

Global Economic Outlook

Global Recovery: signs of stronger growth, overshadowed by the European credit crisis

Economic growth has been generally stronger than anticipated over the past quarter. But the good news on industrial output, employment and profits has been partially undercut by the eruption of sovereign credit problems in Europe. As Greece heads towards debt rescheduling, with Portugal, Ireland, Spain and Italy waiting in the firing line, markets reacted as if this were the start of round two of the global financial crisis. Greece is small, but so was the U.S. sub-prime mortgage market. Now, despite massive rescue plans, global markets are being forced to confront sovereign risk head-on.

Meanwhile, a surge in industrial output around the world has brought healthy growth across Asia, and sharply improved the prospects for a rapid turnaround in North America. Exports are rising everywhere, as business recovers and inventories are rebuilt. The inventory cycle may be a temporary shot in the arm, but this is how recoveries always begin, and it should be enough to start a sustainable global expansion. Lately, both jobs and consumer spending have been stronger than expected in North America.

However, a sustainable expansion requires a continued recovery in consumer and business confidence that supports hiring, spending and business investment. A renewed financial crisis could undermine confidence and derail this benign outlook. For the moment, we judge that the tribulations of the euro zone are limited and manageable, but the potential long-term losses and the ramifications of a weak and volatile euro certainly raise the risk temperature around the world.

MFC Economic Research Global Forecast - May 2010

	5-yr Average					5-yr Average
	2004-'08	2009	2010	2011	2012	2010-'14
	Forecast starting 2010					
Gross domestic product (annual % change)						
World	3.5	-1.9	3.8	4.2	4.1	4.0
United States	2.4	-2.4	3.6	4.2	4.0	3.4
Canada	2.4	-2.6	3.5	3.7	3.3	3.3
Eurozone	2.0	-4.1	1.2	1.6	1.7	1.7
Germany	1.7	-4.9	2.0	2.0	1.9	1.9
France	1.8	-2.5	1.5	1.7	1.9	1.8
United Kingdom	2.2	-4.9	1.3	2.0	2.3	2.1
Asia-Pacific	5.1	1.6	6.3	5.5	5.5	5.8
Japan	1.6	-5.2	2.7	1.7	1.7	2.0
China	10.9	8.7	10.5	9.1	8.5	9.2
Inflation Rates (annual % change)						
United States	3.2	-0.2	2.1	1.8	2.2	2.2
Canada	2.1	0.3	2.0	1.8	1.9	2.2
Eurozone	2.3	0.2	1.5	1.7	2.2	2.0
Germany	1.9	0.3	1.2	2.0	2.1	1.9
France	2.0	0.1	1.7	1.7	1.7	1.8
United Kingdom	2.3	2.2	2.3	1.8	1.8	2.0
Asia-Pacific	2.7	0.9	3.4	1.7	1.9	2.2
Japan	0.2	-1.4	0.0	0.9	1.2	1.0
China	3.6	-0.7	4.0	3.2	3.1	3.3
Long Term Interest Rate						
United States	4.3	3.3	3.9	4.9	5.2	5.0
Canada	4.1	3.3	3.7	4.6	5.3	5.0
Eurozone	4.0	3.8	4.0	4.6	4.7	4.6
United Kingdom	4.7	3.6	4.1	4.6	4.8	4.8
Japan	1.5	1.3	1.4	2.0	2.3	2.2
China	6.7	5.9	6.1	6.5	6.8	6.7
Exchange Rates						
Canada (C\$/US\$)	1.16	1.14	1.01	0.99	0.97	0.98
Eurozone (US\$/Eur)	1.31	1.39	1.25	1.24	1.31	1.32
United Kingdom (US\$/GBP)	1.86	1.56	1.46	1.52	1.65	1.60
Japan (Yen/US\$)	111.2	93.6	91.0	90.7	89.0	89.2
China (Yuan/US\$)	7.80	6.83	6.8	6.6	6.3	6.3

North America: better news on jobs and consumer spending, but still plenty of headwinds

