



Eric Lascelles
Chief Economist
RBC Global Asset Management Inc.

HIGHLIGHTS

- › In the near term, emerging market investments remain at the mercy of global sentiment and are beholden to a variety of sector-specific risks.
- › But over the longer term, the prospects are compelling, by dint of superior productivity growth, better demographics and a protective moat of policy measures constructed after the trauma of the Asian and Tequila crises of the 1990s.

THE EMERGING VIRTUES OF EMERGING MARKETS

Financial crises strew wreckage in their wake. This is indisputable. Less acknowledged is that they also leave a positive legacy for those open-minded enough to seek it out.

This is hard to fathom right now given the goulash of crises bubbling in Europe, the U.S. and elsewhere. Unquestionably, there is enduring damage being done. But by the same token, useful lessons are being learned. The end result should fuse Europe more tightly together than ever, secure a well-fortified banking system, imbue governments with a fuller appreciation for fiscal prudence, and bequeath to policymakers a more sophisticated warning system to detect future crises and a larger toolkit to subdue them.

Emerging markets underwent a similar process in the late 1990s. The Asian financial crisis of that period came with little warning and left several Asian emerging markets and eventually Russia reeling. These countries took their lumps, but also learned their lessons, and have since radically revamped their conduct, reducing the risk of a sequel. Collectively, they have dug a protective moat consisting of low government debt loads, sizeable current account surpluses and enormous foreign reserves.

To be sure, it is not entirely clear sailing for emerging capital markets. They are still connected to the outside world and treated as a risk asset, translating into underperformance during times of global trouble. Equally, individual emerging-market regions grapple with their own bugaboos, including too much inflation, overextended credit in China, excessive reliance on foreign financing in Eastern Europe and a reliance on high commodity prices in Latin America.

Exhibit 1: Weighing Emerging Markets

ADVANTAGES

- Superior growth
- Favourable demographics
- Low government debt
- Current account surpluses
- Large FX reserves

DISADVANTAGES

- Too much inflation
- Chinese credit market under stress
- Vulnerable to global downturn
- Vulnerable to foreign credit withdrawal
- Vulnerable to falling commodity prices

Source: RBC GAM

By themselves, these threats might raise a yellow flag. But when compared to the tumult in the developed world, the outlook for emerging-market economies over the medium and long term appears positively bucolic. And the central features of emerging-market economies – their favourable demographics and ebullient economic growth rates – have lost little of their charm (Exhibit 1).

Superior Demographics

With the prominent exceptions of China and Russia, most developing nations benefit from a young citizenry and high fertility rates. If handled correctly,¹ this pays a

¹ Inadequate focus on education and good public policy risks creating a bulge of unhappy young people, with resultant political risk.

demographic dividend in the form of minimal expenditure on health care and pensions, and permits superior economic growth via a naturally expanding workforce. Even as fertility rates begin to ebb in the developing world – a natural consequence of rising incomes – emerging-market demographics will continue to propel their economies forward more quickly than in the developed world (Exhibit 2).

Muscular Economic Growth

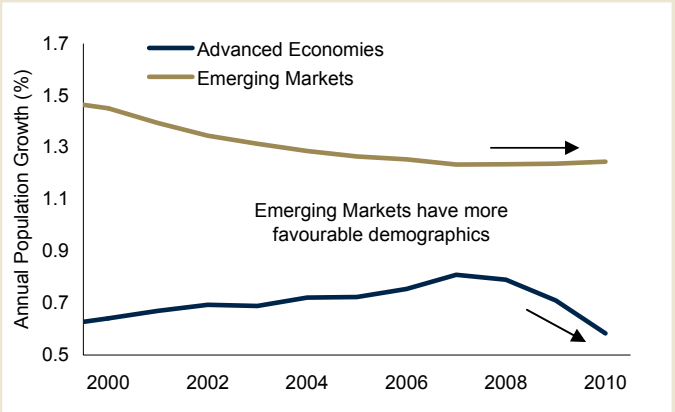
Surely the most attractive quality of emerging markets is their extraordinary economic growth rates. Developing nations have certainly been feeling their oats over the past several decades, with their real gross domestic product (GDP) growing at a 4.8% annualized rate since 1970, almost twice that of the developed world. What’s more, emerging markets have collectively managed to avoid a single year of economic decline over that period, and most developing nations have dodged the worst of the Great Recession. Their clout and outperformance have grown to such a degree that they now generate almost half of all global economic growth, versus less than a quarter in the 1970s (Exhibit 3). This is well in excess of their share of the economy.

While there is evidence of decelerating economic growth among developing nations, they still look set to knock the socks off the developed economies. Part of this relates to the aforementioned demographic dividend, the rest to outsized productivity growth.

