

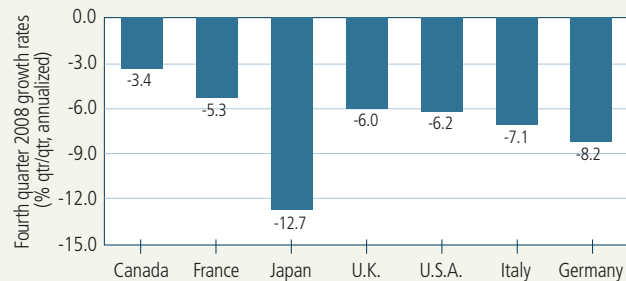
Global Economic Outlook

Global Recession: The Downhill Slide Accelerates

Economic growth in the U.S. for the fourth quarter was a dismal -6.2% annualized rate, while other countries have turned in even weaker reports. Europe, Japan and most of the Pacific Rim are contracting more rapidly than the U.S., while even China is slowing at a pace that looks like a severe recession. For now, the global rate of contraction is still accelerating as job and income losses feed on themselves into a downward spiral.

The global policy response has been aggressive, but the nature of the financial crisis has forced much of the world into or nearing a "liquidity trap", where low interest rates fail to boost economic activity. Since the world as a whole obviously cannot depend on exports as a driver of recovery, the last resort is to boost domestic demand directly through fiscal stimulus. Policy-makers worldwide are moving in the right direction, but seemingly slowly and timidly. The U.S. and China have announced the largest programs, but the speed with which they take effect is limited both by politics and by physical constraints on the ability to ramp up public spending.

The G7 are falling.....hard



Source: Data Insight; Economic Research

Spring Global Outlook

Spring 2009	5-yr Average		5-yr Average		
	2003-'07	2008	2009	2010	2008-'12
History		Forecast			
Gross Domestic Product (annual % change)					
World	3.6	2.3	-1.1	2.5	2.3
United States	2.9	1.3	-2.5	3.0	1.7
Canada	2.7	0.6	-1.8	3.1	1.9
Eurozone	2.0	0.8	-2.4	1.0	0.5
United Kingdom	2.8	0.7	-3.1	1.1	0.6
Asia-Pacific (ex Japan,China)	5.2	3.8	0.7	3.8	4.1
Japan	2.1	-0.4	-3.3	2.0	0.9
China	10.8	9.0	5.9	8.4	8.5
Inflation Rates (annual % change)					
United States	2.9	3.8	-1.3	1.0	1.6
Canada	2.2	2.4	0.2	1.8	1.6
Eurozone	2.0	3.2	0.6	1.3	1.7
United Kingdom	1.9	3.6	0.8	1.1	1.8
Asia-Pacific (ex Japan,China)	2.1	7.3	3.3	3.1	4.2
Japan	-0.1	1.3	-0.5	-0.4	0.4
China	2.6	5.9	0.9	1.1	2.7
Long-Term Interest Rate					
United States	4.4	3.7	3.0	4.0	3.9
Canada	4.4	3.6	2.8	3.9	4.2
Eurozone	4.0	4.3	3.9	4.2	4.3
United Kingdom	4.7	4.5	3.6	4.0	4.4
Japan	1.5	1.5	1.4	1.7	1.9
China	6.3	7.5	5.3	5.1	5.7
Exchange Rates					
Canada (US\$/C\$)	0.8	1.07	1.23	1.30	1.14
Eurozone (US\$/Eur)	1.2	1.47	1.32	1.33	1.37
United Kingdom (US\$/GBP)	1.8	1.82	1.43	1.54	1.67
Japan (Yen/US\$)	113.7	103.0	90.4	92.5	93.1
China (Yuan/US\$)	8.1	7.0	6.8	6.7	6.62
Forecast beginning in 2009					

The health of national banking systems varies around the world, but few have escaped the fall-out from the U.S. financial crisis and ensuing downturn in economic activity. Most countries have been forced to provide guarantees, subsidies or direct capital infusions to keep their banks afloat; and the problems continue to escalate as long as the underlying recession causes expectations of mounting default losses.

North America

U.S.: rapid descent continues

The U.S. economy is falling quickly, and dragging Canada down with it. Desperate times call for desperate measures – something that both countries' policymakers understand. However, as with the rest of the world, Canada's struggling export sector must await a stabilization of the U.S. economy. For now, all signs still point down.

