

Perspective on Current Markets

Recent months have been extremely challenging for investors, as we pass through a historic period for global capital markets. During this time, you have likely seen significant declines in the value of your portfolio and, in many cases, been left wondering what has happened and how to react. The following provides an overview of the issues gripping markets today, looks at previous downturns to provide perspective, and offers potential next steps.

Where we are today

Equity markets are continuing to deal with the fallout of a crisis in credit markets and a deteriorating outlook for the global economy. Being at the epicentre of the sub-prime mortgage bust, U.S. equity markets were the first to feel the brunt of a deteriorating financial sector and growing concerns over economic growth. However, as it became clear that European economies faced similar housing issues and problems in their financial sector, the outlook for global growth weakened significantly.

Earlier this year, Canadian equities were the single bright spot among global markets, with strong commodity prices lifting the S&P/TSX Composite Index to record highs in July 2008. That changed in recent months with sharp declines in commodities taking their toll on the Canadian equity market due to its high concentration in resource companies. In the three months ending October 31, the Canadian stock market had fallen almost 28%.

Importantly, the Canadian banking sector has managed to avoid many of the problems that have plagued global financial institutions over the past year. For the three months ending October 31, financials had fallen by 17% in Canada compared to 28% globally.

Have we seen this before?

There have been 12 bear markets since 1950, with an average decline of 28%. The length of these bear markets has varied considerably, with the average lasting 13 months. Though any bear market feels like the worst while it's happening, we have witnessed significant declines in the past and markets have always recovered. The worst bear market in U.S. history lasted 31 months and saw markets fall over 49%. By comparison, we have seen U.S. markets fall more than 40% since the current crisis began in October 2007.

Historical U.S. Bear Markets

Bear Market Began	% Decline	Duration (Months)	3-Month Return from End of Bear Market	6-Month Return from End of Bear Market	12-Month Return from End of Bear Market	2-Year Return from End of Bear Market
1-Jul-56	-19.0%	17	5.3%	13.1%	38.1%	49.8%
12-Dec-61	-24.6%	6	2.8%	15.3%	26.7%	5.9%
18-Jan-66	-22.1%	9	4.9%	17.8%	26.3%	34.1%
14-Nov-68	-36.1%	19	15.8%	26.7%	37.1%	47.3%
11-Jan-73	-48.2%	21	7.9%	31.2%	32.0%	65.6%
21-Sep-76	-19.4%	18	11.7%	18.7%	10.6%	31.0%
13-Feb-80	-17.1%	1	11.9%	22.9%	33.2%	40.7%
28-Nov-80	-27.1%	21	11.2%	35.7%	51.8%	50.2%
25-Aug-87	-33.5%	3	16.3%	13.8%	18.8%	37.7%
16-Jul-90	-19.9%	3	13.1%	23.5%	29.1%	58.5%
17-Jul-98	-19.3%	2	21.5%	29.3%	37.9%	36.7%
24-Mar-00	-49.1%	31	7.9%	4.0%	22.2%	17.7%
Average	-28.0%	13	10.9%	21.0%	30.3%	39.6%
Current (Began Oct. 9, 2007)	-42.7%	14				

Note: Bear Market defined as Peak-Trough corrections exceeding 15.0%. Data based on daily close prices of S&P 500 Index. Source: RBC Asset Management Inc. as of November 28, 2008.

What will solve the problems?

The current environment calls for a two-part solution that is already underway. The first was lowering interest rates to stimulate economic activity, a measure that has consistently been shown to rekindle economic growth over time. Lower interest rates should also begin to stabilize U.S. housing prices, which will be a key indicator that a recovery is underway. Since the crisis began, the U.S. Federal Reserve Board (the Fed) has reduced the Fed Funds rate from 5.25% to 1.00%, while the Bank of Canada has followed with rate cuts of its own, from 4.50% to 2.25%. Central banks in North America and around the world still have room to lower rates further, and we expect this is something they will continue to do as the situation requires.