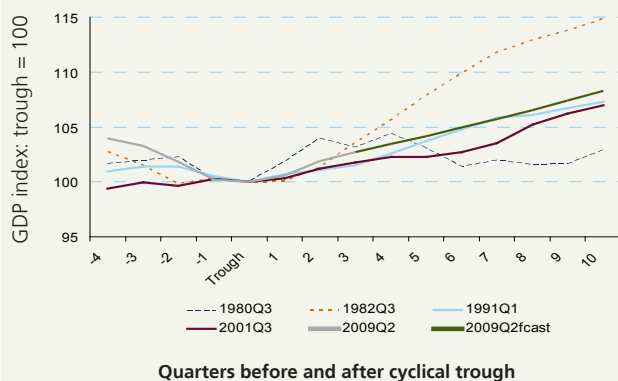
United States: job gains offer hope of sustained growth

With new data showing substantial payroll gains and positive revisions to earlier months, the outlook for the U.S. expansion has strengthened. Jobs were always the key to translating the short-term boost from inventories and fiscal stimulus into a self-sustaining recovery. Now the odds look better that jobs and spending will reinforce each other in the usual vigorous post-recession pattern, as pent-up demand is released from consumers and businesses alike.

Improved employment data is important, not only in its own right, but as an indicator that the surprising strength in consumer spending may be sustainable. As income and jobs are revised up further – the normal pattern when the cycle turns – concerns should fade about consumers spending beyond their means.

The benign current data cannot hide the many headwinds that continue to affect confidence and spending. Mortgage defaults mount, and the pipeline of home foreclosures remains full. Household formation will generate demand for the backlog of homes for sale, but home prices could take another leg down, with painful results for banks. Other shoes are still waiting to drop: state and local government layoffs and commercial real estate losses. The good news is that all of these will be mitigated by job gains, as tax revenues and commercial rents exceed earlier pessimistic expectations.

U.S. recovery started strong, but forecast reflects headwinds keeping growth below normal for such a deep trough



Source: Bureau of Economic Analysis; MFC GIM calculations

We do not anticipate that contagion from European bond markets will derail the U.S. expansion. The effects range from a general loss of confidence to reduced competitiveness for U.S. exporters as the euro weakens. There is some offset from lower interest rates as the U.S. becomes once again the world's safe haven for capital. The overall impact is likely to be negative but small, unless the current crisis expands from a focus on Greece to a more generalized panic.

Our forecast remains somewhat above consensus, with close to 4% growth in 2010 and slightly more in 2011. The risk of a policy mistake or other setback is real, but seems to be diminishing; meanwhile, the odds may be rising that growth accelerates into a more typical V-shaped rebound. Financial markets reflect this uncertainty, with frequent mood swings as noisy data points up one week and down the next.

Canada – a strong run is getting more impressive

Canadian economic output is advancing at a pace consistent with more than 5% for Q1. A strong April employment report combined with a similar outcome in the U.S. clearly indicates that the North American recovery is starting to feed on itself. Further ahead, the ongoing momentum will likely propel Canadian GDP growth at or ahead of the growth pace in the U.S. The strong Canadian dollar will probably act as a drag on output in the second half of 2010. This implies that the Bank of Canada may make some upward adjustments to the overnight rate in the third quarter if not sooner. A later adjustment would be justified if a rise in the Canadian dollar and global economic events pose a material challenge to Canadian exports.

Europe: recovery overshadowed by the Greek tragedy

The Eurozone – a weak euro helps out, but the crisis continues

Eurozone GDP turned up again in the first quarter of 2010 after stalling out late in 2009. The recovery was lackluster, held back by extreme winter weather, but growth in Germany, France and Italy nonetheless establishes a solid basis for further expansion, and even Spain managed to eke out a positive 0.1% rate. The latest data on exports and industrial production

confirm positive survey results that suggest a faster pace in the second quarter, though there are still lingering weaknesses in consumer spending and employment.

Meanwhile, Greece's troubles dominate the news. The sense of imminent disaster was allayed by the announcement of a massive €750b credit line from EU member states and the IMF, along with the ECB's willingness to issue its own bonds, buy weaker nations' government debt, and reinstate swap arrangements with the Federal Reserve. However, these measures do not solve Greece's underlying insolvency, nor do they give investors confidence that Portugal and perhaps Spain are not heading down the same road. In addition, there is no certainty that national governments will live up to their promises either of fiscal austerity or of contributions to the rescue package.