Admittedly, productivity growth tends to slow as nations become wealthier and the middle-income trap looms,² but most major emerging markets have a considerable length of unobstructed runway left before they bump up against the ceiling of developed-world prosperity (Exhibit 4). To illustrate, China’s economic output per person is no better than the U.S. in 1935. Some degree of outsized growth remains very much achievable by mimicking existing technologies and processes, leaping past redundant technological way stations such as landline telephone networks, and capitalizing on large and receptive foreign markets.

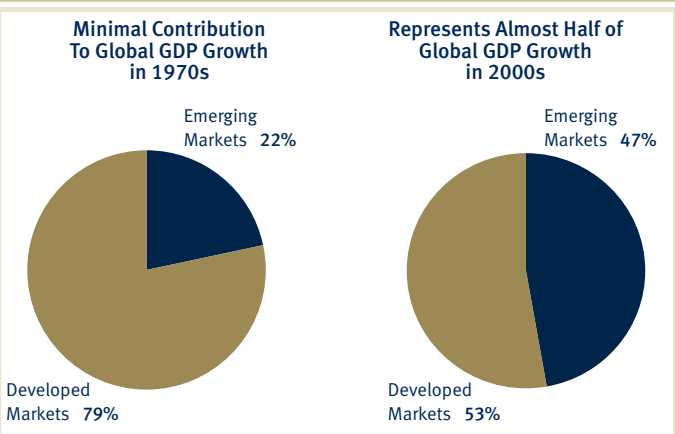
In an effort to rebalance their economies and reduce their reliance on the arthritic economies of the developed world, some nations – China, notably – have recently committed to a greater focus on domestic consumption (Exhibit 5). Of course, this is easier said than done and requires enhanced societal safety nets to persuade

Exhibit 2: Population Growth is Slowing Down in Advanced Economies and Holding Steady in Emerging Markets



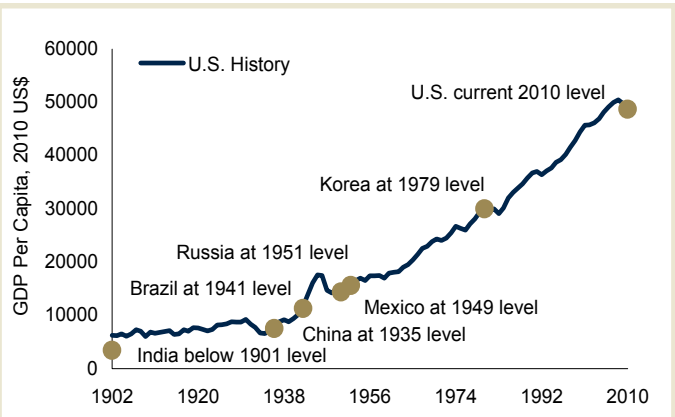
Source: Haver Analytics, RBC GAM

Exhibit 3: Emerging Markets Contribute To Global Growth



Calculated using market-based FX rates. Source: Haver Analytics, RBC GAM

Exhibit 4: Emerging Market GDP Per Capita Has Ample Room for Improvement



Source: Haver Analytics, RBC GAM

²Some emerging market countries struggle to make the necessary transition from the production of low-value goods to the production of high-value goods and services.

households to reduce their precautionary savings. But the potential for domestic growth is immense.

The Asian Financial Crisis

The Asian financial crisis of the late 1990s laid bare the flaws of the old Asian economic model, and to a degree that of most emerging markets of that era. Emerging Asia had achieved a decade of extraordinary economic growth on the order of 8% to 12% per year, in large part thanks to titanic capital inflows from abroad that supercharged domestic investment. These flows built upon themselves due to the illusion of stability offered by pegged currencies and the impressive returns they initially generated, culminating in excessive and inefficiently directed investments.

When these excesses began to reveal themselves, there was a sudden race for the exits. Starting with Thailand and ricocheting outwards to Indonesia, South Korea, the Philippines and Malaysia, each country suffered enormous capital withdrawals and speculative attacks against their currencies. They fought back with their foreign exchange reserves, but these were not nearly large enough to offset the exodus of foreign capital. Their currencies broke free and depreciated by between 40% and 80%, practically overnight.

