MFC Global Investment Management®

WINTER 2009-2010

Canada Economic Outlook

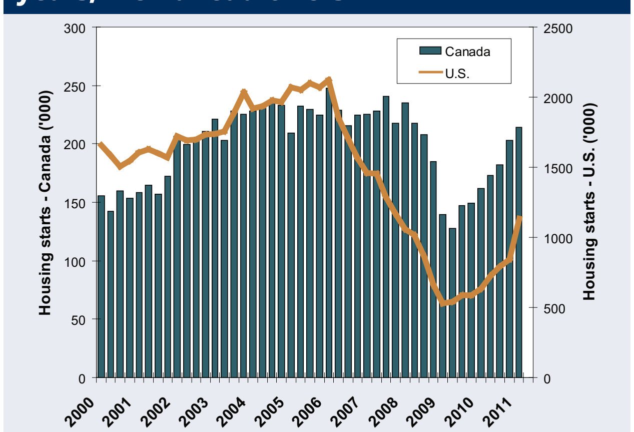
Climbing out of recession, barely

Canada joined the U.S. with positive real growth in the third quarter of 2009, though the 0.4% rate looks tiny beside a 2.2% surge in the U.S.

Behind the somewhat disappointing headline number, the components are more reassuring. Final domestic demand jumped 4.7%, underpinned by a solid 3.1% gain in consumer spending, assisted by growth in business investment, housing and government spending. The negatives were inventories and imports – both of which are likely to be turning around in the quarters ahead.

While there are still areas of weakness, the overall picture for Canada is promising. Job growth is on a positive trend despite great volatility; and the housing market seems set to recover steadily from its recent lows – which were never close to the depressed levels reached in the U.S. and other bubble-prone economies. The banking system came through the crisis in the best shape of any major developed economy, and the global recovery is expected to lift demand and presumably prices for Canada's key commodity exports.

Housing Starts: fell "only" 40% in Canada, now set to rebound to normal over two years, well ahead of U.S.



Source: U.S. Census Bureau; Statistics Canada; MFC Global Economic Research forecast

A healthy economy in a not so healthy neighborhood

The big question mark for Canada is the strength of the U.S. recovery. Sluggish growth or even a double-dip recession would drag down Canada hard, but as the indicators in the U.S. improve, so does the outlook for Canada's exports to the south. The exchange rate will cause stresses throughout the manufacturing sector, but a strong currency will also restrain inflation and allow the Bank of Canada to keep rates lower for longer than it otherwise might have chosen.

So far, Canadian manufacturing has been boosted by the temporary resurgence of auto sales and related industries (transportation equipment, rubber, primary metals). The problems of maintaining competitiveness will tend to increase as the exchange rate is driven higher by investors looking for a "commodity currency," but commodity exports themselves should sustain the trade balance and permit continued growth with a more domestic orientation.

Inflation: no great concern

Inflation in Canada is non-threatening, and seems likely to remain so for at least another year. The headline year-over-year comparisons reflect the history of oil prices, but the underlying monthly trend is tame. Core inflation is expected to stay comfortably under 2% throughout 2010, with the Bank of Canada's measure of the output gap (the degree of slack in the overall economy) holding at just over 4%. This should leave plenty of time to tap the brakes and keep inflation in check for the foreseeable future. Since Canada has avoided the worst of the global crisis, and enjoys the strongest fiscal position of any major economy, there is little risk that the Central Bank will be lax in its pursuit of price stability in the years ahead.

