The Global Investment Outlook

RBC Investment Strategy Committee

SPRING 2007

The RBC Investment Strategy Committee

The RBC Investment Strategy Committee consists of senior investment professionals drawn from individual client focused business units within RBC Financial Group. 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 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

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Chief Investment Officer — RBC Asset Management Inc.

FOLLOWING A LONG PERIOD OF CALM, THE RECENT CORRECTION FELT ESPECIALLY SEVERE. WE DON'T BELIEVE THAT THE PLUNGE REFLECTED A SUDDEN RE-APPRAISAL OF THE ECONOMIC OUTLOOK, OR THAT THE CORRECTION WAS SERIOUS ENOUGH TO CAUSE COLLATERAL DAMAGE TO GROWTH. OUR FORECAST REMAINS MUCH THE SAME AS IT'S BEEN – A LONG CYCLE OF MODERATE GROWTH WITH MILD INFLATION, COUPON-LIKE RETURNS FROM BONDS AND ABOVE-NORMAL RETURNS FROM STOCKS. THE RETURN OF MARKET VOLATILITY HASN'T ALTERED OUR VIEW. SPECIFICALLY:

A Soft Landing for North America...

The North American economy has emerged from a successful soft landing. Moderating growth and inflation may allow for the expansion to extend through the current decade. We look for growth averaging 3.0% in the U.S. with 2.25% inflation for this year and next. Canada should post similar results with 1.75% growth in 2007, improving to 2.0% in 2008, and inflation moving between 1.75% and 2.0%.

...and a Firmer Tone to Eurozone and Japanese Growth

Offshore, European growth is quickening as Germany in particular enjoys the benefits of restored competitiveness. We look for Eurozone growth of 2.75% for 2007 and 2008 and inflation holding near the 2.0% level. Japan's economy, too, has entered 2007 on a firmer footing and we look for 2.25% growth this year before a further move up to the 2.5% level in 2008. Inflation should crawl higher as the expansion ages and broadens and we look for 0.5% in 2007, rising to 0.75% next year.

More Weakness Ahead for $US

The U.S. dollar has been trading in line with interest rate expectations, so its performance has been highly sensitive to economic data releases and changing expectations about monetary policy. The seemingly directionless and choppy currency market is characteristic of a mature economic cycle. While dollar supportive factors may occasionally come to the forefront, structural negatives will prevail over the longer term. The coming 12 months are likely to see a decline in the dollar, with the potential for an unwind of the carry trade a likely source of weakness.

Rounding Out the Cycle of Rate Hikes

Moderating growth and inflation were probably enough to eliminate the need for additional rate hikes in North America, but an increase in market volatility bolsters our view that short-term interest rates peaked last summer in both the U.S. and Canada. Limited interest rate cuts are possible later in 2007, but they are not an essential element of our forecast. In Europe, the ECB should complete its program of rate hikes within the current calendar year, and we expect Eurozone rates to lie within 25 basis points of current levels one year from now. The Bank of Japan's monetary policy has become data-dependent, and with short-term interest rates now back to equilibrium levels, we look for no more than an additional 25 basis point hike to the 0.75% level over the coming 12 months.

Scope for Lower Bond Yields

Fixed income markets appear fairly valued but an economic soft landing, moderate inflation and the end of Fed rate hikes open up scope for further declines in bond yields. We look for a 4.5% 10-year T-bond yield and a 4.0% yield for 10-year Canadas by this time next year. Similar, coupon-like returns are also forecast for Eurozone and U.K. bonds over the coming 12 months. In Japan, however, we expect yields to move toward the 2% level over the year ahead. In all regions, our forecast could prove conservative should the real rate of interest begin to reflect near-universal confidence in the skills and resolve of central bankers following another successfully engineered soft landing.

Environment Favours Equity Markets

Environments of durable growth, low inflation and mild interest rates are consistent with solid stock market returns. Valuations range from attractive (the U.S., U.K. and Japan) to full (Eurozone) to expensive (Canada) and our recommended regional weights reflect these differences.

The largest, broadest and most mature of the world's equity markets remain well-priced in an economic cycle that could stretch through decade's-end. Corrections, like that of late February, are a regular and essential part of a bull market's development, realigning valuations with a reasonable view of earnings potential and cooling the speculative excess that can lead to imbalances.

Remain Overweight Equities

Our economic outlook and relative return expectations favour equities, as they have for some time. For a balanced investor, we recommend an asset mix of 62.5% equities (allowed range: 40 – 70%), 32.5% bonds (allowed range: 30 – 60%) with the balance of 2.5% in cash.

Economic & Capital Markets Forecasts

ECONOMIC FORECAST (RBC INVESTMENT STRATEGY COMMITTEE)										
	UNITED STATES		CANADA		EUROPE		UNITED KINGDOM		JAPAN	
	SPRING 2007	CHANGE FROM NEW YEAR 2007	SPRING 2007	CHANGE FROM NEW YEAR 2007	SPRING 2007	CHANGE FROM NEW YEAR 2007	SPRING 2007	CHANGE FROM NEW YEAR 2007	SPRING 2007	CHANGE FROM NEW YEAR 2007
REAL GDP										
2006A	3.30%		2.70%		2.50%		2.70%		2.10%	
2007E	3.00%	0.25	2.75%	N/C	2.75%	0.50	2.50%	0.10	2.25%	(0.25)
2008E	3.00%	N/A	3.00%	N/A	2.75%	N/A	2.50%	N/A	2.50%	N/A
CPI										
2006A	3.20%		2.10%		2.20%		2.60%		0.30%	
2007E	2.25%	(0.25)	1.75%	(0.25)	2.00%	(0.25)	2.25%	0.25	0.50%	(0.30)
2008E	2.25%	N/A	2.00%	N/A	2.00%	N/A	2.00%	N/A	0.75%	N/A

A = ACTUAL E = ESTIMATE

TARGETS (RBC INVESTMENT STRATEGY COMMITTEE)				
	FEB. 2007	FORECAST FEB. 2008	CHANGE FROM NEW YEAR 2007	1-YEAR TOTAL RETURN ESTIMATE (%)
CURRENCY MARKETS AGAINST USD				
USD–CDA	1.17	1.12	0.02	3.4
EURO–USD	1.32	1.35	0.01	0.8
USD–JPY	118.48	110.00	2.00	2.9
GBP–USD	1.96	1.95	N/C	2.4
FIXED INCOME MARKETS				
U.S. Fed Funds Rate	5.25	5.00	0.25	5.2
U.S. 10 Year Bond	4.56	4.50	0.25	5.0
Canada Overnight Rate	4.23	4.00	N/C	4.2
Canada 10 Year Bond	4.03	4.00	0.25	4.5
Eurozone Repo Rate*	3.71	4.00	0.50	3.9
Eurozone 10 Year Bond*	4.04	4.00	0.25	4.5
U.K. Base Rate	5.35	5.25	0.50	5.4
U.K. 10 Year Gilt	4.80	4.75	0.25	4.8
Japan Overnight Call Rate	0.60	0.75	(0.25)	0.7
Japan 10 Year Bond	1.64	2.00	N/C	(0.6)
EQUITY MARKETS				
S&P 500	1,407	1,600	50	15.5
S&P/TSX Composite	13,045	13,500	500	5.8
MSCI Europe	1,913	2,100	100	12.6
FTSE 100	6,172	6,900	100	15.7
Nikkei	17,525	19,250	1,000	10.8

Source: RBC AM * GDP Weighted average of Germany, France and Italy.

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 35-year study of historic returns and the volatility 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 income 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 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, 40% fixed income, 5% 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. If, for example, the recommended current equity exposure for the

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GLOBAL ASSET MIX

	BENCHMARK POLICY	PAST RANGE	SUMMER 2006	FALL 2006	REVISED OCT. 16, 2006	NEW YEAR 2007	**SPRING 2007**
CASH	**5.0%**	3% – 16%	7.5%	7.5%	5.0%	2.5%	**2.5%**
BONDS	**40.0%**	25% – 54%	32.5%	32.5%	35.0%	35.0%	**35.0%**
STOCKS	**55.0%**	36% – 65%	60.0%	60.0%	60.0%	62.5%	**62.5%**

REGIONAL ALLOCATION

GLOBAL BONDS	**CWGBI* FEB. 2007**	PAST RANGE	SUMMER 2006	FALL 2006	REVISED OCT. 16, 2006	NEW YEAR 2007	**SPRING 2007**
North America	**23.1%**	9% – 46%	22.8%	25.3%	22.8%	25.3%	**23.0%**
Europe	**48.1%**	40% – 90%	45.5%	46.8%	48.0%	47.9%	**48.0%**
Asia	**28.9%**	0% – 29%	31.8%	28.0%	29.3%	26.8%	**29.0%**

Note: *Based on anticipated 12-month returns in $US hedged basis*

GLOBAL EQUITIES	**MSCI** FEB. 2007**	PAST RANGE	SUMMER 2006	FALL 2006	REVISED OCT. 16, 2006	NEW YEAR 2007	**SPRING 2007**
North America	**52.3%**	15% – 60%	53.0%	53.0%	53.0%	55.0%	**55.0%**
Europe	**33.0%**	30% – 70%	29.0%	30.0%	30.0%	31.0%	**30.0%**
Asia	**14.7%**	10% – 39%	18.0%	17.0%	17.0%	14.0%	**15.0%**

GLOBAL EQUITY SECTOR ALLOCATION

	MSCI** FEB. 2007	RBC ISC NEW YEAR 2007	RBC ISC SPRING 2007	CHANGE FROM NEW YEAR 2007	WEIGHT vs. BENCHMARK
Energy	8.78%	9.00%	8.50%	(0.50)	96.8%
Materials	6.02%	6.75%	6.50%	(0.25)	108.0%
Industrials	10.79%	10.50%	12.00%	1.50	111.2%
Utilities	4.39%	4.25%	4.25%	N/C	96.8%
Consumer Discretionary	11.50%	12.50%	11.50%	(1.00)	100.0%
Consumer Staples	7.99%	6.50%	6.50%	N/C	81.4%
Health Care	9.22%	9.00%	8.50%	(0.50)	92.2%
Financials	26.47%	27.50%	27.50%	N/C	103.9%
Information Technology	10.29%	10.50%	10.25%	(0.25)	99.6%
Telecom. Services	4.55%	3.50%	4.50%	1.00	98.9%

* Citigroup World Global Bond Index **MSCI World Index Source: RBC Investment Strategy Committee

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Balanced profile is set at 62.5% (i.e.: 7.5% above its benchmark of 55% and part way toward its upper limit of 70% for equities), that would imply a tactical shift of + 5.02% to 25.02% for the Income profile (i.e.: a proportionate adjustment above the benchmark equity setting of 20% within the allowed range of +/- 15%).

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

Regular review of portfolio weights is an essential part of the ultimate success of an investment plan as it ensures that current exposures are aligned with the level of long-term returns and risk tolerances best suited to individual investors.

Anchoring portfolios with a suitable strategic asset mix, and placing limits around the allowed range for tactical positioning imposes a discipline that can limit the 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 1970 – 2005, 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.

Income

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
CASH & CASH EQUIVALENTS	5%	0-15%	2.8%	2.8%
FIXED INCOME	75%	55-95%	72.2%	72.2%
TOTAL CASH & FIXED INCOME	80%	65-95%	75.0%	75.0%
CANADIAN EQUITIES	10%	5-20%	10.0%	10.0%
U.S. EQUITIES	5%	0-10%	9.1%	9.1%
INTERNATIONAL EQUITIES	5%	0-10%	5.9%	5.9%
TOTAL EQUITIES	20%	5-35%	25.0%	25.0%

	RETURN	VOLATILITY
35-YEAR AVERAGE	9.8%	7.3%
LAST 12 MONTHS AVERAGE	6.9%	3.2%

Income-oriented 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	5%	0-15%	2.6%	2.6%
FIXED INCOME	60%	40-80%	55.4%	55.4%
TOTAL CASH & FIXED INCOME	65%	50-80%	58.0%	58.0%
CANADIAN EQUITIES	15%	5-25%	15.0%	15.0%
U.S. EQUITIES	10%	0-15%	15.5%	15.5%
INTERNATIONAL EQUITIES	10%	0-15%	11.5%	11.5%
TOTAL EQUITIES	35%	20-50%	42.0%	42.0%

	RETURN	VOLATILITY
35-YEAR AVERAGE	10.2%	7.8%
LAST 12 MONTHS AVERAGE	7.7%	3.7%

Conservative investors will pursue modest income and modest 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	5%	0-15%	2.5%	2.5%
FIXED INCOME	40%	20-60%	35.0%	35.0%
TOTAL CASH & FIXED INCOME	45%	30-60%	37.5%	37.5%
CANADIAN EQUITIES	20%	10-30%	20.0%	20.0%
U.S. EQUITIES	20%	10-30%	26.4%	26.4%
INTERNATIONAL EQUITIES	15%	5-25%	16.1%	16.1%
TOTAL EQUITIES	55%	40-70%	62.5%	62.5%

	RETURN	VOLATILITY
35-YEAR AVERAGE	10.6%	9.4%
LAST 12 MONTHS AVERAGE	8.2%	4.8%

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 a medium to long-term (minimum five to seven years).

Growth

ASSET CLASS	BENCH-MARK	RANGE	LAST QUARTER	CURRENT RECOMMENDATION
CASH & CASH EQUIVALENTS	5%	0-15%	1.5%	1.5%
FIXED INCOME	25%	5-40%	19.5%	19.5%
TOTAL CASH & FIXED INCOME	30%	15-45%	21.0%	21.0%
CANADIAN EQUITIES	25%	15-35%	25.0%	25.0%
U.S. EQUITIES	25%	15-35%	32.5%	32.5%
INTERNATIONAL EQUITIES	20%	10-30%	21.5%	21.5%
TOTAL EQUITIES	70%	55-85%	79.0%	79.0%

	RETURN	VOLATILITY
35-YEAR AVERAGE	10.8%	11.0%
LAST 12 MONTHS AVERAGE	8.9%	5.9%

Investors who fit the Growth portfolio 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	5%	0-15%	1.5%	1.5%
FIXED INCOME	0%	0-10%	0.0%	0.0%
TOTAL CASH & FIXED INCOME	5%	0-20%	1.5%	1.5%
CANADIAN EQUITIES	35%	20-50%	35.0%	35.0%
U.S. EQUITIES	30%	15-45%	34.6%	34.6%
INTERNATIONAL EQUITIES	30%	15-45%	28.9%	28.9%
TOTAL EQUITIES	95%	80-100%	98.5%	98.5%

	RETURN	VOLATILITY
35-YEAR AVERAGE	11.1%	14.1%
LAST 12 MONTHS AVERAGE	10.7%	8.2%

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 international 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. Investment Policy – RBC Asset Management Inc.

Over the past three months, the U.S. dollar strengthened against major world currencies, rising 2.5% against the Canadian dollar and 2.2% relative to the yen. Against the euro and British pound, the gains were more modest at nine basis points and 12 basis points, respectively. In the year ended March 1, 2007, the U.S. dollar gained 2.9% relative to the loonie and 2.2% against the yen. In that period, it declined 11% against the euro and 11.9% against the pound.

Over the past three months, major bond markets have provided low or slightly negative returns. Even so, they've generally outperformed equities since January 1, 2007. The best performing fixed-income market, measured in U.S. dollars, was the U.S. The Citigroup U.S. Bond Index returned 0.66% in the three-month period. The worst performing region was Europe, with the Citigroup Europe Total Return Index (measured in U.S. dollars) losing 1.05% because of the rising U.S. dollar and interest rates hikes in the U.K. On a one-year basis, European fixed income continues to be the top performer, providing a 11.7% return. Japanese bonds, measured by the Citigroup Japan Index in U.S. dollars, have lagged other major bond markets on a one-year and five-year basis.

The equity market plunge in late February wiped out many of the gains achieved during the previous three months. In fact, had the quarter ended just two days earlier, the quarter would have been a strong one for stocks around the globe. Before the 3.5% drop on February 27, the S&P 500 had gained 2.2% in 2007, building on four years of advances. The S&P 500 and Nasdaq had both recently closed at six-year highs, and the Dow set several records. Following the slump, however, the S&P 500 and the S&P 400 mid-cap index have declined in 2007, while the Nasdaq is almost unchanged. European and Asian stocks have also slumped, while emerging-market stocks had their steepest two-day drop in eight months. Federal Reserve Chairman Ben Bernanke said there didn't appear to be "any single trigger" for the rout in stocks, and financial markets "seem to be working well."

Over the three months ended February 28, 2007, the best performing major country equity indexes were the MSCI Japan and MSCI Germany, returning 7.5% and 6.6%, respectively. The late-February decline in Japanese equity prices appears to have been largely the result of investors locking in profits after a run that had sent Japanese stocks to a 15-year high. Overall, returns for global equities, as measured by the MSCI World Total Return Index (measured in U.S. dollars, after taxes), were 2.7% for the three months. Asian markets provided the highest returns of the three major regions, with the MSCI Pacific

EXCHANGE RATES (USD RETURNS)
PERIODS ENDING FEBRUARY 28, 2007

	Current USD	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
USD–CAD	0.85	2.49	0.40	2.92	-4.36	-6.12
EUR–USD	0.76	0.09	-0.26	-10.98	-1.93	-8.77
GBP–USD	0.51	0.12	-0.26	-11.94	-1.69	-6.75
USD–JPY	118.34	2.19	-0.59	2.19	2.71	-2.46

CANADA (CAD $ BASIS)
PERIODS ENDING FEBRUARY 28, 2007

Fixed Income Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
S&P/TSX Broad Comp. Bond Index	0.38	1.13	5.33	NA	NA

U.S. (USD $ BASIS)
PERIODS ENDING FEBRUARY 28, 2007

Fixed Income Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
Citigroup US	0.66	1.49	4.80	2.95	4.59
LB Aggregate Bond Index	0.47	1.05	5.07	3.41	4.91

GLOBAL (USD $ BASIS)
PERIODS ENDING FEBRUARY 28, 2007

Fixed Income Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
Citigroup WGBI	-0.95	0.93	6.29	3.10	8.90
Citigroup Europe	-1.05	0.66	11.68	6.04	14.28
Citigroup Japan	-1.84	1.03	-0.90	-2.03	3.63

Source: Bloomberg/MSCI

Index climbing 7.4%, followed by Europe and North America.

Within North America, the S&P 500 outperformed the S&P/TSX Composite over the past three months. In both the U.S. and Canada, mid-cap stocks significantly outperformed large caps. For example, the S&P/TSX Mid Cap Total Return Index outperformed the S&P/TSX 60 Total Return Index by 341 basis points. U.S. value stocks outperformed growth stocks, with the Russell 3000 Value Index returning 1.9%, compared with a 1.0% increase for the Russell 3000 Growth Index. The worst performing U.S. market was the Nasdaq, which lost 0.64%.

The best performing global sectors since December 1, 2006, were Materials, Telecommunication Services and Industrials, returning 8.1%, 6.6% and 5.8% respectively. Underperforming sectors were Energy and Information Technology, which lost 5.7% and 1.3%, respectively. On a one-year basis, Telecommunication Services and Utilities were the market leaders, returning 33.5% and 28.3%, respectively. Sectors whose performance lagged on a one-year basis were Information Technology, which gained 5.9%, and Energy, which gained 8.9% over the period.

CANADA (CAD $ BASIS)
PERIODS ENDING FEBRUARY 28, 2007

Equity Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
S&P/TSX Composite	2.93	1.41	14.43	16.41	13.50
S&P/TSX 60	2.08	0.41	15.00	17.08	13.44
S&P/TSX Mid Cap	5.49	4.12	16.14	17.74	15.14
S&P/TSX Small Cap	4.94	4.05	10.40	9.28	11.21

U.S. (USD $ BASIS)
PERIODS ENDING FEBRUARY 28, 2007

Equity Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
S&P 500	0.92	-0.08	15.24	4.33	0.27
S&P 400	3.89	-0.47	11.97	9.09	6.82
S&P 600	1.49	4.39	9.68	13.01	11.94
RUSSELL 3000 Value	1.86	-0.25	16.40	13.59	11.24
RUSSELL 3000 Growth	1.01	0.72	7.82	6.42	4.47
NASDAQ Composite Index	-0.64	0.04	5.91	5.98	6.89

GLOBAL (USD $ BASIS)
PERIODS ENDING FEBRUARY 28, 2007

Equity Markets: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
MSCI World*	2.70	0.65	15.86	13.69	10.99
MSCI EAFE*	4.68	1.49	21.07	19.05	16.42
MSCI Europe*	3.45	0.23	25.70	19.40	16.17
MSCI Pacific*	7.40	4.29	11.99	18.41	17.21
MSCI UK*	2.23	-0.30	23.71	17.04	14.44
MSCI France*	3.27	-0.26	25.45	19.12	15.36
MSCI Germany*	6.55	2.33	27.66	21.02	15.61
MSCI Japan*	7.51	4.90	7.01	16.88	15.54
MSCI Emerging Markets*	2.76	-1.66	17.05	26.42	24.93

* NET OF TAXES

GLOBAL EQUITY SECTORS (USD $ BASIS)
PERIODS ENDING FEBRUARY 28, 2007

Sector: Total Return	3 months (%)	YTD (%)	1 year (%)	3 years (%)	5 years (%)
Energy	-5.65	-3.94	8.88	22.15	16.33
Materials	8.10	5.05	26.78	24.24	20.09
Industrials	5.77	3.09	16.61	16.95	12.25
Utilities	4.98	2.24	28.34	24.31	17.94
Consumer Discretionary	4.49	1.36	18.07	11.52	9.24
Consumer Staples	3.94	1.32	18.85	10.85	9.68
Health Care	1.61	0.91	9.14	7.90	4.93
Financials	3.07	-0.17	16.05	15.50	14.59
Information Technology	-1.31	-1.25	5.86	4.13	3.66
Telecommunication Services	6.63	2.54	33.47	11.44	8.18

Source: Bloomberg/MSCI

Investment Outlook

DANIEL E. CHORNOUS, CFA
Chief Investment Officer — RBC Asset Management Inc.

Asset Mix Still Positioned for a Long Economic Cycle

FOLLOWING A LONG PERIOD OF CALM, THE LATE-FEBRUARY CORRECTION FELT ESPECIALLY SEVERE. WE DON'T BELIEVE THAT THE PLUNGE REFLECTED A SUDDEN RE-APPRAISAL OF THE ECONOMIC OUTLOOK, OR THAT THE CORRECTION WAS SERIOUS ENOUGH TO CAUSE COLLATERAL DAMAGE TO GROWTH. IT MAY BE, THOUGH, THAT THE WAY AHEAD FOR THE ECONOMY APPEARS SO CLEAR AND COMPELLING THAT COMPLACENCY HAD SET IN. THE CORRECTION SHOULD BRING BACK A HEALTHY DOSE OF SCEPTICISM, LIMITING THE RISK THAT WIDESPREAD SPECULATION WILL CREATE THE KINDS OF IMBALANCES THAT ULTIMATELY BRING ABOUT THE END OF AN ECONOMIC CYCLE.

Our forecast remains much the same as it's been – a long cycle of moderate growth with mild inflation, coupon-like returns from bonds and above-normal returns from stocks. The return of market volatility hasn't altered our view. Specifically:

- The North American economy has emerged from a successful soft landing. Moderating growth and inflation may allow for the expansion to extend through the current decade. We look for growth averaging 3.0% in the U.S. with 2.25% inflation for this year and next. Canada should post similar results with 1.75% growth in 2007, improving to 2.0% in 2008, and inflation moving between 1.75% and 2.0%.

- Offshore, European growth is quickening as Germany in particular enjoys the benefits of restored competitiveness. We look for Eurozone growth of 2.75% for 2007 and 2008 with inflation holding near the 2.0% level. Japan's economy, too, has entered 2007 on a firmer footing and we look for 2.25% growth this year before a further move up to the 2.5% level in 2008. Inflation should crawl higher as the expansion ages and broadens and we look for 0.5% in 2007, rising to 0.75% next year.

- Moderating growth and inflation were probably enough to eliminate the need for additional rate hikes in North America, but an increase in market volatility bolsters our view that short-term interest rates peaked last summer in both the U.S. and Canada. Limited interest rate cuts are possible later in 2007, but they are not an essential element of our forecast. In Europe, the ECB should complete its program of rate hikes within the current calendar year, and we expect Eurozone rates to lie within 25 basis points of current levels one year from now. The Bank of Japan's monetary policy has become data-dependent, and with short-term interest rates now back to equilibrium levels, we look for no more than an additional 25 basis point hike to the 0.75% level over the coming 12 months.

- Fixed income markets appear fairly valued but a soft landing for the economy, moderate inflation and the end of Fed rate hikes open up scope for further declines in bond yields. We look for a 4.5% 10-year T-bond yield and a 4.0% yield for 10-year Canadas by this time next year. Similar, coupon-like returns are forecast for Eurozone and U.K. bonds over the coming 12 months. In Japan, however, we expect yields to move toward the 2% level over the year ahead. In all regions, our forecasts could prove conservative should the real rate of interest begin to reflect near-universal confidence in the skills and resolve of central bankers following another successfully engineered soft landing.

- Environments of durable growth, low inflation and mild interest rates are consistent with solid stock market returns. Valuations range from attractive (the U.S., U.K. and Japan) to full (Eurozone) to expensive (Canada) and our recommended regional weights reflect these differences. The largest, broadest and most mature of the world's equity markets remain attractively priced in an economic cycle that could stretch through decade's-end. Corrections, like that of early March, are a regular and essential part of a bull market's development, realigning

valuations with a reasonable view of earnings potential and cooling the speculative excess that can lead to imbalances.

- Our economic outlook and relative return expectations favour equities, as they have for some time. For a balanced investor, we recommend an asset mix of 62.5% equities (allowed range: 40% - 70%), 35% bonds (allowed range: 30% - 60%) with the balance of 2.5% in cash.

A Soft Landing Leading to Durable Expansion...

Fifteen hikes in the fed funds rate and tight control of the monetary aggregates lowered the pace of U.S. economic growth below 3% for the final three quarters of 2006 (Exhibit 1). A certain amount of luck is still useful in managing the monetary levers, but Exhibit 2 shows that the Fed has a deft hand. The dotted line represents the fed funds rate (inverted and advanced 6-months on the chart). The boldface line traces the ISM Manufacturing Diffusion Index, an important indicator of U.S. manufacturing activity. Aggressive rate cuts between 2001 and 2004 (rising dotted line on chart) pulled the economy out of recession and into rapid expansion. Since mid-2004, progressive hikes in the fed funds rate (falling dotted line on chart) nudged growth down to a sustainable, low inflation pace.