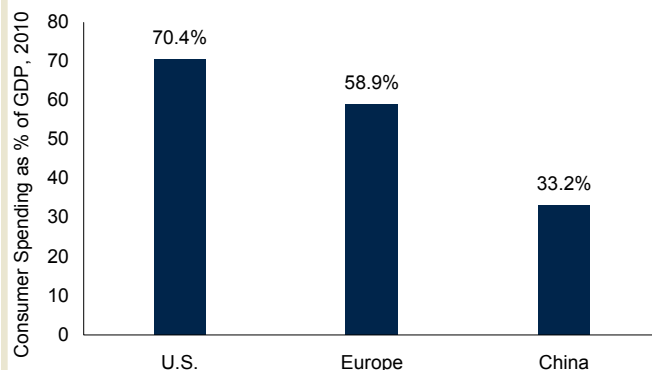
While a moderate currency depreciation is beneficial to export-oriented economies, the extremity of this move had few redeeming qualities. Inflation skyrocketed. Foreign funding dried up. Banks, households, businesses and governments suddenly found themselves on the hook for several times the foreign debt (in local currency terms) that they had bargained for, even as the asset side of their ledgers fell. Governments found their hands tied, limiting the capacity for compensatory action. The International Monetary Fund (IMF) was forced to bail out several sovereigns.

As a condition for these bailouts, IMF orthodoxy at the time demanded that these countries hoist their interest rates to as high as 40% to halt the outflow of capital and instil confidence in their currencies. This was unsuccessful, and created a further wave of economic problems associated with costly credit. Corporate failures ensued.

Lessons Learned

In retrospect, there were some remarkable aspects to this experience. The first was that the affected countries demonstrated impressive buoyancy. The

Exhibit 5: Emerging Market Consumers Remain Underdeveloped



Source: Haver Analytics, RBC GAM

crisis was intense while it lasted, but had little enduring economic influence. No country defaulted on its debt obligations and the rubble was quickly swept aside.

Second, emerging market nations learned that favourable demographics and naturally fast economic growth do not, on their own, grant immunity from financial crises. Fortunately, they have fruitfully applied the lessons from that near-death experience, and from the earlier “Tequila Crisis” in Latin America.

Strengthened Institutional Frameworks

Emerging markets have now mostly embraced a set of best practices designed to aid economic development and minimize crises. These include greater fiscal discipline, a focus on education, freer trade, privatization, deregulation and inflation-targeting central banks. Further improvements to governance and institutions are still needed, but enormous strides have been, and are being, made on all fronts.

In fact, with the ferocity of the Asian financial crisis still seared in their minds, many emerging markets opted to go well beyond these generic prescriptions. In so doing, they created what amounts to a new economic model, sacrificing a sliver of growth in exchange for superior disaster-avoidance capabilities. Specifically, these countries have aggressively minimized both their government debt loads and their reliance on foreign money. This strategy appears to be working well.

Down Periscope on Debt

Debt markets are highly intolerant of profligate nations. Once burned, they are twice shy. Endeavouring to avoid this fate,

emerging markets have muscled their government debt-to-GDP ratios lower over the past decade, from 50% to just 39% (Exhibit 6). The IMF projects further improvement in the coming years. Indonesia is the poster child for this, chopping its ratio from nearly 100% to just 27% in 10 years. Peru and Russia also merit special commendation. The trend is particularly striking versus developed nations, which sag under pendulous and growing debt ratios already more than twice as large.

The advantage of low debt extends to a less burdensome regime of interest payments, an amicable relationship with the bond market, and also to the capacity to deliver a shot of stimulus during times of economic peril.

Upon close inspection, it is hardly surprising that developing nations have managed to whittle away their debt loads, given their compelling debt dynamics. These countries can afford the luxury of modest fiscal deficits (2% of GDP currently), engage in sizzling double-digit government spending growth, and yet still revel in declining debt-to-GDP ratios thanks to nominal GDP growth averaging an enviable 13% per year over the past decade.

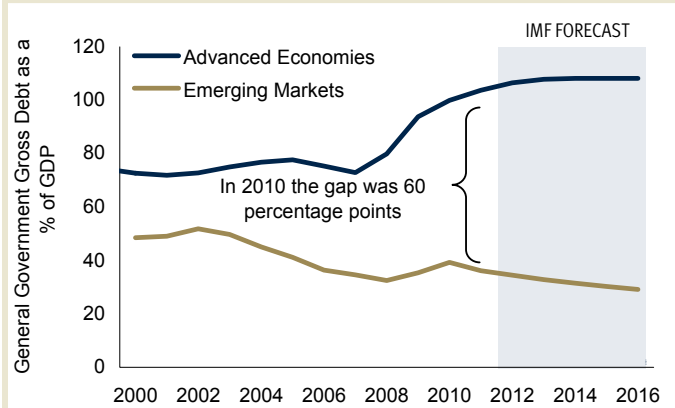
A Surfeit of Surpluses

The other thing emerging markets learned was the importance of controlling their own destiny. When borrowing from foreign investors, this is sacrificed. Developing nations have regained control of the rudder by stabilizing their currencies at moderately depressed levels (Exhibit 7), which enables them to run persistent current account surpluses (Exhibit 8). Put simply, they export more to the rest of the world than the world exports to them.

