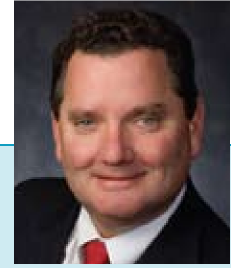
Market Commentary

John Hancock Asset Management



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GLOBAL EQUITY OUTLOOK

Global equities have the ability to move significantly higher this year and the key catalyst will be Europe's big step back from the brink of the catastrophe it confronted in 2011. This development, supported by steady, if slow, improvement in the U.S. and global economies, will entice investors back into global equities to take advantage of compelling valuations. Active management will again prove its worth as high correlations and the "risk-off/risk-on" trade subside as drivers of performance.

The improvement in Europe is multifaceted. A year ago, there were widespread expectations that Greece would default on its debt, possibly followed by systemically much more important players, like Italy. Equally disconcerting, there was little clarity on what financial institution exposures were, evoking memories of the pervasive subprime mortgage rot that brought the global financial system to its knees in 2008. Furthermore, regulators and political leaders seemed paralyzed by the situation.

Today, the word "default" is off the front pages, there is transparency as to what bank exposures to sovereign debt are (and how those banks will recapitalize) and governments and central banks have taken key steps to protect the financial system. To be sure, many problems remain. Harsh austerity programs being demanded by the region's creditors are helping push the eurozone toward recession. Longer-term solutions to what are essentially structural defects in the eurozone will take years. The region's leadership appears to be moving forward on potential solutions, though, having recognized that the problems did not simply originate with a few derelict national governments. At the national level, there are new governments in all the PIIGS, the countries that were at the center of Europe's debt crisis — Portugal, Italy, Ireland, Greece and Spain.

Eurozone "Worst Case" Off the Table

European equity valuations continue to discount much more serious market dislocations than we think are likely given the above steps being taken to support capital markets. That being the case, European equities could surprise on the upside (even as the region's economy enters a probable recession) as markets price in the lowered risk.

Headline risk remains — it always does. But we believe Europe has turned the corner and will be considerably less prominent as a trigger for global risk aversion in 2012. This will allow more positive factors, such an improvement in the U.S. economy, to come to the fore. The key U.S. weak points — employment and the housing market — aren't expected to rebound sharply, but a base for recovery appears to be well established.

Much has been made in the current era of low interest rates about the global search for income, but the fact is that we expect investors will need income growth to help them overcome their skittishness about volatility in equity markets and recommit to the asset class. Using the S&P 500 Index as an example, equity cash flows, dividend yields and dividend growth rates are all near historic highs.

PERFORMANCE AT A GLANCE AS OF 12/31/11[1]	Quarter	1-year
S&P 500 Index	11.82%	2.11%
Dow Jones Industrial Average	12.78%	8.38%
NASDAQ Composite Index	7.86%	–1.80%
Russell 2000 Index	15.47%	–4.18%
MSCI EAFE Index	3.38%	–11.73%
MSCI World Index	7.72%	–5.02%
Barclays Capital U.S. Aggregate Bond Index	1.12%	7.84%
Barclays Capital High Yield Index	4.33%	13.02%

Gains Seen on Multiple Expansion

With profit margins near all-time highs, the biggest potential source of equity outperformance is expansion of valuation multiples, which should rise to levels more consistent with current low interest rates as the equity risk premium falls. Nor do we expect this to be offset in any way by any drop in profitability. Margins may come under some pressure from the slowdown in Europe, but will be supported by continuing global wage arbitrage via China and the rest of emerging Asia.

It would require nothing more than a return to normalized valuations and volatility for equities to perform well this year. We expect the improvement in the macro risk backdrop to be the catalyst for a combination of reduced volatility, improved sentiment and higher overall volume that should allow global equities to outperform as an asset class this year. Broadening market participation will set off a virtuous cycle, as rising volumes reduce the excessive impact in recent quarters by sector- and market-level trading in exchange-traded funds. As the risk-off trade that has recently dominated global markets subsides, correlations among countries, sectors and stocks that reached historic highs in 2011 will also fall, increasing the scope for active managers to add value.

