

# U.S. Economic Outlook

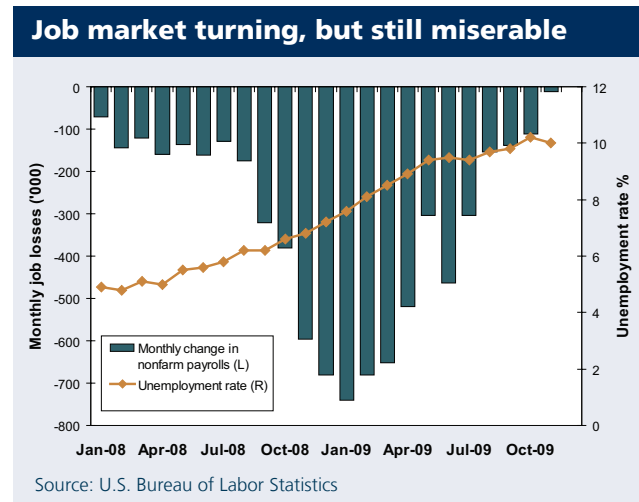
## United States: Recession over, but still waiting for jobs

The U.S. economy turned up in the third quarter with growth reported at a healthy 2.8% pace even after downward revisions. The “Great Recession” will probably be deemed to have ended in July, and on the surface a new expansion seems to be off to a satisfactory start.

This incipient recovery is being driven by a combination of fiscal and monetary stimulus, assisted by the beginning of a turnaround in the inventory cycle. In a normal recovery these temporary forces jump-start the normal processes of growth in incomes and spending. But this cycle is far from normal, raising doubts about the sustainability of the expansion. The key is how soon and how strongly employment will turn up.

### **Anxiously awaiting a recovery in the job market**

We believe that employers, who fired workers at an unprecedented pace in the recession, will find that they need to start hiring again as soon as sales pick up even a little. Job market indicators (unemployment claims, layoff announcements, ISM manufacturing surveys, temporary employment) already show improvements, but so far they haven’t added up to gains in total payrolls. Time is of the essence in re-starting the economic engine, and without jobs the recovery could sputter out. Given the headwinds facing the economy as consumers and banks try to rebuild their balance sheets, there is a real risk that if growth doesn’t accelerate soon, it might actually fall back into a “double-dip.”



Our forecast of a sustained, moderate recovery depends on the temporary boosts from inventories and policy stimulus continuing for another 2 or 3 quarters, extending the window of opportunity for the job market to turn around. Our base-case projection calls for job gains around the end of 2009, but even if the upturn in employment is delayed until the first quarter of 2010, there should still be time for increased wage and salary income to drive a gradual reacceleration of growth over the course of 2010 and 2011.

Optimism about the near-term outlook has to be tempered by acknowledgement of the headwinds caused by the financial crisis. Consumers have raised their saving rate in response to lost wealth and heavy debt burdens, and they might choose to raise it further as their incomes rise. We believe, however, that they will relax a little as wealth losses diminish and as the level of job insecurity abates, so that the saving rate will stay roughly constant or even decline. But it’s too soon to have any certainty about this, and unexpected restraint in spending could jeopardize the whole recovery process.

