Manulife Mutual Funds

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GLOBAL ECONOMIC OUTLOOK

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Bill Cheney

Chief Economist

Manulife Asset Management (U.S.), LLC

Forward momentum, with plenty of risk

With Europe flirting with recession and China slowing, the U.S. has emerged as the source of global economic recovery, backed by a Japan recovering strongly from last year's disasters.

The U.S. economy has mostly exceeded expectations in recent months, while growth in Europe has been weaker and China seems to be slowing slightly. The U.S. still has the largest economy in the world, so its resilience suggests that the global economy will keep growing. However, there are warning flags elsewhere. The European Central Bank (ECB) has averted a feared banking system meltdown, and a substantial chunk of its money has probably flowed into Italian and Spanish government bonds, lowering the risk of a crisis as these countries roll over maturing debt. As long as banks remain wary about lending, though, economic growth in the region remains elusive. We expect China to maintain rapid growth, even if a little slower than in recent years. The government has the motivation, information and resources to avoid any serious downturn.

China to remain main global growth driver

	2011(e)	2012(f)	2013(f)	2014(f)
Gross Domestic Product (annual % change)				
World	3.0	3.0	3.9	4.2
United States	1.7	2.6	3.1	3.5
Canada	2.5	2.6	3.1	3.0
Eurozone	1.5	-0.3	1.1	1.8
Japan	-0.7	1.6	2.1	2.3
China	9.2	8.2	8.1	8.0
Inflation Rates (annual % change)				
United States	3.1	2.2	2.0	1.9
Canada	2.9	2.3	2.1	2.0
Eurozone	2.6	2.2	1.9	1.9
Japan	-0.3	-0.3	0.2	0.2
China	5.4	3.5	3.3	3.2

Source: Manulife Asset Management (March 16, 2012). For illustration purposes only.

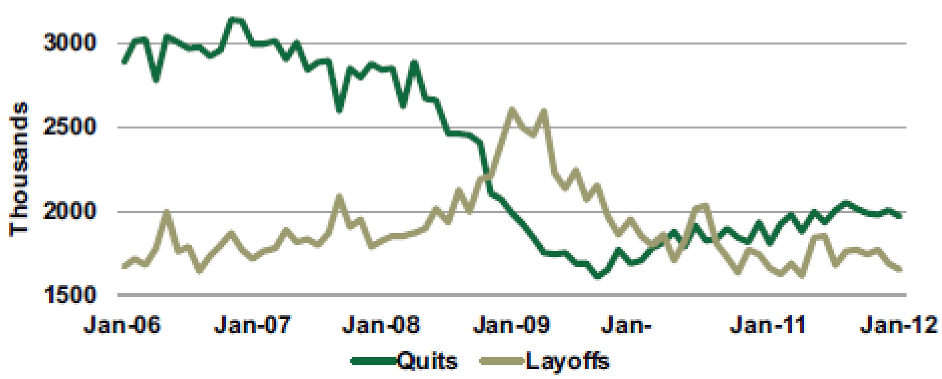
The greatest risk to global growth is probably the price of oil, with attention focused on the potential for conflict over Iran's nuclear ambitions. So far the impact on the U.S. has been mitigated by a mild winter and cheap natural gas. If nothing interrupts supplies, the global expansion will probably roll on little worse for wear. But a confrontation that actually reduces oil shipments would spike up prices to levels where U.S. and global recessions would be real risks.

Given our positive global outlook, we anticipate that corporate earnings, equities, bond rates and commodity prices will all on balance trend up.

U.S. job gains reflect sustainable expansion

U.S. job growth is driving consumer spending and feeding on itself. Consumers feel more secure, lenders see them as more creditworthy, demand for housing rises and government tax revenues increase. Overall economic growth is much more likely to accelerate than to stall out. The key threats are energy prices and politics. Current oil prices do not appear high enough to stop the economy's momentum, and the odds of a catastrophic spike are beyond our expertise. On the political front, however, a huge fiscal tightening is scheduled for 2013 unless the government acts on many contentious issues before year end. Our forecast of 3.1 per cent U.S. growth in 2013 depends on at least one more episode of kicking the fiscal reckoning can another year forward.

U.S. job market normalizing as quits outnumber layoffs



Source: U.S. Bureau of Labor Statistics (March 13, 2012). For illustration purposes only.

Canada is adapting to government cutbacks at the same time as its exports depend on shaky economies abroad. We expect Canada's economy to grow, but at a snail's pace. Increased household debt remains a concern, even if Canada has not approached the sea of unaffordable mortgages that plagued the U.S. Housing prices appear inflated when compared to household incomes, and we expect roughly a 10 per cent drop in prices over the next several years. Canadian households and banks should be able to weather this, but in the short run lower household wealth will weigh on consumption.