Slower growth, lower oil prices and some statistical noise have allowed inflation to sink close to the Fed's range of tolerance of between zero and 2%. *For the eighth time in a half century, the Federal Reserve Board has successfully engineered a soft landing, and that's had a dramatic impact on confidence and expectations.*

EXHIBIT 1. **United States**
Real Gross Domestic Product and CPI Inflation

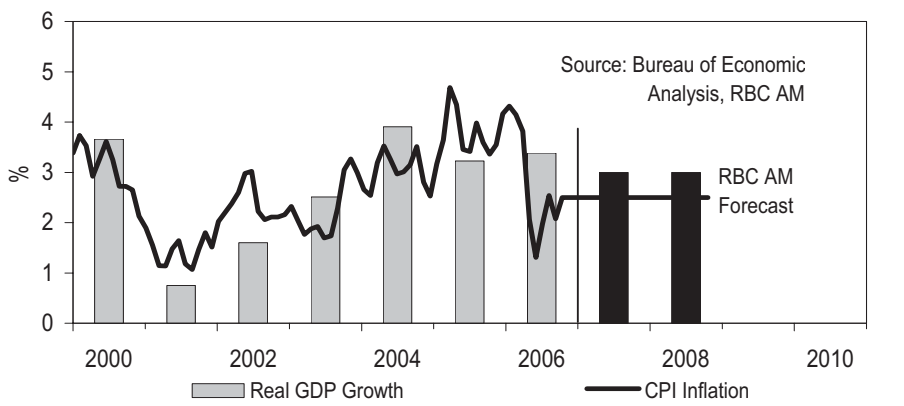


EXHIBIT 2. **U.S. ISM Manufacturing Index and the Fed Funds Rate**
Fed Funds Inverted and Advanced Six Months

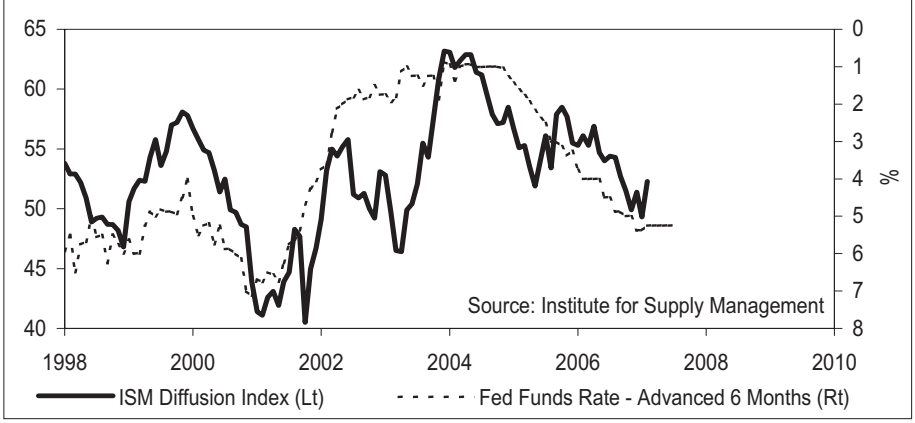


Exhibit 3 plots the breakeven inflation rate buried in the interest rate differential between nominal coupon and inflation index-linked government bonds in the U.S. and Canada. The spread represents a market-based indicator of long-run inflation expectations. In simple terms, today's 2.38% spread is a proxy for the market's best bet on inflation over the coming years. That's almost 30 basis points below the average inflation rate of the past five years, and is especially impressive considering that the recent drop in the premium occurred after the Fed stopped raising interest rates.

...with Mild Inflation...

The Chicago Fed's National Activity Index (Exhibit 4) is a good barometer

of the tone and sustainability of the business cycle. The Index is a composite of almost 100 economic statistics gathered nation-wide. We began following it several years ago as a leading indicator of inflation, but it's just as useful in forecasting recessions. Specifically, as the indicator rises above 0.7 (read off the left hand axis), an early warning of inflationary pressures is signalled. Movement above 1.0 confirms that inflation has already taken root. In seven instances since the mid-1980's the indicator flashed an early warning of inflation, but in every case including that of late 2005, a well-timed interest rate strike by the Fed calmed price pressures before a corrosive spiral began.

A sustained decline in the indicator below -0.7 signals the risk of recession, and timely warnings were flashed in 1990 and again in 2001. Recently, the National Activity Index has fallen below 0, but it's hovering at a level that is consistent with neither inflation nor recession – let's call it a soft landing.

...Confirmed by Capital Markets

To us, though, the most compelling proof of the soft landing comes from the action of the capital markets. Exhibits 5 and 6 plot the performance of 10-year T-bond yields and the S&P 500 Index through the year leading into and beyond a final hike in the fed funds rate. The data is drawn from 15 cycles reaching back to 1953 and is separated into three groups: the median experience across all 15 cycles, the median experience for the eight cycles where the economy eventually fell into recession and

EXHIBIT 3. Implied Long-Term Inflation Premium
Breakeven Inflation Rate: Nominal vs. Real Return Bond

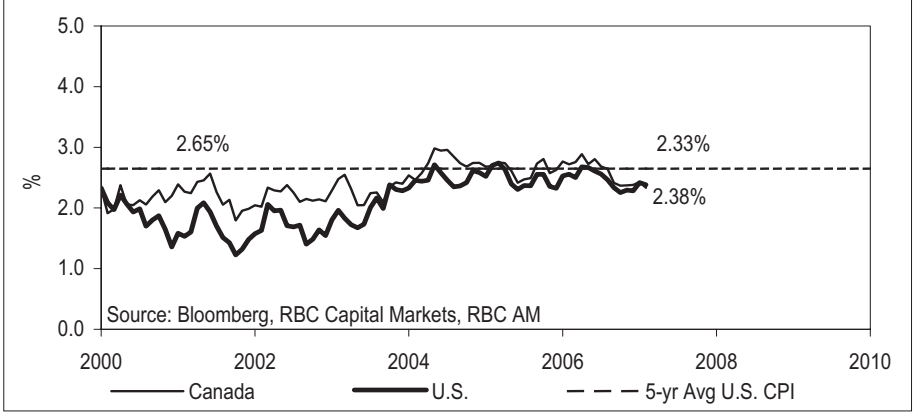


EXHIBIT 4. Chicago Fed National Activity Index
Three Month Moving Average

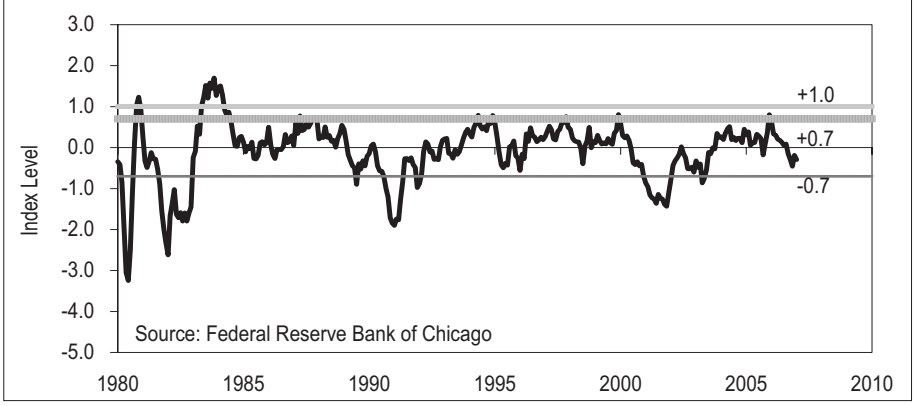
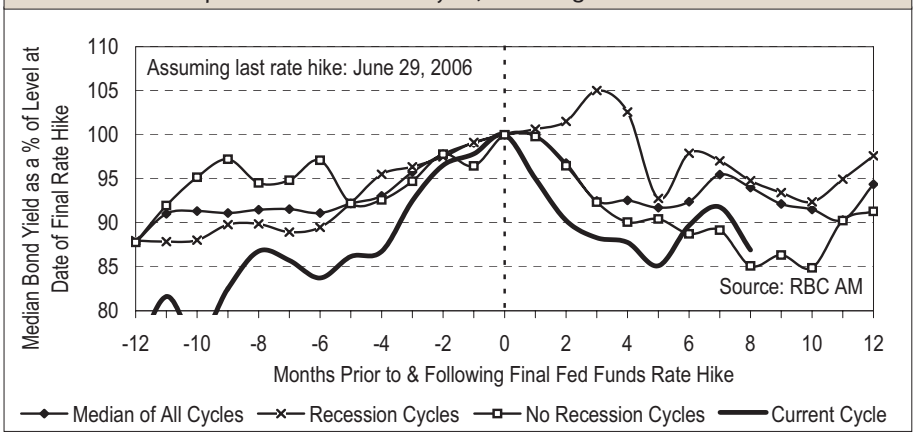


EXHIBIT 5. U.S. 10-Year Bond Yield and the Fed Funds Rate Hike
Implications for Current Cycle, Following Last Rate Hike



the balance of seven soft landings. For both bond yields and stocks, the data has been re-based to an index level of 100 at the date of the final rate hike, which we believe was June 29, 2006 for the current cycle.

Bond yields have typically risen quite sharply through the final year of Fed rate hikes, and the current cycle (boldface line) conformed to the norm. The rise tends to continue for about another quarter in the hard-landing scenario, but yields peak quite close to the final hike in rates for those cycles where a soft landing unfolded. Stocks have shown a mild rising trend through the final year of rate hikes, although a correction typically begins about a quarter prior to the last hike in the hard-landing scenario. Once the final hike is in place, equity market performance appears to be highly dependent on the ultimate direction of the economy. Where recession eventually grips, stocks continue to tumble. In the soft landing scenario, the S&P 500 (and the TSX) sprint a median of 20% over the first 10 months following the end of rate hikes. *Even after the recent correction, the movement of both bond yields and stock prices are clearly consistent with the soft landing scenario.*

A Long Economic Cycle...

For investors, the implications of the soft landing are nothing short of enormous. Exhibit 7 shows that recessions tend to begin about 11 months following a final hike in the fed funds rate, but individual cycle results cover a wide range. For those cycles where interest rate hikes were followed by recession,

EXHIBIT 6. S&P 500 and the Fed Funds Rate Hike
Implications for Current Cycle, Following Last Rate Hike

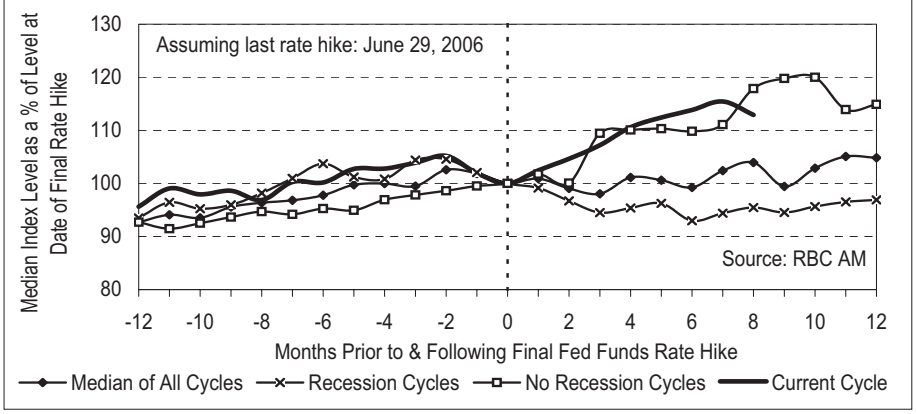
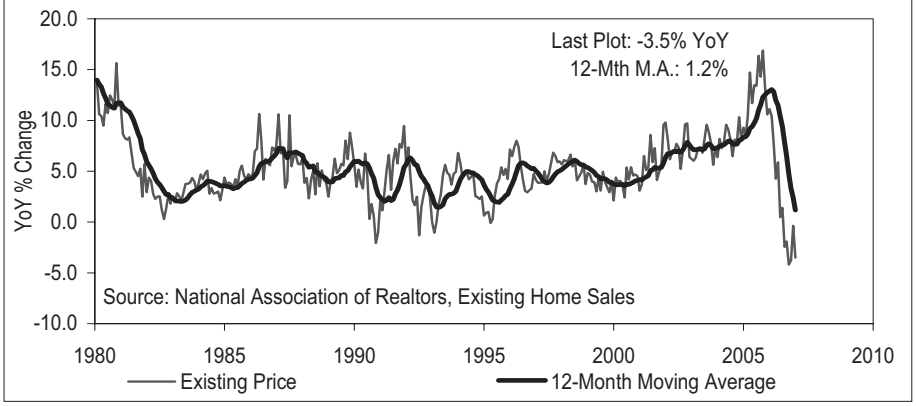


EXHIBIT 7. Mapping Out The Extended Economic Cycle

NUMBER OF CYCLES	RECESSION CYCLES		SOFT LANDING CYCLES	
15	8		7	
	TIME LAPSE: LAST HIKE TO RECESSION			
	Median Period (Mths)	Shortest Period (Mths)	Longest Period (Mths)	Market Anticipates Recession
Median: All Cycles	11			10 Mths Prior
Median: No-Recession Cycles	39	18	76	
Median: Recession Cycles	4	-5	11	

Source: Federal Reserve, RBC AM

EXHIBIT 8. U.S. Housing – Median Sales Price
Existing Single Family Homes



the business cycle peaked only four months after the final rate action. For the seven soft landings, though, the business cycle extended a minimum of 18 months after the final rate hike, the median life gained was 39 months and one cycle stretched for more than six years. *The soft landing of 2006 reduced growth to a long-run sustainable pace, arrested inflation before a corrosive spiral took hold and likely pushed the next recession out till the end of this decade, if not beyond.*

None of this suggests the economy is without risk. The pressure on residential real estate prices and related problems in the sub-prime mortgage market are front of mind, but both appear to be limited in scope. Housing prices (Exhibit 8), continue to fall but only at a 3.5% year-over-year rate, and that follows annual gains averaging 7.1% over the prior five years. Inventories of unsold homes (Exhibit 9) remain a big overhang in a market that has clearly lost its "bid" tone, but the passage of time is already working them down.

The sub-prime mortgage market has been rocked, and it's really quite shocking what it *doesn't* take to get a mortgage, at least until the recent tightening of lending standards. We have to believe that there is an element of gaming, if not instances of fraud in mortgages that become impaired within eight months of initiation. Perhaps housing prices were so hot in certain areas that dodgy "borrowers" simply bought houses and applied for mortgages that they never intended to service, hoping to re-sell the home at a substantial profit before it was

EXHIBIT 9. U.S. Housing – Month's Supply of Homes on the Market
Existing Single Family Homes

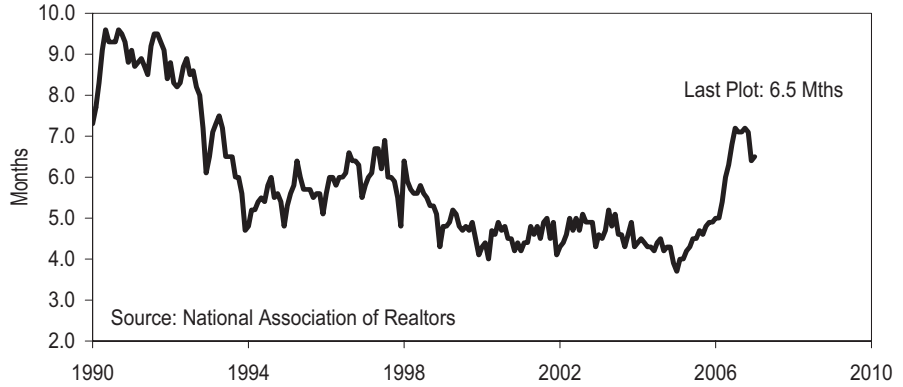


EXHIBIT 10. U.S. Consumer Balance Sheets – Net Worth
Households and Nonprofit Organizations

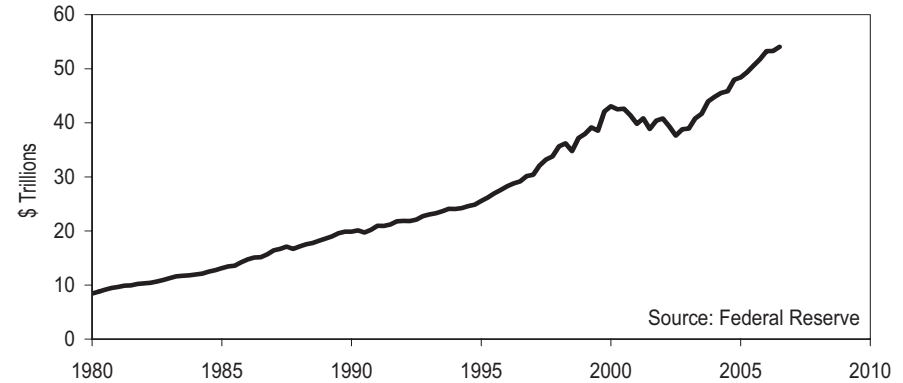
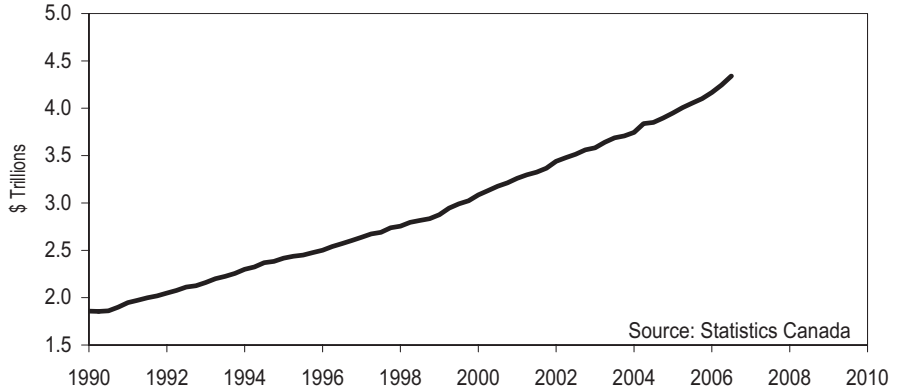


EXHIBIT 11. Canada: Net Worth
Persons and Unincorporated Business



seized for non-payment. This is a simple "kiting" scam with schemers taking advantage of the minimum eight- month period that lenders must wait before moving to take back a property. Housing prices peaked in October of 2005, so the bodies are now floating to the surface.

...With the Capacity to Absorb Risks

The mortgage news is ugly, but the economy can take a punch. Debt levels appear reasonable for the personal, corporate and government sectors. Net worth of U.S. and Canadian households (exhibits 10 and 11) are at all-time high levels. Corporate debt and interest coverage ratios are sound. Indeed, healthy balance sheets could eventually pose a threat to stability as the crush of money into private equity funds creates the need for deals and underleveraged companies fall prey to raiders. Even fiscal balances (exhibits 12 and 13) are suddenly of little concern. The most recent Congressional Budget Office data forecasts a narrowing in the U.S. fiscal deficit to $102 billion by 2012, bringing the deficit /GDP ratio down to -0.6% – a level close to the best years of the Clinton boom. Canada remains a model of fiscal discipline, now in its ninth year of surplus and with its overall debt to GDP ratio the lowest of the G7 nations (Exhibit 14).

New jobs continue to be created at a healthy pace, breathing new life into an aging cycle and offsetting some of the risks that accumulate as the expansion unfolds. Exhibit 15 highlights the close relationship between job creation

EXHIBIT 12. U.S. Fiscal Budget
Total On-Budget Surplus or Deficit

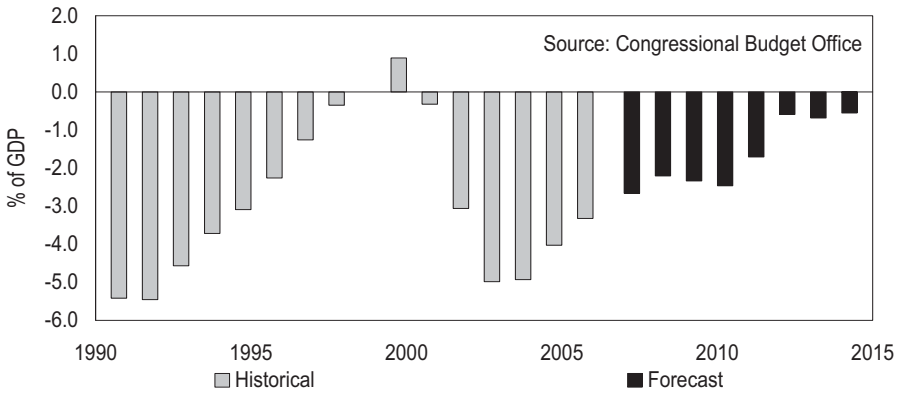


EXHIBIT 13. Canadian Government Fiscal Balances
Budget Surplus or Deficit

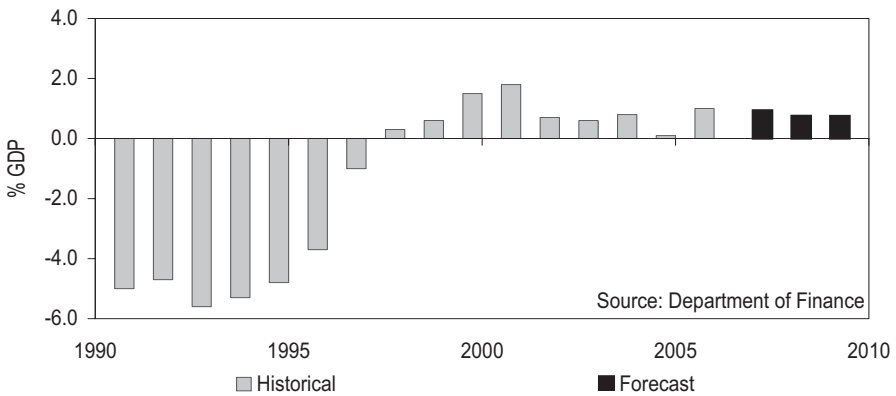
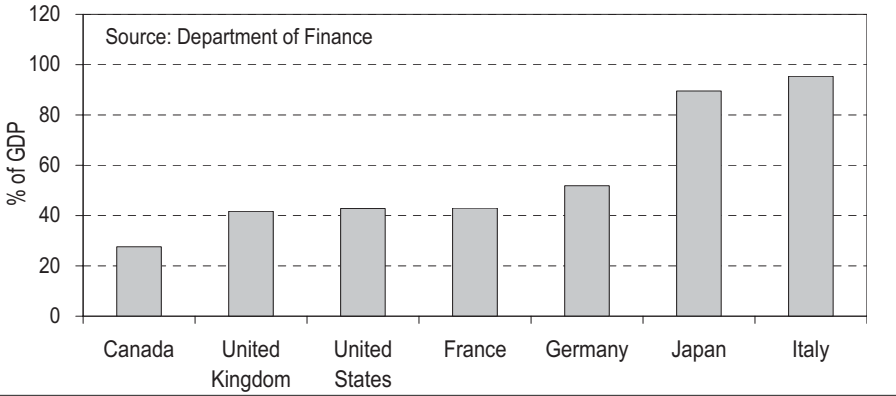


EXHIBIT 14. G7 General Government Net Financial Balances
As a Percent of GDP



and consumption. More people working means more spending. It also means wage gains as businesses compete to attract and retain workers (Exhibit 16), which adds further to consumption. The cycle becomes self-sustaining.

The so-called Phillips Curve trade-off between unemployment and inflation is closely related to exhibits 15 and 16. The increased threat of inflation as the pool of unemployed diminishes has been a key tenet of managing monetary policy since the 1960's, but it's now being questioned. In recent weeks, a variety of Fed speakers have suggested that inflation can remain subdued even as the pool of available talent is depleted. It's possible that the normal pressure to reel in growth as the economic expansion drains the labour pool is somewhat less in the current cycle, reducing the threat of more rate hikes in the future.

Europe, Japan Shift to Higher Gear

Offshore, the economic pulse is quickening. Europe is now in full-fledged expansion (Exhibit 17) as the improved competitiveness of Germany in particular has bolstered exports and job creation, allowing growth to catch up with its smaller EC partners.

After an inventory-induced slowdown, Japan closed 2006 with a flourish, pulling full-year growth up to an average of 2.1% (Exhibit 18), finally allowing the Bank of Japan to move interest rates to a "neutral" position. The mix of growth remains

EXHIBIT 15. United States
Real Consumer Spending and Non-Farm Employment

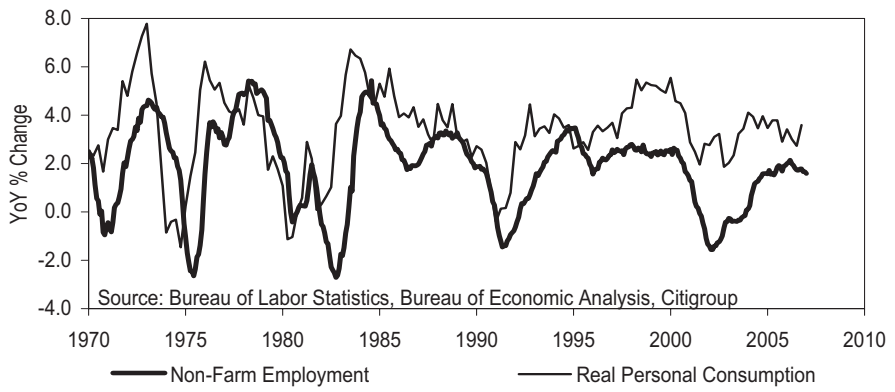


EXHIBIT 16. United States
Real Consumer Spending and Personal Disposable Income

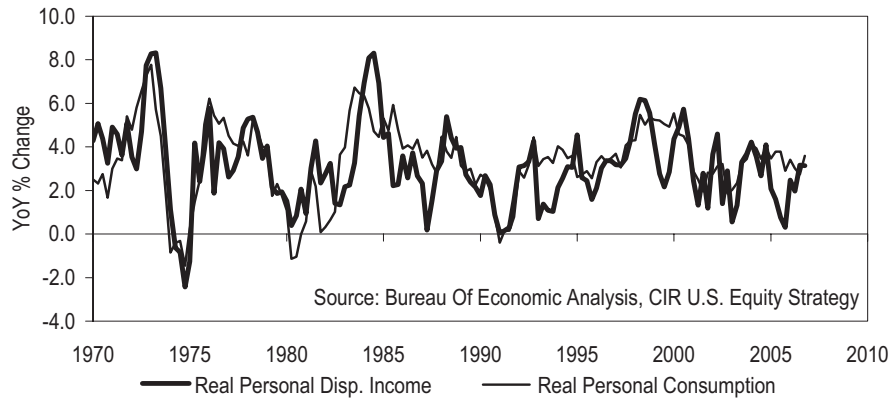
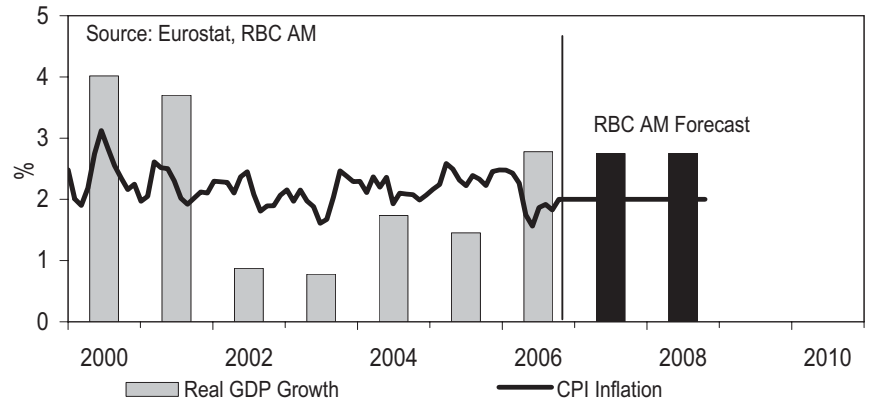


EXHIBIT 17. Eurozone
Real Gross Domestic Product and CPI Inflation



a cause for concern (Exhibit 19) with the corporate sector continuing to drive the economy with high levels of corporate profits and capital investment. Japan's expansion will remain vulnerable until job creation, income growth and consumption gain momentum, but recovery here is the next logical step in achieving balance.