Debate is now raging about the survival of the euro. Given the political capital invested in its creation, the leading architects seem likely to be willing to pay a large price to keep it going. But the possibility that Greece, and perhaps others, will ultimately leave the eurozone is now in play, as the preferences of German and Greek voters may simply be irreconcilable within a currency union. Fiscal control of one country by others is probably unacceptable, but without it the demands of a common currency may be too severe for democratic governments to impose. The only resolution may be for governments and markets to accept the reality of occasional sovereign defaults.

to materially affect the region. Similar fiscal austerity in Spain and/or Italy would be more significant, but, given the gain in export competitiveness from a weaker euro, the net effect for the eurozone as a whole may be minimal or even positive.

Uneven growth prospects

Germany's recovery seems to be gaining fresh strength, as industrial production rebounds, exports benefit from a weaker euro, and the major surveys (PMI, Ifo) show improved sentiment and orders. Waves of market turmoil can undermine confidence again, but in general the growth prospects remain modestly healthy. Even consumer spending could revive as the unemployment rate starts to decline, overcoming the expiration of the "cash for clunkers" program. Our forecast for 2010 and 2011 is a modest 2% pace of GDP growth, but after a 4.9% drop in 2009 there is room for upside surprises.

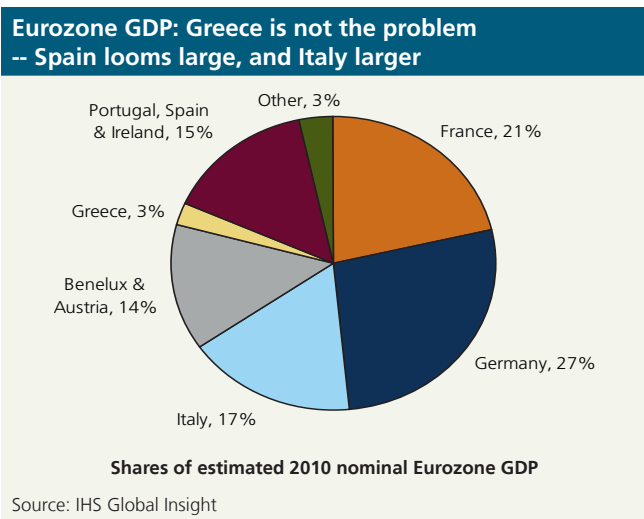
At the other extreme, Spain showcases the weaknesses of southern Europe. The economy finally struggled out of recession in 2010, but growth is anemic and unemployment is up to 20%. Costs are radically out of line with the rest of Europe, and easy foreign credit is no longer available. The pressure from financial markets for fiscal tightening can only make the near-term outlook worse, and growth is likely to be barely positive, well under the government's assumptions. Fiscal austerity may placate bond markets, but the resulting economic pain may be politically unsustainable.

Inflation – still under control

Inflation has risen in the last 6 months, but remains below the ECB's target of just under 2%. Given high levels of unemployment and the current air of crisis, it seems unlikely that inflation will pose enough of a threat to provoke monetary tightening soon. The ECB is now engaged in engaged in quantitative easing through its purchases of government bonds, and despite its inclination to sterilize this monetary expansion, it is more likely to be pushed in the direction of more aggressive easing than of tightening. The arrival of a more hawkish German president in October, 2011 could change the policy bias, but for now that is too far off to matter.

The Euro – the crisis-driven slump has a silver lining for exporters

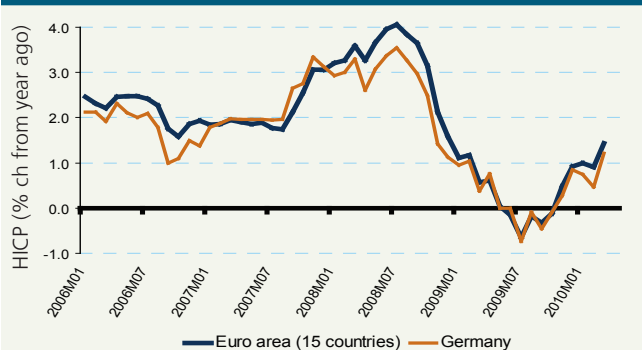
The gyrations of the euro during the Greek debt crisis



