DOLLARS & SENSE

TD Economics

August 8, 2014

IT'S A DANGEROUS WORLD OUT THERE, BUT ECONOMIC FUNDAMENTALS ARE IMPROVING

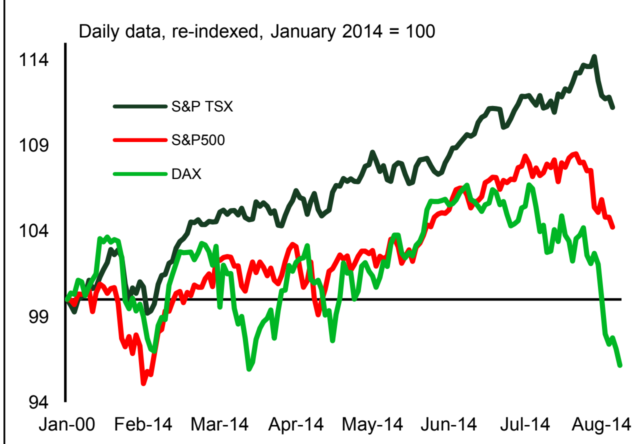
Highlights

- Heightened geopolitical risks, a troubled Portuguese bank, an Argentine debt default and concerns the Fed may hike rates sooner than expected, all conspired to drive equities lower this past month.
- All told, apart from adjustments to the near term to reflect continued risk aversion, our financial forecasts are little changed from our last issue. Although we have pushed back our forecast for the loonie to fall to 87 U.S. cents into the first quarter of next year.
- The lack of major alterations to our view reflects the fact that the latest economic data continues to point to a U.S. economy which is strengthening. This is already showing up in stronger export growth in Canada.

Over the past month a perfect storm of factors conspired to sour equity market sentiment, hitting equity markets on both sides of the Atlantic. Equities were likely ripe for a dip as many analysts have been worried a correction could be imminent given the bull market that is now in its sixth year. A correction is typically defined as a drop of more than 10%. North American equity markets didn't fall that far (the S&P's fallen 3.9% to Aug. 7th), and the TSX has fared relatively better. It is still up 11% year to date (see chart). Moreover, the fundamental underpinnings of equity markets – corporate earnings – are expected to have a very favourable economic backdrop, particularly in the U.S., over the next two years as growth accelerates. Canadian corporate profit growth is expected to be very solid this year, aided by higher energy prices, it is likely to trail the U.S. in 2015, reflecting a relatively strong growth outlook south of the border.

It wasn't just equity markets that took a dip last week; as markets displayed classic flight-to-safety flows. The price of gold, which typically rises during times of uncertainty or crisis, is down since our last issue, but it has risen slightly since equity markets turned sour. U.S. Treasury yields have fallen as demand has picked up, and the U.S. Dollar has strengthened, leading the Canadian dollar lower. The loonie is now 91 U.S. cents, about two cents lower than it was a month ago.

EQUITY MARKETS TAKE A SUMMER DIP



Source: Bloomberg. Data to 11:00 AM, August 7, 2014.

One exception to the increase in risk sentiment is the price of oil, which has dropped off quit precipitously over the past month. The price of oil so far in 2014 had already reflected a great deal of geopolitical uncertainty over the conflict in Iraq, and the risk that response to Russian aggression would trigger sanctions which would crimp Russian oil production. Markets now appear to have recalibrated the risks to current oil production, taking the price more in line with the fundamental supply-demand balance in the

Craig Alexander, SVP & Chief Economist, 416-982-8064
Leslie Preston, Economist, 416-983-7053

market. This is good news for consumers who will benefit from welcome relief at the pumps.

