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RBC Investment Strategy Weekly

The Global Leading Indicator & Resources

Is this commodity cycle long in the tooth? The CRB Index has rallied by close to 45% since December 2008. Performance-to-date now surpasses that seen in three of the past four important cycles, lagging only the gargantuan rally that took prices up in two stages and by a total of 135% between 2001 and 2008.

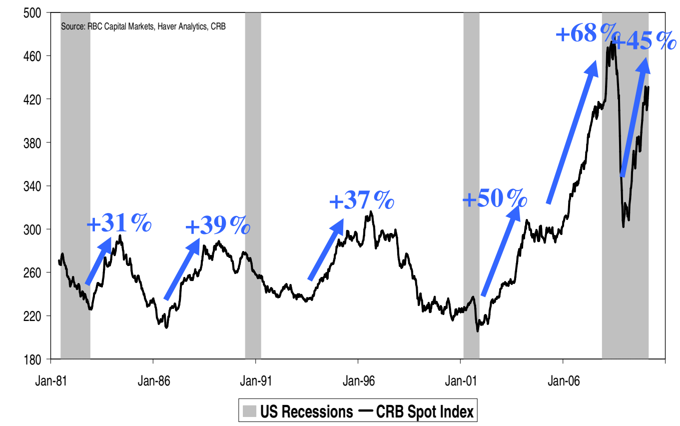
The OECD's global leading indicator (LEI) offers clues about the commodity price cycle. Since 1961, the CRB's returns have tracked the OECD's 30-country leading economic indicator. The correlation is 0.65 between the two series over the full sample and is fairly stable over 10-year rolling windows of time.

The global LEI will probably peak from an elevated level over the next 1-3 months. Historic analysis argues that commodity price gains are likely to slow once the LEI peaks. The danger zone for commodities usually occurs following a drop in the LEI below the critical 100 level, a threshold that is unlikely to be violated for several more months.

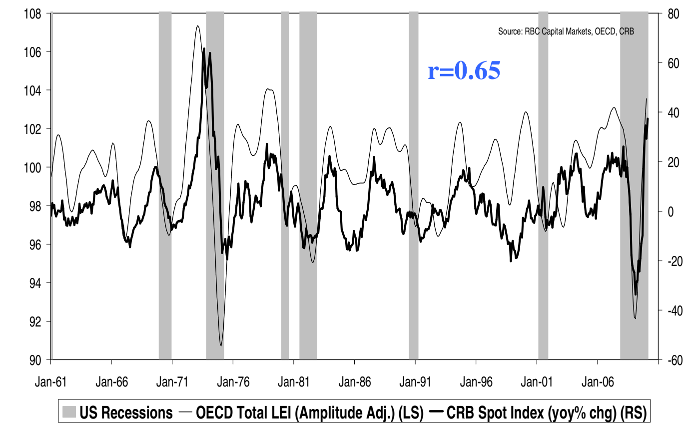
What does this mean for S&P 500 resource stocks? S&P 500 Energy typically outperforms for 2-3 quarters after the global LEI rolls over. This is probably linked to the index's heavy capitalization skew towards Integrateds and Refiners, which tend to be later-cycle performers. In contrast, S&P 500 Materials stocks usually start their period of underperformance around the time that the global LEI peaks. The threat becomes even greater in the year after the indicator drops below 100. Lightening up on higher-beta groups within the Materials sector seems to make sense right now.

What does this mean for TSX resource stocks? TSX Energy is a slight outperformer in the 2-3 quarter period after the LEI rolls over from an elevated level. The sector usually runs into trouble about 6 months after the OECD's indicator drops below 100. Meanwhile, TSX Materials are likely to underperform the market during the 6-9 month period following a peak in the global leading indicator. We recently reduced our TSX Materials exposure to Market Weight from Overweight.

