MFC Global Investment Management®

SUMMER 2010

Canada Economic Outlook

Canada's recovery springs ahead of the U.S.

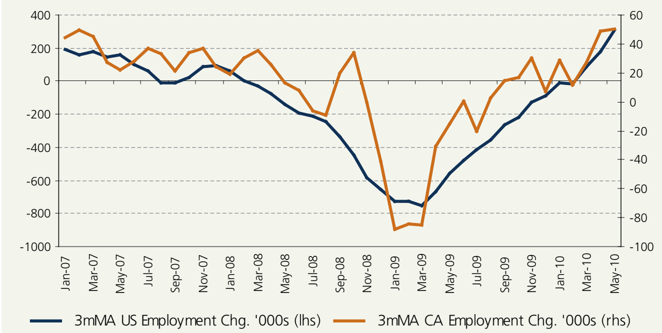
The economy is recovering faster in Canada than in the U.S., with broad-based economic activity advancing at a pace consistent with GDP growth at 3.5- 4% in 2010 and 2011. To date, Canada's economy is close to recovering all the output and employment lost since the peak before the global recession.

On the domestic side, employment this year is growing at a 40,000/month clip. The private sector is shouldering the bulk of the increase while full-time hiring is now advancing faster than part-time. At the same time, construction activity has been strong, although we expect it to downshift to a slower pace. A sign of caution is emerging in manufacturing where minimal job growth is troublesome. Overall, the increases in hours worked in April and May are consistent with continued growth in Q2 following a strong Q1.

This year marks the turning point when private sector demand takes over from the public sector as the primary source of growth. By 2011, the private sector contributes most of the growth of domestic demand in Canada.

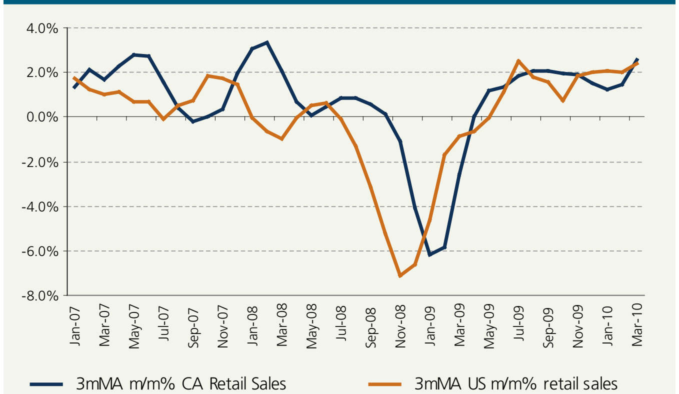
A shallower recession in Canada. allowed Canadian consumers to stay ahead of their U.S. counterparts. In our forecast, Canada's improving labor market – from a relatively better starting position – combined with a U.S. recovery multiply the ongoing kick in Canadian consumer spending and its positive effects on income, investment, and additional hiring. However, further along, with the housing and credit markets slowly recovering in the U.S., consumer spending trends in both countries show similar trajectories as American consumers, once again, return to their malls in force.

Although Canada and U.S. economies remain closely linked measured by their employment and...



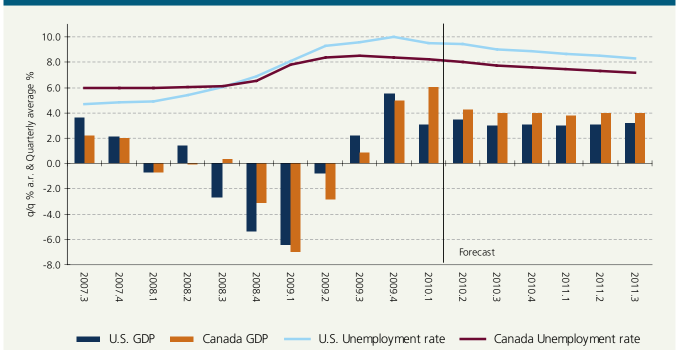
Source: Statistics Canada and BLS

...spending trends...



Source: Statistics Canada and U.S. Census

....Canada is easing out of its recession ahead of the U.S.



