



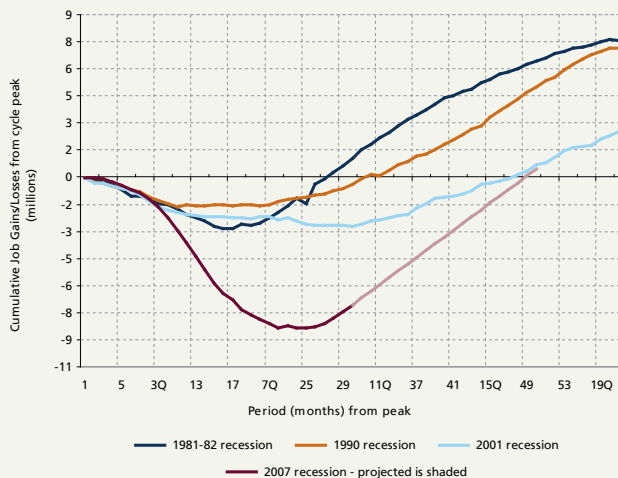
U.S. Economic Outlook

Growth continues... but another patch of uncertainty implies a more cloudy forecast

The U.S. economy continues to grow, and evidence that the economic jump start will reinforce itself is gaining some ground. But the expansion at this stage of the cycle remains weak by historical standards. The spillover from the European sovereign debt crisis and the sluggish recovery in the labor market present the biggest forces muddling the U.S. forecast.

We forecast 3.4% growth this year and 4.1% in 2011. This is 0.5%-1% above the consensus and above the 2.5%-3% trend.

A deep employment contraction, but as usual, an uncertain recovery path...



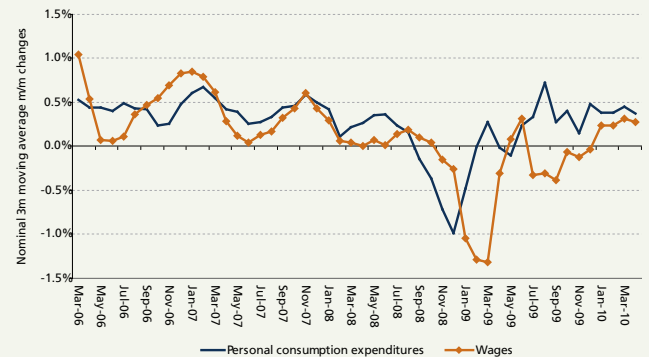
Source: MFC GIM
Note: 2007 cycle assumes 375K/month projected new jobs

We anticipate enough improvement in employment, households' balance sheets and credit conditions to drive incomes, revive lending and encourage faster consumer and investment spending. Overall, economic drivers gain enough momentum or become less negative to

overcome the winding down of government spending. Unemployment remains around 8% by the end of 2011 (versus 8.7% expected by the consensus) and annual inflation falls close to 1.5%. Meanwhile, corporate profits before taxes are expected to rise 27% in 2010 and 6% in 2011.

Rising employment will be critical to self-sustained growth, while the unemployment rate will be the crucial input for Federal Reserve policy, as any tightening moves will mostly depend on a sustained downtrend in the jobless rate.

...And without sustained income and job gains there is little hope for higher consumer spending



Source: IHS Global Insight

Much better or much worse GDP growth paths are still possible depending on a very wide range of alternative trajectories for job creation, the speed of repair to households' balance sheets, trade activity and consumers' willingness to spend.

Our central forecast for Europe sees a limited global contagion, and implies only a 0.5%-1% reduction in U.S. growth over the next few years. Although this is a small impact --assuming a decline in interest rates-- the effect is not insignificant at a time that the U.S. recovery pace is already below the typical cyclical upswing.

