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Tough slog expected in 2012

Government bonds that rose strongly in 2011 as economic and risk conditions deteriorated now face an unfriendly blend of improving economies and risk. Credit should outperform.

BarCap US Aggregate Bond Index	As of March 31, 2012	
	3 Months	12 Months
USD Return	0.3%	7.7%
CAD Return	-1.4%	10.9%
DEX Universe Bond Index		
USD Return	1.6%	6.6%
CAD Return	-0.2%	9.7%

Source: Bloomberg. For illustration purposes only.

After enjoying some very handsome gains in 2011, North American bond investors should be looking for much more muted – or slightly negative – returns in 2012. The global economic landscape has changed, with green shoots slowly emerging in most major economies. Finality in the recently negotiated Greece debt deal should alleviate at least some concerns about the near-term prospects for the Eurozone. In Canada, despite recent weakness in labor markets, a combination of low interest rates, rising home prices, an improved trade surplus and strengthening manufacturing suggest at least a modest uptick in growth. The jobless situation in the U.S. has improved and recent signs of some stronger manufacturing and retail activity bode well for the outlook.

This is not to say that a sharp rebound in North American activity is a certainty. There are plenty of possible storm clouds on the horizon and a few squalls are likely along the way. That means central banks on both



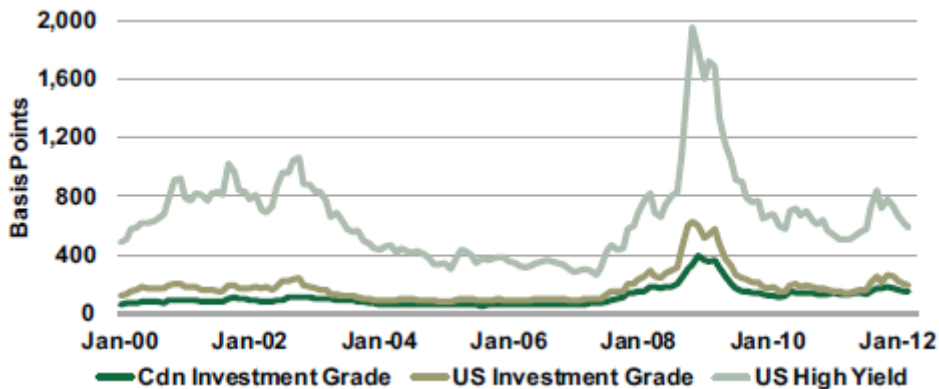
sides of the border will be in a holding pattern for a good time yet. The Bank of Canada is not expected to raise interest rates until the first half of 2013 as policy makers rely on ultra-low borrowing costs to bolster consumer spending and residential construction activity.

The U.S. Federal Reserve has stated that administered interest rates will stay at current lows into 2014. With policy changes being highly data driven, further evidence that growth is accelerating at an even more rapid pace than earlier thought could prompt the Fed to move sooner than previously planned, although a change in policy is highly unlikely until after November's U.S. presidential elections have passed.

Corporate bonds should outperform

We believe corporate credit is still the place to be. Signs of an improving economic landscape, strong balance sheets and increased investor appetite for risk have driven corporate credit spreads significantly lower. In just the first three months of the year, overall Canadian credit spreads have narrowed by nearly 30 basis points (bps). Spreads for U.S. issuers have also moved sharply lower, especially for high yield issues which have enjoyed an overall credit spread contraction of 130 bps so far this year. With spreads still well above historic norms, there remains considerable value across the credit spectrum for North American corporate bond investors to capture in the months ahead.

Corporate spreads still above long-term norms



Source: Bloomberg, Manulife Asset Management (March 22, 2012). For illustration purposes only.

Even if the current economic recovery were to slow, bond yields are expected to rise this year. Bond markets ended 2011 at unsupportive levels, with Government of Canada 10-year yields at a slim 1.94 per cent. Capital markets have been looking for the signs of stability in Europe and stronger U.S. growth that would permit a switch from “safe” government fixed income products into riskier assets such as stocks. Risk appetite has increased and, barring renewed financial upheaval in Europe or a military conflict in the Middle East, this trend will continue for the balance of the year. While there will be some ups and downs, with bonds still the safe-haven play depending on the headlines of the day, the trend is expected to be a gradual and sustained shift into equity and corporate securities.



Higher bond yields are expected if the economy improves later and investors look for higher returns elsewhere. Core inflation is still well contained and barring a big jump in energy costs, price increases should not be a big concern going forward. At the beginning of the year, the Canadian bond desk was looking for 10-year Government of Canada and U.S. Treasury yields to add about 75 bps for all of 2012. In the first quarter, yields on 10-year Canadas added 17 bps and similar Treasury issues have gained 33 bps, both well on their way to our earlier projection.

The team is overweight corporate bonds across the credit spectrum. At the same time, with bond yields expected to rise for the balance of 2012, a shorter duration stance vis-à-vis the market is warranted. Short-term yields are now well anchored at current levels given the outlook for both the Bank of Canada and the Fed. However, once investors start to believe that a change in policy is in the cards, shorter-term yields will rise precipitously.

Provincial credit – especially in Ontario and Quebec – is still a concern given the poor fiscal state of Canada's two largest provinces, and issuance is likely to remain firm. Increased debt levels have put upward pressure on provincial bond yields and spreads are expected to remain elevated relative to historic norms going forward. The Canadian fixed income team believes the ability to ride out near term volatility in exchange for longer term gains will be the overriding factor for providing clients superior returns in the year ahead.

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