

Global Economic Outlook

Global Recession, Global Policy Actions

The economic outlook worsened virtually everywhere over the past quarter, with most major developed economies slipping clearly into recession, and showing signs of stress even in the most dynamic emerging markets. The slowdown has been under way for much of 2008, but the recent flood of worse-than-expected indicators suggests that the global financial crisis clamped down quite suddenly on real growth since mid-September.

At this point, it's hard to see a sharp discontinuity in the credit flow data, but the evidence from credit spreads, bank lending standards and anecdotal reports combine to paint a picture of a sharp halt in new lending. Most existing credit lines in the U.S. are still available to be drawn on, but credit for new borrowers is apparently quite hard to find. Given the normal turnover of startups and failures in a growing economy, a cutoff of credit to new enterprises is a serious obstacle to global growth.

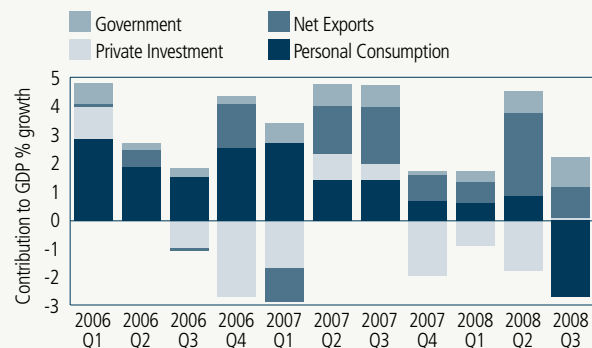
The spreading global impact of the recession which began with the bursting of the U.S. housing bubble is now dragging down exports from Europe, Japan and emerging Asia, hitting hardest those economies that were most export-driven (Japan, China and Singapore). Commodity exporters are suddenly facing an abrupt drop in demand, with both quantities and prices falling precipitously.

The bright spot in this gloomy scene is that governments and central banks are embarking on an unprecedented bout of global stimulus. First it was monetary policy, including unconventional measures to flood the financial system with liquidity. Now it is the turn of fiscal policy, with announcements around the world ranging from small to huge. As always, fiscal stimulus takes longer to get organized, and is harder to isolate from the normal run of government policy. Overall, though, it's clear that governments everywhere are aware of the problem of deficient demand, and they are under increasing pressure to take significant action.

Global Forecast Economic Research

Winter 2008-2009	5-yr Average			5-yr Average	
	2003-'07	2008	2009	2010	2008-'12
	History		Forecast		
Gross domestic product (annual % change)					
World	3.6	2.7	1.1	2.9	2.9
United States	2.9	1.3	-0.7	2.9	2.0
Canada	2.7	0.6	0.2	2.9	1.9
Eurozone	2.0	1.0	-0.5	1.8	1.2
United Kingdom	2.8	0.8	-1.5	2.0	1.3
Asia-Pacific	5.2	4.5	3.6	4.9	4.7
Japan	2.1	0.4	-0.5	1.6	1.1
China	10.8	9.4	7.9	8.3	8.2
Inflation Rates (annual % change)					
United States	2.9	3.9	-0.9	2.4	2.2
Canada	2.2	2.5	1.3	2.1	2.0
Eurozone	2.0	3.3	1.9	1.9	2.1
United Kingdom	1.9	3.8	2.0	1.0	2.2
Asia-Pacific	2.1	5.1	3.3	2.4	3.3
Japan	-0.1	1.6	0.8	-0.5	0.7
China	2.6	6.2	3.6	3.3	4.0
Long Term Interest Rate					
United States	4.4	3.8	3.9	3.9	4.7
Canada	4.4	3.7	4.2	4.0	4.8
Eurozone	4.0	4.3	3.9	4.2	4.3
United Kingdom	4.7	4.6	4.1	4.3	4.6
Japan	1.5	1.5	1.8	2.0	2.2
China	6.3	7.7	6.9	6.7	7.0
Exchange Rates					
Canada (US\$/C\$)	0.8	1.04	1.24	1.13	1.10
Eurozone (US\$/Eur)	1.2	1.45	1.27	1.32	1.34
United Kingdom (US\$/GBP)	1.8	1.85	1.52	1.64	1.72
Japan (Yen/US\$)	113.7	104.0	104.8	102.1	100.8
China (Yuan/US\$)	8.1	7.0	6.8	6.6	6.56
Forecast beginning in 2008					