The U.S. economy remains in free fall. Export growth is as shockingly negative as it was positive over the last two years. Firms are cutting back capital investment at record rates. Consumers are economizing in an effort to accommodate brutal conditions in the labor market and massive wealth declines. And if that wasn't bad enough, the risk of a systemic collapse of the U.S. banking system still looms.

This recession is shaping up to be the worst consumer, and possibly the worst economic, contraction since the 1930s. Eventually, though, it will end, and the economy will grow more consistently in 2010. But for now, we search for faint clues of stabilization in key sectors.

With the new stimulus bill (and perhaps another going forward) leading the way, we expect that the economy will start to climb back later in the second half of 2009 from the longest decline since the 1930's – 18 to 24 months – and deepest fall, rivaling only the worst recessions over that same period.

A negative feedback loop has been established

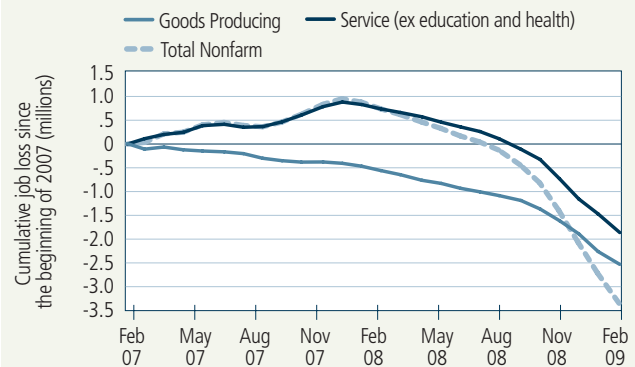
Home values decline and foreclosures rise, banks write down assets, firms and retailers can't get credit, investment falls, consumption falls, GDP falls, firms cut costs, workers lose their jobs, homebuyers cannot qualify for a loan and demand for housing falls, *home values* decline... This is the downward spiral that policymakers are up against.

The financial markets are just a part of this loop – a critical part, but nevertheless, just a part. Over the longer term, credit markets must recover in order to support a growing economy. But in the near-term, fiscal stimulus is crucial, and represents the best hope of breaking the loop without having to endure a much longer period of economic misery.

Private spending has officially stepped out of the picture

■ **Consumers are finally giving up.** Gas prices grew 36% in the first half of 2009, home values nearing 30% off the peak, equity markets pushing 50% in losses, and a surging unemployment rate are all driving households to save. The path of consumer saving into 2010 and beyond is very

(Practically) no industry has been spared, the destruction of jobs has been broad-based



Source: Bureau of Labor Statistics; Economic Research

uncertain, and we tend to believe that pent up demand will spur spending in 2010; but in the near-term, the aggregate effect of the sharp cutback in consumer spending, which accounts for 70% of U.S. GDP, is certainly painful. We expect to see three consecutive quarters of negative consumer spending growth – a first since the data was initially recorded in 1947.

- **The retrenchment in investment is shocking.** One of the most troubling statistics from the Q4 2008 GDP report was the 21% annualized decline in gross investment. The slashing of investment in equipment and software by firms, -29%, was a true sign of the tight credit and a sour economic outlook. However, it is more what we didn't see that really worries us. We expect non-residential construction to tumble much further over the next 3-9 months, which will offset some of the positive effects from the expected stabilization in residential housing. Furthermore, inventory build massively outweighs the current sales rate, and firms will draw on inventories – dragging down GDP – over the next few quarters.
- **Housing should find a bottom this year, but there are no guarantees.** Weak demand is driving the decline in home values, and we expect the trend to continue into 2010. Homebuilding sentiment is tentatively stabilizing, and speculative building has likely been driven out of the market. This leaves an underlying level of demand for new homes which is consistent with replacements and demographics at a time when materials are cheap and labor is abundant. We expect starts to bottom in the middle of the year, after which new residential construction will contribute positively to GDP growth for the first time in three years.
- **Exports – absolutely no help there:** Exports kept the U.S. economy growing through Q2 2008, but then took a sharp 180 U-turn, and dove off a cliff at a 24% rate in Q4 2008. The

trade balance is improving, but global demand for U.S. goods is anemic at best; and only after the U.S. economy has passed on some of its economic strength to the rest of the world will exports grow again – in the later part of 2009, at best.