Source: Forecast - MFC GIM; HIS Global Insight

U.S. MFC GIM Economic Research Forecast Summary

			Forecast							Year-over-Year % Change or Annual Average				
% Change at annual rate	2009.4	2010.1	2010.2	2010.3	2010.4	2011.1	2011.2	2011.3	2011.4	2008	2009	2010	2011	2012
Real GDP and Components														
GDP	4.9	6.1	4.3	4.0	4.0	3.8	4.0	4.0	3.7	0.5	-2.5	3.9	3.9	3.3
Personal consumption expenditures	3.9	4.4	3.8	3.2	3.4	3.7	4.2	4.1	3.9	2.9	0.4	3.8	3.7	3.9
Business Fixed Investment	-9.8	0.9	4.0	6.0	5.5	7.0	7.5	6.3	7.0	3.4	-19.9	-1.4	6.4	5.5
Residential investment	26.3	23.6	8.0	0.0	1.0	3.0	4.0	4.0	3.0	-2.9	-3.6	13.4	2.9	1.5
Government purchases	9.1	2.2	4.7	3.3	3.5	2.3	-0.6	1.1	2.0	4.1	5.1	5.2	2.0	2.5
Change in inventories ($ bill CAD)	-1.2	8.2	7.1	9.4	10.9	10.6	11.7	12.6	13.8	13.9	-1.2	8.9	12.2	1.7
Exports	13.8	12.0	5.1	6.1	7.0	7.0	7.0	6.7	5.7	-4.6	-14.2	7.7	6.6	6.8
Imports	12.4	14.1	5.0	5.7	6.2	5.7	5.7	5.8	6.2	1.2	-13.9	10.9	5.8	5.0
Unemployment rate %	8.4	8.2	8.0	7.8	7.6	7.5	7.3	7.2	7.1	6.2	8.3	7.9	7.3	7.0
Private housing starts (thous. units)	180	199	201	182	198	174	179	182	185	213	149	195	180	225
Prices														
Consumer Price Index	3.7	2.3	1.9	2.3	2.3	2.1	2.0	2.1	2.1	2.4	0.3	2.1	2.1	1.9
CPI excl food & energy	2.0	2.7	1.7	1.3	2.0	2.1	2.0	1.1	2.4	1.7	1.8	1.9	1.8	1.6
FX (USD/CAD)	0.95	0.96	0.97	0.97	1.00	1.00	1.01	1.01	1.01	0.94	0.88	0.98	1.01	1.00
Interest Rates (avg. %)														
BoC Overnight Rate	0.25	0.25	0.25	1.00	1.25	1.50	2.00	2.50	3.00	2.96	0.40	0.69	2.25	3.38
Ninety-day Treasury Bill Rate	0.22	0.19	0.37	0.74	1.26	1.77	2.28	2.66	3.02	2.36	0.34	0.64	2.43	3.80
10-year Treasury Note Yield	3.48	3.57	3.58	3.72	4.03	4.35	4.61	4.78	4.95	3.66	3.27	3.72	4.67	5.30
US GDP	5.6	3.0	3.6	3.8	4.0	4.0	4.3	4.3	4.5	0.4	-2.4	3.4	4.1	4.2
Canada vs. U.S.														
GDP	-0.6	3.0	0.7	0.2	0.0	-0.2	-0.3	-0.3	-0.8	0.1	0.0	0.5	-0.1	-0.8
Policy Rate	13	12	5	80	105	120	130	140	130	103	24	50	130	56
3-m rate	16	8	18	44	56	67	78	76	82	99	19	32	76	78
10-yr rate	2	-15	-2	-28	-47	-30	-29	-27	-15	-1	1	-23	-25	8
CPI	1.0	0.6	1.8	1.2	0.8	0.2	0.2	0.1	0.1	2.7	0.5	0.4	0.5	-0.3
CPI Core	0.5	2.7	0.7	0.5	0.4	0.3	0.3	-0.8	0.5	0.0	0.1	0.9	0.3	-0.4

Forecast beginning in 2010.2

Changes from our Fall Outlook

Data over the past quarter was much stronger than anticipated, suggesting growth rates more in line with a V-shaped recovery than the more uncertain U-shaped U.S. recovery. Consequently, Canadian GDP growth is more front-loaded than that presented in our Spring Outlook, while it reverts to trend a bit quicker.

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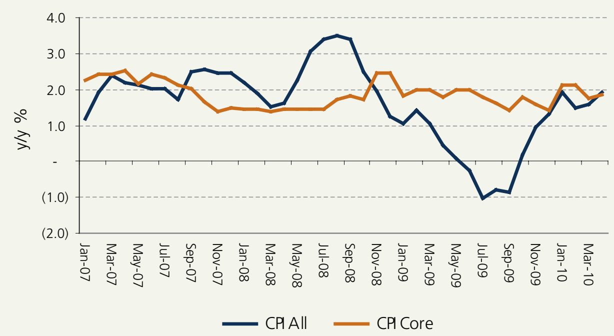
Annual inflation continues to be close to the Bank of Canada's (BoC) 2% target, and expected inflation pressure now appears more to the downside than the upside. With excess capacity unwinding and normal inflation pressures kicking in, the BoC takes a less gradual accommodative monetary stance, tightening one or two steps ahead of the Fed.

On the foreign sector side, the first-quarter current account deficit narrowed in line with the improvement in the trade deficit, providing only in a very small drag (-0.2 %) to GDP growth. Unless there is an unexpected surge in the loonie, most of the future drag from trade should be linked to the speed of the global recovery.