Consumption is dragging down U.S. growth



Source: Bureau of Economic Analysis

North America:

Risks grow with each day that passes

The U.S. economy has gone from bad to worse, and is certain to drag Canada down with it. Barring a significant improvement in the credit markets in the next few weeks, the U.S. recession is expected to last well into 2009. Although the Canadian economy is currently stronger than that of the U.S., trade ties the two together. With the price of oil sinking precipitously, there is nothing to prop Canada up.

The outlook is clouded by risks; and until the heightened uncertainty clears, North America is doomed to a gloomy future.

The U.S. economy pleads with Congress and the Fed

Since our Fall Outlook, consumer spending, exports and credit availability have worsened significantly. If in the first half of 2008 the U.S. economy was slowly walking with a cane of exports, it is now bedridden. Credit conditions have tightened markedly and consumers are retrenching, making the ongoing recession longer and deeper.

Our forecast includes three consecutive quarters of contraction, followed by a couple with sluggish growth in 2009. The U.S. economy returns closer to its potential (3.5%-4.5%) in 2010, but only after a massive amount of policy stimulus is well underway.

Unfortunately, today's negative economic news stems from shocks that occurred six months to a year ago. It is becoming clear that credit markets which are thawing at a glacial speed will cause disruptions in the real economy going forward – restricted lending, a slower housing recovery, reduced consumption and investment, and a longer labor contraction. For each week that credit markets remain on red alert, tack on a week or two to the recession.

Exports are set to revert. A surging U.S. dollar (USD) and global contraction are expected to push export growth under water in Q4. The U.S. economy can no longer rely on foreigners for economic expansion. We must do it on our own, and domestic demand – government, firms and consumers – will need to fill the gap. The only silver lining is that import demand is set to decline alongside weak consumer spending by more than the decline in U.S. exports, which means a little added GDP growth.

Jobs are falling faster than a twenty-pound weight.

The Bureau of Labor Statistics reported that in just three short months enough jobs were slashed to fill the city limits of Boston. This is no longer a manufacturing-driven labor contraction, it's broad-based. Firms in all sectors are clinging to any productivity gains (i.e. profits) that they can muster

up by quickly cutting the size of their workforce. Furthermore, headlines suggest that the layoffs will continue into the first half of 2009. This cycle is going to be bad, and may even approach the horrendous labor market in the 1980s. While the Depression bells won't toll with 25% unemployment, we see another 1%-2% leg up in the unemployment rate to 7.5%-8.5%.

Thrifty consumers are emerging from the woodwork.

Consumers are finally succumbing to housing and equity wealth shocks as real spending shrinks. Third quarter personal consumption expenditures contracted 3.7% on an annualized basis, the worst quarter since an 8.6% contraction during 1980. With the labor market not expected to hit bottom until 2009 and with equity and housing wealth sliding, consumer spending in the fourth quarter will mark the fifth time since 1947 that consumption has contracted two consecutive quarters in ten dated recessions (2008-2009 recession will be the eleventh).

Interestingly enough, there is a positive side....albeit small in comparison. Gas prices were halved since their July peak, falling around \$2/gallon since their July peak, and have stimulated consumer spending power by up to \$20 billion/month. Furthermore, home sales – existing and new – have likely bottomed, signaling an eventual emergence of a housing market. At best, rock bottom pricing encourages sales and jumpstarts a recovery, and at worst the housing market takes another leg down under tight credit conditions. The most plausible forecast, however, is that the worst of the housing contraction is behind us, and that this sector will only drag GDP for one more quarter until housing starts bottom in the second quarter of 2009.