The timing of the recovery is highly uncertain and almost completely dependent on fiscal policy

The Fed is keeping the money supply from shrinking, while contemporaneously battling the negative forces that have frozen credit markets. As long as the USD remains the king of all currencies – except, perhaps, the yen – the Fed can continue its flood of liquidity to the credit markets, which for the time being, poses no risk to the economy. But with short-term rates close to zero, this is just averting disaster and not providing a real stimulus to the economy.

For a real boost to economic activity, it's all about Congress. President Obama signed a large stimulus bill, \$787 billion, into law, which will partially offset the declines in private spending. The bill will certainly help, as most of the spending will occur when the economy needs it most, in 2009 and 2010, but we would have preferred a much larger kick and can't rule out the possibility of another installment.

Forecaster's disclaimer

Although we are calling for negligible growth in the third quarter of this year, we forecast this with an acute sense of caution. The assumptions regarding our U.S. outlook are threefold: (1) housing starts bottom in 2009, (2) fiscal stimulus is big enough to keep the unemployment rate below 9.5%, and (3) policymakers are successful in appeasing market fears about the safety of the banking system.

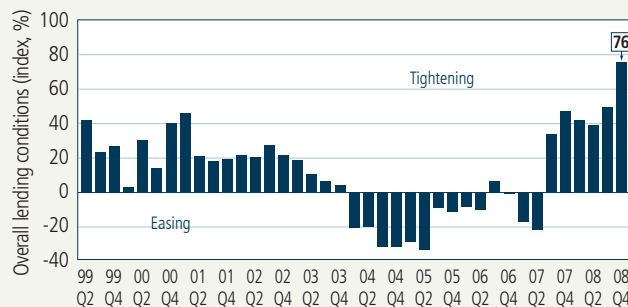
Canada

Fallen down and awaiting U.S. action

The news keeps on getting worse for Canada. The sharp decline of the U.S. economy and resulting global meltdown has driven oil prices into the floor; manufacturing challenges new lows; and the trade balance drops into negative territory. Monetary policy has been aggressive, and with help from a U.S. recovery in the second half of 2009, the economy should pick up thereafter. But as with any forecast, the permutations of potential outcomes are numerous.

The strength of the Canadian dollar receded with oil prices, and in an environment more amenable to export growth, this would be a good thing. But Canada, like many other countries reliant upon exports to fuel economic growth, must await the

More trouble ahead: in Q4, 76% of senior loan officers reported tighter lending standards



Source: Bank of Canada, Senior Loan Officer Survey

re-emergence of the U.S. economy for some export reprieve – especially in the ailing manufacturing industry.

The housing market is showing some pressure points, but its decline to date is benign compared to the carnage in the U.S. The stricter lending standards of Canadian banks will prevent the housing market from tumbling too far, but the pullback in new home construction will be a drag on GDP growth into 2009.

The labor market declined precipitously in January with a 129 thousand drop in payroll and a 0.6% surge in the unemployment rate to 7.2% (February report had not been released at the time of publication). The job loss was overwhelmingly focused in manufacturing, but unless conditions improve unexpectedly, the service sector will hemorrhage jobs next. Overall, domestic demand – as with every other world economy – is retrenching.

The shrinking micro markets – housing, labor, finance, export industries – added up to a sharp fourth quarter decline in GDP, -3.4% annualized. Only with a U.S. recovery and expansionary domestic policy will the Canadian economy hit bottom and recover.

Canada will head down for an extended period of time unless policymakers are aggressive. The Bank of Canada is flushing the banking system with liquidity, and has steadily cut its policy rate to just 0.5% – now it is a member of the near-liquidity trap club. We expect another 25 bps cut at the next meeting with an onslaught of negative economic news, and possibly announcements of quantitative easing measures. In order to provide support to the economy amid crumbling domestic demand, the Department of Finance unveiled a sizable stimulus package, which is currently in its final stages of approval. The economy is likely to fall 1.8% in 2009, and rebound on the heels of a U.S. recovery.

Europe

Eurozone: with the risks skewed towards an even weaker economy, the recovery is postponed

The eurozone suffered its deepest contraction on record in the last quarter of 2008 with its main constituents – Germany, France and Italy – all showing contractions. GDP in the region shrank 1.5 percent from the previous quarter (roughly 6% annualized), a bit worse than we expected in our Winter Outlook.