Canada Economic Research Forecast Summary

Winter 2009-2010

% Change at annual rate	2009.1	2009.2	2009.3	2009.4	2010.1	2010.2	2010.3	2010.4	2011.1	2007	2008	2009	2010	2011
				Forecast						Year-over-Year % Change or Annual Average				
Real GDP and Components														
GDP	-6.2	-3.1	0.4	2.6	3.1	3.6	3.9	4.0	4.1	2.7	0.4	-2.6	2.5	3.9
Personal consumption expenditures	-1.4	1.8	3.1	1.8	3.2	3.7	4.1	4.8	5.0	4.5	3.0	0.0	3.1	4.2
Business Fixed Investment	-31.4	-16.6	4.2	-11.5	-5.0	1.0	1.7	2.5	4.5	3.5	0.2	-15.1	-3.6	4.0
Residential investment	-20.6	7.4	8.1	0.0	-3.0	0.0	1.0	1.0	2.0	3.0	0.0	0.0	0.0	0.0
Government purchases	3.0	5.2	7.9	6.1	6.8	4.2	4.0	3.2	3.0	4.2	4.8	4.2	5.6	2.8
Change in inventories ($ bill CAD)	-10.6	-9.1	-5.8	-3.2	-0.7	1.1	4.2	5.9	5.7	13.2	15.9	-3.8	2.6	7.6
Exports	-29.8	-19.5	15.3	7.9	2.7	4.1	4.6	5.5	5.7	1.0	-4.7	-14.0	4.2	5.7
Imports	-39.2	-6.9	36.0	3.8	3.8	4.6	6.1	6.4	5.8	5.5	0.8	-13.9	7.2	5.9
Unemployment rate %	7.6	8.3	8.6	8.8	9.1	8.8	8.9	8.7	7.9	6.0	6.2	8.3	8.9	7.1
Private housing starts (thous. units)	140	128	148	149	162	173	182	203	214	228	211	141	180	218
Prices														
CPI	-0.9	0.1	0.4	2.5	1.3	1.3	1.9	1.6	1.8	2.1	2.4	0.2	1.4	1.8
CPI excl food & energy	1.0	2.1	1.2	1.4	1.1	1.0	1.7	1.3	1.7	2.0	1.7	1.7	1.3	1.6
FX USD/CAD	0.80	0.86	0.95	0.97	0.96	0.97	0.98	1.00	1.00	0.94	0.94	0.90	0.98	1.00
Interest Rates (avg. %)														
BoC Overnight Rate	0.83	0.25	0.25	0.25	0.25	0.25	1.00	1.50	2.00	4.4	3.0	0.4	0.8	2.7
Ninety-day Treasury Bill Rate	0.66	0.25	0.23	0.3	0.5	0.9	1.3	1.7	2.2	4.1	2.4	0.4	1.1	2.8
10-year Treasury Note Yield	2.95	3.20	3.44	3.5	3.7	4.0	4.1	4.3	4.4	4.3	3.7	3.3	4.0	4.6
Canada vs US														
GDP	0.2	-2.3	-1.9	-0.4	-0.2	0.2	-0.2	-0.5	-0.4	1.1	0.0	-0.1	-0.6	-0.3
Policy Rate (bps)	64	7	11	5	5	5	50	74	73	-67	103	22	34	86
3-m rate	45	8	7	20	33	49	65	69	62	-21	99	20	54	67
10-yr rate	8	-33	-1	15	0	7	-22	-30	-24	-36	-1	-3	-12	-17
CPI	1.4	-1.2	-3.2	0.6	0.0	0.2	0.9	0.6	0.3	1.0	1.2	0.6	-0.2	0.4
Core CPI	0.8	0.3	0.3	0.3	0.3	0.3	1.0	1.5	2.0	4.4	3.0	0.4	0.8	2.7

Forecast beginning in 2009.4

Changes from our last forecast

- Despite making some headway in the third quarter, GDP was below our prior estimate. Consequently, GDP growth in 2009 is a shade weaker than we anticipated. The growth profile in 2010 is largely unchanged.
- Lower than anticipated Treasury yields push forward the path towards higher rates in 2010, although we see them matching our prior forecast by 2011.
- A loftier CAD in Q3 suggests a faster than anticipated (although still likely to be bumpy) convergence towards parity with the USD.

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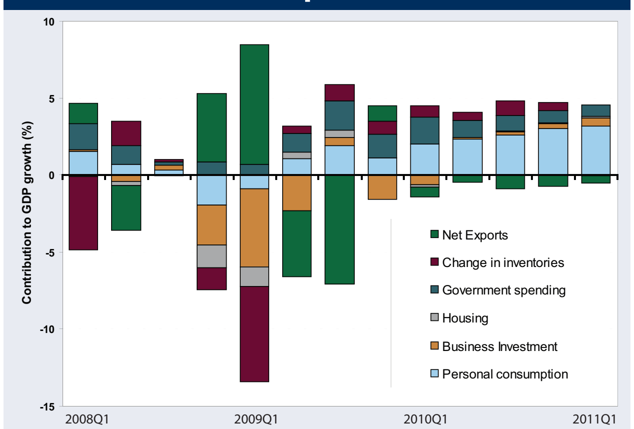
Employment: wobbly but definitely strengthening