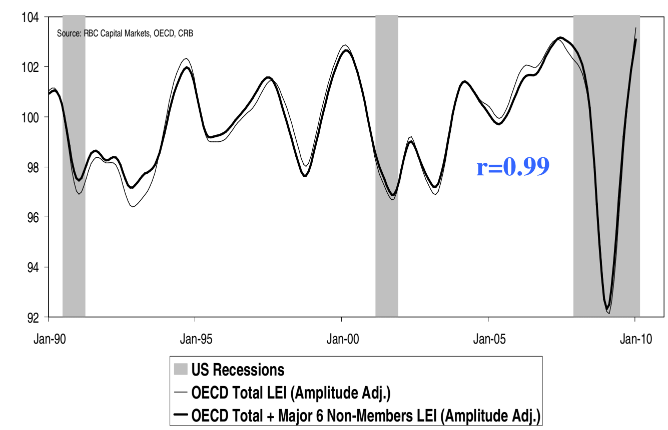
Commodities Likely to Rise at a Slower Pace



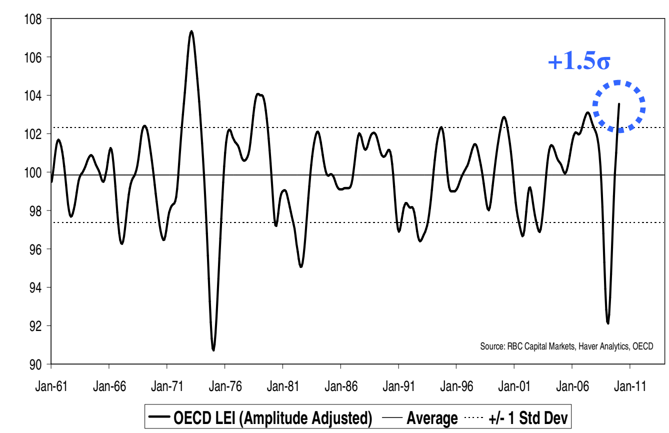
- The CRB Spot Index has rallied by about 45% from the cycle low set in early December, 2008. Performance now surpasses that seen in three of the past four cycles, lagging only the gargantuan rally that took prices up in two stages and by a total of 135% between 2001 and 2008. Is this commodity cycle long in the tooth?



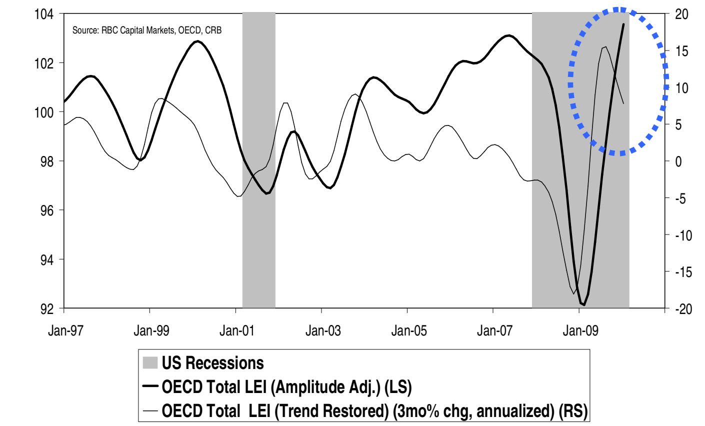
- Since 1961, the CRB's returns have tracked the OECD's 30-country global leading economic indicator (LEI). The correlation is 0.65 between the two series over the full sample and is fairly stable over 10-year rolling windows. One noted exception is the negative correlation between the LEI and commodities during the period surrounding the Tech bubble and its aftermath.



- The LEI we focus on represents 70% of global GDP. There's another OECD leading index which includes Brazil, China, India, Indonesia, Russia and South Africa and captures 90% of global GDP. This latter indicator has a shorter history, but it and the one we use contain virtually identical information.



- The OECD's LEI is mean stationary and is designed to cycle around 100, a level considered the boom/bust threshold not unlike 50 for the ISM Manufacturing Index. The index now stands +1.5 standard deviations above its "normal" level.



- At the same time, shorter-term rates of change suggest that the global LEI is losing upside momentum. We expect the global indicator to roll over within the next 1-3 months.