## U.S. Economic Research Forecast Summary

Winter 2009-2010

Year-over-Year % Change  
or Annual Average

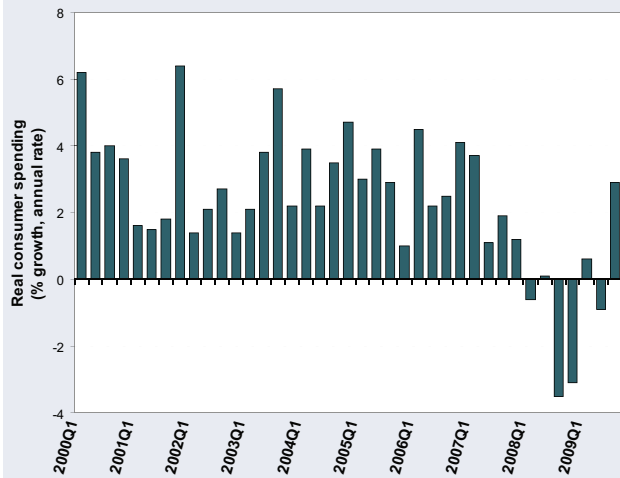
% Change at annual rate	2009.1	2009.2	2009.3	2009.4	2010.1	2010.2	2010.3	2010.4	2011.1	2007	2008	2009	2010	2011	
				Forecast											
<b>Real U.S. GDP and Components</b>															
<b>Gross domestic product</b>	<b>-6.4</b>	<b>-0.7</b>	<b>2.8</b>	<b>3.0</b>	<b>3.3</b>	<b>3.5</b>	<b>4.2</b>	<b>4.5</b>	<b>4.5</b>	<b>1.6</b>	<b>0.4</b>	<b>-2.5</b>	<b>3.1</b>	<b>4.2</b>	
Personal consumption expenditures	0.6	-0.9	2.9	1.5	1.9	2.4	3.0	3.5	3.4	1.6	-0.2	-0.6	2.1	3.2	
Business Fixed Investment	-39.2	-9.6	-4.1	-2.2	-0.8	3.9	8.2	11.0	10.5	3.4	1.6	-17.9	0.6	10.9	
Residential Investment	-38.2	-23.2	19.5	10.1	14.4	16.9	21.7	17.6	17.5	-12.5	-22.9	-20.1	13.0	18.7	
Government purchases	-2.6	6.7	3.1	0.7	3.1	2.0	2.3	1.7	2.1	1.3	3.1	2.0	2.5	0.9	
Change in inventories	-114	-160	-133	-64	-29	-6	10	24	38	19.5	-25.9	-118.0	-0.2	51.9	
Exports	-29.9	-4.1	17.0	8.9	7.9	7.2	8.1	9.0	9.6	6.7	5.4	-10.4	8.4	9.4	
Imports	-36.4	-14.7	20.8	10.2	7.1	6.8	7.5	8.2	9.6	0.1	-3.2	-14.2	7.8	8.7	
Real disposable income	0.2	6.2	-1.5	1.6	1.6	2.7	2.3	2.7	3.9	0.9	0.5	1.2	1.9	3.6	
Personal saving rate (%)	3.7	5.4	4.5	4.3	4.3	4.5	4.5	4.5	4.3	1.7	2.7	4.5	4.5	4.7	
Corporate profits with IVA & CCAadj	22.8	15.7	49.6	5.0	15.4	10.8	2.4	8.8	14.5	-7.7	-11.8	-5.6	13.9	8.3	
<b>Unemployment rate %</b>															
Private housing starts (thous. units)	<b>8.1</b>	<b>9.3</b>	<b>9.6</b>	<b>10.2</b>	<b>10.3</b>	<b>9.7</b>	<b>9.5</b>	<b>9.0</b>	<b>9.2</b>	<b>4.6</b>	<b>5.8</b>	<b>9.3</b>	<b>9.6</b>	<b>8.6</b>	
	528	540	590	586	635	725	790	845	1132	1341	901	561	749	1279	
<b>Prices</b>															
GDP price index	1.9	0.0	0.8	0.4	1.0	0.7	0.8	1.0	1.0	1.3	0.9	1.2	0.7	1.1	
<b>Consumer Price Index: CPI-U</b>	<b>-2.4</b>	<b>1.3</b>	<b>3.6</b>	<b>1.9</b>	<b>1.3</b>	<b>1.1</b>	<b>1.0</b>	<b>1.0</b>	<b>1.5</b>	<b>1.1</b>	<b>1.2</b>	<b>-0.4</b>	<b>1.6</b>	<b>1.4</b>	
<b>CPI-U excl food &amp; energy</b>	<b>1.5</b>	<b>2.4</b>	<b>1.5</b>	<b>0.8</b>	<b>1.0</b>	<b>1.1</b>	<b>1.0</b>	<b>0.9</b>	<b>1.5</b>	<b>1.1</b>	<b>1.1</b>	<b>1.7</b>	<b>1.1</b>	<b>1.3</b>	
Foreign Exchange Rate (Broad trade-weighted value of US\$)	111.1	107.1	103.7	100.1	99.5	99.4	99.2	99.0	98.9	103.4	99.8	105.5	99.3	98.7	
Refiners' cost of imported oil (\$/b)	40.5	57.6	66.7	73.8	73.5	73.9	75.6	76.5	76.9	67.1	92.3	59.6	74.9	77.9	
U.S. Interest Rates (avg. %)															
Federal Funds Rate	0.2	0.2	0.1	0.2	0.2	0.2	0.5	0.8	1.3	5.0	1.9	0.2	0.4	1.8	
Ninety-day Treasury Bill Rate	0.2	0.2	0.2	0.1	0.2	0.4	0.6	1.0	1.6	4.4	1.4	0.2	0.6	2.1	
3-month LIBOR	1.7	1.3	0.7	0.4	0.4	0.6	0.9	1.3	1.8	5.3	3.3	1.0	0.8	2.4	
<b>10-year Treasury Note Yield</b>	<b>2.9</b>	<b>3.5</b>	<b>3.5</b>	<b>3.3</b>	<b>3.7</b>	<b>3.9</b>	<b>4.4</b>	<b>4.6</b>	<b>4.7</b>	<b>4.6</b>	<b>3.7</b>	<b>3.3</b>	<b>4.1</b>	<b>4.8</b>	
Treasury Yield Spreads (avg. basis points)															
5yr - 2yr	90	139	142	146	140	139	129	112	109	7	80	129	130	94	
10yr - 2yr	193	248	245	265	258	253	261	243	206	27	166	238	253	166	
30yr - 10yr	79	86	79	93	72	67	43	36	35	20	61	84	54	35	
Credit Spreads (avg. basis points over Treasuries)															
10yr AAA	202	159	93	97	93	91	89	88	86	87	252	138	90	84	
10yr A	329	264	157	147	142	140	138	135	133	114	305	224	139	129	
10yr BAA	538	426	263	231	224	220	216	212	208	149	368	365	218	203	