Short-Term Interest Rates: Completing the Cycle

In the U.S., short-term interest rates are fixed just above the upper reach of their equilibrium channel (Exhibit 20). The same setting relative to equilibrium allowed for moderate growth, but kept a clamp on inflation through much of the 1990's. We continue to believe that the Fed completed its program of rate hikes in June of 2006, although we are a little less certain that rate *cuts* are now in the offing. In the soft landing environment, the Fed has typically begun to reverse some of its prior tightening only six months after its final hike, but there appears to be little need for rate relief, at least not yet.

Markets seem to concur. Exhibit 21 plots the level of the fed funds rate each month since last June (grey shaded bars) and also the level of rates forecast by futures prices for December of 2007. Last summer, as the cycle of rate hikes was drawing to a close, futures were pricing in progressively smaller hikes through the following 18 months. By the fall of 2006, the rate forecast imbedded in futures prices flipped to cuts, at one point totalling 67 basis points by Christmas of this

EXHIBIT 18. Japan
Real Gross Domestic Product and CPI Inflation

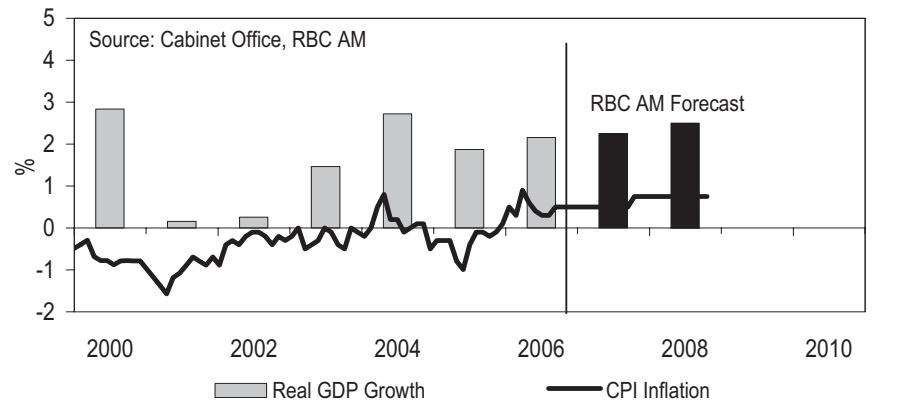


EXHIBIT 19. Japan
Wage and Profit Shares as a % of Nominal GDP

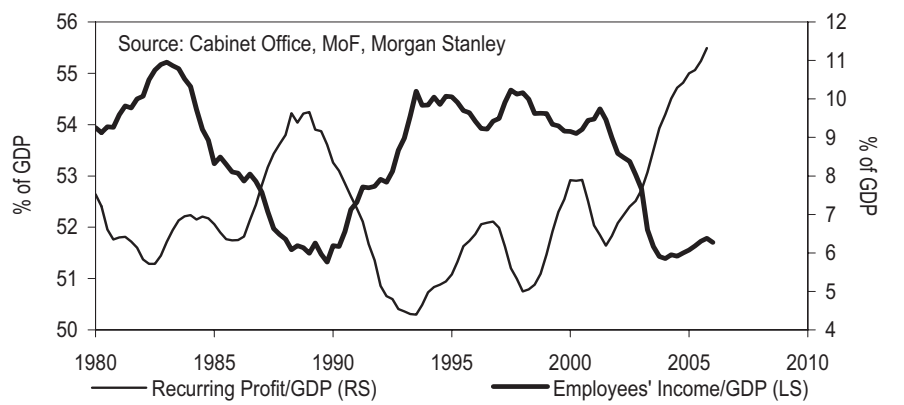
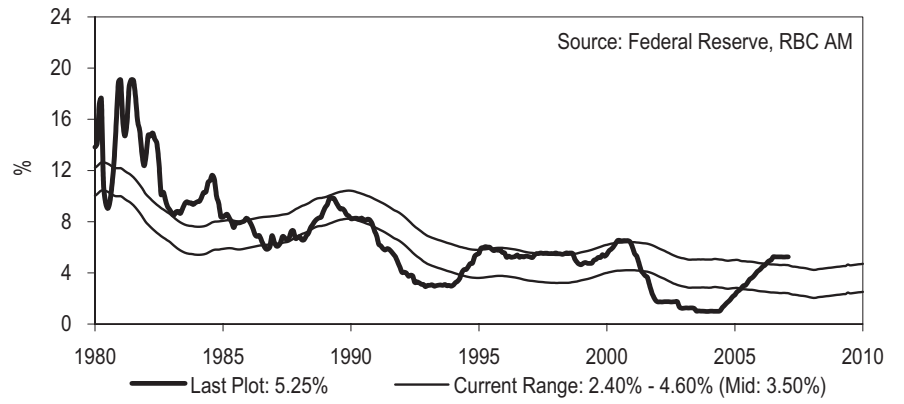


EXHIBIT 20. U.S. Fed Funds
Equilibrium Range



year. As the economy settled into its current comfortable pace, expected cuts fell below 50 basis points.

Our own forecast also looks for a single rate cut and a 5.0% fed funds rate by this time next year, but we don't view that as an essential component of our outlook. It's been almost eight months since the Fed's last action, so most of the burden from higher interest rates is already in evidence. The economy is hardly struggling under the weight, so the need for a cut isn't compelling. And with Ben Bernanke still gaining credibility as Alan Greenspan's successor, the bias to monetary policy is likely to be tighter, rather than looser, for some time yet.

The Bank of Canada has mimicked the Fed, positioning overnight rates at a similar level relative to equilibrium (Exhibit 22). Still feeling the pressure from a currency that's up 36% over the past five years, the economy is continuing to expand at a reasonable rate, but core inflation is within the Bank's range of tolerance. Like the U.S., Canadian short-term interest rates look to be stable well into the forecast horizon.

The ECB has also pushed short-term interest rates to the upper boundary of the equilibrium channel (Exhibit 23). The futures markets, however, still anticipates a little more than 50 basis points in additional hikes by year-end, likely as a result of strong growth in the region's money supply and the normal "growth-phobia" of European central bankers. Our own view is that with inflation now at 1.9% and likely to stay close to the 2% level over the next two years, rates should end the coming

EXHIBIT 21. Fed Funds Rate and Implied Expectations
December 2007 Futures

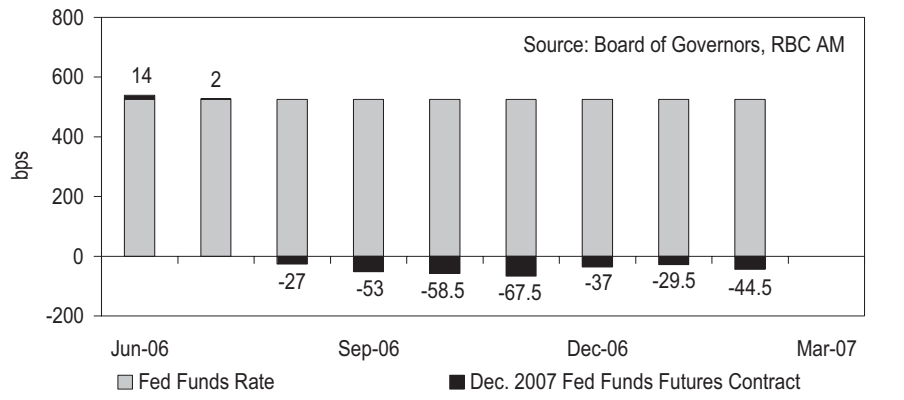


EXHIBIT 22. Canada Overnight Rate
Equilibrium Range

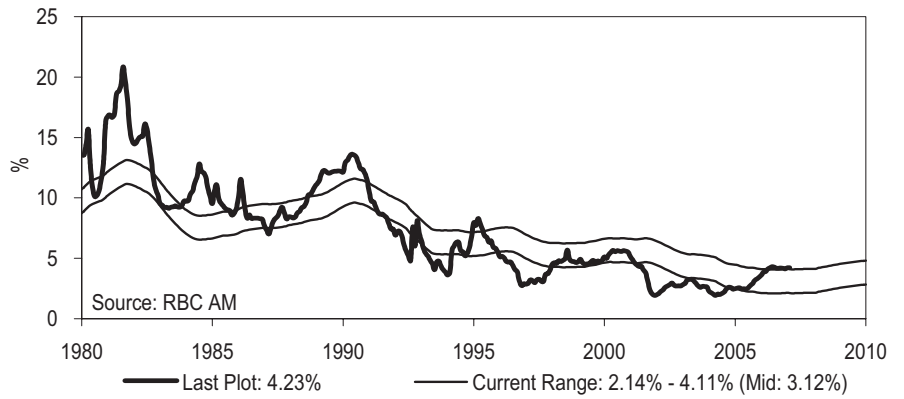
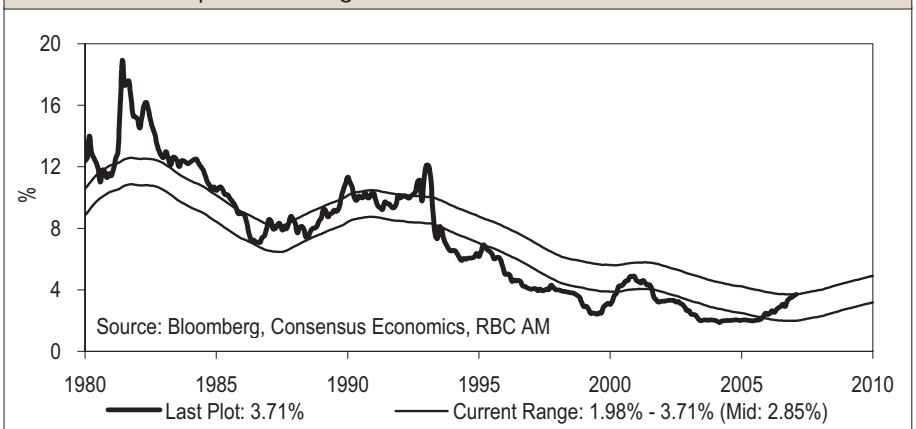


EXHIBIT 23. Eurozone Repo Rate
Equilibrium Range



12 months no more than 25 basis points above the current level.

The Bank of Japan seems to have learned the nuance of "data-dependency" in managing monetary policy. When growth surged late last year, the Bank took advantage of the opportunity to move short-term rates up to 0.5%, almost exactly the mid-point of the equilibrium channel (Exhibit 25). As growth continues and broadens, more hikes will likely appear, but with rates now back at their neutral position, monetary policy has finally been normalized, lessening the need for immediate action.

The rate cycle has dominated the economic and market outlook for the past two years as central banks worked to remove the massive stimulus injected during the decade's early years. That process is mostly complete and *economies are generally moving ahead at sustainable, low inflation growth rates. As a result, monetary policy should exert less of an influence on the investment outlook over the months ahead.*

Bond Yields: More Room to Fall

Last summer, about the time the Fed stopped raising interest rates, we began the process of moving recommended exposure to the bond market up toward the midpoint of our past range. At 35% (allowed range for a balanced investor: 30% – 60%), our commitment to bonds remains a little below the 40% neutral position, but the shortfall reflects our view

EXHIBIT 24. United Kingdom Base Rate
Equilibrium Range

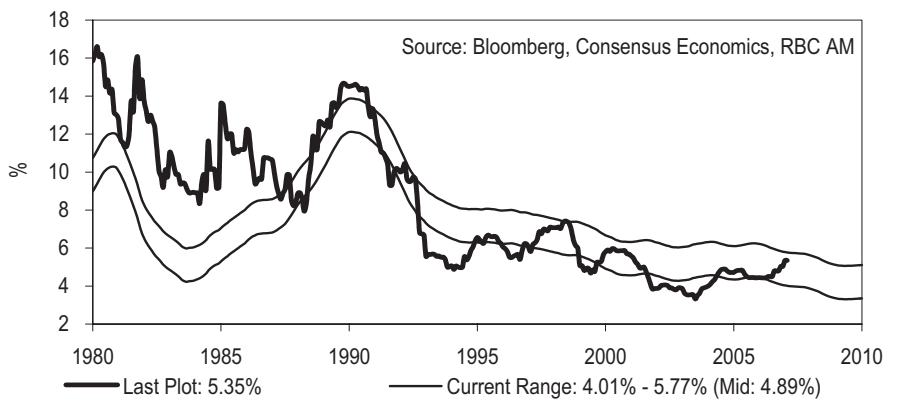


EXHIBIT 25. Japan Overnight Call Rate
Equilibrium Range

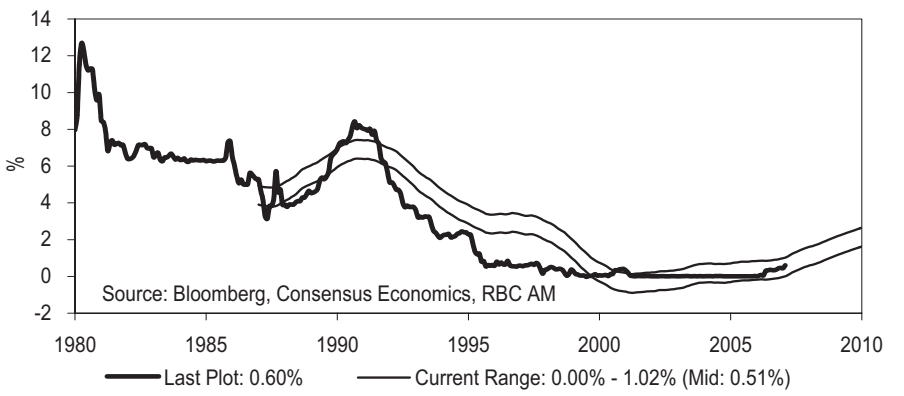
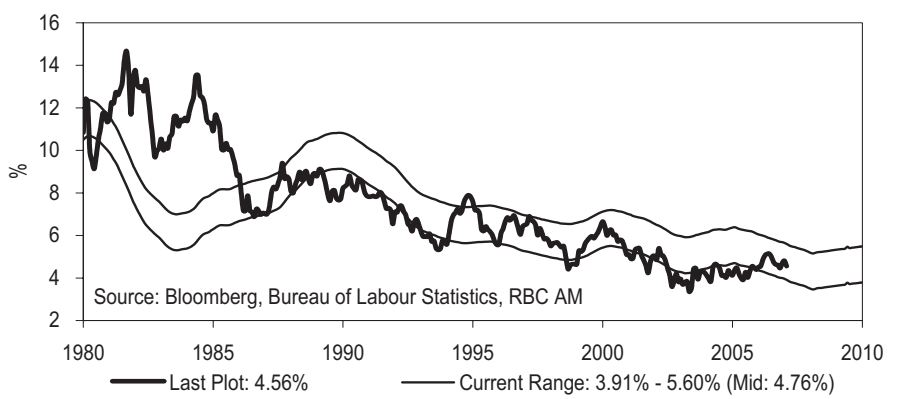


EXHIBIT 26. U.S. 10-Year T-Bond Yield
Equilibrium Range



that stocks offer better relative prospects. We continue to look for a coupon return on government bonds, and also believe that if our forecast proves wrong, it's probably too conservative.

Exhibits 26 through 30 plot our equilibrium models for the major government bond markets. Recovering economies and the pressure of rising short-term interest rates pushed yields up from depressed levels beneath the equilibrium channels. By the summer of last year, most countries' 10-year government bond yields were approaching the mid-point of their bands and a variety of technical indicators suggested the likelihood of a rally in prices. Subsequent to that, yields declined in each of the major markets, except for the United Kingdom, before climbing back toward the bands' midpoints. *At current levels, 10-year government bonds once again offer the prospect of coupon-like returns over the coming 12 months, and perhaps a little more.*

The "little more" portion would require yields to drift toward the bottom of the bands, or lower. That can't happen without a further decline in inflation or a fall in the real rate of interest. The latter probably offers the best near-term prospect for change. In fact, we are surprised that it hasn't happened already.

The Next Decline in Bond Yields

The real rate of interest is simply the market interest rate less the

EXHIBIT 27. Canada 10-Year Bond Yield
Equilibrium Range

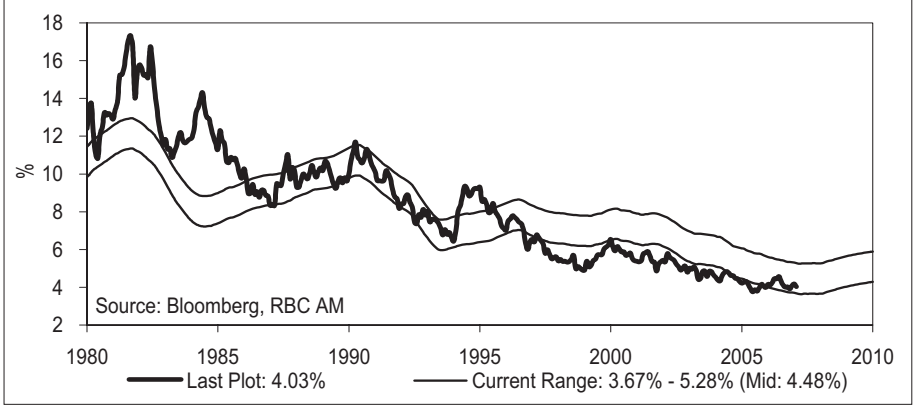


EXHIBIT 28. Eurozone 10-Year Bond Yield
Equilibrium Range

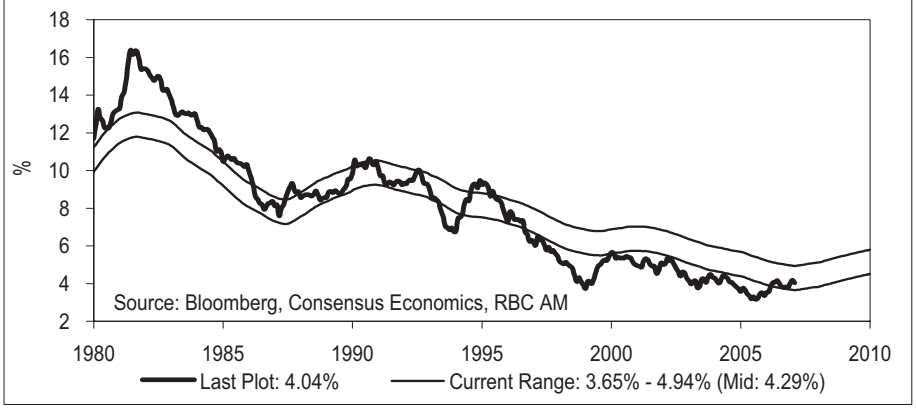
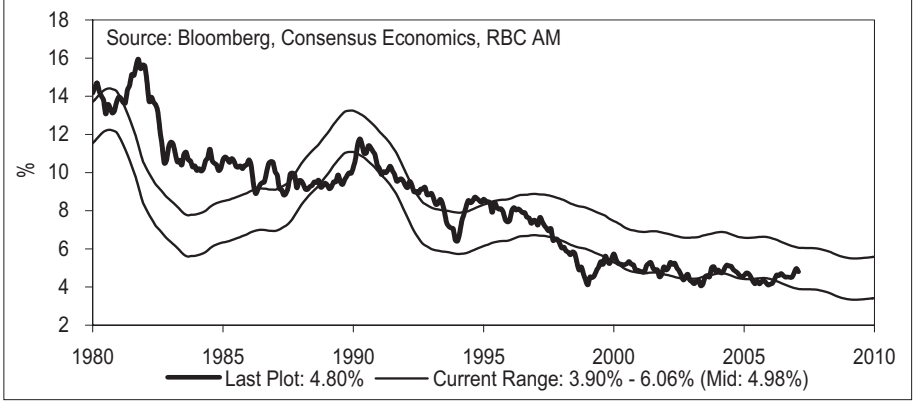


EXHIBIT 29. United Kingdom 10-Year Gilt
Equilibrium Range



rate of inflation. Exhibit 31 plots the real rate (volatile line on the chart) and the modeled real rate that we use as the base rate of interest in our equilibrium model (ie: the time-weighted trailing 10-year moving average of the real rate). The modeled real rate has been gradually falling for almost two decades, reflecting investors' growing comfort with their ability to predict the future. Such comfort is gained through a decline in inflation's volatility and from a near-universal belief that central banks now have the skill level and the resolve to protect against corrosive inflation. *With the economy settling into a durable, low inflation expansion, the Fed's most recent success should encourage the real rate on government bond yields to fall as this cycle rolls on.*

We look for a 10-year T-bond yield of 4.5% by this time next year, but we also recognize that the potential exists for it to probe the lower boundary of the band just beneath the 4% level, and for the band to sink as the modeled real rate of interest gradually declines.

Canadian 10-year bond yields are currently 60 basis points below those of the U.S., and we expect the gap to narrow to 50 basis points over the year ahead, leaving yields near current levels over the forecast horizon. Eurozone yields also show limited scope for decline, barring a fall in real rates of interest, although the risk of upside pressure seems even more limited. Yields in Japan, however, could rise somewhat as the Bank of Japan lags other central banks in completing its program of rate hikes.

EXHIBIT 30. Japan 10-Year Bond Yield
Equilibrium Range

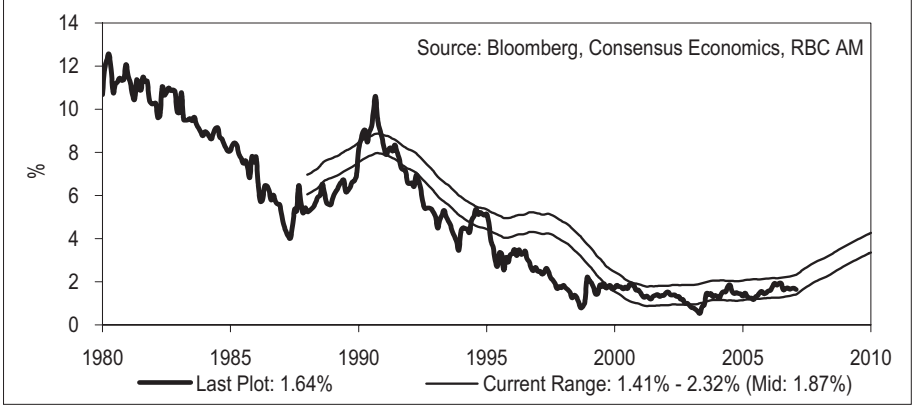


EXHIBIT 31. U.S. 10-Year Treasury Yields
Simple Real Rate Versus "Modeled" Real Rate

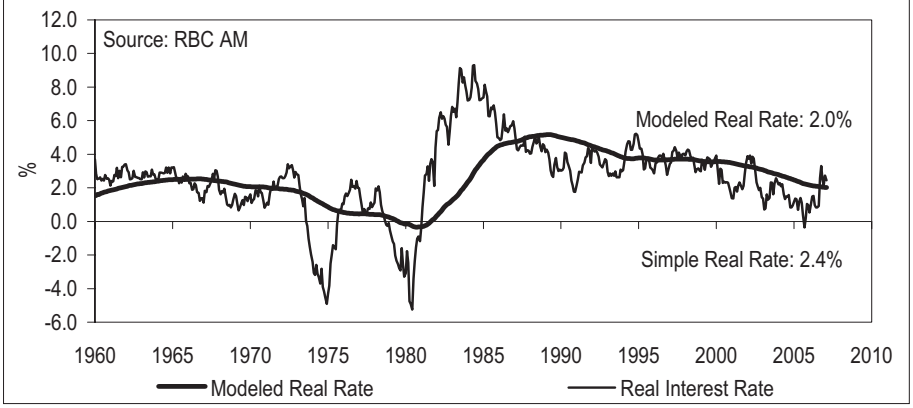
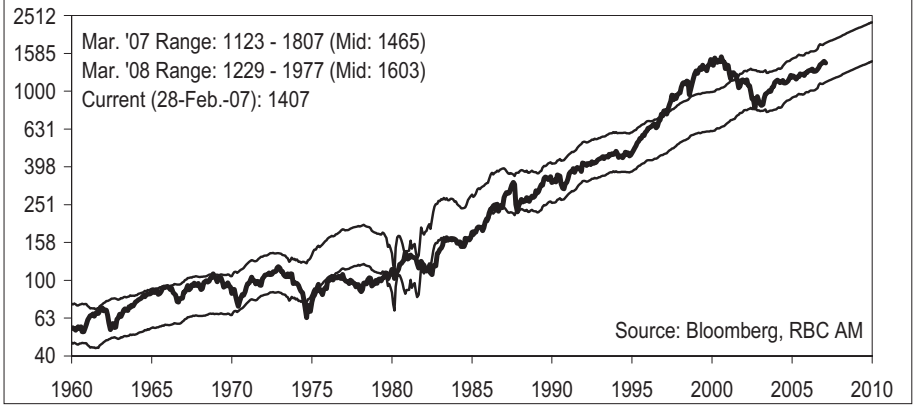


EXHIBIT 32. S&P 500 Equilibrium
Normalized Earnings & Valuations



Equity Markets – Correction, Not a Bear Market

The late-February correction in stocks did not shake our bullish outlook. We continue to recommend exposure to equities of 62.5% for our balanced profile – high in its allowed range of 40% - 70%. Froth had begun to appear in a variety of places, but valuations for the world's exchanges cover a very wide range, with the largest markets and biggest capitalization issues showing about the best potential.