What might a downturn in the global LEI mean for the performance of commodities? We start the quest by looking at commodity price behavior in the 12-month period following a crest in the OECD's LEI. The work, contained in the following table, summarizes data for the full sample, in cases when the peak started from an elevated level (i.e., >= + 1 SDTEV), and under the conditions of a premature rollover (i.e., < 100, which is the boom/bust threshold). Three broad conclusions drawn from this work are as follows:

CRB Commodity Price Index Performance After Peak of OECD LEI
% chg

Peak	3 mo	6 mo	9 mo	12 mo
Aug-61	-1.6	-2.0	-5.0	-5.7
Jun-64**	6.2	7.5	9.3	9.5
Feb-66	-2.7	-4.9	-10.4	-11.5
Jan-69	4.6	7.2	9.4	11.5
Feb-73*	13.8	38.3	31.5	63.8
May-76	1.1	-2.6	4.9	6.4
Nov-78*	8.2	10.9	12.5	13.1
Mar-81**	-3.7	-4.8	-9.4	-10.7
Jan-84*	1.7	-3.1	-5.0	-8.5
Aug-87	-0.1	1.0	7.1	8.6
Nov-88	4.7	2.2	1.4	-3.1
Mar-90	2.3	0.7	-4.9	-6.0
Sep-91**	-2.6	-1.2	2.0	0.0
Sep-94*	6.7	5.6	11.3	9.4
Aug-97	0.4	-9.9	-6.4	-13.2
Feb-00*	6.1	-0.4	2.1	2.1
May-02**	5.1	8.7	12.7	12.9
Mar-04	-4.7	-3.4	-4.1	-2.4
May-07*	1.1	3.2	17.0	13.8
Median Total	1.7	0.7	2.1	2.1
Median (above 1 Std Dev)	6.4	4.4	11.9	11.2
Median (below 100)	1.3	3.1	5.6	4.7

*** peaks above 1 std deviations.**
**** peaks below 100.**
Source: RBC Capital Markets, Haver Analytics

CRB doesn't necessarily decline in the period following a crest in the LEI.

In fact, we often see decent gains in the year after the LEI crests starting from an elevated level.

- Commodity prices typically continue to rise following a peak in the LEI. Price performance was positive for all horizons out to one-year. Median commodity price gains ranged from +0.7% in the six months to +2.1% in the nine- and twelve-months after the peak.

- CRB price appreciation was substantially stronger following episodes when the LEI crested from an elevated level, which we define as +1 STDEV above normal. The median price increase ranged from +4.4% in the six months after the peak to +11.9% in the nine months after the peak.

- Surprisingly, commodities prices managed to rise even after the LEI rolled over prematurely. We find that the CRB appreciated at a mid-single digit pace in the year after the LEI initially peaked below the boom/bust threshold of 100.

The danger zone for the commodity complex doesn't usually begin after a crest in the LEI, and especially not in the immediate aftermath of a peak from an extended level. So when does the red flag need to be raised?

CRB Commodity Price Index Performance After OECD's LEI Drops Below 100 (% chg)

	3 mo	6 mo	9 mo	12 mo
Jan-62	-2.6	-4.9	-4.0	-3.9
May-66	-2.3	-8.0	-9.1	-10.5
Sep-69	0.7	1.8	-0.4	-2.7
Mar-74	-2.6	-1.5	-10.8	-13.8
Jan-80	-6.0	-2.1	4.2	-4.1
Oct-84	-3.7	-4.7	-10.9	-13.7
Jul-90	-4.9	-7.5	-8.2	-10.7
Mar-95	5.3	3.5	2.2	2.2
Apr-98	-3.6	-5.8	-14.8	-18.8
Dec-00	0.3	4.4	-2.4	-5.3
Apr-05	-3.3	-1.4	3.0	8.4
Jul-08	-25.5	-30.1	-26.4	-19.0
Median	-3.0	-3.4	-6.1	-7.9

Source: RBC Capital Markets, Haver Analytics

Widespread commodity price drops are evident in the period after the LEI declines below 100.

The table above seems to contain a pretty clear answer. It shows the performance of the CRB in the year after the LEI drops below the critical boom/bust threshold of 100. There are very few instances over the past 50 years when commodities have gained following a drop in the LEI below this level. And, while the LEI is approaching a peak, it remains a significant distance above the boom/bust line.

Bottom Line: The global LEI will probably peak from an elevated level over the next 1-3 months. Our historic analysis of the relationship between the global LEI and CRB Index argues that commodity price gains are likely to slow once the LEI tops out. The danger zone for commodities usually occurs following a drop in the LEI below the critical 100 level, a threshold that is unlikely to be violated for several more months.

