Economic Update

August 24, 2011

TD Economics
www.td.com/economics

Craig Alexander
SVP & Chief Economist
416-982-8064
craig.alexander@td.com

Derek Burleton
VP & Deputy Chief Economist
416-982-2514
derek.burleton@td.com

Beata Caranci
AVP & Deputy Chief Economist
416-982-8067
beata.caranci@td.com

Martin Schwerdtfeger
Senior Economist
416-982-2559
martin.schwerdtfeger@td.com

James Marple
Senior Economist
416-982-2557
james.marple@td.com

Diana Petramala,
Economist (Canada)
416-982-6420
diana.petramala@td.com

WORLD OUTLOOK

- The global economic outlook has deteriorated in recent months and the risks to the recovery have intensified. Worsening U.S. and European growth prospects are the primary issue, not only because of their direct impact on global GDP, but also because of the implications for other advanced and emerging economies. The global growth forecast has been revised down to 3.4% for 2011 and 3.2% for 2012 (compared to 3.6% and 3.7%, respectively, in June), but this assumes that fiscal progress is made in both Europe and the United States.

- In the euro zone, preliminary estimates show real GDP stalled in the second quarter. During the second half of the year, economic conditions are expected to deteriorate further, as a number of headwinds exert greater resistance on growth. The recent escalation of the European sovereign debt crisis will likely curtail consumer and business confidence, with material repercussions for aggregate demand. In all, this means the euro zone is likely to experience a modest contraction on a quarterly basis during the third and fourth quarters – i.e., a technical recession – but still post growth of around 1.6% y/y for 2011 as a whole. Furthermore, softer global demand for euro zone exports and fiscal tightening efforts will restrain the fragile euro area economy in the coming months. The negative forces will persist in 2012, leading to meagre euro zone growth of 1.2% next year.

- In Japan, real GDP declined during the second quarter due to the natural disaster, but the overall economic contraction was smaller than first anticipated. Early reconstruction efforts helped to temper the decline. During the second half of this year, economic growth should turn positive, as continued strength in fixed investments will be joined by improvements in exports and private consumption. A risk for Japanese net-exports stems from the sustained strength of the Japanese yen. However, we should be mindful that a stronger currency also reduces costs for the domestic economy through lower import prices, which provides some offset to the lost competitiveness on exports.

- A key question mark for the global growth outlook is China's economic reaction to the foreseen slowdown in the U.S. and European economies. Similar to most of its advanced Western counterparts, the Chinese government has lost some maneuvering room relative to the policy actions it implemented in the aftermath of the 2008 financial crisis. Stubbornly high inflation and the need to control ballooning credit means that the government will be more cautious in propping up domestic demand. Accordingly, the pace of the Chinese economic expansion will likely moderate to around 8.2% next year.

- Slower growth across the largest world economies will undoubtedly impact other emerging markets, as it will constrain commodity prices and reduce export growth. Nonetheless, the former might not be an entirely bad thing. Over the first half of 2011, many developing economies were trying to engineer an economic slowdown to stave-off high inflation. They concentrated their

efforts on the monetary front, which is natural given that they reacted to the 2008 financial crisis by providing liquidity and stimulating credit growth. However, their fiscal policies have also been lax, and emerging market governments have been slower than their central banks to react to rising inflation. Both Brazil and China are prime examples of this situation. If they are serious about reining in inflation, they will have to revert to more prudent fiscal policies. In this regard, a moderate decline in commodity prices will act as a partial offset to weaker economic growth, as it will ease inflationary pressures across developing economies, allowing for a delay of monetary tightening.

- The main global risk remains the European sovereign debt crisis. The ideal economic solution to this crisis would be significantly higher economic growth. That is not in the cards even if the structural reforms introduced in most countries are swiftly implemented. Therefore, in the near term, the solution must be a political one. Unfortunately, the record on that front so far has been poor, and political tensions among European leaders are growing. The lack of progress has led to increased liquidity pressures on many European banks. In the aftermath of the U.S. credit rating downgrade by S&P, the European Central Bank had to buy Italian and Spanish sovereign debt to avert a dangerous escalation in yields. It also expanded its emergency liquidity lines to prevent funding squeezes across European banks. These actions have exacerbated the divisions within the ECB governing council. Some of its most orthodox members see these actions as proxies for fiscal deficit monetization. As unpleasant as this could be, the ECB remains the only effective backstop against a full-blown European financial crisis. The bottom line is that a European financial crisis is a clear and present danger to the economic outlook.

