

# GLOBAL INTELLIGENCE

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## Global Economic Outlook



**Bill Cheney**

**We view the current weakness in developed economies as a soft patch and believe it is still likely that global growth will accelerate into 2011.**

After shrinking in 2009, the world economy rebounded decisively in 2010 back to growth now forecast at about 4%. While there are reasons to expect a slight slowdown in the second half of this year, the steadily rising weight of fast-growing emerging economies seems to ensure that global growth will remain robust.

We view the current weakness in developed economies as a soft patch rather than a warning of imminent double-dip recession. Despite the slow pace of consumer spending in the U.S., and budget-driven austerity in Europe and Japan, we believe it is still likely that global growth will accelerate into 2011.

The risks remain formidable. The inventory cycle has largely run its course, and pressures are building for fiscal retrenchment as sovereign debt issues loom. With both consumers and businesses unusually cautious about spending, the danger of a slowdown

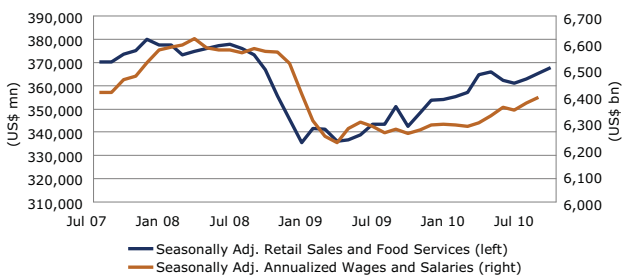
# Global Economic Outlook (Cont'd)

or even another recession is real. Given the downside risks in all major economies, concerns about deflation are rising. China might export a little inflation to its trading partners, but with huge economic slack in developed economies and inflation already close to zero, the possibility of slipping into persistent deflation is real.

## Consumer Is Key In U.S.

The U.S. continues to generate robust corporate profits but mediocre job gains. Consumers are saving more, which may indicate less need for further increases in saving and a greater likelihood that spending growth will track incomes. Consumers' disposable incomes are rising, so spending could speed up and drive some material job growth – at last. Meanwhile, business capital spending is rising rapidly.

**U.S. Income Rebound To Prop Up Consumption**



Source: U.S. Bureau of Economic Analysis, U.S. Census Bureau

Public policy is a huge wild card. Health care reform, financial regulation and tax policy are all creating uncertainty for businesses. More tangibly, fear of budget deficits is creating pressures to reduce government spending. While we doubt that spending will be cut enough to derail the economic recovery, the politics of debt have lined up against any additional fiscal stimulus.

Canada's recovery, which initially had appeared quite vigorous, lost some momentum during 2010.

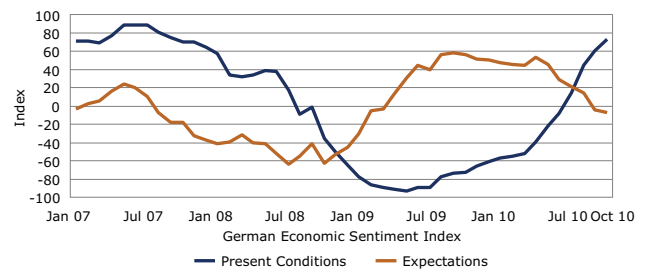
However, with a healthier fiscal position, trade balance and banking system than most other developed countries, Canada's recovery looks relatively secure despite its close links to the U.S. economic cycle.

## Two-Speed Recovery In Europe

Northern Europe is generally positioned for growth, subject to a gradual revival of domestic demand. Portugal, Ireland, Italy, Greece and Spain are desperately digging themselves out from under a burden of debt and inflated labor costs. Greece still looks unlikely to be able to pay its way without some debt relief, but the rest of the Eurozone is probably just able to survive without default. At this point the chief uncertainty is political, as democratic governments struggle with unpopular fiscal austerity.

German industry remains the key engine of growth, benefiting and suffering as the euro falls or strengthens. With renewed anxiety about European sovereign debt, the euro is now expected to weaken, which should further boost regional exporters. In the longer run, though, we still believe that a declining U.S. dollar will imply a stronger euro. European Central Bank policy remains expansionary, and will probably remain so for the next year.

## German Industry – And Sentiment – Are Key



Source: Center for European Economic Research (ZEW)

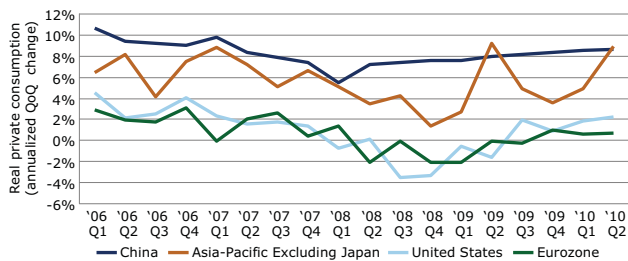
In the near term U.K. growth may be limited by the new government's severe budget cuts, but the separate currency allows an independent monetary policy to compensate with additional easing.

### Asia Is Global Growth Driver

Asia as a whole is reaping the benefits of stimulus and growth in China. In 2009, China, Indonesia, Vietnam and South Korea were among the top contributors to world GDP growth, and the story will be the same in 2010. Further ahead, Asia's expansion will continue, but may slow.

Asian consumers are becoming the global economy's growth locomotive. With rapidly rising incomes, their spending rebounded relatively quickly. The global boost from Asian consumers will only increase as time passes.

#### Asian Consumption Softened "The Big Dip"



Source: IHS

Inflation is on the rise, but should remain fairly subdued for the next year or two due to excess manufacturing capacity and diminishing pent-up demand. Nonetheless, caution calls for a policy tightening bias, as some countries (China, Taiwan) appear to have developed imbalances in their expanding housing markets.

China is already slowing down in the wake of moves to tighten credit, but worries about a "hard landing" seem overblown. We expect GDP growth of 9% in

2011, with a long-term drift downward as the size of the economy increases. Rapid growth in demand is facilitating rising wages, but counter-cyclical policies should keep inflation under control.

A housing-led crisis as in the U.S. is unlikely. The interdependence between household spending, the housing market and financial markets is weaker in China, and a bursting housing bubble in China would be much shorter and less destructive.

The exchange rate has so far appreciated minimally since the new flexibility announced in June. With increasing pressure from the International Monetary Fund, Europe and the U.S., and also to ease domestic inflation, Beijing is expected to allow appreciation vs. the U.S. dollar at a 5-8% annual pace.

After the deepest contraction among the Group of Seven<sup>1</sup> economies, Japan roared back on a rapid rebound in exports. Growth in 2011 seems likely to be much weaker, as fiscal policy measures run out and the global inventory cycle fades. Recent monetary steps to hold down the appreciating currency and engage in additional quantitative easing should help, but a political impasse seems likely to curtail any active governmental role in reviving domestic demand. Unemployment hit 5.3% in June, and shows no sign of imminent decline. Consumer demand is likely to remain weak, and the Bank of Japan will have to keep policy as expansionary as possible.

*Bill Cheney is Chief Economist at MFC Global Investment Management. Economist Oscar Gonzalez also contributed to this report. Both are based in Boston, Massachusetts.*

<sup>1</sup>Canada, France, Germany, Italy, Japan, United Kingdom, United States

# Global Tactical Outlook



**Don Rich**

**In this issue of *Global Intelligence*, we introduce MFC Global Investment Management's Head of Tactical Asset Allocation, Don Rich. Don will present insights into opportunities to add value in asset allocation portfolios over investment horizons of six months or shorter.**

At the onset of the millennium, globalization was touted as the mechanism that would integrate regional economies, societies and cultures through a network of communication, trade and transportation. As a result, business cycles across the globe have become increasingly synchronized, resulting in elevated financial market correlations (over the past decade, correlations are 70% higher). This has created a short term\* "risk-on/risk-off" environment that has serious implications for portfolio risk management.

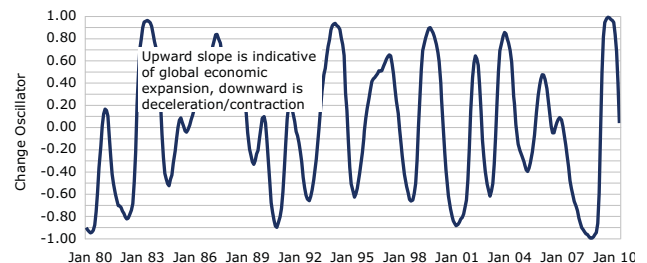
The most important short-term risk factor is global macro risk related to global output and production. It measures whether the global economic cycle is expanding or contracting.