Resource Stocks: Performance Risks Build First for Materials, then Energy

What might a peak in the OECD's LEI signify for North American resource stock performance? We ran through a similar exercise to the CRB, but this time for the relative performance of S&P 500 and TSX Energy and Materials. The relevant findings using consistent price data back to 1980 are summarized in the following tables. It is important to keep in mind that the sample sizes do drop given that the stock price analysis starts in 1980.

S&P 500 Energy: Outperforms for a Period After the LEI Crests

S&P 500 Energy Excess Return After Peak of OECD LEI % chg				
Peak	3 mo	6 mo	9 mo	12 mo
Mar-81**	-6.3	-4.9	-2.7	-13.4
Jan-84*	10.7	-0.1	-0.3	-5.4
Aug-87	0.7	2.0	7.8	5.4
Nov-88	-0.4	-4.6	-9.0	-0.4
Mar-90	-5.5	13.4	3.3	-4.4
Sep-91**	-10.9	-17.1	-9.6	-6.3
Sep-94*	1.8	3.3	-4.1	-11.2
Aug-97	-4.7	-14.9	-15.7	-19.7
Feb-00*	15.4	7.4	19.9	25.7
May-02**	0.8	-3.8	4.2	0.0
Mar-04	5.7	19.2	15.5	39.3
May-07*	6.7	11.2	23.1	31.0
Median Total	0.7	1.0	1.5	-2.4
Median (above 1 Std Dev)	8.7	5.3	9.8	10.2
Median (below 100)	-6.3	-4.9	-2.7	-6.3

*** peaks above 1 std deviations.**
**** peaks below 100.**
Source: RBC Capital Markets, Haver Analytics

- S&P 500 Energy stocks usually outperform by a small margin during the 9-month window after the LEI peaks. The sector is more likely to maintain leadership if the LEI rolls over from an elevated level. Unlike the CRB, however, an early crest in the LEI usually spells bad news for the sector's relative return profile.

S&P 500 Energy Excess Return After OECD's LEI Drops Below 100 (% chg)				
	3 mo	6 mo	9 mo	12 mo
Jan-80	6.8	3.8	17.4	14.4
Oct-84	-5.0	4.0	-5.6	-1.2
Jul-90	6.2	-6.6	-5.8	-10.2
Mar-95	-6.9	-13.5	-8.8	-9.3
Apr-98	-11.3	-7.8	-31.4	-11.4
Dec-00	5.4	1.7	5.5	0.8
Apr-05	6.7	10.1	22.0	19.7
Jul-08	-4.9	1.6	-5.4	-8.4
Median	0.3	1.6	-5.5	-4.8

Source: RBC Capital Markets, Haver Analytics

- S&P 500 Energy stocks often hang onto slim leadership in the 6-month period after the LEI drops below 100. Thereafter, it is pretty much downhill for the relative performance profile.

Bottom Line: S&P 500 Energy typically outperforms for 2-3 quarters after the global LEI rolls over. This is probably linked to the index's heavy capitalization skew towards Integrateds and Refiners, which tend to be later-cycle performers.

S&P 500 Materials: Less Room to Maneuver Post the LEI Peak

S&P 500 Materials Excess Return After Peak of OECD LEI % chg				
Peak	3 mo	6 mo	9 mo	12 mo
Mar-81**	-2.5	-7.6	-11.0	-15.4
Jan-84*	-0.8	-6.4	-9.8	-10.8
Aug-87	-0.6	-0.8	-1.5	0.9
Nov-88	1.1	-5.1	-3.8	-11.9
Mar-90	-6.6	-6.6	-7.7	-13.2
Sep-91**	-4.9	3.8	5.2	-3.2
Sep-94*	-7.4	-9.4	-10.9	-16.9
Aug-97	-13.4	-20.6	-19.6	-29.0
Feb-00*	-1.8	-16.6	-5.9	10.9
May-02**	0.3	0.1	-1.5	-3.5
Mar-04	0.7	6.0	5.8	10.0
May-07*	-0.1	5.4	13.8	18.0
Median Total	-1.3	-5.7	-4.8	-7.1
Median (above 1 Std Dev)	-1.3	-7.9	-7.8	0.1
Median (below 100)	-2.5	0.1	-1.5	-3.5

*** peaks above 1 std deviations.**
**** peaks below 100.**
Source: RBC Capital Markets, Haver Analytics

- The relative performance of S&P 500 Materials turns down almost immediately following a peak in the global LEI. Underperformance seems to dig in regardless of the level from which the LEI turns south.

