DOLLARS & SENSE
TD Economics

July 28, 2016 - For updated financial forecasts please see our September Quarterly Economic Forecast here.

THE "CENTRAL BANK PUT" KEEPS MARKETS IN A RISK-ON MOOD

Highlights

- Central banks are acting as the automatic stabilizer for a world with high political and economic uncertainty. Rates will remain low to support a global economy hampered by aging populations and its interplay with lower productivity and credit growth.
- Lower rates for longer will keep investors in search of yield. This is evident not only by the revival in U.S. and Canadian equity markets, but also by the recent revival in funds into emerging markets.
- Risks have not diminished to any great degree. The increased frequency of bouts of financial market volatility that has particularly characterized the past year may reflect the new normal for some time to come.

Global financial markets have shown resilience in the face of yet another shock, this time coming from the British vote to leave the European Union on June 23rd. The market's knee-jerk reaction to flee risk-assets has since given way to a strong revival in equity markets and a compression in corporate bond spreads to their lowest levels in several months. This is surprising given that the global outlook has become more uncertain, both politically and economically.

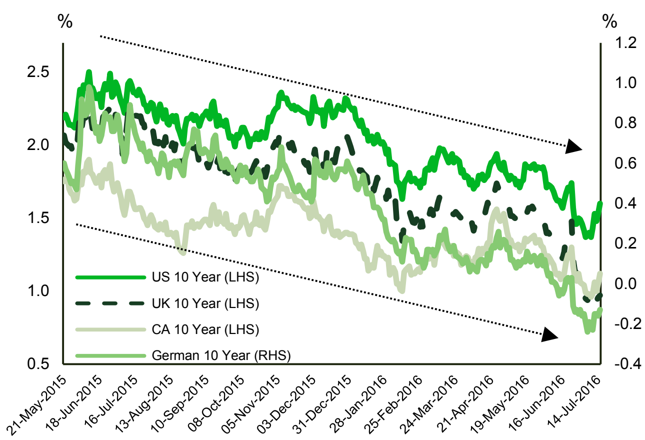
At the heart of the market's enduring confidence is the belief that central bankers will continue to act as automatic stabilizers to any bump on the road. Past behavior has certainly lent credence to this belief. The words "whatever it takes" by the ECB's President, Mario Draghi, still rings loud in the ears of investors amidst a long historical pattern that extends back to the Federal Reserve and the "Greenspan put" in 1987. From liquidity funds for LTCM, to organized mergers during the global financial crisis, these central bank efforts have the same root: stave off disinflationary forces, support investor risk appetite, and keep the global economy moving forward.

Interconnected economies = interconnected central banks

Nonetheless, there are significant differences between the central bank stabilizers of the past and what exists today. We live in a world where developed economies are working hard to grow consistently at just one-to-two percent per year. This low cruising speed leaves very little cushion against economic or financial shocks. Moreover, given slow growth and elevated sovereign debt levels, many governments have been more apt to exercise restraint on fiscal policy, which has left monetary policy as the only game in town.

Increased global interconnectedness has led central banks to consider and respond to foreign-sourced shocks almost as forcefully as those originating on their own shores. As a result, the uncertainty and lower global growth profile generated by an event like Brexit argues for central banks to maintain policy rates lower

CHART 1: GOVERNMENT BOND YIELDS REFLECT LOWER FOR LONGER POLICY RATES



Source: FRB, BoE, BoC, BBK, TD Economics.

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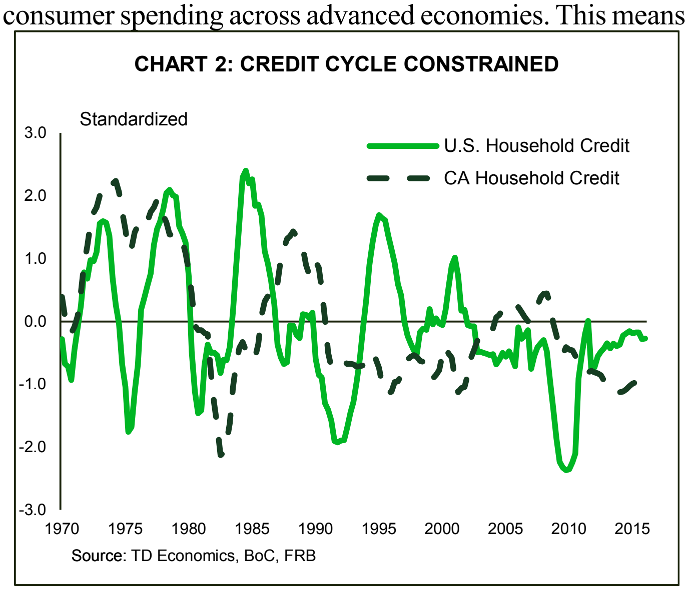
for even longer. Unsurprisingly, in the immediate aftermath of the vote, U.S. and Canadian 10-year government yields touched new lows of 1.32% and 0.93%, respectively, while the 10-year German bund crossed into negative territory, where it remains today (see Chart 1).