The second part of the solution is a coordinated effort towards resolving the current credit situation. To date, the impact of rate cuts by the Fed has not passed through into the U.S. economy due to a much tighter lending environment. Typically, lower rates lead to increased lending by banks which in turn stimulates the economy through higher spending. Today, instead of lending money out, banks are holding onto their cash to shore up their balance sheets, which is reducing the amount of credit available. While we have seen some positive signs in recent weeks suggesting credit conditions are improving, credit markets remain a key focus of concern. This is important because credit is like the oil in the engine of the economy. It's what allows people to start businesses and hire workers. It's what allows people to buy houses or cars. And just like a car, take the oil out of the economy's engine and the engine stops working.

The credit situation has spread to impact banks and corporations all around the world. The rapid failure (and near failure) of a large number of leading financial institutions has caused credit markets to freeze to the point where even good companies that have been prudent are finding their access to credit drying up, and their cost of borrowing rising. This has important spill-over effects into the economy, which is already dealing with the shock of falling housing prices and diminished consumer confidence.

So what's next?

We have witnessed increasing focus, flexibility and coordination across political lines and between countries in dealing with the credit situation. For example, on October 8, central banks around the world announced simultaneous interest rate cuts of 0.50%. And during the week of October 12, central banks in Europe and the U.S. announced plans to take ownership stakes in several banks by investing hundreds of billions of dollars in their financial institutions. These investments came with government guarantees on new debt issued by banks and increased guarantees on deposits in an effort to bolster consumer confidence. The theory is that with the additional capital and the government guarantees, banks will be willing to resume a normal lending pattern with each other and with borrowers. Most recently, China announced a \$500 billion package on November 9 designed to stimulate their economy through construction, affordable housing, and other social programs.

Our view is that policy makers will increase their efforts to match the seriousness of this crisis and succeed in the quarters ahead. The most important objective is to stabilize credit markets to the point where lower interest rates already in place will begin to have the desired positive effect on economic activity. The U.S. economy, and Canada with it, is likely to face a period of contraction over the next two quarters as we await evidence of an economic recovery later in 2009.

We expect that equity markets will remain volatile and we cannot be certain exactly when they will recover. What is likely is that equity markets, which normally anticipate economic growth in advance, will move higher well before either sentiment or the economy recovers. Warren Buffett, who is now aggressively buying U.S. equities, was recently quoted "if you wait for the robins, spring will be over." If there is a risk to this forecast, it clearly lies with the authorities' ability to effectively deal with the credit issues, the amount of time it takes for banks to decrease their financial leverage, and whether the current volatility and uncertainty will have a lasting impact on consumers.

What should you be doing now?

It's difficult to sit back and watch the value of your investments decline, making times like this very stressful for you. With this in mind, there are a few important investment principles to follow that will increase your long-term probability of success:

