



North American Economic Outlook

The U.S. economy has gone from bad to worse over the past quarter, and is dragging Canada down with it. The U.S. recession is shaping up to be the worst in decades, lasting well into 2009, as credit conditions keep tightening, consumers pull back, exports plummet, and the housing sector continues to shrink. Canada may currently be the stronger, but trade binds the two countries together. With the price of oil sinking precipitously, there is no way for Canada to dodge the impact of the U.S. cycle.

The only silver lining is that with current and expected conditions so painful, the urgency of massive government spending to boost demand is now almost universally recognized. In both countries, however, political uncertainties cloud the prospects for immediate fiscal action.

U.S.: an outlook uniquely dependent on prompt and effective government policy

Since our Fall Outlook, consumer spending, exports and credit availability have worsened significantly. If in the first half of 2008 the U.S. economy was slowly walking with a cane of exports, it is now bedridden. Tight financial conditions are squeezing the real economy as consumers retrench, making this recession longer and deeper than either of the last two cycles.

It is unclear whether consumers are cutting back primarily by choice as they worry about their jobs and lost equity and housing wealth, or simply because they are unable to get credit for major purchases. Retail marketing still stresses easy terms of zero interest or no payments for a year, but lenders are tightening standards and potentially denying credit to much of the consumer population.

The resulting increase in savings, whether voluntary or not, exposes the economy to the "paradox of thrift" whereby individuals wisely cut spending to rebuild their savings, causing

Newsflash: U.S. consumers are saving - too soon to tell if it's by choice or just tight credit



Source: Bureau of Economic Analysis; Economic Research

the economy to contract and ultimately reduce the amount of wealth they can accumulate.

Consumer spending is such a large part of the U.S. economy that this shift in direction is huge and hard to reverse. Personal consumption expenditures have already dropped about \$150 billion (at an annual rate) from July to October and are set to fall much faster. This drop drags down business spending and government tax revenues, leading to further retrenchment. The only effective near-term antidote will be federal government spending of several hundred billion dollars.

Government efforts to resolve the credit market turmoil and to boost the real economy are complicated by the political interregnum, when neither the outgoing nor the incoming administration has both the incentives and the clout to act quickly. This looks like an unfortunate coincidence, though history shows that financial crises often hit at exactly such politically inopportune moments, precisely because of the uncertainties created by a temporary decision-making vacuum. In the current situation, delaying the required fiscal boost by a couple of months may allow the recession to deepen further, as the cutbacks and layoffs feed on each other.

(continued on page 3)