\*Forecast beginning in 2009.4

### Changes from our Fall Outlook

- Data over the past quarter has largely validated our relatively optimistic outlook for the U.S. economic recovery. We have barely changed our overall forecast for GDP growth through the end of 2011.
- Interest rates have remained lower than expected, and we now forecast slightly lower rates over the forecast time horizon.
- The U.S. dollar has been weaker than anticipated, and we believe that this trend will continue for several years. The forecast level of the broad index is therefore lower than last quarter.

**Consumer spending: one good quarter after two bleak years, but that was driven by cash for clunkers -- now we need some income growth to keep it going**



Source: Bureau of Economic Analysis

**Credit market fallout**

In addition, the tribulations of the financial sector raise the possibility that credit will be a binding constraint on economic growth – in other words, that banks will not lend enough to fuel a normal or satisfactory pace of recovery. Once again, we believe that while the lending excesses of the last cycle will be avoided, enough credit will be available to permit a moderate pace of economic growth. Declines in total loans outstanding reflect a lack of demand from borrowers and attempts to pay down existing debts. As the economy starts to grow, there will be more creditworthy applicants, the declines in outstanding loans will get smaller, and the flow of new credit will probably be adequate. We don't expect the 7%-9% quarterly growth rates that the U.S. experienced at the start of the 1980s expansion, but we do anticipate that 3%-5% growth is entirely likely.

**The bottom line: a modest recovery, with lots of risks**

In this scenario, unemployment declines slowly, but is still over 8% in 2011. Faster growth is possible, given the amount of slack in the economy and the potential impact of pent-up demand for consumer durables and business equipment, but the greater risk still seems to be to the downside. The history of the recessions associated with financial crises around the world is

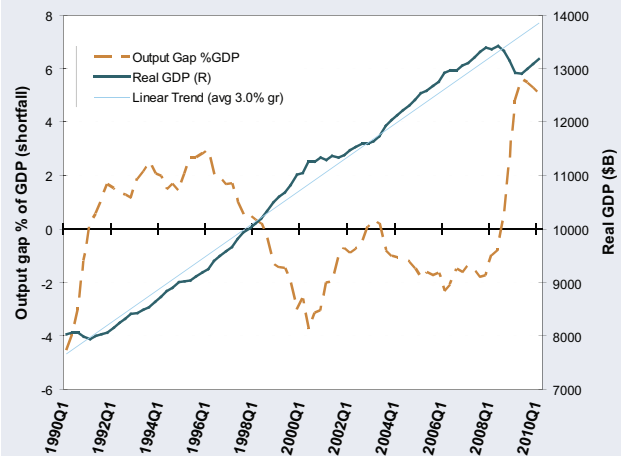
not encouraging for those who bank on a rapid pace of recovery. Unprecedented policy measures have averted a much worse economic collapse, but it will take unprecedented insight and timely action going forward to avoid a long and arduous recovery.