Exhibits 32 through 36 update our fair value channels for the major equity markets. At the mid-point of these bands, equity market valuations are consistent with their normal relationship with prevailing interest rates, inflation and sustainable profits. Moreover, markets have tended to trend within the upper half of the bands through sustained periods of economic expansion, low inflation and mild interest rates. Indeed, as Exhibit 37 displays, *the very best returns for U.S. stocks have been generated through periods where positions were established with the index below the band's mid-point and inflation at, or below, its long-term average of about 4.0%. Following the recent correction, the S&P 500 has once again dropped into that range.*

Valuations Cover a Wide Range

The U.K. and Japanese stock markets also lie beneath the mid-point of their respective fair value

EXHIBIT 33. S&P/TSX Composite Equilibrium
Normalized Earnings & Valuations

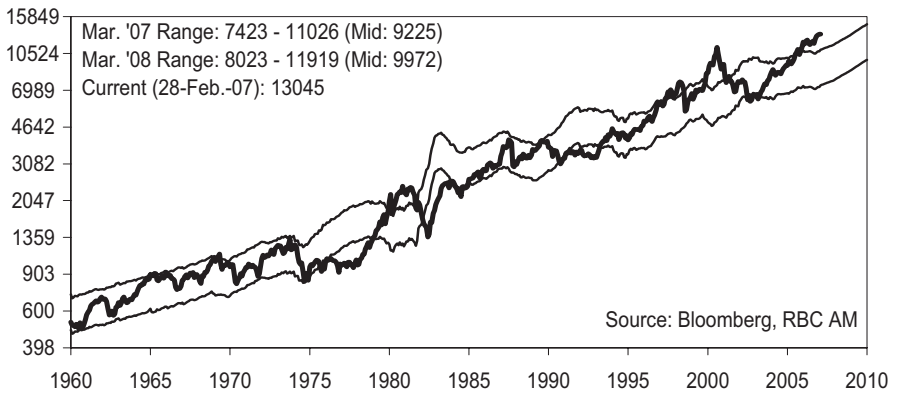


EXHIBIT 34. Eurozone Datastream Index Equilibrium
Normalized Earnings & Valuations

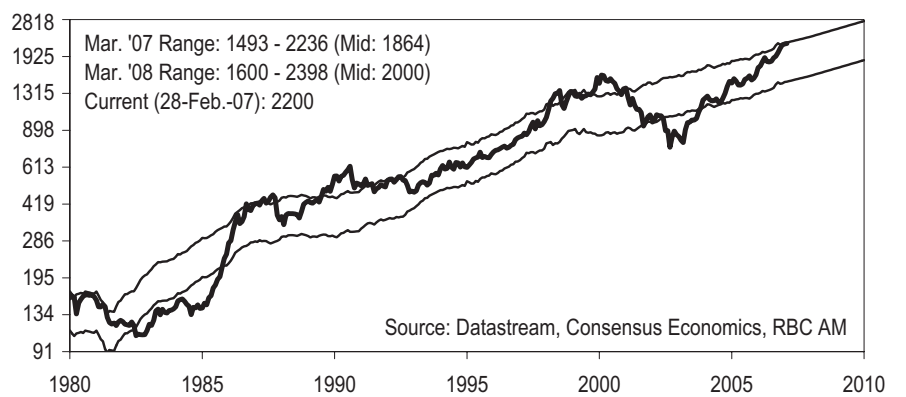
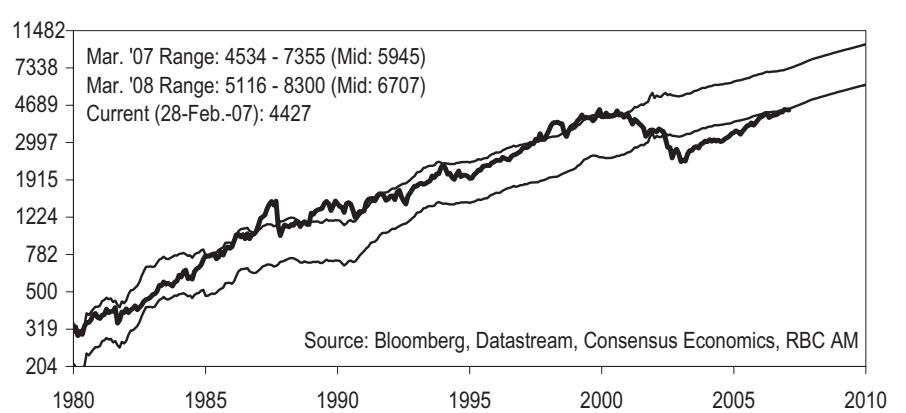


EXHIBIT 35. United Kingdom Datastream Index Equilibrium
Normalized Earnings & Valuations



channels, with the former showing particularly good potential should stocks ultimately move up to fair value. But, following relatively strong gains throughout the bull market, Eurozone stocks are trending near the upper boundary of their band. Similarly, Canada's major market index remains relatively unattractive, reflecting the huge gains already posted by heavily weighted energy and materials stocks in the TSX.

We don't believe that the more-fully valued Indices are headed for bear markets as long as the rest continue to move forward, but we have reflected relative discounts or premiums to fair value in our recommended global equity weights. North America is once again overweight the benchmark this quarter, with a focus on the U.S., Japan is fixed just above neutral and the Eurozone has been reduced further below its benchmark weight.

Slowing Profits...

Almost everywhere, earnings gains have been impressive throughout this business cycle. Exhibit 38 details the current consensus estimates for index earnings, and also their long-run trendline growth rates. Most markets have pumped out double-digit gains in each of the past four years, well above the long-term norm. In fact, even as the growth rate for profits finally slips into single digits in the U.S., over 75% of earnings reports are coming in above analysts' estimates, making this the 16th consecutive quarter with earnings exceeding expectations.

EXHIBIT 36. Japan Datastream Index
Normalized Earnings & Valuations

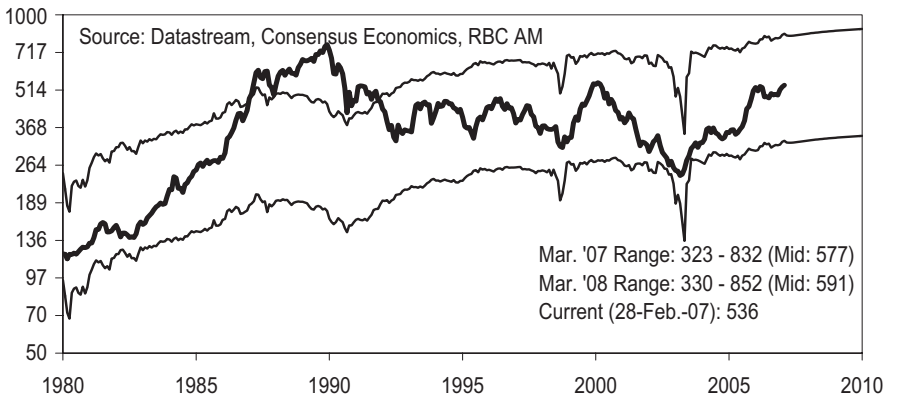


EXHIBIT 37. S&P 500
Returns for Positions Established at Various Valuation Levels

	FREQUENCY	1 YEAR
All Months Since 1960		8.3%
Months When S&P Above Fair Value	41.9%	2.6%
Months When S&P Below Fair Value	58.1%	12.6%
S&P Below Fair Value &		
Inflation is At or Below 2.0%	6.5%	18.2%
Inflation is At or Below 2.5%	3.0%	16.9%
Inflation is At or Below 3.0%	7.3%	14.2%
Inflation is At or Below 3.5%	6.7%	12.9%
Inflation is At or Below 4.0%	6.2%	12.9%
Inflation is Above 4.0%	28.3%	12.2%
S&P Above Fair Value &		
Inflation is At or Below 2.0%	14.5%	4.7%
Inflation is At or Below 2.5%	3.0%	5.9%
Inflation is At or Below 3.0%	6.7%	7.5%
Inflation is At or Below 3.5%	4.6%	6.9%
Inflation is At or Below 4.0%	3.2%	5.8%
Inflation is Above 4.0%	9.9%	-7.9%

Source: RBC AM

Challenges are now appearing for the earnings pools. Exhibits 39 and 40 show the difficulty in sustaining such solid year-over-year comparisons, with U.S. and Eurozone earnings so far above their long-run trends. We continue to believe that margins, earnings and profitability are benefiting from a variety of secular improvements, but it grows harder and harder to harvest new gains as the cycle extends. For the S&P 500, current quarter earnings look to be only 4.4% above the comparable period last year – not bad considering the slowdown in the economy and the fact that last year's period was up close to 12% on the year prior – but a considerable distance below levels that the market has grown used to.

Slowing profits are, of course, a normal part of the development of the business cycle. They don't necessarily indicate the approach of recession, or even a weakening of equity market returns. Exhibit 41 shows that some very good years for the S&P 500 have actually occurred with a backdrop of slowing earnings. Through the last four economic soft landings, earnings fell a median of 4.3% through the first four quarters of the slowdown. The stock market rose a median of 21% in each of those years and the worst of these still showed a gain of 10.1%. Index gains in the second year following the onset of a soft landing were of a similar magnitude.

...Challenge Leadership

Slower profit growth does, however, frequently correspond to a period of leadership rotation between markets, sectors and styles.

EXHIBIT 38. Aggregate Country Overview
As of February 28, 2007

	CONSENSUS EARNINGS GROWTH FORECAST			TRENDLINE EARNINGS GROWTH
NORTH AMERICA	2007E	2008E	2009E	
S&P 500 Composite	6.4%	11.1%	10.0%	6.7%
S&P/TSX Composite	12.3%	8.8%	8.6%	5.7%
EUROPE	2007E	2008E	2009E	
FTSE 100	6.8%	5.6%	3.1%	9.4%
MSCI Europe	8.1%	8.5%	7.6%	8.1%
JAPAN	2007E	2008E	2009E	
TOPIX Stock Index	6.1%	14.9%	8.2%	2.1%

Source: Thomson FirstCall, RBC AM

EXHIBIT 39. S&P 500: Trendline Earnings
January 1956 - February 2007

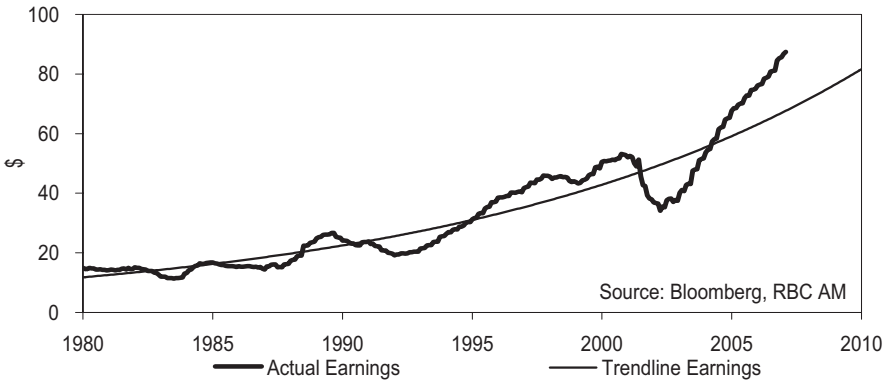
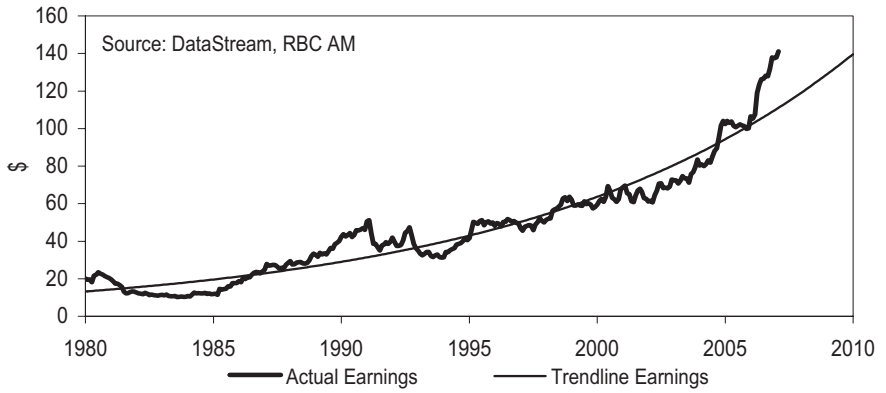


EXHIBIT 40. Eurozone DataStream: Trendline Earnings
January 1973 - February 2007



Specifically, exhibits 42 and 43 plot the performance of small cap (S&P 600) to large cap (S&P 500) stocks in the U.S. and the S&P Barra Growth Index to the S&P Barra Value Index. In both charts, we've overlaid the year-over-year rate of change for S&P 500 earnings (boldface line). Periods of rapid profit increases frequently feature leadership by smaller, value-tilted firms. Leadership typically flips to larger cap, growth-oriented firms as profits slow. The relationship is loose and unstable, but there is some logic to it. Smaller companies may be more vulnerable to swings in the economy, so recessions are particularly severe on their share prices and profits, and economic recoveries are symmetrically beneficial. As the expansion matures, however, cost cutting and the ability to maintain margins in the face of competition will favour larger companies that dominate their markets.

For the past several quarters, we have expected to see a more rapid deceleration in S&P earnings, and also interest flowing away from small cap/value stocks and toward large cap/growth shares. Exhibits 42 and 43 show that the rotation did begin as the U.S. market moved out from its summer lows, but small cap and value once again assumed the mantle of market leadership in November 2006.

Continuing relative gains in small cap stocks may be a sign of too much enthusiasm gripping investors. Exhibit 44 plots the fair value channel for the S&P 600. Now 53% above the midpoint of its equilibrium band, investors appear to be anticipating a very long period of superior earnings gains for these companies. The S&P

EXHIBIT 41. Earnings Growth and Stock Market Gains During Economic Soft Landings

	EARNINGS GROWTH		STOCK MARKET GAIN	
Soft Landing Period	12 Mths Annual (%)	24 Mths CAGR (%)	12 Mths Annual (%)	24 Mths CAGR (%)
Q3 '84	-4.7%	-3.1%	10.1%	18.0%
Q1 '89	-5.0%	-4.5%	15.3%	12.8%
Q1 '95	21.5%	15.3%	28.9%	23.0%
Q4' 97	-3.9%	2.7%	26.7%	23.0%
Q2 '06				
Average	2.0%	2.6%	20.2%	19.2%
Median	-4.3%	-0.2%	21.0%	20.5%

Source: Bloomberg, RBC AM

EXHIBIT 42. Profit Momentum vs. Relative Strength
S&P 600 DataStream Index and S&P 500

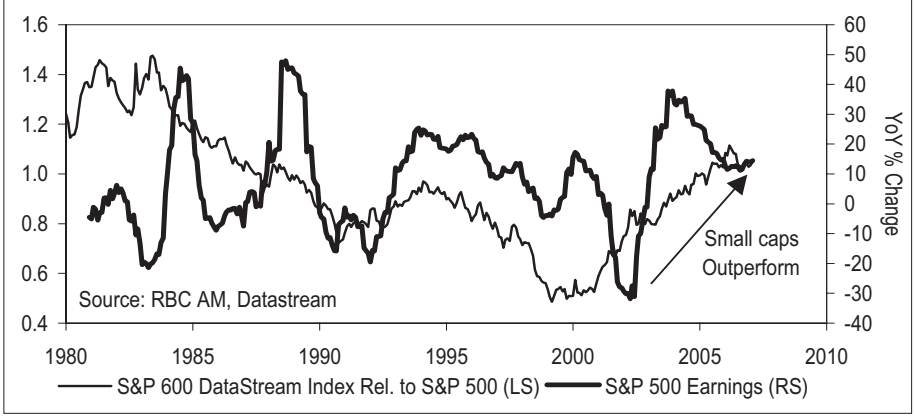
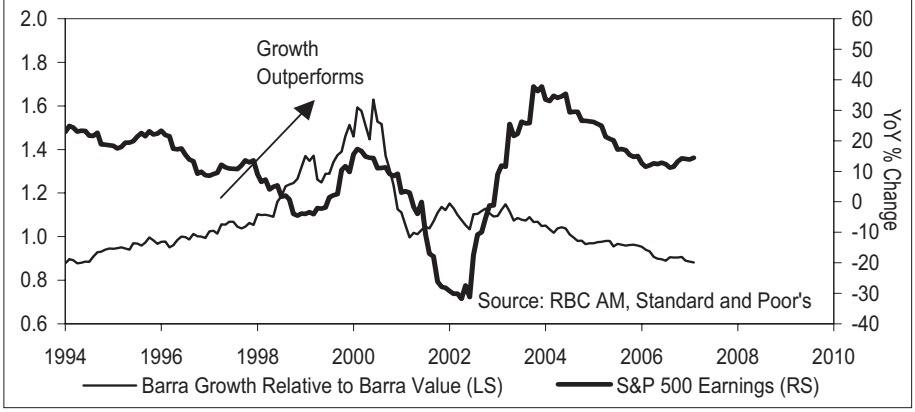


EXHIBIT 43. Profit Momentum vs. Relative Strength
S&P Barra Growth to Barra Value



500 currently lies 3.2% *below its fair value. Satisfying the level of expectations implied by valuations for large cap issues looks to be much easier than those for smaller stocks, especially as the economic cycle matures and earnings comparisons become somewhat more challenging.*

Too Much Enthusiasm?

Extraordinary valuations for small cap companies and lagging performance of the largest, most stable firms is sometimes a sign that investors are mispricing risk, counting on the current good times to last long enough to justify paying a premium for a more speculative investment. There may also be some degree of overconfidence evident in the valuations of Eurozone and Canadian stocks as these market indices have moved up to, or above, the upper boundary of their fair value ranges.

To the extent that complacency or overconfidence exists, historically low volatility may have contributed to its emergence. Leading into last week's market plunge, option volatility had fallen to its lowest levels in 13 years (Exhibit 45). The length of time since the last 2% correction stretched to 154 days, the second-longest period reaching all the way back to the 1920's. Lower volatility reinforces the feeling of comfort and predictability, further encouraging a lowering of risk premiums.

A variety of sentiment measures also flashed warning signs as the rally progressed, and these are receiving a lot of attention in the wake of the market's fall. Investors Intelligence Index of bullish

EXHIBIT 44. S&P 600 Datastream Equilibrium
Normalized Earnings & Valuations

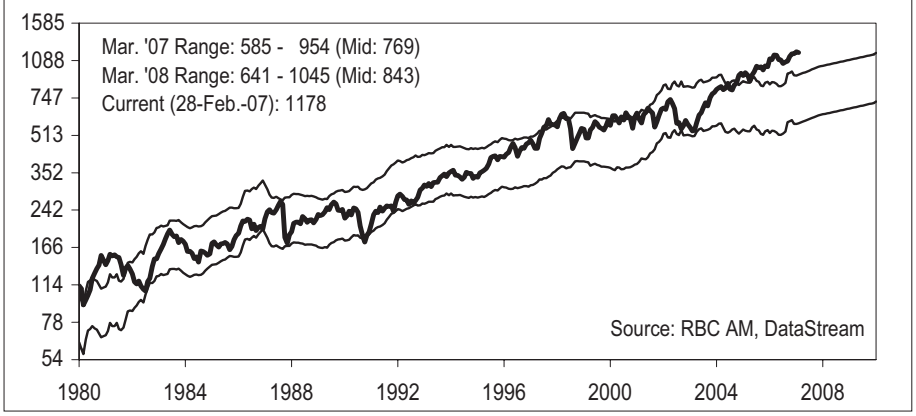


EXHIBIT 45. CBOE Volatility Index

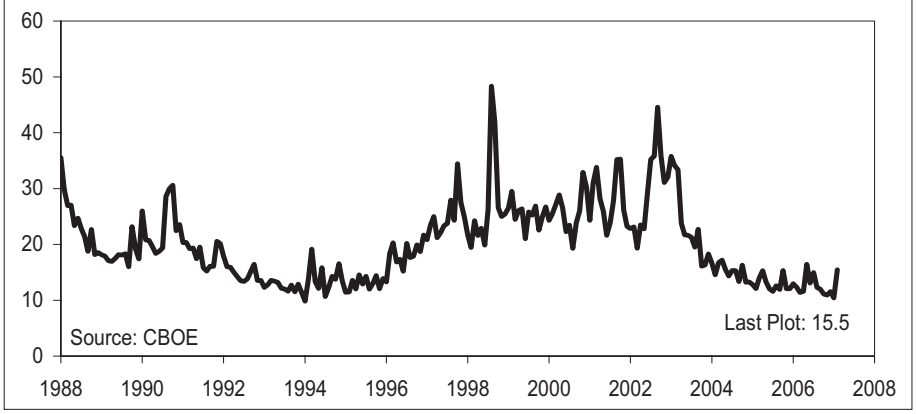
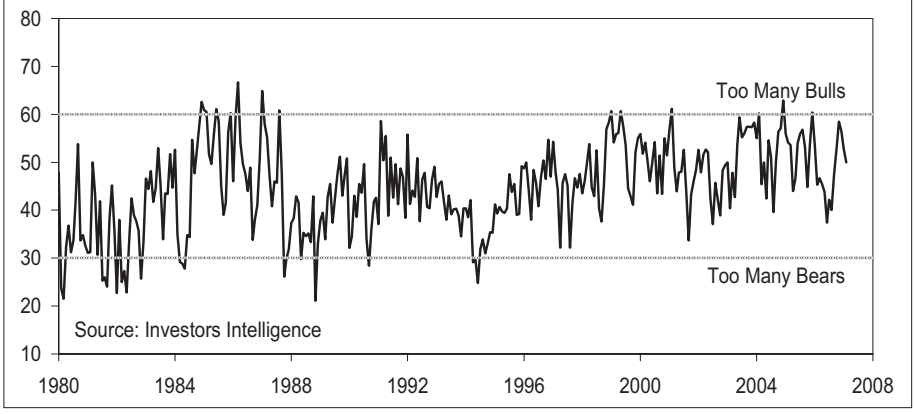


EXHIBIT 46. Equity Market Bullish Consensus
Investors Intelligence Weekly Survey of Financial Advisors



sentiment approached the 60% level late in 2006 and bears fell below 20% (exhibits 46 and 47) – both typical of the kind of enthusiasm that precedes a correction. NYSE margin debt (Exhibit 48) surged to an all-time high, surpassing even the spike at the end of the tech bubble. Moving out the risk spectrum, even more evidence accumulated that investors were beginning to look far into the future. Both prices and volumes on Canada's Venture Exchange swept to new highs in February. Emerging market stocks are up an average of 40.8% over the past year with four markets, including the newly opened Vietnamese exchange, soaring over 100%.

EXHIBIT 47. Equity Market Bearish Consensus
Investors Intelligence Weekly Survey of Financial Advisors

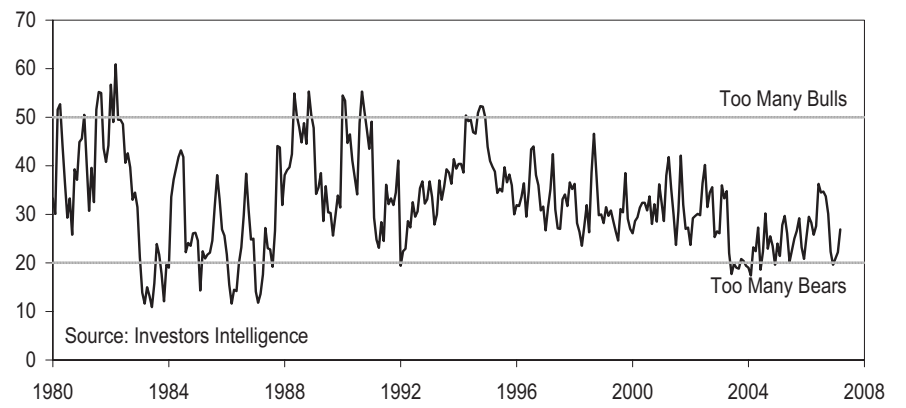
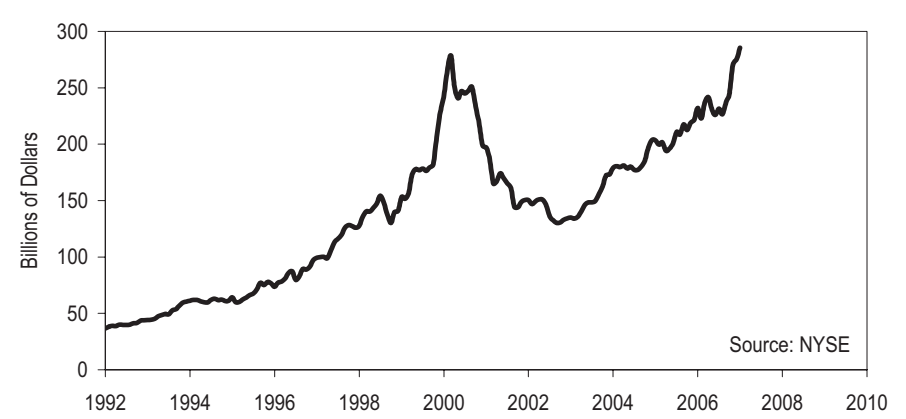


EXHIBIT 48. New York Stock Exchange Customers' Margin Debt
Debit Balances In Margin Accounts



Roots of the Correction

Economic conditions may appear so stable, the future so clear and central banks so skilled and disciplined that some investors have relaxed their normal scepticism. Left unchecked, market prices could begin to imbed a requirement for above-normal and sustained profit growth, leaving little room for shortfalls. The return of a normal level of volatility, and the gut-check of the odd correction, are essential to maintaining balance, without which the bull market and maybe even the business cycle are put at risk.

Valuations for smaller cap, emerging market and other more speculative equities still require significant gains in profits, lower prices or some combination of both to reflect a realistic view of company prospects through whatever is left of the current business cycle. But the S&P 500 in particular rests below equilibrium – the minimum price level common to periods of durable economic growth, mild inflation and low interest rates.

Stay With Stocks

Some degree of excessive enthusiasm is evident, and it must be calmed, although it doesn't appear to be all that widespread. Large cap stocks, especially, do not yet reflect the full benefits of an enduring economic cycle. It's not unreasonable to look for another three years of growth before the next recession sets in, and a bull market that could survive till decade's - end. Our recommended asset mix for a balanced investor remains at 62.5% equities (allowed range: 40% - 70%), 35% bonds (allowed range 30% - 60%) and 2.5% cash.