Why is the global macro risk factor important to financial markets? Corporate earnings are generated from the sale of products and these products have to be produced before they are sold. As a result, changes in fundamental macroeconomic activity lead corporate earnings.

## Heightened Risk Through February

The chart below is MFC GIM's composite proxy of the global macro risk factor. It is a single monthly measure of change in global output/production from across 28 individual countries. Currently, it is telling us that, within the current global economic cycle, we are in the down cycle which we believe started in November 2009. Each down cycle is unique but they tend to last between 12 and 16 months. Given the average length of previous down cycles, we expect maximum market dislocation between November 2010 and February 2011. However, it should be noted we don't expect a repeat of the events of 2008.

### Global Economy Still Decelerating

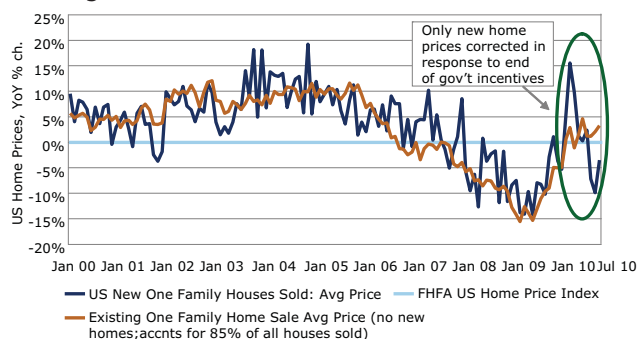


Source: Bloomberg, MFC GIM

As we enter the depths of the current down cycle, there are two questions that need to be answered: What areas will be the source of economic pain and which asset classes will likely be the casualty of the next dislocation?

First, we expect the pain will originate within U.S. housing and U.S. manufacturing, which are both expected to contract again in coming months. The imbalance between the supply of available U.S. housing and the demand for those houses is at all-time highs – in other words, greater than it was at the height of the '07-'08 crisis! This imbalance has not received extensive coverage as prices have been stable. However, the chart below illustrates the recent rapid deterioration in the growth in new U.S. house prices, and we expect a similar price adjustment for existing homes.

### Existing Home Prices Still Need to Correct



Source: Bloomberg, MFC GIM

In addition to housing, we expect to see a contraction in U.S. manufacturing in response to slowing global growth. Some of the regional manufacturing numbers, such as the Philadelphia Fed manufacturing index, have already entered the contraction phase. We expect the national U.S. manufacturing index, the ISM, to contract in the coming two or three months.

As a result, we expect U.S. consumption to soften due to deteriorating personal balance sheets which will lead to lower global growth. While we don't expect the double-dip in housing and manufacturing to lead to a double-dip in overall growth, we do expect GDP to stagnate, hovering around 1% in the U.S.

Slow growth is dangerous, though, as it could easily turn into negative growth. This transition ultimately depends on consumers' reaction to slow growth, the so-called "second round effects". If consumers are concerned about job security in a slow growth environment, this could reduce aggregate demand and push a slow growth situation into negative growth.

### Commodities, Credit Most Vulnerable

Second, what asset classes are most vulnerable to the expected changes in the economic landscape?

We think commodities, particularly oil, are vulnerable in a global slowdown. Decelerating/contracting global

production results in less demand for commodities, and will result in falling commodity prices. In addition to commodities, credit is one of our biggest concerns. Credit has recently enjoyed its greatest period of equity outperformance in history. History suggests that equities should begin to outperform credit and that equity outperformance should last for multiple periods. There are also other reasons for credit concerns. We believe that there is a false sense of security based on performance during May's dislocations. The space is extremely crowded with yield-seeking investors and given the relative lack of liquidity within the asset class, there could be a sharp price movement downward in the event of a correction, as investors rush for the exits. As credit has enjoyed its biggest and longest period of relative outperformance, we anticipate a period of mean reversion in which performance within credit will be lower.

Higher correlations and choppy equity returns are the expected response to upcoming head winds, including:

- Weak global expansion as a result of unwinding of the unprecedented expansion in fiscal and monetary policies
- Increased regulation and government intervention
- Increase in taxes on the rich (including, in the U.S., the expiration of Bush era tax credits)
- Reduced personal consumption, particularly in the U.S.
- An aging demographic
- Growing budget deficits across the world
- Sustained levels of above average unemployment
- Reduced current account recycling

We are expecting a winter characterized by poor financial market performance as we enter the depths of the current down cycle. Capital preservation is integral in the upcoming months. Large negative

# Global Tactical Outlook (Cont'd)

returns can occur during down cycle pullbacks which could escalate into tail events (tail events are infrequent, high impact events, such as the U.S. housing crisis in '07-'08 or the European bank funding crisis in May '10).

Longer term, we expect choppy equity returns as global imbalances correct, with value added by actively managing risk around cycle turns.

*Don Rich, PhD, is Head of Tactical Asset Allocation at MFC Global Investment Management. He is based in Toronto.*

# Global Equity Outlook



**Christopher Conkey**

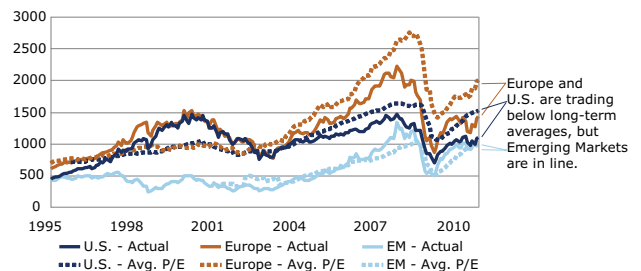
**The risk of a slowdown and lower earnings appears well discounted by global equities. Solid opportunities are emerging in reasonably valued, high-quality companies with sustainable competitive advantages.**

As we enter the final quarter of what has been a volatile year for global equities, headlines still portray a daunting wall of worry. The early drivers of economic recovery – fiscal and monetary stimulus and inventory replenishment – are clearly in their latter stages. Sustainable engines of growth – business investment and job creation – remain weak. Moribund consumer activity in the U.S., the world's traditional growth engine, has put a floor under global demand.

Meanwhile, the future path of the U.S. housing market remains unresolved and an adverse turn could easily set back the recovery. Debt-related problems endure in the U.K. and across Europe, while the Chinese government has recently put on the stimulus brakes to deal with runaway real estate markets.

Further, major industrialized economies seem to be engaged in competitive currency devaluations, with the assumption this will devalue their large and growing fiscal deficits. Political risk is dominant in the U.S., with uncertainty about November's mid-term election and what potential change this may bring on the regulatory and tax policy fronts.

### US, Europe Undervalued vs. Long-Term Averages



Source: MSCI Barra, Factset, MFC GIM

## Equity Rebound Factors Aligning

However, beyond these headlines, we believe the foundation is being laid for a rebound in global equity markets as we move closer to an attractive alignment of valuation, sentiment and business fundamentals. We do recognize the existence of headwinds, and by no means are we saying short-term risks are inconsequential, but we see an emerging opportunity for excess returns from global equities on both an absolute and relative basis.

First, business conditions are improving. Using U.S. corporations as a proxy, earnings reports continue to meet or beat expectations, while free cash flow generation has followed suit. Most sector growth forecasts are either at or above long-term medians for 2011 and 2012 and, while estimates typically come down over time, the attractiveness of equity valuations relative to other asset classes indicates prices have reasonable upside potential even at below-median growth rates. As an example, the equity risk premium, as measured by the gap in earnings yield relative to risk-free rates, is almost as high as it was in March 2009.

Ex-financials, corporate balance sheets are in good shape. Cash balances are high; several large cap tech firms would rank in the top 50 of the S&P 500 index based solely on the cash balances on their balance sheets.

## M&A Activity May Be Rally Catalyst

Managements are beginning to employ this asset. For example, dividends are beginning to rise; merger and acquisition activity is also showing signs of renewed life, as evidenced by Hewlett-Packard's purchase of 3Par and BHP Billiton's bid for Canada's Potash Corp. If, as expected, corporate top-line growth remains modest, we expect merger and acquisition activity to

exploit reasonable valuations and provide an impetus for an equity market rally.