The implications for economic growth are not so dire, since Greece is too small for any likely austerity measures

make any prediction potentially outdated within days. Nonetheless, any resolution will take time, during which the overall lack of confidence will presumably keep the exchange rate under pressure. Germany was already prospering from a surge in exports, and a weak currency should boost manufacturing industry further, spreading some positive effects around the region. Spanish, Italian and Greek producers will also be a little less constrained by their inflated costs.

Euro zone inflation: back above zero, but still no threat



Source: Eurostat

United Kingdom – barely emerging from recession

The UK emerged from a long and deep recession in the last quarter of 2009, but growth is still too slow to ensure a healthy pace of job gains. The arrival of a new government sparked market instability, but should allow for a start at reducing deficits and setting the stage for a rebound. With its own currency, Britain is probably better-positioned than the euro zone to take advantage of global recovery and accelerate its expansion. As of now, the pound is weaker than the euro, though we expect this to reverse as UK growth resumes and the euro's problems linger.

Production data in recent months has shown robust expansion, and business surveys suggest that this will continue. Unfortunately, though, manufacturing is a fairly small part of the economy, and not a great generator of jobs, which are the key for a self-sustaining expansion. Full-time employment is still falling, and government layoffs may be coming if budget cuts materialize. The weak pound has helped competitiveness, but the euro crisis may work the other way, letting eurozone producers gain market share.

We are forecasting 2.3% growth as the rebound begins

in 2010, followed by a roughly 2% trend. While the damage done in a 6-quarter recession was serious, and fiscal constraints will limit the scope for government action, the UK seems better placed than much of Europe to bounce back over the next few years.

Bank of England (BoE) – trading monetary ease for fiscal tightening?

The Bank of England is enthusiastic about the new government's deficit-cutting plans. Given the continued fragility of the economic recovery this will presumably justify easier monetary policy, perhaps including a resumption of quantitative easing if the fiscal tightening is severe. Rate hikes will await stronger growth and inflation, as well as policy moves by other Central Banks.

Asia: the steady flow of strong 2010 data continues, but economies and markets are not immune to global panic attacks

China is pacing the recovery in the rest of Asia, and positive feedbacks are stimulating additional strength in the smaller economies. Contagion surrounding Euro sovereigns could possibly derail Asia's expansion, but we are not anticipating this. Instead, we see sustained growth with a moderate bounce in inflation rates.

Relatively attractive investment returns and strengthening macroeconomic fundamentals are keeping foreign money flowing into the region. Vast foreign exchange accumulation, massive energy and infrastructure needs along with growing private investment opportunities are all making global investors more comfortable. Although we see material value in this strategy, the risk diversification advantage is less certain. If financial instability increases, the relative macroeconomic strength of less liquid markets may cease to drive superior performance.

A worsening euro is anticipated to hurt Asian exports over the short and medium term. Increased competition and weaker European domestic demand should hold back growth in this export-driven region. On the other hand, a stronger U.S.\$ and U.S. economy should help Asia. Overall, our U.S. and Eurozone outlooks imply a roughly balanced amount of macroeconomic downside and upside risk for Asia. The wild card in this equation

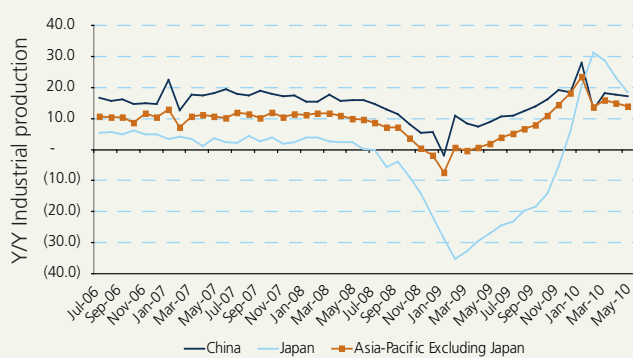
is the unpredictable impact of increasing global market volatility.