The slump in the industrial and export sectors provide negative momentum for 2009. In our base case, this implies a -2.4 percent growth in 2009 without a sustained economic recovery before the first half of 2010. This pessimistic near-term forecast is supported by the persistent financial weakness, which has markedly worsened lending conditions for non-financial businesses. There is also some question whether policymakers will do enough to offset the macroeconomic plunge.

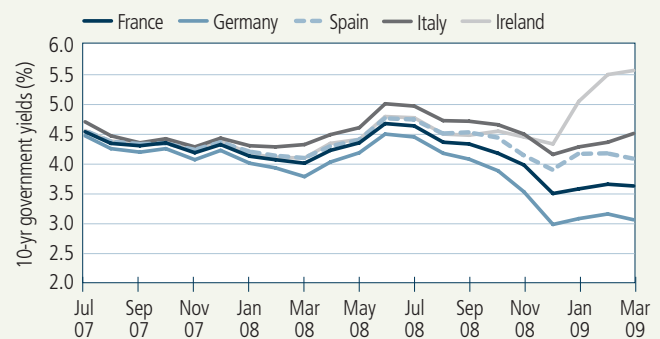
Eurozone member nations have agreed to spend only 1.5% of GDP in an effort to boost aggregate demand. However, some countries facing spiraling borrowing costs are expected to see sharp declines in tax revenues driven by surging unemployment. Therefore, the reality is that many countries will be unable to spend much more as the rising cost of their rich social benefit system will need to be balanced against a European mandate to keep budget deficits contained.

Similar to the policies in the U.S., central banks and governments have come to the aid of large banks saddled with non-performing assets through direct capital injections, stabilization funds and guarantees. In October 2008, Germany unveiled a plan costing 480 billion euro (US\$603.7 billion). Early in February, the Irish government announced a 7 billion euro (US\$9 billion) effort to recapitalize the country's largest banks. But, as in the U.S., with only a few signs of success, the German cabinet just approved a draft law allowing the state to seize control of banks as a last resort. In similar actions, the British government has already become majority owner of the Northern Rock, Bradford & Bingley and the Royal Bank of Scotland.

A close look at the export data (about 43% of GDP) reveals another gloomy situation. Exports outside the eurozone are struggling, but so too are exports within the eurozone countries, which amounted to 174.2 billion euros in December, down 9% y/y. Given the broad declines in economic activity across Europe, trade activity is likely to fall significantly in the foreseeable future.

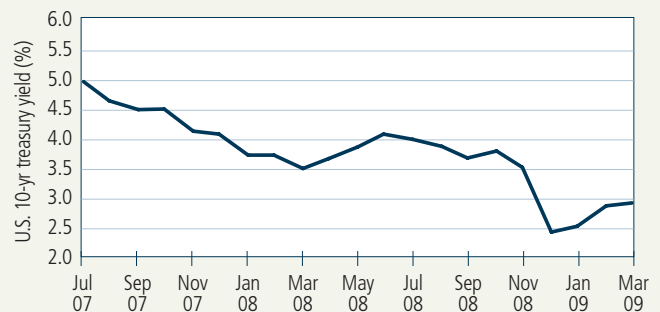
Eurozone inflationary pressures have retreated sharply, with consumer price inflation falling to 1.1% in January from a peak of 4.0% in mid-2008. Even so, the ECB has reduced interest

In Europe, all euros are equal, but some are more equal than others...



Source: Global Insight

...While the U.S. bond yields may be discounting the huge new supply of government debt

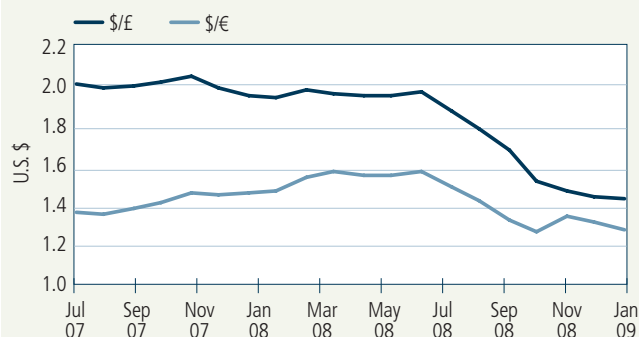


Source: Global Insight

rates at a far slower rate than other central banks. The policy rate now stands at 2%, 225bps lower than a recent 4.25% peak in July 2008. Going forward, the ECB is expected to cut rates below 1% within a year, and to complement further rate cuts with a more aggressive quantitative easing package to shore up the region's struggling banks.