Global equities continue to be whipsawed by macroeconomic factors. As it seemingly always does after periods of high volatility, uncertainty reigns. Within that uncertainty, however, we see clear signs of solid opportunities emerging in reasonably valued, high quality, profitable companies with sustainable competitive advantages.

A renewed slowdown is certainly possible and perhaps even likely. From a bottom-up perspective, however, we are reasonably sanguine that this risk to global equities is well discounted in current valuations. Even accounting for a ratcheting down in earnings expectations if the recovery slows in the months to come, global equities are still inexpensive relative to history and generally to all fixed income asset classes.

*Christopher Conkey, CFA, is Chief Investment Officer, Global Equities, for MFC Global Investment Management.*

# U.S. Equity Outlook

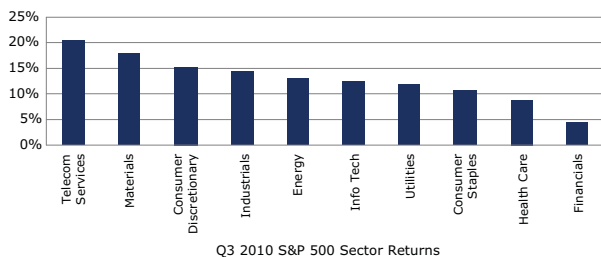


Roger Hamilton

Given our positive longer-term outlook, investors may be well served to use any weakness in the market as an opportunity to add U.S. equity market exposure.

The U.S. equity market finished the third quarter with a roar as the final month was the best performing September since 1939, up 8.92% in U.S. dollar total return terms. The quarter's return was even higher, up 11.29%. Driving returns were a search for dividends, decent industrial growth, less concern over the possibility of renewed recession and anticipation that the Federal Reserve may employ more quantitative easing. The four best performing sectors included both the stable, high dividend payer, telecoms, and three cyclical sectors - materials, consumer discretionary, and industrials. Financials were the laggard on fears that low interest rates and new regulation may pressure earnings. Since most financials are value stocks, growth easily outperformed value during the quarter.

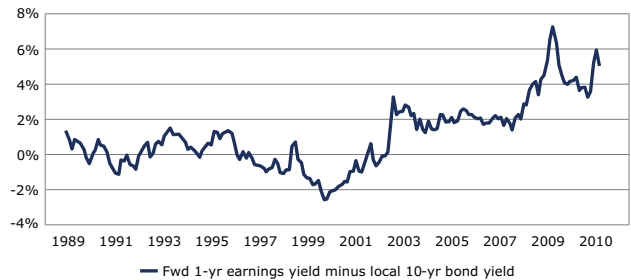
### Cyclicals, Income Stocks Led Q3 Gains



Source: Factset

The longer term prospects for the stock market are quite promising for two reasons. First, valuation is low, and, second, the extended period of moderate growth that we expect can be quite favorable for investment returns. With regard to valuation, the market is inexpensive relative both to bond yields and to its own history. The following chart shows how the earnings yield of the stock market has moved over time versus the 10-year bond yield, while the subsequent one shows the relatively low price-earnings ratio of the stock market relative to its history.

### US Stocks Remain Cheap vs. Bonds...



Source: MSCI, FactSet, Moody's, Bloomberg, MFC GIM analysis

### ...And On Trailing P/E Basis



Source: Morningstar Research Inc.

### Fundamentals Are Supportive

The market's valuation has been dampened by fears of another recession and, to some extent, even fears of deflation. We think neither event will occur. Both are rare. The only double-dip recession in U.S. history

was during the Great Depression, and that was arguably due to policy errors. Housing and employment may remain weak, but recoveries are natural and the economy is slowly recovering. The industrial side of the economy is healthy, corporate profits have surged, interest rates are low and the yield curve is positive. The U.S. dealt swiftly with its greatest deflation risk, a collapse in the banking system, as losses were quickly recognized and the government provided the financial assistance needed to work through these losses.

While recent deflation concerns probably stem from the prospect of weak spending by deficit-burdened governments at all levels, we do not see it leading to deflation. In fact, it actually ties in with the second reason for our optimism about the market – an extended period of moderate economic growth. This outlook is a function of the dampening effect of government austerity being offset by growth in emerging markets. For added comfort on the economy, the Fed has already stated that it will employ another round of quantitative easing if necessary (possibly soon) to boost inflation and the economy.

### **Near-Term Risks Remain**

Our confidence regarding the short-term direction of the market is not quite as strong. The market has just had a strong rally at a time when housing and unemployment data may still be weak enough to stoke fears that the economy may shrink again. In addition, protectionist rhetoric has heated up, and the sovereign credit issue could scare equity markets again. The tax selling season can lead to some mean-reversion movement in particular names. The market may be able to do well once we have more clarity on the U.S. mid-term elections and the fate of George Bush era tax breaks in legislation now moving

through the Congress. The fourth quarter is also often a seasonally strong time for the market.

Given our positive longer-term outlook, where suitable, investors may be well served to use any weakness in the market as an opportunity to add U.S. equity market exposure. Regardless of the broader market direction, however, there are many appealing investment areas. Growth should outperform value in a moderate economy. Dividends are attractive relative to corporate bond yields. Taking these two together, a prime opportunity may be companies that are both growing their dividends and well positioned with emerging market consumers, an area of highly visible growth. Other examples of promising themes include industrial businesses with tailwinds (power and energy efficiency); growth in smart phones; the high cost of producing oil; banks trading near tangible book values; and companies about to return more cash to shareholders. If housing could show hints of finding a solid footing, many other attractive opportunities would open up.

*Roger C. Hamilton is Portfolio Manager for MFC Global Investment Management (U.S.), LLC. He is based in Boston, Massachusetts.*

# Canadian Equity Outlook



Pat McHugh

**Based on either price-book or on a price-earnings multiples, strong returns are in store for the Canadian market over the coming 12 months.**

The Canadian equity market is the place to be as it offers investors leverage to U.S. economy as well as the commodity-export sector. Attractive earnings and dividend yields, combined with a forecast 25% and 12% earnings improvement for 2011 and 2012<sup>1</sup> give us confidence that high double-digit returns are possible over the coming 12 months. While the nimble trader may be able to exploit periods of volatility, the patient, suitable long-term investor should build an overweight exposure to this market and stay the course.

As concerns regarding a renewed recession subsided, markets steadily improved and the Canadian stock market index popped 10.3% for the third quarter and is up 7.5% year to date as we enter the fourth quarter.

There were several possible factors behind the rally. With bond yields at historic lows, investors began to anticipate another round of quantitative easing – a scenario given credence by statements by various regional governors of the U.S. Federal Reserve. In addition, the previous quarter’s market declines helped nudge dividend and earnings yield back up to historically attractive levels when compared to alternatives. Finally, a number of economic

announcements exceeded expectations and offered investors hope that the economy, while not resurgent, was at least bottoming out, leading to revised third quarter U.S. GDP growth estimates of 3% or more (substantially higher than the revised second-quarter 1.7%). Should these estimates be close, the U.S. economy would likely be clear of the risk of renewed recession.

## Forward P/E Near 20-Year Low

Based on consensus estimates, the market is currently trading at compelling valuations last witnessed in the late 1980’s. The S&P/TSX Composite Index trades at 13.9 and 18.8 times forward and trailing earnings respectively. While consensus estimates will no doubt undergo negative revisions over the course of the next 12 months, and the current earnings season will bring with it market price corrections as a result of various earnings disappointments, valuation bottoms have been established on a trailing 12-month basis and should hold.

## Canadian Trailing P/Es Are Not Demanding



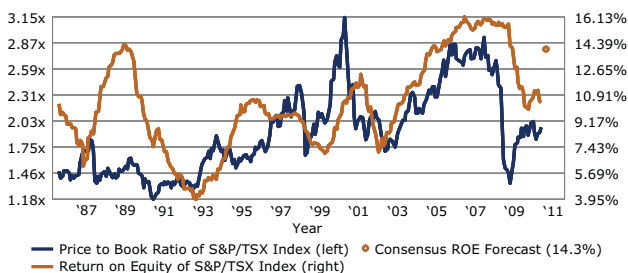
Source: Morningstar Research Inc.

