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For asset allocation summary, please see pages 7-8.

RBC Investment Strategy Weekly

Risk-seekers Might Have to Take Pay Cuts, Not Lose Their Jobs

- Performance characteristics from the past four months highlight a common behavioral thread running through the equity market – namely a clear and marked shift in portfolio preference from the avoidance of risk at all costs to its pursuit but not yet at all costs.
- Benchmark index, sector and style analysis all point in the same general direction: The more fundamentally broken and the less expensive a sector or stock was in early March, the better it has subsequently performed. In other words, leadership has been among the group of stocks initially placed on the endangered species list in the event that the recession extended into the future. Many of these same stocks are now perceived as having the most to gain from economic recovery and have performed accordingly.
- The opportunities to arbitrage abnormally wide risk spreads from here forward will be more difficult to find and possibly be less rewarding given the big run from the March low. That said, we believe excess return possibilities are still available to those willing to venture into the right tail of the risk distribution.
- Low-quality leadership, as it is often called, usually persists for as long as investors gain confidence in the economic and earnings outlook. The peak in confidence typically corresponds with the peak in earnings growth and we are nearer to the bottom than to the top on this front. Meanwhile, a valuation indicator we developed by taking a cue from Jeremy Grantham's (Chairman of GMO LLC) recent quarterly report shows that low-quality stocks remain inexpensive relative to their higher-quality counterparts despite the impressive period of outperformance.
- In our opinion, equity investors are still being sufficiently compensated for taking on a higher than normal level of risk.

In this week's ***Stock Chart of Interest***, we look at how the current bust-boom action of the S&P 500 stacks up against previous snap-back rallies over similar time frames going back to the 1930s.

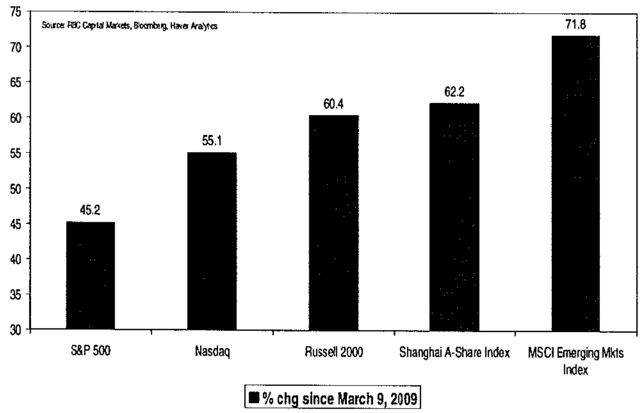
Priced as of prior trading day's market close, ET (unless otherwise noted).

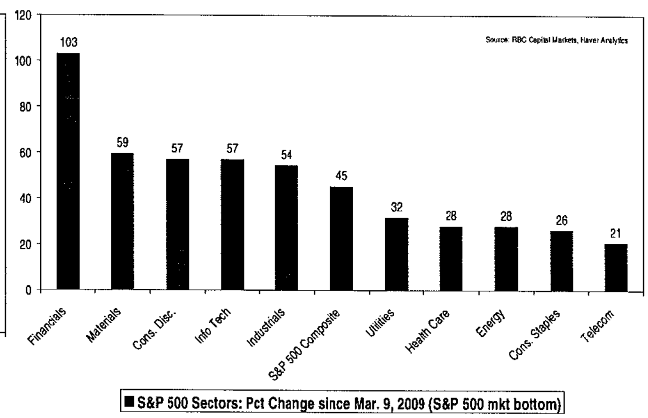
For Required Conflicts Disclosures, please see Page 9.

The Unambiguous Shift in Risk Preference

Performance characteristics from the past four months highlight a common behavioral thread running through the equity market – namely a clear and marked shift in portfolio preference from the avoidance of risk at all costs to its pursuit (but not yet at all costs, as we highlight later in the report). The chase has proven incredibly rewarding for those investors who were early and on the right side of the trade. In our opinion, the opportunities to arbitrage abnormally wide risk spreads from here forward will be more difficult to find and possibly be less rewarding. That said, we believe excess return possibilities are still available to those willing to venture into the right tail of the risk distribution.

