MFC Global Investment Management®

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TACTICAL ASSET ALLOCATION VIEW

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The short-term outlook is for a 3-6-week risky asset relief rally followed by the next down leg. Market gains or any apparent bottoming out are not expected to be sustainable. We are using those opportunities to de-risk portfolios ahead of a major correction expected later in the fourth quarter or early in the New Year.*

Asset and Market Survey

Economy — Expected to continue surprising on downside

The Tactical Asset Allocation team continues to expect economic data to disappoint in the short term and believes any rallies in asset values should be used to reduce risk exposures. While some indicators may appear to bottom out in coming weeks, we expect this will just be a pause before a further leg down in late 2010/early 2011. Manufacturing is expected to contract again in the next few months once the global inventory rebuilding cycle is exhausted, and the U.S. housing market is also perilously close to a "double dip". Although China's PMI numbers for August were better than expected, they still point to slowing global growth. We continue to rate the prospects for further overall economic contraction as low, however.

Fixed Income — Negative on high yield, neutral on high grade

High yield bonds held up well earlier this year because of their link to a then recovering U.S. economy. With the U.S. now slowing, high yield bonds are now vulnerable, although a true sell-off could still be three to four months out.

It looks safer higher up the capital structure. Quality investment grade corporate debt is likely to at least hold onto its value in the short term, while government bonds could see gains, depending on the severity of the economic slowdown.

Equities — Negative; yields reflect escalating risk

Much has been made of how attractively valued equities are, based on earnings yield. We think equity yields, which in the U.S. now rival those on high yield bonds, will get more attractive yet as markets will need to price in a further deterioration in conditions. U.S. equities could see declines cushioned by safe-haven demand for U.S. dollar denominated assets.

Emerging Markets — Negative on sensitivity to slowdown, portfolio de-risking

These markets are sensitive to weakening global demand and risk appetites. China is the bellwether among these markets, so they would be expected to react particularly strongly to any external demand related negative surprises there.

Currency — Positive on U.S. dollar in flight to quality

The U.S. dollar might take a bit of a breather after rallying sharply recently, but is expected to rise in the short term as deteriorating economic and market conditions boost demand for safe-haven assets.

Commodities — Negative on weakening global demand

Industrial commodities face further downside. For example, copper inventories plunged during the second quarter, but remain near historical highs.

* "Short term" </= 6 months, "Long term" > 6 months

Oil has held above $70 per barrel, but the fall is a weak season. Gold is a standout, and could benefit from rising risk aversion.

REITs — Neutral as strong fundamentals balance outperformance

This market remains the best performer year to date, buoyed in part by nervous bond investors attracted by the high and possibly rising income pay-outs that REITs offer. Sector activity is muted, but balance sheets are healthy.

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