In so doing, developing nations naturally acquire a stockpile of foreign currency, and foreigners are less able to get their claws into the developing nations (Exhibit 9). Emerging-market foreign exchange reserves have ballooned from relatively modest levels in the late 1990s to almost US\$8 trillion today, eclipsing the reserves of developed nations (Exhibit 10). This gives emerging markets additional firepower to defend their economic sovereignty in the event of speculative attack, and the very action of accumulating reserves helps to depress their currencies and perpetuate this virtuous circle.³

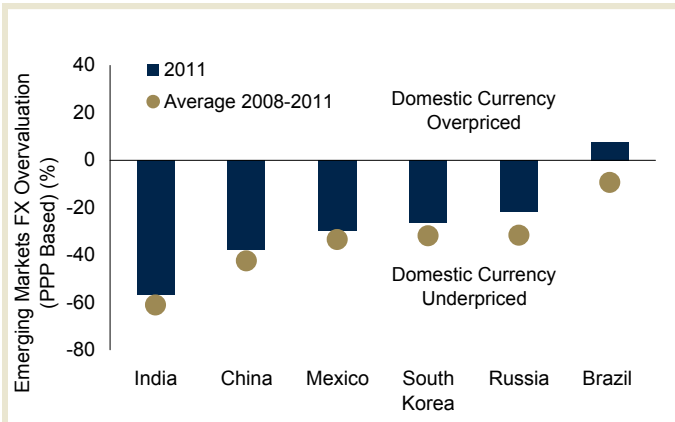
This is a mixed blessing, in that foreign capital should theoretically be attracted to (and support) the growth of

Exhibit 6: Government Debt Gap Grows



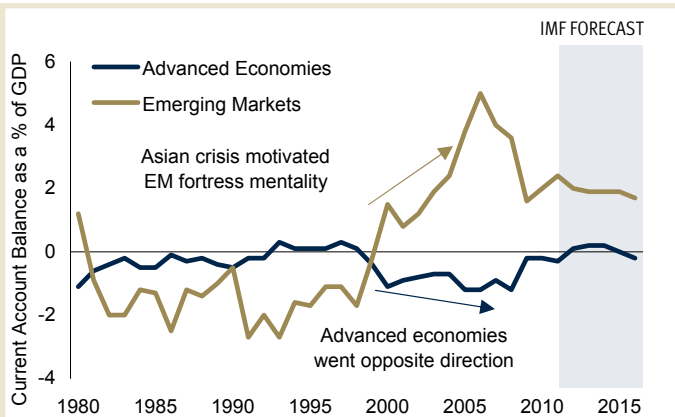
Source: Haver Analytics, IMF, RBC GAM

Exhibit 7: Majority of Emerging Market Currencies are Undervalued



Source: Haver Analytics, RBC GAM

Exhibit 8: Emerging Markets Protected By Big Current Account Surpluses



Source: Haver Analytics, RBC GAM

³ Whether this is also a virtuous circle for the global economy is another question – international current account imbalances are widely viewed as an inefficiency that may be holding back global economic growth.

emerging-market economies. It also represents a sort of “beggar-thy-neighbour” strategy. But the greater good seems to be avoiding a reprise of the “sudden stop” from foreign investors that brought on the 1997 crisis.

Risks

We can conclude that emerging-market economic fundamentals are compelling, and that the risk of another crisis like that of Asia in the late 1990s is diminished by the precautionary actions taken over the past decade. The proof is in the pudding: emerging markets have avoided a financial blow-up despite all that has lately gone wrong in the world.

However, emerging markets are not entirely devoid of risks. The credit default swap (CDS) market pegs the risk of default in most emerging-market nations as higher than in most developed nations. There is historical support for this view. The most recent sovereign defaults were in the developing world, when Ecuador and Seychelles both reneged on their obligations in the fall of 2008.⁴

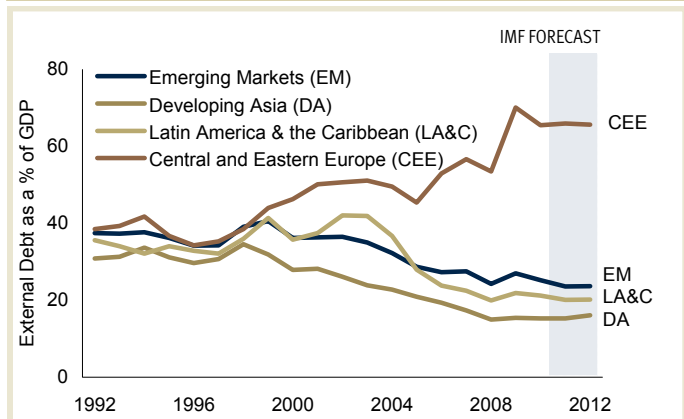
Debt ratings agencies agree with the CDS market, arguing that most emerging markets are less safe than the bulk of the developed world (Exhibit 11). Most major emerging markets have A to BBB- ratings, shy of the AAA to A ratings in the developed world.