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Fixed Income Markets

When we last published the Global Investment Outlook in early December, yields on 10-year Treasuries had fallen to 4.41%, a level not seen in almost a year. At that time, a barrage of weaker than expected economic data and overblown fears of a housing meltdown induced an over-anxious bond market to price in a 25 basis point rate cut at the March 2007 FOMC meeting. Further clarity through the end of January of this year, however, confirmed the economy was holding its own and underscored our base case forecast for a soft landing and extended economic cycle. By the end of January, the probability of a 2007 rate cut had been trimmed to almost 0%, and the 10-year U.S. yield had risen to a high of 4.91%. Recent equity market volatility, a recalibration of risk premiums and an ensuing flight to quality has pushed bond yields back down near their December lows. In addition, disappointing economic data in recent months have revived the recession whisper.

While financial markets have grown increasingly pessimistic over the past week, we remain true to our base forecast that the U.S. economy has transitioned to a moderate, durable economic expansion following the soft landing of mid/late 2006. Our outlook and its implications are as follows:

- The U.S. economy's transition from rapid growth to a more sustainable pace coupled with easing inflation has virtually eliminated the threat of additional rate hikes. Our base case view is for a rate cut at some point toward the end of our forecast period and for continued yield curve inversion. While inflation and additional housing weakness remain the biggest risks to our forecast, inflation is trending lower and a healthy consumer sector buoyed by strong employment and rising incomes should entrench growth in 2007 and 2008.

- While Eurozone inflation looks to have peaked last summer, risks to price stability continue in the form of Germany's three percentage point VAT increase. The effects have yet to be fully felt and we expect prices to rise as the year wears on. We expect that upside risk to inflation combined with solid growth will push the European Central Bank to continue its "vigilance" and return monetary policy to a more restrictive level.

- Japan's impressive fourth quarter GDP report and strong domestic demand proved that the world's second largest economy isn't down for the count despite a dismal third quarter. The Bank of Japan will continue its nascent monetary tightening campaign as deflation is wrung from the financial system and growth accelerates into 2008.

- In Canada, three consecutive quarters of below potential GDP growth stand in stark contrast to the strong job market of 2006. We believe that GDP has been understated and will begin to reflect the employment strength in the first half of 2007. With GDP still likely to be shy of its potential growth rate in 2007, we expect the Bank of Canada to follow the Fed with cuts of its own as inflation inches lower.

- After another surprise rate hike from the Bank of England, the U.K. economy seems to be on track for solid growth in 2007 despite tentative signs of a moderating real estate market. As inflation moves toward the BoE's target, the central bank will find it difficult to lift rates above their current setting.

- Our asset allocation recommendation of 35% fixed income (for a balanced investor) remains unchanged from last quarter. The current return profile between regions is the tightest that it has been since the inception of the Global Investment Outlook and precludes us from overweighting any one region this quarter.

United States

Ben Bernanke's semi-annual testimony on February 14, 2007, stopped short of using the words "soft landing," but the spirit of the message suggested that's exactly what he was pointing to. The Fed chairman characterized the expansion as making a transition from rapid growth to a more sustainable pace. At the same time, he stated that core inflation would continue to trend lower, reflecting a moderation in prices for oil and other commodities, an easing of rental increases and a downward pull from low inflation expectations. Of course there are risks, with "the

high level of resource utilization" and "the risk that inflation will not moderate" being the "predominant policy concern." But the upside risk to inflation was carefully balanced with the downside risks to growth from any housing market spillover. By no means did the testimony suggest rate increases, nor did it imply imminent rate cuts. Rather, it suggested that both the upside and downside risks have diminished somewhat, and that the Fed appears comfortably on hold indefinitely.

As mentioned in the Fed minutes to the January 31, 2007, FOMC meeting, incoming data indicate a leveling out in housing demand and strength in consumer spending outside the housing and auto sectors. Concerns that the weakness in housing and autos would spill over into the broader economy have not materialized, and the auto market appears stable while housing is showing tentative signs of a bottom. Following a 15% decline in existing home sales from its summer 2005 peak, sales raced up 3% in January after having been locked in a tight range since the third quarter of 2006 (Exhibit 1). Months' supply of unsold homes has begun to decline (Exhibit 2) and the affordability index has begun to show improvement, as has the National Association of Home Builders Index. Less encouraging, however, have been the recent prints in new home sales and housing starts (Exhibit 3), both of which fell in January, auguring for weaker construction and a drag on GDP in the months ahead (fewer starts now means less projects in the ground to complete in subsequent months). We expect that the recent weakness in new home sales and

EXHIBIT 1. **United States**
New and Existing Home Sales

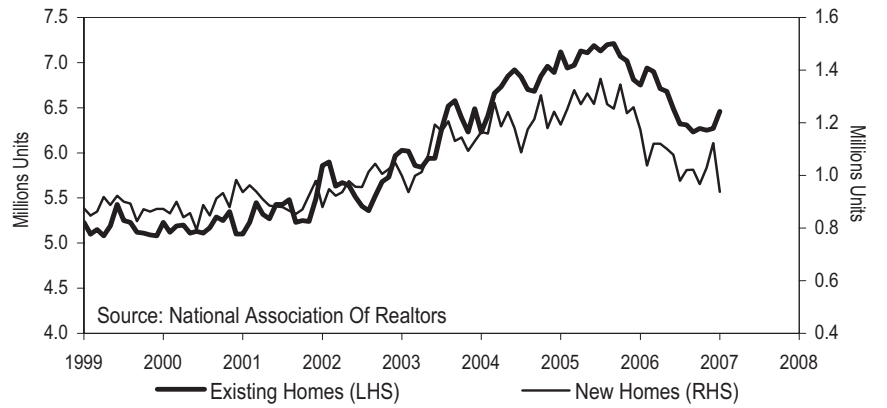


EXHIBIT 2. **U.S. Single Family Homes**
Months' Supply of Existing and New Homes on the Market

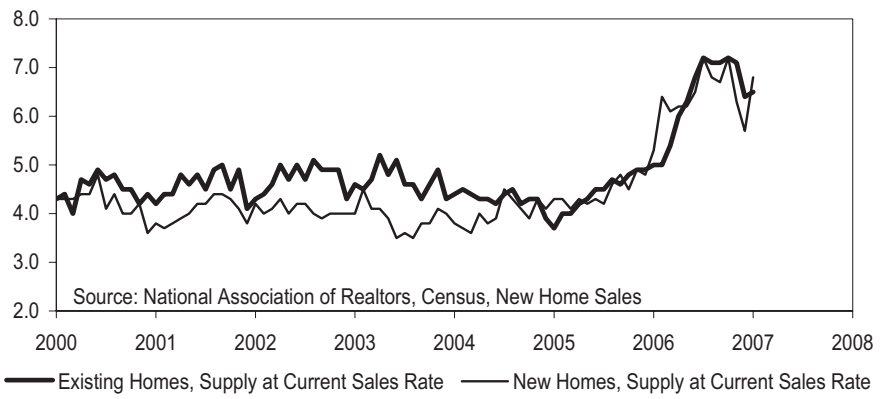
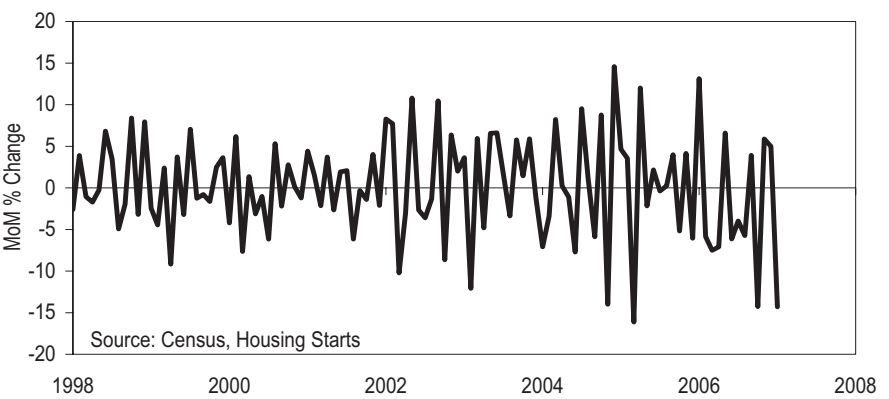


EXHIBIT 3. **U.S. Housing – New Private Housing Units Started**
Total Starts Including Farm Housing

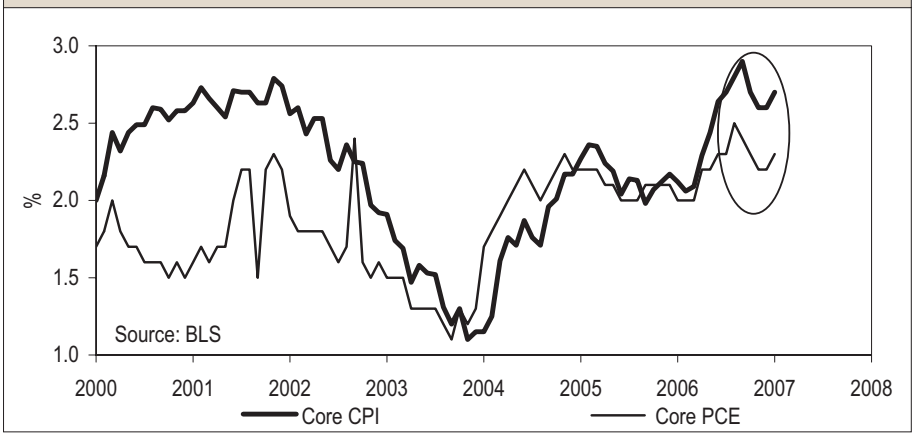


starts will subside and begin to mirror the strength in existing home sales with the next two quarters.

While we believe that the housing market has reached a trough, further weakness is unlikely to send the consumer and the broader economy into a tailspin even if we're wrong. At the consumer level, much of the resilience in the face of the housing slowdown reflects the addition of more than 2 million jobs in 2006, income gains in excess of 3% and continued increases in household net worth. The combination of a healthy job market, solid wage gains, strong household balance sheets, lower energy prices, supportive financial conditions and strong equity market returns should underpin consumer spending through a prolonged housing market downturn, should one materialize.

Inflation remains the biggest risk to our forecast, although the risks have been fading. Notwithstanding an uptick in January to 2.7% on core CPI and 2.3% on core PCE, inflation is well off its high set in September 2006 (Exhibit 4). While it's still premature to declare an outright victory over inflation with core CPI and core PCE at the high end of the Fed's comfort zone, we remain confident that inflation will recede. Recent increases in housing affordability should take the pressure off rents, as shelter represents 42.3% of core CPI and has disproportionately inflated measures of consumer inflation. Risk to oil and other commodity prices is to the downside while measures of resources utilization – the Fed's major concern – seem to be abating (the unemployment rate stands two ticks off its low at 4.6% while capacity utilization has fallen below its 20-year average to 81.2%).

EXHIBIT 4. United States
Core CPI and Core PCE



With the slowdown in economic growth largely limited to housing and autos and inflation likely to resume its downtrend, the next few quarters seem unlikely to provoke a policy response from the Fed. While fourth quarter growth was revised lower to 2.2% from 3.5%, the revision was concentrated in inventories, suggesting that fourth quarter weakness should be offset by first quarter strength as inventory levels are replenished. We continue to see the consumer on a strong footing, as lower energy prices and a healthy job market underpin consumer spending. Similarly, supportive financial conditions, strong corporate profits and solid balance sheets should support business investment. While we acknowledge recent data weakness (ISM flirting with the 50 boom/bust line, January retail sales and January housing starts) that seems to have rekindled imminent rate cut chatter, a preponderance of the evidence suggests the expansion remains well entrenched. That said, in light of recent Fed commentary and economic data we have pared back the fed funds forecast in our base case to one cut from two. The cut is likely to come in the fourth quarter of 2007 or first quarter of 2008, with the Fed Funds rate ending the forecast period at 5%.

Our view continues to be that monetary policy is well positioned to underscore trend-like growth and bring inflation down to the lower end of the Fed's comfort level within the next 12 months. With the drag from housing and autos offset in other consumer related areas, we have raised our 2007 growth forecast by a quarter point to 3% (the high end of the Fed's "central tendency" forecast). At the same time we have lowered our inflation forecast by a quarter point to 2.25% in 2007 as rental pressures ease while average hourly earnings and broader employment costs continue to abate (Exhibit 5). Our growth and inflation forecasts for 2008 are the same as for 2007, with steady economic

expansion expected to endure for at least another year. Central banks' stranglehold on inflation should underpin lower risk premiums and further entrench the secular trend toward sustained lower bond yields. Our 12-month yield forecast for 10-year Treasuries is 4.5% (up ¼ point from last quarter), with the risk skewed toward lower bond yields and further yield curve inversion (exhibits 6 and 7).

The risks to our forecast are evenly balanced. Should recent equity market volatility persist and the housing correction deepen, consumer confidence could buckle and cast a pall on consumer spending, pushing the economy to the brink of recession. This outcome would send 10-year yields towards 4% and put the Fed firmly in rate-cutting mode barring any unforeseen spike in inflation. On the other hand, should the bout of recent equity market volatility prove to be short-lived and if the housing market regains some traction, GDP could easily breech our 3% forecast for the year and push out the prospect of a Fed rate cut deep into 2008. In this scenario, rates could push back up to the 4.91% high of January 26, 2007.

Europe

While the ECB left rates unchanged on February 8, 2007, the central bank's statement used the now familiar phrase "strong vigilance" when referring to inflation. For more than a year the ECB has used this phrase to flag its intent to raise interest rates, and this trend has continued in 2007. The re-utterance

EXHIBIT 5. United States
Employment Cost Index and Average Hourly Earnings

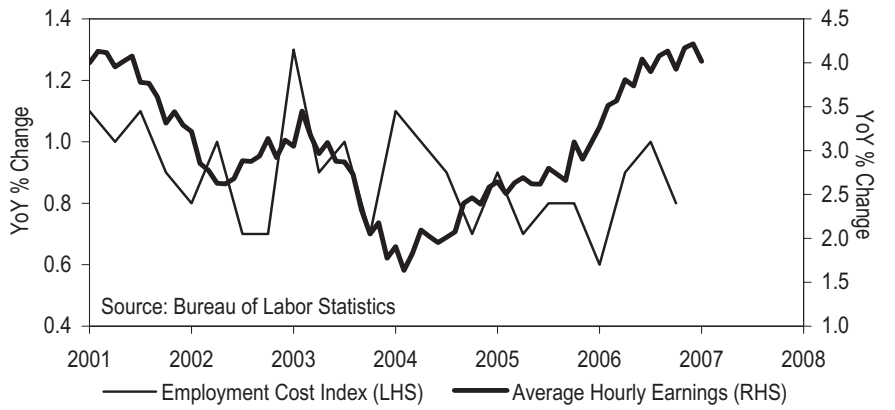
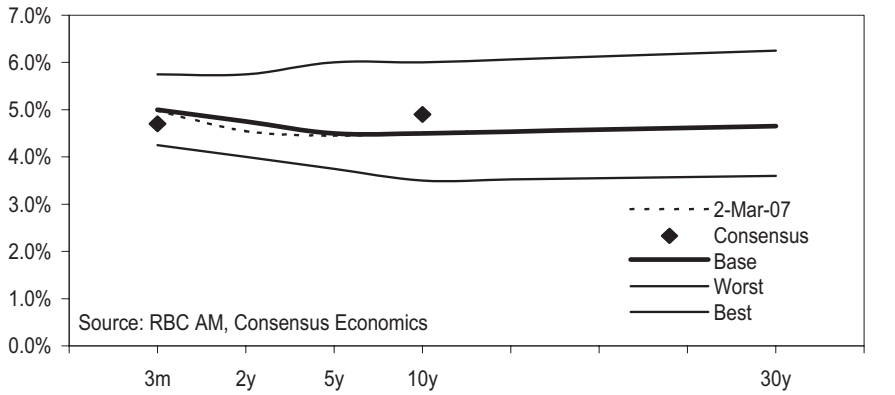


EXHIBIT 6. United States
12-Month Yield Forecasts

	2-MAR-2007	BASE	WORST	BEST
3mo	4.98%	5.00%	5.75%	4.25%
2yr	4.55%	4.75%	5.75%	4.00%
5yr	4.44%	4.50%	6.00%	3.75%
10yr	4.51%	4.50%	6.00%	3.50%
30yr	4.64%	4.65%	6.25%	3.60%

Source: RBC AM

EXHIBIT 7. United States
Yield Curves: Current and 12-Month Forecast Levels



of "strong vigilance" in February is a near-certain sign of another 25-basis-point hike from Trichet & Co. when the ECB meets again in March. Policy remains accommodative in the ECB's view, and higher rates will keep inflation expectations "anchored at levels consistent with price stability." While the committee sees lower inflation in the near term due to favourable base effects and lower energy prices, they expect inflation to rise later in the year as base effects unwind and work against the ECB's goal of price stability. The closely watched M3 money supply rose to a 17-year high in January 2007 (Exhibit 8), up 9.8% year-over-year, cementing expectations of higher rates from the ECB in 2007. While the full effect of Germany's VAT increase has yet to be felt in official data, it is likely just a matter of time. Along with the risk that the high energy prices of the past begin to feed through to consumers, the ECB thinks the longer-term inflation outlook is subject to upside risks. This should lead policy rates higher as the year goes on, with our target revised to 4% from 3.5% previously. At the longer end of the curve, our 10-year bond yield forecast has been raised to 4%, maintaining both the 50 basis point negative spread versus the U.S. and the curve flattening trend seen in other global bond markets.

EXHIBIT 8. Eurozone M3 Money Supply Growth

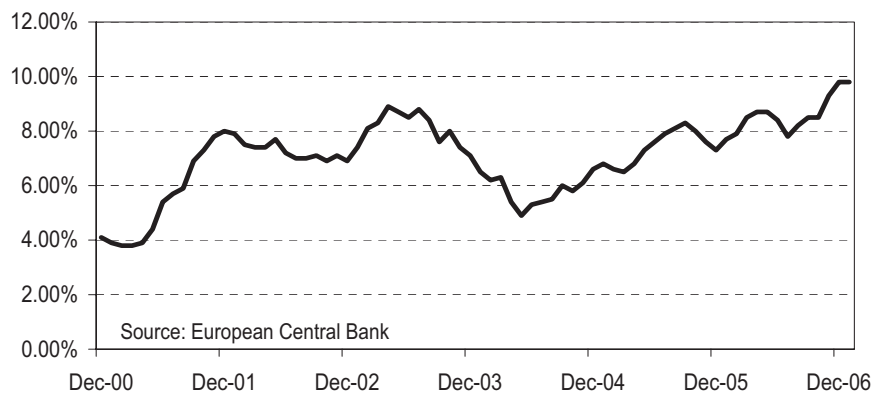
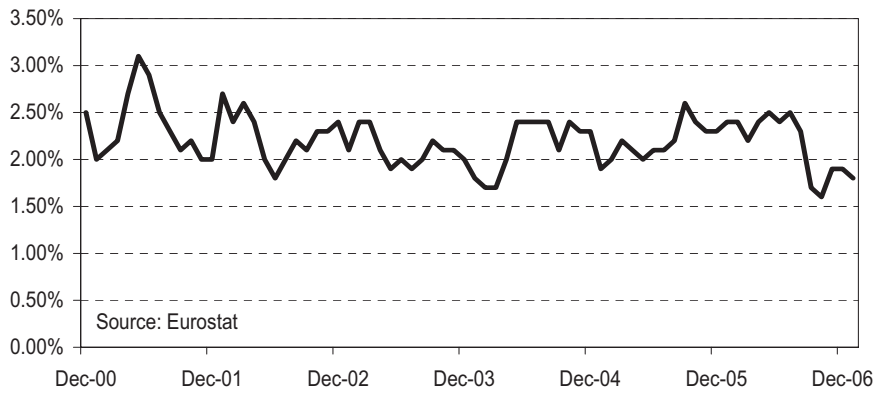


EXHIBIT 9. Eurozone CPI



The Eurozone economy continues to expand at a healthy pace with fourth quarter GDP largely exceeding expectations at 3.6% on an annualized basis and 2.7% for 2006 as a whole. It continues to outpace the growth rate of the U.S., which grew at a less impressive 2.2% rate in the fourth quarter. Germany grew 0.9% quarter-over-quarter, and domestic demand has caught up with that of France for the first time since 2000 as consumers stocked up on goods ahead of January's three percentage point rise in VAT.

Sentiment indicators in the Eurozone are now singing the same tune, with the ZEW returning to positive territory in February after five months below zero. Meanwhile, the more closely watched IFO continues to post strong results, though the index is slightly off the 15-year high set in December. The expectations component has rebounded since bottoming out in the fall, pointing to economic strength in the Eurozone's largest economy later this year. While early indications on the inflation front suggest a limited amount of VAT pass-through to the consumer, prices are likely to trend higher as we move forward into 2007. Indeed, the February IFO indicated this pass-through may already be happening as retailers saw weaker conditions, though they expect improvements later in the year. This was confirmed by German retail sales falling 10% in

January. Lower energy prices should offset the lack of World Cup related stimulus, and with strength forecast by both of the Eurozone's forward-looking indicators, our base case for EU growth in 2007 has increased to 2.75% from 2.25%, and we introduce our 2008 forecast at 2.75%.

Eurozone CPI remains subdued after the summer's oil price-induced run-up. January CPI printed 1.9%, in line with December and below the 2.1% economists had expected on the back of Germany's VAT increase. February also surprised to the downside at 1.8% year over year, versus an expected 1.9% (Exhibit 9). With the prospect of the VAT having a less immediate effect on inflation and the seeming willingness of retailers to absorb some of the increase (similar to the trend seen in the U.S. in 2005-2006 as energy prices spiraled higher), we have trimmed our 2007 inflation call to 2.0% and see the same for 2008 as the ECB is successful in its goal of "price stability," which in turn will keep inflation expectations and annual pay settlements in check.

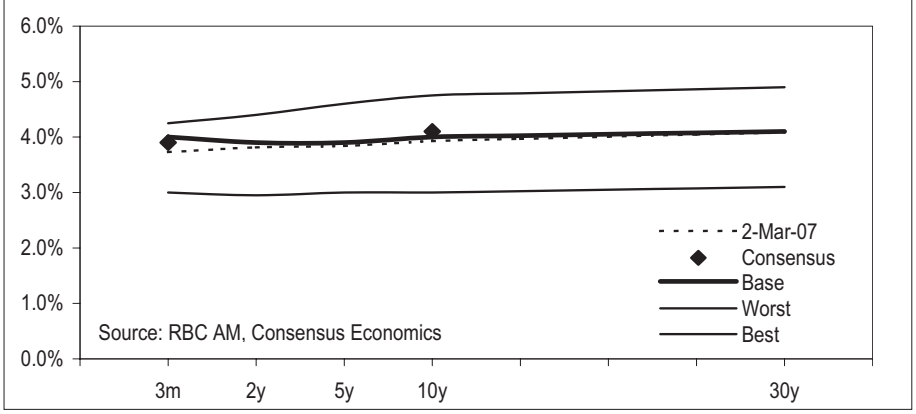
The risk to our growth forecast is to the upside should the Eurozone economy gather momentum due to an acceleration in the U.S. and restrained energy prices. In this scenario, the ECB would not hesitate to continue acting with "strong vigilance" to keep inflation contained, and an extra hike to 4.25% is possible should growth and inflation spike unexpectedly. However, we still see rates likely to end the forecast period at 4%, as the damage done by any extra monetary tightening would have the ECB reversing course in late 2007 (exhibits 10 and 11).

EXHIBIT 10. Europe
12-Month Yield Forecasts

	2-MAR-2007	BASE	WORST	BEST
3mo	3.73%	4.00%	4.25%	3.00%
2yr	3.81%	3.90%	4.40%	2.95%
5yr	3.84%	3.90%	4.60%	3.00%
10yr	3.93%	4.00%	4.75%	3.00%
30yr	4.08%	4.10%	4.90%	3.10%

Source: RBC AM

EXHIBIT 11. Europe
Yield Curves: Current and 12-Month Forecast Levels



Japan

The Bank of Japan resumed its nascent tightening campaign on February 21, 2007, taking the overnight rate to 0.5% after disappointing the market by standing pat one month earlier. The latest interest rate hike comes amid debate about pressure being exerted on the Bank by the Japanese government, which is keen to preserve a low interest rate environment that fosters economic growth. In the accompanying press conference, Governor Fukui said that the bank won't raise rates at consecutive meetings and has no predetermined schedule for raising rates. The Governor indicated that the hiking campaign will be "very gradual", and said that the BoJ will maintain "extremely accommodative monetary policy." The popular yen carry trade "could eventually have a negative impact on

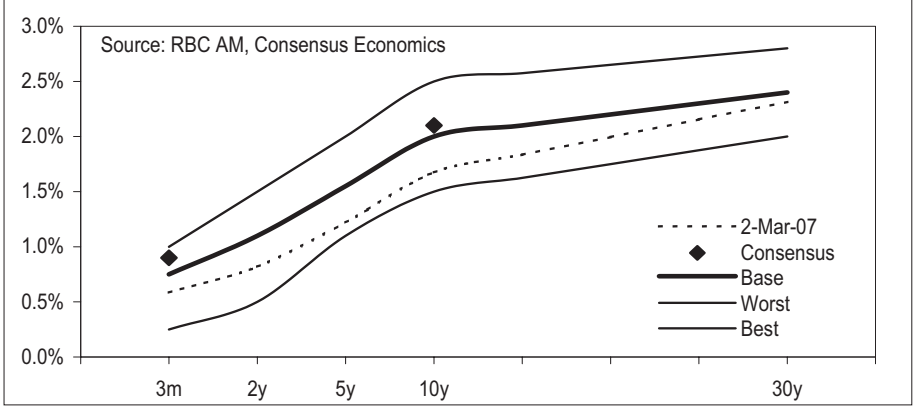
the economy" according to Fukui. While we've seen a partial unwind of the carry trade in the week of February 26, a disorderly unraveling, while not our forecast, could result in a sharp appreciation of the yen and cast a pall on Japanese exports. Our 12-month forecast for short rates is 0.75% as the recovery in Japan continues to entrench and the BoJ remains focused on removing the substantial amount of excess liquidity in the financial system (exhibits 12 and 13). The BoJ will be careful in its approach, however, as government officials have said the Bank will be held responsible for the consequences of changes in monetary policy.