**Inflation vs. deflation**

Inflation seems an obvious risk when the Federal Reserve has pumped out trillions of newly created dollars. Inflation is still ultimately a monetary phenomenon, so higher prices appear inevitable.

There are two reasons to argue that inflation is unlikely, and even that deflation may be a greater risk. First, the so-called "output gap" – the level of slack in the economy, roughly measured by the unemployment rate – is large, reducing the pricing power of both businesses and labor. Prices might rise in a global commodity boom, but a bona fide wage-price spiral seems far-fetched with 10% unemployment. Even our relatively optimistic forecast calls for unemployment over 8% through 2011.

**Huge output gap should restrain inflation**



Source: U.S. Bureau of Economic Analysis; calculations by MFC GIM Economic Research. Assumes 3% GDP growth in 2009Q4 and 2010Q1

This logic is persuasive, but hides uncertainties about how the output gap is measured. The amount of slack in the economy is not necessarily equivalent to unemployment, and it may change as different sectors rise and fall. The "potential output" represented by unemployed bankers and auto workers may be an illusion; if so, when growth resumes in other sectors requiring other skills and equipment, those idle resources may not limit inflationary pressures at all.

For now, unemployment and capacity utilization rates are signaling no imminent risk of inflation, but it could raise its ugly head sooner than yesterday's measures suggest.

Second, however, even if the output gap analysis turns out to be mistaken, Central Bankers know what to do about inflation, and have the independence to do it. The tightening may be painful, but they all view price stability as job #1 – that's how they earn the respect of their peers and their place in history, not through short-term popularity.

This argument, too, is compelling on the surface, but it also has flaws. The Federal Reserve may be reluctant to tighten if inflation creeps up unexpectedly before they are sure that the economic recovery is self-sustaining. They may view a little inflation as desirable relative to the risk of snuffing out economic growth like Japan in the 1990s. But a little inflation could be the precursor to more than a little. In due course, they would step in and stop it, but after a period of accelerating inflation, the cure could be another painful recession.

A balanced conclusion seems to be that inflation is not a big threat for a couple of years, and that the Fed will avert any major inflationary surge beyond that horizon. But even if the most likely outcome is benign, the risks are probably biased towards higher inflation. This traumatic economic cycle may have permanently impaired some of the economy's productive capacity, and raised the danger that inflation could come back before the Fed is entirely comfortable acting decisively against it.

### ***The Federal Budget: time to start worrying***

The federal deficit has soared to previously unimaginable levels – now we talk in trillions. This has probably been vital to avert a worse economic catastrophe, but it keeps adding uncomfortably to the national debt. A budget crisis driven by rising entitlement spending as the baby boom retires was already looming; now it is imminent – most likely a mere 5 or 10 years in the future, not decades away any longer. Rising rates will exacerbate the burden of interest payments, driving an explosion of debt in the absence of drastic corrective action.

The U.S. political establishment seems incapable of resolving this time-bomb, despite the obvious need for both higher taxes and cuts in entitlements. It's unclear exactly what kind of crisis would compel action, especially since the experience of other countries may not be a good guide. The sheer size of the U.S. economy and debt market, and the U.S. dollar's role as the world's primary reserve currency, combine to make the situation unique. But unique does not mean that a crisis cannot happen, perhaps in the form of a dramatic slump in the dollar that forces up interest rates and inflation simultaneously.

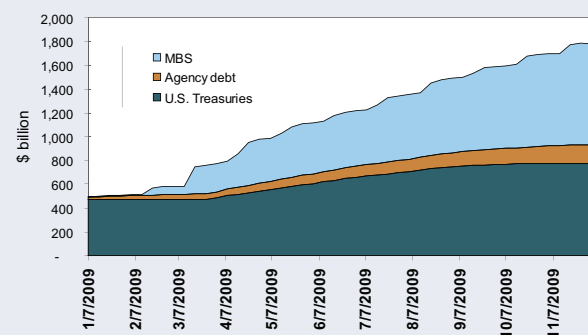
In any case, we don't expect this scenario to play out within the next couple of years, and it would be dangerous to try to balance the budget before the economic recovery is under way. But the growing imbalance is storing up pain for the future, and the future may soon be within the time horizon of elected officials.

