

Car!

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Tensions between North and South Korea, an Irish bailout, Chinese authorities raising the reserve requirements of the banks - its a cornucopia of global issues. I am reminded of when I was a kid playing street hockey. Every once in a while someone would yell "car" and we'd have to put the game on hold and wait for it to pass. While we were waiting it gave us a chance to catch our breath, grab some water and reflect. The past couple of weeks and the issues therein have given pause to the rally that started at the beginning of September. If anything, the recent events reinforce the fact that its not all smooth sailing from here on out.

Irish troubles came to a head last week as the country could no longer deny the reality of a bailout by the International Monetary Fund and European Union. Estimates for the bailout range near €85-90 billion. Austerity measures announced by the country this week amount to 9.5% of GDP spread out over the next four years. The issues in Ireland have been well known since the Greek crisis and market expectations of a bailout have increased over the past few months. Interest rate spreads between Irish bonds and German bunds started their ascent in April and peaked on November 11 at 647 basis points. Interestingly though, the equity markets shrugged it off as a mere annoyance and yesterday roared ahead. Markets were helped by better than expected news on the US first-time jobless claims which came in at 407,000, the lowest level in two years and a bright spot on the US job market.

According to the bond markets, the European debt crisis doesn't end with Ireland. Rising yields on Portuguese debt (6.79% on its 10 year bond), indicate that country may be next in line for a bailout. Given its similarly sized economy to Ireland and

contribution, or lack thereof, at 1.3% of eurozone GDP, it is unlikely that a Portuguese bailout would ruffle the market's feathers anymore than Ireland has. Should Spain, at 9% of eurozone GDP, or Italy at 13% of eurozone GDP require a bailout, consequences and market reaction would likely be more severe. At the moment, there is a lower probability for Spain and Italy than Portugal with spreads at 233 bps, 163 bps and 409 bps respectively as at time of writing (November 23rd).

Judging by the reaction, there appears to be a dislocation between bond and equity markets at the moment. The bond markets are yelling "car", while the equity markets are yelling "game on". Bond investors remain focused on the trouble in Europe, weaker developed market growth and emphasis on the "risk-off" trade. Equity investors are embracing risk and driving stocks higher. It is unusual to see this type of dislocation and at this juncture it is unclear as to which side of the debate is right. Macro-economic data in the U.S. is improving starting with this week's third quarter GDP revision to 2.5% up from 2.0%, and this morning's first-time jobless claims report but perhaps not enough to outweigh the troubles of Europe and concerns over tightening efforts in China.

At this week's Tactical Asset Allocation Committee meeting the tone was one of caution. Equities may be vulnerable to a short-term correction and bonds require a deft hand to balance between credit and interest rate risk. Don Rich, Senior Managing Director and Senior Portfolio Manager for the Manulife Leaders portfolios comments, "the market participants are sending a mixed message, one that we rarely see whereby the bond markets are at discord with the equity markets. Given the lack of clarity, we prefer to be defensively positioned over the near-term. In our balanced portfolio we are 45% equities (an underweight position) with an emphasis to U.S. and Canadian large cap companies, and 45% in bonds (a slight overweight position) with 10% cash. I am most comfortable with caution as we await greater clarity."

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