Exhibit 1: Performance of Various Benchmarks & Sectors since March 9th Low



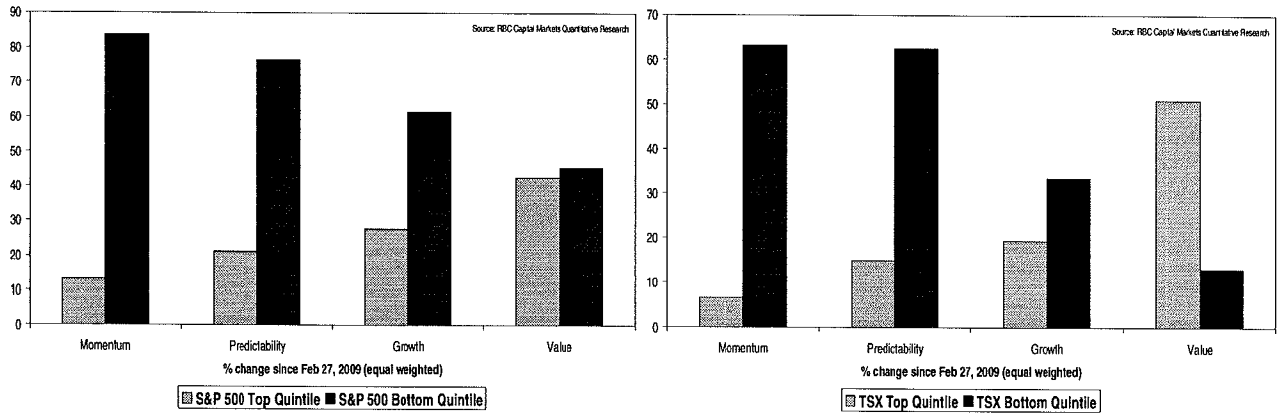


There is no question that equities have been on a tear. What we might call a higher-quality index, the S&P 500, has rallied by 45% since the March 9th low. A duration-adjusted gain of this magnitude is rarified air, having been surpassed on only one prior occasion and that was in the early 1930s. It is equally important to keep in mind the symmetry of the current cycle's performance profile, with the extent of the prior decline only surpassed during the post-1929 bear market (please see our *Stock Chart of Interest* section for more details). At the same time, comparative benchmark performance underscores the power of the risk trade operating at its most basic level (Exhibit 1, LHS). In particular, the S&P 500's price surge has been no match for the 60%-plus gains delivered by the smaller-cap or the more cyclically-oriented benchmarks such as the Russell 2000 and the MSCI Emerging Markets Indexes.

Similar risk-seeking behavior is evident at the sector level within the benchmarks (Exhibit 1, RHS). At the extreme, the balance-sheet challenged S&P 500 Financials sector has more than doubled and has led all other S&P 500 sectors since the springtime. In broader terms, sectors with less visible earnings streams over a full economic cycle have generally been the top performers. These developments are paralleled in Canada with the TSX Metals & Mining index's near 200% gain and TSX Financials' 85% gain from early March helping to vault them into the top spots.

The message from an analysis of stock selection is equally telling in both the US and Canada (Exhibit 2). The worst ranked stocks on a fundamental basis have massively outperformed their best ranked counterparts across three of RBC's four proprietary multi-factor style models. Our value model offers the exception, with the cheapest (i.e., Top Quintile) stocks keeping pace with the most expensive (i.e., Bottom Quintile) stocks in the US while vastly outperforming in Canada.

Exhibit 2: Fundamentally Broken + Cheap = Massive Outperformance in North America



Additional color surfaces when we look at performance since early March parsed along a few basic but well-known factors. Our quantitative team has helped us characterize this rally using nine stock-specific attributes broadly grouped into three themes: Size/liquidity, valuation and profitability. Each attribute is sorted from lowest to highest by decile, accompanied by equally-weighted stock price performance (Exhibit 3).