U.S. Forecast Summary

 Year-over-Year % Change
or Annual Average

| Winter 2008-09 | History | | | Forecast | | | | | | | | Year-over-Year % Change or Annual Average | | | | |
|---|-------------|-------------|-------------|-------------|-------------|------------|------------|------------|------------|------------|------------|--|------------|------------|-------------|------------|
| % Change at annual rate | 2008.1 | 2008.2 | 2008.3 | 2008.4 | 2009.1 | 2009.2 | 2009.3 | 2009.4 | 2010.1 | 2010.2 | 2010.3 | 2010.4 | 2007 | 2008 | 2009 | 2010 |
| Real U.S. GDP and Components | | | | | | | | | | | | | | | | |
| Gross domestic product | 0.9 | 2.8 | -0.5 | -6.0 | -4.0 | 0.0 | 2.5 | 3.0 | 3.3 | 3.3 | 3.0 | 3.0 | 2.0 | 1.1 | -1.6 | 2.9 |
| Personal consumption expenditures | 0.9 | 1.2 | -3.7 | -6.3 | -5.0 | -0.4 | 1.5 | 1.9 | 2.9 | 5.5 | 4.0 | 4.4 | 2.8 | 0.1 | -2.6 | 3.0 |
| Business Fixed Investment | 2.4 | 2.5 | -1.5 | -12.7 | -9.9 | -7.8 | -0.1 | 5.7 | 3.5 | 8.4 | 12.1 | 14.5 | 4.9 | 2.3 | -6.2 | 5.4 |
| Residential Investment | -25.1 | -13.3 | -17.6 | -19.7 | -30.5 | -22.1 | 11.6 | 45.3 | 52.5 | 48.9 | 37.5 | 25.4 | -17.9 | -20.8 | -16.1 | 35.7 |
| Government purchases | 1.9 | 3.9 | 5.4 | 0.5 | 4.0 | 4.4 | 4.0 | 4.0 | 2.9 | 2.1 | 2.0 | 1.3 | 2.1 | 2.8 | 3.6 | 3.0 |
| Change in inventories | -10.2 | -50.6 | -29.1 | -63.2 | -60.9 | -35.4 | -19.0 | -1.5 | -24.3 | -10.4 | 14.9 | 34.5 | -2.5 | -38.3 | -29.2 | 3.7 |
| Exports | 5.1 | 12.3 | 3.4 | -9.4 | -7.1 | -1.1 | 2.1 | 2.7 | 1.7 | 6.4 | 7.9 | 9.0 | 8.4 | 7.4 | -2.3 | 3.9 |
| Imports | -0.8 | 3.9 | 5.4 | -5.0 | -3.3 | 0.4 | -1.0 | 0.0 | 10.6 | 12.0 | 12.5 | 12.1 | 2.2 | 0.6 | -0.9 | 7.0 |
| Real disposable income | -0.7 | 10.7 | -9.2 | 4.2 | 3.5 | 1.0 | 1.2 | 1.9 | 2.5 | 4.1 | 4.5 | 4.5 | 2.8 | 1.2 | 1.5 | 2.8 |
| Personal saving rate (%) | 0.2 | 2.5 | 1.1 | 3.4 | 5.4 | 5.7 | 5.6 | 5.6 | 5.5 | 5.2 | 5.3 | 5.4 | 0.6 | 1.8 | 5.6 | 5.4 |
| Corporate profits with IVA & CCAdj | -4.3 | -14.3 | -3.8 | -34.3 | 21.1 | 23.2 | -21.1 | -25.0 | 12.7 | 20.0 | 15.0 | 12.3 | -1.6 | -4.6 | -5.3 | 1.8 |
| Unemployment rate % | 4.9 | 5.3 | 6.0 | 6.7 | 7.3 | 7.7 | 8.0 | 8.1 | 8.2 | 8.2 | 8.1 | 7.7 | 4.6 | 5.7 | 7.8 | 8.1 |
| Private housing starts (thous. units) | 1053 | 1025 | 877 | 751 | 583 | 654 | 857 | 1027 | 1258 | 1426 | 1533 | 1612 | 1341 | 927 | 780 | 1457 |
| Prices | | | | | | | | | | | | | | | | |
| GDP price index | 2.6 | 1.1 | 4.2 | 1.1 | 1.5 | 1.4 | 1.5 | 1.5 | 0.6 | 0.0 | 0.1 | 0.2 | 2.7 | 2.3 | 1.7 | 0.7 |
| Consumer Price Index: CPI-U | 4.3 | 5.0 | 6.7 | -5.7 | -0.3 | 0.4 | 1.0 | 0.9 | 0.9 | 1.5 | 1.6 | 2.0 | 2.9 | 4.0 | 0.2 | 1.2 |
| CPI-U excl food & energy | 2.5 | 1.9 | 3.2 | 2.4 | 1.8 | 1.4 | 2.2 | 2.1 | 0.6 | 0.4 | 0.6 | 0.7 | 2.3 | 2.4 | 2.1 | 1.1 |
| Foreign Exchange Rate | 97.3 | 95.8 | 97.9 | 109.6 | 110.8 | 109.9 | 109.7 | 108.9 | 108.4 | 107.3 | 106.5 | 105.7 | 103.4 | 100.1 | 109.8 | 107.0 |
| (Broad trade-weighted value of US\$) | | | | | | | | | | | | | | | | |
| Refiners' cost of imported oil (\$/b) | 89.8 | 115.9 | 113.3 | 57.4 | 46.0 | 50.4 | 55.1 | 57.3 | 58.0 | 60.0 | 62.0 | 62.0 | 67.1 | 94.1 | 52.2 | 60.5 |
| U.S. Interest Rates (avg. %) | | | | | | | | | | | | | | | | |
| Federal Funds Rate | 3.2 | 2.1 | 2.0 | 1.0 | 0.3 | 0.3 | 0.3 | 0.3 | 0.5 | 0.9 | 1.3 | 1.5 | 5.0 | 2.0 | 0.3 | 1.0 |
| Ninety-day Treasury Bill Rate | 2.0 | 1.63 | 1.5 | 0.3 | 0.3 | 0.5 | 0.5 | 0.8 | 0.9 | 1.4 | 1.7 | 1.9 | 4.4 | 1.4 | 0.5 | 1.5 |
| 10-year Treasury Note Yield | 3.7 | 3.88 | 3.9 | 3.3 | 2.9 | 2.9 | 3.2 | 3.4 | 3.6 | 3.8 | 3.9 | 4.1 | 4.6 | 3.7 | 3.1 | 3.9 |
| Treasury Yield Spreads (avg. basis points) | | | | | | | | | | | | | | | | |
| 5yr - 2yr | 73 | 74 | 75 | 98 | 101 | 108 | 101 | 98 | 83 | 90 | 88 | 86 | 7 | 80 | 102 | 87 |
| 10yr - 2yr | 164 | 147 | 150 | 210 | 174 | 171 | 178 | 170 | 161 | 155 | 150 | 145 | 27 | 168 | 173 | 153 |
| 30yr - 10yr | 75 | 69 | 59 | 45 | 78 | 99 | 108 | 101 | 99 | 95 | 90 | 85 | 20 | 62 | 96 | 92 |
| Credit Spreads (avg. basis points over Treasuries) | | | | | | | | | | | | | | | | |
| 10yr AAA | 191 | 199 | 260 | 362 | 349 | 347 | 335 | 320 | 306 | 292 | 278 | 263 | 87 | 253 | 338 | 285 |
| 10yr A | 230 | 232 | 291 | 465 | 465 | 462 | 446 | 427 | 408 | 389 | 370 | 351 | 114 | 304 | 450 | 379 |
| 10yr BAA | 281 | 276 | 322 | 572 | 597 | 594 | 572 | 548 | 524 | 499 | 475 | 451 | 149 | 363 | 578 | 487 |

