

# GLOBAL INTELLIGENCE

<b>Global Economic Outlook</b> Bill Cheney . . . . .	Page 1
<b>Global Market Outlook</b> Steve Tyson and Peter Mennie . . . . .	Page 4
<b>U.S. Equity Outlook</b> Mark Schmeer . . . . .	Page 6
<b>Canadian Equity Outlook</b> Pat McHugh . . . . .	Page 9
<b>European Equity Outlook</b> David Hussey . . . . .	Page 12
<b>Emerging Markets Outlook</b> Peter Mennie . . . . .	Page 14
<b>Asian Equity Outlook</b> Tahnoon Pasha . . . . .	Page 16
<b>Japanese Equity Outlook</b> Yoshihiro Murakami . . . . .	Page 19
<b>Global Fixed Income Outlook</b> Barry Evans . . . . .	Page 21
<b>North American Fixed Income Outlook</b> Terry Carr . . . . .	Page 23
<b>Asian Fixed Income Outlook</b> Victoria Ip-Cheung . . . . .	Page 26

## Global Economic Outlook



**Bill Cheney**

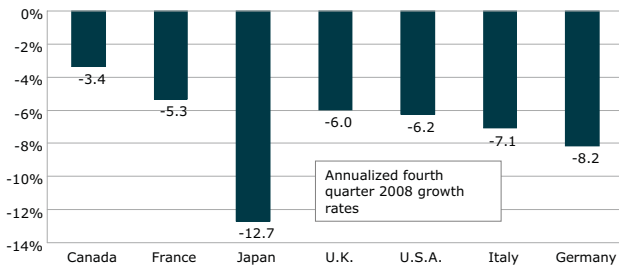
**Only after the U.S. economy has passed on some of its economic strength to the rest of the world will exports increase, which, at best, will occur in the latter part of 2009.**

The U.S. economy contracted at an annualized rate of 6.3% over the fourth quarter. Japan and countries in Europe and most of the Pacific Rim are contracting even more rapidly. Even China's economic growth is slowing at a pace that looks like a severe recession.

The policy responses by governments around the globe have been aggressive, but the nature of the financial crisis has forced much of the world into what looks like a "liquidity trap," where low interest rates fail to boost economic activity. Since exports cannot drive economic recoveries in individual regions during a global downturn, the last resort is to boost domestic demand through fiscal stimulus, and virtually all countries are now doing so.

# Global Economic Outlook (Cont'd)

## The G7 have fallen....hard



Source: Data Insight, MFC Global Investment Management

## U.S. Descent Continues

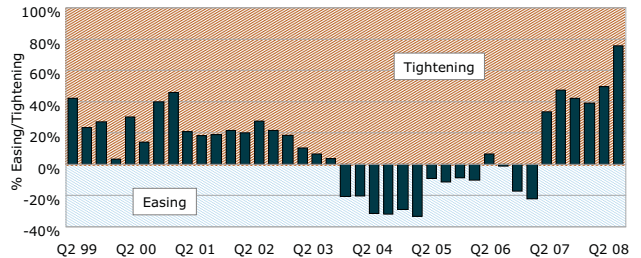
This recession is shaping up to be the worst consumer – and possibly economic – contraction since the 1930s. Eventually the recession will end and the economy will grow. But for now, we search for faint clues of stabilization in key sectors.

Exports kept the U.S. economy growing through the second quarter of 2008, but dropped 24% in the fourth quarter. Weaker imports are now improving the trade balance, shifting some of the pain to the rest of the world and mitigating the impact on U.S. growth. Only after the U.S. economy has passed on some of its economic strength to the rest of the world will exports increase. At best, this will occur in the latter part of 2009 and more likely in 2010.

As long as the U.S. dollar remains the world's safe haven currency, the U.S. Federal Reserve Board will continue to flood liquidity into the credit markets. With short-term rates close to zero, however, this is just averting disaster and not really providing stimulus to the economy. To give the economy a real boost, President Obama signed a \$787 billion stimulus bill into law, which should partially offset the declines in private spending. Additional measures to boost home and auto sales are also in the pipeline.

Although we are calling for negligible growth in the third quarter of 2009, the assumptions regarding our U.S. outlook are threefold: (1) housing starts bottom in 2009; (2) the fiscal stimulus being introduced is enough to keep unemployment from rising above 9.5%; and (3) policymakers are successful in appeasing market fears about the safety of the banking system.

## Canadian Bankers Still Tightening Credit



Source: Bank of Canada, Senior Loan Officer Survey

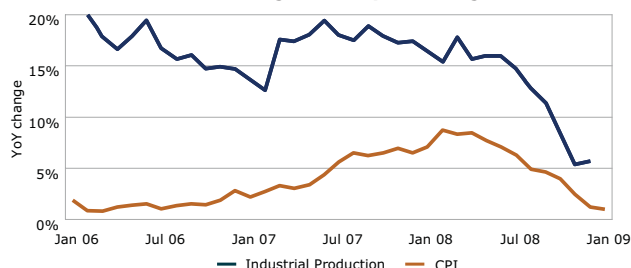
## Canada Feels U.S. Pain

For Canada, the bad news comes in the form of a sharp U.S. economic decline and resulting global meltdown driving down oil prices, slamming exports and threatening the survival of many manufacturers.

Shrinking housing, labor, finance, and export industries all resulted in a sharp, annualized fourth quarter GDP decline of 3.4%. Domestic demand is retrenching, while the labor market has lost over 270,000 jobs in the first three months of 2009.

Canada's economy is expected to shrink for an extended period even with an aggressive policy. The Bank of Canada (BOC) is flushing the banking system with liquidity, and has steadily cut its key lending rate, which now stands at only 0.5%. We expect another 25-basis-point (bp) cut at the next BOC meeting, along with the possibility of announcements regarding quantitative easing measures.

### Chinese Inflation Fading As Output Plunges



Source: National Bureau of Statistics (China)

### Timing of Eurozone Recovery in Question

The eurozone suffered its deepest contraction on record in the last quarter of 2008 as GDP shrank by more than 6% on an annualized basis.

The slump in the industrial and export sectors has provided negative momentum for 2009. In our base case this implies a 2.4% contraction in 2009, with no sustained economic recovery expected before the first half of 2010.

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 also expected to see sharp declines in tax revenues because of surging unemployment. The reality is that many countries will be unable to spend much more, as the rising cost of their rich social benefit systems will need to be balanced against a European mandate to keep budget deficits contained.

A close look at eurozone export data (about 43% of GDP) reveals another gloomy situation. Exports outside the eurozone are struggling, but so too are exports between the eurozone countries. Given the broad declines in economic activity across Europe, trade activity is likely to fall significantly in the foreseeable future.

### U.K. Downturn Worsens

The U.K.'s contraction of 1.6% (6.5% annualized) in the fourth quarter of 2008 was followed by another 1.5% monthly decline in March. Even with aggressive policy support, the U.K. economy is expected to recover only weakly in 2010. The collapse in the British pound is helping ease the pressure, but the lack of global trade limits the positive impact of a weaker currency on the economy.

Consistent with the current gloomy picture, the Bank of England has cut its policy rate to 0.5%, the lowest rate since the founding of the central bank in 1694.

### Asia Hit by Falling Exports and Domestic Demand

After much talk about "decoupling," the drop in U.S. and European demand has decimated Japan's export industries and sent its economy into a severe downturn. GDP has already contracted for three quarters, with the fourth quarter of 2008 showing the sharpest drop since 1974. There is now little chance of Japanese economic growth until the second half of 2009 (at best).

Japan's year-over-year core Consumer Price Index (CPI) is back down to zero, and is heading into negative territory. With commodity prices sliding, consumer demand weak and exports plummeting, there is no pricing power and nothing to arrest the country's slide into deflation.

China is the dominant buyer, supplier, competitor and powerbroker in Asia. As exports have ground to a halt, so has business investment and real estate development. Fiscal and monetary stimuli are being introduced, but it's unclear how quickly such an unbalanced economy can redirect its huge productive capabilities towards domestic demand. The latest signs of revival have raised forecasts, but from a very low level.