Exhibit 3: S&P 500 Performance since March Low by Individual Factors

S&P 500: Returns Since March 9 Low Based on Various Metrics by Decile	Deciles (D1 = Highest, D10 = Lowest)									
	1	2	3	4	5	6	7	8	9	10
Market Cap	42.0%	49.8%	43.9%	52.3%	68.3%	54.2%	57.0%	63.6%	118.4%	157.9%
Average Daily Dollar Volume	60.4%	60.1%	69.2%	68.7%	67.1%	63.5%	72.5%	76.8%	80.1%	88.9%
Price	32.8%	35.1%	43.7%	41.6%	52.4%	61.6%	67.6%	96.4%	98.3%	177.8%
B/P	178.0%	91.1%	81.8%	68.5%	56.8%	46.8%	49.3%	52.8%	40.4%	41.9%
Trl EPS Yield	133.8%	83.8%	60.3%	57.5%	49.9%	44.2%	40.8%	40.2%	57.0%	139.8%
Est EPS Yield	146.2%	67.0%	60.2%	53.9%	53.6%	42.9%	39.9%	47.1%	71.2%	125.4%
Dividend Yield	148.5%	77.8%	70.6%	68.5%	58.5%	55.4%	45.9%	41.8%	49.9%	77.8%
Trl ROE	52.8%	47.3%	53.7%	50.5%	61.1%	63.5%	62.5%	85.5%	97.3%	113.9%
Est ROE	48.3%	64.4%	50.8%	62.3%	62.5%	72.1%	63.7%	78.9%	106.7%	100.0%

A clear bias towards the smaller/less liquid…

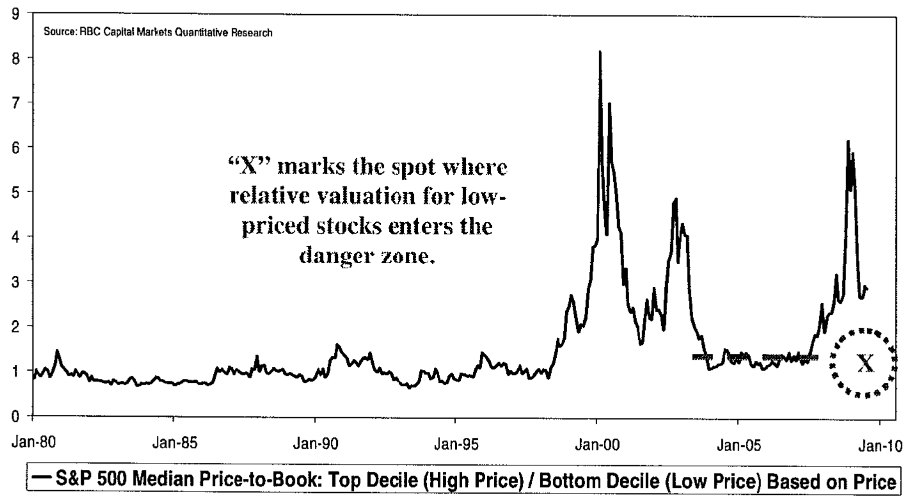
…less expensive…

…less profitable.

Source: RBC Capital Markets Quantative Research

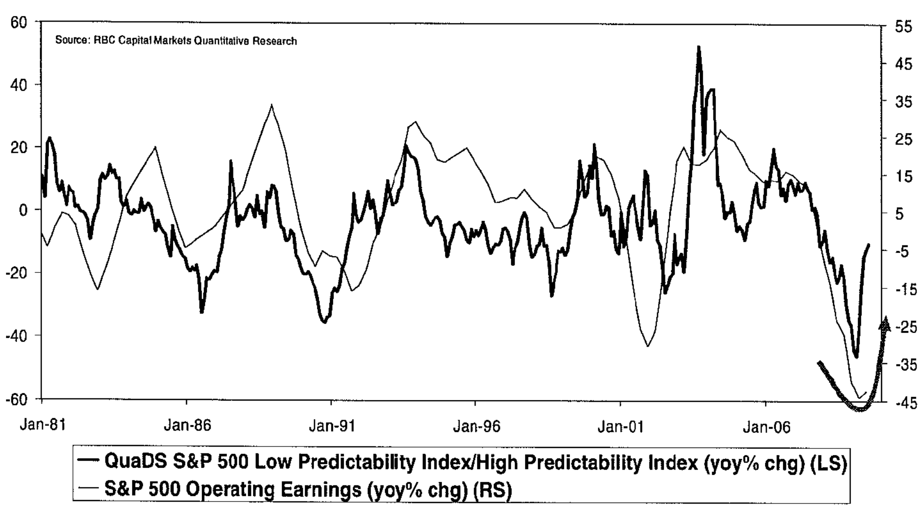
All of the work points to the same general conclusions: The more fundamentally broken and the less expensive a sector or stock was in early March, the better it has subsequently performed. In other words, leadership has been among the group of stocks initially placed on the endangered species list in the event that the recession extended into the future. Many of these same stocks are now perceived as having the most to gain from economic recovery and have performed accordingly.

