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Set to gain from stimulative monetary environment

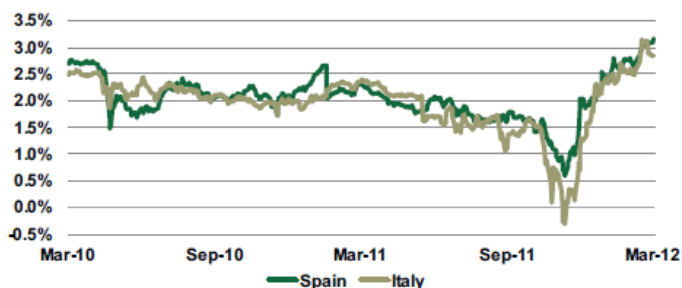
Dramatic central bank action has improved European monetary conditions and select regional markets and companies now enjoy competitive positioning and attractive valuations.

MSCI Europe Index (Total return)	As of March 31, 2012	
	3 Months	12 Months
USD Return	11.1%	-7.4%
CAD Return	9.2%	-4.7%

Source: Bloomberg. For illustration purposes only.

Investor risk appetite has turned sharply more positive early in 2012 as the European Central Bank’s (ECB) actions have allayed fears of a euro implosion. The most significant of these have been the two Longer Term Refinancing Operations (LTROs), which have lent €1 trillion at 1 per cent to over 800 financial institutions. The effect has been profound on the yield curves in the Spanish and Italian bond markets, which mere months ago teetered on the brink of disaster. Forcing down short-dated bond yields and ring fencing Italy and Spain from the domino effect of the risk of Greek default have so far been the main successes of the LTROs. The question now is whether European growth can recover quickly.

Yield curves normalizing in Spain, Italy



Source: Bloomberg (March 15, 2012). For illustration purposes only.



By resorting to such unorthodox monetary policy, the ECB has joined the ranks of the U.S. Federal Reserve and the Bank of Japan in stimulating their respective economies by forcing down long term real interest rates. We believe the result of these quantitative easing policies will be to create asset price inflation. This in turn will stimulate consumption, create negative real interest rates and discourage saving, thus creating the conditions to reflate economies and reduce government debt levels.

A weaker euro, which will favor Europe's and especially Germany's export led model, is another likely outcome. We expect terms of trade to shift in favor of the Western economic bloc versus emerging markets, which will suffer from rising commodity prices and strengthening currencies.

Europe open for business

Our recent meetings with multinational firms have confirmed that Europe (especially Eastern Europe) is once again becoming a good place to do business. Cheap labor, weakening currencies relative to China and rising Chinese blue collar labor costs mean we anticipate capital flows into Europe at the expense of emerging markets.

In addition, access to cheap three-year money will slow the pace of deleveraging in the real economy and will offset austerity measures across Europe to some degree.

It's too early to speculate whether these "free" funds will flow into economies, however recent pan-European lending data has turned positive for the first time in many months. The narrowing of Italian and Spanish bond spreads over German bunds shows that governments are tentatively winning the trust of markets to reduce their debt-to-GDP (Gross Domestic Product) ratios toward sustainable levels. This is not guaranteed to endure as political change could upset these hard won reforms.

The unelected Italian Prime Minister Mario Monti is implementing a package of pension reforms, spending cuts and tax increases designed to eliminate the country's budget deficit by 2013. In Spain, the recently elected conservative government is liberalizing labor laws and has vowed to halve its public budget deficit in 2012. Ireland has made great strides to force through reforms aimed at enhancing competitiveness and has been rewarded by the bond markets.

Elsewhere, the political environment looks less rosy. In France, the Socialist opposition leader François Hollande, who stands a good chance of winning the summer elections, is campaigning to increase subsidies, enhance employee rights and rein in the banking sector. His election could be a setback for greater European integration. Also, it's possible that disenchanting voters in Greece, Italy, Portugal and Ireland could elect populist governments who would rail against enforced austerity and threaten default once again.

Economic data rebounding strongly

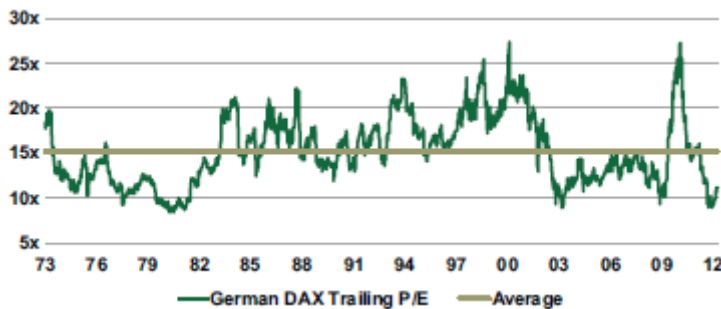
It is early days, but some data points are encouraging, such as the surprise March ZEW German economic sentiment index, which reached the highest level since June 2010; over the past three months the index has



seen its steepest gains ever since it was established in 1992.* Also, the Eurozone PMI, while still at a lower level, has rebounded more sharply than its global counterpart, highlighting the beta of the European economy to global recovery.

Since December, Germany's DAX index has outperformed the S&P 500, FTSE 100 and Euro STOXX50 by a wide margin. Despite the rally, though, German equities still trade at very attractive long term valuations. Despite talking tough in recent months over the Greek restructuring and the LTRO, Germany will benefit from inflation and a weaker euro.

Despite rally, German stocks still cheap



Source: DataStream (March 12, 2012). For illustration purposes only.

In coming years, we believe inflation, the outlook for real bond yields and how this will influence European and global equities will become a core investment theme for equity investors. With real yields already negative, the long term outlook for sovereign bond returns seems poor. In the medium term, therefore, we believe inflation will be positive for real assets such as equities and in particular for economies such as Europe and Japan that will be beneficiaries of inflationary expansion. In terms of stocks, inflation will be good for those with real pricing power, and also financials, which will see rising asset yields, and bad for those companies in commoditized industries without real pricing power.

*Source: Barclays Capital (March 16, 2012).

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