Without any positive stimulus coming from the Treasury and the Fed, the economy would take an even deeper and harder tumble. While the Fed has already turned on the printing press, the Treasury is dragging its feet on stimulus spending. With a new administration waiting to spread its wings, we are confident that Congress will take the suggestions of an overwhelming majority of economists – including those who are normally fiscal conservatives – to pass a massive fiscal stimulus package.

In this environment, expansionary policy gets a free ride. There is no better time to crank up the deficit spending and print shiny new Greenbacks than in the middle of a recession-backed credit crisis. We see very active policy as the only way to mitigate this recession to the point that it lasts just twelve rather than twenty-four months. Fiscal policy is our get-out-of-jail-relatively-free card, and we must use it.

Canada has officially entered the danger zone

At first, it looked as if Canada was immune to the woes of its largest trading partner to the south. However, betting on an extremely volatile commodity like oil definitely has a downside....its price comes down. As world commodity markets collapse, so too does Canada's crutch.

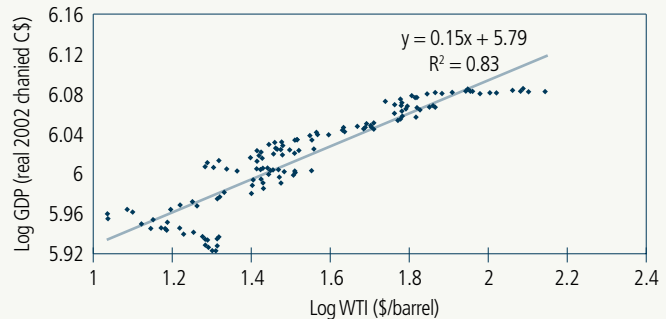
Canada is bound to suffer as the U.S. economy shrinks, but its economic pain won't be quite as bad. First of all, Canada is starting at a higher point than is the U.S. Its labor market is stronger with historically low unemployment, its housing market has started to tumble, but only slightly, and there is a lot of room for expansionary policy at the Bank of Canada and the Department of Finance.

A decline in exports is no longer a risk to the outlook – they are definitely going to decline. Although the Canadian dollar has depreciated relative to the USD, a fourth-quarter U.S. contraction of 4% will certainly weigh very heavily on Canada's export sector. Unfortunately, the economy must suffer through it and hope that the U.S. recession is just as expected rather than the worst-case scenario.

With oil prices tumbling, Canada has lost its main growth driver, and we now expect a sharp slowdown in domestic demand that is driven by reduced consumption and investment spending. With a predominantly commodity-based revenue stream, firm profits are set to decline until manufacturing and commodities production picks up again with global growth. In our baseline scenario, this is not until the middle of 2009, the recovery in these sectors will be slow at best.

In the meantime, the labor and housing markets will turn downward. Although employment posted three monthly increases, the latest month was mostly an election-driven surge in hires. Furthermore, sinking equity values and production will force firms to scale back their workforce – at least partially – in an attempt to maintain some productivity, which is currently negative. Housing has already started to tumble, and with labor income expected to decline, households will be slow to make big borrowing decisions, like buying a home.

Falling commodity prices pose a real risk to Canada's growth outlook



Source: Statistics Canada; Bloomberg; Economic Research

The upside for Canada is more aggressive policy. The Governor of the Bank of Canada, and the Minister of Finance are expected to support expansionary fiscal and monetary policies. Amid disinflation and the increasing downside risks to growth, the Bank of Canada is expected to cut interest rates up to 50 bps at their next meeting. Furthermore, with the support of the Prime Minister, we expect that the Department of Finance will provide a fiscal stimulus package for Canadian consumers early in 2009. Hopefully, the stimulus measures will be large enough, and soon enough, to give footing to an economy that is quickly approaching a slippery slope.