# Global Economic Outlook (Cont'd)

## Renewed Developed World Growth Seen In 2010

	2003-07 Average Estimate	2008	2009 Forecast	2010 Forecast
<b>Real Economic Growth (% change in GDP)</b>				
World	3.6%	2.3%	-1.5%	2.5%
United States	2.9%	1.3%	-2.6%	3.0%
Canada	2.7%	0.6%	-2.0%	3.1%
Eurozone	2.0%	0.8%	-2.4%	1.0%
Japan	2.1%	-0.4%	-5.8%	1.3%
China	10.8%	9.0%	6.1%	8.4%
<b>Inflation (% change in CPI)</b>				
United States	2.9%	3.8%	-1.3%	1.0%
Canada	2.2%	2.4%	0.2%	1.8%
Eurozone	2.0%	3.2%	0.6%	1.3%
Japan	-0.1%	1.3%	-0.7%	-0.4%
China	2.6%	5.9%	0.9%	1.1%

Source: MFC Global Investment Management

*Bill Cheney is Chief Economist and Assistant Vice President at MFC Global Investment Management. Economists Oscar Gonzalez and Rebecca Braeu also contributed to this report. All are based in Boston, Massachusetts.*

# Global Market Outlook



Steve Tyson



Peter Mennie

The equity market return has compounded at a 6.2% real rate when measured over the very long term and we expect returns over the next 10 years to be above that long-term average.

Last quarter, we argued that equity markets were in the process of bottoming and that the projected rate of economic decline would start to slow. The recession wouldn't be over but leading indicators would start to bottom out.

So it has happened. Market weakness in January and February turned around sharply in March. It is impossible to know whether the start of quantitative easing by global central banks will have coincided exactly with the market bottom, but monetary policymakers have certainly sent the signal that they are prepared to print their way out of a crisis.

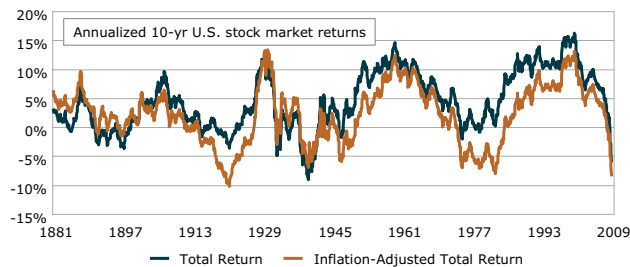
We spend a lot of time debating the tactical movements of asset classes, but in fact, this winter has been a time to be more strategic in one's thinking. We've had to go back over the last century

to find data which covers previous eras of serious deep recession and even depression to find suitable periods of comparison.

## A "Lost" Decade

This last decade has been a miserable one for equity investors. This is not unprecedented, but we think the next decade will be very different.

### A "Lost Decade" of Returns...

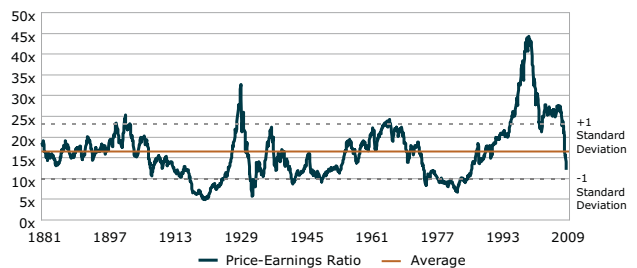


Source: Robert Shiller website ([www.econ.yale.edu/~shiller/](http://www.econ.yale.edu/~shiller/))

The equity market return has compounded at a 6.2% real rate when measured over the very long term. The last 10 years have been very disappointing and thus caused us to fall below the trend by over one standard deviation. Over the past hundred years, when equities have been this far below trend, real returns have been higher than the 6.2% average. This is one reason we expect returns over the next 10 years to be above that long-term average.

Valuations are getting closer to historic lows as well. The method of adjusting the price-earnings (P/E) ratio to be based on the last 10 year's average earnings has become increasingly popular. Known as the Shiller P/E (after Robert Shiller, the American academic who popularized the method), this smoothing of the earnings cycle is useful in periods where earnings are depressed – and quite frankly should have been given more heed back in 2000 when valuations were excessive.

### ...Has Valuations At Multi-Year Lows



Source: Robert Shiller website ([www.econ.yale.edu/~shiller/](http://www.econ.yale.edu/~shiller/))

Recently, the cyclically adjusted real Shiller P/E touched the bottom quartile of its historic range. In the past, investors have never lost money 10 years later on a cumulative basis from that point. A few months later can be a different story: these are not market timing tools, they are strategic tools, but we believe it is better to be slightly too early and to continue a policy of steady accumulation than to miss the turn in markets.

## The "Wall of Worry"

This brings us to what will happen over the next few months. As of the end of March, the market had rallied sharply. This is exactly what we expected and we think it's justified. But there will be lots of bad news yet to emerge in 2009. Corporate profits and the economy aren't rebounding just yet, and the various quantitative easing policies have yet to gain traction. Nevertheless, markets "climb a wall of worry" as they emerge from recession.

We expect a rally, then setbacks, as investors realise that after some initial policy success, there are many years of slower consumer spending and debt deleveraging ahead.

# Global Market Outlook (Cont'd)

Our favourite market has been the U.S., for the reason that we expect policy actions to have their first impact there. Our least favourite asset class is government bonds. We see significant inflation risk emerging in 2011-2013, and bonds are not pricing in that scenario.

*Steve Tyson is Chief Investment Officer and Peter Mennie is Senior Portfolio Manager at MFC Global Investment Management (Europe). Both are based in London.*

## U.S. Equity Outlook



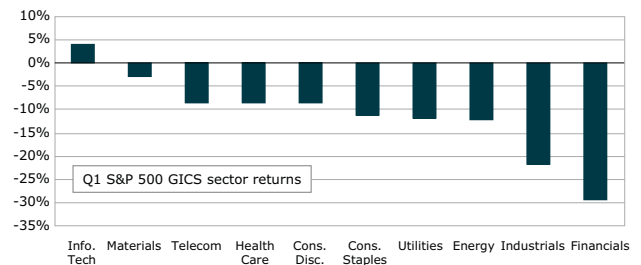
Mark Schmeer

**The valuations of many outstanding companies are at exceptional levels. Although we could see a short-term correction, we believe investors will be rewarded over the coming year.**

The S&P 500 Index fell 11.7% in total return terms over the first quarter of 2009, marking the index's sixth consecutive quarter of negative returns. From the index's October 2007 high to its March 2009 low, the S&P 500 Index fell a total of 57%, making this the worst bear market since the Great Depression. A rally of 18% from its March 9, 2009 low to the end of the first quarter of 2009 softened the blow, and set off a wave of optimism that the bear market may finally be over.

Financials declined almost 30% over the quarter and once again led the market lower. The second weakest sector was industrials, which was off 22%. Areas of relative strength were information technology, which was up 4%, and materials, down a relatively meager 3%.

### Financials Again Led Market Lower In Q1



Source: Bloomberg

Over the month of March, the financial sector was the strongest-performing, increasing 18%. The materials sector was second, closing the month up 15%. The weakest-performing sectors in March were utilities, consumer staples, and energy, with each of these sectors up approximately 3%.

This bear market has been extraordinary. The market's return over the past 10 years is now negative, making this the first 10-year period of negative returns since the 1930s. The decline has been driven largely by the financials industry, where write-offs have now

exceeded US\$1 trillion. At the market's peak, financials were over 20% of the S&P 500 Index. They bottomed in early March at less than 9% of the index.

### History Points to Better Times Ahead

While earnings were especially weak among financial companies, they have actually been quite weak across the board. At the market's peak in 2007, 2008 consensus earnings estimates for the S&P 500 Index were US\$101 per share. Actual 2008 earnings came in 32% lower (at \$68.54). Earnings for 2009 are expected to decline even further, to \$51. This suggests the stock market's decline has been largely driven by earnings, rather than valuations. In fact, when the market peaked in October 2007, the price-earnings (P/E) ratio on the index's 2008 estimated earnings was 15.5 times. At the end of March, the P/E on 2009 estimated earnings was 15.6 times.

The good news about such a severe bear market is that in the past, when long-term returns have been well below average, the following 10 years have generally been periods of above-average returns. Shorter term, the question investors must ask themselves is: Was the rally off the March low the beginning of a new bull market or just a bear market rally? There has, in fact, already been one bear market rally of more than 20%. This occurred between November 20, 2008, and January 6, 2009. That rally fizzled and the March low soon followed.

### Stocks Recover Before the Economy

To answer the question of where we are today (bull market vs. bear market rally) requires clarity about the economy, about the pace of the decline and about the timing of the recovery. Stocks generally bottom before the economy and then rally sharply off their lows. Most typically, the stock market bottom occurs

three to five months before the recession ends, but the lead time can be as much as 10 months before the end of the recession. If March was the bear market bottom, we must believe it is reasonable to expect the economic recovery to begin sometime in the second half of 2009. The unprecedented steps taken by the U.S. Treasury Department and the U.S. Federal Reserve suggest a second half recovery is quite possible.