Exhibit 4: Low-priced (i.e., "Riskier") Stocks still Relatively Inexpensive



It is important to assess where this risk-based or low-quality trade now stands given that it has already surrendered abnormally large excess returns. Jeremy Grantham, a renowned value investor, suggests in his most recent quarterly piece that the valuation spread between high-priced stocks and low-priced stocks (i.e., the S&P 500's analog to penny stocks) offers a quick and dirty way to determine whether sufficient compensation for taking risk is on offer. This relative spread has come in since its February 2009 extreme, but remains elevated not only relative to recent history but to almost all periods since 1980 (Exhibit 4). In other words, the low-priced (or "riskier") stocks still offer a significant valuation advantage relative to their higher-priced counterparts.

Exhibit 5: "Low-quality" Leadership is Married to Economic & Earnings Confidence



The "low-quality" trade is probably not over, but strong technical arguments can be made for the case that it is in need of a rest. However, we might ultimately get to valuation levels that make little investment sense. Historic examples of investors' willingness to subsidize risk for extended periods of time are easy to find. Low spreads offered by junk bonds early in 2007 and astronomical valuations found across the Tech sector through much of the late-1990s are just a couple of recent examples. If confidence in the economic outlook improves over the next few quarters, we could once again find investors over-paying for risk.

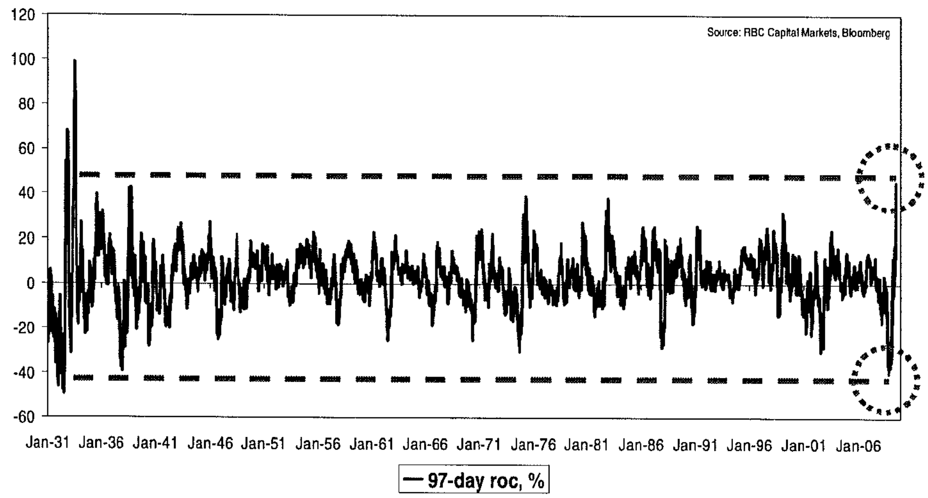
Take the relative performance of low-predictability versus high predictability stocks as one example of how this risk trade might extend (Exhibit 5). A stock's predictability score according to our proprietary ranking system captures the characteristics of earnings quality and stability. Lower predictability rankings, in some sense, reflect increasing investment risk. We see that these low predictability stocks have sharply outperformed, and usually continue to do so over the full period that earnings growth is rising. If the economic recovery extends well into 2010, lower-quality stocks might not simply stop at fair value but could move to an overvalued extreme as they have done many times in the past.