U.S. OUTLOOK

U.S. recovery treads water in the first half of 2011

- The U.S. economy stalled in the first half of 2011, with just 0.8% annualized growth. The first quarter was particularly weak after revisions shaved real GDP growth to just 0.4% annualized (from an initial estimate of 1.9%). Growth improved somewhat in the second quarter to 1.3%, due to a greater contribution from business investment. The weak pace of economic growth in the first six months of 2011 did not even keep pace with population growth. The unemployment rate, which in January stood at 9.0%, finished the second quarter in June at 9.2%.

U.S. ECONOMIC INDICATORS

Annual Percent Change Unless Otherwise Indicated

	2000-07	Annual Average Percent Change				
		2010	2011F	2012F	2013F	2014F
Nominal GDP	5.0	4.2	3.7	3.3	4.8	4.9
Real GDP	2.4	3.0	1.5	1.6	2.6	2.8
Personal Consumption Expenditures	2.9	2.0	1.9	1.5	2.4	2.7
Business Investment	2.4	4.4	6.5	2.5	7.6	9.2
Machinery and Equipment	3.2	14.6	8.9	3.2	9.0	10.1
Residential Construction	0.1	-4.3	-2.4	1.3	4.9	13.2
Government Expenditures	2.2	0.7	-2.0	-1.0	-1.5	-1.5
Exports	3.9	11.3	7.4	6.0	7.3	7.3
Imports	4.3	12.5	5.0	2.8	4.9	6.2
Consumer Price Index(y/y%)	2.7	1.7	3.1	2.1	2.1	2.3
Unemployment Rate (%)	5.2	9.6	9.1	9.1	8.8	8.3
3-Month T-Bill*	2.87	0.12	0.07	0.10	1.10	2.45
10-Year Gov't Bond*	4.52	3.30	2.40	2.75	3.25	4.00

Source: BEA, BLS, FRB; Economic & volumes forecast by TD Economics as at August 2011, financial forecast by TD Economics as at August 2011 -- all forecasts to be revised in September following release of quarterly national accounts; *end of period levels

- While the first half of the year turned in a disappointing economic performance, part of the blame went to temporary factors such as extreme weather, a sharp rise in gas prices, and supply chain disruptions from the Japanese disaster. The dissipation of these factors will alleviate some downward pressure on the economy in the second half of the year. Now, however, there is heightened risk that financial market turmoil and economic uncertainty will bleed into real economic activity.

- With the U.S. economy treading water, the risk of a recession amidst the recent financial market turmoil is high. We put the odds at 40%. The collective American psyche is already fragile, with nearly 14 million people looking for work and one-in-four homeowners having been delinquent at some point on their mortgage. Businesses are also struggling to get a handle on major policy initiatives from Washington, from health care to financial regulatory reform. The U.S. has a razor thin economic cushion to absorb any further deterioration in consumer and business confidence.

- The outlook for economic growth has been materially scaled back in the coming quarters, due to the recent financial market turmoil, the deterioration in personal

wealth and confidence, earlier-than-expected fiscal consolidation, and the loss of economic momentum experienced in the first half of the year.

- U.S. real GDP growth is expected to average 1.0% over the remainder of 2011. Growth is expected to improve slightly to 1.6% in 2012 and further to 2.6% in 2013.

Crisis of confidence has roiled financial markets

- There has been no shortage of events to unnerve global investor confidence. The lists includes weaker economic growth momentum from Europe and the U.S., a protracted debate over the U.S. statutory debt ceiling, a U.S. credit rating downgrade, and an inability of European policy makers to stay ahead of their sovereign debt crisis.
- In addition to the sell-off in equity markets, corporate bond spreads have widened. For riskier credit products such as high yield corporate debt, yields have risen in absolute terms, even as government bond yields have fallen to near-crisis lows.
- In the face of financial market turmoil, the real economy managed to show a sliver of improved momentum in July. Retail sales and industrial production both turned in commendable results. In addition, the most recent Senior Loan Officer Survey taken in July revealed an easing in consumer and business credit standards.
- However, we are now in a wait-and-see mode as to the degree to which the stresses in financial markets of the past few weeks will undermine the improvements in credit availability in the real economy.