S&P 500 Materials Excess Return After OECD's LEI Drops Below 100 (% chg)	3 mo	6 mo	9 mo	12 mo
Jan-80	-6.8	-3.1	-7.2	-8.3
Oct-84	-0.2	-4.3	1.5	-2.8
Jul-90	-7.3	-4.0	-6.7	-0.9
Mar-95	-0.7	-6.1	-14.0	-6.0
Apr-98	-15.8	-17.9	-36.7	-19.7
Dec-00	5.9	10.2	11.8	14.0
Apr-05	-4.7	-5.7	2.9	6.7
Jul-08	-13.8	-14.0	-7.2	-7.8
Median	-5.8	-5.0	-7.0	-4.4

Source: RBC Capital Markets, Haver Analytics

- S&P 500 Materials rarely wins in the year after the LEI drops below 100.

Bottom Line: S&P 500 Materials stocks usually start their underperformance period right around the time the global LEI peaks. The threat becomes even greater in the year after the indicator drops below 100. Lightening up on higher-beta groups within the sector makes good sense to us right now.

TSX Energy: Not Immediately Threatened by a Peak in the Global LEI

TSX Energy Excess Return After Peak of OECD LEI % chg				
Peak	3 mo	6 mo	9 mo	12 mo
Mar-81**	15.4	-2.1	-4.2	-13.5
Jan-84*	11.0	-0.3	2.3	-8.4
Aug-87	-4.8	0.0	-0.3	-0.3
Nov-88	1.0	4.3	-1.7	2.4
Mar-90	-2.6	20.4	4.4	-4.1
Sep-91**	-14.4	-16.9	-10.0	-1.4
Sep-94*	-6.4	-2.8	-6.1	-5.8
Aug-97	-5.5	-15.4	-28.0	-21.9
Feb-00*	37.3	16.0	40.4	67.4
May-02**	12.4	5.3	16.4	12.6
Mar-04	2.3	11.9	12.9	29.8
May-07*	-4.8	-6.6	0.7	11.3
Median Total	-0.8	-0.2	0.2	-0.9
Median (above 1 Std Dev)	3.1	-1.6	1.5	2.7
Median (below 100)	12.4	-2.1	-4.2	-1.4

*** peaks above 1 std deviations.**
**** peaks below 100.**
Source: RBC Capital Markets, Haver Analytics

- TSX Energy stocks are market performers in the 9-12 months after the global LEI peaks. They are more likely to outperform in the year after the LEI peaks from an elevated level. Meanwhile, an early crest in the LEI usually paints a poor picture for the sector's performance prospects.

TSX Energy Excess Return After OECD's LEI Drops Below 100 (% chg)	3 mo	6 mo	9 mo	12 mo
Jan-80	9.6	10.6	-6.8	-1.8
Oct-84	-11.2	0.0	-17.5	-11.0
Jul-90	12.2	-3.7	-6.7	-11.3
Mar-95	-3.2	-3.0	-0.1	1.6
Apr-98	-5.3	1.9	-20.2	-1.6
Dec-00	16.8	15.6	19.7	20.3
Apr-05	17.1	19.4	35.1	29.5
Jul-08	-3.3	-6.7	-4.9	-8.4
Median	3.2	0.9	-5.8	-1.7

Source: RBC Capital Markets, Haver Analytics

- The odds begin to noticeably tilt against TSX Energy about two quarters after the 100 level for the LEI has been violated on the downside.

Bottom Line: TSX Energy can be considered a slight outperformer in the period after the LEI rolls over from an elevated level. The sector usually runs into trouble about 6 months after the OECD's global indicator drops below 100.