#### Equities Rally Well Before Recession's End

Recession start date	Length (months)	No. of months before recession's end that market bottoms	Subsequent rally*
Aug-57	8	5.3	28%
Apr-60	10	3.2	29%
Dec-69	11	5.1	51%
Nov-73	16	5.0	54%
Jan-80	6	3.2	43%
Jul-81	16	2.7	61%
Jul-90	8	4.6	34%
Mar-01	8	1.4	21%
Average	10.4	4.2	40%

\*Trough to peak within six months

Source: MFC Global Investment Management, Bloomberg

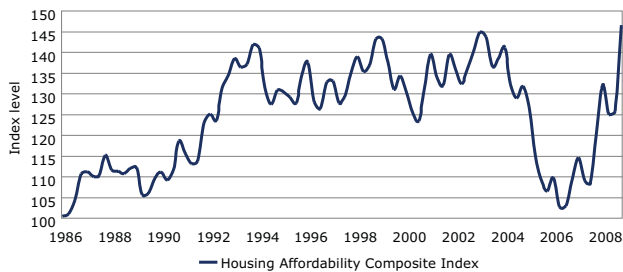
### Lower Mortgages and House Prices Underpin Recovery

The massive amount of mortgage refinancing activity that is now underway is also impacting consumers. The average rate on existing mortgages is around 6.50%. Mortgages are being offered today at rates of around 4.75%, with rates likely headed to 4.50%. The surge in refinance activity that has resulted from these low rates is so great that some banks are overwhelmed and adding staff to meet the demand. If all outstanding mortgages in the U.S. were refinanced, the American consumer would reap a \$200 billion benefit. Not all mortgages will be refinanced, but the impact will be very significant nonetheless.

## U.S. Equity Outlook (Cont'd)

Lower mortgage rates are impacting the economy in another way. With both mortgage rates and house prices declining, home purchase affordability has reached an all-time high. The mortgage affordability index illustrates how a family with a median income can now afford a home valued at 147% of the median value of a home in their region. Increased demand for homes as a result of improved affordability is eventually going to stabilize home prices, which is a necessary part of any economic recovery.

### Home Affordability At All-Time High



Through Dec. 31, 2008

Source: Bloomberg

### Not All the News is Bad

It is encouraging to note that the flow of good and bad economic news has also become more balanced in recent weeks. In November, as the recession was gaining momentum, the overwhelming majority of economic news was negative. By our count, the news flow has actually been more evenly mixed in recent weeks. Any shift toward more positive headlines can only be good for stock prices. Some recent favorable economic news included higher home sales in February, higher auto sales in March, favorable trade numbers in January, and two months of surprisingly good retail sales in the first quarter.

Provided the economy improves in the second half of 2009 as expected, it seems likely the market did reach its bottom in early March. Typically the rally off a bear market low is dramatic. There is still some significant risk, however, particularly in the short term. Credit conditions, while better, are not yet back to normal. The recession is in full force and job losses are mounting. Consumers are more interested in saving than spending, a factor that will likely impact economic growth for years. The impact of the recession on corporate earnings is still being felt. We believe first quarter earnings could generate some disappointment, particularly if guidance remains subdued.

These risks notwithstanding, the length and depth of this bear market has been dramatic and a bottom was likely reached in early March. Investor pessimism is extraordinarily high and the valuations of many outstanding companies are at exceptional levels. We would not be surprised to see a short-term correction, but believe investors will be well rewarded over the coming year.

*Mark Schmeer, CFA, is Chief Investment Officer, Global Equities, and Head of Research at MFC Global Investment Management. He is based in Toronto.*

# Canadian Equity Outlook



Pat McHugh

**A retest of the recent lows is possible, but investors are encouraged to take advantage of the solid fundamentals offered by the Canadian equity market and to position themselves accordingly.**

The Canadian equity market experienced a strong and sharp 7.8% rebound in total return terms in March, putting the S&P/TSX Composite Index down only 2.0% for the first quarter of 2009 as a whole.

The first quarter losses were broadly distributed across the Canadian equity market, as seven of the index's 10 sectors lost ground over the period. The only sectors that advanced during this period were information technology, which gained 8.8%; materials, up 7.8% (in response to the potential bottoming of a variety of commodity prices); and health care, which advanced 4.3%. While only three sectors were positive performers in the first quarter, at the sub-sector level, integrated oil & gas and banks also enjoyed positive performance, advancing 14.8% and 1.0%, respectively. Utilities, industrials, and consumer discretionary were the worst performing sectors, falling 11.9%, 10.2%, and 7.5%, respectively, over the quarter.

## Economic Signals Promising

As the first quarter came to a close, consensus opinion was still decidedly mixed as to the magnitude and duration of the recession. Nonetheless, the market experienced a strong rally in March based on a number of positive market and earnings-based developments. Bank executives highlighted improved business conditions, while a number of U.S. banks reported an interest in returning some of their Troubled Assets Relief Program (TARP) funds to the government.

Signs also began to emerge that the U.S. economy is starting to stabilize, especially with regard to housing and mortgage refinancing. Investors positively responded to U.S. Treasury Secretary Timothy Geitner's Public-Private Investment Program, and were further encouraged to see a change in the mark-to-market accounting rules. As the quarter came to an end, March employment data was released and was also not as bad as some had feared.

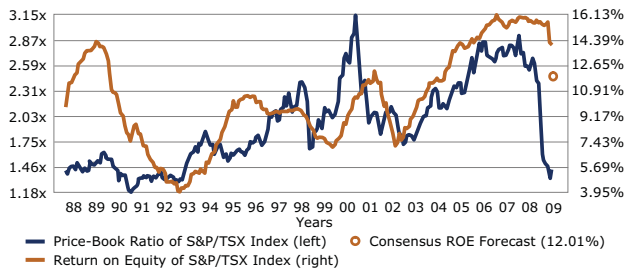
Overall, there were plenty of positive developments that helped bolster equity markets. Our view remains unchanged: the market has already discounted the negative economic news and we expect the March Canadian equity market lows to hold. A significant part of the market movement in March was not hedge funds covering their short positions, but investors re-establishing long exposure. While this may have been simple trading activity, establishing long positions should be viewed as positive nonetheless.

We believe investors should pay heed to the significant and unprecedented global stimulus packages that will begin to gain traction and help stimulate an equity market recovery. No matter how one measures it, equity markets are cheap and the

# Canadian Equity Outlook (Cont'd)

fundamentals supporting the Canadian economy are solid. Most importantly, investors are reminded that over the past 50 years, the S&P/TSX Composite Index has, on average, bottomed 14 months before the trough in trailing earnings.

## ROE Slipping, But Valuation Attractive



Source: Computerized Portfolio Management Services Inc.

The Canadian equity market is trading at a price-book (P/B) multiple of 1.5 times. This is unchanged from its level three months ago, but is up from its recent low of 1.3 times in the previous two months. The trailing return on equity (ROE) of 14.16% is down sharply from the 15.50% ROE of three months ago. While consensus expectations continue to be lowered, and current estimates call for an ROE of 12.01% by the end of calendar 2009, the market is still trading at levels associated with significantly lower levels of profitability.

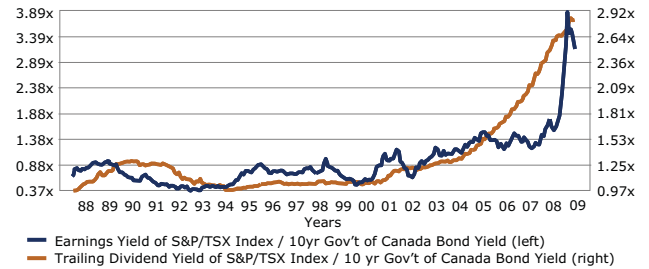
## Valuation Remains Well Below Norm



Source: Computerized Portfolio Management Services Inc.

The Canadian equity market trades at a trailing price-earnings (P/E) ratio of 10.8 times; 12.8 times if based on 2009 consensus estimates. These multiples are very attractive on a historical basis and rival levels not seen since the late 1980s. And when compared to the current yields of Government of Canada bonds, Canadian equities today offer attractive relative value on both an earnings and a dividend-yield basis.

## Stocks Still Much Cheaper Than Bonds



Source: Computerized Portfolio Management Services Inc.

## Market Still Attractively Valued

Consensus estimates for 2009 call for a 21% decrease in earnings, which is almost entirely the result of energy sector weakness. In fact, half of the index's 10 sectors are expected to record positive growth over the calendar year. We believe investors shouldn't put too much faith in the consensus number, as we anticipate frequent and significant revisions to these estimates as we proceed through the 2009 earnings season. Moreover, we believe that putting forth a projected return for the Canadian equity market is not a worthwhile exercise; valuations clearly need to establish a trough to make it possible to determine meaningful return estimates.