Structural forces holding back economic growth

- While U.S. economic performance has been underwhelming, it is unrealistic to exit the worst financial crisis and global recession in post-war history and experience smooth sailing. The crisis of confidence in recent weeks is an added complication to several structural problems that are already constraining the U.S. recovery. Perhaps the most important of this is the interplay between the large supply of foreclosure and seriously delinquent loans on bank balance sheets, coupled with inadequate private demand as households deleverage.
- Residential mortgage credit is the one area that has failed to improve. As of the beginning of August, residential mortgage credit on the balance sheets of commercial banks was down 2.4% from a year ago. While mortgage rates are flirting with all time lows, increased economic uncertainty is likely to slow improvement in this sector.
- A second structural problem is the depressed labour market. The median duration of unemployment has stabilized in the past year at 21 weeks, but the average duration has climbed to 40 weeks. This deviation is the greatest it has ever been and highlights the increasing number of people who are long-term unemployed – likely a reflection of skills mismatch, skills atrophy, and/or an inability to seek out employment in other districts due to housing lock. Meanwhile, employment participation rates in the U.S. sit at the lowest level since 1982.
- A final structural problem resides with US public debt levels. The unwinding of fiscal stimulus and state and local cutbacks have shaved an average of 0.7 percentage points off economic growth over the last three quarters. In the past three months, the public sector has cut 35-45K jobs per month from the payrolls tally. This trend has intensified from an average of -25K in the months prior. Fiscal drag is a key theme to the economic outlook, expected to subtract around one percentage point from overall economic growth in each of the next two years.
- Along this vein, an additional key risk to our forecast is whether the Joint Select Committee succeeds in reaching an agreement by the November 23rd deadline on the additional $1.5 trillion in fiscal consolation that was a condition to lifting the debt ceiling in August. Should they fail, an automatic trigger would shave $1.2 trillion from government coffers in military and discretionary spending over the next nine years. Unfortunately, this would cause a massive swing in government cuts from $22 billion in 2012 to $157 billion in 2013. Macroeconomics Advisers estimates that the direct economic impact of the size and frontloaded nature of this dramatic swing would shave 0.7 percentage points from GDP in that year, but this is only a partial impact, since indirect effects would need to be considered. In all probability, with the U.S. economy already dangerously close to recession territory, this would be the final blow.
- In contrast, if an agreement is reached and cuts are dispersed more evenly over the next decade, the economic drag would be more contained to roughly 0.25 percentage points in any particular year.

Interest rates – lower for longer

- Given the economic risks and structural problems, the Federal Reserve made a conditional commitment to leave the fed funds rate on hold until mid-2013. It will take years before the output gap closes and expectations of future inflation – whether measured through financial markets (TIPS spreads) or through consumer surveys – remain well anchored. With unemployment at 9.1% and few signs that economic growth will accelerate dramatically over the forecast horizon, the Federal Reserve is justified in leaving interest rates at their effective lower bound for a prolonged period. However, it is clear that the bar for QE3 is very high, given the limited impact of prior quantitative easing. The simple truth is that the U.S. economy is in a liquidity trap, where low interest rates are not providing their traditional boost to economic activity. In order to unlock economic growth, progress on the fiscal and foreclosure front is required, but this is outside the scope of monetary policy.

CANADIAN OUTLOOK

Canada's economy stalls in the second quarter

- This outlook is prepared before the Canadian national accounts for Q2 are released on August 31, but reflect our current tracking of the economy.

- After a good start to the year, Canada's economy could not buck the trend of weakness evidenced across the advanced world in the second quarter. The softness during the last three months reflected in large part the impact of falling U.S. demand for Canadian exports. In addition, some temporary factors weighed on export-oriented industries, notably the hit to automotive and other manufacturing supply chains resulting from the Japanese earthquake as well as reduced mining activity due to bad weather and forest fires in Alberta.