## **Financial Markets**

### ***New year and new risks: when will the Fed move?***

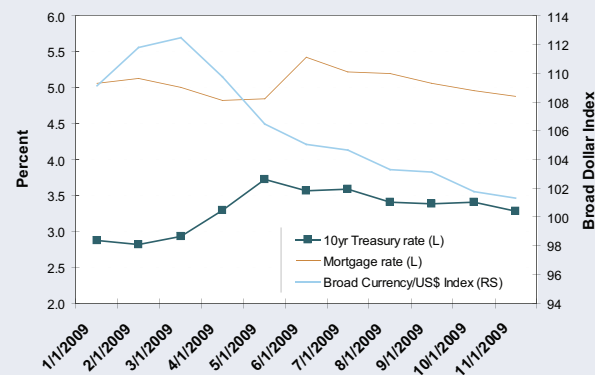
The economic stabilization has encouraged a return to risk-taking, but going forward, we see a return of some risk aversion. For sure, the bond and equity markets appear in disagreement. Low interest rates suggest low inflation fears and a soft recovery, while a bullish equity market suggests little fear of a weak economy. The two views are hard to reconcile. They mirror real uncertainty about the sustainability of the economic recovery and the long-term inflation implications of unprecedented fiscal and monetary easing.

### **The Fed's asset acquisitions...**



Source: Federal Reserve; Economic Research

### ...Are keeping rates down and offering little lift for the dollar



Source: Fed

The important question is how will the Fed respond to next year's economic conditions? We judge that by the middle of 2010 there will be enough tailwinds that the Fed will begin to move to a more neutral stance. We are looking for changes in language and a slow removal of financial guarantees as early steps, signaling that the Fed is sensing a material change in the balance of risks. If we are correct, by late in the third quarter there will be enough evidence that inflation has stabilized (unlikely to slow too much or to rise too much) and that growth is on a sustainable rebound to justify a first tentative rate hike.

An alternative, worse scenario would be that even in the absence of sustained growth, something happens (oil prices?) to dislodge inflation expectations, threatening longer-run price stability. In this case, the Fed might be forced to tighten outright or introduce a strongly worded warning to defend its anti-inflation credentials.

Our policy rate forecast is broadly consistent with the market consensus. However, we note that there is a wide range of views that imply alternative policy adjustments. For example, those who judge that underlying drags on growth will resurface as fiscal drives fade don't expect any tightening for at least another year or two. Others are more optimistic about growth, but expect that the output gap and high unemployment will preclude rate hikes until 2011. Both views have merit, but they largely ignore the role of risk-shifts in policy making.

Ultimately, we expect that the Fed's comfort with maximum accommodation will diminish as the odds of deflation shift towards inflation pressure. If inflation remains close to our forecast of 1½%, the Fed will probably see that inflation expectations are anchored, and consequently, give relatively less weight to measures of slack in its inflation forecast for 2011 and beyond. This implies that policy rates start going up gradually by the end of the third quarter in 2010. Given the lower than anticipated treasury-bond yields in the last few months, we are now expecting bond rates to go up slightly faster than in our last Outlook, ending at similar levels by the end of 2010.

### The Dollar

A declining dollar and low interest rates have been key drivers of financial markets, with many observers arguing that a weak dollar is fueling investments in higher-yielding currencies funded by selling dollars. Nobody knows how big this "carry trade" really is, nor when a reversal – a short-term appreciation in the USD – might bring it crashing to an end.

Longer-term, we are anticipating that the dollar will remain weak under the weight of massive monetary stimulus and a worsening fiscal position. This may continue for some time even after the Fed begins to drain liquidity and starts raising short-term rates. It is only if U.S. rates rise more than those in other major countries beyond 2010 that the dollar may get a counterbalancing lift.