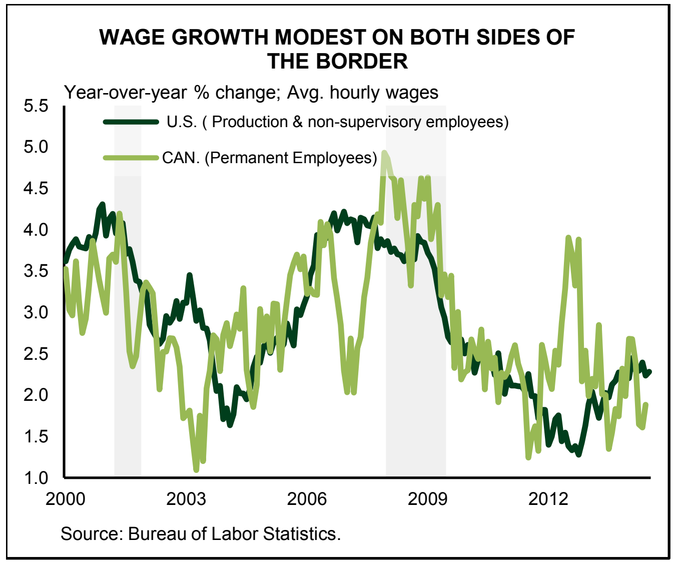
Plenty of reasons to be gloomy

The factors that likely contributed to increased risk aversion in financial markets can be grouped into three main buckets: heightened geopolitical risks, pockets of increased risk in the financial system, and increased uncertainty on the timing of interest rate hikes in the United States. The world is a dangerous place these days, including widespread fighting in many parts of the Middle East. But, the primary source of increased risk has been the conflict in Eastern Ukraine, and increased sanctions against Russia by Western nations for its involvement with the pro-Russian rebels in Ukraine. While energy markets are shrugging off risks that sanctions will affect current Russian oil production, and hence prices, retaliatory sanctions by Russian could have a negative impact on parts of Europe's already fragile economy, depending on how long they last.

There was also heightened risk aversion stemming from the financial sector. The already beleaguered Portuguese bank, Banco Espirito Santo, posted severe losses in the first half of the year, wiping out its capital buffers. The Bank will be bailed out by the Portuguese government, using its remaining EU and IMF bailout loans. In addition, Argentina defaulted on its debt, which had previously been restructured after the country defaulted on in 2001. The default is small in the scope of the global economy, and is unlikely to spark contagion in other emerging markets.

Finally, two U.S. FOMC members, and perennial hawks, Fisher and Plosser made public statements last week highlighting their concerns that markets are complacent about when interest rates will rise. These hawkish statements likely increased uncertainty about when the Fed would hike, and dampened sentiment on markets.

The Bank of Canada struck a cautious tone in its recent interest rate announcement and Monetary Policy Report. While acknowledging the recent uptick in inflation, it chalked up much of the recent upswing to temporary factors. The Bank also downgraded its growth forecast, emphasizing that Canada needs to see sustained above-potential economic growth in order for core inflation to stay at the Bank's 2% target. We concur with the Bank's assessment that Canada doesn't have an inflation problem (please see report The Fog Of Core: Seeing The Trees For The Forest In Canadian CPI Inflation). Our forecast for the Bank to hold off on hiking interest rates until the second half of 2015 remains unchanged.



Bank of Canada Governor Poloz aptly described the current economic recovery as one of serial disappointment, which has weighed on business confidence and investment. Moreover, slack remains in the Canadian labour market, as evidenced by wage growth that remains muted (see chart). To break out of this serial disappointment, Canadian export growth needs to accelerate, and early indications are that momentum was strong heading into Q3. Moreover, the U.S. economy rebounded by 4% in the second quarter, and early indicators for Q3 showed another solid month of hiring and increased optimism in the manufacturing sector. All of this has reaffirmed our expectation that the U.S. economy is gathering speed, which should drive stronger demand for Canada's exports.

Bottom line

Fortunately for rattled investors, the fundamental underpinnings of equity markets – corporate earnings – are expected to enjoy an improved economic backdrop over the next two years. Markets are frequently dominated by animal spirits, and we wouldn't rule out a correction in equities driven by escalating geopolitical strife or market overreaction to Fed policy speculation. However, recent events have not significantly altered our forecasts. The near-term bond yield targets have been adjusted to reflect continued gains in bonds in the face of heightened risk aversion, and further U.S. dollar strengthening has been modestly delayed, but our year-end 2015 targets remain unchanged, as do our forecasts for commodity prices. There is no question that geopolitical risks loom large in the current environment, but we remain optimistic that the economic fundamentals, particularly in the U.S., and to a lesser extent in Canada, will continue to improve.

