DOLLARS & SENSE

TD Economics

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AMERICA IN THE LEAD, BUT PEERS ARE CLOSING IN

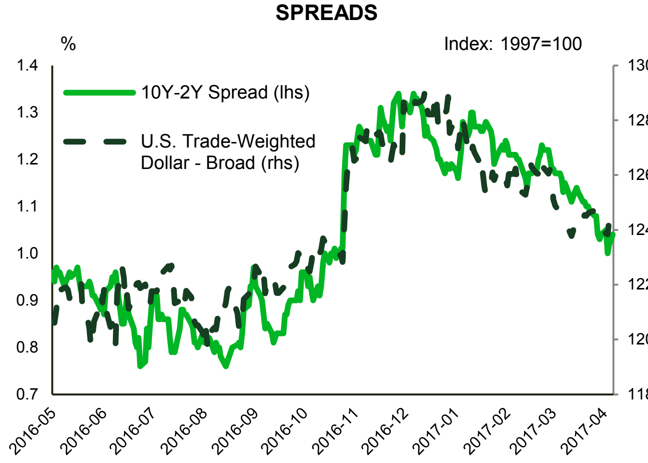
Highlights

- While America's economy is nearing the Fed's objectives of full employment and stable inflation, a recent string of disappointing data releases has bond yields and futures markets discounting its strength.
- Temporarily-sluggish U.S. growth is occurring at a time of resurgent strength among America's peers. Economies in Europe, Canada, and even Japan are poised to eliminate slack earlier than expected, leading their central banks to ease off the monetary accelerator.
- International economies may have closed the gap, but America is primed to re-accelerate. Spurred on by rising real wages, consumer spending will rebound from its doldrums early in the year. With stronger demand both at home and abroad, business investment should also pick up. As it does, Treasury yields will rise again.

Bond yields have fallen in recent weeks, reflecting reduced optimism surrounding American economic growth and inflation. The 10-year U.S. Treasury has given back close to 40 bps from 2017 highs, with the 10-2 year spread currently sitting near the same level as it was prior to the U.S. election (Chart 1). This retracement started with the failure of President Trump to pass health care reform, putting into question the administration's ability to deliver pro-growth tax reform and fiscal policy.

The knock-on to inflation expectations and the term premium has coincided with a soft-patch in real-time economic data. First quarter real GDP is tracking growth well below potential, while consumer price inflation has decelerated. The apparent weakness stateside contrasts with some surprising strength among America's major trading partners. As a result, economic divergence has diminished and the high-flying greenback has had some of the wind taken from it. America may still be leading the pack, but the gap is closing.

CHART 1: THE GREENBACK IS FALLING WITH SPREADS



Source: FRB

Something's Gotta Give

For the last few years, the U.S. economy has shown steady improvement while the majority of advanced economies have sputtered or experienced setbacks. The persistent push toward full employment has prompted the Federal Reserve to stake out a more hawkish tone toward the removal of monetary accommodation. Sentiment indicators have taken that optimism one step further. The Dow is up 17% post-election and both small business and consumer

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confidence measures have hit decade highs. Bond markets in the U.S. had initially mirrored this sentiment, with the 10-year Treasury yield rising over 100 basis points post-election. But, now a new reality has crept in, causing yields to make a U-turn, as they attempt to reconcile hope and economic reality.

There is little doubt that the U.S. economy has eased off the accelerator – at least temporarily. Consumer spending pulled back in the first two months of the year, led by falling auto sales. And, both job growth and consumer price inflation softened in March. However, recent history has shown first quarter growth to be a poor harbinger for the rest of the year. Better data is likely to re-emerge, revealing economic growth slightly above potential, and sufficient to move inflation toward the 2% mark. This should give investors the confidence they need to re-price bond yields towards our 2.80% target by year-end.

Still, bridging the gap between "hard" economic data and "soft" sentiment indicators will be a tall order. Confidence measures are at levels that have historically been associated with economic growth close to 3% growth on a sustained basis. This would equate to 10-year yield closer to the 4% mark, which is simply unrealistic. Something's gotta give, and we think that eventually it will be the sentiment indicators that begin to reflect the economic reality of the hard data.