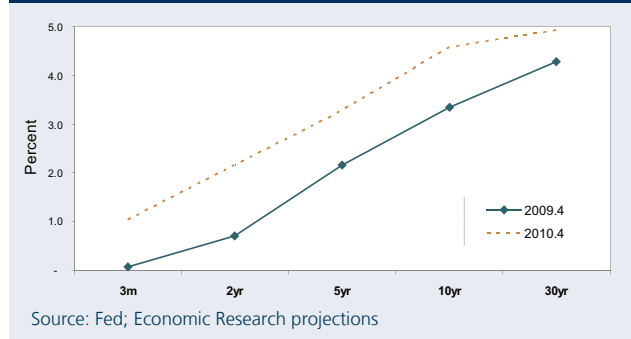
Finally, a much worse long-term alternative scenario is that a dollar collapse, triggered by a loss of confidence in U.S. fiscal and monetary policy, drives inflation and interest rates so high that we could be facing a bigger and more damaging recession than the one we have just survived.

### Yield Curve – a distorted yield slope

It is difficult to spin a positive story from the fact that there is a huge demand for Treasury bills yielding less than 0.05% and Treasury bonds yielding 3.4%. We believe that this is the result of at least two powerful drivers. One is that investors are parking funds in the liquid-safe short-end and long-end of the curve waiting to see how the recovery evolves. Another is that banks may be adding the safest securities to improve balance sheets in the absence of attractive

alternatives and capital requirements. Yet another more important reason, from the policy perspective, is the role of government printing a huge amount of money (buying securities).

**Our forecast calls for a steeper yield curve, as bond yields rise ahead of Fed tightening**



We are anticipating that rates will stay down a bit longer. However, as the recovery gains credibility, the Fed drains liquidity and investment alternatives emerge, the pressure on short- and long-term yields lifts. While initially long-rates go up faster than short-term rates, we judged that as the Fed starts draining liquidity more aggressively, the rates on bills rise faster than long-term rates. As a result, we see a flatter yield curve by the end of 2010.

**Credit Spreads – tightening offers a sign of relief**

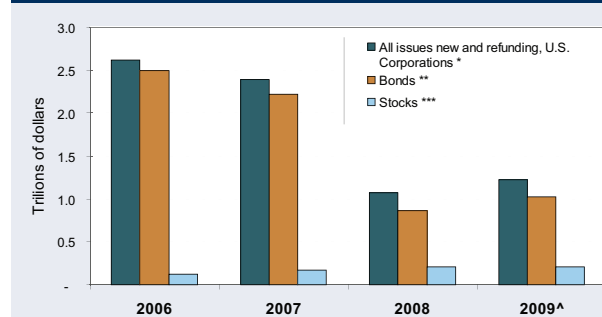
The latest figures on bank credit and banking lending practices remain discouraging. Industrial and consumer credit year-to-date has declined by more than \$250 billion and despite lower mortgage rates, mortgage lending remains weak. A wider incidence of tightening of prime residential mortgage credit and indications that more than half of surveyed banks are poised to tighten consumer credit still further will weigh on the economy and policymakers’ confidence that financial conditions can underpin a second-stage recovery next year.

However, as a sign of relief, bond spreads continue to fall from their highs earlier this year, as the subjective odds of worse-case economic scenarios fade. Default rate projections have come down substantially and the flow of new bond issuance continues to increase. This in part seems due to the fact that demand for this type

of debt is so great that companies that had no chance of refinancing short-term debt into long-term debt suddenly have abundant takers. However, with current corporate spreads still above their long-term values, these investments remain somewhat attractive.

Overall, we believe the compressed yields are a natural result of investors stretching for yield at a time that Treasury yields are low and the economic outlook has been improving. Looking ahead, the change in monetary policy should not create momentous changes in the bond market, although a change in language “for an extended period of time” could temporarily trigger a surge in bond yields. As bad as this may be, a greater risk is that as the possibility of a double-dip recession gains momentum, the options to refinance will dry up and spreads will widen again.