Europe:

In recession, but policymakers have been slow to attack

All of Europe is tracking the global credit and economic cycle, weakening sharply as the crisis intensified this fall. The impacts range from a near-total collapse in Iceland to a sharp recession in the U.K., a more gradual slide in the eurozone – though probably just as painful in the end – and severe stresses in Scandinavia and Switzerland. Eastern and Central European countries are also suffering to varying degrees, depending on their financial vulnerability.

Eurozone

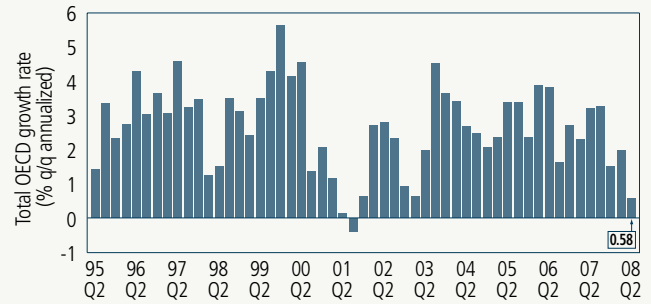
The eurozone, at first, seemed relatively unscathed by the U.S. slowdown as most countries (except for Spain and Ireland) had not experienced a housing bubble of the same magnitude, while, apart from regional German banks, the sub-prime fallout looked modest. Meanwhile, exports, especially from Germany, maintained a seemingly unstoppable momentum even as the euro strengthened.

Since mid-year, however, everything looks worse. All the major economies are contracting, and the European Central Bank (ECB) is only now, very belatedly, coming to appreciate the worsening real economy and the receding threat of inflation. With exports finally shrinking as the global recession develops, the outlook for coordinated fiscal stimulus is poor, and the ECB is still lagging in terms of monetary easing.

A more severe recession than in the U.S. now seems likely. The existence of the eurozone has averted the internal currency crises that might otherwise have occurred, though at the cost of severe fiscal strains in the weaker economies. These are expressed in the credit markets through higher interest rates on government debt.

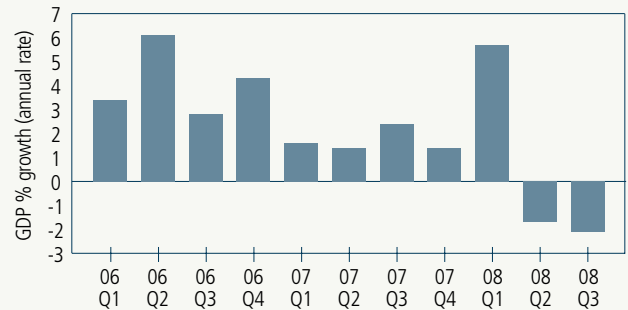
In Germany, although GDP declined for the second straight quarter in Q3, employment kept growing, and is probably only now (Q4) starting to slide. But with the rest of the region already soft, the serious weakening in the German outlook seems certain to further drag down its neighbors. Political obstacles to coordination across the eurozone will not prevent any fiscal stimulus, but will nonetheless make it harder to generate a significant boost to the macro-economy. The European Union lacks the kind of cooperation between central bank and treasury that is feasible in more unified governments.

A global slowdown is already underway



Source: Organization for Economic Co-Operation and Development

The German growth engine has stalled out...



Source: Eurostat

...and business sentiment is plummeting



Source: Eurostat

U.K.

With its heavy dependence on the financial sector, as well as a housing cycle to rival that of the U.S., the U.K. economy is sinking fast into its first recession since the early 1990s. The Bank of England has shifted abruptly to easing, with a dramatic 150 basis point interest rate cut and more expected very soon. The collapse of oil prices has mitigated headline inflation pressures, while the steep downturn has eliminated inflation as a near-term policy issue.

Meanwhile, the government is burnishing its popularity with decisive action, a large and economically powerful package of tax cuts and public spending. The economy is still expected to contract for more than four quarters, with GDP declining by about 1.5% in 2009 as a whole. Aggressive policy actions should lead to renewed growth by the end of 2009.