Nonetheless, the S&P/TSX Composite Index historically rewards patient investors with exceptional performance after reaching its bear market lows. We strongly believe this cycle will be no different.

### Market Historically Rebounds Strongly

Bear Market	Decline	Returns from End of Bear Market		
		6 months	12 months	24 months
May 57–Dec 57	-26.9%	14.2%	31.2%	37.3%
May 69–Jun 70	-25.4%	19.1%	27.5%	45.5%
Oct 73–Sep 74	-35.9%	22.1%	23.2%	35.9%
Jun 81–Jun 82	-39.2%	46.8%	86.9%	76.3%
Jul 87–Nov 87	-25.4%	10.9%	14.5%	42.1%
Dec 89–Oct 90	-20.1%	14.8%	18.6%	16.4%
Apr 98–Aug 98	-27.5%	15.1%	28.1%	109.4%
Aug 00–Sep 02	-43.2%	3.7%	22.5%	45.4%
<b>Median</b>	<b>27.2%</b>	<b>15.0%</b>	<b>25.4%</b>	<b>43.8%</b>

Source: Computerized Portfolio Management Services Inc.

### History Points to Rewarding Markets

Given the market volatility and strong recent performance, investors should recognize that an eventual retest of recent lows is quite possible. We still believe this is a good time to buy. First, the Canadian market is trading at historically low valuations on an earnings and book value basis. Second, there are few alternatives to equities in the Canadian capital markets, as the absolute and relative prospects for Government of Canada bonds and for cash remain largely unappealing.

Third, when markets recover, they tend to do so in dramatic fashion. And finally, on average over the past 50 years, the market has reached its trough 14 months before trailing earnings have bottomed out. History has shown time and again that the early and patient investor is richly rewarded. Investors are encouraged to take advantage of the solid fundamentals being offered by the Canadian equity market and to position themselves accordingly.

*Pat McHugh, CFA, is Vice President and Senior Portfolio Manager at MFC Global Investment Management. He is based in Toronto.*

# European Equity Outlook



David Hussey

**Until the European Central Bank becomes more pro-active in thawing credit markets, European equities may initially lag the recoveries of emerging markets and the U.S.**

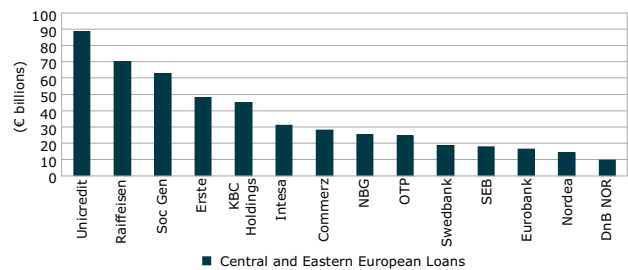
European equities did manage to rally toward the end of the first quarter of 2009, but lost value over the period as a whole, with the MSCI Europe Index declining 14.5% in U.S. dollar total return terms. Economic activity continued to contract sharply and European Union (EU) confidence fell to all-time lows.

There was particular concern about the financial stability of a number of Eastern European countries. Many of these countries run significant current account deficits and their borrowing costs have risen sharply as credit lines have tightened. Within the eurozone, it is possible we will see countries like Greece and Spain seeking aid from stronger states like Germany and France.

Since the collapse of the Soviet Union, Western European banks – especially those of Austria, Greece and Sweden – have been penetrating formerly socialist Central and Eastern European (CEE) markets. The easy credit they dispensed fuelled property and consumer booms in the east, which led to rapid gross domestic product (GDP) expansion. Now, as these credit lines are cut and the real value of debt rises,

the economic gains of the past decade could start to unravel. This raises two acute concerns for the EU.

## Euro-Banks Are Exposed To Emerging Europe



Source: JP Morgan, Citi Investment Research

## Biggest Risk In Emerging Europe

First, an economic meltdown in the east that results in a high loan default rate could destabilize major European financial institutions at a time when the Western banking system is extremely vulnerable. In addition, CEE is a key export destination for the eurozone, representing twice the demand of the U.S. and accounting for 26% of eurozone export growth in 2008.

Many CEE markets retain their own currencies. Those with currencies pegged to the euro, such as the Latvian loti, risk seeing their exports undercut by cheaper competitors. On the other hand, countries that allow their currencies to devalue are exposed to the real cost of foreign debt spiking. Given such predicaments, it appears Eastern Europe lacks the tools to avert an economic crisis.

To prevent such an outcome, euro currency governments are under increasing pressure to alleviate Eastern Europe's debt burden. Assuming aid becomes necessary, the cost shouldn't be prohibitive. Eastern EU countries account for a modest 8% of EU GDP and about half this GDP (4%) comes from the more stable economies of Poland and the Czech Republic.

**Emerging Europe Conditions Vary Widely**

	Czech	Hungary	Poland	Bulgaria	Romania	Latvia
External Debt (% of GDP)	45	126	58	111	52	144
Current account deficit (% of GDP)	-3	-6	-5	-24	-14	-20
Loan to deposit ratio (%)	80	133	123	137	131	176
Real GDP forecast (%)	-2	-3	1	-2	-2	-12

Sources: National sources, World Bank, IMF, BIS, UBS, Bank of America/Merrill Lynch, The Economist

**Default Risk Manageable**

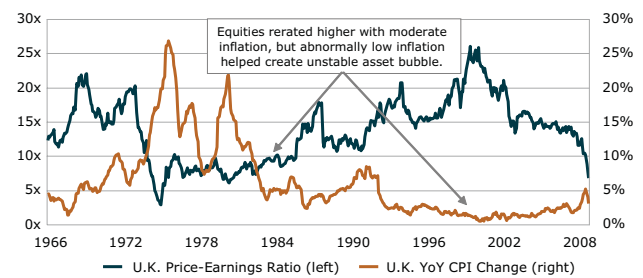
In the event of a widespread default in the order of 30% of foreign debt payments, the ultimate liability would be insufficient to spark panic in Western European treasuries. All told, the cost to Western Europe of a bailout would be high (perhaps in the US\$100-\$200 billion range), but not backbreaking.

A rescue package via the International Monetary Fund would help politicians avoid the potential lack of will by their electorates to see taxpayer money plugging financial holes that were not of their making. Politicians know that the consequences of inaction would be weakened EU banks, reduced exports and an additional blow to the economic recovery.

The last edition of *Global Intelligence* illustrated how U.K. and European equities appear to be good values on a historical basis using the Shiller price-earnings (P/E) ratio (based on average earnings over the past 10 years). By this measure, European equity markets are trading at over one standard deviation below the 40-year average P/E. Indeed, when adjusting for the higher inflation of the 1970s, the real P/E ratio is even lower and at levels not seen since the era of the Great Depression.

Equity markets react positively to reasonable, but stable, inflation and can re-rate aggressively. The lesson of the recent turbulence, though, is that allowing inflation and interest rates to fall too low can propagate asset bubbles and a de-rating.

**Moderate Inflation Is Key For Equities**



Source: UBS, MFC Global Investment Management

**Trick Is Balancing Stimulus and Inflation**

The challenge facing policy makers will be to stimulate the global economy and allow some inflation (2% to 5% looks ideal), but, importantly, reduce the stimulus in time to prevent the formation of an extreme inflationary shock.

This will be difficult to accomplish, but we believe there is sufficient spare capacity in global economies to give the policymakers a reasonable window of opportunity.

The struggle between the bulls and the bears has resulted in somewhat volatile markets thus far in 2009. Our last report opined that markets were in a bottoming process, and could be positive over the year. We still believe this will be the case. Cash balances are high and equity sentiment has been improving from its previously depressed levels. Studies of equity market valuations and long-term returns indicate that future returns from such depressed levels could be strong. Until the European Central Bank

## European Equity Outlook (Cont'd)

becomes more pro-active in thawing credit markets with quantitative easing, though, European equities may initially lag the recoveries of emerging markets and the U.S.

Looking further out, we believe the economic debate will switch focus from rising inflationary expectations to how the global authorities will wean the markets off the massive stimulus that has been provided. This will likely be a critical phase in the market recovery.

*David Hussey is Head of Pan-European Equities at MFC Global Investment Management (Europe) and is based in London. MFC GIM's London-based European Equities Portfolio Manager Gregor Rapprich, CFA, and Investment Analysts David Dugdale, CFA, and Will Hamlyn, also contributed to this report.*

## Emerging Markets Outlook



**Peter Mennie**

**Emerging markets are not completely immune to the economic collapse occurring in the developed regions, but do offer some attractive features, including a higher aggregate growth rate than developed markets and the opportunity to benefit from increased demand that should result from the unprecedented U.S. stimulus programs.**

The first quarter of 2009 was a strong period for emerging markets, with the MSCI Emerging Markets Free Index up 1.0% in total return, U.S. dollar terms

over the quarter. This return is especially impressive when compared to the MSCI World Index, which fell by 11.8%. It is somewhat unusual for emerging markets to prove more resilient than developed markets, as emerging markets have historically been more prone to crises and higher market volatility. The reason for this unusual situation is that the current bear market and worldwide recession have been led by the United States housing market collapse and the subsequent financial system failure. Emerging markets appear to have become something of a safe haven, with economic growth remaining relatively strong until quite recently.