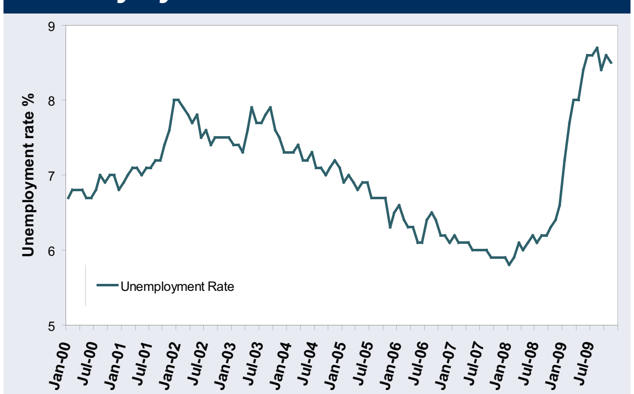
The surge in hiring in November has propelled expectations that growth is accelerating after the third quarter's somewhat anemic GDP. The gains were driven by full-time jobs, while part-time jobs have declined over the last four months. Nonetheless, there are still grounds for caution. Hours worked declined, and the average hourly wage actually fell slightly after three months of solid gains. The principal lesson is probably that not much weight should be put on any one particular month's data, and in this context the employment picture remains encouraging. Any reasonable calculation of a moving average trend suggests that the labor market has made a turn for the better. Barring any unhappy surprises from south of the border, employment is most likely to continue upward.

Stable growth ahead as consumer spending revives and the drag from trade and inventories dissipates



Source: Canadian National Income Accounts; MFC Global Economic Research forecast

Unemployment: probably past the worst, but only by a hair



Source: Statistics Canada

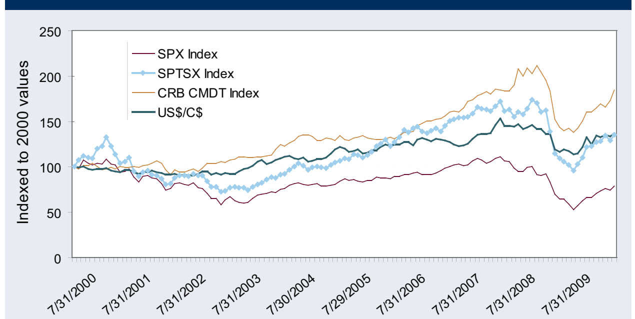
Canada Financial Markets

The loonie takes center stage

Higher commodity prices and the ongoing U.S. economic recovery are positive for the CAD. A modest rise in Canada's GDP and stable Fed policy in the U.S. should provide additional reasons for the Bank of Canada (BoC) to maintain the 0.25% rate floor through at least the first half of 2010. Furthermore, substantial spare capacity and a projected decline in core inflation mean that unless there is an unexpected surge in economic activity, the CAD/USD exchange (currently at 1.04) is still expected to move gradually towards parity.

We see the strengthening CAD as a key downside risk to Canada's monetary policy-stance. It is possible that a lofty *loonie* would more that offset the positive developments in the country's financial markets and economy. In this respect, policymakers have voiced their concern about the CAD strengthening too quickly, hinting that quantitative easing could be used to intervene in the currency market to prevent rates from rising and the CAD from strengthening any further.

Canada's market closely tied to commodity markets and the US$



Source: Bloomberg

Overall, we still believe that the BoC will not wait too long before moving policy rates from their current emergency lows to levels that could be deemed more neutral. As such, we anticipate that policy rates in Canada will go up before the Fed hikes them in the U.S., which should support the CAD.

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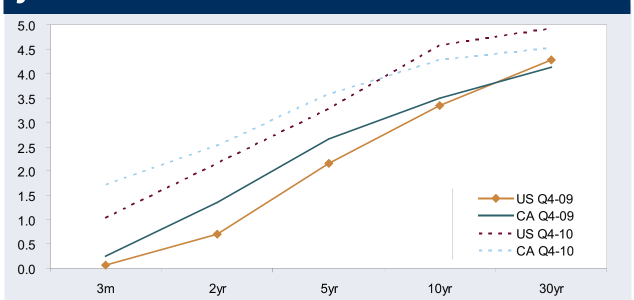
We look for the *loonie* to trade at parity by the third quarter of 2010. This would probably lead the BoC to hike policy rates more cautiously, although it would probably keep them 25-75 bps above the fed funds rate depending on the relative strength of the two economies. A more benign monetary policy in 2010 would require that expectations of core inflation fall below 1%, while the Fed remains on the sidelines until 2011.