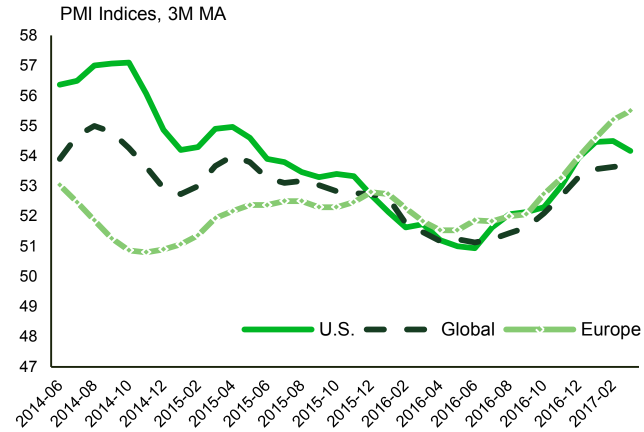
International economies on the rebound

While America is sputtering, its major trading partners are flexing their muscles (Chart 2). The strength of their performance has been broadly represented across economic, sentiment, and inflation indicators. Chinese growth beat expectations early in the year and its drivers have become more diverse across service related industries. Even unofficial indicators of growth, such as freight turnover and electricity usage have been pointing higher of late.

Data out of Europe and the UK have told a similar story. Consumption spending and low currency valuations have stabilized inflation in both economies. The improvement has been such that the European Central Bank and, to a lesser extent, the Bank of England are likely to move away from emergency accommodative monetary policy earlier than previously expected. This will be priced via diminishing yield differentials with the U.S. and, likewise, lift the floor for the euro and pound sterling.

These currencies will be further supported if favorable political results occur in the French and UK elections. Brexit and Frexit have been hanging over sentiment, keeping these currencies lower than would otherwise be the case. The jump in the euro and pound after the results of the first round of Presidential voting in France and after the national election was called in the UK may be a sign of more to come.

CHART 2: AMERICA'S STUMBLE ALLOWS FOR PEERS TO CLOSE GROUND



Source: Bloomberg

In North America, both Canada and Mexico have defied gravity with solid growth over the last nine months. Canada is expected to have grown at an eye-popping 3.4% annualized pace during the first quarter of 2017, marking the third straight quarter that growth has come in above the Bank of Canada's forecast.

While economic slack is diminishing, there is a long road ahead in a landscape riddled with risks. Most recently this was made evident by tariffs placed on Canada's softwood lumber industry and threats of more action against other industries. This, alongside a less-than-favorable composition of growth, will keep the Bank of Canada in a cautious stance this year. In particular, the Bank would take comfort if economic momentum displayed greater breadth across industries. Much of the recent growth-spurt has been due to consumer spending, which in turn is being heavily influenced by a housing boom in key regions. Over time, other sectors will need to carry more of the weight.

Fortunately, some seedlings are becoming visible. Business investment intentions are near all-time highs and a leveling off in commodity prices is already offering a boost in energy investment from very low levels. Furthermore, the impact of the Liberal government's fiscal spending program should become more apparent as we approach the end of the year.

All this means that Canada, like other international economies, is moving in the right direction to ensure core inflation measures move toward central bank targets. Outside of a major trade or housing shock, the Bank of Canada will be looking at a more balanced economy, allowing it to raise policy rates as early as the first half of 2018. While the Canadian dollar is currently depreciating with the threat of trade disputes, an earlier start to the central bank's rate hiking cycle will support the currency as the year moves along.

Who will win the race in 2017?

Readers of this publication are well aware of our longstanding call for American economic outperformance. It has underpinned our forecast for consistent Fed rate hikes and a strong U.S. dollar. But in this, the ninth year of recovery from the Great Recession, international economies are closing the gap. We are pleasantly surprised by the upturn in growth by G10 economies. The reduction in economic slack means that the central banks of Canada, Europe, the UK, and even Japan are poised to tighten monetary policy earlier than previously thought, albeit 2018 is the more likely target date for these central banks to make up ground on the Fed.

By all counts, the headwinds to growth remain greater in these economies. Political, banking, and trade threats will caution central banks that already experienced false starts on market signals since the financial crisis.

Overall, equity markets appear priced for an optimal outcome, but the Treasury market is not. Treasury yields are trading near the bottom end of our fair value range and futures are only pricing one more Fed rate hike for 2017. This may prove too cautious given the labor and output pressures building in the economy. Once the data returns back to trend, markets will start to push expectations for the Fed, inflation, and Treasury yields higher.