In conclusion, the data is depicting an increasingly weaker global environment with diminishing inflationary pressures. Consumer price inflation is likely to fall to very low levels in 2009, before starting to rise again as a gradual recovery begins to take hold. Fiscal steps to stimulate demand combined with a stable euro and expansionary monetary policy may only slow the overall fall in output this year, but should prepare the ground for a more steady recovery in 2010. At that point we anticipate a strengthening euro and slightly higher long-run rates.

Global turmoil has increased the appetite for USD



Source: Federal Reserve (H.10) Release

U.K.: the downturn gets deeper

The 1.5% fourth quarter contraction was followed by another 0.5% monthly decline in January. To date, the collapse in both commercial and residential real estate prices is still gaining momentum, banks have shut off the credit taps, and business sentiment surveys indicate a contraction that is accelerating. Overall, consumer demand faces strong headwinds from plunging net worth and surging unemployment. Disinflationary forces are gaining momentum, and in order to prevent outright deflation policymakers must maintain aggressive expansionary measures.

Without substantially more support from policymakers, the economy will not recover in 2009, and possibly not even in 2010. Thus far, the collapse in the pound is helping ease the pressure for current monetary conditions, but the lack of global trade limits the positive impact for the economy.

The Bank of England (BoE) has announced a direct asset-purchase program that will help recapitalizing the banking system, and should provide a valuable boost to the corporate debt market. For now, the Treasury has stopped short of setting up a bad bank to take over toxic assets, probably for fear of a growing government deficit in the event of catastrophic losses. Many signs suggest that with each new government initiative to shore up the banking system, the prospect of full scale nationalization is one step closer.

Consistent with the current gloomy picture, the BoE has cut its policy rate to 1.0%, the lowest target since the founding of the Bank in 1694. The Bank's forecast now expects 2009 GDP to contract -4.0% over the year, reflecting a recession roughly twice as severe as it was projecting in November. Furthermore, the BoE is nearly certain that inflation will drop sharply below the 2.0% target this year and remain below target for the foreseeable future. In addition, the Bank projects about a 30% chance of sustained deflation by 2010, despite assuming that the policy rate remains below 1.00% throughout this year.

Overall, we agree with the BoE assessment, and therefore expect at least another 50 basis point cut in the official Bank Rate.

As in the U.S., further easing will likely be pursued through the expansion of the Bank's quantitative easing program.

Central and Eastern Europe: the party is over

At the time when many countries were expecting to celebrate their new economic and political freedom, the region's economies are now furiously trying to keep from sinking further. The surge in unemployment is challenging political and social stability. As with the sharp declines in the rest of Europe, the smaller countries are already contracting or barely growing.

Germany and other European countries are vital export markets for Eastern Europe. As long as domestic demand remains slim, the export incomes for Eastern and Central Europe will remain on a slow-growth track.

The global credit crisis has in many instances hit this region hardest. The currency structure, banking, and dependence on external financing from the rest of Europe are the key links that keep these countries dependent on the future of the eurozone. Declining currency values in countries like Hungary and Poland are awakening the specter of a rising cost of debt, while in countries like Slovenia and Slovakia (euro currency areas) the government cannot devalue their currency to spur their exports. In either case, the region will remain exposed and highly vulnerable to the financial fluctuations of the West.

Asia

Paying the price for reliance on exports

Asia as a whole has been sucked into the vortex of the western financial crisis, mostly through the channel of sharply reduced exports. The risks of the export-surplus-driven growth strategy adopted across the region in the aftermath of the 1997 Asian financial crisis have been cruelly exposed. Singapore's GDP fell at a 17% rate in Q4 2008, Japan's at 12.7%, and the rest of the region is similarly – though less dramatically – stricken. It now appears that most of the recent boom in intra-regional trade was ultimately driven by exports to the West, not by final demand in Asia.