The market is currently generating a trailing return on equity of 10.4%, down slightly from 11.1% three months ago. However, consensus estimates currently imply an ROE of 14.3% for calendar 2011. The last time the market was generating that kind of return was mid-2005 and the index traded at 2.6 times book value. The last time the index traded at two times

<sup>1</sup>Morningstar Research Inc.

book (mid-2003), the market was generating similar trailing returns. Thus, based on a current book value of just under two times, the Canadian market can achieve much higher multiples as the economy and profitability improve.

**Profit Outlook Supports Higher P/B Multiple**



Source: Morningstar Research Inc.

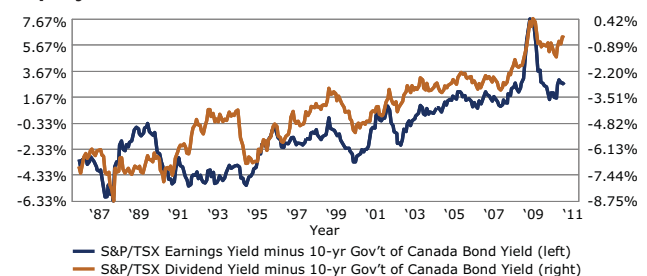
In the last issue of *Global Intelligence*, we stated that, in our opinion, “the downside in bond yields (was) limited and that, along with continued improvement in global economic activity, market fundamentals shall reassert themselves and shall give investors the green light to step back into higher-risk assets”. While we were right – investors have clearly stepped back into the equity sector – we were so wrong on the bond call. Government of Canada bond yields are down about 10% in the last three months! Japan’s aggressive quantitative easing announcement to cut rates to virtually zero, along with the realization that, in the words of Brazil’s Finance Minister, “we’re in the midst of an international currency war” and the implicit belief that a second global round of quantitative easing is only a matter of when, not if, have helped pushed rates much lower than we would have imagined. While the U.S. seems to be winning the global currency “race to the bottom”, the implications have not been missed by investors: a falling dollar gives the U.S. a competitive advantage (U.S. exports leaped to a 20-month high) and most commodity prices are flying, since practically all are

denominated in greenbacks. U.S. housing still makes us queasy, but it means that interest rates there aren’t going anywhere any time soon and mortgage rates should remain stable. We also note that the buy/rent ratio has been halved to a low of 0.92 times since 2006 on a trailing twelve-month basis. This means that mortgage payments are now less than rent; it’s only a matter of time for this segment of the market to bottom out and improve.

**Equities Remain Attractive Vs. Bonds**

In sum, the Canadian equity market looks very attractive. Our leverage to the slowly improving U.S. economy and our commodity export sector give us an advantage that few equity markets can challenge. Dividend and earnings yields on the S&P/TSX compare favorably to 10-year Government of Canada bonds. Indeed, with the exception of the brief period following the collapse of Lehman Brothers two years ago, investors have to go back to the mid-50’s to find a time when the dividend yield spread of the Canadian market was as attractive. The story is only improved by expectations that Canadian banks will announce dividend increases before year-end; we expect the increases to surprise on the upside.

**Equity Yields Still Near Record vs. Bonds**



Source: Morningstar Research Inc.

While the Bank of Canada is most likely to put interest rate increases on hold for the near term, they shall be among the first to resume increasing rates

# Canadian Equity Outlook (Cont'd)

once conditions warrant. We believe this will sustain investor demand for the Canadian dollar and reward those investors and funds which are overweight Canadian equities. Based on either price-book or on a price-earnings multiples, strong returns are in store for the Canadian market over the coming 12 months.

The main risk which we envision is that, given the slower than normal global economic growth prospects, equity markets may overrun their longer-term potential, especially after strong performance periods such as the recent quarter. Nimble traders

may be able to exploit these opportunities, but many Canadian equity securities can experience prolonged periods of illiquidity or “seller’s strikes” at the most inopportune times. Long-term patient investors who are comfortable with this risk and have an appropriate level of diversification in their portfolios are strongly encouraged to build an overweight exposure to this asset class and to hold their course.

*Pat McHugh, CFA, is Senior Portfolio Manager at MFC Global Investment Management (Canada). He is based in Toronto.*

# European Equity Outlook



David Hussey

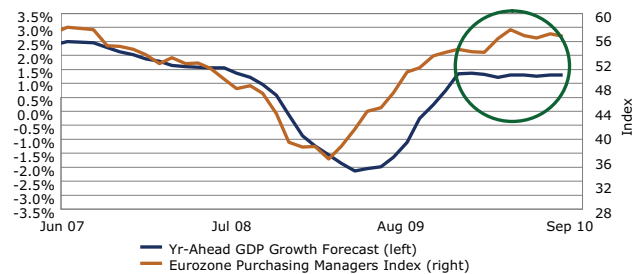
**European stocks generally look cheap when comparing earnings and bond yields and we expect European equities to remain attractive relative to other developed markets.**

European markets rose strongly in the third quarter, with the MSCI Europe Index up 19.40% in U.S. dollar terms. Sentiment turned positive after the European Union’s banking stress tests didn’t produce any nasty surprises and strong economic indicators from the European core drove risk assets higher. German bond yields fell significantly and the euro strengthened

considerably despite a further widening from May crisis levels in credit spreads in peripheral E.U. markets.

The strength of the European recovery has surprised many. The chart below highlights how European manufacturing indicators have been well ahead of consensus predictions for GDP recovery. The data are supportive of an outlook for Eurozone growth to remain comfortably above recent consensus of 1.4% for 2011.

**GDP Forecasts Underestimating Actual Activity**



Source: Consensus Economics, Markit

Manufacturing has been helped by a still competitive euro and by Europe’s trade exposure to a resurgent

China and the emerging markets. Business confidence and leading indicators remain positive. Relatively low consumer debt levels in core Europe and resurgent Eurozone wage inflation hold out the possibility that leadership of the recovery in core Europe could in fact shift from exporters to consumers.

### Key Risks Are Austerity, Strong Euro

The main risks to a sustainable recovery are the following: (a) budget deficit reduction via austerity, (b) tightening monetary conditions relative to peers, and (c) a resurgent euro. Taking these in turn:

(a) Is austerity actually a positive? The received wisdom is that fiscal austerity could reduce Eurozone GDP by around 0.5%. However, an alternative school of thought suggests that austerity could be positive for growth as budget cuts reduce the need to raise taxes in the longer term.

The austerity programs are also expected to increase political integration in the Eurozone by, for example, increasing Italian labor flexibility and reducing Spanish and Irish wages and pension benefits to be in line with the rest of the region. The European Central Bank (ECB) clearly believes that balancing budgets is the road to sustainable recovery rather than more rounds of debt fuelled quantitative easing to force down real rates.

(b) Is the ECB really thinking of tightening monetary conditions? The ECB would argue that classical academic theory shows hikes should have happened already. However, given that the recovery seems based on massive liquidity stimulus and near-zero interest rates, this argument seems flawed.

Higher interest rates would threaten severe damage to peripheral Eurozone competitiveness because it would likely force the euro higher versus the currencies of trading partners. We think that the ECB

will have to accept some inflation and set policy keeping the vulnerability of the periphery in mind, as long as those countries continue to enact required austerity measures.

(c) Could euro strength slow the recovery? The €750bn European Financial Stability Fund (EFSF) effectively reassured the market regarding a euro break-up and focused attention on the fact that the recovery was stronger in Europe than in the U.S. The downside is that the subsequent recovery in the euro threatens the region's export-led recovery. A 5% move by the euro against a trade weighted basket of currencies could impact GDP by 0.3% to 0.5%.

#### Euro Rebound Threatens Exports



Source: Bloomberg

Philosophically, the ECB is likely to resist competing in a global competitive devaluation and in any event it's not clear how it would go about implementing broad quantitative easing like the U.S.

This poses the risk that the euro becomes a default global strong currency like the yen, which is remarkable given market opinion in the aftermath of May's Greece-related crisis that the euro's days were numbered and the fact that peripheral spreads over German government bonds have widened further since the crisis.

The last thing peripheral Europe needs is a stronger euro and higher real rates that would make these countries even less competitive. This may present the

# European Equity Outlook (Cont'd)

ECB with a policy dilemma. Should the euro strengthen above U.S.\$1.40, we would expect political pressure from the French, export lobbyists and the peripheral nations to force the ECB to reluctantly join the global currency devaluation race perhaps by cutting interest rates.