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INTEREST RATE & FOREIGN EXCHANGE RATE OUTLOOK

		Spot Rate	2016				2017				2018			
		Apr-26	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Interest Rates														
Fed Funds Target Rate		1.00	0.50	0.50	0.50	0.75	1.00	1.25	1.50	1.50	1.50	1.75	2.00	2.25
3-mth T-Bill Rate		0.80	0.21	0.26	0.29	0.51	0.76	1.15	1.40	1.40	1.40	1.65	1.90	2.15
2-yr Govt. Bond Yield		1.27	0.73	0.58	0.77	1.20	1.27	1.55	1.70	1.95	2.10	2.25	2.40	2.55
5-yr Govt. Bond Yield		1.82	1.21	1.01	1.14	1.93	1.93	2.15	2.35	2.55	2.75	2.95	3.00	3.05
10-yr Govt. Bond Yield		2.30	1.78	1.49	1.60	2.45	2.40	2.40	2.60	2.80	3.00	3.20	3.25	3.30
30-yr Govt. Bond Yield		2.96	2.61	2.30	2.32	3.06	3.02	3.15	3.25	3.35	3.40	3.50	3.60	3.65
10-yr-2-yr Govt Spread		1.03	1.05	0.91	0.83	1.25	1.13	0.85	0.90	0.85	0.90	0.95	0.85	0.75
Exchange rate to U.S. dollar														
Chinese Yuan	CNY per USD	6.89	6.45	6.65	6.67	6.94	6.88	7.04	7.12	7.18	7.20	7.22	7.10	7.00
Japanese yen	JPY per USD	111	112	103	101	117	111	114	112	110	110	108	105	100
Euro	USD per EUR	1.09	1.14	1.10	1.12	1.06	1.07	1.07	1.08	1.11	1.12	1.14	1.16	1.18
U.K. pound	USD per GBP	1.29	1.44	1.32	1.30	1.23	1.25	1.26	1.26	1.28	1.30	1.33	1.36	1.38
Swiss franc	CHF per USD	0.99	0.96	0.98	0.97	1.02	1.00	1.00	1.00	1.00	0.99	0.98	0.97	0.96
Canadian dollar	CAD per USD	1.36	1.30	1.30	1.31	1.34	1.33	1.36	1.34	1.33	1.32	1.31	1.30	1.29
Australian dollar	USD per AUD	0.75	0.77	0.74	0.77	0.72	0.76	0.72	0.73	0.74	0.75	0.75	0.75	0.75
NZ dollar	USD per NZD	0.69	0.69	0.71	0.73	0.70	0.70	0.64	0.64	0.64	0.64	0.64	0.64	0.64
Exchange rate to Euro														
U.S. dollar	USD per EUR	1.09	1.14	1.10	1.12	1.06	1.07	1.07	1.08	1.11	1.12	1.14	1.16	1.18
Japanese yen	JPY per EUR	121	128	113	114	123	119	122	121	122	123	123	122	118
U.K. pound	GBP per EUR	0.85	0.79	0.83	0.86	0.86	0.85	0.85	0.86	0.87	0.86	0.86	0.85	0.86
Swiss franc	CHF per EUR	1.08	1.09	1.08	1.09	1.07	1.07	1.07	1.08	1.11	1.11	1.12	1.13	1.13
Canadian dollar	CAD per EUR	1.48	1.48	1.44	1.47	1.42	1.43	1.46	1.45	1.48	1.48	1.49	1.51	1.52
Australian dollar	AUD per EUR	1.46	1.48	1.48	1.47	1.46	1.40	1.49	1.48	1.50	1.49	1.52	1.55	1.57
NZ dollar	NZD per EUR	1.58	1.65	1.55	1.54	1.52	1.53	1.67	1.69	1.73	1.75	1.78	1.81	1.84
Exchange rate to Japanese yen														
U.S. dollar	JPY per USD	111	112	103	101	117	111	114	112	110	110	108	105	100
Euro	JPY per EUR	121	128	113	114	123	119	122	121	122	123	123	122	118
U.K. pound	JPY per GBP	143	162	136	132	144	140	144	141	141	143	144	143	138
Swiss franc	JPY per CHF	111.8	117.3	105.0	104.4	114.9	111.4	114.0	112.0	110.0	111.1	110.2	108.2	104.2
Canadian dollar	JPY per CAD	81.6	86.7	79.0	77.2	87.0	83.6	83.8	83.6	82.7	83.3	82.4	80.8	77.5
Australian dollar	JPY per AUD	83.0	86.3	76.4	77.6	84.4	85.1	82.1	81.8	81.4	82.5	81.0	78.8	75.0
NZ dollar	JPY per NZD	76.6	77.9	73.2	73.8	81.3	78.0	73.0	71.7	70.4	70.4	69.1	67.2	64.0

F: Forecast by TD Economics, April 2017; Forecasts are end-of-period; Source: Federal Reserve, Bloomberg.