EXHIBIT 12. Japan
12-Month Yield Forecasts

	2-MAR-2007	BASE	WORST	BEST
3mo	0.59%	0.75%	1.00%	0.25%
2yr	0.82%	1.10%	1.50%	0.50%
5yr	1.22%	1.55%	2.00%	1.10%
10yr	1.68%	2.00%	2.50%	1.50%
30yr	2.32%	2.40%	2.80%	2.00%

Source: RBC AM

EXHIBIT 13. Japan
Yield Curves: Current and 12-Month Forecast Levels



Japan's economy surprised to the upside in the fourth quarter with real GDP expanding at a 4.8% annualized pace, 1% higher than forecast and exponentially stronger than the third quarter's dismal 0.3%. This marks the eighth consecutive quarter of economic growth and is the strongest since the first quarter of 2004. The deflationary period that haunted the economy has seemingly come to a close, as inflation has not been negative since May 2006 on a year-over-year basis. Further proof that deflation is likely a thing of the past came from the fact that nominal GDP exceeded real GDP in the quarter as the nominal number jumped at a 5% annual rate, the fastest in six years. Domestic demand led the charge at 1.1%, reversing a third quarter drop of the same magnitude, with household expenditures (55% of GDP) rebounding strongly from the previous quarter's weather-induced weakness. Business investment rose 2.2% versus 0.8% last quarter.

The consumer's performance in the fourth quarter reinforces our constructive view on private consumption. Steadily rising prices are likely to boost consumer spending, as the realization that goods are not going to be cheaper in the future prompts shoppers to spend now. This should bolster economic activity and reward businesses with improved pricing power, keeping inflation positive and the BoJ on track to remove stimulus. The 4% unemployment rate continues to point to a strong jobs market, as does the 1.06 print on the January jobs-to-applicants ratio, the 14th month in a row above 1.0 (Exhibit 14). We think that the personal consumption disappointment in the third quarter will prove to be merely a delay in the consumer's revival as strong demand for labour should foster higher wages and bolster consumer spending. With the jury still out on U.S. housing's ultimate effect on the broader economy, we recognize that further weakness, if sustained, could wreak havoc on the Japanese export

sector, as would a meaningful strengthening of the yen. Any trepidation is yet to be reflected in the manufacturing sector, however, as the December Tankan survey came in at 25, the highest level since the third quarter of 2004.

Canada

For some time now we've been concerned with Canada's two-speed economy and the implications for monetary policy. Since before 2006, resource-driven strength in the West has been the pulse of economic expansion while central Canada's manufacturing sector suffered the grueling adjustment of a strong currency and the painful restructuring of the auto sector. Add to the regional growth divergence another dichotomy – GDP growth seems to have stalled since August, while the jobs market has been on a tear. While the fourth quarter grew at a meager 1.4%, marking the third consecutive quarter of sub-potential growth, 2006 saw the creation of 345,000 jobs, representing the second biggest advance in a decade (Exhibit 15).

Statistics Canada's recently concluded study to reconcile the disparity between weak economic growth and strong employment numbers produced two important takeaways. First, the resource boom is clouding the numbers (i.e. recent job gains in Alberta have not yet translated to GDP growth, but should in the future); and second, labour market tightness has required resource-rich provinces to "job hoard" and dig deeper into a pool of less productive labour.

EXHIBIT 14. Japan Jobs to Applicant Ratio

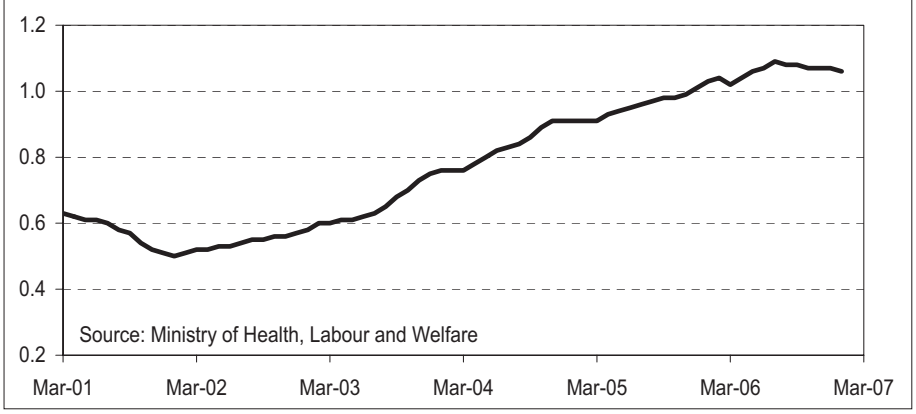
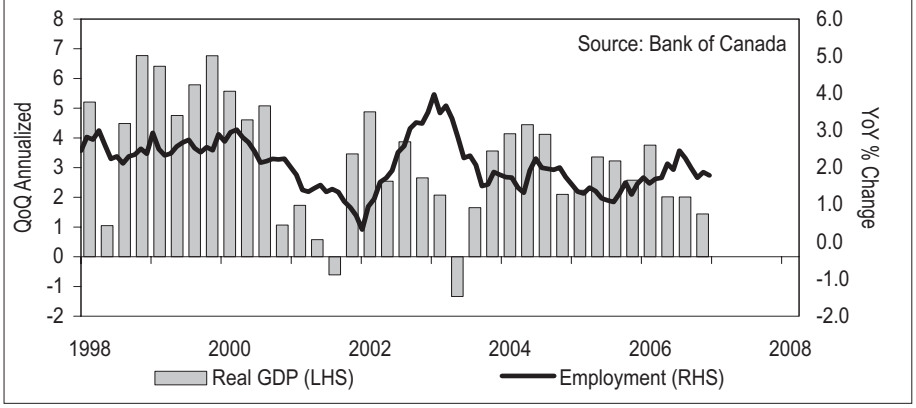


EXHIBIT 15. Canada
Real GDP and Employment



Implicit in the report was the idea that the Bank puts more faith in the jobs numbers (i.e. the economy is doing fine) than it does in the growth numbers. Provincial and Federal coffers continue to grow healthily, flying in the face of weaker output statistics. In addition, core inflation edged higher through most of last year, peaking at 2.3% and supporting the theory that the output gap was, in fact, positive (Exhibit 16). Fully discounting the reprieve in growth in favour of the jobs data, however, is not without its problems. If reported job gains were accurate and the labour market was as tight as the data suggests, one would expect upward pressure on wages. In fact, we've seen the opposite, with average hourly earnings down to 2% year-over-year after peaking at 4% last summer (Exhibit 17). This is by far the largest six-month drop in wage inflation in more than a decade.

Notwithstanding the confusion, we're confident that the strong jobs market, the expected addition of

fiscal stimulus via tax cuts and a weaker Canadian dollar will give the economy a shot in the arm going into 2007. Recently, economic data have begun to show signs of life on four fronts. First, manufacturing shipments rose 1.7% in December alongside an upward revision to the November number. In addition, we've seen three consecutive months of manufacturing employment gains – the longest such stretch since May 2004 and the first sign that the two-speed economy may be looking a little more uniform. Second, the December trade balance widened to $5 billion (the best result since February 2006), adding to growth for the first time in 2006, with export gains broadly based across the energy, automotive and consumer goods sectors. Signs that the U.S. auto sector is troughing should give a boost to Canadian exports going forward. Third, retail sales rebounded 2.3% in December and 2% excluding autos. While fourth quarter sales were still an unimpressive 1.6%, down from 8.1% and 3.5% in the second and third quarters, respectively, it would appear that consumer spending has strong momentum going into the new year. Fourth, the Canadian jobs engine is in full force, with January employment adding 88,900 jobs on the heels of a banner year for job creation in 2006. The report underscores our forecast that sluggish fourth quarter performance is unlikely to persist, buoyed by rising incomes and a faster pace of consumer spending.

Our base case calls for growth of 2.75% in 2007, slightly above the 2.7% rate in 2006, supported by job gains, healthy domestic demand and an unwinding of the 2006 inventory correction. This puts growth ¼ point behind our U.S. growth forecast in 2007. In 2008, we expect Canadian GDP will match its U.S. counterpart at 3%, buoyed by continued growth in the labour market, rising wages and the extended global growth cycle. Inflation remains well behaved, with the 2.1% core rate only a hair shy of the Bank's 2% target. We expect inflation to fall to 1.75% this year and pick up to 2% in 2008 as a tighter labour market puts upward pressure on wages and the base effect of the GST cut is unwound.

We have maintained our call for one rate cut from the Bank of Canada at some point in late 2007 taking the Bank rate to 4%, with the risk skewed towards no change should GDP begin to fully reflect the strength in employment. With Canadian growth building momentum to the point where it matches U.S. GDP in 2008, we expect Canadian bonds to underperform slightly and have raised our 10-year bond forecast to 4% from 3.75% (exhibits 18 and 19). This flattens the Canadian yield curve between the overnight rate

EXHIBIT 16. Canada Consumer Price Index Inflation
Headline vs. Core

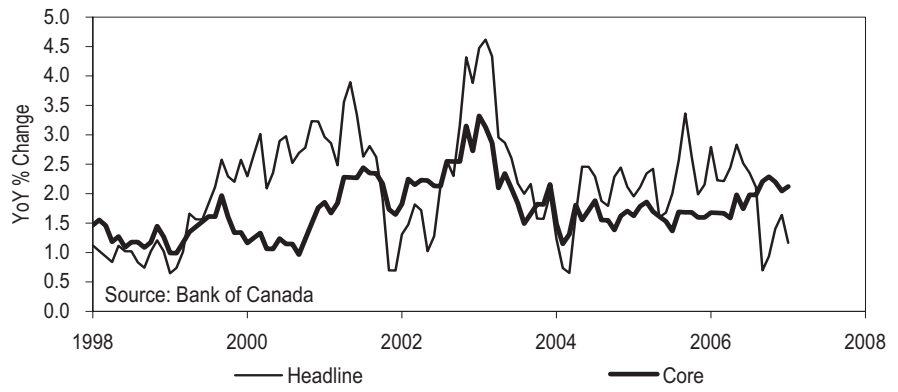


EXHIBIT 17. Canada
Average Hourly Earnings

and 10-year bonds, and puts the 10-year Canada-U.S. spread at negative 50 basis points one year out.

United Kingdom

The BoE's Monetary Policy Committee surprised the market again in January, raising the base rate 25 basis points to 5.25%. December's subsequent spike in inflation to 3% (Exhibit 20) validated their decision and led some committee members to conclude that inflation risks had shifted to the upside and could lead to a "dislodging of inflation expectations." The majority of members saw no reason to delay raising rates, as "the world economy was robust, nominal domestic demand was growing strongly and real output grew at least at its potential rate. Spare capacity had diminished and inflation had been rising as it had become easier to increase prices." That said, the decision was a close one, as four of nine members preferred to leave rates unchanged. In light of January's move, expectations shifted to a no rate change decision for the February meeting and the Bank did not disappoint, though two members voted for a second consecutive increase.

Fourth quarter GDP growth surprised to the upside, rising by 0.8% against expectations of 0.7%, while the annualized rate was the highest since the second quarter of 2004 at 3%. Services and construction led the way, though it seems cracks may be starting to show in the housing market. While Rightmove's survey of asking prices for housing accelerated to 0.9% in

EXHIBIT 18. Canada
12-Month Yield Forecasts

	2-MAR-2007	BASE	WORST	BEST
3mo	4.26%	4.00%	4.50%	3.50%
2yr	3.92%	3.90%	4.75%	3.25%
5yr	3.90%	3.85%	4.90%	3.00%
10yr	4.00%	4.00%	5.00%	3.00%
30yr	4.07%	4.05%	5.10%	3.10%

Source: RBC AM

EXHIBIT 19. Canada
Yield Curves: Current and 12-Month Forecast Levels

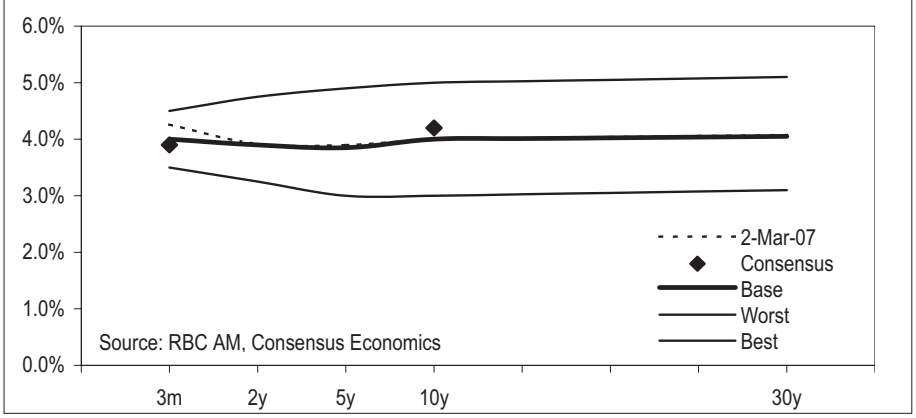
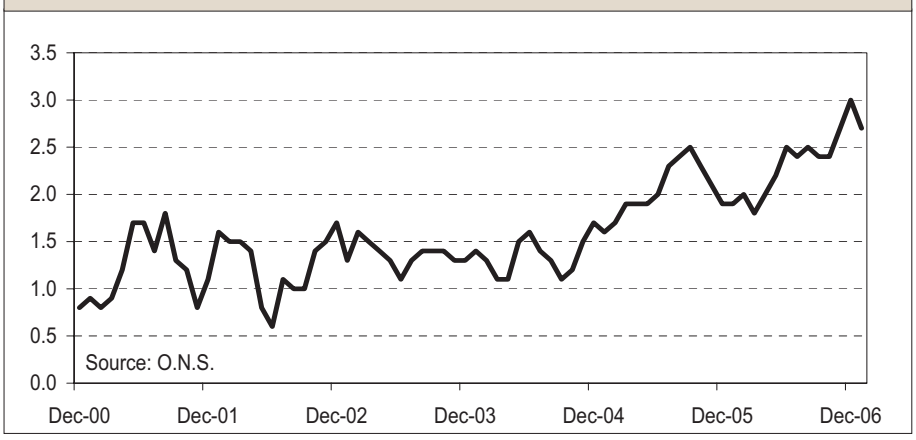


EXHIBIT 20. United Kingdom CPI



February from 0.5% the prior month, it was the smallest February gain since the survey began five years ago, suggesting the 75 basis points of tightening since July may be having an effect. This sentiment is in line with the Royal Institute of Chartered Surveyors (RICS), which posted a decline in its January survey. While City bonus season will likely buoy the London market for the first few months of the year, it appears that the BoE's monetary tightening could weigh on the property market in 2007, with any softness likely to show up in consumer activity (Exhibit 21).

February's Inflation Report noted a limited amount of spare capacity in the economy, with "signs that businesses are more confident in their ability to raise prices." It was clear that the BoE views risks on the growth front as balanced, with downside inflation risks in the near term and upside in the medium term. The report indicates that the public's inflation expectations have risen in tandem with actual inflation, as have market-based inflation expectation measures. Our 2007 economic growth and inflation forecasts have increased, with 2007 GDP at 2.5%. We introduce our 2008 forecast, also at 2.5%. We see CPI at 2.25% this year as workers' inflation expectations result in higher wage negotiations, and falling to 2.0% next year. We have increased our forecast for the overnight rate to 5.25% from 4.75% previously (exhibits 22 and 23), with the risk being that the MPC first goes to 5.50% before taking back the final hike late in the forecast period. Any additional tightening will put undue pressure on the housing market and therefore consumers, at which point

EXHIBIT 21. United Kingdom
Retail Sales

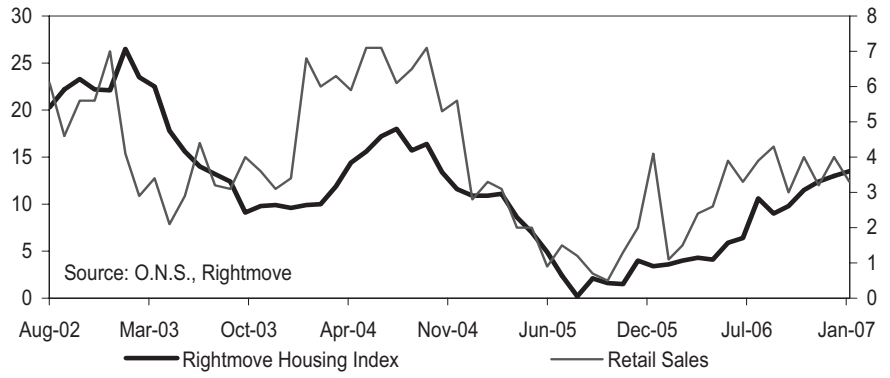
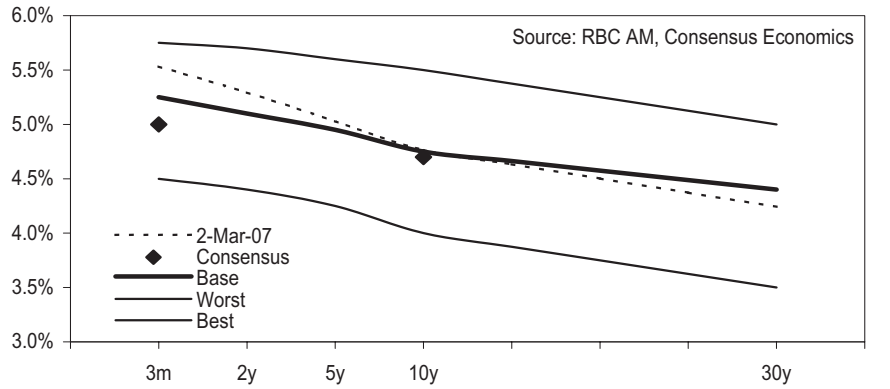


EXHIBIT 23. United Kingdom
12-Month Yield Forecasts

	2-MAR-2007	BASE	WORST	BEST
3mo	5.53%	5.25%	5.75%	4.50%
2yr	5.29%	5.10%	5.70%	4.40%
5yr	5.03%	4.95%	5.60%	4.25%
10yr	4.76%	4.75%	5.50%	4.00%
30yr	4.24%	4.40%	5.00%	3.50%

Source: RBC AM

EXHIBIT 24. United Kingdom
Yield Curves: Current and 12-Month Forecast Levels



the committee would intervene. Yields on 10-year gilts should trend toward our 4.75% forecast as inflation returns to target.

Risks to our forecasts are skewed to the upside on growth and inflation. While the housing market has shown some cracks, the previously mentioned City bonuses are likely to mop up any weakness and have the potential to push prices and hence consumption into overdrive, a situation the MPC will be keen to avoid. While the inflation outlook and recent trends point toward the MPC having completed rate hikes, a surge in housing or renewed energy price strength may cause the MPC to take further action.

Returns and Recommendations

Our expected country returns reflect the scenarios discussed above and are listed in Exhibit 24. With the U.K. as the notable exception, a mere 0.7 percentage points separate the highest and lowest returning markets (Canada at 5.0% and the U.S. at 4.3%) on a U.S. dollar-hedged basis. The U.K. offers the lowest expected return at 2.5%.

The recent volatility in the equity markets and pessimistic economic view has sent yields rallying nearly 20 basis points over the past five business days. While 12-month returns based on our yield forecasts were in the magnitude of 6%-plus only a week ago, they now reflect coupon-like returns with limited capital gain potential in all markets. It is conceivable that yields trend lower over the first half of the year should the recent sharp pessimistic turn in outlook persist. We're confident, however, that the U.S. economy will pass through its current soft patch and regain its trend-like momentum leaving yields broadly in-line with current levels at the end of our 12-month forecast period and returns close to coupon.

Our recommendations are threefold. First, we have maintained our fixed income allocation at 35% – still well below the 40% neutral setting but consistent with our view that an increased confidence in the Fed's ability to snuff out inflation will suppress risk premiums and lead to lower real yields in the medium term. Second, we advise maintaining portfolio duration below neutral and extending to a neutral setting should U.S. yields approach the January 26 high of 4.91%. Third, we recommend benchmark weightings in the U.S., Europe and Japan until such time as there is sufficient differentiation in relative expected performance. For the first time since we initiated the Global Investment Outlook, the tight expected return profile of all regions precludes us from making a bond regional call this quarter.

A total return analysis of expected global bond market returns reveals that the performance between bullet and barbell strategies varies widely by country. As we are not able to make a blanket recommendation that applies to all regions, a summary of our analysis is posted in Exhibit 25.

EXHIBIT 24. Expected Return
12 Months

	LOCAL CURRENCY	U.S. HEDGED
U.S.		
3mo	5.0%	5.0%
2yr	4.2%	4.2%
5yr	3.9%	3.9%
10yr	4.6%	4.6%
30yr	4.7%	4.7%
All	4.3%	4.3%
EUROPE		
3mo	3.9%	4.9%
2yr	3.7%	4.7%
5yr	3.6%	4.7%
10yr	3.5%	4.6%
30yr	3.9%	4.9%
All	3.7%	4.7%
JAPAN		
3mo	0.7%	5.0%
2yr	0.7%	5.0%
5yr	0.5%	4.8%
10yr	-0.3%	4.0%
30yr	1.0%	5.3%
All	0.5%	4.8%
CANADA		
3mo	4.1%	5.0%
2yr	3.9%	4.7%
5yr	4.0%	4.8%
10yr	4.2%	5.1%
30yr	4.5%	5.4%
All	4.2%	5.0%
U.K.		
3mo	5.4%	4.7%
2yr	5.4%	4.7%
5yr	5.1%	4.5%
10yr	4.6%	3.9%
30yr	1.4%	0.8%
All	3.2%	2.5%

Source: RBC AM

EXHIBIT 25. Scenario Analysis – 12 Months
Barbell vs. Bullet (Duration Weighted)

2/10-Year vs. 5-Year								
	EXPECTED		BASE		WORST		BEST	
	Local CCY	USD Hedged	Local CCY	USD Hedged	Local CCY	USD Hedged	Local CCY	USD Hedged
U.S.								
2yr – 10yr	5.79%	5.79%	5.93%	5.93%	0.68%	0.68%	9.71%	9.71%
5yr	5.40%	5.40%	5.60%	5.60%	0.89%	0.89%	8.37%	8.37%
EUROPE								
2yr – 10yr	4.62%	5.86%	4.48%	5.72%	1.79%	2.99%	8.58%	9.86%
5yr	4.63%	5.86%	4.51%	5.75%	2.23%	3.44%	7.93%	9.21%
JAPAN								
2yr – 10yr	0.34%	4.90%	0.32%	4.88%	-1.57%	2.90%	2.42%	7.07%
5yr	0.43%	4.99%	0.40%	4.96%	-1.26%	3.23%	2.35%	7.00%
CANADA								
2yr – 10yr	5.04%	5.99%	5.03%	5.98%	1.38%	2.30%	8.79%	9.78%
5yr	4.97%	5.92%	5.03%	5.98%	1.47%	2.39%	7.97%	8.95%
U.K.								
2yr – 10yr	6.00%	5.37%	5.98%	5.35%	3.53%	2.92%	8.70%	8.05%
5yr	6.13%	5.50%	6.10%	5.47%	3.84%	3.23%	8.66%	8.01%

2/30-Year vs. 10-Year								
	EXPECTED		BASE		WORST		BEST	
	Local CCY	USD Hedged	Local CCY	USD Hedged	Local CCY	USD Hedged	Local CCY	USD Hedged
U.S.								
2yr – 30yr	6.98%	6.98%	7.13%	7.13%	-5.65%	-5.65%	18.40%	18.40%
10yr	6.76%	6.76%	7.07%	7.07%	-3.39%	-3.39%	14.43%	14.43%
EUROPE								
2yr – 30yr	5.50%	6.74%	5.13%	6.37%	-1.16%	0.00%	15.10%	16.46%
10yr	5.28%	6.52%	5.04%	6.29%	-0.31%	0.87%	12.72%	14.05%
JAPAN								
2yr – 30yr	1.54%	6.15%	1.48%	6.10%	-2.42%	2.02%	5.92%	10.73%
10yr	-0.01%	4.53%	-0.03%	4.51%	-3.94%	0.43%	4.06%	8.79%
CANADA								
2yr – 30yr	5.95%	6.91%	5.84%	6.80%	-2.28%	-1.39%	15.07%	16.11%
10yr	5.94%	6.89%	5.90%	6.86%	-1.43%	-0.54%	13.58%	14.60%
U.K.								
2yr – 30yr	5.36%	4.73%	5.06%	4.44%	0.92%	0.32%	12.19%	11.52%
10yr	6.41%	5.77%	6.36%	5.73%	1.20%	0.60%	11.94%	11.28%

Source: RBC AM

Currency Markets

DAGMARA FIJALKOWSKI, MBA, CFA
V.P. & Senior Portfolio Manager – RBC Asset Management Inc.

The U.S. dollar strengthened on a trade-weighted basis in the quarter ended February 28, 2007 (Exhibit 1). Sentiment, negative for the dollar in October and November, turned positive in December and January as falling oil prices, warm weather and statistics suggesting robust U.S. growth dampened expectations for interest rate cuts.

Interest Rate Expectations Key To FX

These days, as was the case for most of 2006, currency markets have tended to react more to changing expectations for future monetary policy than to the level of interest rates. Exhibits 2 and 3 illustrate this point well. Exhibit 2 shows currency changes regressed on interest rate differentials versus the U.S. dollar in 2006. While some currencies behaved as expected (the yen, as well as the Canadian, Australian and New Zealand dollars), the relationship has not been very tight (see Swiss franc and sterling). Exhibit 3, on the other hand, shows currency changes regressed on changes in interest rate expectations. It demonstrates that the market rewarded currencies for which interest rate expectations were increasing.