However, as developed nations buckle under their soaring debt obligations and grapple with diminished prospects for economic growth, the tables are starting to turn. Less than 20% of global GDP is now AAA-rated, and many developed nations are on negative watch. No developed nation has had a rating upgrade since September 2008, whereas emerging markets have managed 117 upgrades in that same period. Similarly, the countries most acutely at risk of default today are “advanced” nations: Greece, Portugal and Ireland. China’s five-year CDS is now lower than that of France. Nonetheless, several specific emerging-market risks do exist, and are discussed below.

The Illusion of Decoupling

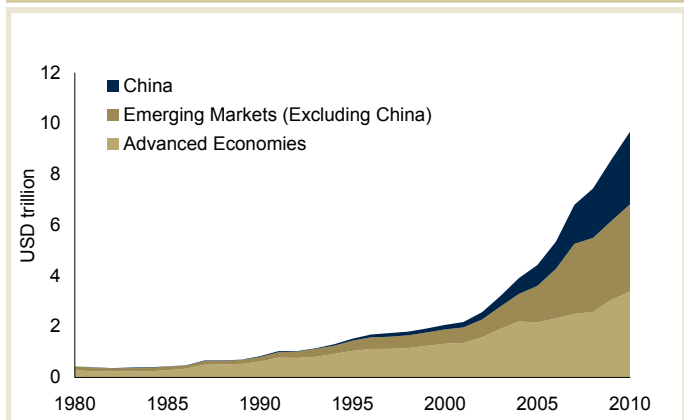
The view that emerging markets are decoupling from the developed world and thus immune to their problems is a touch optimistic. Despite their superior trend growth, minimal exposure to Western banks and greater capacity to support their economies with stimulus, the world is a deeply connected place.

Exhibit 9: Most Regions Have Cut Their Reliance on Foreign Financing



Source: Haver Analytics, IMF, RBC GAM

Exhibit 10: Emerging Markets Now Wield Enormous Clout with Big Foreign Exchange Reserves



Source: Haver Analytics, RBC GAM

Exhibit 11: Sovereign Debt Ratings As of October 2011

COUNTRY	S&P RATING
Germany	AAA
U.S.	AA+
China	AA-
Korea	A
Mexico	BBB
Russia	BBB
Brazil	BBB-
India	BBB-

Source: Bloomberg

⁴ Though the sums were a relative pittance: \$3.2 billion for Ecuador and \$230 million for Seychelles.

Developing nations are unavoidably attached to the developed world via immense trade flows, financial flows and also by intertwined confidence. These connections grow deeper by the year. Thus, if the developed world spirals into recession – not yet assured, it is worth noting – emerging markets cannot sidestep the problem entirely.

Commodity Reversal

Although several prominent emerging market nations are major commodity importers – China is the best example – more are net commodity exporters. This is especially true in Latin America. Many emerging-market nations have been flying high at least in part thanks to the surge in commodity prices of the past decade.

There is a risk that if commodity prices continue to fall – a conceivable element of a global recession scenario – the commodity-intensive subset of developing nations could suffer materially worse economic prospects. Mercifully, most nations understand the fickle nature of commodity cycles, and are conducting themselves in a fiscally responsible fashion.

Currency Vulnerability

Emerging markets are perhaps most exposed to the twin risks of foreign borrowing and volatile exchange rates. Each has the capacity to inflict damage on its own, but in combination the risks multiply.

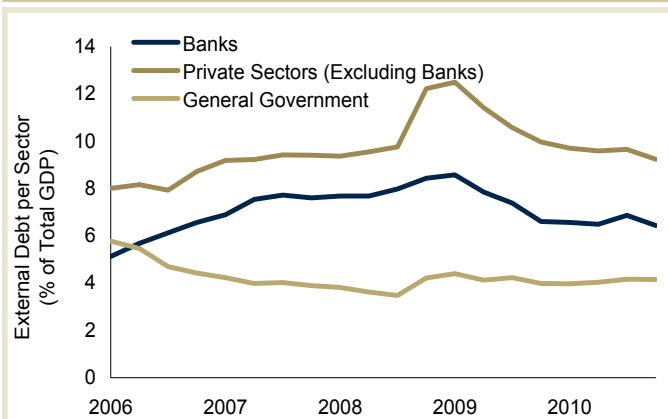
By itself, currency volatility constitutes a key danger for emerging-market nations, both because their foreign exchange markets are thinner and thus more prone to speculative manipulation, and because their economies are trade-oriented.