Central & Eastern Europe

The outlook for the smaller economies of East and Central Europe varies widely depending largely on their fiscal and external debt balances. The Czech Republic, Slovakia and Slovenia seem in relatively good shape, Hungary and the Baltics mostly worse, with Poland somewhere in the middle. All face slower growth in the downdraft from the euro zone, with credit tight and inflation falling.

Ultimately, however, the newer EU member countries remain highly competitive, enjoying advantages of proximity, low costs, free trade and institutional support. In some cases, growth rates will remain positive despite the slowdown; and even those who are in recession will rebound fast when Germany and the core of Europe start to recover, probably by the end of 2009 or early 2010.

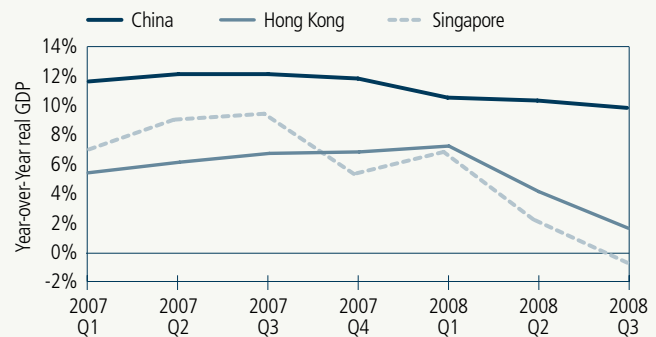
Asia:

Cannot remain immune to global troubles

The U.S. troubles have quickly spread overseas, depressing growth around the world and cutting into demand for all products. With Asian exports falling down, its cost of credit heading up and corporate capital inflows drying up, the region suffers a greater than anticipated hit to growth.

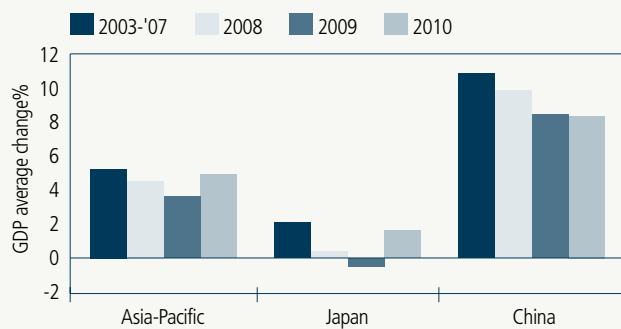
The main challenge to policymakers going forward will be how aggressively to support their shrinking economies. We remain optimistic that a combination of growing intra-regional trade, firming domestic demand, lower interest rates and more aggressive pro-growth policies will offset most of the pullback in foreign demand. More importantly, as the rest of the world recovers, the growth in the export sector will pull the region back up to its long-term growth trend.

The asian slowdown has been precipitous



Source: Data Insight

...Dampening expectations of a quick recovery



Source: Economic Research

Japan is in a recession and its outlook gets worse

Japan's Economy Minister confirmed that the economy shrank another 0.1% in the third quarter, following a 0.9% drop in the second quarter. Overall, the country's GDP – second only to the United States – is down 0.4% this year.

Manufacturing activity has weakened, and small wage gains signal that consumer spending will not provide enough support to the slowing economy. Employment data, consumer confidence through October and a sharply rising yen point to worsening conditions immediately ahead. Therefore, we now anticipate that the contraction in the second half of 2008 will extend into the first half of 2009, and that it will be followed by a slow recovery in the second half of the year.