European stocks generally look cheap when comparing earnings and bond yields. A clear example is the European telecom sector, where free cash flow yields and dividend yields are now higher than investment grade bond yields. Factoring in resumed top line growth, such opportunities look good for investors.

## Europe Seems Attractive Vs. Peers

We expect European equities to remain attractive relative to other developed markets. Since the 1960s, it hasn't been unusual for European GDP to outpace U.S. GDP. Also, European equities have outperformed U.S. equities over the past decade.

Current euro strength could slow the European recovery if it persists, but we expect the longer term euro trend to be soft given the expectation of sustained weakness in the peripheral E.U. economies.

Europe is taking a different approach to recovery than the U.S. European monetary authorities are not yet convinced of the need for another round of debt fuelled market manipulation via quantitative easing, preferring instead short term austerity and budgetary conservatism in expectations that they will yield long term stability and growth. We believe this approach is preferable over the long term and would promote lower volatility in risk assets in the future.

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# Emerging Markets Equity Outlook

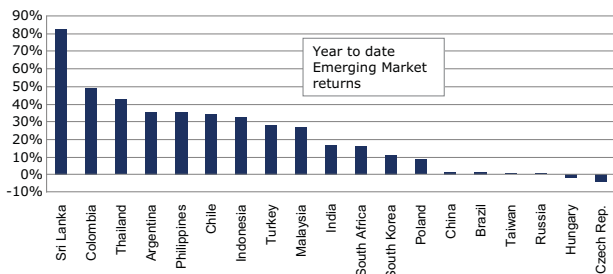


Peter Mennie

Quantitative easing and zero-interest rate policies in the developed world are creating tremendous pressures, pushing money into emerging markets, which are structurally very attractive for the long term.

Emerging markets had a very strong third quarter, up over 18% (as measured by the MSCI Emerging Markets Index) in U.S. dollar terms, outperforming developed markets by over four percentage points. Year to date, emerging markets are up by over 11%, well ahead of developed markets. According to EPFR Global, emerging market equity funds have seen inflows of \$45 billion this year.

## Not the Usual Suspects

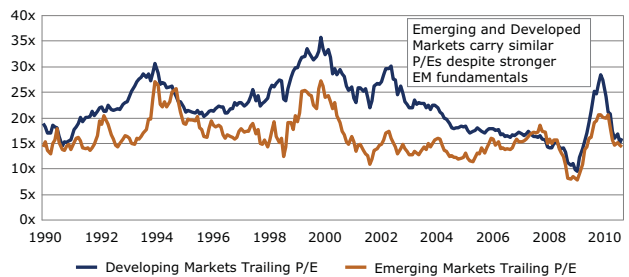


Source: MSCI Barra

Why have emerging markets been rallying so strongly? The easiest explanation is relative global growth. Brazil, India and China are all likely to grow their economies by more than 7% in 2010, while in the developed

world some countries will contract, and even the better performers are unlikely to grow faster than 3%. Growth usually commands a higher price, but in fact emerging markets are priced similarly to developed markets, with a price-earnings (P/E) multiple of 14.8 and dividend yield of 2.26% on the MSCI Emerging Markets Index, in comparison with MSCI World on a P/E of 15.5 and dividend yield of 2.54%<sup>1</sup>.

## Emerging Markets Undervalued vs. Fundamentals



Source: MSCI Barra, UBS

## Still Discounting Past Crises

So, are markets hopelessly inefficient, pricing likely high and low growth similarly, or is there a rational explanation for this disparity? The answer lies in the history of emerging markets, which have in the past suffered numerous crises. Since 1997, there have been six monthly returns worse than 10% in developed equities, whereas there have been 16 such months in emerging markets.

The discounting of such crises may explain why expected emerging market growth does not command a premium, but what is the likelihood that they will recur at the moment? Many emerging markets have built substantial sovereign wealth funds that would cushion them in the event of a global downturn and which allow fiscal stimulus without the associated debt. While the U.S. Federal Reserve contemplates a possibly further round of quantitative easing, central banks in places like Brazil and India need to contend

<sup>1</sup>Source: Bloomberg

## Emerging Markets Equity Outlook (Cont'd)

with reasonably high inflation. The resultant higher central bank base policy rates gives those emerging markets room to cut rates if needed to mitigate renewed recession in developed economies.

### Political Risk Waning

Political concerns have held back some markets, with the Brazilian elections perhaps weighing on that market, and some nervousness surrounding a constitutional referendum in Turkey. Most key political events are behind us for this year, though, and most governments are stable, comparatively prudent compared to some of their predecessors, and in general likely to respect private property.

So, emerging markets generally have more attractive growth prospects, and reasonable valuations and

political backdrops. In contrast to many developed markets, where the working age population is decreasing, countries like India and Turkey have very attractive demographics. Emerging markets are not a one way bet, even though they have been incredibly attractive for the last 10 years. If there is a substantial second recession globally, it is likely that investors will sell emerging market equities almost instinctively. But quantitative easing and zero-interest rate policies in the developed world are creating tremendous pressures, pushing money into emerging markets. As an asset class, emerging markets are also structurally very attractive for the long term.

*Peter Mennie is Senior Portfolio Manager at MFC Global Investment Management (Europe) Limited. He is based in London, England.*

## Asian Equity Outlook



Linda Csellak

**Strong domestic consumption...looks set to be the key structural theme underpinning the markets for quite some time.**

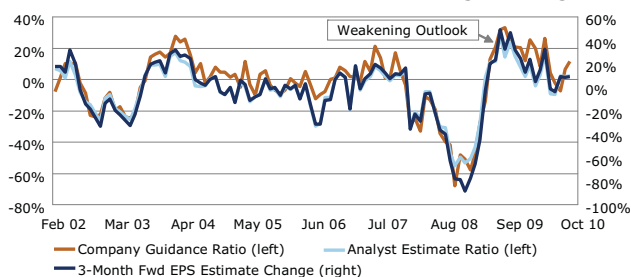
Stronger than expected earnings in the first half of 2010 have left Asia's markets fairly valued in our

opinion and we continue to believe that investors should brace themselves for 2011 earnings expectations to be pared down. However, our expectation is that this will lead to little more than a healthy pause for Asian markets after a period of volatility this year.

While some companies have merely shaved 2010 full year earnings expectations, we expect to see more extensive cropping of 2011's forecasts. Once this is reflected in share prices, we believe that Asian markets will present a potential buying opportunity for savvy investors. Until then, our focus is on individual stock selection.

Looking at what the earnings season tells us about regional markets, it's clear that the dominant theme

### Asia Vulnerable Near-Term to Weakening Earnings



Note: Company Guidance Ratio = (Rising guidance minus falling guidance)/Total guidance. Analyst Estimate Ratio = (Upward revisions minus downward revisions)/Total revisions

Source: Macquarie Securities Group

remains that of strong domestic consumption in the ASEAN<sup>1</sup> nations. These countries comfortably beat earnings expectations – particularly the Philippines, where strong domestic demand has been driven by resilient consumer sentiment. This consumption story looks set to be the key structural theme underpinning the markets for quite some time.

Increasing political stability, already an important support to Indonesia's stock market, is also driving consumer confidence in the Philippines, following this year's elections. Likewise, consumers and investors in more turbulent markets like Thailand have been able to dust themselves off after the unrest earlier this year and continue to forge ahead. This resilience shows little sign of abating.

### Domestic Consumption Story

The domestic consumption story is not limited to the Southeast Asian markets, but is a prevalent theme in North Asia too. In Taiwan and South Korea, we have been underweight the traditionally strong technology sector, which has underperformed of late, and are focusing instead on individual consumer stocks that offer relative value. We have successfully rotated between these stocks wherever we find value and have

begun to add back into tech in certain theme segments, such as companies in the Apple product chain.

So what might derail consumer and investor sentiment in Asia? Some commentators are murmuring about the resurgence of inflationary pressures, but while it's important to keep an eye on this, we believe inflation is unlikely to affect the markets any time soon.