TSX Materials: Not Immediately Threatened by a Peak in the Global LEI

TSX Materials Excess Return After Peak of OECD LEI
% chg

Peak	3 mo	6 mo	9 mo	12 mo
Mar-81**	-9.8	-7.1	-12.8	-12.1
Jan-84*	1.0	-9.1	-8.8	-10.4
Aug-87	1.2	-5.4	-2.1	-5.2
Nov-88	1.1	-8.4	-6.8	-7.8
Mar-90	-0.8	3.3	-3.8	-7.5
Sep-91**	0.4	1.1	6.6	7.2
Sep-94*	-4.6	-4.8	-5.5	-4.6
Aug-97	-17.9	-18.4	-25.5	-23.9
Feb-00*	4.7	-19.5	3.2	20.4
May-02**	-4.1	-4.5	-6.0	-14.3
Mar-04	-3.3	3.5	-0.2	-5.5
May-07*	5.3	12.2	34.7	25.7
Median Total	-0.2	-5.1	-4.7	-6.5
Median (above 1 Std Dev)	2.9	-6.9	-1.2	7.9
Median (below 100)	-4.1	-4.5	-6.0	-12.1

*** peaks above 1 std deviations.**
**** peaks below 100.**
Source: RBC Capital Markets, Haver Analytics

- TSX Materials usually lags the market in the year following a peak in the global LEI. The immediate loss of leadership is marginally less likely if the OECD Index's initial peak is from an elevated level versus a level below 100.

TSX Materials Excess Return After OECD's LEI Drops Below 100 (% chg)

	3 mo	6 mo	9 mo	12 mo
Jan-80	-5.9	-4.7	1.5	-4.5
Oct-84	-0.8	-7.5	-6.6	-16.3
Jul-90	-4.8	-9.7	-11.4	-9.9
Mar-95	-0.6	0.4	-4.0	-0.1
Apr-98	-11.3	-0.3	-13.8	-7.4
Dec-00	15.4	19.8	22.1	22.5
Apr-05	-2.5	-3.1	12.0	20.4
Jul-08	-19.4	2.3	-3.5	-3.0
Median	-3.6	-1.7	-3.7	-3.7

Source: RBC Capital Markets, Haver Analytics

- TSX Materials typically lag in the year following a drop in the OECD LEI below 100. That said, substantial countertrend rallies become more likely as the horizon from the indicator's initial violation lengthens.

Bottom Line: TSX Materials are likely to underperform the market during the 2-3 quarter period following a peak in the global leading indicator. We recently reduced our exposure in TSX Materials from Overweight to Market Weight.

RBC CM North American Market Views

Market Index Earnings (all net of unusual items)	2009E	Change from Last Quarter	2010E	Change from Last Quarter	2011E	Change from Last Quarter
S&P 500 (RBC Strategy)	$60.0	+0.00	$76.0	+4.00	$91.0	+5.00
S&P 500 (consensus bottom-up)	60.1	(1.40)	78.0	+1.42	93.7	+0.60
S&P/TSX (RBC Strategy)	$600.0	+25.00	$702.0	+62.00	$835.0	+67.00
S&P/TSX (consensus bottom-up)	638.4	+20.75	775.8	(7.72)	934.1	+10.79

RBC Strategy Targets	28-Feb-10	Forecast 2010	Implied Total Return
U.S. 91-Day T-Bill Rate	0.12	0.25	0.2
U.S. 10-Year Bond Yield	3.62	3.75	2.8
Canada 91-Day T-Bill Rate	0.15	0.25	0.2
Canada 10-Year Bond Yield	3.39	3.80	0.3
S&P 500	1104	1225	12.8
S&P/TSX Composite	11630	13025	14.7
Canada Dollar	0.95	0.98	3.1

Source: RBC Capital Markets, BEA, Statistics Canada, Thomson Analytics

Investment Themes:

- **The economic recovery is progressing**. Positive GDP growth is likely to persist throughout 2010 supported by improved financial conditions, domestic demand and the global economic recovery. The potential intensification of the European debt crisis, a housing market relapse and a peak in global leading indicators offer challenges to this view.

- **Corporate earnings are improving**. Our earnings models remain positive on the cycle. A low cost base joined by top-line improvement should lead to a period of robust earnings growth through 2010.

- **Our year-ahead targets imply higher returns for equities relative to government bonds**. The most intense phase of the cyclical re-rating process for equities has ended and a normalized return environment has increasingly come into focus. Nevertheless, earnings support is likely to maintain investors' interest in stocks over bonds.