In brief:

- The sluggish business investment seen since last winter continues, and profit margins are declining as companies are unable to pass on increasing costs to consumers. Going forward, tight credit conditions and greater financial and macroeconomic uncertainty will keep profit gains under pressure.
- Japan is a big exporter of goods, and a strong yen hurts profits for Japanese firms. It hits export demand, and foreign sales translate back into fewer yen. Therefore, the more the yen has climbed, the worse Japan's stock market has performed.
- The JPY climbed to a 13-year high against the USD and a 6-year high compared to the EUR as the worldwide drop in stocks has encouraged investors to sell higher-yielding assets and pay back low-cost loans in Japan. Going forward, the yen will fluctuate around a weakening trend line against the USD as the domestic recession gets worse, the fiscal deficit increases, interest rates remain low, and the external surpluses narrow. Longer term, we see the yen settling near the Y100/USD.
- The Bank of Japan (BoJ) cut its target overnight rate by 20bps to 0.3% on October 31st. This was the first cut in seven years. Further cuts are possible, but are unlikely to change the outlook. We anticipate that only a more aggressive fiscal stimulus than the \$51 billion already unveiled along with a global recovery can offset a Japanese tradition to save even more as economic times get difficult.

China opts to shore up its rocky landing using fiscal stimulus

China's incoming economic data points to a sharp slowdown. The housing market is tapering off, production and exports are faltering, and consumer spending is pulling back. Indicative of the repressed economic environment is the 4% y/y drop in electricity output in October, and the 8.2% y/y growth in industrial production, its weakest in four years.

To prevent a stronger retreat, authorities announced in November a US\$600 billion fiscal stimulus package that amounts to about 14% of GDP over the next two years. The package includes a range of infrastructure projects, enhanced government services and tax cuts. How much is really incremental spending remains murky, but in conjunction with monetary easing and a slower pace of the renminbi's appreciation, the stimulus should anchor the economy going forward.

In the very near-term, China's economic growth is expected to turn weaker in response to past tightening measures and

weaker global demand. Q4 will hopefully mark the low point in China's growth cycle, with policy stimulus increasingly helping the economy early in 2009. Although our forecast calls for GDP to expand at 8.4% in 2009, this is a significant slowdown for an economy that has experienced double-digit growth, and where anything below 8% is not sufficient to support its growing labor force.

In brief:

- A slower world economy implies weaker Chinese exports. The main risk is that a greater than anticipated collapse in exports may overwhelm the projected 20% y/y growth in investment and 11% y/y growth in consumer spending.
- Exports may decelerate very sharply during the Christmas season, which is consistent with our U.S. forecast of Q4 GDP growth at -3%.
- The weakness in the export sector and real estate construction has depressed, and will continue to depress demand for raw materials and manufacturing products.
- Destocking of inventories – especially in the raw materials sectors – continues, exacerbating the downward pressures on product pricing.
- A 10% drop in exports (40% of GDP) in the first half of 2009 would require huge growth in non-export demand to make up the loss to GDP. However, if the world economy is not recovering by then, China's growth could slide below 8%.
- The growth of foreign direct investment in China slowed further in October to 35% y/y to US\$81 billion from a gain of 40% during the first nine months of the year.

Hong Kong's expansion slows sharply

The economy has decelerated since the end of last year. On a year-over-year basis, the economy grew 1.7% in Q3, a sharp slowdown from the 4.2% growth in Q2, and a strong indication that the territory is over the edge into a recession. Given the continuing global slowdown, GDP growth is expected to follow a downward trend for the rest of 2008 with a mild recovery in 2009.

Further ahead, the speed in Hong Kong's recovery depends on the global recovery. While the domestic service sector will continue to make a sizable contribution to growth, it is not expected to be enough to offset the loss from exports.

A risk to the outlook comes from a sharper decline in dollar reserves (selling) to maintain the peg for the HKD versus a firming U.S. currency. The FX intervention could drain reserves from the banking system, but this may not be sustainable

without risking a more negative economic outlook. On the positive side, HKMA will provide government backing for all the territory's bank deposits through 2010, and stand ready to inject capital into the banking system.

Singapore also in a recession, but taking the right pro-active steps

The -0.5% y/y drop in Singapore's GDP in Q3 is the latest sign that the economy is slipping into a recession. However, given the good start in 2008, we are still projecting near 2% y/y growth for 2008. Further ahead, we see the economy growing at 1%-2%.