China is an engine of growth, but facing fears of policy mistakes and the inevitability of slower growth

The growth in the first quarter's gross domestic product accelerated to 11.9% from the 10.7% gain reported in the fourth quarter of 2009. With domestic demand

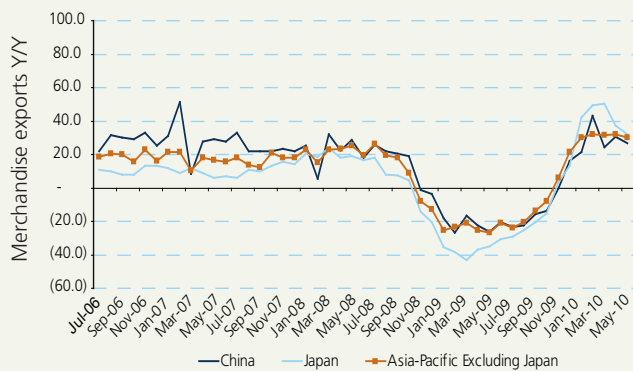
holding up, it appears that exports, while still very important, are only part of the recovery story. The uptick was faster than the consensus forecast and is one more sign that most of the impact from the global financial crisis is over. This is not to say that there aren't significant risks to the country's economic outlook. The massive stimulus policy intended to counterbalance the worst global contraction during the "reform era" have fomented a housing boom and rising inflation risks.

After the crash, Asian manufacturers are again growing at pre-crisis pace...



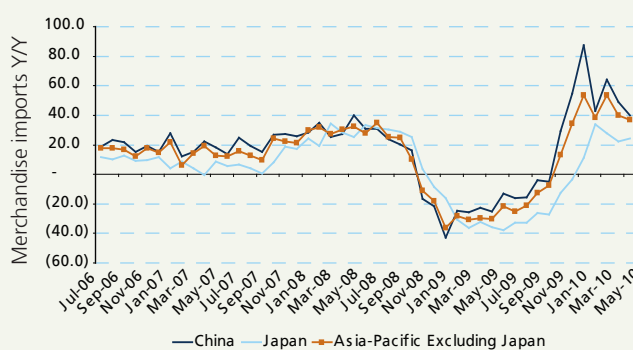
Source: IHS Global Insight

...Aided by a sharp recovery in exports



Source: IHS Global Insight

...and providing a positive feed back to the rest of the world



Source: IHS Global Insight

It is uncertain how effectively Beijing will manage to balance a need for macroeconomic restraint with the social goal to expand low-income housing. What is clear is that the real estate sector has become an increasingly important driver of China's economy via a flood of bank lending. Some now fear that a collapse in the housing market could trigger a crisis similar to the one seen in the U.S. While it could happen, we are less pessimistic, and instead believe that even if prices and volumes drop as in the U.S., the impact on China's economy will be less severe than the U.S. suffered during the sub-prime crisis for two reasons: 1) Chinese home buyers are less leveraged than their American counterparts, and 2) China does not have a similar complex web of exotic financial derivatives tied to the property markets.

Nonetheless, the jump in housing prices (particularly in some regions) is on policymakers' radar, and to ward off a housing bubble, the government has already implemented aggressive measures to deflate prices, including zoning regulations, cracking down on speculative investment and setting lower credit targets. We are confident that this approach will be generally successful and that a worse-case macroeconomic scenario can be prevented.

Inflation is of some concern

China's inflation remains subdued so far, but still, inflation is clearly getting closer to Beijing's assumed 3% target, so additional measures may yet be needed. The central bank has already moved to dial back the amount of new lending the banking system delivers to the economy, and now it is expected to begin raising interest rates for the first time in two years.

CPI inflation is projected to rise to about 4% by end-2010, due mainly to rises in commodity and service

prices. Pro-growth fiscal policy is projected to continue, supported by moderate increases in the FX rate. We anticipate that Beijing will face the threat of inflation using direct and indirect control of bank lending. Bold predictions of an imminent China crisis fail to capture the big picture of the country's economic dynamic: the government still controls, directly, a major portion of the banking system while growth is being driven by huge capital investment, a big pool of productive labor and a vast demand for China-made products.