Forecast beginning in 2008.4

Canada Economic Research Forecast Summary

 Year-over-Year % Change
or Annual Average

| Winter 2008-09 | History | | | Forecast | | | | | | | | Year-over-Year % Change or Annual Average | | | | |
|---------------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|------------|------------|------------|------------|------------|--|------------|------------|-------------|------------|
| % Change at annual rate | 2008.1 | 2008.2 | 2008.3 | 2008.4 | 2009.1 | 2009.2 | 2009.3 | 2009.4 | 2010.1 | 2010.2 | 2010.3 | 2010.4 | 2007 | 2008 | 2009 | 2010 |
| Real CAN GDP and Components | | | | | | | | | | | | | | | | |
| Gross domestic product | -0.6 | 0.6 | 1.3 | -2.3 | -2.1 | -0.5 | 1.6 | 2.5 | 3.2 | 3.3 | 3.0 | 3.3 | 2.7 | 0.7 | -0.5 | 2.6 |
| Personal consumption expenditures | 2.5 | 2.0 | 0.7 | -1.9 | -0.5 | 0.8 | 1.9 | 2.3 | 2.1 | 3.7 | 4.4 | 5.0 | 4.5 | 3.2 | 0.3 | 2.8 |
| Business Fixed Investment | -0.5 | 0.3 | 0.5 | -7.9 | -2.2 | -9.0 | -3.5 | 1.5 | 5.2 | 6.5 | 5.4 | 2.1 | 3.5 | 1.1 | -4.1 | 2.5 |
| Government purchases | 3.2 | 3.7 | 0.3 | 4.2 | 7.1 | 3.7 | 3.4 | 3.4 | 3.8 | 4.5 | 4.0 | 3.8 | 4.2 | 3.9 | 4.1 | 3.8 |
| Change in inventories (\$ bill CAD) | 4.2 | 10.2 | 12.0 | 13.8 | 9.6 | 7.5 | 13.2 | 8.2 | 10.2 | 8.5 | 7.2 | 6.4 | 13.2 | 10.0 | 9.6 | 8.1 |
| Exports | -4.2 | -5.2 | -5.4 | -9.4 | -7.1 | -1.8 | 0.1 | 6.5 | 3.0 | 3.2 | 3.0 | 3.5 | 1.0 | -4.7 | -4.6 | 3.0 |
| Imports | -9.0 | 2.8 | -6.1 | -5.8 | -2.3 | -0.5 | 1.3 | 2.3 | 3.7 | 4.1 | 4.5 | 4.4 | 5.5 | 1.1 | -2.1 | 3.1 |
| Unemployment rate % | 5.9 | 6.1 | 6.1 | 6.4 | 6.8 | 7.1 | 7.3 | 7.4 | 7.5 | 7.2 | 6.8 | 6.7 | 6.3 | 6.1 | 7.2 | 7.1 |
| Private housing starts (thous. units) | 234 | 220 | 220 | 210 | 199 | 185 | 180 | 177 | 180 | 190 | 200 | 210 | 229 | 221 | 185 | 195 |
| Prices | | | | | | | | | | | | | | | | |
| Consumer Price Index: CPI-U | 1.7 | 5.3 | 4.9 | -2.9 | 0.7 | 1.9 | 2.3 | 2.1 | 2.0 | 1.9 | 2.2 | 2.1 | 2.1 | 2.4 | 1.3 | 2.1 |
| CPI-U excl food & energy | -0.1 | 2.5 | 1.3 | 0.3 | 1.5 | 2.0 | 1.7 | 1.7 | 0.9 | 0.5 | 0.6 | 0.6 | 2.1 | 1.1 | 1.4 | 1.1 |
| Foreign Exchange Rate USD/CAD | 1.00 | 0.99 | 0.96 | 0.83 | 0.79 | 0.79 | 0.82 | 0.86 | 0.87 | 0.88 | 0.91 | 0.99 | 0.93 | 0.97 | 0.84 | 0.87 |
| CAN Interest Rates (avg. %) | | | | | | | | | | | | | | | | |
| BoC Overnight Rate | 3.83 | 3.00 | 3.00 | 2.1 | 1.5 | 1.0 | 1.0 | 1.0 | 1.5 | 2.0 | 2.5 | 3.0 | 4.4 | 3.0 | 1.1 | 2.3 |
| Ninety-day Treasury Bill Rate | 3.01 | 2.55 | 2.33 | 1.6 | 1.5 | 1.7 | 1.9 | 2.2 | 2.5 | 2.8 | 3.2 | 3.5 | 4.1 | 2.4 | 1.8 | 3.0 |
| 10-year Treasury Note Yield | 3.79 | 3.75 | 3.65 | 3.5 | 3.3 | 3.6 | 3.8 | 4.0 | 4.1 | 4.3 | 4.5 | 4.8 | 4.3 | 3.7 | 3.7 | 4.4 |