INTEREST RATE OUTLOOK	Spot Rate	2013				2014F				2015F			
	Aug-07	Q1	Q2	Q3	Q4	Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
CANADA													
Overnight Target Rate	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.50	1.50
3-mth T-Bill Rate	0.96	0.98	1.02	0.98	0.91	0.90	0.94	0.95	0.95	0.95	1.05	1.40	1.40
2-yr Govt. Bond Yield	1.07	1.00	1.22	1.19	1.13	1.07	1.10	1.10	1.30	1.50	1.70	1.95	2.05
5-yr Govt. Bond Yield	1.52	1.30	1.80	1.86	1.95	1.71	1.53	1.75	1.95	2.30	2.60	2.75	2.90
10-yr Govt. Bond Yield	2.08	1.76	2.44	2.54	2.77	2.46	2.24	2.40	2.65	2.85	3.00	3.20	3.35
30-yr Govt. Bond Yield	2.62	2.50	2.89	3.07	3.24	2.96	2.78	2.90	3.10	3.30	3.45	3.60	3.75
10-yr-2-yr Govt Spread	1.01	0.76	1.22	1.35	1.64	1.39	1.14	1.30	1.35	1.35	1.30	1.25	1.30
U.S.													
Fed Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50
3-mth T-Bill Rate	0.03	0.07	0.04	0.02	0.07	0.05	0.04	0.12	0.15	0.15	0.25	0.40	0.55
2-yr Govt. Bond Yield	0.43	0.25	0.36	0.33	0.38	0.44	0.47	0.70	0.80	0.90	1.05	1.40	1.75
5-yr Govt. Bond Yield	1.59	0.77	1.41	1.39	1.75	1.73	1.62	1.75	2.00	2.20	2.40	2.75	3.05
10-yr Govt. Bond Yield	2.41	1.87	2.52	2.64	3.04	2.73	2.53	2.75	2.90	3.10	3.20	3.45	3.60
30-yr Govt. Bond Yield	3.22	3.10	3.52	3.69	3.96	3.56	3.34	3.45	3.60	3.75	3.85	4.05	4.20
10-yr-2-yr Govt Spread	1.98	1.62	2.16	2.31	2.66	2.29	2.06	2.05	2.10	2.20	2.15	2.05	1.85
CANADA - U.S SPREADS													
Can - U.S. T-Bill Spread	0.94	0.91	0.98	0.96	0.84	0.85	0.90	0.83	0.80	0.80	0.80	1.00	0.85
Can - U.S. 10-Year Bond Spread	-0.33	-0.11	-0.08	-0.10	-0.27	-0.27	-0.29	-0.35	-0.25	-0.25	-0.20	-0.25	-0.25

F: Forecast by TD Bank Group as at July 2014; All forecasts are end-of-period; Source: Bloomberg, Bank of Canada, Federal Reserve.

GLOBAL STOCK MARKETS	Price Aug-07	30-Day % Chg.	YTD % Chg.	52-Week High	52-Week Low
S&P 500	1,910	-3.2	3.3	1,988	1,630
S&P/TSX Composite	15,119	-0.6	11.0	15,525	12,542
DAX	9,039	-7.8	-5.4	10,029	8,103
FTSE 100	6,597	-1.8	-2.2	6,878	6,338
Nikkei	15,232	-0.5	-6.5	16,291	13,338
MSCI AC World Index*	418	-2.7	2.3	434	364

* Is a weighted equity index including both developed and emerging markets
Source: Bloomberg.

COMMODITY PRICE FORECASTS	Price	52-Week	52-Week	2013				2014F				2015F				Annual Average		
	Aug-07	High	Low	Q1	Q2	Q3	Q4	Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	2013	2014F	2015F
Crude Oil (WTI, $US/bbl)	97	111	92	94	94	106	97	99	103	106	100	96	96	92	94	98	102	95
Natural Gas ($US/MMBtu)	3.98	8.03	3.27	3.50	4.01	3.56	3.85	5.17	4.46	4.50	4.75	4.75	4.50	4.25	4.25	3.73	4.72	4.44
Gold ($US/troy oz.)	1307	1418	1189	1631	1415	1328	1271	1294	1289	1260	1240	1225	1250	1300	1300	1411	1271	1269
Silver (US$/troy oz.)	20.0	24.5	18.8	30.0	23.1	21.4	20.8	20.5	19.7	19.80	19.50	19.25	19.75	20.00	20.25	23.8	19.9	19.8
Copper (cents/lb)	317	336	292	360	324	321	325	319	307	312	310	300	300	280	280	332	312	290
Nickel (US$/lb)	8.50	9.53	6.03	7.87	6.79	6.30	6.31	6.64	8.36	8.50	8.50	9.25	9.50	9.75	10.00	6.82	8.00	9.63
Aluminum (Cents/lb)	92	93	76	91	83	81	80	78	82	84	86	84	82	82	80	84	82	82

F: Forecast by TD Bank Group as at July 2014; All forecasts are period averages; Source: Bloomberg, USDA (Haver).