As a final thought on so-called rational decision making, we turn to the now famous "$20 bill auction" conducted by Harvard Professor Max Bazerman. Each year, Professor Bazerman invites his MBA class to participate in an auction where the prize is a brand spanking new $20 bill paid out by the professor himself. The bidding begins at $1 and can only increase in dollar increments. No bidder can bid more than once. The auction's winner gets the $20 bill in exchange for the amount of the winning bid while the runner-up also has to pay the professor an amount equal to the second place bid. And I quote from the book *The Winner Take All Society*, "...Max Bazerman reports that during the past ten years he has earned more than $17,000 [all of his proceeds are donated to charity] by auctioning $20 bills to his MBA students.... In the course of almost two hundred of his auctions, the top two bids never totaled less than $39, and in one instance totaled $407." How's that for rationality?

Bottom Line: Strong technical arguments can be made in favor of the so-called low quality trade taking a breather. However, we do not believe this will spell the end of the road for the theme. Riskier assets typically outperform as investors gain confidence in the economic and earnings outlook. The peak in confidence usually corresponds with the peak in earnings growth and we are nearer to the bottom than to the top on that front. Meanwhile, some valuation work suggests that low quality stocks remain inexpensive relative to their high quality counterparts despite an impressive period of outperformance. Or, in other words, investors are still being sufficiently compensated for taking above-average levels of risk.

Stock Chart of Interest: S&P 500's Rally from the March Low

Current Rally has been Fast and Furious



The rally off of the March lows has not only been furious, but fast as well. In just 97 trading days since troughing, the S&P 500 has rebounded 45% – the largest increase over a comparable time window since the 1930s. Incidentally, and similar to the current rally, the massive jumps back then also came directly on the heels of dramatic sell offs. The "snap back" nature of these moves offers some comforting context to those wondering how a rally as big as the current one can even occur, let alone be justified. Just as with a rubber band, the further it is pulled one way, the faster and harder it can be expected to snap back the other way.

RBC Capital Markets North American Economic and Market Forecasts

Asset Mix	Past Range	Fall '08 Canada	Fall '08 US	New Year '09 Canada	New Year '09 US	Spring '09 Canada	Spring '09 US	Summer '09 *Canada*	Summer '09 *US*
Stocks	40% - 70%	60	55	60	55	55	50	60	60
Bonds	10 - 55	20	20	25	30	30	35	30	30
Cash	0 - 40	20	25	15	15	15	15	10	10

Economic Forecast		Canada	Change from Last Quarter	United States	Change from Last Quarter
Real GDP	2Q'10/2Q'09	1.00%	+2.75	1.25%	+3.25
	2Q'11/2Q'10	2.00	+0.50	2.00	+0.50
CPI	2Q'10/2Q'09	0.00	N/C	0.00	+0.50
	2Q'11/2Q'10	1.00	N/C	1.00	+0.50

Market Index Earnings (all net of unusual items)	2008	2009E	Change from Last Quarter	2010E	Change from Last Quarter
S&P/TSX (top-down)	$905.9	$600.0	+28.00	$650.0	+60.00
S&P/TSX (consensus bottom-up)	905.9	677.2	(65.78)	842.2	(59.61)
S&P 500 (top-down)	65.2	58.0	+3.00	62.0	+2.00
S&P 500 (consensus bottom-up)	65.2	56.6	(6.57)	72.5	(7.43)

Targets	29-May-09	Forecast 31-May-10	Change from Last Quarter	1 Year Total Return Est.
Canada 91-Day T-Bill Rate	0.18	0.25	(0.75)	0.2
Canada 10-Year Bond Yield	3.38	3.25	+0.75	4.4
U.S. 91-Day T-Bill Rate	0.14	0.25	(0.25)	0.2
U.S. 10-Year Bond Yield	3.47	3.25	+1.25	5.1
Canada Dollar	0.92	0.95	+0.17	3.7
S&P/TSX Composite	10370	11600	+2900.00	15.2
S&P 500	919	1050	+200.00	16.6

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

Asset Allocation Themes:

- **The asset mix is aligned with a recovery scenario.** Government-aided asset price inflation and income support shows early signs of breaking the self-reinforcing downward spiral that has been spreading from the financial sector to the real economy. Riskier assets like corporate bonds and equities should benefit from a continuation of recent macro economic trends.