U.S. MFC GIM Economic Research Forecast Summary

% Change at annual rate	Forecast									Year-over-Year % Change or Annual Average				
	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	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
Personal consumption expenditures	1.6	3.5	3.2	3.2	3.0	2.8	3.7	4.2	5.0	-0.2	-0.6	2.6	3.4	3.8
Business Fixed Investment	5.3	3.1	9.3	4.8	11.2	11.7	9.2	8.8	5.5	1.6	-17.8	3.3	9.4	7.0
Residential Investment	3.7	-10.7	-5.8	2.9	26.0	26.5	15.6	11.0	13.9	-22.9	-20.5	-1.0	16.2	20.0
Government purchases	-1.3	-1.9	3.4	5.2	1.1	1.8	2.3	1.7	2.3	3.1	1.8	1.3	2.3	2.0
Change in inventories	-20	34	38	44	51	53	57	58	57	-26	-108	42	56	40
Exports	22.8	7.2	18.0	7.4	6.6	7.2	6.7	7.0	3.8	5.4	-9.6	12.5	7.4	9.0
Imports	15.8	10.4	15.4	7.2	6.4	6.3	6.4	6.5	5.4	-3.2	-13.9	11.1	6.9	9.0
Real disposable income	0.0	1.9	3.3	2.7	3.1	2.8	2.8	2.7	2.7	0.5	0.8	1.5	2.9	1.4
Personal saving rate (%)	3.7	3.4	3.5	3.5	3.6	3.4	3.5	3.5	3.5	2.7	4.2	3.5	3.5	4.4
Corporate profits with IVA & CCAdj	36.0	24.1	27.9	7.0	1.5	8.9	17.6	18.7	15.0	-11.8	-3.8	25.2	11.5	8.0
Unemployment rate %	10.0	9.5	9.5	9.0	8.9	8.7	8.5	8.3	8.1	5.8	9.2	9.2	8.4	7.5
Private housing starts (thous. units)	559	617	606	688	849	875	915	960	1010	901	554	690	940	1200
Prices														
GDP price index	0.4	1.0	1.0	1.2	1.1	1.6	1.6	1.6	1.6	1.2	1.2	0.8	1.4	1.8
Consumer Price Index: CPI-U	2.6	1.7	0.1	1.1	1.5	1.9	1.8	2.0	2.0	-0.3	-0.2	1.7	1.6	2.2
CPI-U excl food & energy	1.5	0.0	1.0	0.8	1.6	1.8	1.7	1.9	1.9	1.7	1.7	1.0	1.6	2.0
Foreign Exchange Rate (Broad trade-weighted value of US\$)	101.6	103.3	104.9	108.0	107.5	106.6	106.2	106.0	105.8	99.8	105.9	105.9	106.1	101.0
Refiners' cost of imported oil (\$/b)	73.0	76.1	79.1	72.2	73.4	74.7	75.9	76.9	77.6	92.3	59.4	75.2	76.3	78.0
US Interest Rates (avg. %)														
Federal Funds Rate	0.1	0.1	0.2	0.2	0.2	0.3	0.7	1.1	1.7	1.9	0.2	0.2	1.0	2.8
Ninety-day Treasury Bill Rate	0.1	0.1	0.2	0.3	0.7	1.1	1.5	1.9	2.2	1.4	0.2	0.3	1.7	3.0
3-month LIBOR	0.5	0.4	0.3	0.5	0.9	1.3	1.7	2.1	2.5	3.3	1.0	0.5	1.9	3.3
10-year Treasury Note Yield	3.5	3.7	3.6	4.0	4.5	4.7	4.9	5.1	5.1	3.7	3.3	4.0	4.9	5.2
Treasury Yield Spreads (avg. basis points)														
5yr - 2yr	143	151	141	140	130	130	120	100	93	80	123	141	111	66
10yr - 2yr	258	280	269	260	270	255	250	225	180	166	230	270	227	123
30yr - 10yr	87	91	89	80	50	45	30	25	25	61	81	77	31	25
Credit Spreads (avg. basis points over Treasuries)														
10yr AAA	87	61	59	63	63	63	62	62	61	252	133	62	62	61
10yr A	137	109	106	112	112	111	110	110	109	305	219	110	110	108
10yr BAA	216	168	170	176	176	175	174	173	171	368	357	173	173	171