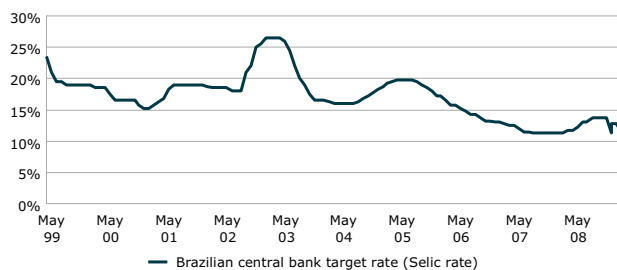
Over the last 12 months it has become very clear that emerging markets are not completely immune to the effects of the economic collapse occurring in the developed regions. What will be key for emerging market economies is their ability to offset falling exports with steady domestic demand. We expect the global economic recovery to remain weak, and the synchronized nature of this crisis makes it unlikely that exports will be able to prop up any country's economy for the foreseeable future.

Eastern Europe was actually the strongest performing emerging market region in March, although it was actually the weakest region over the first quarter. We can find few reasons to be positive about Eastern Europe today; its key export markets have slowed dramatically and the collapse of its currencies, coupled with high foreign exchange lending, have resulted in grave problems for regional financial sectors and domestic demand. This has resulted in some political instability. We believe value can be found in Russia, however, where some companies still offer solid earnings and attractive valuations.

### Brazil Positioned For Performance

Economic activity has weakened across Latin America, although currency depreciation is helping the region's competitive position. Brazil benefits from a relatively well capitalized banking system, and falling inflation has offered an opportunity to cut interest rates. Brazil has maintained fairly high interest rates, leaving plenty of room to cut. Recent growth numbers out of Brazil have been disappointing, although the consensus still calls for positive economic growth in 2009. Our research actually points to negative growth this year, but we still believe Brazil is well positioned to offer relative outperformance.

#### Brazil Has Room To Cut Rates



Source: Bloomberg

Chile has a relatively small equity market, but we believe this country presents an attractive investment opportunity after building up a US\$22 billion sovereign fund during the era of high copper prices. In response to the falling global economy, Chile's interest rates were slashed from 8.25% in December to 2.25% at the end of the first quarter of 2009, and the country's significant reserves provide ample opportunity for fiscal stimulus. In contrast to some developed European countries (i.e., the U.K.) that overspent during the period of economic growth that marked the early 2000s, Chile has managed its economy quite well.

### Asia A Mixed Bag

Chinese economic growth decelerated last year, with exports and industrial production turning sharply weaker. The government responded with a stimulus package in late 2008 worth approximately four trillion renminbi. There are signs this package may be having a positive impact, as fixed asset investment numbers have been improving sharply and, although retail sales have slowed, China's retail sales numbers are still growing rapidly on a year-over-year basis. We strongly dispute the "decoupling" theory, which has been put to rest by China's slowing growth rate, but we do expect to see continued growth in domestic demand.

#### Chinese Retail Sales Growth Still Above 10%



Source: Bloomberg

## Emerging Markets Outlook (Cont'd)

Elsewhere in Asia, we continue to be cautious on India and expect growth to slow in that country. South Korea, one of the worst hit markets in 2008, may be seeing signs of a recovery. Korea's currency saw a massive and sustained depreciation in the second half of 2008, which has sharply improved Korea's terms of trade and should bolster the country's financing position. Likewise, we have seen an improvement in Korea's foreign debt profile, while the lower price of oil should help its current account.

Although there was a strong rally in March 2009, we do not believe we are witnessing the start of a new bull market. In fact, we believe there is likely to be plenty of bad news to come this year. However, emerging markets do offer some attractive features, including a higher aggregate growth rate than developed markets and the opportunity to benefit from an increase in demand that should result from the unprecedented U.S. stimulus programs.

*Peter Mennie is Senior Portfolio Manager at MFC Global Investment Management (Europe). He is based in London, England.*

## Asian Equity Outlook



**Tahnoon Pasha**

**Our outlook is more positive than it was earlier in the year. We expect strong and sustained long-term returns as Asia moves toward the status of a developed region.**

The MSCI Far East ex-Japan Index rose by 0.41% in total return U.S. dollar terms over the first quarter of 2009, while the MSCI Asia-Pacific ex-Japan Index delivered a -0.78% total return over the same period<sup>1</sup>.

Markets were weak in January and February, and set a low in early March. This was followed by a dramatic rally through the end of March in response to a global rise in investor risk appetites. By the end of the first quarter, the MSCI Asia-Pacific Index (ex-Japan) had risen 19.3% off its March lows.

On a sector basis, the rebound was led by the more cyclical sectors like materials and consumer discretionary. As risk appetites rose, defensive sectors like consumer staples, telecommunications, and utilities underperformed significantly during the rally.

A number of governments across Asia implemented fiscal stimulus packages. The focus of these packages was infrastructure spending, as well as spending to strengthen employment numbers and consumer spending. While China's four-trillion-renminbi stimulus program got the most attention, several other Asian governments announced their own significant packages.

<sup>1</sup>The MSCI All-Country Far East ex Japan Index comprises China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand. The MSCI All-Country Asia-Pacific ex Japan Index also includes Australia, India and New Zealand.

### Massive Stimulus Region-Wide

Economy	Total	% of GDP
China	CNY 4,450 bn (USD 654 bn)	6.8% per year
India	Rs 1,300 bn (USD 26.4 bn)	2.4%
South Korea	KRW 81.3 trillion (USD 54.9 bn)	8.6%
Taiwan	NT 369.4 bn (USD 10.7 bn)	3.0%
Hong Kong	HK\$4.1bn (USD 0.5 bn)	2.4%
Indonesia	72 trn rp (USD 6.6 bn)	1.5%
Malaysia	MYR 67 bn (USD 10 bn)	10.0% (over 2 years)
Philippines	PHP 120 bn (USD 1.3 bn)	1.0%
Thailand	THB 300 bn (USD 11.4 bn)	3.0%
Singapore	SGD20.5 bn (USD 13.7 bn)	8.0%

Source: UBS, MFC Global Investment Management

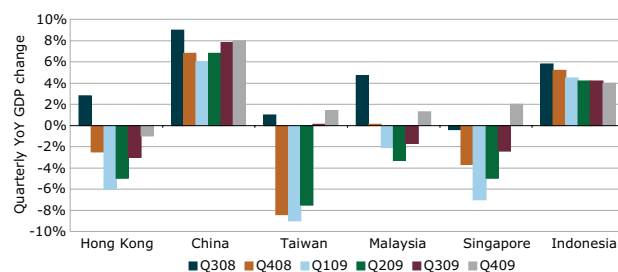
### Cyclical Sectors Led Rebound

Information technology rebounded on the back of inventory re-stocking and rising utilization levels amid signs of a resumption in demand. A moderation in downgrades to earnings expectations boosted optimism toward the sector, which, when combined with some attractive valuations, triggered the rally in the sector.

The auto sector led the bounce in the consumer discretionary sector on a growing belief that the weak U.S. auto industry will result in significant market share gains for Korean automakers. Optimism also grew on encouraging sales numbers for Korean automakers in markets like China. Robust retail sales in the department store channel also buoyed the consumer discretionary sector.

The early impact of previously announced government stimulus programs was the main factor behind the regional rally in March, though. This level of spending has proven necessary as exports and industrial production have experienced severe declines. In most of Asia (excluding China), economies will likely shrink through the third quarter of 2009. While public and private consumption are rising as a result of the large fiscal and monetary stimulus being introduced by Asian governments, this consumption is insufficient to offset the impact of the Western world's economic contraction on Asia.

### Some Economies May Shrink Through Q3



Source: UBS, MFC Global Investment Management

### China Leads The Way

On a positive note, there are signs emerging that end demand is recovering for some specific products - typically those at the lower end of the spectrum. China is playing a large role in the recovery of demand for telecom equipment and materials as a result of its recent third generation (3G) technology and construction materials inventory-building initiatives. The paralysis of the fourth quarter of 2008 is also starting to be replaced by low levels of replenishment in many Western markets.