One concern that should be kept in mind is liquidity. Any cracks in the U.S. bond market are likely to see money being ploughed into U.S. equities which, we believe, offer some attractive valuations. It's possible that investors in Asia's emerging markets could follow suit and turn their attention towards U.S. equities if valuations remain cheap. Any sudden and significant move westwards would present the Asia region with liquidity challenges. Overall, though, we think this is a relatively minor risk as the Asian growth story is a long-term theme for many investors and the region has emerged firmly intact following the global financial crisis.

### India, Australia Bear Watching

Turning to individual markets, we maintain a cautious overweight position in India where concerns about overheating valuations are weighing on investors' minds. In particular, we are seeing some very full valuations in large cap stocks.

While domestic investors have been selling the market, Indian stock valuations have been supported by strong demand from foreign investors. However, as foreign portfolio investment can expose markets such as India's to large, sudden cash flows, investors should keep a watch for any sign of a reversal in those flows as this could herald declines in the market.

<sup>1</sup>Association of Southeast Asian Nations (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam)

## Asian Equity Outlook (Cont'd)

Australia has been in the news in recent weeks as investors awaited the final outcome of elections. Although the incumbent Labour government received enough independent support to form a minority government, the narrow margin of victory still leaves much uncertainty. The country is a two-speed economy, buoyed by a booming resources industry but held back by a moribund services sector.

One area where we think investors need to be careful relates to the controversial mining tax. Following pressure on Australia's new Prime Minister from a disgruntled mining industry, the current tax is a watered-down version of the unpopular Resource Super Profits Tax originally tabled by the outgoing government. While the markets appear to believe that this issue has all but gone away as a result of these changes, we believe that with the Greens poised to take control of the Senate and support from the Independents, the tax could be very much back on the agenda. What is clear is that any signs of further

intervention by the government in terms of raising taxation levels and imposing an additional round of taxation onto a profitable sector are likely to hurt investment in the sector.

In China and Hong Kong, the markets are being dominated by uncertainty and this is encouraging companies to push through capital-raising. We are seeing a real rush of companies coming to the markets with placements. This could be a sign of general nervousness about market levels with companies keen to get their deals through while the market is healthy. The view that a degree of correction is on the way is compounded by the fact that trading volumes have been comparatively low. This suggests that significant sums of money may be sitting on the sidelines waiting to buy in to these markets on any dips.

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## Greater China Equity Outlook



**Matthew Lee**

**The economic rebalancing trends currently at work in China are expected to benefit consumption and infrastructure stocks.**

China's rapid urbanization and shift from export-driven to domestic consumption-driven growth are among the secular trends that continued to influence the direction of Greater China equity markets in the third quarter of 2010.

Domestic consumption is being supported, in part, by rising salaries. However, rising labor costs are in turn putting pressure on manufacturers and export-related companies – decreasing their competitiveness compared to other Asian nations. In response, investment flows are moving to the interior of China as companies search for cheaper wage costs and an 'early-mover' advantage in tapping nascent consumer

demand in these developing parts of the country. We expect to see significant infrastructure improvements as the government seeks to encourage and support these moves.

### Chinese Wages Have Been Rising



Source: HSBC

### Secular Themes Drive Opportunities

The rising labor costs may hurt manufacturers and export-related stocks in Greater China. On the other hand, mainland cement and consumption stocks are expected to benefit from the urbanization, rising wages and economic rebalancing trends. The information technology services sector is expected to benefit from the increased penetration of IT services in China. Finally, Chinese telecom operators are expected to see forthcoming positive cash flows and growth in data revenue because capital expenditure on third generation (3G) cellular infrastructure appears to have peaked.

In Hong Kong, the market is focused on a couple of key themes. The first and perhaps most important is the development of Hong Kong as an offshore currency market for the renminbi (RMB). In the last few months, we have seen large organizations such as fast food chain McDonald's issue RMB-denominated bonds to institutional and retail investors in Hong Kong.

It is estimated that the Hong Kong banking system net profit pool will rise significantly over the next five years, in part because of the internationalization of the RMB. The short term net profit impact from RMB business is likely to be small (1-2% of bank net profit), but we believe that the trend is positive in the long term as regulatory easing continues.

### Hong Kong Property Cooling

Another theme is the continued fortunes of the Hong Kong property market, long a source of tabloid headlines and speculation. While the price of physical property continues to trade up, we expect stock prices for Hong Kong property developers to start lagging the market over the next few months. In October, the Chief Executive of Hong Kong announced a package of measures aimed at cooling Hong Kong's skyrocketing property prices.

Longer term, market watchers are keeping an eye on political transition as the Chinese Communist Party Central Committee reorganizes in 2012. It is widely anticipated that, as part of this transition, seven of the nine Politburo Standing Members will step down but it is not expected that these changes will alter the economic model. The focus will remain on stable, sustainable growth and the gradual shifting of the economy to rely less on external forces. We expect that the new generation of leaders, whether central or local, will be keen to maintain the status quo between now and 2012, and so we do not anticipate any major shifts in policy in the meantime.

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# Japanese Market Outlook



**Kaoru Kurata**



**Keisuke Tsumoto**

## Japanese Equity Market

*Kaoru Kurata*

**The yen's sharp appreciation is causing concerns about downward revisions for the second half and fiscal 2011 profit estimates.**

The Japanese economy continued its modest recovery during the third quarter of 2010. Private consumption seemed generally strong during the summer, thanks to extremely hot weather and last minute demand for energy efficient cars ahead of the expiration of buyer incentives. Accordingly, business sentiment improved across all sectors in the September Tankan survey from the previous survey in June, but the survey also showed worsening sentiment going into the year end, due to the expiration of the eco-car measures and the recent surge in the Japanese yen.

In September, the government intervened in the foreign exchange market for the first time since 2004 on concerns that the yen's appreciation would threaten the recovery. Japanese intervention has little support from other nations, which are devaluing their own currencies to help drive exports, and is expected to have little impact on the yen's strength.

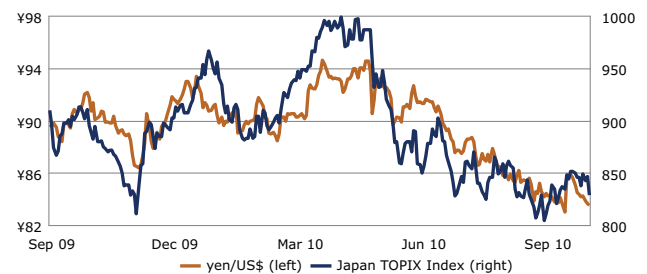
Japanese equities touched their lowest level for the year at the end of August, before the yen intervention by the government and the Bank of Japan (BOJ). Nonetheless, the market continues to lag other global

equity markets due to investor skepticism that Japanese authorities will be able to do anything to halt yen gains.

## Strong Yen Threatens Profits

Going forward, earnings announcements for the second quarter of fiscal 2010 (ending March 31, 2011) scheduled toward December will stand out as the primary driver of market direction. Despite consensus estimates earlier this year of growth in recurring profits of more than 50%, the yen's sharp appreciation is causing concerns about downward revisions for the second half and fiscal 2011 profit estimates, especially in sectors with a higher reliance on exports.

## Stronger Yen Weighing Down Japanese Equities

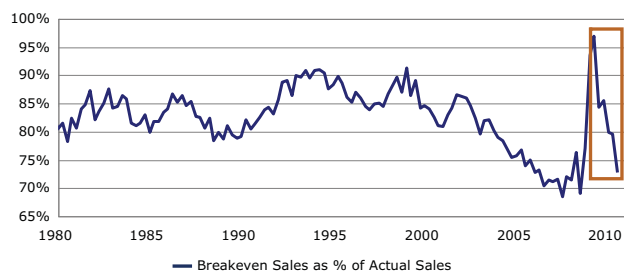


Source: Bloomberg

Given the somewhat difficult broader near-term stock market environment, we are selectively looking for stocks and sectors to outperform. Along with evidence of earnings resilience against currency volatility, we are looking for companies that can benefit from cost cutting initiatives and those that can grow market share in emerging markets because of strong brand recognition.

Factory automation is an example of the former. Due to increasingly sophisticated manufacturing, and a surge in labor disputes and associated costs, we expect factories in China to show strong demand for automation systems.