Forecast beginning in 2010.2

Changes from our Spring Outlook

- Data over the past quarter continues to validate our relatively optimistic outlook for the U.S. economic recovery. We have incorporated a limited hit to GDP growth related to the strengthening dollar and the Eurozone sovereign crisis, but otherwise have barely changed our overall forecast for GDP growth through the end of 2011. Most of the new impact is filtered through a change in trade trends, with imports growing somewhat faster and exports pulling back a bit.
- Interest rates remain lower than anticipated. Much of the decline is due to the recent European sovereign crisis. As markets return to a more normal environment, we anticipate that rates will again increase, although to a slightly lower level than we projected in our Spring Outlook.
- The U.S. dollar has also been stronger than anticipated due to the tribulations of the Euro, but we believe that this trend will reverse and the dollar will continue lower for several years. The forecast level of the broad index is therefore range bound through 2010 before it matches our forecast from last quarter.
- Credit spreads first narrowed faster than anticipated, then blew out with the European credit crisis. Going forward, we see range bound spreads with a tilt down towards long-term averages starting next year.

Hopeful signs in current developments

Income and spending trends imply a better Q2 than Q1. The aggregate income data from the May employment report revealed a higher income gain than in April, and suggests somewhat stronger consumer spending at least through Q2.

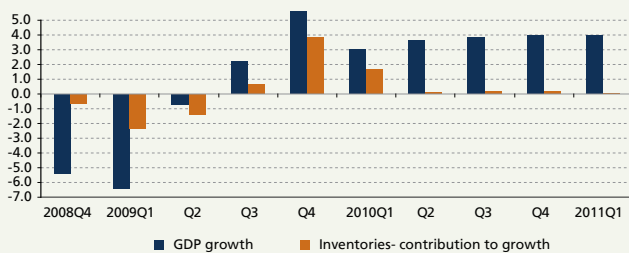
On the downside, the pop in April's savings rate to 3.6% follows a 0.3% upward revision to 3.4% in Q1. While the savings rate is still down from last year's quarterly average rates of 3.7% in Q4 and 3.9% in Q3, the overall pattern suggests that consumer's confidence remains very sensitive to continued economic volatility.

... the central worry is that job growth is not guaranteed

Without strong job gains, consumers' desire to spend will take longer to heal from the trauma of the recession. The latest disappointing payroll readings heighten this risk. A disappointing 41K increase in new private jobs (431K including government jobs) doesn't bode well for a labor force that is growing at about 200K/month.

More troubling is the possibility that, even with increased hours or wages, consumer spending could be stunted by fears of worsening job conditions. For now, it seems that businesses continue to cut, and few new jobs are materializing.

The process of inventory re-building is not over, but it is expected to diminished over the next year...



Source: MFC GIM; Forecast begins in 2010Q2

Despite the bad news, we judge that the 0.3% jump in average weekly hours and weekly earnings in April and May signal that income gains can be sustained. Furthermore, industrial production and capacity utilization continue to rise, also suggesting that as demand expands and inventories need to be re-built, new hiring and new investment spending will accelerate. Another source of optimism comes from the employment components of the

service and manufacturing ISM surveys, where upward trends are holding up, while the jobs components of consumer confidence also continue to improve.

In sum, the monthly employment data may not be providing a high resolution picture. While it reveals some weakness, it doesn't unequivocally indicate a deteriorating trend going forward.

...Leaving the main drivers growth to consumers and investors



Source: MFC GIM; Forecast begins in 2010Q2

Record productivity growth could in principle postpone the 350K/month job growth implied in our GDP projection, although we doubt that the spike in productivity during the last year will be sustainable without significant re-capitalization. Of course, it could also turn out that we are experiencing a real transformation caused by ever-wider adoption of labor-saving technologies. In case, we may need new pro-growth stimulus policies in the short term, such as payroll tax cuts or more public spending to avoid the loss of significant momentum.

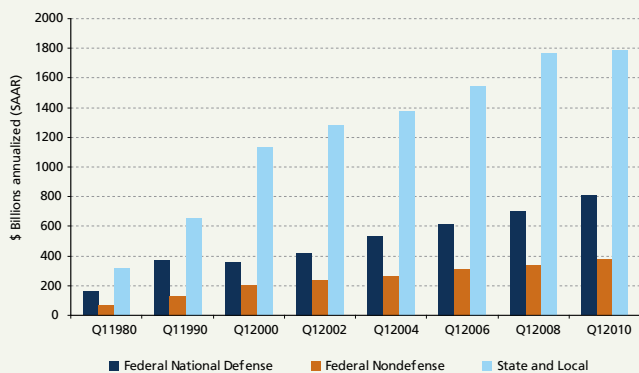
All the talk is about Washington, but the real tension between spending and taxes will be at the state level

The fiscal stimulus package winds down later in 2010, and despite high unemployment, the voices arguing for an extension of stimulus policies can hardly be heard. The European debt crisis and the sudden demand for fiscal austerity are promoting the view that we need to start cutting back now. This makes economic sense only if cuts are conditional on future growth.

