ECONOMIC SNAPSHOT

TD Economics

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ECONOMIC & FINANCIAL OUTLOOK: 3 MONTHS INTO 2014

GLOBAL OUTLOOK

- Our forecast for global economic growth in 2014 remains at 3.4%, as the slight increase in prospects for advanced economies was matched by a commensurate decrease in developing nations. Our forecast for world GDP growth in 2015 was revised upward, from 3.6% to 3.7%.

EMERGING MARKETS

- The story of the year so far in emerging markets is the tense geopolitical environment in Ukraine. After the ousting of Pro-Russia President Viktor Yanukovych, a secession referendum in Crimea to join Russia remains unrecognized by western nations and may lead to economic sanctions against Russia. Financial markets have reacted to developments but without much guidance to what may come next. Most of the uncertainty is being reflected in FX markets – the Russian Ruble and the Ukrainian Hryvnia are down 10% and 18%, respectively, relative to the USD since the start of 2014.
- China is also a big market mover recently, as trade balance numbers and industrial output have disappointed – although this may to a large extent be due to seasonal factors related to the Chinese new year. The government has also changed its GDP growth target to 7.5%. This is closer to our forecast of 7.4% growth in 2014. Concerns regarding domestic credit and shadow banking have also gained attention and remain a risk to our forecast.
- Emerging markets' central banks remain busy navigating in a post-taper world. The Banco do Brasil has tightened rates to fight inflation for eight meetings in a row, taking the Selic rate to 10.75% from 7.25% at the same time last year. This is weighing on already sub-par growth for the Latin American giant. Other central banks such as those of South Africa, India and Turkey have followed suit to fight off recent capital exits.

UNITED STATES

- After beating expectations in the second half of 2013, U.S. economic data have been unimpressive so far in 2014. The slowdown reflects a number of temporary factors, including an unusually cold winter, the expiration of unemployment benefits for the long-term unemployed and tax credits for capital investment, and a slower pace of inventory accumulation following an outsized build up in the second half of 2013.
- As temporary factors fade and pent-up demand is unleashed, economic growth should re-accelerate. Our forecast for real GDP growth in 2014 is 2.7%, supported by reduced fiscal drag, resurgent consumer spending, and continued gains in housing construction. In 2015, economic growth is expected to accelerate further to 3.2%.
- The recent fall in home sales reflects the transition away from investor-supported buying. The next stage of the housing recovery will shift more to traditional homebuyers. This transition was impeded by a sudden 100 basis point increase in mortgage rates in 2013 and, to a lesser extent, the introduction of mortgage regulations at the start of this year. Borrowing costs have recently dropped, and are likely to rise slowly over the course of this year and next. In combination with strengthening job growth, this should support a rebound in housing demand over 2014-15.

DEVELOPED ECONOMIES

- There is little doubt that Europe has begun its recovery. After contracting 0.6% in 2012 and 0.4% in 2013, we believe that Europe's momentum from the second half of last year will carry over in 2014 and 2015. In turn, real GDP growth should be 1.2% and 1.9%, respectively.
- Strengthening demand in Germany and reduced fiscal drag in Europe are the main factors behind these upward revisions.

CANADA

- Canada's economy performed better than anticipated in 2013, as the transition towards more export-led growth is finally underway. An accelerating U.S. economy will continue to lift Canada's exports and, therefore, economic growth. We expect GDP growth to accelerate from 2.0% in 2013 to 2.3% this year and 2.5% in 2015.
- The weaker Canadian dollar will also contribute on the export front. We expect the loonie to reach a low of 85 U.S. cents over the next couple of months. This will help the hard-hit manufacturing sector recover some of its lost competitiveness over the last few years. Some industries, such as the wood products, machinery and primary metals, stand to benefit more than others from the loonie's fall (see report here).
- Low inflation remains a concern for the Bank of Canada. TD Economics estimates that the cause is a mix of temporary factors, a weak global backdrop and domestic economic slack (see report here). As the temporary factors subside, and the impact of a weaker Canadian dollar filters through to consumer prices, inflation is expected to grind gradually higher, reaching 2% in late 2015.
- The job creation engine has stalled since last September, averaging only 3k net new jobs per month since. We expect the pace of job creation to pick up in line with economic growth, taking the unemployment rate lower from its current 7% level to 6.4% by the end of 2015.
- Housing starts fell 13% last year, and are expected to weaken by a further 5% this year and 6% in 2015. Looking forward, softer demand and a rising supply of homes for sale will likely pull some steam out of home price growth over the next couple of years.

FINANCIAL MARKETS

- After largely underperforming the S&P500 in 2013, the tide has turned for the S&P/TSX in 2014 so far. The Canadian outperformance has coincided with the conflict in Ukraine which has raised fears of increased energy prices.
- Following a depreciation of 6.5% in 2013, the loonie has lost another 5.3% since the start of 2014. From its current level of 89 U.S. cents, we see the Canadian dollar reaching a low of 85 U.S. cents mid-year before returning to 90 U.S. cents by the second half of 2015.
- Inflationary pressures have picked up in recent months but they remain well below the Bank of Canada's target of 2%. This will keep the central bank on the sidelines until the second half of 2015, at which point it will start hiking its overnight rate at a very gradual pace.
- In the U.S., the Fed is expected to continue to taper its Quantitative Easing program. That said, the central bank is expected to remain highly accommodative well into the future. Well-anchored inflation expectations will allow the Fed to focus its efforts on an economy that still has a lot of healing to do. As a matter of fact, the statement from the Federal Open Market Committee meeting on March 19th explicitly removed all references to specific economic thresholds by replacing them with qualitative descriptors that will take into account a wider range of economic information and indicators.
- Bond yields have fallen since the start of 2014. For one, the 10-year Canadian government bond yield went from 2.80% to 2.50%, but we remain of the view that more robust domestic economic growth should contribute to the yield increasing to 3.10% by the end of 2014 and 3.55% by the end of 2015.
- A recent spike in natural gas prices has not changed our longer-term forecast for flat commodity prices, although the crisis in Ukraine represents a near-term upside risk to that profile reflecting the potential for supply disruptions.