**New issuance is improving**



\* Figures represent gross proceeds of issues maturing in more than one year; they are the principal amount or number of units calculated by multiplying by the offering price. Figures exclude secondary offerings, employee stock plans, investment companies other than closed-end, intracorporate transactions, Yankee bonds, and private placements listed. Stock data include ownership securities issued by limited partnerships.  
 \*\* Monthly data include 144(a) offerings.  
 \*\*\* Monthly data include public offerings  
 Source: Securities Data Company and the Board of Governors of the Federal Reserve System

**Equities – nervous investors and great expectations**

There is growing anxiety that equity values have got too far ahead, setting the stage for a down-leg. Treasury bills are paying no interest while stocks continue to appreciate, raising the stakes if the Fed makes a mistake and starts to raise rates prematurely. We don’t see this happening, but believe that low to declining inflation and an increasing fiscal deficit will support a steady increase in interest rates and will result in only modest equity returns as rising profits are offset by reduced valuations.

There is an argument that the equity market has been driven by excess liquidity and that it is not necessarily supported by fundamentals. While this is possible, we note that Bernanke said recently that it's "not obvious" that asset prices in the U.S. are out of line with underlying values, adding that "It is inherently extraordinarily difficult to know whether an asset's price is in line with its fundamental value". *Amen*

**Bottom Line – for investors, risks on all sides**

Economic conditions continue to improve and the Fed will be reversing policy in due course, at a time dependent mainly on the pace of recovery. Our forecast is relatively optimistic, and most alternatives would be worse for equity, commodity or bond investors. The bottom line is that uncertainty rules; accurate predictions would be nice, but the times call for prudent diversification.

## Risks to the Outlook

The recession may be over, but there is little consensus on whether the recovery will be fast (V-shaped), sluggish or even “double-dip”. We are still forecasting sustained recovery gathering strength through 2010 and 2011, but there are many alternatives.

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

### 1. The perfect outcome – probability 20%

Fiscal and monetary policies provide just enough stimulus to fire up the normal processes of self-reinforcing growth. The Fed withdraws excess liquidity in time to avoid a surge in inflation, while private capital returns to credit markets and bank lending recovers sufficiently to support healthy growth. This V-shaped recovery sends growth sharply higher for two years without triggering inflation.

### 2. Policy mistakes lead to a double dip recession – probability 15%

Higher consumer savings and political blockages in the flow of fiscal stimulus cause the U.S. to fall back into recession in mid-2010. Home values and equities set new cyclical lows, generating political support for restricting trade. Stimulus policies become more aggressive, but not in time to avoid double-digit unemployment rates through 2010.

### 3. Deflation – probability 10%

Premature withdrawal of fiscal and monetary stimulus could set in motion a deflationary spiral, pushing ever more borrowers into bankruptcy as the real burden of debt rises. Assuming that major countries do not then embark on a trade war, we would expect that global

fiscal responses and massive injections of liquidity eventually pull us away from depression dynamics, but not without serious collateral damage to households and businesses, and even scarier levels of government debt.

### 4. Inflation – probability 15%

There is a legitimate concern that the Fed and the bulging fiscal deficit will awaken the inflationary beast. A resurgence of growth followed by rising labor costs and a spike in commodity prices catch policymakers by surprise before any tightening can prevent a surge in inflation. In this scenario, the delayed policy reaction leads to a painful recession in 2011.

### 5. Global meltdown – probability 5%

A weaker U.S. economy could help send Europe and Asia into another downward spiral, leading to a sharper drop in asset prices with further spiking of corporate and financial defaults. If U.S. and European consumer demand dives in shock, it may take more than another year before the cumulative impact of pro-growth policies gains any traction. Other triggers for similar scenarios include a U.S. dollar crisis, as a slumping currency drives up inflation and compels the Fed to tighten the screws on an already weak economy.

#### Bill Cheney — Chief Economist

MFC Global Investment Management  
Telephone: 617-572-9138  
Email: bcheney@mfcglobalus.com

#### Oscar Gonzalez — Economist

MFC Global Investment Management  
Telephone: 617-572-9572  
Email: ogonzalez@mfcglobalus.com

#### MFC Global Investment Management

MFC Global Investment Management® (MFC GIM) is the asset management division of Manulife Financial. The MFC GIM 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.

The information contained herein is based on sources believed to be reliable, but it is neither all-inclusive nor guaranteed by MFC GIM. Opinions and forecasts reflect our judgment at the time of publication and are subject to change.

TORONTO BOSTON LONDON HONG KONG TOKYO

200 Bloor Street East, Toronto, Ontario, Canada M4W 1E5 Tel: (416) 926-6262

 **MFC Global**  
Investment Management®