To be sure, emerging markets have done a great deal to clamp down on this risk and wield their sky-high foreign exchange reserves as a tool of intimidation against ill-intentioned speculators. But this does not render them completely immune, as without the natural escape valve of a freely floating currency, the pipe can sometimes burst with little warning.

Foreign Borrowing

Emerging-market reliance on foreign financing is a mixed blessing. Indisputably, it is a crucial way to obtain the necessary capital to fund rapid economic growth, especially since domestic sources are frequently scarce due to low wealth and underdeveloped credit markets. Equally, it is natural for investors in mature economies to seek to hitch their wagons to more lucrative returns in

Exhibit 12: Private Sector More Exposed to External Debt



Note: Emerging Market represents: Brazil, Russia, India, Mexico and Korea
Source: Haver Analytics, RBC GAM

fast-growing developing economies. This is a timeworn tradition, dating back to the British Empire and before.

The fact that many emerging-market nations now run current account surpluses argues that a sizeable fraction are not disproportionately exposed to the rest of the world, at least not on a net basis. But some major emerging-market countries continue to run current account deficits (particularly those in Eastern Europe and Latin America, but also India), and even those with surpluses have at least some gross exposure to foreign investors.

The problem with this foreign exposure is that when market sentiment sours, foreign investors head for the hills. This “sudden stop” is problematic for emerging economies that have grown fat on a diet rich in foreign investment, and can place corporations and banks in peril. History is riddled with these events. More often than not, emerging-market troubles are created or compounded by the retreat of foreign investors.

A sharp drop in the domestic currency can also make foreign debt obligations much heavier than previously anticipated. This has been particularly true in Eastern Europe, where the popularity of securing mortgages in foreign currencies such as the Swiss franc has backfired badly as the franc appreciated.

How large is the risk associated with foreign borrowing right now? It is comforting that the emerging-market external government debt-to-GDP ratio has declined over time. However, the developing world’s corporate sector has enlarged its foreign borrowing over the past several years, succumbing to the offer of cheap credit from foreign investors desperate for yield. The private sector external debt-to-GDP

burden has thus experienced moderate growth (Exhibit 12). The risks here are by no means extreme, especially since less of the debt is of a short-term nature and foreign equity is beginning to supplant credit, but they have grown.

Despite this vulnerability, two things are worth noting. First, this emerging-market Achilles heel proved surprisingly durable during the 2008-2009 credit crunch. Globally, markets were in a state of panic and the sale of risk assets was extreme, and yet few emerging-market nations stumbled. Second, emerging markets do not face the world alone. The IMF regularly steps in to assist beleaguered developing nations, as do various regional authorities.⁵

Percolating Inflation

Inflation is regularly a problem for emerging markets, and is currently running somewhat higher than desired (Exhibit 13). This is partially because their economies have fared well, resulting in the usual set of wage and price pressures. It is partly because ultra-low policy rates in much of the developed world have whipped up speculative excesses, including higher commodity prices. And it is in part because emerging markets have heavy direct exposure to commodity prices, by dint of a populace that spends a larger fraction of its income on staples like food (Exhibit 14).

Higher inflation presents three challenges. First, it compromises households' purchasing power. Second, it obliges central banks to tighten monetary policy (Exhibit 15), slowing the economy's progress. Third, it can induce political instability, especially since it is borne most heavily by the poor.⁶ Inflation has recently shown signs of topping out, but food prices in particular are still vulnerable to further ascent given rapidly changing tastes (in particular, a growing appetite for protein) and the detrimental effect of climate change on farm yields.

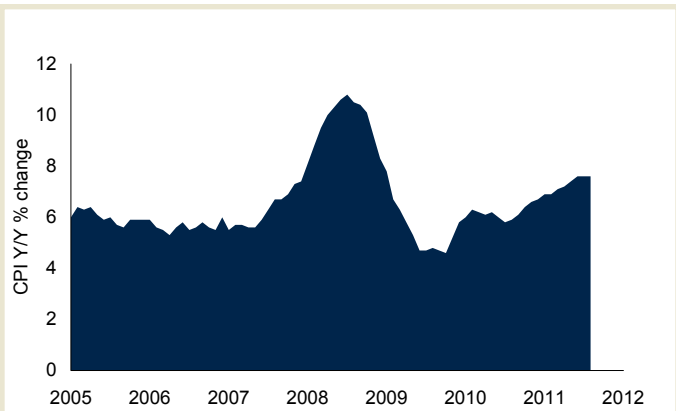
Chinese Credit

China presently looks to have a higher-than-usual risk of a hard landing. These problems revolve around the robust rate of bank credit growth over the past several years, and the misallocation of some of that credit. To a lesser extent, other emerging markets share the same risk. China's property market looks toppish, and Chinese banks may have extended more credit to Chinese municipalities than they can realistically

⁵ These include the Asian Development Bank (Asia), the European Bank for Reconstruction and Development (Eastern Europe) and the American Development Bank (Latin America).