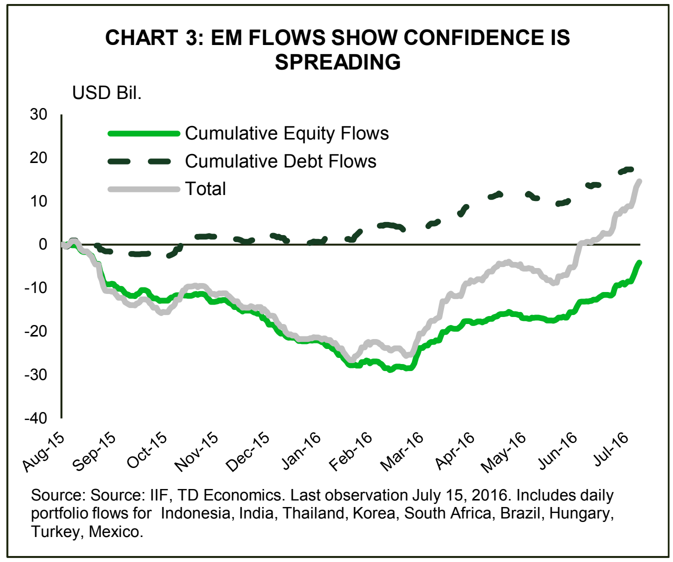
The Economic Restrictor Plate: Fewer crashes, less speed

The low level of interest rates should, in theory, buoy an economy by increasing incentives to borrow and spend. But, debt building is a young person's game. Advanced economies are experiencing an aging population which, by its very nature, takes on less credit. Our prior research demonstrated that prime spending years occur at 40-54 years of age, with a 40% drop-off once a person surpasses the age of 65. And, an aging population against a backdrop of burdensome global debt levels further limits credit demand, as well as lowers trend productivity growth through the interplay of all these forces. The end result: downward pressure is maintained on the natural rate of interest and inflation.

At the same time, on the supply side, low interest rates squeeze net interest margins of financial institutions, while tighter regulatory requirements act as a restrictor plate to further limit lending growth. These regulatory provisions were certainly needed following the financial crisis. However, just as they are intended to limit crashes, so too do they cap the speed of economic acceleration. This perfect storm hitting both the demand and supply side has dampened the credit cycle and economic growth (see Chart 2).

As a result, even with historically low yields, corporate investment by non-financial firms is occurring at a slower pace than previous decades, particularly when the health of balance sheets is taken into account. The same holds true for consumer spending across advanced economies. This means





that low yields become a necessity rather than a nicety to supporting even a temperate pace of economic growth.

Investors seeking higher returns have one option for portfolio positioning and that is to move up the risk spectrum. Moving into equities is the common trade. Even historically and cyclically high valuations for many equity markets have not slowed fund flows. The combination of the "central bank put" and elevated equity valuations within advance economies is now pushing investors further afield into far riskier emerging market securities (see Chart 3). This demonstrates that low yields within advance economies can (and do) displace risks, making it not a risk-free proposition.

Bottom Line

Financial markets are telling diverging stories. While risk assets such as equities and corporate bonds are valued at levels that imply relatively robust future earnings and therefore nominal growth, government bonds are priced for continued weak economic growth and low inflation.

There are limits to how long this divergence can continue. Our view is that the global economy does not have a catalyst for a burst of growth. Slow improvement as headwinds fade is likely all that can be expected. As global economies adjust to the new normal, financial markets will continue to experience regular bouts of turbulence, especially where valuations are the most stretched. As such, the Federal Reserve and Bank of Canada will keep rates low during these times of uncertainty and obscurity. Even amid the recent return to market stability, central banks will remain highly tuned into the DNA of global developments and asymmetric risks. This is especially true for the Bank of Canada, as the health of its export market is a linchpin to the outlook. The path forward will not be smooth. Please keep your seatbelts fastened.