There are many issues that still need to be addressed. Industrial production and global trade have shown no real signs of recovery. Exports have been falling across Asia at rates of about 20%-30%, and industrial

# Asian Equity Outlook (Cont'd)

production is still contracting across many Asian nations. There remains overcapacity in numerous sectors of the global economy. Most multinational banks are working to improve their capital positions, and will be reducing their assets.

Lower debt levels and overcapacity are bad for earnings, as they suppress demand and put pressure on margins. We expect the profit cycle to take time to normalize, although the pricing environment is unlikely to be deflationary for long. The amount of money being deployed to sustain global economies is very substantial and we see this as inevitably inflationary.

Asian equity markets have already had a meaningful rally, outperforming the global mean this year and bouncing back to "fair" short-term valuations. Earnings prospects are likely to be weak in the first quarter, but may level off over the full year. China has been the most aggressive in reflating its economy, and may experience positive economic and earnings surprises by the fourth quarter.

## Research Points to Strong Long-Term Returns

Our research has shown that equity returns tend to be highest following the bottom of a severe bear market. We are likely approaching that point based on our belief that earnings will trough in 2009. We also believe the global pressure on profit margins will result in additional market share gains for Asian manufacturers.

We continue to believe Asian equity prices will experience heightened volatility in the near term and that current pricing is already reflective of the recent positive news. That said, our outlook is more positive than it was at the start of the year, and we believe that, over the long term, Asia is likely to experience sustainable, strong returns as the region moves more rapidly toward the status of a developed region.

*Tahnoon Pasha, CFA, is Head of Investments, Equities, at MFC Global Investment Management (Asia). Morten Frederiksen, Executive Director at MFC Global Investment Management (Asia), also contributed to this commentary.*

# Japanese Equity Outlook



Yoshihiro Murakami

**The Japanese credit market offers good buying opportunities as most Japanese bond issuers have sound financial profiles that should enable them to endure this unprecedented economic predicament.**

The Tokyo Stock Price Index (TOPIX) declined 10% over the first quarter of 2009. Against the ongoing backdrop of global financial and economic crisis, the precipitous fall of Japanese corporate earnings placed additional pressure on equities and pushed the TOPIX's price-book ratio down to 0.9 times, compared to a 10-year historical average of 1.7x. In fixed income, 10-year Japanese government bond yields increased by 18 basis points to 1.35%.

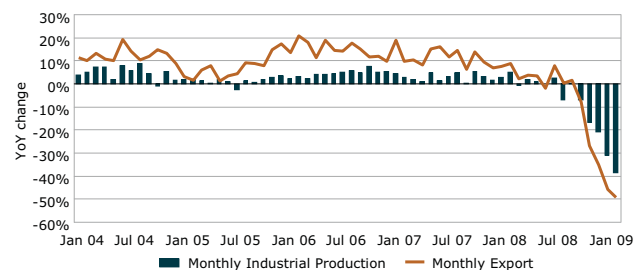
## Economic Crisis Deepens

Japan's quarter-over-quarter gross domestic product (GDP) in the fourth quarter of 2008 fell an annualized 12.1%, the result of an unprecedented deterioration in the country's net exports. A 49.4% year-over-year drop in exports was announced in February, which followed a 23.1% reduction in exports in the fourth quarter of 2008. Among the hardest-hit sectors were automobiles and electronics, which have long accounted for the largest share of Japan's exports. Industrial production fell for the fifth consecutive month in February, by 38.4% year-over-year.

Related machinery orders fell 39.5% year-over-year in January and thus capital expenditures for plant and equipment are expected to fall further.

Given Japan's considerable dependence on exports to drive the economic recovery of the previous several years, it is little surprise that Japan's economic predicament is worse than that of the United States. Domestic consumption was nearly flat in the fourth quarter, and was sustained mainly by increases in public sector spending and in private sector inventories. As a growing number of people have lost their jobs, consumer demand has also fallen.

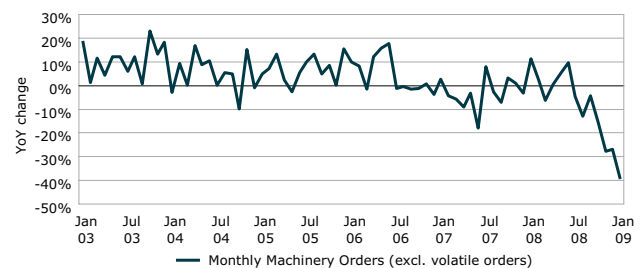
## Exports And Industrial Output Plunged...



Data through Feb. 28, 2009

Sources: Japanese Ministry of Finance and Ministry of Economy, Trade and Industry

## ...Driving Down Machinery Orders



Source: Economic and Social Research Institute

# Japanese Equity Outlook (Cont'd)

## Economic Stimulus Insufficient

Japan's output gap<sup>1</sup> in the fourth quarter of 2008 was 4.1% (approximately 21 trillion yen), according to the government's Cabinet Office. This gap should grow further, with Japan's GDP likely to decline another 10% on an annualized basis in the first quarter. Economic stimulus packages outlined and approved under two supplementary government budgets are primarily guarantees on loans to small- and medium-sized enterprises (SMEs). Direct government expenditure is estimated to be only about 7 trillion yen, which is likely not enough to prop up Japan's struggling economy. As such, the government is currently considering an increase of its direct spending to a range of 10-20 trillion yen. There are few projects to which this assistance could go that would have an immediate and meaningful impact on economic growth, with exports still key to any economic recovery. Also complicating Japan's efforts to execute a timely and meaningful stimulus package is the government's deteriorating fiscal position and a political showdown occurring between the ruling and opposition parties before the imminent general elections.

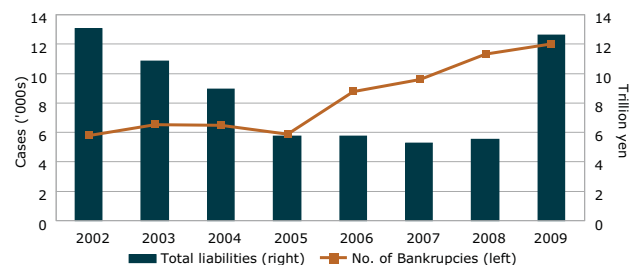
## Credit Deterioration Looms

The Japanese government and the Bank of Japan have been working to shore up the economy via stimulus packages and the introduction of additional liquidity through large-scale public spending, massive credit guarantees for SMEs, the purchase of corporate bonds and commercial paper, and an increase in the outright purchase of Japanese government bonds. But the number of bankruptcies continues to grow. According to Teikoku Databank, in February alone, the number of bankruptcies – and the resulting liabilities – increased year-over-year to 1,131 cases (a 21%

increase) at a cost of 1.2 trillion yen (a 142% increase). During the fiscal year ending March 31, 2009, 45 listed companies went bankrupt, greatly surpassing the previous record of 22 cases during the fiscal year ending March 31, 2003.

We expect continued credit deterioration over the rest of 2009. Corporations are facing growing operating losses and booking impairments against asset values, both of which will erode shareholder's equity. We also expect banks to face pressure on their capital adequacy due to the falling values of their assets (i.e., securities) and declining earnings. This will further limit the financial industry's ability to respond to the rising need for credit. Possibly the most important factor in the credit deterioration, however, is the prevailing consensus that a V-shaped economic recovery is not likely this year or next. In fact, the prevailing environment of reduced global demand makes a quick return to previous credit levels unlikely.

### Bankruptcies Soared In Fiscal 2009\*



\* The number of companies filing for legal bankruptcy with liabilities of JPY10 million or more

Source: Teikoku Databank

## Sound Credits Are Available

Since last year, six issuers have defaulted on their public bond obligations. All of the defaulters are so-called "newly emerging real estate companies" that had not yet developed solid, long-term relationships with their banks. We see these defaults as largely isolated incidents and do not expect many traditional

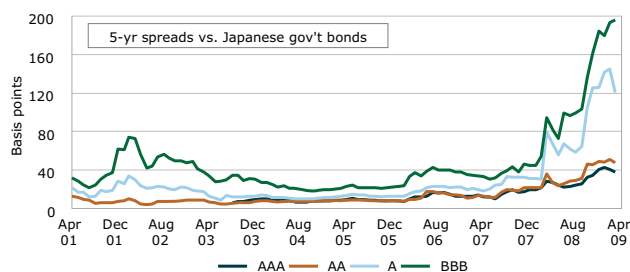
<sup>1</sup>The difference between actual and potential real GDP growth

bond issuers to default. That said, we do expect credit spreads to widen. Fiscal year-end 2009 results and fiscal year-end 2010 projections will be released soon and are expected to jolt credit markets by illustrating the severity of this unprecedented economic contraction. Rapidly deteriorating bank loan portfolios and capital ratios will remind investors of how bad banks looked during the financial crises that occurred from the late 1990s through to the early 2000s. Finally, the potential for major credit events in other parts of the world (like the collapse of huge global enterprises and possible sovereign defaults) will deter market participants from taking on additional risk.

