above its normal level.

This factor, combined with the weakening of some U.S. and emerging market economic data, are indications to Zyblock that the OECD data is so stretched beyond its mean, it could roll over in the next few months. The Energy sector has historically delivered strong returns versus the S&P 500 when the OECD Leading Indicator rolls over from very high levels, as the bar chart on the left illustrates.

Energy Sector: It tends to Outperform when Economic Momentum Slows



Source: RBC Capital Markets, Haver Analytics. Bar chart on the left reflects the historical Energy sector return since 1980 after the OECD leading economic indicator peaks one standard deviation above its mean. Return is in excess of the S&P 500' return.

Zyblock added, "The relative performance of the Energy sector and the oil price have been married at the hip for well over a decade. However, during the past year the oil price has more than doubled while the Energy sector has lagged. This highly unusual breakdown has left the sector looking increasingly attractive from a valuation perspective ... Energy is one of the least expensive S&P 500 sectors."

Finally, this late-cycle sector has more defensive attributes than other cyclical sectors. Nearly 65% of the sector's market capitalization is less volatile than the S&P 500. We recommend focusing on natural gas and oil shale stocks. Additionally, valuations of the major integrated oil companies are attractive. We would also be on the lookout for a potential pullback in Master Limited Partnerships (MLPs).

S&P 500 Sector Recommendations

In summary, to cope with additional aftershocks that could potentially occur, RBC adjusted its equity sector recommendations recently. The adjustments reflect the shift in sector strategy away from purely cyclical sectors, such as Consumer Discretionary, Materials, and Industrials, and toward defensive sectors, such as Consumer Staples, and late-cycle plays, such as Energy. The following table highlights the sector changes since last quarter and lists current recommendations.

Third-Quarter Sector Recommendations

Sector	S&P 500 Weighting 6/22/10	RBC CM's Current Stance*	RBC CM's Previous Stance 3/1/10
Consumer Staples	11.2%	Overweight	Market Weight
Energy	11.0%	Overweight	Market Weight
Health Care	11.7%	Overweight	Overweight
Info. Technology	18.9%	Overweight	Overweight
Financials	16.2%	Market Weight	Market Weight

Sector	S&P 500 Weighting 6/22/10	RBC CM's Current Stance*	RBC CM's Previous Stance 3/1/10
Industrials	10.5%	Market Weight	Overweight
Consumer Discret.	10.3%	Underweight	Market Weight
Materials	3.5%	Underweight	Market Weight
Telecom. Services	2.9%	Underweight	Underweight
Utilities	3.7%	Underweight	Underweight

Source: RBC Capital Markets * as of June 22, 2010

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			Count	%
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