



Canada Economic Outlook

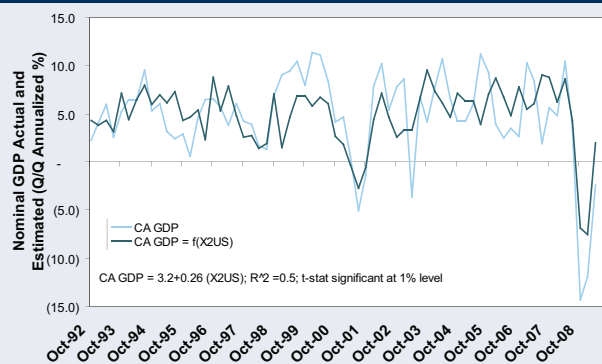
The stage is set for an economic recovery

...but a lot still depends on the U.S. economy

The sharp deterioration in the first half of 2008 and early 2009 in the Canadian economy is ending. Canada continues to benefit from sound fiscal and monetary policies, and less severe credit damage than in the U.S. Therefore, policymakers are in a good position to intervene more aggressively if domestic demand sputters.

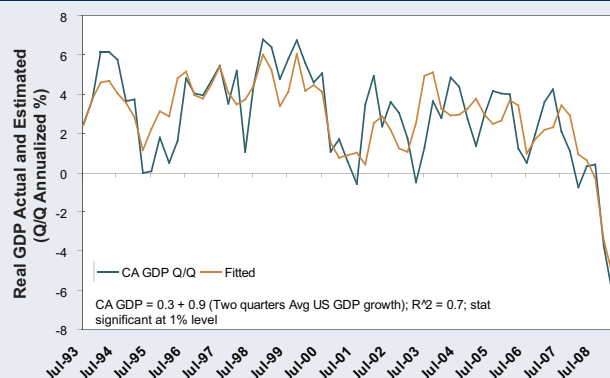
GDP fell 3.4% annualized in the second quarter, its third consecutive decline but significantly lower than the 6.1% recorded in Q1. However, positive signals from leading indicators for July and August (from new orders to housing) corroborate our sense that the economy probably started growing sometime in the third quarter, helped by an upswing in the inventory cycle, consumer and fiscal spending, and a U.S. economic bounce. With the macroeconomic foundation for an expansion in place, the main risk to the forecast is the extent to which domestic demand may need to offset the effects of a weaker than anticipated U.S. economy and the impact of an already strong Canadian dollar on the manufacturing sector.

A tight link between good-exports to U.S. and Canadian GDP...



Source: Statistics Canada and Economic Research

...With an even tighter macroeconomic link with the U.S. as a whole



Source: Statistics Canada, BEA and Economic Research

Net exports were responsible for the bulk of the weakness during the second quarter, as exports fell -19.3% after a massive -30.4% decline and imports slipped a smaller -8.5% after the -38.9% loss in Q1. Already in June and July, exports started to turn around, although we are still forecasting a drag on growth through next year. Firming global commodity prices and rising U.S. domestic demand are anticipated to offer significant support for Canadian exports. We note that both nominal exports and imports have increased since May and a surge in U.S. consumer demand could improve Canada's outlook to the upside.

Inventories exerted a modest, but still larger drag than we anticipated in the first half of 2009. Going forward, inventory liquidation will likely continue as the overall inventory-to-sales ratio remains very high. Nonetheless, some momentum in consumer spending is projected to reduce the inventory drag, pushing the inventory-sales ratio down, closer to historical levels.