INTEREST RATE OUTLOOK

	Spot Rate	2015				2016				2017			
	Jul-27	Q1	Q2	Q3	Q4	Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
CANADA													
Overnight Target Rate	0.50	0.75	0.75	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
3-mth T-Bill Rate	0.52	0.55	0.58	0.43	0.51	0.45	0.50	0.50	0.50	0.50	0.50	0.50	0.65
2-yr Govt. Bond Yield	0.58	0.51	0.49	0.53	0.48	0.54	0.45	0.50	0.55	0.60	0.65	0.70	0.80
5-yr Govt. Bond Yield	0.65	0.77	0.81	0.81	0.73	0.68	0.60	0.60	0.70	0.80	0.95	1.05	1.15
10-yr Govt. Bond Yield	1.08	1.36	1.68	1.45	1.39	1.23	1.10	1.05	1.15	1.30	1.40	1.50	1.60
30-yr Govt. Bond Yield	1.69	1.99	2.31	2.21	2.15	2.00	1.75	1.70	1.80	1.90	2.00	2.05	2.10
10-yr-2-yr Govt Spread	0.49	0.85	1.19	0.92	0.91	0.69	0.65	0.55	0.60	0.70	0.75	0.80	0.80
U.S.													
Fed Funds Target Rate	0.50	0.25	0.25	0.25	0.50	0.50	0.50	0.50	0.50	0.50	0.75	0.75	1.00
3-mth T-Bill Rate	0.28	0.03	0.01	0.00	0.16	0.21	0.25	0.30	0.30	0.35	0.55	0.60	0.80
2-yr Govt. Bond Yield	0.72	0.56	0.64	0.64	1.06	0.73	0.55	0.55	0.60	0.70	1.00	1.10	1.30
5-yr Govt. Bond Yield	1.09	1.37	1.63	1.37	1.76	1.21	0.95	0.95	0.95	1.00	1.25	1.35	1.55
10-yr Govt. Bond Yield	1.50	1.94	2.35	2.06	2.27	1.78	1.45	1.40	1.40	1.55	1.70	1.80	1.90
30-yr Govt. Bond Yield	2.21	2.54	3.11	2.87	3.01	2.61	2.30	2.25	2.20	2.35	2.50	2.55	2.65
10-yr-2-yr Govt Spread	0.78	1.38	1.71	1.42	1.21	1.05	0.90	0.85	0.80	0.85	0.70	0.70	0.60
CANADA - U.S SPREADS													
Can - U.S. T-Bill Spread	0.25	0.52	0.57	0.43	0.35	0.24	0.25	0.20	0.20	0.15	-0.05	-0.10	-0.15
Can - U.S. 10-Year Bond Spread	-0.42	-0.58	-0.67	-0.61	-0.88	-0.55	-0.35	-0.35	-0.25	-0.25	-0.30	-0.30	-0.30

F: Forecast by TD Economics, July 2016; Forecasts are end-of-period; Source: Bloomberg, Bank of Canada, Federal Reserve.
*Spot rate as at July 27, 2016.

GLOBAL STOCK MARKETS

	Price Jul-27	30-Day % Chg.	YTD % Chg.	52-Week High	52-Week Low
S&P 500	2,167	6.3	5.2	2,175	1,829
S&P/TSX Composite	14,547	4.7	-0.6	14,601	11,843
DAX	10,320	8.0	5.2	11,636	8,753
FTSE 100	6,750	10.0	2.8	6,752	5,537
Nikkei	16,665	11.5	-4.5	20,809	14,952
MSCI AC World Index*	413	6.3	-1.1	427	353

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

COMMODITY PRICE OUTLOOK

	Price	52-Week	52-Week	2015				2016				2017			
	Jul-27	High	Low	Q1	Q2	Q3	Q4	Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Crude Oil (WTI, $US/bbl)	42	51	26	49	58	46	42	34	44	48	50	52	52	55	55
Natural Gas ($US/MMBtu)	2.80	2.93	1.49	2.87	2.78	2.75	2.10	1.97	2.13	2.75	2.85	3.00	3.10	3.25	3.25
Gold ($US/troy oz.)	1340	1366	1051	1218	1191	1124	1104	1182	1259	1335	1325	1295	1275	1250	1250
Silver (US$/troy oz.)	20.4	20.4	13.7	16.7	16.4	14.9	14.8	14.9	16.8	19.5	18.8	18.0	17.3	16.5	16.5
Copper (cents/lb)	223	246	196	264	275	238	222	212	215	218	219	220	221	226	227
Nickel (US$/lb)	4.70	5.10	3.45	6.51	5.94	4.78	4.27	3.86	4.00	4.60	4.80	4.20	4.20	4.50	4.50
Aluminum (Cents/lb)	72	76	65	82	79	72	68	69	71	73	72	74	74	76	76
Wheat ($US/bu)*	5.86	7.95	5.58	7.45	7.34	6.39	6.36	5.89	6.06	6.15	6.20	6.25	6.25	6.50	6.75

F: Forecast by TD Economics, July 2016; Forecasts are period averages; E: Estimate. Source: Bloomberg, USDA (Haver).