We have argued that the public and politicians have grown accustomed to a free lunch, which started back in the 1980s' when round after round of new spending and lower taxes began. The only solution appears to be some combination of higher taxes, faster than trend economic growth and significant cuts in national defense or popular entitlement programs.

Unfortunately, the economy may need a different policy medicine: wider deficits in the near term to keep the economy out of another recession, which would risk even bigger deficits. Not allowing for this policy flexibility could end up costing us more than the current increase in fiscal deficits.

To cut spending, think about state and local services and national defense



Source: IHS Global Insight and MFC GIM

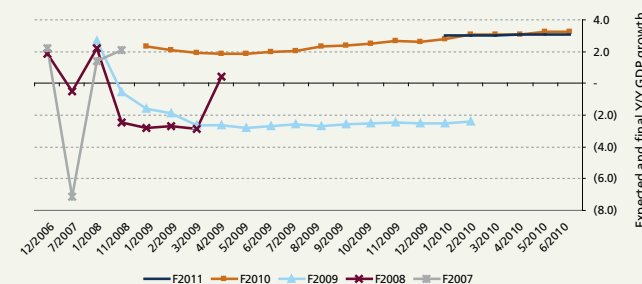
To complicate matters, contrary to popular perception, most of public spending is at the state and local levels. Going forward, it is here that the economy will be facing some of the toughest budgets decisions with repercussions from cuts in education and public safety. In our forecast, we see a small chance for a new round of spending, but an even smaller chance of significant cuts in long-term spending. Either way, if growth does not take hold soon, current trends will trigger huge deficits for states that are already slashing services and raising taxes to balance their wracked budgets. While for the economic outlook this is yet another source of risk, we assume that political considerations prevent any significant changes over the next two years, and only minimal changes in the underlying long-term trends. In our forecast, state and local spending remains flat and federal spending slows from 4% in 2010 to 1% in 2011.

A monetary tightening is less likely to be influenced by politics, but inflation is quiescent, and expected to remain so as long as unemployment and unused capacity are at recession levels. We therefore expect the Fed to maintain an expansionary policy through most of 2011, although risk-management concerns may result in a measured tightening if inflationary pressures emerge.

In sum, there are many opinions, but nobody should claim to "know"

The recovery continues to battle significant headwinds, and underlying trends are far from clear. We see a huge range of opinions, with no real "consensus". Everybody is entitled to an opinion, but nobody should claim that their projections are demonstrably correct. In particular, nobody knows if there has been too much or too little monetary and/or fiscal stimulus already. We believe that blindly pushing for immediate fiscal austerity or refusing to use macroeconomic policy to help a faltering recovery is the surest way to undercut growth, and may even allow a painful double-dip. The biggest potential mistake would be premature tightening of either the budget or monetary policy.

Many forecasts, but only one outcome



Time of Blue Chip consensus (BC) '07, '08 & '09; first point is initial forecast, last point is actual...for '10 and '11 first point is initial forecast, last point is last forecast; Source: Blue Chip Economic Forecast -53 professional forecasters

Financial Markets

Tension between home-grown economic momentum and financial turmoil overseas

U.S. financial markets reacted with alarm to the burgeoning sovereign debt crisis in Europe. The euro zone has probably patched over Greece's fiscal problems for the next year or two, but the markets instantly look through to the ultimate resolution, and they don't like what they see. Long-run insolvency thus becomes an immediate issue, as markets downgrade bonds and reassess the credit of institutions that hold them. As major European banks look vulnerable, the contagion spreads. So far it seems most likely that the fall-out in the U.S. will be minor, but we have seen in recent years how illiquidity driven by panic can cause real economic damage. At the very least, the equity market correction will make U.S. consumers and businesses even more cautious about spending and hiring.