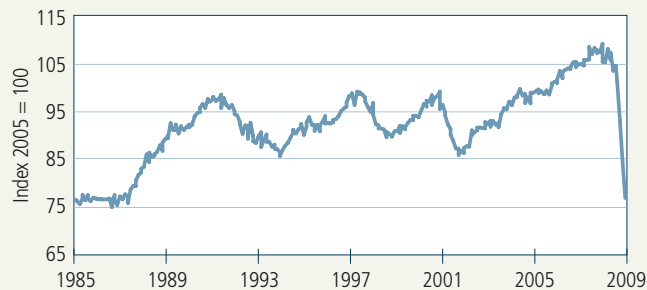
Pain across the Pacific Rim as exports slump

(% change in exports from one year ago)

Jan 09 data:		Dec 08 data:	
Japan	-46%	Malaysia	-15%
China	-18%	Indonesia	-21%
Korea	-33%		
Taiwan	-44%		
Singapore	-35%		
Thailand	-25%		
Hong Kong	-22%		
India	-16%		

Source: Global Insight; Economic Research

Japan's industrial production collapses: lowest since 1987



Source: Ministry of International trade & Industry

Japan: relapsing back into recession

After much talk of “decoupling”, the drop in demand from the U.S. and Europe has decimated Japan's export industries and sent the overall economy into a severe downturn. GDP has already contracted for three quarters, with Q4 2008 showing the sharpest decline since 1974. There is little prospect of growth until the second half of 2009 at best, implying the longest recession since WWII. Consumer spending has stalled, business capital spending is down, unemployment is up, and both monetary and fiscal authorities have shifted quickly towards expansionary policies. With the stock market in a new tailspin, the government is even discussing measures to boost equity prices through direct purchases.

After a short period of positive inflation, prices are falling once again. The core CPI is back down to zero (year-over-year) and is heading into negative territory. Producer prices, both goods and services, are already declining. With commodity prices sliding, consumer demand weak and exports plummeting, there is no pricing power and nothing to arrest the overall slide back into deflation.

The strengthening yen has added to the woes of Japan's export industries, and the authorities have resolutely refrained so far from intervening in currency markets. Given the continued weakness of domestic demand, it remains to be seen how long they can tolerate the strongest exchange rate in almost a decade. However, with the rest of the world mired in recession and losing jobs, any overt measures to boost exports run the risk of retaliation. Fundamentally, Japan is too big to export its way out of trouble during a global recession. Either it must stimulate domestic demand or it must wait for a U.S. recovery.

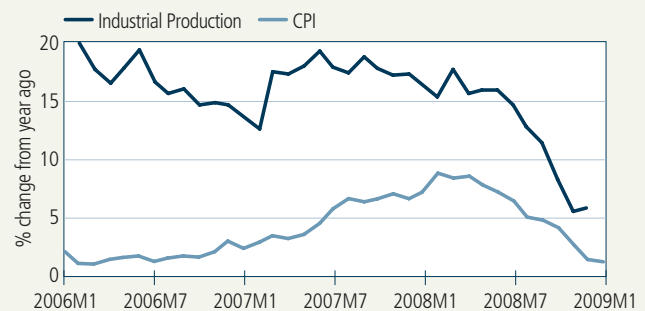
Government policy is expansionary, with 12 trillion yen of fiscal spending pledged since October, and more under discussion. However, effective stimulus may be derailed by politics as the opposition and factions within the governing party use fears of Japan's mountain of public debt to their own advantage. The Bank of Japan has cut rates back close to zero, but this is no more likely to be the catalyst for recovery than it was during the past decade.

China: the growing behemoth stumbles

China is the dominant force for change in the region, as buyer, supplier, competitor and power broker. As exports grind to a halt, business investment and real estate development have been dragged down too. Fiscal and monetary stimulus are rushing to the rescue, but – as in much of the region – it's unclear how quickly such an unbalanced economy can redirect its huge productive capabilities towards domestic demand.

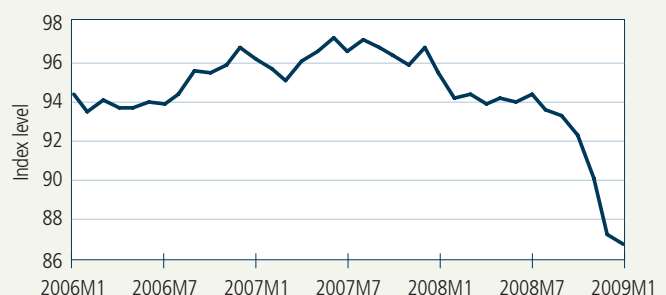
Despite the sharp drop in exports, the Chinese economy looks robust by many measures. January retail sales were up 17.5% and Q4 GDP was up 6.8% from a year ago. However, the statistical fog created by year-over-year reporting obscures how rapidly recent trends may be reversing. Quarter-to-quarter GDP growth was probably close to zero, while plummeting imports and a steep drop in inflation cast doubt on the continued strength of domestic demand. Easier lending will help, and massive infrastructure projects will help to support overall employment, but important structural reforms will be needed before consumer spending can take over as a stable support for aggregate demand.