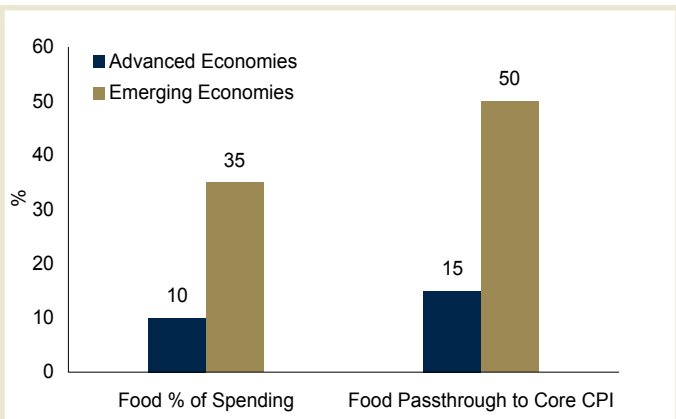
⁶ The Arab Spring was motivated in part by high food prices; some argue Tiananmen Square was similarly motivated.

Exhibit 13: Emerging Market Inflation Rising



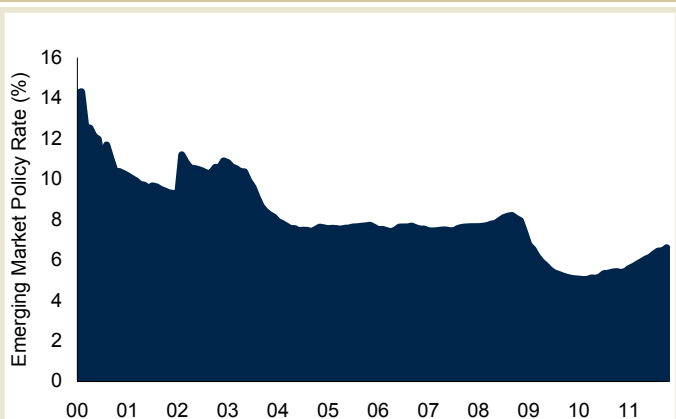
Source: IMF, RBC GAM

Exhibit 14: Emerging Markets Exposed to Food Inflation



Source: IMF, RBC GAM

Exhibit 15: Emerging Markets Tightening Policy Rates



Regions included: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Korea, Taiwan, Thailand and Turkey. PPP weights by GDP share. Source: Haver Analytics, RBC GAM

expect to recoup. Meanwhile, a shadow banking system has sprung up outside the purview of traditional regulators. In short, a haze of concern envelops the Chinese financial sector.

It is worth emphasizing that there is considerable debate around every element of this narrative. To be sure, housing affordability is worse than it should be and many Chinese have taken to speculating in this market, inflating prices. But home prices have not risen nearly as quickly outside major urban centres, and there are still artificial regulatory constraints on home-buying that could be removed if demand looked to be seriously lacking. In particular, most rural Chinese are still blocked from migrating to or acquiring property in urban areas. By the same token, the wave of rural-urban migration that the government does permit has turned many a seeming construction boondoggle into a thriving development. Lastly, China's housing stock fell into serious disrepair during the Cultural Revolution, and much of the construction since then has merely compensated for that gaping hole.

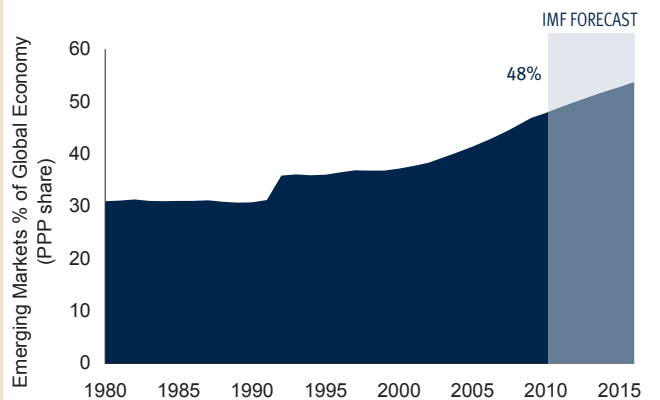
It is clear that many Chinese municipalities have taken on more bank credit than they can afford. This translates into non-performing loans, and eventually banking-sector losses. But two factors mitigate this problem. First, recent revelations show that banks only hold municipal debt equal to around 27% of GDP – less than was feared. Second, much of the lending occurred at the national government's behest, as a form of indirect stimulus to local governments. The banks would never have made the loans under other circumstances, and understood that a sizeable fraction would never be repaid. The other half of the implicit contract is that when Chinese banks begin to stumble due to these loans, the national government will step in to bail them out. In fact, this has already begun.