Monetary policy – an even longer wait for serious tightening

The Federal Reserve was widely expected to start normalizing short-term interest rates later in 2010, perhaps as early as September. Now, with markets in disarray and the risks shifting even further from inflation towards economic weakness, the odds of any tightening action have decreased. The Fed has a dual mandate: to strive for both price stability and full employment. With unemployment close to 10% and the economy still struggling, it will be hard to justify any move to tap the brakes until well into 2011. Even a token move would be the wrong signal when deflation and recession are the primary concerns.

The timing of the Fed's exit from its ultra-expansionary policies will depend mainly on the course of the real economy. Our growth forecast is somewhat above consensus, but we expect U.S. unemployment to remain very high through 2012, at levels that will continue to put downward pressure on inflation even if the "natural rate" of unemployment turns out to have risen substantially. It would take a shockingly rapid burst of job growth, or a huge shift in the historical relationship between inflation

and unemployment, to raise a real threat of ongoing inflation before 2012.

In this cycle, of course, monetary tightening will have additional components relating to the withdrawal of Quantitative Easing (QE). The easing process is largely over already, but its reversal – shrinking the Fed's balance sheet – will take a considerable time. The technicalities are less important than the magnitude and timing of bond sales or repo operations. We do not expect the Fed to risk driving up bond rates by any large scale moves in the near term. The same issues of confidence in the sustainability of the economic recovery that constrain rate hikes will also limit quantitative tightening to no more than token or experimental actions through most of 2011.

The U.S. dollar – relatively attractive, for now

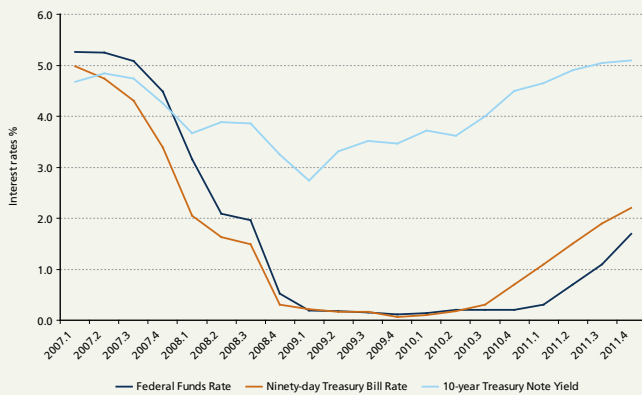
In the long term we assume that the trade-weighted dollar has to weaken in order to bring the U.S. current account back towards balance. This is particularly true relative to emerging Asian currencies, but will eventually play out relative to Japan and Europe too.

For the moment, however, with the world's focus on European sovereign debt, the USD looks like the safest haven. If the U.S. economy successfully rides out the storm and continues to outgrow Europe and Japan, the currency is likely to remain relatively strong. The timing of the transition from short-term strength to long-term weakness will depend on how quickly the euro zone overcomes its fiscal woes, and whether U.S. growth relapses to the sub-par pace many observers expect. We believe that another year of dollar resilience is likely, and the greater the economic impact of the euro's problems, the longer it will be before the world's capital finds an attractive alternative.

A steeper yield curve ahead

As usual, financial market turmoil overseas and equity market losses at home have combined to drive Treasury bond yields back down. While the risks of economic weakness have clearly risen, we continue to believe that the most likely scenario is a revival in private-sector credit demand as the recovery progresses. This will collide with massive government borrowing to drive up real interest rates and steepen the yield curve. Given our expectation of a long delay before the Fed begins tightening in earnest, this process could continue for at least a year. Even if the Fed moves sooner, they will presumably not only raise short-term rates, but also reverse QE, so their actions will tend to raise bond rates too. Either way, the yield curve gets steeper unless the private sector fails to revive at all.

Bond rates likely to rise ahead of Fed tightening, steepening the yield curve



Source: Federal Reserve Board

Credit Spreads – a quicker than anticipated narrowing

Credit spreads narrowed quite rapidly during March and April, as expected in an economic recovery with rising profits. In May, however, the European credit crisis drove investors away from all risky assets, so that by early June, spreads were wider than at the end of 2009.