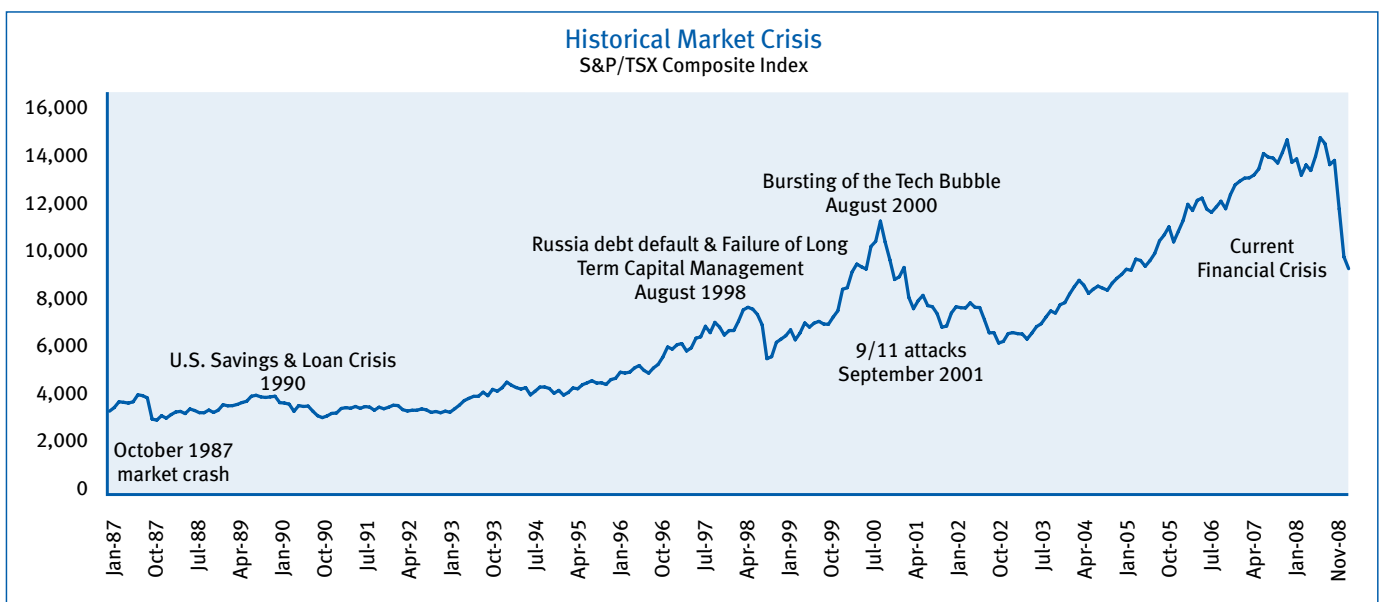
Let history be your guide

There have been 30 bear markets over the past 100 years, each one followed by a recovery. After major declines in 1929, 1973/74, 1987, and 2001/2002, equity markets recovered and climbed to new highs. Actions are being taken by central banks and governments to right the ship, including lowering interest rates, and never before has this failed to rekindle economic growth over time.

Step back and reflect

The sell-off in equities is potentially setting up a very attractive buying opportunity. However, extreme volatility may continue for some time given that the Canadian market has just come off four successive years of above-average gains. While the period of intense price declines may not have much further to run, it would probably be overly optimistic to imagine that after a short, sharp correction, markets would revert immediately to sustained growth. However, investors with a long-term focus should recognize that this period of adjustment presents an opportunity to acquire great businesses at attractive valuations.

David Dreman, a legendary contrarian investor, was quoted recently as saying **“Someday, we’re going to look back and ask ourselves why we weren’t more aggressive in picking up bargains in this market.”** The difficulty is that while these bargains often appear obvious in hindsight, it is hard to muster up the confidence to “buy low” in the face of adversity. One approach to bargain hunting that is more cautious and comfortable is a periodic investment plan that invests a fixed amount of money on a regular basis. Using this approach allows you to buy more of an investment when it is “cheap” and less of the investment when it is “expensive.”



Review risk tolerance

The right mix of cash, bonds and equities for your portfolio is a personal decision related to your risk tolerance and time horizon. When times are good, it's hard to be realistic about how much risk you are prepared to take. A bear market is the true test of how you really react to declines. So if you're feeling uncomfortable with the current level of volatility, talk to your advisor and consider re-visiting your asset mix, keeping in mind that a crisis is not the time for all-or-nothing decisions.

Stay diversified

You've heard it before and you'll hear it again – diversification is the key to reducing risk in your portfolio. The impact of commodity price declines in recent months on Canada's stock market underscores this fact. You can lessen these risks by diversifying your portfolio into other countries that offer access to sectors poorly represented in our domestic market – especially in the traditional defensive areas such as Consumer Staples, Health Care, and Utilities.

Closing thoughts

As investors, we are passing through a very challenging period, and it's times like these that make it most difficult to stay focused on the long term. Turbulent markets require good advice. And your advisor can help you stick to a disciplined investment approach, which has been shown to reward investors in the past. We encourage you to speak with your advisor today, and we thank you for your continued investment in RBC Funds.

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