GLOBAL STOCK MARKETS

	Price Apr-26	30-Day % Chg.	YTD % Chg.	52-Week High	52-Week Low
S&P 500	2,388	1.9	16.0	2,396	2,001
DAX	12,473	3.4	27.2	12,473	9,269
FTSE 100	7,289	-0.7	11.0	7,430	5,924
Nikkei	19,289	0.1	10.5	19,634	14,952
MSCI AC World Index*	456	1.9	9.4	456	380

*Weighted equity index including both developing and emerging markets.
Source: Bloomberg

COMMODITY PRICE OUTLOOK

	Price	52-Week	52-Week	2016				2017				2018			
	Apr-26	High	Low	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Crude Oil (WTI, $US/bbl)	50	54	40	33	45	45	50	52	52	55	55	56	56	57	57
Natural Gas ($US/MMBtu)	3.02	3.76	1.75	1.97	2.13	2.85	3.02	3.15	3.15	3.25	3.25	3.30	3.30	3.30	3.30
Gold ($US/troy oz.)	1269	1366	1128	1182	1259	1335	1216	1225	1250	1275	1275	1300	1300	1325	1325
Silver (US$/troy oz.)	17.5	20.6	15.7	14.9	16.8	19.6	17.1	16.8	17.0	17.8	17.8	18.8	18.8	19.5	19.5
Copper (cents/lb)	258	277	204	212	215	216	240	258	252	252	254	260	260	265	265
Nickel (US$/lb)	4.23	5.28	3.78	3.86	4.00	4.65	4.90	5.10	5.00	4.75	4.75	5.00	5.00	5.25	5.25
Aluminum (Cents/lb)	89	89	70	69	71	73	78	75	75	76	76	78	78	78	78
Wheat ($US/bu)	6.29	7.13	5.41	5.89	6.06	5.73	6.48	6.60	6.55	6.50	6.60	6.60	6.70	6.75	6.75

F: Forecast by TD Economics, April 2017; Forecasts are period averages; E: Estimate. Source: Bloomberg, USDA (Haver).

INTERNATIONAL INTEREST RATE OUTLOOK

	Spot Rate	2016				2017				2018			
	Apr-26	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Germany													
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.25	-0.25
3-mth T-Bill Rate	-0.80	-0.59	-0.68	-0.80	-0.99	-0.85	-0.90	-0.80	-0.75	-0.75	-0.75	-0.60	-0.55
2-yr Govt. Bond Yield	-0.69	-0.52	-0.66	-0.68	-0.88	-0.67	-0.70	-0.55	-0.45	-0.40	-0.25	-0.05	0.10
5-yr Govt. Bond Yield	-0.34	-0.33	-0.57	-0.58	-0.54	-0.33	-0.35	-0.25	-0.15	-0.10	0.05	0.25	0.40
10-yr Govt. Bond Yield	0.35	0.15	-0.13	-0.12	0.20	0.36	0.55	0.85	1.00	1.30	1.55	1.70	1.75
30-yr Govt. Bond Yield	1.11	0.84	0.83	0.78	0.94	1.11	1.45	1.60	1.80	1.85	2.05	2.15	2.20
10-yr-2-yr Govt Spread	1.04	0.67	0.53	0.56	1.08	1.03	1.25	1.40	1.45	1.70	1.80	1.75	1.65
United Kingdom													
Bank Rate	0.25	0.50	0.50	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-mth T-Bill Rate	0.32	0.51	0.46	0.32	0.32	0.17	0.25	0.25	0.25	0.25	0.25	0.25	0.25
2-yr Govt. Bond Yield	0.09	0.44	0.10	0.10	0.05	0.10	0.20	0.35	0.40	0.45	0.50	0.65	0.70
5-yr Govt. Bond Yield	0.52	0.84	0.35	0.22	0.47	0.52	0.75	0.80	0.85	0.90	1.00	1.05	1.15
10-yr Govt. Bond Yield	1.08	1.42	0.87	0.75	1.45	1.10	1.35	1.50	1.55	1.75	1.90	2.00	2.00
30-yr Govt. Bond Yield	1.72	2.29	1.70	1.49	1.87	1.73	1.95	2.10	2.15	2.35	2.45	2.50	2.55
10-yr-2-yr Govt Spread	0.99	0.98	0.77	0.64	1.40	1.00	1.15	1.15	1.15	1.30	1.40	1.35	1.30

F: Forecasts by TD Bank Group, April 2017; Forecasts are end-of-period; Source: Bloomberg.