Forecast beginning in 2008.4

Changes since our Fall Outlook

Economic reports took a sharp turn for the worse since September. We were already expecting one negative quarter for U.S. GDP in Q4 2008, but since then, we have learned that Q3 was down slightly, and our outlook now calls for a much steeper decline in Q4 continuing into Q1 2009. Even the second quarter of 2009, currently projected at zero growth, may be on the optimistic side.

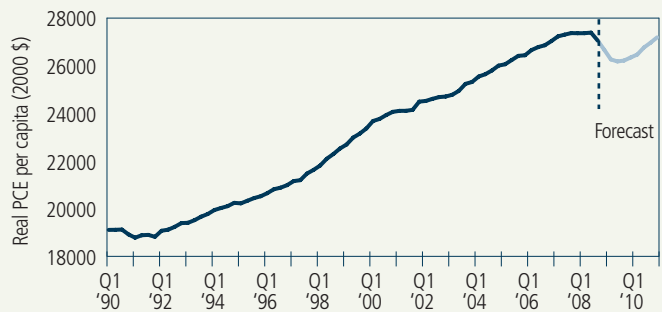
- As a result of the rapid deterioration in economic conditions, we now expect unemployment to rise much faster, peaking above 8% rather than at 6.7% as we had previously anticipated.
- The increased idle capacity in the economy will tame inflation, bringing it down to around 1% rather than closer to 2%, with risks to the downside.
- Interest rates will remain correspondingly lower for longer, with the fed funds rate dropping to new record lows for all of 2009, and Treasury bond yields staying at historically meager levels until well into 2010.
- Canada's outlook has worsened significantly, based primarily on the rapid deterioration of the U.S. economy. We now expect unemployment to peak roughly 1% above its previous peak in the second half of 2009, driven by downward revisions to growth in 2008-2009.
- The Bank of Canada is projected to cut its overnight target to over half of what we had previously forecast, 1.0% versus 3.0%. We expect the BoC to pursue aggressive expansionary policy amid the serious downside risks to growth and strong disinflationary pressures.

We still expect the economy to revive later in 2009, driven largely by massive government spending worldwide. But this is by no means a sure thing, and until both central banks and financial markets are convinced of this scenario, the current sense of crisis will persist, along with lower bond rates, wider credit spreads and more volatile markets than seemed likely only three months ago.

(continued from page 1)

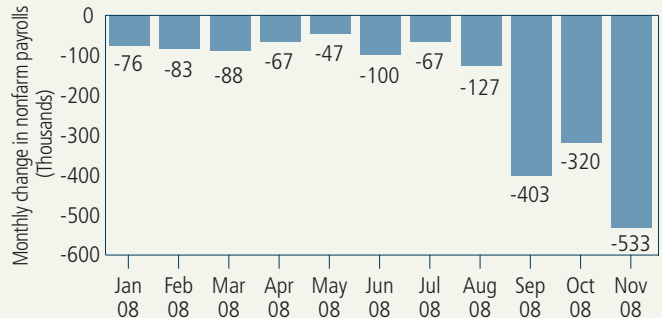
Our forecast includes three consecutive quarters of contraction, followed by a period of sluggish growth. The U.S. economy returns closer to its potential (3.5%-4.5%) in 2010, but only after a massive amount of policy stimulus is well underway.