In a world focused on yield, the Bank of England's surprise 25-basis-point rate hike in January catapulted sterling into the ranks of the high yielders (Exhibit 4). Moreover, the market expects about 50 basis points of hikes from the BOE this year, while Fed expectations have been reduced to approximately one cut (23 basis points in Exhibit 5). If the market is right, U.S. central

EXHIBIT 1. Trade Weighted USD

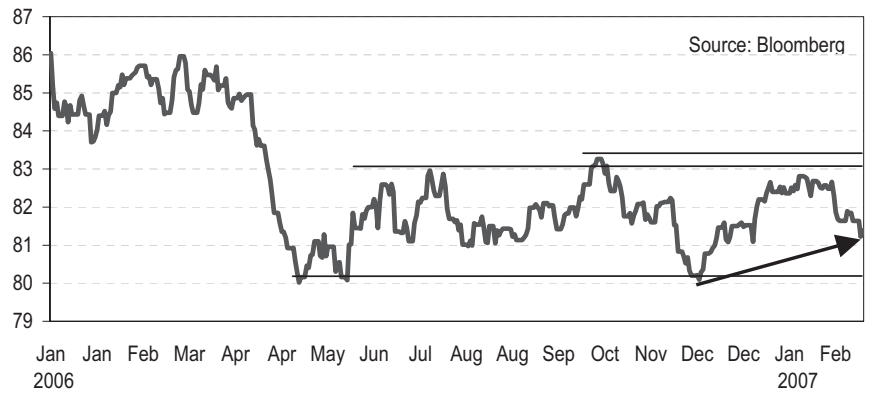


EXHIBIT 2. Carry vs. Performance

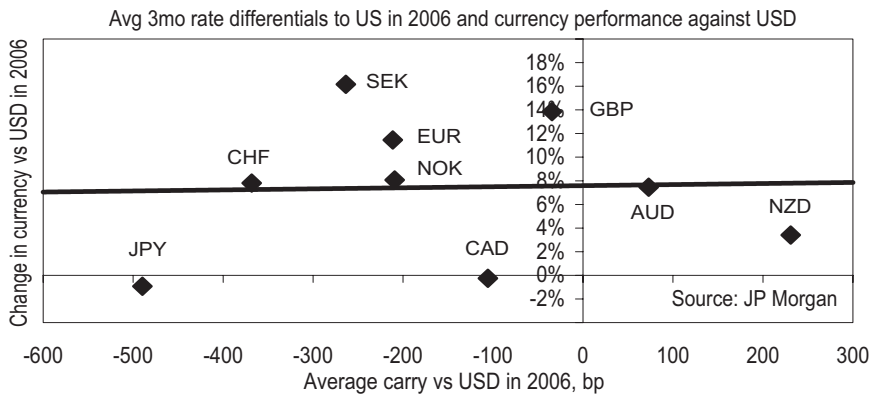
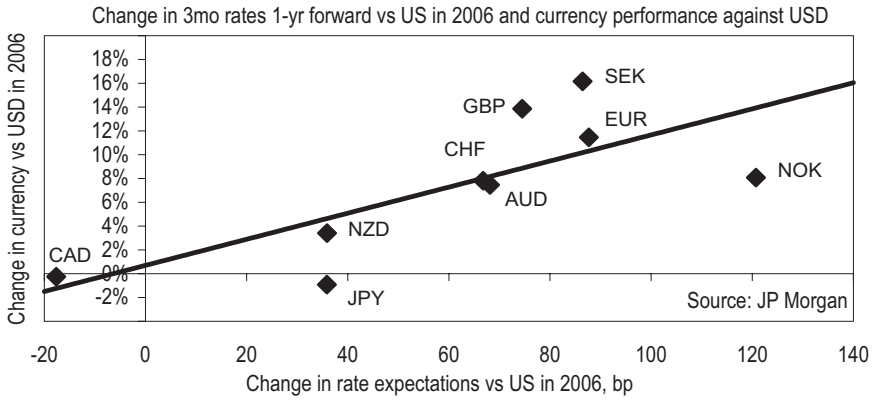


EXHIBIT 3. Rate Expectations vs. Performance



bank rates will have fallen behind those offered on sterling by May. On the other hand, the European Central Bank has more than two hikes priced in at the moment, making the euro vulnerable to disappointing economic data. Unless we expect more than 23 basis points of cuts in the U.S., or more than 60 basis points of hikes in Europe over the next 12 months, the U.S. dollar should hold within the range that we have known for some time and perhaps even appreciate somewhat in the short term. It is worth noting that while the futures contract closest to expiration is generally a good indicator of whether a central bank will raise or lower rates, longer-term contracts (six to 12 months away) are just sentiment indicators with little predictive value. J. LaVorgna of Deutsche Bank noted that "a steady Fed does not necessarily imply a steady market,"[1] reminding us that in 1993, the only calendar year in which monetary policy did not change, the futures market still re-priced by a large 173 basis points.

The Carry Trade

With markets focused on interest rates, the press has been full of articles and references to the so-called 'carry trade,' that is, the practice of borrowing in currencies with relatively low interest rates (the yen or Swiss franc, for example) and investing in currencies offering much higher rates (Australia and New Zealand are noteworthy high yielders). While G7 finance ministers and central bankers expressed worries about excessive risk taken on by hedge funds that engage in massive carry-currency

EXHIBIT 4. Short Term Interest Rates (one month)

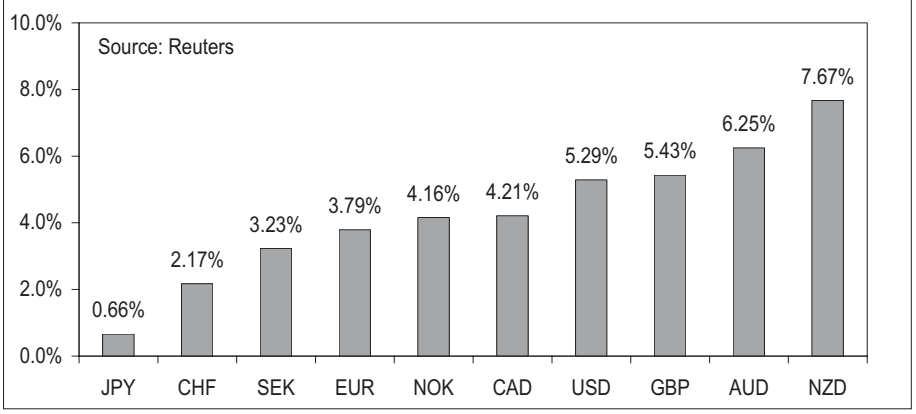


EXHIBIT 5. Implied 12-Month Changes in Short Term Interest Rates

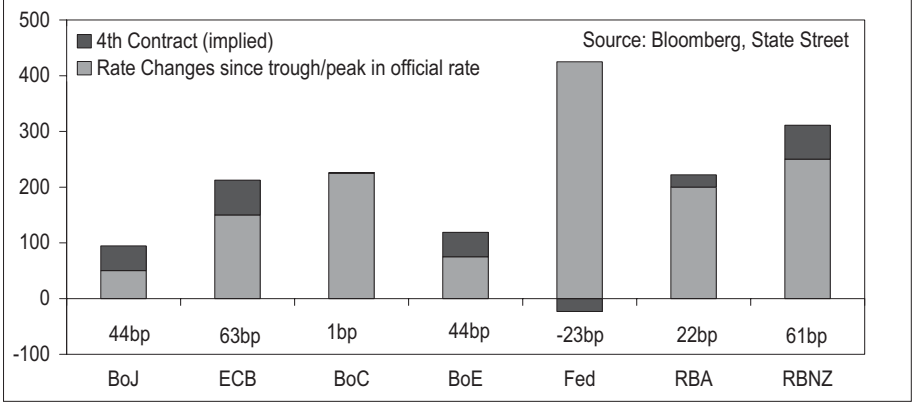
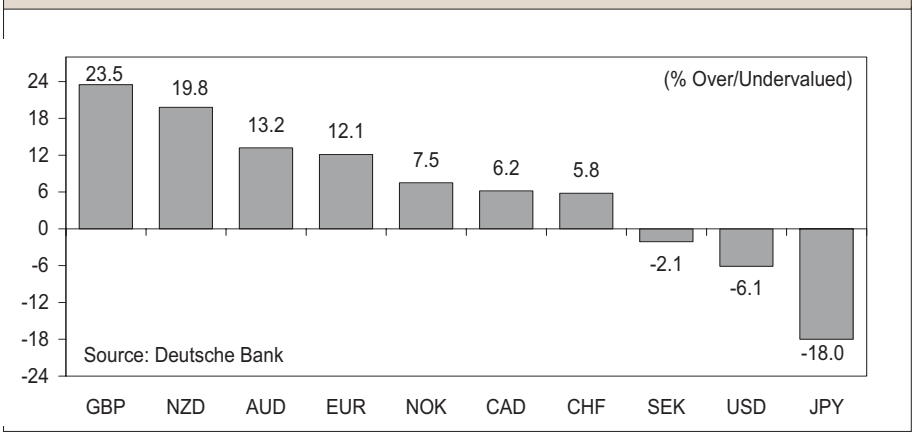


EXHIBIT 6. Currency Valuation Relative to Purchasing Power Parity



trades multiplied by leverage, many other parties are involved in similar bets, although they may not lever their wagers. Think about insurance companies, pension funds, Japanese retail investors[2], central banks themselves and even Eastern European homeowners, some of whom are financing mortgages in Swiss francs.

While we cannot quantify the value of assets involved in carry trades, we can highlight a few signs of their ubiquity. For example, at the beginning of February short yen positions on IMM were the largest on record, although not extreme when considered as a proportion of total outstanding positions. Using another measure, State Street in February of this year reported that selling in a recent 120-day window was heavier than in all but 6% of comparable time frames dating to the beginning of State Street's FX Flow Index in 1994. The Bank of Japan attempts to monitor the carry trade while admitting it cannot measure its scope.

What would cause the carry trade to unwind? That is the $64,000 question. One thing is for sure: it will be infinitely easier to identify a trigger in retrospect than to spot one in advance. Events that may, by themselves or in tandem with each other, result in an unwinding of the carry trade include:

1. **An increase in Japanese interest rates**. The change would have to be sizeable and rapid. At the very least, the BOJ would have to appear aggressive to cause unwinding.

EXHIBIT 7. Historical PPP Valuation of Trade Weighted USD

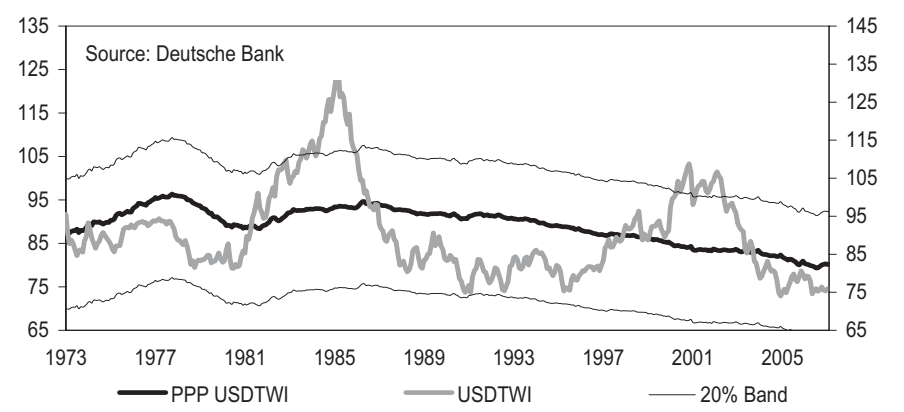
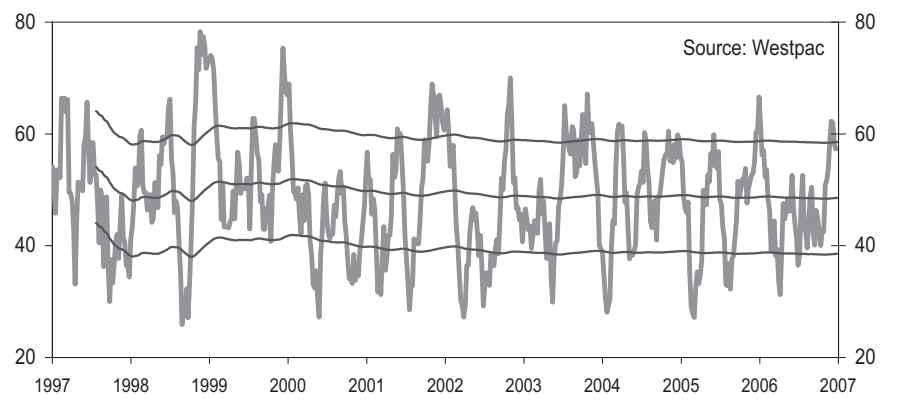


EXHIBIT 8. U.S. Data Surprise Index



2. **An increase in foreign exchange volatility.** Negative economic news in the U.K., Australia, New Zealand or Brazil could have as much impact as positive economic news in Japan. Weakness in the euro would have a similar effect as the Eurozone currency is stretched versus the yen on many valuation measures.

3. **An increase in risk aversion.** This can be triggered by non-economic factors such as war and heightened geopolitical tensions, changes of political leadership, natural disasters, etc.

4. **Central-bank intervention.** A low probability. However, with the trade-weighted yen

[1] DB, US Economics Weekly, Jan 19, 2007
[2] E.g. motivated by higher yields on global bonds Japanese retail investors have poured the money into mutual fund companies investing abroad. For the past two years, Japanese retail investors have also been able to buy investment trusts investing in foreign stocks at the network of 24,000 post office branches.

index at an eight-year low and reserves of over US$850 billion accumulated back when the BOJ was intervening to stop yen appreciation, the BOJ could sell dollars and buy yen to undermine the carry trade and introduce more two-way risk into the market.

We cannot forecast when the carry trade will begin to unwind. Positions, while undoubtedly big, have accumulated a sizeable cushion of profit and may not be very sensitive to small corrections. We do, however, assume that the carry trade will unwind over the next 12 months.

Long Term and Short Term

From a longer-term perspective, an environment of global liquidity withdrawal via higher interest rates makes it more difficult for the U.S. to fund its current-account deficit and easier for central banks (other than the Fed) to accept currency appreciation when they face inflationary pressures. Valuation models suggest that the U.S. dollar is 6% undervalued (Exhibits 6 and 7). Adjustments to external imbalances, i.e. a reduction in the current-account deficit, will require that the U.S. dollar move to the depreciated end of the valuation bands. This implies a drop of 14%, and the dollar would need to stay cheap for a period of time to effect the adjustment. As a historical example, recall that the U.S. dollar started falling in 1985, but the trade balance did not start improving until 1988. The dollar stayed cheap till 1995 so that the full adjustment could take place. Even from a short-term perspective, the U.S. dollar is in a worse position now than three months ago. It has competition from sterling for third highest yielder, and with elevated expectations on economic data, positive surprises will be hard to come by (see surprise index on Exhibit 8).

Our base case scenario (70% probability) calls for one Fed interest rate cut within our forecast horizon, which is a bit less dovish than at the November RISC meeting. As U.S. data disappoint (retail sales and housing were boosted by unusually warm weather late in 2006), the market will shift expectations back toward Fed easing, helping to undermine interest rate support for the U.S. dollar. Accordingly, we would expect a gradual decline in the currency. One alternative scenario (15% probability) calls for a much more intense slowdown caused by another leg of weakness in the housing market, prompting the Fed to cut rates aggressively. The U.S. currency would decline significantly in this scenario. If, on the other hand, U.S. growth proves more resilient and unit labour costs or core inflation do not decline, market expectations could shift in the direction of Fed hikes. The impact would be dollar-supportive on the grounds of interest rate differentials, but also raise global risk premiums and volatility.

To Conclude

- Monetary policy and the inflation outlook are keys for the U.S. dollar. Rising global rates are detrimental to the U.S. currency.
- Underperformance in the yen is prone to sudden and unpredictable reversal, as carry trades come under pressure.
- Carry trades are widespread and an unwinding would affect bond and stocks markets.

A. Greenspan has likened forecasting exchange rates to a "coin toss," and we are still waiting for a currency-forecast quotable from Ben Bernanke. We are asked to forecast for a 12-month horizon, and we attempt to deliver to the best of our current state of knowledge and information. This quarter our euro forecast was adjusted marginally to 1.35 from 1.34, Canadian dollar to 1.12 from 1.10, yen to 110 from 108 and sterling unchanged at 1.95. Details of our currency evaluation are presented on the following pages.

The Currency Outlook: Key Factors

EURO

Supportive

- Monetary policy: ECB tightening due to concerns about stronger money growth (three-month average to 9.2% in December from 8.8% versus reference rate of 4.5%), dynamic bank lending, import prices and inflation risk.
- Gradual changes in the desired foreign exchange reserve mix by central banks.
- Middle East accounts protecting the purchasing power of their oil receipts through diversification.
- European growth: economic recovery broadening and leading indicators point higher, unemployment rate lowest in six years (7.5%), PMI strong, consumer confidence up, strong corporate balance sheets and business confidence.
- Fiscal deficit in 2006 likely to be better than expected.
- EU enlargement may bring down tax rates as competition for investment intensifies between countries.

Negative

- ECB nearing the end of tightening cycle as inflation has been below 2% since September 2006 and household borrowing seems to be slowing.
- U.S. current-account and trade deficits stopped deteriorating in 2006, while capital flows into U.S. corporate bonds are funding current-account deficit easily.
- U.S. fiscal deficit expected to turn into surplus by 2012 on stronger economic growth.
- Euro is 30% overvalued versus yen based on purchasing power parity.
- Concerns about resilience of growth due to combined impact of fiscal and monetary tightening.
- Moderating oil prices could reduce diversification demand from the Middle East.
- Falling inflation typically supportive of U.S. dollar.
- Lack of popular support for European institutions may flare up during French elections.
- Exposure to religious unrest, geographic proximity to Iran.

12-MONTH FORECAST: stronger 1.35, but choppy trading characteristic of latter part of FX cycle.

YEN

Supportive

- Renewed focus on global imbalances, yuan and yen in particular (highlighted by February's G7 meeting in Essen and trade frictions with other Asian countries) may result in verbal or actual intervention (with $875 billion in foreign reserves BOJ has plenty of firepower).
- Economic expansion entering mature stage and well balanced nature of growth (domestic demand, capital investment and net exports) should make for a shallow slowdown.
- Unemployment at 4.1%, an eight-year low.
- Bank lending on the upswing.
- Major trading partners in good economic health (China and U.S.), so nominal exports/GDP growing.
- Current-account surplus.
- Renewed interest from central banks to add yen to reserves.
- Most undervalued on purchasing power parity basis (18% vs. U.S. dollar, 30% versus euro).
- Risk of 'carry trade' unwinding.

Negative

- Monetary policy: tightening cycle extremely gradual.
- Low interest rates make the yen a favourite short for leveraged and unleveraged trades.
- BOJ's "credibility deficiency" as independence questioned.
- Recent strength of U.S. economy and reduced expectations of interest rate cuts by the Fed make the U.S. dollar somewhat more attractive.
- Core CPI barely positive at 0.1% year-over-year in 2006, little change in unit labour costs continues to cap inflation.
- Vulnerability to high oil prices; basic balance (current account and foreign direct investment) would continue to deteriorate with continued run-up in oil prices.
- Pressure on fiscal policy due to high government debt and pension liabilities, possibility of higher taxes as Abe government favours fiscal probity.
- Foreign investors have been reducing holdings of Japanese equities and foreign direct investment on 12-month average basis.
- Japanese retail investors increasingly are buying foreign bonds and equities on an unhedged basis.

12-MONTH FORECAST: stronger JPY 110, but choppy trading characteristic of latter part of FX cycle.

CANADIAN DOLLAR

Supportive

- Non-energy commodities remain strong and energy prices have stopped deteriorating.
- Long-term demand for commodities as global growth resilient and U.S. economy reaccelerating.
- BOC believes output gap has closed, no slack in economy.
- Trade and current-account surpluses (best in G7).
- Only G7 country with budget surpluses (nine years in a row).
- Canadian firms taking advantage of stronger currency to invest for increased productivity.
- Domestic demand supported by GST cut.
- Central banks buying to diversify reserves.
- Economic adjustment apparent (labour force mobility).
- Unemployment at 6.1% (30-year low).
- CAD less sensitive to storm from 'carry trade' unwind.

Negative

- Weakness in energy prices; trade balance in deficit if energy commodities are excluded; weaker housing market and auto sectors in the U.S. mean that Canada may not benefit so much from U.S. economy.
- BOC on hold as inflation risk in Canada lower than in the U.S. and wage inflation limited to Alberta.
- Interest rates are lower at short end and on 10-year bond relative to U.S.
- Canadians buying foreign securities after removal of content limits.
- M&A inflows remain negative, Canadians on foreign asset-buying spree.
- Risk that tighter monetary conditions in the U.S., Europe and Japan threaten global growth and commodity prices.
- Political uncertainty due to federal and Quebec elections, risk that proposed federal budget will be rejected.

12-MONTH FORECAST: stronger CAD 1.12, but choppy trading characteristic of latter part of FX cycle.

POUND STERLING

Supportive

- BOE surprises with earlier-than-expected rate hike (5.25%) and more hikes possible if inflation does not subside.
- Headline inflation above 2.0% since May, reaching 3% in December, and BOE forecasts inflation to be above-target through 2008.
- PMI index very strong, suggesting above-trend growth for next year. Industrial production improving; spare capacity limited.
- Housing market continues to appreciate.
- Strong capital inflows as petrodollars get re-invested and recipient of Japanese retail flows (other side of carry trade).
- Low unemployment at 3.0%.

Negative

- 23% overvalued on a purchasing power parity basis.
- Sterling has had trouble breaking through 2 U.S. dollars over the past 25 years.
- Trade deficit worsening and income surplus declining.
- Market expectations excessive (2 hikes priced in).
- Unemployment rate increasing since the beginning of 2005.
- Political uncertainty due to elections.
- Risk of 'carry trade' unwinding.

12-MONTH FORECAST: stronger at 1.95, but choppy trading characteristic of latter part of FX cycle.

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RBC Asset Management Inc.

BRAD WILLOCK, CFA – V.P. & Senior Portfolio Manager
RBC Asset Management Inc.

REGIONAL OUTLOOK – U.S.

Economic Outlook

U.S. stock prices rebounded and interest rates declined over the past six months as investors embraced the 'soft landing' scenario. Economic statistics show a mixed picture, with strength in employment growth offset by weakness in manufacturing activity, particularly in auto and housing-related industries. Inflation has been reasonably well contained as falling energy costs since the fall of 2006 cushioned the effect of rising prices for some metals and grains. As a result, investors have pushed out expectations of future rate cuts until the second half of 2007. We expect U.S. GDP growth to approximate 2.75% to 3.0% in 2007, while our initial forecast for 2008 growth is 3.0%. Inflation should be stable at 2.25% for both 2007 and 2008.

Corporate profits continue to be strong, especially given that we are four years into the current economic cycle. Earnings in the fourth quarter of 2006 likely expanded again at a rate exceeding 10%, though we are now seeing some of the moderation that we expected. We still believe that 2007 earnings for the S&P 500 will climb between 8% and 10% to as much as $95 a share and are raising our target for the S&P 500 to between 1600 and 1650 by year-end. The market is supported by solid economic fundamentals, and the potential for lower interest rates suggests higher earnings multiples.

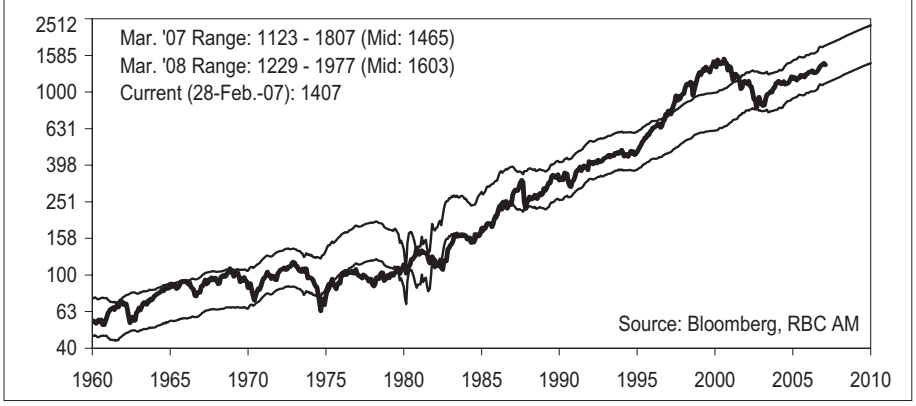
U.S. equity markets have fully recovered from their June/July decline, with most indexes reaching all-time or at least cyclical highs at the time of this writing. New leadership from large-cap companies continues to take hold. While there are few technical indicators suggesting storm clouds on the horizon, we would note that investor sentiment is overwhelmingly positive. A first-half correction may be required to moderate expectations and set the stage for higher prices later this year.

UNITED STATES RECOMMENDED SECTOR WEIGHTS

	RBC INVESTMENT STRATEGY COMMITTEE FEB. 2007	BENCHMARK S&P 500 FEB. 2007
Energy	9.0%	9.7%
Materials	3.5%	3.1%
Industrials	12.0%	10.8%
Utilities	3.5%	3.5%
Consumer Discretionary	11.0%	10.8%
Consumer Staples	8.0%	9.2%
Health Care	11.5%	12.2%
Financials	23.0%	22.2%
Information Technology	15.0%	15.0%
Telecommunication Services	3.5%	3.5%

Source: RBC AM

S&P 500 EQUILIBRIUM
Normalized Earnings & Valuations



Sector Analysis

The mild winter in North America has finally taken its toll on investor psychology regarding crude and natural gas and, in turn, ENERGY stocks. With over half the winter gone, ample inventories of crude and natural gas remain, putting downward pressure on prices. While the sector's underperformance is likely to continue for a while, we are reluctant to go too far underweight the group because we believe the ENERGY sector will have at least one more significant run to all-time highs over the next 12 to 18 months. We are currently positioned in multinational oil companies,

refiners and selective companies with expanding production growth.

With the likelihood of moderate economic growth through 2007 and relatively high valuations, opportunities in the CONSUMER STAPLES sector will continue to be stock-specific. Tobacco makers, selective food companies and restaurant chains appear the best situated. While the group is likely to outperform during a market correction, we do not anticipate sustained outperformance until the economy appears headed for a recession.

The CONSUMER DISCRETIONARY sector ended the year on a solid footing despite concern about the effects of a weakening housing market and higher energy prices. There were signs of increased discounting by some retailers, though inventory levels appear to be in good shape and gift cards continue to sell well. Department stores and selective apparel and footware retailers are currently in the sweet spot, while gaming, leisure and hotels continue to do well as the fundamental backdrop remains positive, and private equity interest abounds. We are reducing the size of our overweight position while remaining constructive.

The HEALTH CARE sector continues to perform reasonably well, as a combination of good growth prospects and reasonable valuations draw more investors. With the Democrats winning both the House and the Senate, pressure to revamp the U.S. health-care system will likely intensify. We retain our underweight ranking on the sector.

Our constructive thesis regarding the economy remains unchanged, and we are moving to an overweight position in the INDUSTRIALS sector from market weight given the attractiveness of many companies in the sector. Within the sector, the best group has been aerospace and defense and we still think companies in this group have further upside.

The performance of U.S. FINANCIALS continues to be quite mixed, as banks struggle to meet earnings expectations due to the effect of a flat yield curve. Non-performing loans are on the rise for the first time in several years albeit from very low levels, and weaker credit profiles may begin eating into earnings. Many of the riskier groups, such as brokers, appear overvalued in the short term so it wouldn't be surprising to see a pullback in the group along with any market consolidation. That said, the sector appears to offer decent returns, so we are maintaining our overweight position while decreasing its magnitude.

We are reducing our overweight exposure to MATERIALS. Recent price declines in steel and copper were met immediately with industry downtime, and some political intervention that has helped rebalance any temporary inventory movements. We remain constructive on the gold sector over the longer term, and are seeing renewed interest by private equity firms in the forest industry, including wood and paper products due to their depressed valuation. Specialty chemicals and fertilizers are still attractive.