- Business investment and residential construction remained two bright spots in the April-June period, with the former soaring by an estimated 30% at annual rates. Households also appeared to hold their own, with real consumer spending growing at an estimated 2.5%. Unfortunately, the strength on the domestic side of the economy only managed to offset the export drag. As such, it is likely that overall real GDP recorded no growth during the second quarter.

CANADIAN ECONOMIC INDICATORS

Annual Percent Change Unless Otherwise Indicated

	2000-07	Annual Average Percent Change				
		2010	2011F	2012F	2013F	2014F
Nominal GDP	5.2	6.3	5.2	3.6	4.5	4.2
Real GDP	2.5	3.2	2.3	2.0	2.5	2.4
Consumer Expenditures	3.5	3.3	2.1	2.2	2.3	2.0
Business Investment	5.1	7.3	14.0	5.2	8.4	6.1
Machinery and Equipment	5.5	11.8	16.8	7.0	10.3	7.3
Residential Construction	6.4	10.2	3.3	1.1	-2.0	1.3
Government Expenditures	3.2	4.7	0.9	-0.5	-0.3	0.3
Exports	0.6	6.4	2.8	2.1	5.5	6.0
Imports	3.7	13.1	5.4	1.5	3.8	4.4
Consumer Price Index (y/y%)	2.2	1.8	2.8	1.8	1.8	2.1
Unemployment Rate (%)	7.0	8.0	7.7	7.5	7.1	6.9
3-Month T-Bill*	3.50	1.04	1.00	2.00	3.00	3.30
10-Year Gov't Bond*	4.80	3.12	2.75	3.40	3.95	4.70

Source: Statistics Canada, Bank of Canada; Economic & volumes forecast by TD Economics as at August 2011, financial forecast by TD Economics as at August 2011 -- all forecasts to be revised in September following release of quarterly national accounts; *end of period levels

- Despite our estimate for a flat real GDP performance in the second quarter, there is a reasonable chance that the result could be negative. If a contraction is realized, worries that Canada's economy has already entered a recession will increase, especially in light of the financial market turmoil that erupted mid-way through the third quarter.

Canadian economy to limp along in H2 2011

- The risk of a "technical" recession (i.e., two consecutive quarters of real GDP contractions) has undoubtedly risen in Canada. If the U.S. economy contracts, the chances that Canada will follow suit are high.

- Much will depend on the future path of financial markets and how confidence holds up in the coming weeks. As we noted in the previous sections, the U.S. economy is expected to only narrowly avoid a technical recession in the coming quarters. What's more, Europe's debt crisis will likely remain unresolved. In that environment, Canadian consumer and business confidence could be significantly constrained.

- While the headwinds emanating from U.S. woes and financial market volatility will remain considerable in the coming months, Canada's economy enjoys several

advantages that will help to keep the economy expanding. First, Canada doesn't suffer from the significant structural imbalances evident in the United States, such as a troubled banking system and massive government indebtedness. Second, Canada is entering this challenging period with decent underlying momentum in private-sector job creation, which will stand households in good stead through this more challenging period. Thirdly, the resource orientation of the economy is likely to provide a leg up, as China's economy continues to grow strongly and commodity prices remain relatively elevated.

- Canada's advantages are only expected to translate into a modest outperformance vis-à-vis the U.S. in the second half of 2011, as households and businesses display heightened caution. Real GDP growth in Canada is likely to average a sub-par 1.5% annualized during the third and fourth quarters, about half the pace we had projected in our previous forecast in June. With job gains slowing to less than 10,000 per month over the remainder of this year – well below the recent trend pace of 25,000 per month – the jobless rate is likely to head up towards 8%.
- For 2011 as a whole, real economic growth is likely to come in at 2.3% – marking a downward revision from our projection of 2.8% in June.