### Corporate Breakeven Level Plunged on Cost Cutting



Source: Japanese Ministry of Finance

Japanese consumer goods and services are also winning strong brand recognition in neighboring Asian nations. Inbound tourism to Japan from these countries is once again hitting record highs, and this should be correlated with higher consumption of higher-value added Japanese consumer goods with strong brand recognition (such as cosmetics), despite anemic domestic demand due to low growth in household incomes and an aging domestic population.

## Japanese Fixed Income Market

*Keisuke Tsumoto*

**We see little relative value in either the short end or the long end of the yield curve and remain overweight in intermediate maturities.**

The Japanese Government Bond (JGB) yield fell sharply over the course of the recent quarter, with the 10-year yield falling to 1.1% at the end of June from 1.4% at the end of March. Eurozone financial problems and a deteriorating global economic outlook, along with political uncertainty surrounding the appointment of the new Prime Minister, Naoto Kan, drove Japanese yields to their lowest levels since 2003. We believe, though, that Japan's large financial surplus was the strongest contributor to the Japanese

bond market rally. Japanese banks have a large excess of deposits over loans, and the gap has widened sharply recently. Japanese corporations are still repairing their balance sheets and demanding fewer loans from banks, while households continue to save large amounts. Banks have to close this imbalance by investing in bonds – JGBs and corporate bonds.

Even with this bond-friendly backdrop, it is difficult to expect a further rally in Japanese bonds. If the 10-year yield were to decline below the 1.0% level, it would reflect market discounting of a renewed global recession and anticipated additional monetary accommodation by the Bank of Japan and other central banks. The 10-year yield reached its historic low of 0.4% in June 2003, and at that time the Bank of Japan was in the midst of quantitative easing and the overnight call rate was virtually zero. Now, the call rate is around 0.1%, and the market is not expecting any more monetary accommodation by the Bank of Japan.

As nominal interest rates do not go below zero by definition, bond investors should be aware of the asymmetrical risk of investing in low yielding fixed income instruments. We do not believe JGBs at current levels are attractive, and look for other sources of return such as credit and structured products. While we have a negative bias on the JGB market overall, we are concentrating our JGB holdings in intermediate maturities because of a higher rolling yield. We also maintain a moderately positive view on corporate credit.

*Kaoru Kurata is Senior Portfolio Manager, Japanese Equities, and Keisuke Tsumoto is Head of Japanese Fixed Income Investment at MFC Global Investment Management (Japan) Limited. Kaoru and Keisuke are based in Tokyo.*

# Global Fixed Income Outlook



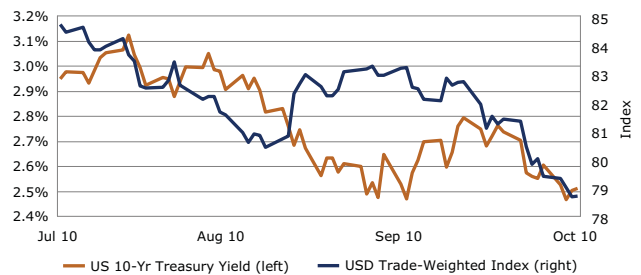
Barry Evans

**In this low, but steady growth environment, U.S. corporate bonds, particularly high yield debt, should perform well. We also continue to be bullish on non-Japan Asian currencies.**

Heading into the end of the year, the current market focus is on the perceived slowdown of the global economic recovery and the potential need for further monetary stimulus measures in some developed markets. The sovereign debt crisis which roiled Europe in the second quarter appears to have stabilized. While risks in the peripheral Eurozone nations still exist, they appear to have been contained through actions taken by both the European Central Bank (ECB) and the International Monetary Fund.

In the United States, the market is already pricing in moderate quantitative easing by the Federal Reserve, causing Treasury yields to tighten to levels not seen since early 2009. The question now seems not whether further quantitative easing will be initiated in the U.S., but the degree to which it will occur. We would not be surprised if the Federal Reserve were to engage in a new moderate quantitative easing program before the end of the year. Recent economic releases have been mixed, but overall have indicated a lower level of U.S. growth than the Fed desires.

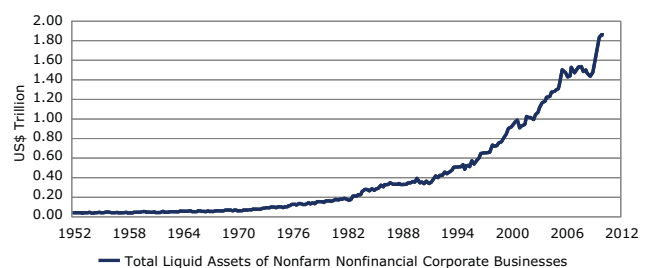
## USD, Treasuries Pricing in More Easing



Source: Bloomberg

We expect U.S. GDP growth to remain in the 1-3% range. In this low, but steady growth environment, U.S. corporate bonds, particularly high yield debt, should perform well as investors seek higher investment income. While yields on corporate bonds have come down considerably from their peaks in 2008, high yield debt still offers a premium of 6 percent above Treasuries. Corporate default rates continue to decline in the U.S., from a recent peak of nearly 11% almost one year ago to less than 3%. While credit has been tight for consumers, corporations have been able to issue bonds at a record pace this year, taking advantage of the low interest rate environment to refinance existing debts or shore up balance sheets. Cash levels on corporate balance sheets are at their highest ever.

## Record Cash on the Sidelines



Source: Ann Arbor Research

Stabilization in Europe and increased expectations of a weaker U.S. dollar brought on by potential further

accommodative monetary policy in the U.S. saw strong performance for many developed currencies over the past quarter. On the back of two central bank rate increases during the period, the Swedish krona was the best performing currency, gaining almost 15.5% versus the U.S. dollar. The euro itself also exhibited strength, rallying from the year to date low in early June back to levels seen just prior to the outbreak of the sovereign debt crisis.

### Currencies Prompting Intervention

The rally in currencies has not been without policy implications. In mid-September Japan intervened in the currency market for the first time since 2004. Although their actions did initially weaken the yen as desired, it quickly rallied back to the level seen at the time of the intervention based on market skepticism over the ability of non-coordinated unilateral intervention to ultimately be successful. Showing that the slowdown in growth has not affected all regions similarly, while some central banks consider further easing, there are numerous others including those in Canada and New Zealand that continued to hike rates over the period.

A battle over the strength of the Chinese renminbi has been escalating between the U.S. and China, with the U.S. recently working on legislation intended to give it more tools to combat what it considers undervalued subsidized currencies. Since the announcement by the Chinese central bank at the end of the second quarter that it would end the renminbi's peg to the U.S. Dollar, the currency has appreciated roughly 2%. China has also moved towards internationalization through the creation of an offshore renminbi-denominated fixed income market eligible to anyone trading in Hong Kong. While this market is currently in its infancy, it is expected to grow quickly.

Recent economic indicators have been mixed in regards to the prospects of growth; however we do not anticipate renewed global recession. We continue to expect the divergence of regional economic growth prospects to remain pronounced. Capital continues to flow into emerging markets, particularly in Asia.

We continue to be bullish on non-Japan Asian currencies such as the Korean won, Indonesian rupiah, and Singapore dollar, as well as to a lesser extent, the Malaysian ringgit and Philippine peso. Outperformance in these currencies has already occurred in many cases; for example, the Singapore dollar increased roughly 6% versus the U.S. dollar over the past quarter. However, we expect strong performance to continue in the future as these economies transition from being driven by exports to being driven by domestic demand.

Traditional commodity currencies such as the Australian, New Zealand, and Canadian dollars should continue to benefit from growth in Asia. However, we foresee having to be more tactical in managing exposures here. We continue to remain constructive on the Brazilian real due to strong domestic growth and high prevailing interest rates. Relative to the aforementioned growth areas, we anticipate that most currencies of the Group of Seven industrialized nations will lag in performance. Of these the British pound seems weakest, as there has been increasing talk of further monetary easing in the United Kingdom.