We anticipate that the trans-Atlantic contagion from Europe’s troubles will blow over soon, even if the crisis itself persists in European markets. We therefore expect credit spreads to revert to the earlier range as investors regain their appetite for U.S. corporate risk. Lingering effects may keep spreads somewhat wider than the lows that they reached at the end of April, so we are forecasting that the quarterly averages will remain roughly flat for the rest of 2010 before narrowing very gradually during 2011.

The main risk to spreads is the same one that affects every aspect of our outlook – if the recovery falters, whether due to a global crisis or home-grown weaknesses, risk premia will rise across the board while Treasury rates decline once again.

Equities – a sharp correction leaves no safe bets

Equity values close to historical average relative to aggregate corporate profits



Source: Federal Reserve Flow of Funds; National Income Accounts; MFC GIM Economic Research (includes estimates for 2010 Q2)

The equity market’s run since the low in March, 2009 was almost too good to be true, so a correction was always in the cards. Nonetheless, the sharp drop during May was a surprise, erasing all the year-to-date gains and more.

Looking ahead, there is no clear-cut valuation argument showing that the market is either ahead of itself or unreasonably gloomy. Essentially, everything now depends on whether real economic growth will deliver real economic profits. For now, it seems most likely to us that the prospects for growth and earnings will tend to improve going forward. Job growth will pick up, and will drive overall spending and GDP growth. Given today’s fears, this will probably represent a “better-than-expected” outcome, and justify increased confidence in further growth and earnings in the future.

But the range of opinion is unusually wide, and the fears of worse outcomes are not completely groundless. Diversification and caution are always the basis of investing, and more than ever with today’s uncertainties.



Risks to the Outlook

The recession is over, but there is still uncertainty about the shape of the recovery. We forecast a sluggish path gathering strength through 2010 and 2011, but we see big risks to our cautious forecast. Alternative employment and spending growth paths, along with policy shifts, can produce better or worse outlooks.

[These scenarios are not all mutually exclusive, so probabilities cannot be added]

1. The perfect outcome – probability 15%

Fiscal and monetary policies provide just enough momentum to fire up the normal processes of self-sustaining growth. The Fed withdraws excess liquidity in time to avoid a surge in inflation, while private capital returns to credit markets and bank lending recovers sufficiently to support healthy growth. Consumer spending accelerates, boosted by a sharp drop in unemployment. This V-shaped recovery sends growth sharply higher for two years without triggering inflation.

2. A renewed global crisis – probability 15%

A global collapse in confidence as the euro sinks into a full-fledged crisis. Paralyzed by budget deficits, policymakers respond too late, and the world falls back into recession. Deflation becomes a major risk, and it could take another year before any pro-growth policies gain traction.

An even worse version of this scenario would add a U.S. dollar crisis: the growing fiscal imbalances of Greece are prescient of the fiscal imbalances in the U.S. The US\$ suffers a major relapse driving up inflation; investors lose confidence that the U.S. government can tame its deficit. Sharply higher interest rates (led by Fed hikes) arrive ahead of sustainable growth, as investment contracts and financial markets dive, leading to another U.S. downturn.

3. Policy mistakes allow a double dip recession and deflation – probability 10%

Higher consumer savings, a sudden reversal in interest rates as the Fed pulls back liquidity and political blockages in the flow of fiscal stimulus cause the U.S. to fall back into recession sometime in 2011. This sets in motion a deflationary spiral, pushing ever more borrowers into bankruptcy as the real burden of debt rises. Assuming that major countries do not then embark on a trade war, we would expect that global fiscal responses and massive injections of liquidity eventually pull us away from depression dynamics, but not without serious collateral damage to households and businesses, and even scarier levels of government debt.

4. Inflation – probability 5%

There is a legitimate concern that the Fed's quantitative easing and the bulging fiscal deficit will awaken inflation. A resurgence of growth followed by rising labor costs and a spike in commodity prices catch policymakers by surprise before any tightening can prevent a surge in inflation. In this scenario, the delayed policy reaction leads to a painful recession in 2011.

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