Inflation measures are back to BoC's 2% target



Source: Statistics Canada

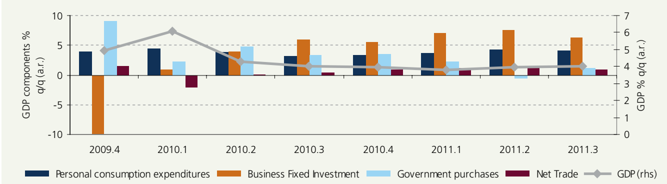
Policy and risks

Canada is starting this year ahead of some of the most optimistic forecasts. Plus, Canada is in better external and internal financial condition than the rest of the G-7 economies. The budget deficit and debt (the statistics du jour) place Canada in a comfortable position to continue using stimulus macroeconomic policy as needed without seriously damaging investors' confidence.

Despite its enviable fiscal and trade balance, Canada is not immune to global volatility. In this sense, Europe's fiscal woes, and their impact on financial markets and macroeconomic policy, should have alerted Canadian policymakers to the risks from premature tightening. Against this backdrop, the BoC's hike in the overnight rate by 25 bps to 0.5% suggests that the Bank considers this risk very limited.

Our forecast implies that the BoC adjusts policy rates up towards 3% by the end of 2011, while fiscal spending slows towards a 2% annual rate vs. 4-5% in 2008 and 2009.

A strong rebound in investment is crucial to a self-sustainable expansion as government spending declines



Source: MFC GIM

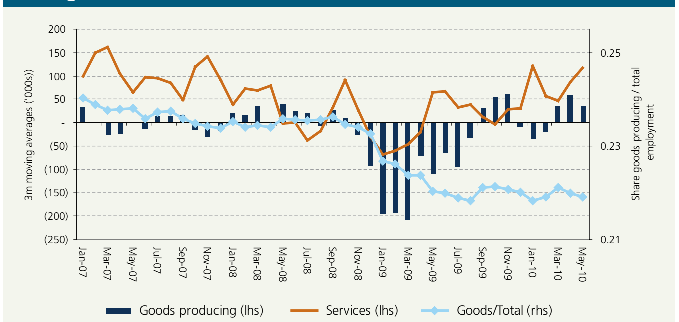
Exchange rate appreciation: a mixed blessing

The main uncertainty hanging over Canadian financial markets is the exchange rate. Two forces raise the prospects for a strengthening currency: a uniquely well-balanced fiscal and trade position and a solid base in commodity exports at a time of global expansion. The net result is a consensus expectation that the Canadian dollar (CAD) will reach parity with the USD by 2011, and continue strengthening thereafter.

This outlook depends on continued global growth, particularly in the commodity-intensive economies of Asia. It is probably less affected by U.S. growth, since a weaker (or stronger) than expected U.S. economy would tend to propel both currencies in the same direction.

The consequences of exchange-rate trends are wide-ranging. A strengthening CAD adds to the attractiveness of Canadian bonds and equities, while damping the economy and thus allowing the Bank of Canada to maintain a slightly easier monetary stance than might otherwise be appropriate. The BoC will be watching carefully to gauge how the exchange rate is impacting Canadian manufacturing and tourism, so as not to over-tighten policy as the recovery develops.

With goods-productiing sector shrinking service jobs are filling the void



Source: Statistics Canada

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Risks to the Outlook

Despite the firming recovery in Canada, the crisis in Europe and its impact on an already sub-par U.S. recovery still pose considerable risks around the outlook.

The perfect outcome – probability 20%

Fiscal and monetary policies provide just enough stimulus to fire up the normal processes of self-reinforcing growth. The CAD goes up, but productivity, after lagging in the past, surges ahead, keeping exports competitive and fast growing. The BoC tightens, avoiding a surge in inflation, while private investment, consumer spending and bank lending accelerate sufficiently to support even faster growth. This V-shaped recovery sends growth sharply higher and unemployment lower for two years without triggering inflation.

A renewed global crisis –- 10% to 15% probability

Global calls for fiscal restraint are running the risk of snuffing out the nascent global recovery. Global confidence collapses as the euro sinks into a full-fledge crisis. The U.S. implements premature fiscal tightening measures and is paralyzed by fear of ballooning budget deficits. Policymakers backpedal too late, and the world falls back into recession. Commodity prices collapse, and deflation becomes a major risk. It takes more than another year before renewed stimulus policies can bring a revival.

Inflation/deflation – 10% to 15% probability

The main upside risks to inflation are associated with the possibility of a stronger-than-anticipated global recovery and even stronger external demand for Canadian commodity exports.

On the downside, the risk is that persistent strength of the Canadian dollar drags on growth, adding downward pressure on inflation. Alternatively, the global recovery could be even more protracted than expected, as policymakers misjudge the recovery's strength, and withdraw global monetary and fiscal policy stimulus too soon for self-sustaining growth in private demand to get traction.

We estimate the risks to deflation have now gained a slight edge over inflation, although overall, they still remain roughly in balance.

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