China: economic activity slows, inflation fades...



Source: National Bureau of Statistics

...and consumer confidence slumps



Source: China Statistical Information & Consultancy Center

The government has announced (or leaked) proposals to stimulate demand for autos and other consumer durables, and leaders are talking about a major effort of social spending to remedy some of the current constraints on private consumption. Measures to provide basic medical or old-age insurance would free up vast amounts of precautionary personal saving, while some shift towards a less unequal income distribution would probably boost spending sharply. But these kinds of policies, how much of a priority they are deemed to be, will have minimal impact within the current cyclical downturn.

Hong Kong: entirely dependent on U.S. and Chinese rebounds

Hong Kong's GDP has been falling for three straight quarters, exports and imports are down sharply, retail sales are flat, and the unemployment rate is rising towards 5% after a decade of declines. At this point, the territory's economy is so tied to trade with and through China that its outlook is almost completely dependent on the success of China's stimulus programs. A recovery in China and a revival of exports to the U.S. are the key ingredients for an end to Hong Kong's recession, and we do not expect this until the second half of 2009, at the earliest.

While it waits for its key trading partners to revive, Hong Kong is taking some steps to alleviate the pain. A program of loan guarantees for the private sector and a wave of direct job creation in the public sector will help to stabilize employment and incomes. The banking system is in reasonable health, and the authorities intend to keep it that way by providing a guarantee for all deposits as well as standing ready to inject capital into locally incorporated banks as needed. The currency peg to the US\$ has been reaffirmed, and the markets appear convinced that no change is imminent.

Taiwan: deep troubles, but deep pockets and a prompt policy response

Taiwan will almost certainly undergo its worst recession ever. Exports have collapsed, and a rapid run-up in inventories implies even steeper production cuts to come. However, the authorities have already started on an ambitious infrastructure plan to stimulate growth, and initiatives to build better relations with China may help to revive confidence. The banking system and the government budget are both relatively healthy, and foreign exchange reserves are ample. Therefore, overall, the outlook is quite positive for a less damaging cycle than in some other countries in the region.

Singapore: exports crumble, but still ample resources to ride out the storm

Singapore exhibits in microcosm the risk of dependence on exports, even in a fundamentally very well-managed economy. Exports – led by electronics and biotech – have plunged, taking industrial production and GDP with them. The economy has now been shrinking for three quarters, and at least one more seems unavoidable. The currency has weakened only slightly, given the markets' confidence in the economy's underlying strength and in the skills of policymakers, and with inflation dropping back towards price stability. The Purchasing Managers' Index remains close to its November all-time low, but may be edging up slightly despite the continuing recession. Like the rest of the region, recovery will depend on, at least, a stabilization in its key export markets.

How important is the U.S. consumer? Very

Global policymakers are on red alert. From North America to Europe and throughout Asia, central banks and sovereign governments are accepting the harsh reality – the U.S. is passing its recession pain on to the rest of the world with force. The U.S. is facing the worst consumer recession in over 60 years. Although each economy suffers a slightly different economic pain, the link that ties them all together is a joint retrenchment in exports. At 16% of global GDP, sharp declines in U.S. consumer spending have created a tidal wave of global economic destruction.

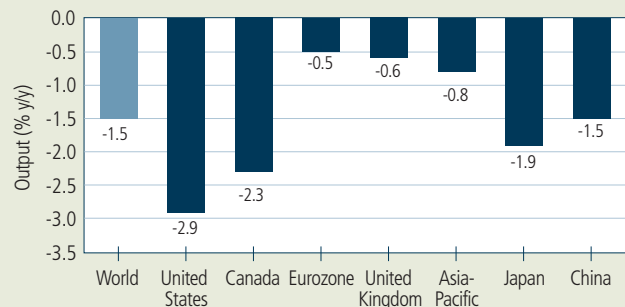
To understand the importance of the U.S. consumer in the current global economy, we simulate two scenarios: Scenario 1: U.S. real consumption falls another 5% in 2009 as a whole, and Scenario 2: U.S. and Chinese real consumption fall 5% each in 2009.