Canada Economic Research Forecast Summary

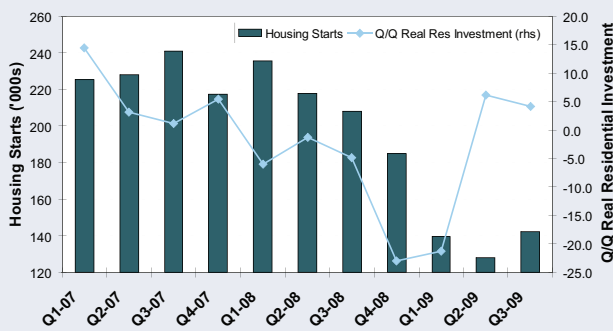
Fall 2009 % Change at annual rate	2008.4	2009.1	2009.2	Forecast						Year-over-Year % Change or Annual Average				
				2009.3	2009.4	2010.1	2010.2	2010.3	2010.4	2007	2008	2009	2010	2011
Real CAN GDP and Components														
Gross Domestic Product	-3.7	-6.1	-3.4	2.5	2.6	3.2	3.6	4.3	4.6	2.7	0.4	-2.4	2.9	4.2
Personal consumption expenditures	-3.1	-1.2	1.8	2.6	2.6	2.5	3.1	3.6	3.9	4.5	3.0	0.0	2.8	4.3
Business Fixed Investment	-16.2	-31.3	-17.0	-11.9	-10.4	-6.0	1.0	1.7	2.5	3.5	0.2	-16.7	-5.7	3.8
Residential investment	-5.0	-21.2	6.2	3.9	4.3	2.5	5.6	6.6	12.2	3.0	0.0	0.0	0.0	0.0
Government purchases	3.6	2.9	5.0	-7.5	6.3	6.8	4.2	4.0	3.2	4.2	4.8	2.2	3.6	4.3
Change in inventories (\$ bill CAD)	10.3	-8.9	-10.5	-7.5	-4.3	-1.4	0.3	3.3	4.7	13.2	15.9	-4.2	1.7	12.3
Exports	-17.7	-30.4	-19.3	5.3	2.8	3.2	4.1	5.6	7.5	1.0	-4.7	-15.4	2.5	3.4
Imports	-23.4	-38.9	-8.5	3.0	3.8	3.8	4.6	6.1	6.4	5.5	0.8	-17.0	3.5	6.5
Unemployment rate %	6.4	7.6	8.4	8.7	9.0	9.2	9.0	8.9	8.7	6.0	6.1	8.4	9.0	7.1
Private housing starts (thous. units)	185	140	128	142	144	152	158	162	178	228	212	139	163	223
Prices														
Consumer Price Index: CPI-U	-3.1	-0.9	0.1	0.0	1.4	1.2	1.5	1.8	1.8	2.1	2.3	0.1	1.2	1.9
CPI-U excl food & energy	0.8	1.3	1.1	1.7	1.0	1.0	1.3	1.4	1.4	2.0	1.2	1.2	1.2	1.6
Foreign Exchange Rate USD/CAD	0.83	0.80	0.86	0.91	0.94	0.96	0.97	0.98	1.00	0.94	0.94	0.88	0.98	1.00
CAN Interest Rates (avg. %)														
BoC Overnight Rate	2.00	0.83	0.25	0.25	0.25	0.25	0.25	1.00	1.50	4.4	3.0	0.4	0.8	2.7
Ninety-day Treasury Bill Rate	1.53	0.66	0.25	0.27	0.51	0.78	1.01	1.33	1.77	4.1	2.4	0.4	1.2	2.8
10-year Treasury Note Yield	3.44	2.95	3.20	3.51	3.69	3.87	4.01	4.10	4.25	4.3	3.7	3.3	4.1	4.6
U.S. GDP	-5.4	-6.4	-1.0	3.0	2.5	3.2	3.5	4.2	4.5	1.6	0.4	-2.6	3.0	4.2
Policy Rate vs. U.S.	148	64	7	5	5	5	5	56	56	-67	103	20	30	1
3m vs. U.S.	123	44	8	11	30	46	46	47	56	-21	99	23	49	12
10yr vs U.S.	19	8	-33	8	-24	-28	-30	-40	-43	-36	-1	-10	-35	-28

Forecast beginning in 2009.3

Statistics Canada and BoC; MFC GIM forecast beginning in 2009.3

Among some other positives since our last Outlook is a much smaller reduction in residential construction. Housing starts surged 12.1% to 150.4K in August, following the 2.6% drop in July. The August activity suggests a bottom to the housing recession and supports a stronger than previously anticipated growth in housing activity.

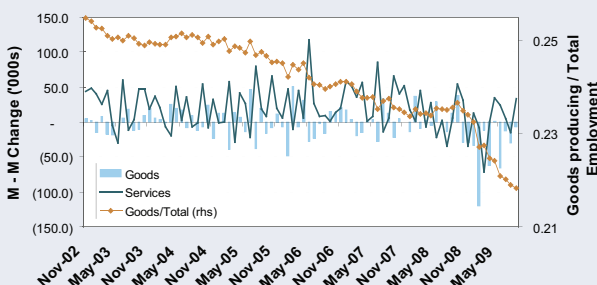
The worse of the housing market is likely over



Source: Statistics Canada

Led by new jobs created in the service sector, total employment grew in August, after losing about 31,000 jobs from May to July. Employment unexpectedly jumped 27,100 in August. However, the quality of the gain was less positive, with part-time jobs rising substantially and full-time jobs declining. The strength was narrowly focused in services sector, while the goods-producing sector remained weak, as manufacturing shed another 17,300 workers. The unemployment rate edged up to 8.7% from 8.6% in July. Looking ahead, positive but slow economic growth implies that unemployment continues to rise, peaking at about 9.2% before it begins to fall in the second half of 2010.