Currency	Exchange rate	Spot Price	2015				2016				2017			
		Jul-27	Q1	Q2	Q3	Q4	Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Exchange rate to U.S. dollar														
Chinese Yuan	CNY per USD	6.67	6.20	6.20	6.36	6.48	6.45	6.65	6.78	6.88	6.96	7.04	7.12	7.18
Japanese yen	JPY per USD	105	120	122	120	120	112	103	100	102	103	105	104	103
Euro	USD per EUR	1.11	1.07	1.12	1.12	1.09	1.14	1.10	1.06	1.06	1.07	1.07	1.09	1.12
U.K. pound	USD per GBP	1.32	1.49	1.57	1.51	1.48	1.44	1.32	1.30	1.30	1.32	1.32	1.32	1.33
Swiss franc	CHF per USD	0.99	0.97	0.94	0.98	1.00	0.96	0.98	1.03	1.08	1.06	1.04	1.01	1.00
Canadian dollar	CAD per USD	1.32	1.27	1.25	1.34	1.38	1.30	1.30	1.34	1.34	1.33	1.33	1.32	1.30
Australian dollar	USD per AUD	0.75	0.76	0.77	0.70	0.73	0.77	0.74	0.75	0.74	0.72	0.72	0.73	0.74
NZ dollar	USD per NZD	0.71	0.75	0.68	0.64	0.68	0.69	0.71	0.69	0.67	0.65	0.64	0.64	0.64
Exchange rate to Euro														
U.S. dollar	USD per EUR	1.11	1.07	1.12	1.12	1.09	1.14	1.10	1.06	1.06	1.07	1.07	1.09	1.12
Japanese yen	JPY per EUR	117	129	136	134	131	128	113	106	108	110	112	113	115
U.K. pound	GBP per EUR	0.84	0.72	0.71	0.74	0.74	0.79	0.83	0.82	0.82	0.81	0.81	0.83	0.84
Swiss franc	CHF per EUR	1.09	1.04	1.04	1.09	1.09	1.09	1.08	1.09	1.15	1.13	1.11	1.10	1.12
Canadian dollar	CAD per EUR	1.46	1.36	1.39	1.50	1.50	1.48	1.44	1.42	1.42	1.42	1.42	1.44	1.46
Australian dollar	AUD per EUR	1.48	1.41	1.45	1.59	1.49	1.48	1.48	1.41	1.43	1.49	1.49	1.49	1.51
NZ dollar	NZD per EUR	1.56	1.44	1.65	1.75	1.59	1.65	1.55	1.54	1.58	1.65	1.67	1.70	1.75
Exchange rate to Japanese yen														
U.S. dollar	JPY per USD	105	120	122	120	120	112	103	100	102	103	105	104	103
Euro	JPY per EUR	117	129	136	134	131	128	113	106	108	110	112	113	115
U.K. pound	JPY per GBP	139	178	192	181	177	162	136	130	133	136	139	137	137
Swiss franc	JPY per CHF	106.9	123.5	130.6	122.6	120.1	117.3	105.0	97.1	94.4	97.2	101.0	103.0	103.0
Canadian dollar	JPY per CAD	79.9	94.6	97.9	89.4	86.9	86.7	79.0	74.6	76.1	77.4	78.9	78.8	79.2
Australian dollar	JPY per AUD	78.9	91.5	94.1	84.1	87.6	86.3	76.4	75.0	75.5	74.2	75.6	75.9	76.2
NZ dollar	JPY per NZD	74.5	89.8	82.8	76.6	82.3	77.9	73.2	69.0	68.3	67.0	67.2	66.6	65.9
Exchange rate to Canadian dollar														
U.S. dollar	USD per CAD	0.76	0.79	0.80	0.75	0.72	0.77	0.77	0.75	0.75	0.75	0.75	0.76	0.77
Japanese yen	JPY per CAD	79.9	94.6	97.9	89.4	86.9	86.7	79.0	74.6	76.1	77.4	78.9	78.8	79.2
Euro	CAD per EUR	1.46	1.36	1.39	1.50	1.50	1.48	1.44	1.42	1.42	1.42	1.42	1.44	1.46
U.K. pound	CAD per GBP	1.74	1.88	1.96	2.03	2.04	1.87	1.72	1.74	1.74	1.76	1.76	1.74	1.73
Swiss franc	CHF per CAD	0.75	0.77	0.75	0.73	0.72	0.74	0.75	0.77	0.81	0.80	0.78	0.77	0.77
Australian dollar	AUD per CAD	1.01	1.03	1.04	1.06	0.99	1.00	1.03	1.00	1.01	1.04	1.04	1.04	1.04
NZ dollar	NZD per CAD	1.07	1.05	1.18	1.17	1.06	1.11	1.08	1.08	1.11	1.16	1.18	1.18	1.20