FOREIGN EXCHANGE OUTLOOK														
Currency	Exchange rate	Spot Price	2013				2014F				2015F			
		Aug-07	Q1	Q2	Q3	Q4	Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Exchange rate to U.S. dollar														
Japanese yen	JPY per USD	102.1	94.2	99.2	98.3	105.3	103.0	101.3	102.0	103.0	105.0	106.0	110.0	111.0
Euro	USD per EUR	1.34	1.28	1.30	1.35	1.38	1.38	1.37	1.30	1.29	1.28	1.26	1.24	1.22
U.K. pound	USD per GBP	1.68	1.52	1.52	1.62	1.66	1.67	1.71	1.67	1.68	1.68	1.68	1.65	1.61
Swiss franc	CHF per USD	0.91	0.95	0.95	0.90	0.89	0.88	0.89	0.95	0.97	0.99	1.03	1.05	1.07
Canadian dollar	CAD per USD	1.09	1.02	1.05	1.03	1.06	1.11	1.07	1.11	1.12	1.15	1.14	1.11	1.11
Australian dollar	USD per AUD	0.93	1.04	0.92	0.93	0.89	0.93	0.94	0.93	0.90	0.88	0.85	0.85	0.84
NZ dollar	USD per NZD	0.85	0.84	0.78	0.83	0.82	0.87	0.88	0.83	0.80	0.78	0.74	0.73	0.72
Exchange rate to Euro														
U.S. dollar	USD per EUR	1.34	1.28	1.30	1.35	1.38	1.38	1.37	1.30	1.29	1.28	1.26	1.24	1.22
Japanese yen	JPY per EUR	136	121	129	132	145	142	138	133	133	134	134	136	135
U.K. pound	GBP per EUR	0.79	0.85	0.86	0.84	0.83	0.83	0.80	0.78	0.77	0.76	0.75	0.75	0.76
Swiss franc	CHF per EUR	1.21	1.22	1.23	1.22	1.23	1.22	1.22	1.23	1.25	1.27	1.30	1.30	1.30
Canadian dollar	CAD per EUR	1.46	1.30	1.37	1.39	1.47	1.52	1.46	1.44	1.45	1.47	1.43	1.38	1.36
Australian dollar	AUD per EUR	1.44	1.23	1.42	1.45	1.54	1.49	1.45	1.40	1.43	1.46	1.48	1.46	1.45
NZ dollar	NZD per EUR	1.58	1.53	1.68	1.63	1.68	1.60	1.56	1.57	1.61	1.64	1.70	1.70	1.69
Exchange rate to Japanese yen														
U.S. dollar	JPY per USD	102.1	94.2	99.2	98.3	105.3	103.0	101.3	102.0	103.0	105.0	106.0	110.0	111.0
Euro	JPY per EUR	136	121	129	132	145	142	138	133	133	134	134	136	135
U.K. pound	JPY per GBP	172	143	151	159	174	172	173	170	173	177	178	182	178
Swiss franc	JPY per CHF	112.3	99.2	105.0	108.7	118.2	116.5	114.2	107.8	106.3	105.8	102.7	104.9	104.2
Canadian dollar	JPY per CAD	93.4	92.7	94.3	95.4	98.9	93.4	95.0	91.8	91.7	91.4	93.3	99.0	99.9
Australian dollar	JPY per AUD	94.7	98.0	90.9	91.8	94.0	95.5	95.5	94.9	92.7	92.4	90.1	93.5	93.2
NZ dollar	JPY per NZD	86.5	78.7	76.9	81.8	86.6	89.4	88.7	84.7	82.4	81.9	78.4	80.3	79.9
Exchange rate to Canadian dollar														
U.S. dollar	USD per CAD	0.92	0.98	0.95	0.97	0.94	0.91	0.94	0.90	0.89	0.87	0.88	0.90	0.90
Japanese yen	JPY per CAD	93.4	92.7	94.3	95.4	98.9	93.4	95.0	91.8	91.7	91.4	93.3	99.0	99.9
Euro	CAD per EUR	1.46	1.30	1.37	1.39	1.47	1.52	1.46	1.44	1.45	1.47	1.43	1.38	1.36
U.K. pound	CAD per GBP	1.84	1.54	1.60	1.67	1.76	1.84	1.83	1.85	1.88	1.94	1.91	1.84	1.78
Swiss franc	CHF per CAD	0.83	0.93	0.90	0.88	0.84	0.80	0.83	0.85	0.86	0.86	0.91	0.94	0.96
Australian dollar	AUD per CAD	0.99	0.95	1.04	1.04	1.05	0.98	0.99	0.97	0.99	0.99	1.04	1.06	1.07
NZ dollar	NZD per CAD	1.08	1.18	1.23	1.17	1.14	1.04	1.07	1.08	1.11	1.11	1.19	1.23	1.25

F: Forecast by TD Bank Group as at July 2014; All forecasts are end-of-period: Source: Federal Reserve, Bloomberg, TDBG.