Consumer spending stalls for the first time since 1990



Source: U.S. Bureau of Economic Analysis; Economic Research

U.S. job market collapsed in September



Source: Bureau of Labor Statistics

The export boom is over

A surging U.S. dollar and global recession caused exports to stall in Q3 2008, and probably decline in Q4, hurting what had been one of the few areas of U.S. economic strength. However, falling consumer demand will also cut imports, lifting GDP by shifting some of the pain to foreign economies. If the U.S. recovers sooner than the rest of the world, the trade deficit will grow again for a while until the longer-term trend of rising exports reasserts itself.

The paradoxical pain of productivity

Productivity continues to rise at a respectable pace. In the long run, this permits higher real living standards, but in a downturn, it adds to the pain by further reducing the demand for labor at a time when unemployment is already rising fast. It appears that businesses are finding ways to cut back and make do with fewer people, rather than treating labor as a fixed cost and holding on to their workforce. The boom in temporary help over the past decade added greatly to firms' ability to respond quickly to growing demand; now the same is true on the downside, as temporary employment drops precipitously.

Cheap oil – until the global economy revives

Gas prices have halved since their July peak, falling below \$2 from over \$4/gallon, boosting consumers' spending power by up to \$20 billion/month. However, consumers don't seem willing to part with the extra cash, possibly because they really couldn't afford the peak prices in the summer, and just got by with credit cards. The heightened awareness and behavioral changes brought about by the multi-year run-up in oil prices will not wear off overnight, as energy-saving investments and habits persist at least through the recession. In the longer run, we assume that oil prices will recover along with the world economy.

Housing: sales and starts bottoming, as prices fall further

Home sales – existing and new – have likely bottomed, as the number of new homes for sale shrinks fast. At best, rock bottom pricing and lower mortgage rates will encourage sales, and jump-start a revival in transactions, working down rapidly the inventory of existing homes for sale. More likely, however, the weak labor market will hold down demand while foreclosures add to supply, further depressing home prices and pushing the prospect of a rebound in home-building off into 2010. In any case, though, this now shrunken sector should be only a minor drag on GDP for one or two more quarters.

Inflation and deflation: dueling risks

Alarmist discussions of the risk of deflation are competing in the media with worries about the inflationary consequences of the Federal Reserve's massive outpouring of money. Both fears are legitimate: we know about the dangers of deflation from the history of both the U.S. in the 1930s and Japan in the 1990s, while examples of inflation following rampant monetary expansion are commonplace.

As unemployment rises fast, the idle capacity in the U.S. economy will exert downward pressure on inflation. Since we are starting from a historically moderate pace of core inflation, a significant step down brings us dangerously close to a negative trend in prices, which could pose serious problems going forward if it gets embedded into the expectations of consumers and investors. The specter looms of the 1930s, when rapid deflation raised the real cost of debt and contributed to spiraling defaults.

In the end, though, the combination of expansionary monetary and fiscal policies should avert a serious deflation, as the Federal Reserve and the Treasury between them have the ability to create and spend unlimited amounts of money – the only real risk on this front is of political foolishness.

Inflation is a more genuine – if distant – concern, especially given that central banks are painfully aware of how the Japanese authorities repeatedly snuffed out incipient expansions by tightening policy too soon. This time, therefore, they may be inclined to err on the side of risking some inflation in order to ensure that economic growth is really reviving. From a policy perspective, a period of slightly more rapid inflation (say 3%-4%) might even be considered desirable, as a modest contribution to deleveraging the economy by reducing the real value of debt. This risk is probably not too pressing, however, since unemployment will in all likelihood be rising until early 2010, and will remain well above a level that could generate price pressures before 2011. In effect, this is a problem we would welcome, since it will occur only in the context of a healthy economic recovery.

Canada now suffers like the rest

Canada's economy is deteriorating quickly. Commodity prices take a nose dive, the U.S. recession gains footing, the manufacturing sector continues to tumble, and the economic wall that once divided the commodity-rich West from the struggling manufacturing-based East has now collapsed.

The economy grew at a striking 1.3% annualized rate in the third quarter, and Canada is just one of two G7 countries (alongside France) to still enjoy positive growth. But don't let that fool you - the contributions to growth from exports remained negative; from investment was barely positive; and from consumption and government spending barely zero. Labor and housing are sliding faster than expected, and the economy looks to policy makers for a reprieve.