GLOBAL FIXED-INCOME OUTLOOK

Much like 2011, in 2012 the primary focus for global fixed income investors will remain on Europe. The risk of protracted policy negotiations and any difficulties surrounding implementation of plans will again be a large driver of market sentiment and volatility this year. We believe, however, that the steps taken in 2011 show that European policy makers are on a path to a solution of the problems within the region. There have been two main concerns in this crisis: liquidity and capital levels within the banking sector and the sustainability of sovereign debt. Steps taken at the end of last year should allay liquidity concerns in the banks for the near future. Through its long-term refinancing operation, the European Central Bank (ECB) is now offering loans with maturities of up to three years to banks throughout the eurozone and has also eased restrictions on collateral requirements. Regarding the sovereign debt concerns, and in turn

the future of the euro itself, we believe it unlikely that the eurozone will dissolve, given how much the member states have at stake. And while it is possible that we may see individual nations eventually leave, we expect Germany and France to coordinate a process of policy makers taking the steps needed to address the debt issues and move toward a fiscal union. They must move quickly though, as yields on peripheral sovereign debt remain stressed and more than 150 billion euros worth of maturities are expected in the first quarter of 2012.

Even once sovereign concerns are addressed, it appears that Europe is headed for at least a mild recession in the coming year. As such, it is expected that the ECB will cut rates further, with the market currently pricing in greater than 50 basis points in cuts over the next 12 months. In this already low-rate environment, it is possible that the ECB will also engage in quantitative easing as another means of addressing an economic slowdown. Taken in tandem with the positive effects from the liquidity provided to the banks, this could provide support for the sovereign bonds. While the time for investing in the region is not yet here, it is possible that attractive opportunities will arise in the coming year.

Accomodative Global Monetary Backdrop

The situation in Europe has influenced central bank decisions around the globe, with the Norges Bank in Norway, the Riksbank in Sweden and the Reserve Bank of Australia all recently cutting interest rates. The Bank of Canada and the Reserve Bank of New Zealand left rates unchanged, but have made note of the potential economic risks from the continuing developments within Europe. We continue to like the bonds of these nations, particularly when considering their relative fiscal strength versus some of their developed-nation peers. And while we generally think the currencies will strengthen, we will manage exposures here tactically.

Our preferred region globally is Asia, excluding Japan. This area should continue to see economic growth rates above global averages, particularly as countries transition from being export-driven to being driven by domestic consumption. While we do expect a slowdown in growth in China, we do not believe that it will be a so-called hard landing, instead slowly transitioning from previous elevated levels towards something more sustainable over the longer term. On the fiscal front, nations in this region are strong. We anticipate that the improving credit metrics of both Indonesia and the Philippines will continue in the coming year, and that they will complete the transition to being investment grade nations. We also anticipate that the currencies of the nations in this region will continue to strengthen, and would generally not hedge positions held here.

U.S. High Yield Very Attractive

Despite global uncertainty, we expect the U.S. economy to continue to grow in the coming months. We wouldn't be surprised to see somewhere in the range of 2–3% growth for the year, with any possible surprise more likely to occur to the upside. Recent economic data has been positive, including a consumer confidence number at the end of 2011 that exceeded expectations. And while unemployment continues to be high, the steady downward trend in initial

jobless claims has continued, reaching levels in December that hadn't been seen in over three years. As a result of our positive expectations for the U.S., we find corporate bonds, particularly high yield, to be another favored asset class. Corporations spent much of the past two years taking advantage of the low interest rate environment to get balance sheets in order, refinance debts and extend maturities. Default rates have been low, at less than 2%, and we anticipate that they will remain so. In an environment of a growing economy and against the backdrop of favorable fiscal positioning, high yield corporate bonds at the current yield levels in excess of 8% are very attractive.

The performance data contained within this material represents past performance, which does not guarantee future results. Performance, especially for short time periods, should not be the sole factor in making your investment decision.

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1 Source: Lipper, Inc. All performance figures are as of 12/31/11. The S&P 500 Index is an unmanaged index commonly used to measure stock market performance. The Dow Jones Industrial Average represents share prices of selected blue chip industrial corporations, as well as public utility and transportation companies. The NASDAQ Composite Index is a market-capitalization price-only index that tracks performance of domestic common stocks traded on the regular NASDAQ market. The Russell 2000 Index is an unmanaged index of small-cap stocks. The MSCI EAFE Index measures performance of a diverse range of developed-country global stock markets. The MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The Barclays Capital U.S. Aggregate Bond Index tracks the daily price coupon, pay downs and total return performance of fixed-rate, publicly placed, dollar-denominated and nonconvertible, investment-grade debt issues. The Barclays Capital High Yield Index is composed of U.S. currency corporate high-yield bonds issued by U.S. and non-U.S. issuers. Performance figures assume reinvestment of dividends and capital gains. This chart does not illustrate the performance of any John Hancock fund. It is not possible to invest directly in an index. Past performance is not a guarantee of future results.

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