Interest rates – higher yields an extra charm for U.S. investors

Canadian Treasury yields have steadied at low levels. Long-rates have regained some yield compared to U.S. rates, although at much lower levels than the lofty spreads at the end of 2008 and early 2009. Overall, the 10-year spread versus U.S. appears to be developing a small positive pattern. This is anticipated to dissolve as the Fed pulls back on its purchase programs, unless a second U.S. stimulus program goes into effect.

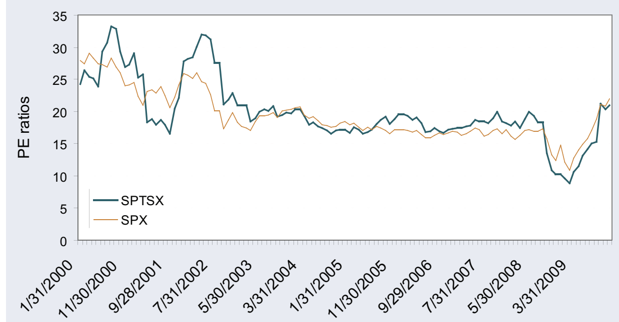
Given Canada's still-superior fiscal fundamentals and expected moderate currency appreciation, Canadian long-rates would likely fall below those in the U.S. Therefore, 10-year Canada-U.S. yield spreads enter into negative territory during the forecast horizon. This effect is anticipated to mute the rise in Canadian yields in the wake of expected BoC policy rate re-normalization.

Economic conditions call for a steeper yield curve in the U.S. than in Canada



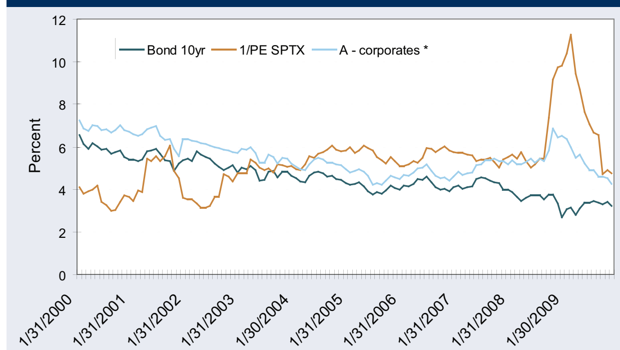
Source: Fed, BoC and MFC Global Economic Research

Trailing PE ratios highlight the markets' rising optimism...



Source: Bloomberg

...While a simple Yield valuation model (trailing basis) shows a closing gap between equity and corporate bond investments



Source: Bloomberg and MFC Global Economic Research; *Estimates exclude financial starting in 2008

Equity markets – facing the same fundamental risks as the U.S. market

Equity returns are likely to finish the year about 25% higher than in the U.S. This followed a significant price gains in commodities - which account for 45% of the Canadian Equity Index - which more than offset Canada's economic contraction.

At present, with interest rates relatively low, a simple trailing-yield valuation model is still suggesting that equities are the place to be compared to government bonds, although corporate bonds appear competitive. Forward looking, PE ratios seem more optimistic as they remain below their historical averages. However, we are concerned that a disappointing tide of future earnings at the time that the BoC starts hiking rates to a more neutral level might depress equity valuations. The outlook is fundamentally dependent on global growth and anticipated commodity price gains.

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Bill Cheney — Chief Economist
MFC Global Investment Management
Telephone: 617-572-9138
Email: bcheney@mfcglobalus.com

Oscar Gonzalez — Economist
MFC Global Investment Management
Telephone: 617-572-9572
Email: ogonzalez@mfcglobalus.com

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TORONTO BOSTON LONDON HONG KONG TOKYO

200 Bloor Street East, Toronto, Ontario, Canada M4W 1E5 Tel: (416) 926-6262

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