We maintain our market-weight view on INFORMATION TECHNOLOGY. We believe that bloated inventories and delayed technology spending, particularly in the telecommunications arena, are temporary in nature. The group has underperformed over the past two months and investor sentiment is poor. We believe that such a contrarian backdrop is positive because many investors do not think the group will be able to sustain anything more than a short-term rally.

The TELECOMMUNICATION SERVICES sector has performed strongly. Business conditions are good due to cost savings in recent mergers, and companies are finding it easier to raise prices in certain lines of business. While there may be room for more gains, we are reluctant to change our market-weight position. The group can take advantage of a recovery in consumer spending while serving as a defensive sector during market declines.

The UTILITIES sector has had mixed results as interest rates rose somewhat, temporarily reducing the attractiveness of high-yielding securities. We do expect interest rates to decline later this year, perhaps creating an opportunity in the sector. Utilities that trade like energy stocks have come under some pressure, and their fate will continue to follow energy prices. We remain market weight.

Regional Outlook – Canada

STUART KEDWELL, CFA – V.P. & Senior Portfolio Manager
RBC Asset Management Inc.

Economic Outlook

Brimming with confidence and focused on a soft landing for the U.S. economy, investors marched global markets steadily upwards during the past quarter, extending one of the longest coordinated periods of global equity gains in memory. While this confidence was shaken at the end of the period, our underlying constructive thesis remains in place.

The U.S. economy is settling into a period of moderate growth after accelerating late last year. Economic data indicate that inflation is falling back within the range of central bankers' tolerance. North American short-term interest rates peaked last summer and are likely to remain in a holding pattern in the intermediate term. While Canadian economic growth is expected to slightly lag that of the U.S., inflation is also expected to remain moderately lower. Stable growth coupled with low inflation and interest rates should be positive for capital markets in North America.

Strength in the S&P/TSX continued in the past quarter, powered by stability in the Financial Services sector and renewed strength in Energy and Materials. Technology also contributed as the market rewarded Nortel's restructuring efforts with 40%-plus share appreciation during the quarter. The Agricultural sector also provided a boost to the index following President Bush's State of the Union address, in which he highlighted the importance of ethanol for the future energy security of the U.S. Finally, many high-quality income trusts with strong levels of free cash flow bounced back to levels near those seen before the federal government's October announcement of changes in taxation early next decade.

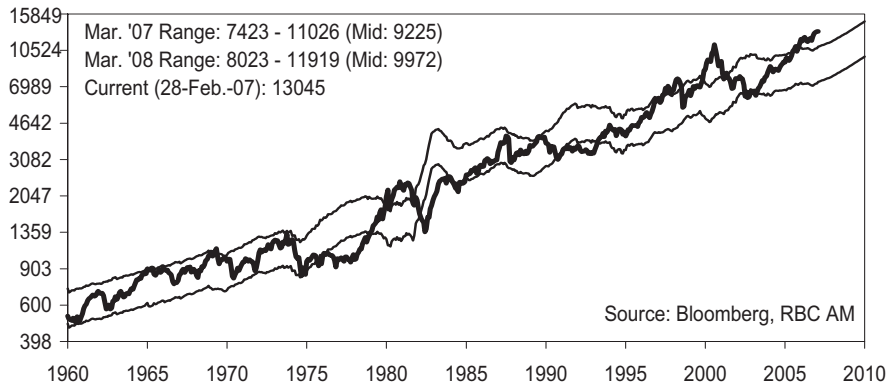
Our view for the S&P/TSX for the intermediate term remains unchanged. Strength in emerging-market economies and improved global capital spending should remain engines of Canadian growth as U.S. consumer spending moderates. As they expand, emerging markets consume more energy and materials on average than developed markets, giving support to tight global commodity markets. Moreover, corporate balance sheets are in excellent shape and free cash flow generation is at the highest levels ever. In recent years, many companies haven't adequately maintained existing assets, let alone invested in new ones.

CANADA RECOMMENDED SECTOR WEIGHTS

	RBC INVESTMENT STRATEGY COMMITTEE FEB. 2007	BENCHMARK S&P/TSX COMPOSITE FEB. 2007
Energy	26.0%	26.6%
Materials	15.5%	16.7%
Industrials	7.0%	5.6%
Utilities	1.0%	1.4%
Consumer Discretionary	5.5%	5.4%
Consumer Staples	3.0%	2.6%
Health Care	0.0%	0.9%
Financials	33.5%	31.6%
Information Technology	3.5%	4.0%
Telecommunication Services	5.0%	5.2%

Source: RBC AM

S&P/TSX COMPOSITE EQUILIBRIUM
Normalized Earnings & Valuations



Against this background, the S&P/TSX index remains above the top end of our estimate of fair value. As a result, we continue to forecast returns below those recorded in the prior two years and below those we forecast for other parts of the globe.

Sector Analysis

We are maintaining our recommendation for FINANCIAL SERVICES at overweight. Some have observed that the valuation of Canadian financial companies is at a premium to their global peers. We think this is for good reason, as banks' returns on equity are above historic averages, while leverage ratios and dividend-to-bond-yield ratios are below average. Such yardsticks provide a solid underpinning for the sector.

We recommend an underweight position in the MATERIALS sector in Canada. While cash flow and valuations remain relatively attractive, volatility witnessed in some of the underlying commodities bears watching in the near term. Over the intermediate term, we believe that cash costs for most commodities will be higher than historical averages and current long-term estimates. Higher assumed prices also appear necessary to justify investments given escalating new-project costs. These factors should combine to provide longer-term support for companies with existing production.

Crude oil's correction continued midway into this quarter before the start of a powerful rebound. Signs of increasing Chinese demand, with additions to strategic reserves in the U.S. and China, cold weather and an improvement in inventories contributed to a turn in sentiment. Of note, while the share prices of many Energy companies had outperformed the fall in crude, so too have they failed to keep pace with its rebound. Notwithstanding a plethora of rumour and speculation about consolidation in the Canadian energy patch, we are maintaining a modest underweight in the ENERGY sector.

Our long-standing overweight in INDUSTRIALS remains in place. The transportation component stands to benefit from increased global trade while others should benefit from a lengthy period of underinvestment in global infrastructure.

We continue to recommend a market-weight position in TELECOMMUNICATION SERVICES, with a focus on the wireless business and companies that bundle a number of services together in a package.

We have increased our recommendation in the INFORMATION TECHNOLOGY sector closer to market weight. For different reasons, the two largest components of the sector appear set to power forward. Research in Motion's Pearl consumer-electronics device appears to have been successful in making wireless email friendlier for the mass market, and the next generation of RIM devices equipped with the compact QWERTY keyboard are just starting to ship. Elsewhere in the sector, Nortel Networks' restructuring program has delivered benefits faster than expected.

Regional Outlook – Europe

VITTORIO FEGITZ – Chief Investment Officer
RBC Asset Management (U.K.) Ltd.

Economic Outlook

After a half-decade of below-trend growth, the Eurozone enjoyed an economic expansion of about 2.7% in 2006. The acceleration was largely thanks to faster growth in Germany, which at 30% of GDP is the region's largest economy. Progress in holding down labour costs has allowed Germany to claw back the competitive edge lost after reunification, and the country as a result has been a major beneficiary of strong growth in global trade since 2003. In 2006, Germany's unemployment rate fell below 10% for the first time in nearly five years and Germany was the world's largest exporter of goods for the third year in a row. For the first time in five years, actual growth exceeded potential growth for two quarters in a row.

For all the positive news, forecasters fear a stronger Germany will provide the justification for higher interest rates and lead to slower overall Eurozone growth in 2007. As Germany's inflation rate rises towards the Eurozone average, the ECB will have to hold down inflation elsewhere to meet its overall target. We expect the ECB to raise its benchmark interest rate to 4% by the end of 2007, up from 2% in late 2005. Not only does this imply a tougher monetary environment for Germany's trading partners but Germany's fiscal deficit, adjusted for the current stage of the economic cycle, is set to fall to 0.9% in 2006, well below the Eurozone average. This will increase pressure for fiscal rectitude elsewhere. According to the IMF, Italy has experienced a 40% loss of competitiveness relative to Germany since 2000, based on real exchange rates, and has a fiscal deficit of 2.8%. France is not much better off, with a 7% loss of competitiveness and a fiscal deficit of 1.8%. Neither of the two candidates in France's forthcoming presidential election has outlined a convincing package of proposals that will improve competitiveness while cutting the deficit. Rather both camps blame the euro and the ECB for France's economic woes. They may have a point in that macro-economic stability since the launch of the euro has – perversely – removed any sense of crisis that would prompt structural reforms. It may be inevitable that every so often France's relative economic underperformance triggers political tensions that raise questions about the longevity of the euro.

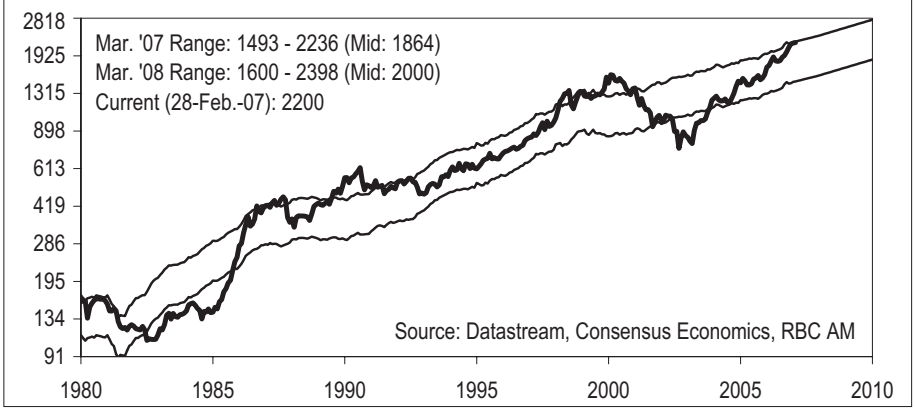
While inflation has retreated since last year in many parts of the globe, the U.K. continues in its struggle to beat back inflation. In November

EUROPE RECOMMENDED SECTOR WEIGHTS

	RBC INVESTMENT STRATEGY COMMITTEE FEB. 2007	BENCHMARK MSCI EUROPE FEB. 2007
Energy	9.3%	9.2%
Materials	7.9%	7.4%
Industrials	10.7%	9.6%
Utilities	5.8%	6.1%
Consumer Discretionary	9.2%	9.6%
Consumer Staples	7.9%	9.1%
Health Care	7.5%	8.1%
Financials	31.3%	30.7%
Information Technology	3.4%	3.6%
Telecommunication Services	6.9%	6.5%

Source: RBC AM

EUROZONE DATASTREAM INDEX EQUILIBRIUM
Normalized Earnings & Valuations



2006, the CPI was almost a full percentage point higher than the Bank of England's November 2005 projection. By December CPI had risen to 3% and the Retail Price Index (the benchmark used in wage negotiations) had climbed to a 15-year high of 4.4%. This increase in inflation has occurred despite a rise in the sterling exchange rate, which should have acted as a damper. Prices rose across all categories of goods and services, and a few economists even forecast that inflation may rise to 5%. This forced the Bank of England to raise rates in January for the third time in six months, to 5.25%. It seems that spare capacity has shrunk because the capital stock has not kept up with output growth, while at the same time prices for goods imported from China have stopped falling. As a result, any sterling weakness will now be seen as adding to inflationary pressures.

Equity Market Outlook

The MSCI Europe index has significantly outperformed the MSCI U.S. index in euro terms over the past three years. While the U.S. economy delivered stronger GDP growth than Europe during that period, earnings at European companies have grown faster. In previous articles we have noted that the introduction of the single European currency in 1998 has allowed European companies to reap benefits of scale and close the profitability gap with the U.S.

At current stock-market levels, and notwithstanding Germany's current economic strength, the relative upside for Europe is probably limited. At this time last year, the market was trading on a prospective multiple of 14.5 on earnings that were expected to grow 12%. Currently the prospective multiple is 17.0 on earnings expected to rise 10%.

A combination of strong cash flows, ample liquidity and European industry consolidation has generated high levels of merger and acquisition activity, which in turn has boosted trend PE valuations to levels last seen in 1987 (excluding the technology "bubble"). In another parallel with 1987, European stock markets have been largely driven by the strong performance of mid- and small-cap stocks, which have been the biggest beneficiaries of M&A. In the 12 months ended February 19, 2006, the DJ Stoxx 50, dominated by large caps, advanced 13.3%, while the wider DJ Stoxx 600 gained 19.6%. This contrasts with the U.S., where mega caps have recently begun to outpace the broader market.

Finally, bond markets have been less supportive of European than U.S. equity valuations. Over the past year bond yields in Europe have risen twice as fast as those in the U.S., albeit from a lower base.

Sector Analysis

After seven years of almost continual outperformance, the UTILITIES sector seems to be running out of steam. It has benefited from rising energy prices, a benign regulatory backdrop (including a perverse carbon dioxide emission-trading scheme that rewarded the biggest polluters with windfall profits), falling bond yields and robust M&A activity. The sector now trades at a 30% premium to the market, and this makes it vulnerable to rising bond yields, falling energy prices and a tougher regulatory environment. In January, EU competition authorities said they found evidence of collusion and other market irregularities. Market remedies might include the forced unbundling of transmission assets and a shift from long- to short-term contracts.

On the other hand, for TELECOMMUNICATION SERVICES stocks, the impact of regulatory and competition-induced price cuts has been offset by a higher-than-expected pick-up in traffic, permitting many investors to discard their worst-case scenario for the sector. Indeed, earnings revisions are in positive territory across the board, and even sector heavyweights Vodafone and BT Group are participating in the rally. Despite a strong performance over the last quarter the sector remains reasonably valued, trading on a market PE and a 55% yield premium. The U.S. has set a precedent for moving to a lighter regulatory approach, which if adopted in the EU, would trigger consolidation of the fragmented European market.

Following four years of outperformance, the current cycle for INDUSTRIAL companies compares very favourably with previous ones. That said, there are reasons to be cautious. Traditional relationships, such as the yield curve, all point to a tougher year for the sector. The IFO index is at a 15-year high and capital-goods stocks have tended to underperform once the IFO peaks. Even a 'soft landing' implies lower growth and some risk of disappointments. Bottom-up estimates of average organic sales growth for 2007 are 5.5%, down from 8.0% in 2006. It is risky to expect profits to grow faster than sales given operating margins are already at cyclical highs and returns on capital employed are above previous peaks.

Regional Outlook – Asia

YOJI TAKEDA – V.P. & Senior Portfolio Manager
RBC Investment Management (Asia) Ltd.

Economic Outlook

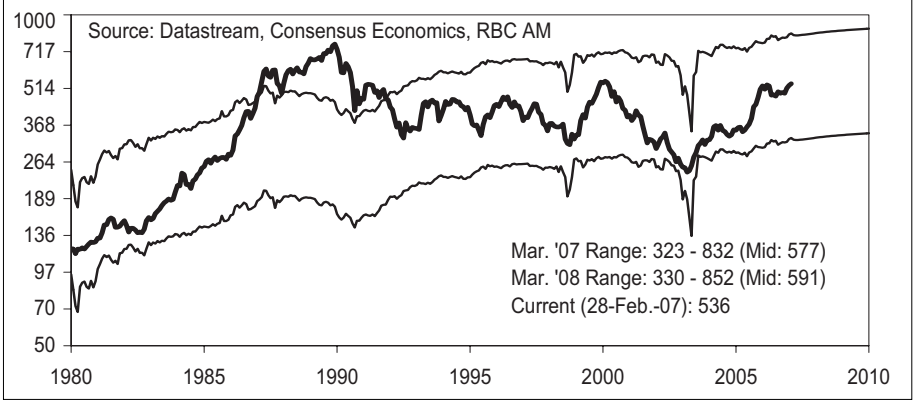
While a mild U.S. economic slowdown in late 2006 boosted inventories in Asia, we believe that after this mild correction passes, economies in the region are likely to enter the next phase of a cyclical upswing. Central banks in China, Korea and Australia have a bias toward tightening monetary policy, though the impact should be offset by lower commodity prices and liquidity inflows. Also, demand for manufactured goods from the region remains strong. The Bank of Japan's decision to stretch the interest rate cycle should give the economy an added boost, and we believe that the global technology cycle will improve moving into the second half of 2007. The Beijing Summer Olympic Games in August 2008 will continue to drive China's economy in the coming quarters.

ASIA RECOMMENDED SECTOR WEIGHTS

	RBC INVESTMENT STRATEGY COMMITTEE FEB. 2007	BENCHMARK MSCI PACIFIC FEB. 2007
Energy	1.3%	1.4%
Materials	10.6%	10.6%
Industrials	17.3%	15.5%
Utilities	4.5%	4.7%
Consumer Discretionary	17.5%	16.7%
Consumer Staples	3.5%	5.0%
Health Care	2.7%	4.6%
Financials	30.1%	28.8%
Information Technology	9.2%	9.2%
Telecommunication Services	3.3%	3.5%

Source: RBC AM

JAPAN DATASTREAM INDEX EQUILIBRIUM
Normalized Earnings & Valuations



The Japanese economy has slowed since mid-2006 but investors are looking ahead to the next uptick in global growth – assuming our scenario for a U.S. soft landing remains intact. Statistics such as the OECD Leading Indicator and the U.S. ISM Manufacturers Index both seemed to bottom out in late 2006. In recent years, such low points have preceded rallies for the stock markets of Asia's export-oriented economies. Japan's slowdown during the second half of 2006 was triggered by weak domestic consumption due to bad weather, an income-tax hike and disappointing wage gains. Export growth also decelerated, leading to excess inventory in the electronics industry. Outside of electronics, however, the demand/supply equation remains tight as evidenced by capacity utilization, which recently touched its highest level since 1991. Looking at the next 12 to 18 months, capital expenditures are likely to remain strong as more companies expand to meet an expected increase in global demand. Japanese consumer spending should also improve gradually, as the number of workers employed is growing at 2% annually, with nearly 1 million workers added to payrolls in 2006. Furthermore, Japanese corporations, backed by strong cash flows, will consider wage hikes in labour negotiations starting in the spring. The current consensus forecast is for 12% to 13% recurring corporate profit growth in fiscal 2007. Importantly, the Japanese government is enjoying an unprecedented increase in tax revenues, and bond issues will be cut by a staggering 22 trillion yen (C$214 billion) this year, which would tend to cap long-term interest rates. Parliamentary elections

slated for July 2007 may unsettle markets as political campaigning brings tax issues to the fore.

Australia must redouble exports to sustain its current economic expansion. While business investment remains robust, momentum is likely softening because of rising costs, and drought continues to exact a toll. However, there are early signs that housing markets are bottoming, and consumer spending is expected to hold up in 2007 as politicians maintain spending during a federal election year. Another round of personal income-tax cuts is expected in the May budget, while the Reserve Bank of Australia will probably maintain a tightening bias to keep inflation expectations anchored. A surge in mergers and acquisitions is likely to result in more leveraged corporate balance sheets.

After GDP growth of 10.7% in 2006, we expect the Chinese economy to experience a slight slowdown in 2007. Fixed-asset investment is likely to moderate due to central-bank tightening, while the country's trade surplus is expected to decline, partly due to a reduction in export-tax rebates. Private consumption is likely to remain buoyant because of rising wages, increased property prices and a strengthening renminbi. As the Olympics approach, the risk of overheating increases, and the government is therefore likely to pursue monetary tightening sufficient to rein in inflation while avoiding a palpable slowdown in the economy. The government's efforts to cool the economy will be delicate, but could result in near-term market volatility.

South Korea is an export-dependent economy, and the strong won is reducing the country's competitiveness relative to Taiwan and Japan. Recent efforts to cool the property market have raised concern that private consumption will falter even as a tight labour market pushes up wages. Although a drop in oil prices should lessen inflationary pressures, a cut in interest rates is unlikely in the near term because the government seems determined to put a lid on asset prices. However, there are early signs that the economy continues to gain strength and we expect fiscal policy to turn more aggressive ahead of elections slated for the end of 2007.

Taiwanese politics have been ugly of late, but the bad news is largely reflected in stock and bond prices. Technology exports dominate the economy and are sensitive to any upturn in global demand, while domestic consumption remains weak. A more constructive relationship with China would benefit many Taiwanese corporations that operate factories on the mainland.

Hong Kong's economic outlook remains bright given an improving job market and sustained services growth, especially financial services. In addition, the economy will continue to benefit from mainland capital outflows and companies coming to Hong Kong for stock listings. Although the renminbi should continue appreciating against the Hong Kong dollar in 2007, Hong Kong monetary authorities don't intend to remove the Hong Kong currency's peg to the U.S. dollar.

Sector Analysis

We remain overweight in the FINANCIAL sector. The Bank of Japan's February rate hike is positive for Japanese banks, which will enjoy wider spreads on loans just as fee income is picking up. Securities firms in Japan and Korea are well placed to benefit from increased trading and investment flows, and the region's life-insurance industry is showing good growth. The Real Estate sector has gained sharply in Japan recently and may be fully valued, but strong liquidity could push prices still higher. Australian banks continue to sustain relatively high returns on capital.

We maintain our overweight in the CONSUMER DISCRETIONARY sector. Japanese automakers continue to take market share in the U.S. and Europe with new models. Sales of flat-panel TVs remain strong and excess inventory should be wrung out soon. Demand for game consoles from Sony and Nintendo remain strong, and sales of digital cameras are still on the upswing. Japanese retailers can expect gradual improvement based on prospects for rising wages.

We are moving to an overweight position for the INDUSTRIALS sector from underweight in light of continued strength in the region. Orders for capital goods such as machinery and shipbuilding

remain stronger than expected, particularly for exports. Japan's trading companies are commodity-sensitive but overall profits remain strong. Asian shipping companies foresee rising rates for both container and bulk cargo. Airlines and railroads are also doing better, helped by lower fuel costs and rising passenger and freight traffic.

We are raising the INFORMATION TECHNOLOGY sector to neutral from underweight. Near term, the momentum for handsets, flat-screen TVs and PCs may be weaker, as new capacity is expected to come online for panels and components. However, while some risk remains, the bottom of this cycle appears to be nearing. In the medium term, the sector should benefit from the new Windows Vista operating system and expectations for a global cyclical upturn.

For the MATERIALS sector, we are lowering our weighting to neutral from overweight. While global commodity prices have become increasingly volatile as geopolitics and growth considerations take turns influencing prices, the bad news seems largely priced in. The long-term trend for demand growth seems intact. Manufacturers of specialty materials, particularly suppliers to electronics producers, face pricing pressure. But prices for high-grade sheet steel, silicon wafers and various specialty chemicals used in electronics continue to hold up well. Prices for traditional bulk chemicals will remain under pressure.

We are cutting the HEALTH CARE sector to underweight from neutral and keeping CONSUMER STAPLES at underweight. These sectors tend to underperform in a cyclical upturn in the market, and valuations are stretched after last year's good performance.

We are slightly underweight TELECOMMUNICATION SERVICES and UTILITIES. Fundamentals for utilities and telco's remain uninspiring in Asia's mature economies. However, dividend yields supported by strong cash flows should draw investors seeking income. Chinese companies offer greater growth potential.

The ENERGY sector in Asia is small and we remain slightly underweight. Australian and Chinese oil companies should benefit from a positive outlook because of new projects. Japanese oil refiners face narrowing margins unless they merge.

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RBC Investment Strategy Committee

Members

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Dan Chornous is Chief Investment Officer of RBC Asset Management Inc., one of Canada's largest mutual fund complexes, with over C$78 billion (US$67 billion) in global equity and fixed income mandates, including the RBC Funds group of products. Dan is responsible for the overall direction of investment policy and fund management at RBC Asset 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 Asset Management's key client groups including RBC Funds, RBC Global Private Banking, RBC Dominion Securities and RBC

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Jim has been in the investment business for 38 years, as both a research analyst and portfolio strategist. He is currently a director of RBC Investments and also Vice-Chair of the RBC Capital Markets Investment Strategy Committee. Through his 33 years at RBC Dominion Securities (and predecessors), Jim has played a key role in developing investment policy for the firm and translating that into solutions for individual clients. He presents extensively on the topic.

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HEAD GLOBAL INVESTMENT
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George has more than 30 years experience in the Financial sector, with over 18 years of investment experience. He is a Fellow of the Securities and Investment Institute. Prior to joining RBC, he worked with Lloyds Bank International in their trust businesses in the British Isles and Monaco. George joined Royal Bank of Canada in 1985 and moved to Guernsey where he was appointed Director of Royal Bank of Canada Investment Management (Guernsey) Limited in 1993. In March 2000, he moved to Geneva, Switzerland, where he was appointed Chief Investment Officer of Royal Bank of Canada (Suisse) in June 2002. In January 2006 George was appointed Head Global Investment Solutions and relocated to Guernsey.

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Jason joined RBC Asset Management in 2005 and is responsible for spearheading the Firm's institutional-investment management business. His career at RBC Financial Group dates from 1998, when he joined the retail bond sales and trading desk at RBC Dominion Securities. In 2001, Jason moved to the Fixed Income Portfolio Advisory Group, where he was responsible for structuring portfolios for high-net-worth clients, writing economic and credit commentary, and formulating trade recommendations for Investment Advisors and their clients. Jason was elevated to Vice President in 2003 and assumed management responsibility of the Fixed Income Portfolio Advisory Group and the retail bond sales and trading desk. He is a member of the RBC Investment Strategy Committee and the Investment Policy Committee.

JANET L. ENGELS
SENIOR V. P. AND DIRECTOR,
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RBC DAIN RAUSCHER CORP.

Janet has more than 24 years of experience in the securities industry. She joined Tucker Anthony, now RBC Dain Rauscher, in 1982. Over the course of her career, she has held the positions of Director of Equity Research for Sutro & Co. and Director of Equity Strategies for Tucker Anthony. In 2002 she was named Director of the Private Client Group for RBC Dain Rauscher where she is also a member of the firm's Director's Circle and the RBC Investment Strategy Committee.

STUART KEDWELL, CFA
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Stu Kedwell 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 later joined RBC Asset Management as a senior portfolio manager, co-managing the RBC DS Focus Fund, RBC Value Fund and a number of other mandates. He is a member of the firm's Investment Strategy Committee.

MARTIN PALECZNY, CFA
V. P. & SENIOR PORTFOLIO
MANAGER,
RBC ASSET MANAGEMENT INC.

Martin Paleczny, with 12 years of experience in the investing field, 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 also serves as advisor to the RBC Investment Strategy Committee for technical analysis.

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RBC Asset Management