Employment is rebounding led by the service sector



Source: Statistics Canada

Labor productivity was also disappointing in Q2, as it unexpectedly stagnated for the second straight quarter. Indeed, productivity hasn't posted a solid gain in over three years. If the economy were at full employment, this disappointing metric would signal heightened inflation risks. But in the current environment of massive excess capacity and weak pricing power, absence of growth in productivity is probably bad news for business profitability.

Headline CPI fell -0.8% y/y in August 2009, the third consecutive negative reading. In contrast, excluding energy and food, consumer prices rose 0.9% y/y, a shade lower than the 1% recorded in July. Therefore, while core inflation remains near the Bank of Canada's (BoC) target of 2%, inflation pressure is very low. Going forward, even as overall inflation is poised to reaccelerate, core inflation is anticipated to slow because of the strong disinflationary pressures associated with the widening output gap and the appreciating Canadian dollar. At present, capacity utilization remains at a low point. Most notably, utilization in manufacturing dropped to a 64.2% low. This massive slack in industrial capacity is one of many indications of the sizable output gap that has opened up in the economy, which according to the BoC was at 4.3% of GDP in Q2.

In conclusion, the stage is set for a gradual but steady recovery in Canada. Much will depend on the U.S. economy, but with still many policy levers at their disposal, policymakers can keep the economy growing at least until the U.S. economy heals more completely.

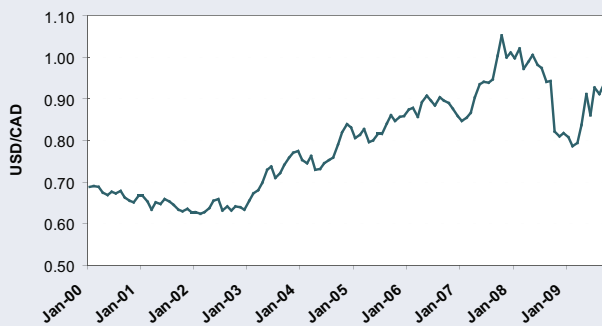
Financial Markets and Monetary Policy

Despite a brightening economic outlook, the level of slack in the Canadian economy remains wide enough to restrain inflation well into next year. The BoC has therefore conditionally committed itself not to raise rates until the middle of 2010, at the earliest. Of course, if the U.S. and global economies were to be surprisingly strong, and if oil prices drive headline inflation higher than expected, the policy outlook would change. For now, however, there is no plausible near-term scenario in which the risk of inflation would require urgent tightening action.

In addition to the substantial output gap and its downward influence on inflation, the strong Canadian dollar (CAD) has added another powerful reason

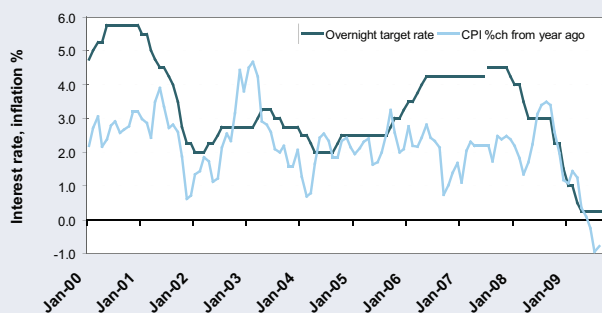
not to tighten policy. The strong CAD weakens the prospects for a revival in the manufacturing sector, which is already under siege from the troubles of the "Big 3" U.S. auto-makers. It also directly limits inflation by reducing the prices of imported goods – which for a small country with a large neighbor represent a substantial portion of consumer prices.

Strong C\$ adds to case for easy monetary policy



Source: U.S. Federal Reserve Board

Collapse in inflation permits near-zero target rate



Sources: Bank of Canada; Statistics Canada

Other policy instruments remain available, specifically Quantitative Easing and currency intervention. The BoC has not ruled out anything; it would require only a modest deviation from the expected track of the economy and/or currency to put both such actions on the agenda. If the CAD moves very rapidly to parity with the USD, and even more if it moves beyond, both the political pressure to do something and the real economic impact may be overwhelming. In this case, given that the Bank would be fighting the fundamental trend, it would probably have to embark on some form of Quantitative Easing at the same time in order to shift market expectations.

We expect Canadian bond rates to follow the path of U.S. rates, rising gradually into the 4%-5% range when the tightening process begins in the second half of 2010. Because of Canada's stronger fiscal and trade balances, we expect Canadian yields to remain slightly below U.S. levels.

Equity markets in Canada face the same fundamental risks as in the U.S. – that the economy may underperform expectations after the initial burst of recovery, leading to a period of lackluster earnings growth. We believe that a healthy growth trend is more probable, but the downside risks are serious. A key difference for Canada will arise from its sensitivity to natural resources. If the U.S. underperforms while the global economy recovers vigorously, commodity prices (in particular oil) may propel Canadian equities ahead regardless of overall North American prospects.

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