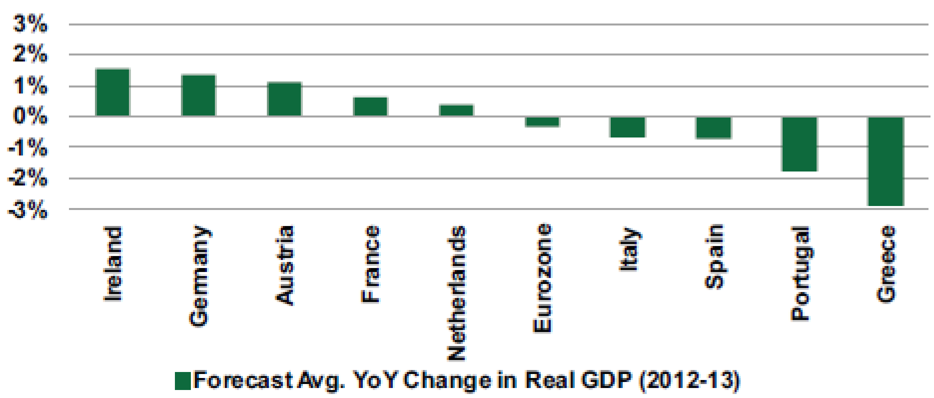
Europe: stabilizing, but downside risks remain

Greece's successful March debt swap and the ECB's provision of virtually unlimited liquidity to European banks have effectively stabilized government bond markets and unclogged interbank lending. However, austerity is bad for growth, especially after a crisis. The Eurozone is probably already in recession, and we expect it to be struggling for another year before a real recovery gets under way. Germany now faces a test of leadership on whether it's prepared to stimulate its economy. The alternative of condemning the weaker economies of the region to long and painful recessions may raise the ultimate cost of keeping the Eurozone in one piece. For now, current conditions are improving despite mixed signals:

- German business sentiment and job growth are holding up, and industrial output has proved resilient
- Inflation eased in the past year, but higher oil prices and a vulnerable banking system could increase the recession's severity
- Short term deposit rates (Euribor) have dropped sharply since December, and are now below the 1per cent refinance rate. Germany's 10-year Bund tumbled back below 1.80 per cent, while Italian and Spanish 10-yr yields are below 5 per cent. Irish and Portuguese spreads have also fallen, although the latter remains high

The United Kingdom is expected to just barely avoid an outright contraction in 2012, with unemployment seen rising to 9 per cent by the second half of 2012. Like most of Europe, though, the UK will rebound above 1.5 per cent Gross Domestic Product (GDP) growth in 2013. We expect monetary policy to stay virtually unchanged over the forecast period.

In Europe, Germany's doing the heavy lifting



Source: Manulife Asset Management (March 15, 2012). For illustration purposes only.

China: A firm foundation matters

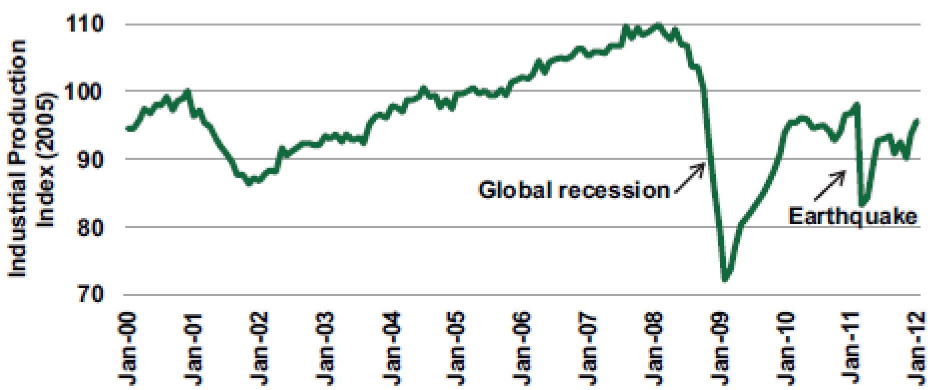
After a slowdown resulting from weaker exports to Europe and from the government's efforts to curtail the housing bubble, policy is already shifting back towards boosting credit. We expect growth to slow only to

8.2 per cent in 2012. Policy continues to emphasize a shift toward services – which should help insulate China from fluctuations in global demand. A mistake is possible, but it seems most likely that either they will successfully engineer a soft landing, or they will turn on a dime and spur a rebound before outsiders can be sure that they are in trouble.

Estimates of bad loans range from an official $500 billion to up to $2.5 trillion, or 30 per cent of total loans, by Fitch Ratings. Since roughly two thirds of bank loans go toward government backed projects, though, many of the losses can in effect be written off as government spending.

Japanese industry has done well in recovering from the tsunami, returning production to pre-disaster levels. We assume that massive public spending is inevitable to replace damaged public infrastructure, to be financed in the early stages at least by central bank quantitative easing. The Bank of Japan's monetary expansion will also serve to restrain any appreciation of the yen. We forecast two years of relatively strong growth, but with a shrinking population and workforce, we expect growth to revert to a long-term trend below 1 per cent.

Japanese industry recovering, but still well below highs



Source: Ministry of Economy, Trade and Industry (February 28, 2012). For illustration purposes only.

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