In our view, however, the Japanese credit market offers good buying opportunities as most Japanese bond issuers have sound financial profiles that should enable them to endure this unprecedented economic predicament. Moreover, global efforts would likely lead to economic recovery in Japan as well as in the

rest of the world in a year or so, which should help increase investor appetites for exposure to credit risk going forward.

#### Investment Grade Spreads At Historic Highs



Note: Where available, Moody's credit rating used rather than S&P's  
Source: Nomura BPI, Nikkocitigroup

*Yoshihiro Murakami is Head of Credit Research and Management at MFC Global Investment Management (Japan). He is based in Tokyo.*

## Global Fixed Income Outlook



**Barry Evans**

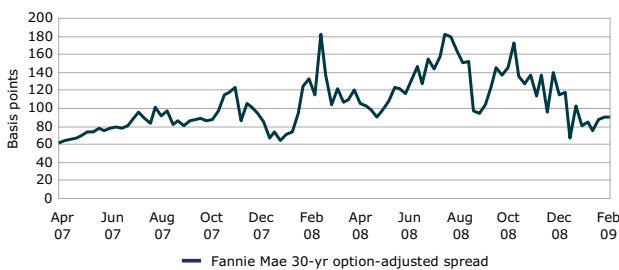
**With short-term interest rates effectively at zero, we expect investors to increasingly migrate away from the Treasury market and take on incremental risk.**

The number of job losses increased in the first quarter of 2009, as companies reacted to the ongoing global economic contraction. On an annualized basis, U.S. gross domestic product was down 6.3% in the fourth quarter of 2008. As part of its ongoing effort to reverse the economic decline, the U.S. government announced additional stimulus programs in the first quarter. The U.S. Federal Reserve Board (Fed) and U.S. Treasury are focused on stabilizing the housing market and opening up the credit spigot. Their efforts appear to be having a favorable impact on credit markets. Concerns about the large deficits the U.S. government will be running for the foreseeable future caused U.S. Treasury rates to rise over the quarter.

# Global Fixed Income Outlook (Cont'd)

Commodity prices have stabilized in anticipation of the bottoming of the economic contraction.

## Gov't Agency Debt Rallied In Q4



Source: Bloomberg

## Flight To Risk Growing

A healing process also appears to be taking hold in the credit markets. Investment-grade and high-yield credit spreads experienced varying degrees of improvement in the first quarter. Valuations across the industrial and utility sectors had the strongest relative outperformance. Government agency debt and pass-throughs also generated favorable returns and outperformed treasuries. Risk premiums for much of the financial sector, however, continued to increase. Securities and structured products issued by financial firms continued to underperform as concern mounted over additional losses and uncertainty about the potential success of the recently announced public-private investment program (PPIP) targeting toxic assets. With short-term interest rates effectively at zero and long-term U.S. Treasury rates around 3.7%, we expect investors to increasingly migrate away from the Treasury market and take on incremental risk for enhanced income and returns. The Fed will leave its central rate low and its policy loose in its ongoing effort to stimulate the economy. This policy should slowly ease the flight-to-quality that drove Treasury rates to record lows at the end of 2008. This stimulus benefited corporate bonds in the first quarter of 2009, and should continue to do so.

## Greenback Stands Alone

The currency market was volatile in the first quarter of 2009 as governments sought to align their fiscal and monetary policies with the severity of the global economic situation. With their central policy rates already near zero, the Bank of England, Bank of Japan, and the Fed sequentially implemented quantitative easing strategies to directly target government bond yields. Although the U.S. near-term economic prospects remain bleak, the U.S. dollar maintained its status as the world's lone reserve currency as an investor flight to safety resulted in the greenback rising more than 5% on a trade-weighted basis in the first quarter. The Japanese yen, burdened by that country's weak and export-dependent economy, appears to have lost its standing as a safe-haven alternative to the U.S. dollar, and weakened considerably over the quarter.

## Global Outlook Supports Strong Dollar



Source: Factset

## Aussie Dollar Boomerangs

We expect demand for the U.S. dollar to remain strong over the coming months as the impact of the financial crisis continues to play out globally. Euroland's looming exposure to Central and Eastern Europe, as well as the possibility that the European Central Bank will have to play catch-up in adopting unconventional monetary easing, make us quite cautious about the euro. Similarly, we believe the

Canadian dollar will come under pressure as a result of worsening economic data and the potential for the Bank of Canada to initiate a quantitative easing program. With positive investor sentiment having markedly shifted away from the Japanese yen, we believe the yen will begin to trade at levels that better reflect deteriorating Japanese economic fundamentals. We are, however, very bullish on the Australian dollar. Australia's beneficial trading relationship with a relatively healthy China, and its ability to maintain a positive interest rate differential relative to the U.S., U.K. and Japan, presents the

opportunity for the Australian dollar to strengthen. With Asian developing markets in a seemingly better position to weather the global economic downturn than their Eastern European and Latin American counterparts, select Asian emerging market currencies also have the potential to strengthen later in 2009.

*Barry Evans, CFA, is Chief Investment Officer, Global Fixed Income, at MFC Global Investment Management. He is based in Boston.*

## North American Fixed Income Outlook



**Terry Carr**

**Bond yields should remain range bound for much of the year, with a modest uptick materializing as issuance in the government and corporate markets picks up.**

Now that Washington has effectively nationalized many of the country's largest banks with funds from the Troubled Assets Relief Program (TARP), policymakers have shifted their focus to stimulating the nation's credit markets. In March, the Term Asset-Backed Securities Loan Facility (TALF) was launched with the aim of bolstering the issuance of asset-

backed securities (ABS) by up to U.S.\$1 trillion. The TALF is expected to free up credit on more favorable terms for consumers and small businesses. Also in March, the Treasury Department announced details of its Public-Private Investment Plan (PPIP), which is intended to remove troubled real estate assets from the balance sheets of many U.S. banks.

The U.S. Federal Reserve (Fed) announced it would broaden its balance sheet by buying up to \$750 million of agency mortgage-backed securities this year (raising its total purchases to \$1.25 trillion), and increasing its purchases of agency debt by another \$100 billion (for a total of \$200 billion). The Fed also plans to buy up to \$300 billion in longer-term Treasury securities by the fall.

### **Policymakers Pull Out The Stops**

It appears the policymakers in Washington are pulling out all the stops in an effort to jump-start the sagging U.S. economy. Treasury yields headed higher over the quarter and yield curves were steeper, even as the Fed

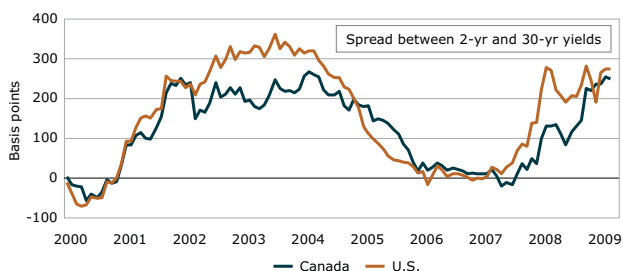
# North American Fixed Income Outlook (Cont'd)

moved aggressively with its Treasury buyback program. Equities rallied in the latter half of March and credit spreads headed lower, though they remain well above their historic levels.

In Canada, stimulus packages announced by the government are expected to push the nation over C\$64 billion further into debt by the end of the 2011 fiscal year. A weakening manufacturing sector in Ontario and Quebec has sent both those provinces deep into the red, and Ontario now projects a deficit of C\$14.1 billion in fiscal 2010. Quebec expects to have a C\$3.9 billion shortfall. Lower oil revenues have taken the wind out of Alberta's economic sails, and that once mighty energy powerhouse is expected to record a C\$4.7 billion deficit in the upcoming fiscal year.

Canadian bond yields were generally higher in the first quarter of 2009. The exceptions were yields at the very short end of the curve, which ended the quarter a bit lower. In March, the Bank of Canada cut its overnight lending rate 50 basis points (bps), to a historic low of 50 bps. Canadian yield curves were about 12 bps steeper in the first quarter, while Canadian corporate credit spreads were about 35 bps narrower.

## Yield Curves Steepened As Long Bonds Sold Off



Source: Bloomberg

## Canada Won't Sink As Low As U.S.

When the U.S. economy does poorly, the Canadian economy typically performs even worse. While Canada has sunk into recession, a more severe downturn, like the one being experienced in the U.S., is not widely anticipated. Canada will not have a deeply troubled mortgage market like that of the U.S., and Canadian banks are much better capitalized than their U.S. counterparts.

