RBC Wealth Management

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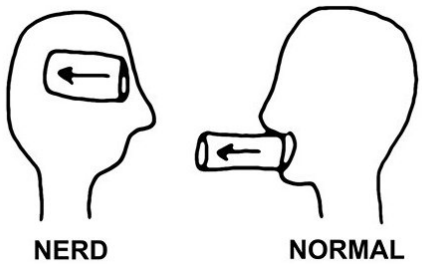
Adjusting to Normal



Making investment decisions based on today's news rarely makes people money in the long run. Rather, *successful investing requires writing tomorrow's newspaper today.* This can best be done by paying attention to leading indicators of fundamental economic activity and maintaining a discipline that allows you to look past current distractions to future opportunity.

Since the recent market peak on May 21st, stocks have declined by around 7% in the US and significantly more in Japan, China and emerging markets. Despite this correction, the DJIA and S&P 500 are up by approximately 10-11% year to date and 17% year/year. Meanwhile, the yield on the 10 year treasury has risen from around 1.8% to 2.5% as investors react to the somewhat more hawkish tone of Fed Chairman Bernanke in recent remarks.

Higher bond yields and a steeper yield curve are a positive indication of economic conditions to come and a good sign for cyclical stocks, particularly financials which will enjoy positive net interest margins for the first time in years. Recent activity is confirmation that the risk premium of bonds vs. equities, which I wrote about in my comment on March 28th "Standing Risk on its Head," reached an excess which would be addressed by the market before too long.

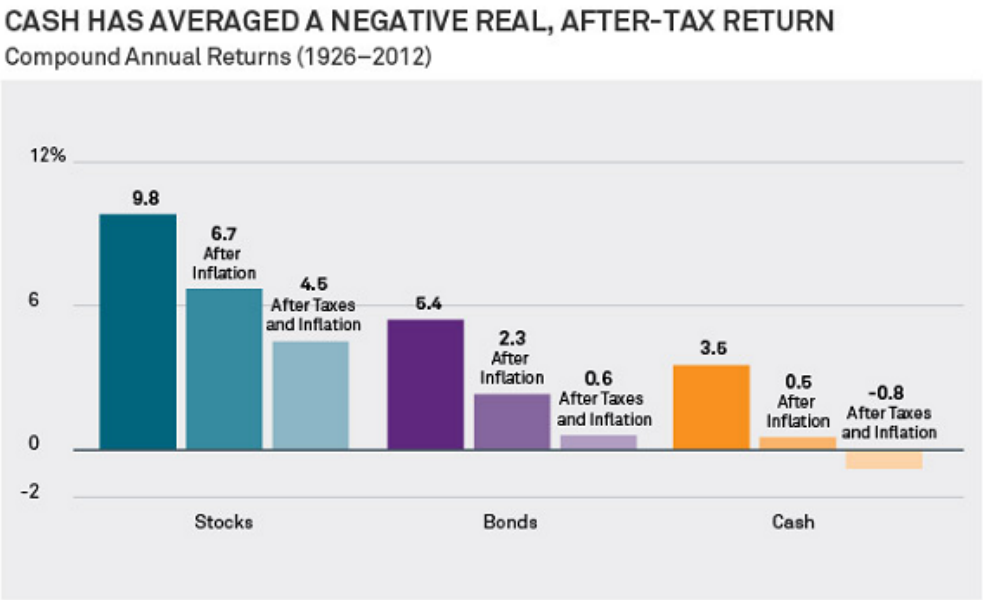
Factors contributing to the recent correction in stocks include: concern that the Fed will "taper" (slow the pace of) QE3 sooner that expected resulting in rising bond yields (as cited above); extended equity markets and overly bullish sentiment; fear of a Chinese liquidity squeeze and slowing economy; unwinding of the Japanese carry trade by hedge funds (borrowing yen at extremely low interest rates, converting to other currencies to invest at higher yields); sharply falling gold prices; ongoing concern regarding the US debt, deficit and the impact of the sequester.

Rising bond yields are simply an adjustment to the more normalized economic conditions that have evolved over the last 4 ½ years due to the success of the extraordinary actions by policy makers through this period. This is evidenced by the Feds indication that such actions are becoming unnecessary. The deficit has fallen from over 10% of GDP in 2009 to about 4% this year and headed for less than 2% by 2015. The sequester did not send us back into recession, instead the economy is beginning to accelerate. The US dollar is strengthening as it becomes clearer that we enjoy the healthiest of the somewhat sickly economies of developed nations around the world. Housing starts and prices are in solid recovery thus bolstering individual/family balance sheets and consumer confidence. Manufacturing activity is picking up as evidenced by today's durable goods order number for May which was up by 3.5% vs. a 2.5% gain in April. Jobs data shows that employment trends are steadily improving. Lastly, while there is great consternation regarding the impact of immigration reform, it creates the possibility of converting 10 million undocumented workers into tax payers which could trim federal deficits by $1 trillion over the next two decades.

In summary, we see nothing to cause us to revise our investment strategy which is: long US equities, particularly in cyclical sectors and financials (we are wary of the chase for yield which has become a crowded trade);

generally short duration for bond holdings, but willing to hold corporate and high yield bonds where there is still room for yield compression as credit ratings improve; and, looking to increase weightings in European stocks where there is an opportunity to invest at steep discounts to US valuations as economies there stabilize/normalize.

Note: for further inspiration, please see the chart below:



Sources: BlackRock; Morningstar; Tax Foundation. Past performance is no guarantee of future results. Assumes reinvestment of income and no transaction costs. This is for illustrative purposes only and not indicative of any investment. Federal income tax is calculated using the historical marginal and capital gains tax rates for a single taxpayer earning $110,000 in 2012 dollars every year. This annual income is adjusted using the Consumer Price Index in order to obtain the corresponding income level for each year. Income is taxed at the appropriate federal income tax rate as it occurs. Capital gains for stocks are assessed every five years when there is a cumulative gain from the last high and assume a five year holding period to determine the long-term capital gains rate. Bonds are assumed to be held to maturity. No state income taxes are included. Stocks are represented by the S&P 500 Index. Bonds are represented by the Morningstar/Ibbotson Intermediate- Term Government Bond Index. Cash is represented by the Morningstar/Ibbotson 30-Day US Treasury Bill Index. Inflation is represented by the Consumer Price Index. It is not possible to invest directly in an index.

Thanks for reading, please call or email with any questions or comments,

Terry