Policymakers will not always be able to avoid serious policy mistakes, but decision making has become increasingly open and pragmatic. As some Chinese observers have noted, "...blind optimism on policy decision making is of course risky. But the view that the economy is essentially in the hands of a few communist mandarins equally deserves no credibility."

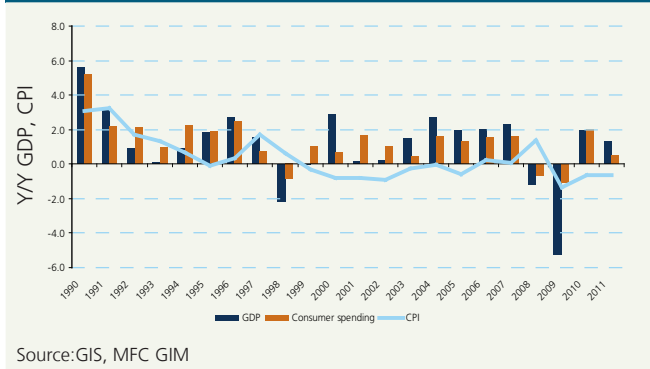
Bottom line, additional credit restraint and higher interest rates will demonstrate the government's determination to manage rising inflationary pressures. A steady FX appreciation will also be an important part of this anti-inflation strategy. However, this will be carefully balanced against the apparent goal of maintaining close to 8% GDP growth. We project 10.5% GDP growth in 2010, up from 8.7% in 2009 followed by less than 9% thereafter. Overall, we should start to see that growth is more broad-based, with increased contributions from consumer spending and less from domestic investment.

In Japan, the worst is behind for now, Longer term, debt and deflation present a significant risk to the economy

Japan was one of the hardest-hit countries during the global financial crisis, but with its dynamic export sector intact, it was only a matter of time before Japan's economy would benefit from rapid growth in the rest of Asia. Going forward, we see the steady growth in global demand and public spending as the main drivers of a very slow recovery.

Unlike the risks elsewhere in Asia, Japan is in a unique macroeconomic position. In principle, driving domestic consumption by any means available would be the appropriate macro-medicine. However, given the country's shaky public finances, the question is whether the current policy mix will propel the expansion before unexpected weakness elsewhere or domestic economic conditions manage to derail it (see box).

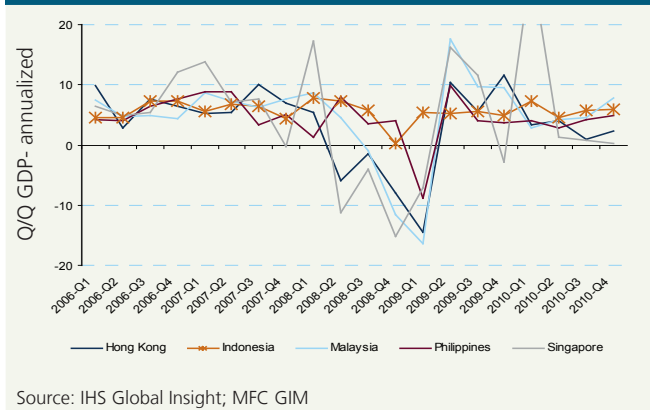
Japan's stagnation saga continues



For now, we believe that a lingering negative link between deflation, consumption, debt and investment will keep the economy growing, avoiding catastrophe but on a stagnant growth trajectory. Further ahead, Japan will run out of options: some kind of domestic default will become more likely, in which the older generation, who hold most of the government bonds, will somehow see the value of their investments cut to reduce the pressure on the younger generation and relieve a worsening fiscal imbalance.

In the meantime, despite the Democratic Party's goal to promote a more balanced economy, we see Japan still depending on exports to drive the anticipated 1.5% growth over the next 2 years. Ongoing growth will depend on households' and firms' willingness to borrow and spend again. On the inflation front, slow growth implies that the risk of deflation could continue beyond what we are anticipating in 2010. Japan's experience shows that in the aftermath of a financial meltdown, minimal growth, ultra-low nominal interest rates, low productivity, rising public debt and deflationary pressures can last for decades, and that policymakers can make all sorts of mistakes.