Singapore exemplifies the challenges faced by the rest of Asia. As the drop in exports to the U.S. and Europe continues, domestic monetary and fiscal policy will need to be more actively injecting liquidity and/or promoting spending to prevent a more painful recession. We are encouraged that on the monetary side, the authorities see a need to increase the monetary base while expanding credit, and like in the U.S. are guaranteeing all bank deposits through the end of 2010.

A fiscal stimulus alongside expansionary monetary policy gives the biggest bang for the policy makers' buck

Globally policy makers are on red alert. From North America to Europe and on into Asia, central banks and sovereign governments are suiting up for attack. Although each economy separately is making policy decisions based on the domestic risks, this is a global crisis; and while each economy suffers separately, tightly interlinked capital markets and trade makes it possible to derive significant mutual benefits from a coordinated response.

We simulate two scenarios to understand the impacts of coordinated expansionary policy: (1) Major central banks cut target interest rates in 2009 by an additional 75% from November 2008 levels, and (2) Fiscal governments increase spending by 1% of GDP in addition to the coordinated rate cut.

Compared to our baseline forecast – a middle ground between these two alternatives – coordinated monetary policy adds 0.5% to world growth over the three year horizon. The biggest impact is seen in Canada and China. A greater impact comes from combining fiscal spending with monetary easing. Overall, the world sees 1.7% additional growth over three years. All of these economies enjoy added growth, ranging from a 1.3% boost in the U.S. to a 3.1% surge in China.

In sum, global economies are weak and getting weaker and while individual countries are responding with various degrees of urgency, it is clear that in this global recession, the biggest boost to economic recovery will come when policy makers join forces.

Accumulated additional growth: 2009-2011*

	Coordinated monetary policy alone	Coordinated expansionary monetary and fiscal policies
World	0.5	1.5
United States	0.3	1.3
Canada	1.1	2.7
Eurozone	0.4	1.6
United Kingdom	0.2	1.6
Asia-Pacific	0.9	2.2
China	1.5	3.1

Source: Economic Research

*The simulated growth rates are the cumulative sum of additional economic growth for each region spanning the years 2009-2011

Risks to the Global Outlook

Global growth is now decelerating more sharply than previously anticipated. We are forecasting a recovery by the second half of 2009. However, this cycle has multiple possible paths. At present, the risks to our gradual recovery by the second half of 2009 are squarely to the downside. Some alternative scenarios:

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

1. Global meltdown – probability 20%

U.S. and European economic troubles could still take another leg downward, compounded by a Chinese hard landing and Japanese consumers retrenching further. This results in a sharper drop in asset prices with spiking corporate and financial defaults. If U.S. and European consumer demand dives in shock, we will be well into a deeper recession or a more sluggish recovery, 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 boom-bust – probability 10%

A combination of good luck and pre-emptive policy propels the major economies' ongoing economic slump into higher gear. However, the massive amount of liquidity and demand stimulus soon ignites fear of inflation. The resurgence of growth underlined by too much cash lying around is followed by severe monetary tightening and a long world recession.

3. 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. Lead by China and the rest of Asia, the sale of U.S. assets creates a downward price spiral. While other major markets might benefit at first, the slump in the U.S. would more than offset any global gains.

4. Deflation – probability 5%

The economic recession results in sharp price declines, raising the prospect of deflation. While we believe that policy can prevent this outcome, fear and incompetence could set in motion a deflationary spiral. In this scenario, lower prices add another threat to an already vulnerable global economy dealing with weak consumer demand, tight credit and slow income growth. We cannot avoid a global contraction, but assuming that we have learned the lessons of the U.S. during the Great Depression, policy prevents a deflation – using massive injections of liquidity and fiscal stimulus – pulling us out of the abyss.

5. The Perfect Outcome – probability <5%

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 after a short period of intense pain, the recovery gains just enough momentum that central banks withdraw excess liquidity just in time to avoid a surge in inflation.

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