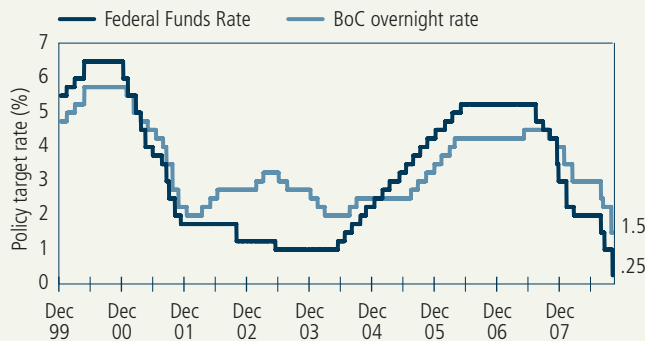
Canada's dependence on U.S. exports is a serious drag

Exports will suffer as U.S. consumers recoil amid what's expected to be the worst recession in almost thirty years. Real exports have already declined five consecutive quarters on a strong Canadian dollar (CAD). But now, in spite of a falling CAD, the downward drag coming from depressed U.S. import demand – roughly 80% of the Canadian goods export market – is too heavy for any hope of re-emerging export growth. Exports will eventually contribute to growth, but not until the second half of 2009 at best.

Labor started to slide, and quickly at that

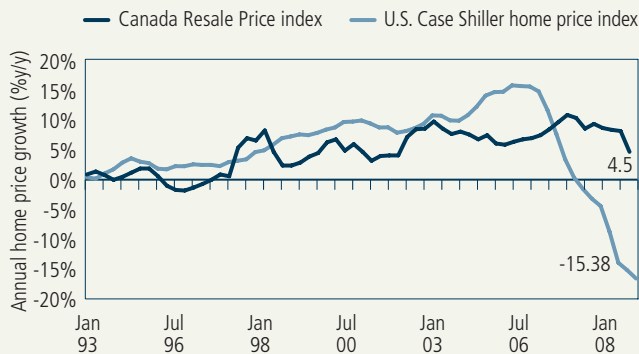
All hopes of a resilient labor market are now gone. November employment toppled over, and job loss hit the mat hard at 71,000. This sounds small relative to -533,000 in the U.S. November report. However, compared to the size of

Bank of Canada policy mimics Fed policy, but in BoC faces no imminent liquidity trap



Source: Statistics Canada, Federal Reserve
Daily data through 12/16/2008

...While the rush to liquidity continues unabated



Source: Federal Reserve
Daily data Jan 2, 2008 - December 12, 2008

Canada's labor force, the pace of job loss is even worse. The unemployment rate continues to hover at historical lows, but with the service sector just starting to lay off workers and the ongoing destruction of manufacturing jobs, the unemployment rate is expected to rise to the 6.9%-7.3% range in 2009.

Housing hit a peak

Starts fell precipitously in November, and although this is a highly volatile indicator, we expect a downward trend to emerge. Housing starts may fall another 10%-15%, and home price appreciation is expected to slow significantly – perhaps to a standstill - but this is to be expected in a recessionary environment and cannot be compared to the carnage in the U.S. Going forward, and under the pressure of falling labor income and wealth, households will be slow to make big borrowing decisions. The housing market will weaken further into 2009.

Policy and financial markets in Canada: similar but not the same as in the U.S.

The Bank of Canada (BoC) is aggressively fighting the downside risks to growth. In December, the BoC cut its policy target rate 75 bps to 1.5%, and unlike its neighbor central bank to the south, faces no imminent liquidity trap. Into 2009, standard expansionary policy – cutting the target overnight rate – is likely to be quite effective in lowering longer-term yields, raising consumption and investment, and eventually growth.

The CAD slid on the Bank of Canada's announcement, but longer term the currency will gain ground against the U.S. dollar. Oil prices, which are currently out for the count, will not stay down. Global coordinated policy attacks will eventually propel world growth out of its rut, and when that happens, oil - a depletable resource – will emerge once again as a costly commodity. At that point, the CAD – currently 20% off its November peak - will gain some ground with demand for natural resources. But like all other things inflationary, that is a year or more off.

Put on hold until Parliament's confidence vote in January is Canada's fiscal stimulus package. Regardless of whether Prime Minister Harper retains his seat or the Liberals snatch it from under him – the speed and size of the spending bill will likely increase if the liberals win the vote – expansionary fiscal policy is expected early in 2009. Given the lags on fiscal policy, it is unfortunate that Parliament squabbles at the onset of Canada's recession. But given the alternative – an even more prolonged recession - late is better than never.