Overall, more dark clouds than usual loom over China, and some evidence of an economic slowdown is already visible. But catastrophic problems remain unlikely.

Investing in Emerging Markets

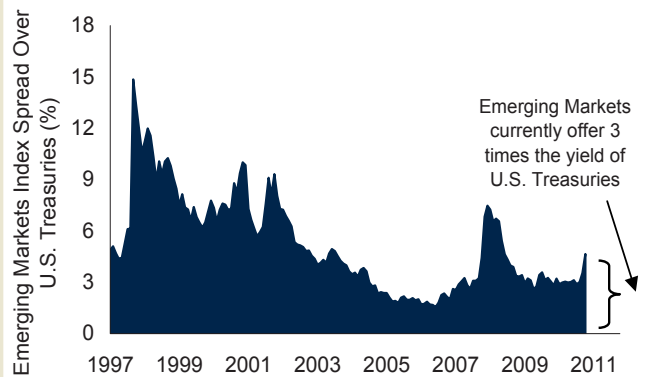
Clearly, there are both positives and negatives to investing in emerging markets. Emerging-market investments are indisputably susceptible to knee-jerk risk aversion, and the nations themselves are at the mercy of myriad risks and economic drags. They have done much to minimize these risks and have proven remarkably resilient through the global turmoil of the past few years, but emerging markets can no more guarantee a near-term investment "win" than any other asset class.

Exhibit 16: Emerging Markets Soon Over Half of Global Economy



Source: IMF, RBC GAM

Exhibit 17: Emerging Market Sovereign Spread Over U.S. Treasuries



Source: JPMorgan EMBIGD

It is also true that the asset class is a challenging one for do-it-yourself investors. The emerging-market universe of securities is enormous, and the sector requires not just the garden-variety capacity for balance sheet analysis and macroeconomic forecasting, but also an understanding of the cultural, political and institutional nuances of dozens of countries.

Despite these challenges, there is a compelling case that emerging market assets should constitute a growing share of investment portfolios over time, at least for those with a sufficiently long investment horizon.

The first reason relates to the undeniably superior economic growth prospects relative to the developed world. Regardless of the stage in the global economic cycle, emerging markets usually come out on top. This effect should dominate over the long run, providing generous returns to investors via

faster corporate profit growth and higher bond yields. Emerging-market currencies also tend to appreciate over time due to their superior economic prospects, offering additional return on locally denominated investments.

Second, a well constructed portfolio should be geographically diversified. Emerging markets now constitute anywhere from 34% to 48% of the world's economy⁷ (Exhibit 16), yet attract a far smaller share of investments.⁸

Third, there is a fascinating shift underway between developing and developed nations. Developing nations have held up much better than the developed world in recent years, arguably altering the risk-reward equation between the two. The lines are beginning to blur as to which group offers the safer investment.

Fourth, emerging markets themselves are transitioning. Put simply, today's emerging nations are tomorrow's developed markets. Admittedly, this isn't unadulterated good news as it means growth rates will eventually slow and demographics will deteriorate. But more importantly, these emerging markets will develop the regulatory and institutional frameworks necessary for greater stability, their financial markets will deepen, their rates of inflation should ebb and the wealth of their citizens will blossom. In other words, most of the risks associated with emerging-market investments are only transitory. For investors with a sufficiently distant investment horizon, these are developed market investments in disguise.

**Exhibit 18: Emerging Market Datastream Index
Normalized Earnings & Valuations**



Source: Datastream, RBC GAM

Fifth, present valuations seem attractive. To illustrate, the main emerging-market bond index offers a yield that is three times higher than the U.S. Treasury market (Exhibit 17). Separately, our proprietary emerging-market valuation chart argues valuations are reasonable in equities (Exhibit 18).

The bottom line is that the emergent virtues of emerging markets render them an increasingly attractive investment option for the long run, so long as the risks are properly understood.

⁷ This depends on the exchange rates used.

⁸ The indirect exposure from multinational corporations is a useful proxy, but highly diluted and less attractively valued.

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