Although there have been some positive signs, we believe there are still many storm clouds on the Canadian economic horizon. The ongoing restructuring of General Motors and Chrysler is creating immense uncertainty in the auto sector. The clock is ticking for these companies to provide acceptable restructuring plans in their effort to secure loans from both the federal government and the province of Ontario. Over 273,000 jobs disappeared in the first three months of the year, and the unemployment rate – which now stands at 8% – could breach 9% by the end of the year. Existing home prices have retrenched by about 9% over the past year, though much of this weakness is centered in the oil patch, British Columbia and Ontario. The net worth of consumers has taken a hit, and consumer confidence has fallen to historic lows. It's clear a deep retrenchment in consumer spending is materializing.

As the Canadian economy slowly works its way to a bottom, core inflation should remain well contained. However, recent Consumer Price Index (CPI) data suggests the concerns over deflation may have been overdone, with underlying year-over-year inflation still in the 2% range. Headline inflation is around 1½%, although much of this decline reflects sharply lower energy costs (relative to early 2008). The BOC is expected to slice another 25 bps off its central lending rate in April, leaving administered rates at a lean

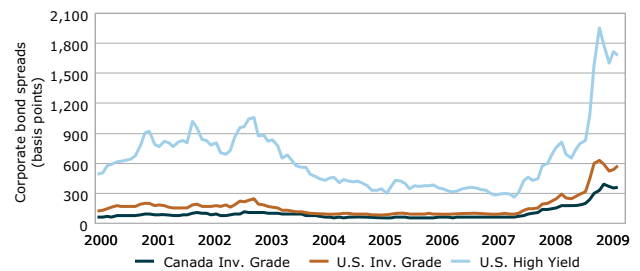
25 bps. The BOC will soon have to rely on other, non-interest-rate-related tools to bolster Canada's credit markets.

### Economic Firming On The Horizon?

With so much liquidity flooding the collective global economic system, there is today a somewhat heightened level of inflation risk. While we do not expect Canada or the U.S. to post a material rebound until late 2009 or early 2010, the potential for rising prices is slowly materializing. Infrastructure spending in China has already bolstered demand for base metals and other building materials. That said, we believe global central banks will remain vigilant against rising inflation trends, and we don't expect a material firming of prices to occur until mid-2010 at the earliest.

There is some promise of stronger economic conditions in the second half of 2009. The current credit crunch will eventually end as lending and issuance activity is revived. As such, we expect to see a sharp outperformance of corporate credit, with double-digit returns probable in what could be the best year for corporate bond investors in recent memory.

### Credit Poised To Outperform In 2009



Source: PC Bond, Bank of America/Merrill Lynch

Bond yields are expected to remain range bound for much of the year, with a modest upward bias materializing as issuance in both the government and corporate markets picks up. Inflation concerns in the latter part of the year should serve to accentuate the upward trend in bond yields.

*Terry Carr, CFA, is Vice President and Managing Director, North American Fixed Income, for MFC Global Investment Management. He is based in Toronto.*

# Asian Fixed Income Outlook



**Victoria Ip-Cheung**

**Going forward, we expect continued tightening of Asian investment-grade corporate spreads. Over the longer term, we should see a further appreciation of Asian currencies.**

Asian fixed income markets had mixed returns over the first three months of 2009. The iTraxx Investment Grade Index, which measures corporate bond spreads, closed the quarter at 310 basis points (bps), a meaningful narrowing from the end of 2008, when spreads were trading at 352 bps. The iTraxx Asia High Yield Index followed a similar pattern, although the contraction was less significant, with the spread remaining above 1,300 bps.

Most of the Asian fixed income market's positive performance was derived from U.S.-dollar-denominated investment grade credits. On the local bond market, performance was mixed. The government bonds of higher-yielding countries like Indonesia and the Philippines performed well, while yields of countries like Thailand and Malaysia bottomed out. Asian currencies were universally weaker, with the greatest declines experienced by the Korean won and the Singapore dollar. In response to local bond and currency movements, the HSBC Asian Local Bond Index had a -4.7% return over the quarter.

## USD Debt Led Investment Grade Rally



Source: Bloomberg

## High Yield Rally Was More Subdued



Source: Bloomberg

## Calming Asian Markets

Although the trading ranges of credit spreads, currencies, and yield levels reflected continued investor nervousness, markets in the first quarter of 2009 were considerably calmer than in the fourth quarter of 2008.

Aggressive monetary accommodation and large fiscal stimulus packages were introduced by the majority of Asian countries in the first quarter. China introduced the largest absolute fiscal stimulus package while, in relation to each Asian country's gross domestic product (GDP), Singapore and Malaysia introduced the largest stimulus packages.

In terms of economic growth, the past two quarters are likely to go down as the two worst periods of this economic recession in Asia. While negative growth should continue to plague some countries, the

declines shouldn't be as steep as those we have experienced over the past six months. Although investor risk aversion appears to have abated somewhat, there is still some potential that we will see a return to the environment of fear that has gripped global markets. We strongly believe that Asian markets will not be the primary source of this additional risk aversion, but that investors will be responding to negative economic news out of other emerging market regions, like Central and Eastern Europe.

### **Global Recovery Key**

Going forward, we expect continued tightening of Asian investment grade corporate spreads, but remain cautious about corporate high yield issues in the region. Over the longer term, we should see a further appreciation of Asian currencies. In the shorter term, however, there are a limited number of catalysts that would trigger such an appreciation. Catalysts would likely need to include a return of foreign investment, stronger foreign direct investment flows and a significant recovery in external trade before we are confident we are indeed witnessing a return to the longer-term uptrends.

In the near term, we believe any return to growth will be sluggish and a recovery will only occur in the region when the United States and Europe also recover. Nevertheless, we are seeing some initial signs that industrial production is picking up. Significant fiscal and monetary stimuli in Asia should also have a material impact over the coming months. These factors will likely assist in the recovery, but investors should not expect a strong, V-shaped recovery for the region.

*Victoria Ip-Cheung, CFA, is Head of Fixed Income at MFC Global Investment Management (Asia). She is based in Hong Kong.*

## Global Offices

### Toronto

MFC Global Investment Management (Canada)  
200 Bloor St. E., NT-6  
Toronto, Ontario  
M4W 1E5  
Canada  
Phone: (416) 852-2204

### Boston

MFC Global Investment Management (U.S.), LLC.  
101 Huntington Ave,  
Boston, MA. 02199  
United States  
Phone: (617) 375-1500

### London

MFC Global Investment Management (Europe) Limited  
10 King William Street  
London, U.K.  
EC4N 7TW  
Phone: (020) 7256-3500

### Hong Kong

MFC Global Investment Management (Asia)  
47/F, Manulife Plaza  
The Lee Gardens  
33 Hysan Avenue  
Causeway Bay, Hong Kong  
Phone: (852) 2910-2600

### Tokyo

MFC Global Investment Management (Japan) Limited  
Kyobashi TD Building 7F  
1-2-5 Kyobashi, Chuo-ku, Tokyo 104-0031  
Japan  
Phone: (81) 3-5204-5540

MFC Global Investment Management® ('MFC GIM') is the asset management division of Manulife Financial. MFC GIM's diversified group of companies and affiliates provide comprehensive asset management solutions for institutional investors, investment funds and individuals in key markets around the world. This investment expertise extends across a full range of asset classes including equity, fixed income and alternative investments such as oil & gas, real estate, timber, farmland, as well as asset allocation strategies. MFC GIM has investment offices in the United States, Canada, the United Kingdom, Japan, Hong Kong, and throughout Asia. Additional information about MFC GIM may be found at [www.mfcglobal.com](http://www.mfcglobal.com). MFC Global Investment Management®, Manulife and the block design are trademarks of The Manufacturers Life Insurance Company and are used by it and its affiliates including Manulife Financial Corporation.

The opinions expressed are those of MFC Global Investment Management® as of April 2009, and are subject to change based on market and other conditions. The information in this document including statements concerning financial market trends, are based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. MFC GIM disclaims any responsibility to update such information. All overviews and commentary are intended to be general in nature and for current interest. While helpful, these overviews are no substitute for professional tax, investment or legal advice. Clients should seek professional advice for their particular situation. Neither Manulife Financial, MFC Global Investment Management®, nor any of their affiliates or representatives is providing tax, investment or legal advice. Past performance does not guarantee future results. This material was prepared solely for informational purposes, does not constitute an offer or an invitation by or on behalf of MFC GIM to any person to buy or sell any security and is no indication of trading intent in any fund or account managed by MFC GIM.