As an added buffer for the Canadian housing and credit markets from the U.S. credit contagion, the Department of Finance and the BoC have initiated non-traditional policy measures. The Department of Finance set in place a \$25 billion program to shore up the MBS market. The program is quite sizable: proportionately to the size of the Canadian economy, just shy of half the Fed's \$US 500 billion MBS budget. Furthermore, the BoC created alternative liquidity programs - Term PRA Facility for Private Sector Money Market Instruments and Term Loan Facility - to back up domestic credit markets. Although the credit markets are healthy compared to those in the U.S., it's better to be safe than sorry.

Canada is approaching a slippery and steep slope and is going to slide with or without the help of policy makers, but expansionary policy will serve to mitigate the recession. Unfortunately, with the U.S. economic outlook worsening by the minute, Canada must suffer until its domestic policy kicks in, and then until the U.S. economy stabilizes.

U.S. Financial Markets

The Fed is using all the ammunition to promote growth

Without making a formal announcement, the Fed has already adopted a near-zero policy rate to complement its aggressive balance sheet expansion. Using a mix of zero-interest bank lending, swap-extensions, financial bailouts, and asset-loan guarantees, the Fed's balance sheet has nearly doubled to \$2.2 trillion since September.

At this point, the macroeconomic impact of all of this policy is in flux while financial volatility remains high, and the value of many asset-backed securities still cannot be determined. Nonetheless, on balance, the market signals, from credit spreads to rate changes show some relief. The economic evidence is also mixed. The commercial banking system continues to accumulate cash, and while aggregate credit lines are still growing, some lending outside of commercial banks has dried up.

The Fed's response to the crisis has been faster and more forceful than other central banks'. The European Central Bank, the Bank of England, and the Bank of Canada have collectively slashed rates by 750 basis points, but their policy rates remains above those in the U.S. We expect additional global rate cuts in the coming year.

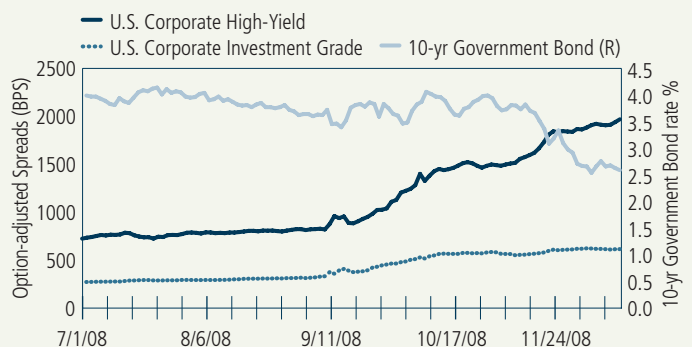
In the short term, the Fed's unprecedented liquidity measures soften what otherwise would have been a more severe economic contraction by lowering interest rates to promote investment and consumer borrowing. Furthermore, the measures provide direct credit to firms so that they are not forced to cut back operations for lack of short-term funding.

However, longer term, the Fed's policy could be inflationary, but only if it continues beyond the point at which private investors are extending credit in a more normal way. We anticipate that such conditions will crystallize by the second half of 2009. At that point, the extraordinary liquidity provisions will no longer be needed, and the Fed will unwind its balance sheet and gradually increase its various policy rates.

The bond market is playing out the perfect growth-deflation-default hand

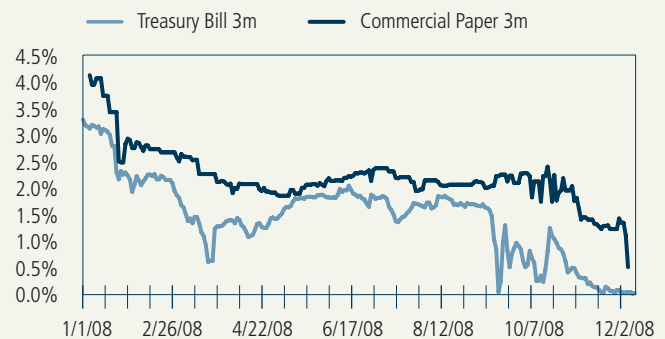
A steady string of dismal economic reports since September have kept markets on edge, with treasury rates and credit spreads near record levels. Government policy, continuing economic weakness, and worsening expectations have shifted the yield curve down and widened credit spreads.

In the credit storm: Widening spreads are offsetting falling rates...