F: Forecast by TD Economics, July 2016; Forecasts are end-of-period; Source: Federal Reserve, Bloomberg. *Spot rate.

INTERNATIONAL INTEREST RATE OUTLOOK

	Spot Rate	2015				2016				2017			
	Jul-27	Q1	Q2	Q3	Q4	Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Australia													
Cash Target Rate	1.75	2.25	2.00	2.00	2.00	1.75	1.75	1.50	1.50	1.50	1.50	1.75	2.00
3-mth T-Bill Rate	1.71	1.97	1.96	2.01	2.02	2.04	1.69	1.70	1.70	1.75	1.70	1.95	2.25
3-yr Govt. Bond Yield	1.52	1.72	2.04	1.84	2.02	1.90	1.55	1.50	1.50	1.50	1.65	2.00	2.25
5-yr Govt. Bond Yield	1.61	1.87	2.27	2.12	2.24	2.09	1.65	1.60	1.60	1.65	1.80	2.15	2.40
10-yr Govt. Bond Yield	1.95	2.33	3.01	2.62	2.88	2.49	1.98	2.00	2.05	2.15	2.25	2.40	2.50
10-yr-3-yr Govt Spread	0.43	0.61	0.97	0.78	0.86	0.59	0.43	0.50	0.55	0.65	0.60	0.40	0.25
Germany													
ECB Deposit Rate	-0.40	-0.20	-0.20	-0.20	-0.30	-0.40	-0.40	-0.50	-0.50	-0.50	-0.50	-0.50	-0.50
3-mth T-Bill Rate	-0.75	-0.31	-0.30	-0.36	-0.54	-0.59	-0.68	-0.70	-0.70	-0.70	-0.70	-0.60	-0.60
2-yr Govt. Bond Yield	-0.62	-0.26	-0.24	-0.27	-0.35	-0.52	-0.66	-0.65	-0.55	-0.45	-0.35	-0.25	-0.15
5-yr Govt. Bond Yield	-0.51	-0.11	0.16	-0.04	-0.05	-0.33	-0.57	-0.55	-0.45	-0.30	-0.15	0.05	0.10
10-yr Govt. Bond Yield	-0.08	0.17	0.81	0.54	0.63	0.15	-0.13	-0.20	-0.30	-0.15	0.00	0.20	0.40
30-yr Govt. Bond Yield	1.05	0.61	1.57	1.33	1.49	0.84	0.83	0.30	0.20	0.35	0.55	0.75	1.00
10-yr-2-yr Govt Spread	0.54	0.43	1.05	0.81	0.98	0.67	0.53	0.45	0.25	0.30	0.35	0.45	0.55
United Kingdom													
Bank Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.25	0.25	0.25	0.25	0.25	0.25
3-mth T-Bill Rate	0.40	0.50	0.53	0.55	0.55	0.51	0.46	0.30	0.30	0.30	0.30	0.30	0.30
2-yr Govt. Bond Yield	0.13	0.39	0.61	0.56	0.65	0.44	0.10	0.30	0.30	0.35	0.35	0.35	0.35
5-yr Govt. Bond Yield	0.31	1.16	1.58	1.18	1.35	0.84	0.35	0.45	0.45	0.50	0.55	0.60	0.65
10-yr Govt. Bond Yield	0.74	1.54	2.11	1.74	1.96	1.42	0.87	0.95	0.75	0.85	0.95	1.05	1.15
30-yr Govt. Bond Yield	1.62	2.28	2.81	2.44	2.67	2.29	1.70	1.50	1.30	1.30	1.45	1.55	1.65
10-yr-2-yr Govt Spread	0.60	1.15	1.50	1.18	1.31	0.98	0.77	0.65	0.45	0.50	0.60	0.70	0.80

F: Forecast by TD Securities, July 2016; Forecasts are end-of-period; Source: Bloomberg.