*Barry Evans, CFA, is Chief Investment Officer, Global Fixed Income, at MFC Global Investment Management. He is based in Boston, Massachusetts.*

# North American Fixed Income Outlook



Terry Carr

**While the recent bond bull market has largely run its course, further gains in the months ahead are possible as credit spreads grind in toward historic norms.**

Weakness in the Canadian economy became more apparent in the third quarter of 2010. Weaker than expected job gains and a general sense of unease among consumers prompted many to rethink spending plans. Real estate activity has eased and recent polls suggest that (at least in Ontario) consumers feel worse off than they did just a couple years ago. In all, economic growth forecasts have been ratcheted lower and the Bank of Canada (BOC) is now expected to desist from further interest rate hikes for the rest of the year. Extremely lackluster economic performance in the United States has contributed to a cooling off of Canada's economic fortunes, and many investors now expect the U.S. Federal Reserve will hold off on rate hikes until 2012. With so much slack in both the U.S. and Canadian economies, inflation on both sides of the border is well contained and should continue to underpin further healthy fixed income returns for the balance of the year.

Signs that the global economic recovery will take longer than expected boosted bond markets during the quarter. Canada's DEX Universe Index returned 3.15%, led by a 4.47% return on provincial bonds

and a 3.16% gain for investment grade corporate bonds. New deals came at a slower pace this past summer, but for the year as a whole, issuance has been robust. With negligible yields on cash balances, appetite for new fixed income product remains healthy, especially from foreign investors. In the seven months ending July, foreign investors added a hefty \$56.5 billion of Canadian bonds to their portfolios, compared to \$47.2 billion in the year-earlier period.

## Curve Flattened on Weakening Recovery

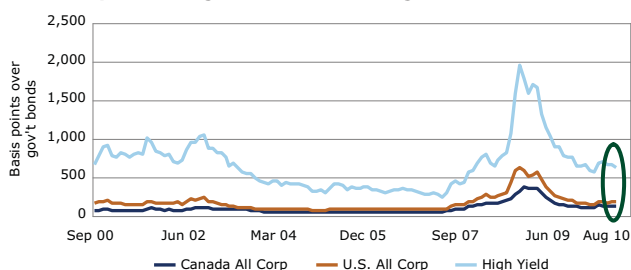
	2-year yields	30-year yields	2-30-year spread (bps)
<b>U.S.</b>			
Jun. 30	0.60%	3.89%	329
Sept. 30	0.43%	3.69%	326
<b>Canada</b>			
Jun. 30	1.39%	3.65%	226
Sept. 30	1.38%	3.36%	198

Source: Bloomberg, PC Bond

## Spreads Narrowed In Q3

Credit spreads were modestly narrower in Q3 after widening out meaningfully in a very tumultuous Q2. Corporate spreads are still 40-50 basis points (bps) above historic averages. Demand for new corporate bond issues is firm, with most new deals being oversubscribed and still providing attractive capital gains in secondary market trading once priced. U.S. investment grade credit spreads narrowed by about 17 bps in Q3 and high yield spreads were about 90 bps tighter.

### Credit Spreads Tightened on Strong Demand



Source: PC Bond, Merrill Lynch

Recent lackluster employment and housing headlines have cast a dark cloud over consumer psyches, and many are having a hard time justifying big spending plans. The jobless rate is still high, and concerns about renewed recession are on the rise. Ottawa is set to turn off the fiscal stimulus spigot in March and the broad-based private sector demand rebound which the Bank of Canada has looked for as the lynchpin in this year's and next's growth outlook has yet to materialize. We expect that the ongoing economic rebound in Canada (and in the U.S. and other industrialized nations) will be a long drawn out process.

Amidst the general weakness, though, Canada continues to outshine most other industrialized nations. It's not only the U.S. that is facing a weak outlook. The European Union continues to struggle with its fiscal mess and, recently, bank bailouts have resumed in Ireland (as well as increased fiscal issues in Spain, Portugal and Greece).

### Canada Seen As Safe Haven

All the turmoil has helped generate firm demand for Canadian government bonds, particularly among foreign buyers, who view Canada as a better bet than most U.S. or European issuers. The interest should also help the Canadian dollar hold its bid and fluctuate around the 95 cents (U.S.) level for the remainder of the year. A loonie at par or better is not

expected until oil can catch a sustained bid, and that will not happen until the U.S. economy also finds some traction.

One worrisome trend for fixed income investors is the extent to which Canadian governments at all levels allow their fiscal houses to deteriorate in the coming months. Even with the prospect that Ottawa will shut off the fiscal stimulus spigot next spring, national and most provincial finances are still deep in the red and are not expected to return to a more balanced status for a few more years (at least). The reining in of budget deficits should be a priority if Canada is to continue to lead the global economic pack.

We continue to favor corporate bonds. While the recent bond bull market has largely run its course, further -- albeit more modest -- gains in the months ahead are possible as credit spreads grind in toward historic norms. With inflation in check, a large increase in bond yields is not expected any time soon. Our team has not succumbed to double-dip recession fears. We still expect growth to remain positive and unemployment to ebb lower. Inflation is well contained, and the recent uptick due to the introduction of the harmonized sales tax in Ontario and British Columbia will only be transitory in nature. The Canadian fixed income team is still overweight in corporate credit, just as it has been for over the past year, and will continue to focus on fundamentals, look for relative value and play the capital structure of individual names to add value. The team, however, is cognizant that any uptick in economic fundamentals will prompt the BOC to boost rates again as conditions warrant and remains ready to position itself accordingly, once that occurs.

*Terry Carr is Vice President and Managing Director, North American Fixed Income, for MFC Global Investment Management. He is based in Toronto.*

# Asian Fixed Income Outlook



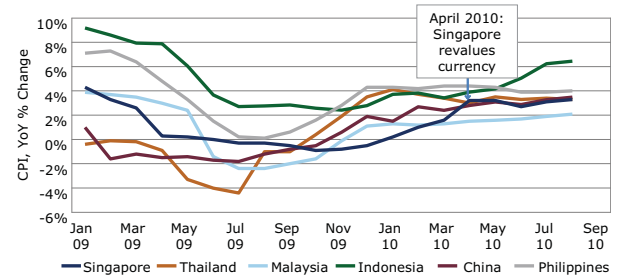
Endre Pedersen

**We expect to see emerging markets, particularly those in Asia, generating some attractive high yield opportunities in the coming months.**

'Run to inflation, not away from it' – this is not normally the view of bond fund managers, it's true. However, in the case of emerging market bonds in particular, this statement has resonance.

While bond managers would usually be running in the opposite direction to inflation, early stage inflation can be a key indicator of pricing power and healthy cash flows among corporates. It can be a homing device for currency appreciation and so we believe that there is benefit in tracking inflation to get exposure to uplift in Asia's currencies. Singapore is just one example of a country where strong growth stoked inflation concerns which led to the government taking steps to allow the Singapore dollar to appreciate earlier this year. Our overall view is that inflation will continue to rise at a decreasing rate, indicating strong cash flows, but that there may be less need to fear the long term impact of inflation on bond returns.

## Inflation Could Presage Asian Currency Revaluations



Source: Bloomberg

As markets seem to be adjusting to expectations that the U.S. is unlikely to dip back into recession, many commentators are factoring in growth, albeit slow growth. In Asia meanwhile, inflation is a sign of continued growth and strong demand. One sector showing strong evidence of this is the airline industry, which continues to operate at near full capacity. While we expect economic growth to drop from the high levels of Q2, any declines are unlikely to be dramatic. This growth and inflationary environment is positive for high yielding companies, which tend to be growth companies which rely on strong demand. We expect to see emerging markets, particularly those in Asia, generating some attractive high yield opportunities in the coming months.

## Emerging Asia Coming To Market

For our part, we are rotating out of New Zealand and Australian bonds and increasing our exposure to Philippines bonds, among others. The Philippines has seen increased investor interest after it raised US\$1 billion in its debut sale of global peso bonds in September. The deal was significantly oversubscribed and this bodes well for expectations of similar deals from other emerging markets in Asia. We believe countries like Vietnam are watching the Philippines' example closely as they too look for simple ways to drive inflows into their countries, while mitigating their own exposure to currency risk.

One of the most significant announcements in Asia's bond market recently was the launch of renminbi-denominated bonds in Hong Kong, seen as a significant step towards the liberalization of the Chinese currency. The first such deal was from fast food chain McDonald's. China Development Bank, a quasi-government organization, followed suit, and we expect to see other headline-grabbing deals under this initiative.

We believe the Chinese onshore and offshore bond market is at the starting point of a long period of sustained development. Those investors that are able to access the market at an early stage in this development, such as those investing through a Qualified Foreign Institutional Investor (QFII) license, are likely to be well placed to benefit from the expansion of this market.

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