- **Earnings remain challenging, but should improve.** Our earnings models have become more positive on the cycle. A bottoming in profitability and some improvement in the top line is likely to lead to better earnings growth in the second half of 2009 and into 2010.

- **Our year-ahead targets imply higher returns for equities over government bonds.** Modest earnings improvement accompanied by receding financial stress and improving investor confidence is likely to maintain investors' interest in stocks over bonds.

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

Canadian Equity Sectors	Current Recommendation	Recent Change (June 1, 2009)	Comments
Financials	Overweight	*Upgraded from Market Weight*	A better tone to capital markets, receding global economic risk and attractive dividend yields.
Industrials	Overweight	*Upgraded from Market Weight*	Attractively valued on a P/B and P/S basis with the potential to benefit from a recovery in economic activity and increase in infrastructure spending.
Consumer Staples	Market Weight	*Downgraded from Overweight*	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.
Materials	Market Weight	*Upgraded from Underweight*	USD weakness, powerful policy stimulus and hopes of a global recovery offer support. Emphasize Gold.
Information Technology	Market Weight	None	Profitability metrics continue to hold up. Valuations are improving but remain elevated relative to the rest of the market.
Consumer Discretionary	Market Weight	None	Weak labor market and tough economic times for Eastern Canada are problematic. Margins are under pressure and earnings estimates are dropping. Media remains our primary focus.
Telecom Services	Market Weight	None	Attractive valuations and dividend yields. Sector known for its shareholder-friendly management. Competitive intensification is a risk.
Energy	Market Weight	None	Excess supply is being matched by powerful policy stimulus. Hopes of a global economic recovery offer support.
Health Care	Underweight	*Downgraded from Overweight*	Selective yield plays with attractive valuations.
Utilities	Underweight	*Downgraded from Overweight*	Stability and attractive dividend yields offer portfolio stability. Valuations are elevated, but look less challenging during a prolonged period of low bond yields.

U.S. Equity Sectors	Current Recommendation	Recent Change (June 1, 2009)	Comments
Consumer Discretionary	Overweight	None	Peak in UI claims, easing credit conditions and stimulative fiscal policy provide support. Favor Restaurants and Retailers.
Information Technology	Overweight	None	Strong profitability metrics and cash rich balance sheets are enhanced by an upturn in forward looking orders data. Valuations remain attractive. Hardware and Semis offer best upside opportunity.
Financials	Overweight	*Upgraded from Market Weight*	Receding financial stress, wide yield curve and potential peak in charge-off rates generate promise for the sector. Favor money-center banks, brokers and asset managers.
Health Care	Market Weight	*Downgraded from Overweight*	An aging population is a key long-term support. Obama administration generates event risk. Attractive valuations, superior profitability and low leverage to the economic cycle maintain our interest. Focus on Biotech.
Materials	Market Weight	None	USD weakness, powerful policy stimulus and hopes of a global recovery offer support.
Industrials	Market Weight	None	Global infrastructure development via urbanization and industrialization is a long-term support. Upward trend in ISM is a positive catalyst for the sector. Machinery and equipment stocks hold promise.
Energy	Market Weight	None	Excess supply is being matched by powerful policy stimulus. Hopes of a global economic recovery offer support. Integrateds are more likely to lag.
Consumer Staples	Underweight	None	Stable earnings and strong balance sheets are key supports. Rising commodities prices crimp margins. Valuations are neutral. Fundamentals remain strong for Food, Beverage & Tobacco.
Utilities	Underweight	None	Sector offers a good hedge against volatile financial and economic conditions. They are often treated as a source of funds during a market upturn.
Telecom Services	Underweight	None	Concerns over competition, broadband saturation, profitability and balance sheet strength linger. Attractive dividend yields. Wireless exposure offers more upside potential.

Source: RBC Capital Markets

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Conflicts Disclosures

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HOLD[SP]	525	46.5	90	17.14
SELL[U]	79	7	5	6.33

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