RBC Capital Markets Recommended S&P 500 & TSX Sector Exposure

U.S. Equity Sectors	Current Recommendation	Recent Change (Mar 1, 2010)	Comments
Health Care	Overweight	*Upgraded from Market Weight*	An aging population is a key long-term support. Attractive valuations and strong profitability metrics maintain our interest. Focus on Equipment & Services and select Biotech. Managed Care and Pharma offer the deep-value ideas.
Industrials	Overweight	None	Industrial orders have bottomed and capex intentions are rising while earnings estimate revisions have just turned positive. Machinery & Equipment, Transportation and Aerospace & Defense stocks hold promise.
Information Technology	Overweight	None	Improving RoE and cash-rich balance sheets are enhanced by strengthening global demand for tech goods and services. Valuations remain attractive. Hardware and Semis offer the best upside opportunity.
Consumer Staples	Market Weight	*Upgraded from Underweight*	Stable fundamentals and strong balance sheets are key supports. A tailing off in commodity prices could offer margin relief. A general lack of leverage to the economic recovery holds back performance prospects.
Consumer Discretionary	Market Weight	*Downgraded from Overweight*	Easing credit conditions and stimulative policy settings provide support. Risk is offered by a turbulent end to the Fed's QE program. Favor Restaurants, Retailers and Media.
Materials	Market Weight	None	Powerful policy stimulus and signs of global recovery are key supports. A peak in leading indicators could generate volatility and valuations are looking stretched. Containers & Packaging has turned the corner.
Energy	Market Weight	None	The global economic recovery offers primary commodity price support. While the bias is towards oil-leveraged groups, Integrated Oil & Gas looks more interesting from a valuation perspective.
Financials	Market Weight	None	Receding financial stress and wide yield curve are translating into an improved earnings outlook. Regulatory overhang and deteriorating technicals are important offsets. Favor Diversified Financials, and Insurers.
Utilities	Underweight	None	A good hedge against volatile financial and economic conditions. Yet, the sector is often treated as a source of funds during an economic upturn. Earnings estimate revisions trends remain weak.
Telecom Services	Underweight	None	Attractive dividend yields and earnings-based valuations. Earnings estimate revisions trends are weak.

Canadian Equity Sectors	Current Recommendation	Recent Change (Mar 1, 2010)	Comments
Energy	Overweight	None	A profitability upturn on the back of oil price strength maintains our interest. Earnings estimate revisions are lagging the commodity price move.
Industrials	Overweight	None	Attractively valued on a P/B and P/S basis with the potential to disproportionately benefit from an economic recovery. Rails and select Capital Goods names offer attractive upside potential.
Telecom Services	Market Weight	*Upgraded from Underweight*	Earnings outlook might be bottoming according to recent estimate revisions trends. Low leverage to the economic cycle offers performance stability. Attractive valuations and dividend yields.
Materials	Market Weight	*Downgraded from Overweight*	Powerful policy stimulus and signs of global recovery are key supports. A peak in leading indicators could generate volatility and valuations are looking stretched.
Financials	Market Weight	None	A better tone to capital markets, receding financial risk and attractive dividend yields. Sector has run up, but pull-backs are likely to offer opportunity.
Consumer Discretionary	Market Weight	None	Forecast RoE has turned up but margins remain under pressure. Media and select Retail remain our focus.
Information Technology	Market Weight	None	Prospective profitability metrics have recently rebounded according to estimate revisions trends. The sector stands to benefit from a strengthening global tech spending cycle.
Consumer Staples	Underweight	None	Stable growth and strong balance sheets. Sector is often used as a source of funds in a recovery scenario. Valuations remain above their historic norm.
Health Care	Underweight	None	Selective yield plays with attractive valuations. Lack of visibility is a recurring theme.
Utilities	Underweight	None	Stability and attractive dividend yields offer portfolio stability. Valuations are elevated, but look less challenging during a prolonged period of low bond yields.

Source: RBC Capital Markets

Required Disclosures

Conflicts Disclosures

The analyst(s) responsible for preparing this research report received compensation that is based upon various factors, including total revenues of the member companies of RBC Capital Markets and its affiliates, a portion of which are or have been generated by investment banking activities of the member companies of RBC Capital Markets and its affiliates.

Distribution of Ratings

Distribution of Ratings
RBC Capital Markets, Equity Research

			Investment Banking Serv./Past 12 Mos.	
Rating	Count	Percent	Count	Percent
BUY[TP/O]	598	49.9	184	30.77
HOLD[SP]	538	44.9	124	23.05
SELL[U]	62	5.2	6	9.68

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