Growth in the rest of East Asia is also stabilizing to pre-crisis trends



Japanese debt on an unsustainable trend – but how will it end?

A cyclical upturn, it is widely feared, may only mask Japan's deep-seated structural problems: deflation, a huge public debt, negative demographics and policy paralysis. This concern is justifiable. First, Japan's economy continues to operate below capacity and this is pressuring inflation down. The Bank of Japan is now predicting that consumer prices may fall through 2011. Deflation means that nominal GDP will shrink while debt obligations will rise closer to unsustainable levels: projections for this year already see government borrowing exceeding tax revenues. Eventually, long-term interest rates could jump sharply, and capital could flee overseas at short notice. So the question is why this long-held-fear has not occurred already -- how can the ten-year Japanese bond still yield less than 1.5%?

It helps to understand what could trigger a fiscal-implosion/sovereign-debt crisis. The key driver is not the level of debt, but the government's inability to finance it. Japan hasn't faced this problem yet. In spite of a steady increase in its debt and deficits, Japanese long-term bond yield have moved in the opposite direction over the last two decades. Research shows many reasons for this apparent paradox. First, domestic investors (with a high savings rate) hold more than 90% of Japanese government bonds. Furthermore, more than half of the country's financial assets are held in cash and deposits, with big public institutions such as the Japan Post Bank holding lots of government bonds. Just as important is that despite very low nominal interest rates, the on-and-off battle against deflation in the last two decades has given investors in government bonds, a relatively high real return compared to other assets.

However, this cannot go on forever. And while the economy is not about to fall down a cliff, as the macroeconomic fundamentals deteriorate, Japan's day of reckoning seems to be inching closer. Research suggests that as the population ages, savings will dwindle, which could reduce inflows to the government-bond market. The problem as an IMF study suggests is that even if the household savings rate remains near 2%, by 2015, gross public debt could exceed households' financial assets, which should make domestic funding more difficult. If Japan has to rely more on foreigners, interest rates will be forced up. But with interest payments already at about 1/3 of tax revenues, even a small increase in yields could shock the economy. What's more, rising social-security payments as the population ages will put even more pressure on public financing, while the shrinking workforce will mean even slower growth and smaller tax revenues. Overall, not a pretty picture!

For the rest of Asian economies, the recovery continues

Growing exports bode well for economic growth in Singapore, Hong Kong, Taiwan, South Korea and Malaysia. Nonetheless, political instability in Thailand and Indonesia heightens some downside economic risks to the region. Worsening civil unrest, however limited, weighs on investment and productive activity.

From the macroeconomic perspective, the region is settling down to pre-crisis mode and improving on metrics usually welcomed by global investors. However, a spreading global financial panic could still trump strong macroeconomic fundamentals. We don't anticipate this, but the risk of sharp swings remains.

Risks to the Global Outlook

We see significant risks to our cautiously optimistic forecast. Alternative employment, trade and spending growth paths, along with policy shifts, can spell better or worse outlooks.

A renewed crisis with a double-dip – probability 20%

A collapse in confidence around the world as the euro sinks into a full-fledge crisis might snuff out the nascent recovery in developed economies. Policymakers could be paralyzed by budget deficits and monetary authorities respond too late. The world falls back into recession and the quantitative easing cycle starts again. Deflation becomes a major risk.

A stronger V-shaped expansion – probability 20%

Policymakers err on the side of caution, and the massive stimulus is allowed to prime the demand pump well after confidence has re-emerged; the global economy recovers unexpectedly fast. Consumer spending accelerates boosted by a sharp drop in unemployment. Major economies achieve emerging-market growth rates for a while, and inflation concerns mount.

A dollar crisis – probability 10%

The troubles of Greece, with its growing fiscal imbalances, are prescient of the fiscal imbalances in the United States. The dollar suffers a major relapse, and investors lose confidence that the U.S. government can bring its deficit under control. Sharply higher interest rates arrive ahead of a sustainable U.S. expansion, leading to a contraction in investment, a correction in financial markets and ultimately to another U.S. downturn. Europe and Asia would probably be unable to avoid the downdraft, and another global recession would follow.

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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