Source: Barclays Capital Inc. (Lehman Brothers Index); Federal Reserve Bank
Daily data June 7, 2007- December 12, 2008

...While the rush to liquidity continues unabated



Source: Federal Reserve
Daily data Jan 2, 2008 - December 12, 2008

The Fed's injection of money via the Commercial Paper Funding Facility, the Term Auction Facility, and the Asset-Backed Commercial Paper Money-Market Mutual Fund Liquidity Facility, combined with rate cuts have put direct downward pressure on the yield curve. With front-end rates close to their zero nominal bound, the slope of the yield curve has flattened. Lending initiatives like the Fed's expected \$600 billion purchase of GSE-debt and MBS have also impacted long Treasury and mortgage rates.

Bad economic data, amid signs of continuing financial distress, are directly eroding the inflation-premium in yields, while fears of rising defaults are pushing spreads wider. The deleveraging and associated asset-price deflation, which began early in the credit crisis, continues today. To add pain to injury, a freezing of credit transactions and a deteriorating price discovery mechanism have driven domestic and international investors to

buy more safe-and- liquid government bonds, and to sell other assets. Altogether, to investors, these forces signal heightened deflation risk.

Going forward, if policy succeeds in reviving risk-taking and increases the demand for private credit, as we expect, then a rise in Treasury yields would be a welcome sign. We expect significant new fiscal stimulus and additional funding (like TARP) to stem the credit crisis which implies massive new debt issuance.

The TARP expenditures were never government consumption, just a shift in assets between holders. In contrast, the expected fiscal boost will involve outright demand-creating government spending. An increase in the deficit and some monetization of this debt serve as a strong counterbalance to deflationary forces, and should provide upward pressure to the long end of the yield curve.

With short rates already close to the zero nominal bound, and GDP expected to contract over the next 2 quarters, we anticipated some disinflation in 2009, but still overall positive CPI inflation. This implies that interest rates will likely see little upward pressure from inflation over the next two years.

The 10-year rate stands at less than 2.5%, near its lowest level on record. Looking ahead, we see the 10-year bond closer to 3.5% by the end of 2009. Furthermore, investment-grade spreads seem to imply defaults at several multiples of their worst 10-year-period since 1980. Conditions in the market reflect a toxic mix of bad news, fear, and uncertainty. Although our near-term outlook is quite dismal, we do forecast a path to recovery where liquidity risks subside materially. This implies that spreads will tighten, but only modestly as investors remain risk-averse and “worst-case-scenarios” are only gradually downgraded.

The equity market is playing out a crumbling economy

As we go to print, the S&P 500 index is down about 40% year-to-date, while European and Asian markets have also been pulled down. The only good news may be that losses have been so striking that most of the bad news and gloomy expectations have been already priced in, and that markets are getting ready to bounce back, or at least shake off the incoming bad economic and corporate news. Our base forecast implies a -5% fall in corporate profits in 2009, followed by 16% increase in 2010, compared to fall of -9% in 2008.

Investors are understandably anxious with such heightened uncertainty. The key consideration is that policy will offer a strong anchor. It is true that the housing market won't recover

overnight, banks will not lend with abandon soon, consumers aren't about to start spending freely, and global economic growth isn't going to rev up instantly to its full potential. It will take time, but with time and substantial stimulus, credit will start flowing again. This should be enough to squeeze out some of the excessive fear in the markets, and in turn could produce a genuine rally.

Commodities: a crash following the usual surge

There has been a seismic shift in the global economic outlook in the past month or so. To date, a crumbling world economy is dragging commodity prices through the mud. Oil prices are flirting with \$40 a barrel, down over \$100 a barrel from as recently as July. Our forecast implies bearish demand for commodities, and barring adverse supply shocks, commodity prices are expected to track slower global growth. However, given that the previous run-up in prices was driven by demand, we assume that the eventual global recovery will lead to a rapid rebound in commodity prices.

Currencies: flight to safety pulls the dollar up

Since September, the U.S. dollar (USD) was essentially unchanged on a trade-weighted basis – strong. It has gained strength only against the Japanese yen. In recent weeks, turmoil in the world's financial markets and concerns about a global recession have driven investors away from the euro and the pound, and in favor of the U.S. dollar and the yen. The underlying reality of global imbalances still favor a downward long-term USD trend, but the depth of the U.S. Treasury market has left the USD as the safest port while the storm lasts.

In conclusion

At present, financial markets are signaling one of the worst economic crises in recent times. While we see a global recession under way, we don't anticipate that this will be as severe as gloomier market views, largely because of the measures already taken by the Fed and Treasury.

Our forecast is conditional on an effective payoff from the anticipated fiscal stimulus and the ongoing monetary policies to stabilize credit conditions. We believe that the ball is on the fiscal side of the court, and while interest rate cuts and other monetary measures will still be required, government spending will be the main force steering the economy. For Treasury debt to crowd out private investment, there needs to be something to crowd; for now, this problem would be welcome.

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