Outlook a little brighter for 2012

- We anticipate a moderate strengthening in the pace of growth as 2012 progresses, mirroring trends in the U.S. economy. Still, given the weak hand-off from this year, annual average growth is expected to fall to 2.0%. In June, we had predicted a 2.5% growth rate next year.
- Recall that a key theme in the June forecast was an expected shift in the drivers of economic growth from fatigued households and governments to the export sector and business investment. Exporters, in particular, were expected to benefit from a recovering U.S. economy and still-buoyant commodity markets. In our revised outlook, this transition is not likely to take hold to any meaningful extent until 2013.
- The downgrade in the U.S. medium-term growth profile, combined with a still-lofty Canadian dollar, will translate into less momentum in exports than anticipated in our June forecast. Businesses are still expected to ramp up capital outlays at a solid clip next year, but lower U.S. demand will likely lead to some investment being postponed or scaled back.
- One spillover effect of the current financial crisis is that interest rates will remain lower for longer. As confidence starts to improve early next year and interest rates remain highly attractive, households are likely to resume a solid pace of spending growth and take on additional debt.
- TD Economics has warned that household debt in Canada has become excessive. The household debt-to-income ratio stood at an estimated 147% in the second quarter, well above the 138-142% we view as "appropriate". Based on the projected trends in spending and income, this ratio would reach 150% by the end of 2012 and climb to 151% in 2013.
- We don't anticipate a further significant leg up in home prices and sales in the coming months ahead, especially given the likelihood of elevated economic uncertainty. Still, with interest rates remaining lower than we had expected in June, the adjustment in sales and prices we had embedded in our latest forecast has been delayed by about six months. Accordingly, the estimated 10-15% overvaluation in Canadian home prices is expected to persist through the first half of next year, and only begin to unwind as interest rates start to climb in the second half and in 2013.
- With the economy gradually gaining traction a bit more traction in 2012, job growth will likely pick up and send the unemployment rate down to 7-7.5% by year-end. In 2013, the jobless rate is likely to edge a little lower as the economy churns out a moderate real GDP gain of 2.6%.

No hike by BoC until mid-2012, at the earliest

- Forecast timetables for a return to more normal interest rates in Canada and globally continue to get pushed back. Up until the bout of financial turmoil in August, TD Economics' projected that the Bank of Canada (BoC) would resume interest rate hikes in January 2012.
- We now believe that the combination of weaker near-term growth prospects, a lower trend rate of inflation and heightened global financial risks will stay the Bank of Canada's hand for longer. Another key consideration is the Federal Reserve decision at its August FOMC meeting to conditionally commit to holding rates steady until

mid-2013. The Bank of Canada has repeatedly noted that there are limits to how much Canadian short-term rates can diverge from those of the United States.

- Our current thinking is that the Bank of Canada will commence a gradual withdrawal of stimulus in the third quarter of 2012, which would contribute to a strengthening in the Canadian dollar towards USD1.05 in advance of the hikes. However, it is conceivable that the Bank will not be comfortable raising rates this quickly, and could join the Fed in waiting until 2013.

Key Risks

- The main risks to the Canadian economy remain largely external. The global economy could turn out to be weaker than projected if policymakers in the U.S. and Europe fail to deal with their fiscal problems. Should sovereign debt concerns escalate and global credit flows are affected, Canada could be severely impacted through trade and financial linkages. One should also not overlook the fact that Canada's domestic demand is currently more vulnerable to another economic shock compared to the period leading up to the last downturn in 2008-09. While the business sector appears better positioned to weather a U.S. downturn, policymakers in Canada have less wiggle room on the fiscal and monetary fronts and households face larger debt burdens.

- Of course, there are upside risks as well. If confidence strengthens, the U.S. recovery surprises on the upside and the European fiscal problems are addressed, Canadian economic growth could be more robust. However, a stronger economic performance could also create its own problems. Low interest rates for longer could boost consumer spending and real estate by more than anticipated, leading to a larger consumer debt problem and further overvaluation in Canadian real estate.

This report is provided by TD Economics for customers of TD Bank Group. It is for information purposes only and may not be appropriate for other purposes. The report does not provide material information about the business and affairs of TD Bank Group and the members of TD Economics are not spokespersons for TD Bank Group with respect to its business and affairs. The information contained in this report has been drawn from sources believed to be reliable, but is not guaranteed to be accurate or complete. The report contains economic analysis and views, including about future economic and financial markets performance. These are based on certain assumptions and other factors, and are subject to inherent risks and uncertainties. The actual outcome may be materially different. The Toronto-Dominion Bank and its affiliates and related entities that comprise TD Bank Group are not liable for any errors or omissions in the information, analysis or views contained in this report, or for any loss or damage suffered.