Compared to our baseline forecast, world growth falls another 1.5% as U.S. consumption drops 5% (Scenario 1). The biggest impact is seen in Canada and Japan, but no country is immune, ranging from a 0.5% loss in eurozone growth to a 1.5% plunge in China. Asia is hard hit, with its overall dependence on U.S. consumption demand. Combining the drop in U.S. consumption with a similar drop in Chinese consumption, the world loses another 0.2% in growth, but the pain is centralized primarily in Asia, with China losing another 1.8% and Japan suffering another 0.2% decline. The U.S. remains relatively unscathed compared to Scenario 1. The drop in commodity prices offsets most of the loss of export income.

In sum, global economies are contracting at record rates, but another leg down from the U.S. consumer would ripple through the world economy with lightening speed. All eyes are on U.S. policymakers – the U.S. financial crisis dragged the world down quickly, while a sharp surge in U.S. consumption (or aggregate demand) would certainly have the opposite affect.

Scenario 1

Loss in 2009 growth under simulation*

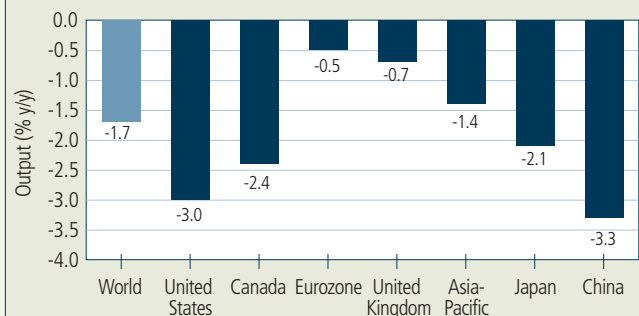


*The 2009 loss in growth compared to our baseline forecast

Source: Economic Research

Scenario 2

Loss in 2009 growth under simulation*



*The 2009 loss in growth compared to our baseline forecast

Source: Economic Research

Risks to the Global Outlook

Global growth is now decelerating more sharply than previously anticipated, and the pain is almost certainly going to get worse before it gets better. We are forecasting stabilization in the second half of 2009, but with the necessary condition that the U.S. economy recovers soon. However, this cycle has multiple possible paths, and the downside risks are broad-based; alternative scenarios have increased in probability relative to our baseline:

[These scenarios are not all mutually exclusive, so probabilities cannot be added]

1. Global meltdown – probability 20%

U.S. and European economic troubles could very well take another leg downward, compounded by a worse-than-anticipated Chinese hard landing. This results in a sharper drop in asset prices with further spiking of corporate and financial defaults. If U.S. and European consumer demand dives in shock, we will be well into a deeper recession, even as policy tries to stop the slide. It is only after more than another year that the cumulative impact of pro-growth policies gains any traction.

2. Policy mistakes lead to longer recession – probability 20%

Independently of the rest of the world, a combination of bad luck and policy mistakes propels the ongoing U.S. economic slump into higher gear. Home values and equities undershoot their equilibrium, causing additional financial strain. Fiscal stimulus is big, but not big enough to counteract the sharp retrenchment in consumer and business spending. Policy becomes more aggressive, but not in time to avoid double-digit unemployment rates through 2010.

3. Deflation – probability 10%

The economic recession results in sharp and persistent price declines. Fear and misplaced fiscal and monetary caution could set in motion a deflationary spiral. In this scenario, lower prices add another threat to an already vulnerable global

economy, pushing ever more borrowers into bankruptcy as the real burden of debt rises. Assuming that major countries do not then embark on a broad-based trade war, we would expect that global fiscal responses and massive injections of liquidity in key financial markets eventually pull us away from depression dynamics, but not without suffering a painful deflationary period.

4. The perfect outcome – probability 10%

Fiscal and monetary policies are on their way to kick in just in time to prevent further macroeconomic deterioration. Credit markets calm down, oil stays cheap, and price stability is maintained. After a short period of intense pain, the recovery gains just enough momentum that central banks can withdraw excess liquidity in time to avoid a surge in inflation.

5. A slump in dollar denominated assets – probability 5%

Finally, global investors might decide that they have enough U.S. dollars in their portfolios. The U.S. takes longer to recover despite massive policy intervention. This causes a sharper drop in dollar asset prices, which in turn leads to higher U.S. interest rates and a more protracted recession-recovery cycle. Led by China and the rest of Asia, the sale of U.S. assets creates a downward price spiral. While other financial markets might benefit at first, the slump in U.S. demand would decimate exporters and more than offset any global gains.

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