



December 14, 2011

GLOBAL ECONOMIC OUTLOOK: WALKING IN A MINEFIELD

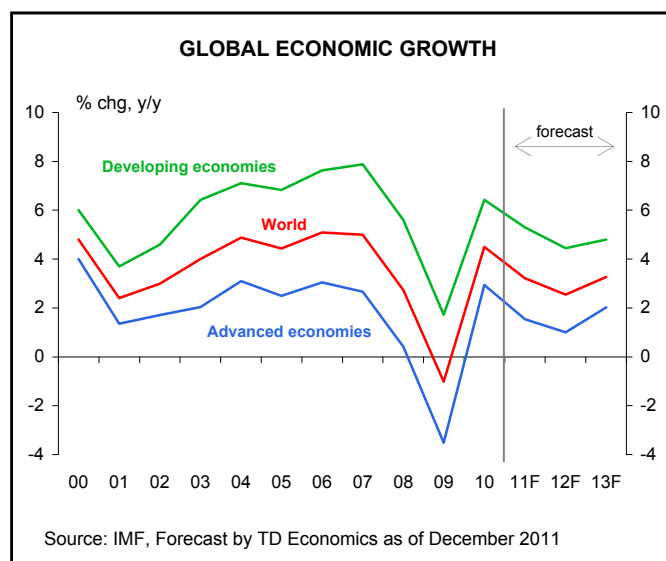
Highlights

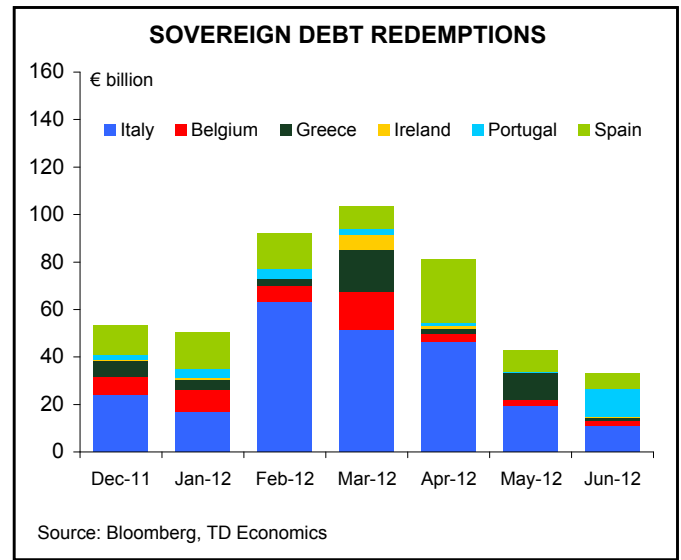
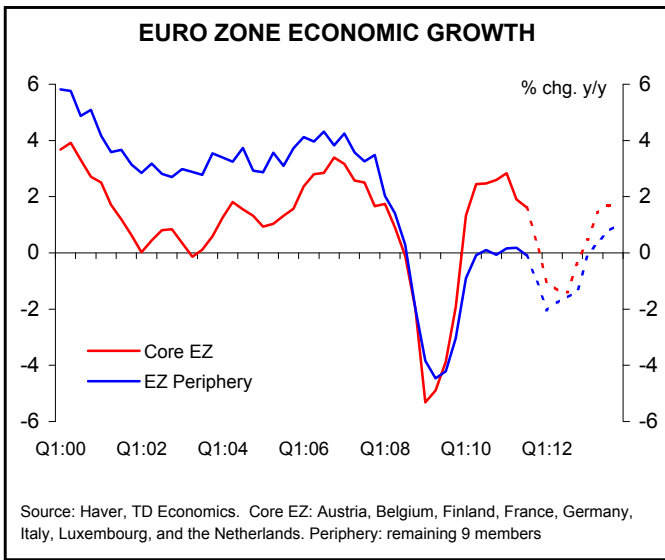
- We have downgraded our 2012 global economic growth forecast to 2.5%, which represents a 0.7 percentage points decline relative to the September forecast
- A renewed recession in the euro zone and slower emerging market growth are the main drivers of this downgrade
- Our main working assumption is that Greece will very likely default within the next six months. European leaders and the European Central Bank will be forced to act extraordinarily to avert a full scale banking crisis and the potential default of other sovereigns.
- The global outlook remains clouded with significant downside risks. The continued escalation of the crisis leaves very little room for manoeuvre, as time for the implementation of bold policies runs out.

The outlook for global economic growth has deteriorated materially in recent months. A renewed recession in the euro zone and slower emerging market growth has caused us to downgrade global growth by 0.7 percentage points relative to the September forecast. Global growth is expected to be 2.5% in 2012, before rebounding to 3.3% in 2013 (compared to 3.2% and 3.4%, respectively, in September). This is equivalent to the global economy stalling next year.

The European sovereign debt crisis remains the dominant risk to the global outlook. If European leaders and the ECB do not act effectively to contain it, the crisis could very well unleash a financial chain reaction that would rapidly spread globally. The final outcome could be as bad, if not worse, than late-2008. To be clear, we are heading for this outcome unless euro-zone leaders change their current approach and their resistance to bold decisive action.

The TD Economics base case forecast is for European financial conditions to deteriorate until a point where Germany and the ECB accept that the central bank must engage in unorthodox, large-scale government bond purchases. Ultimately, some form of mutualization of euro zone sovereign debt will have to take place. The latter action will necessitate further progress politically towards a fiscal union. The [European Union summit](#) last





week presents a vivid example of how difficult it will be for European leaders to manage this process. It appears that European policymakers require staring into a financial abyss before they can introduce and implement the needed policy actions.

Europe: Deepening financial crisis will thrust the euro zone into recession

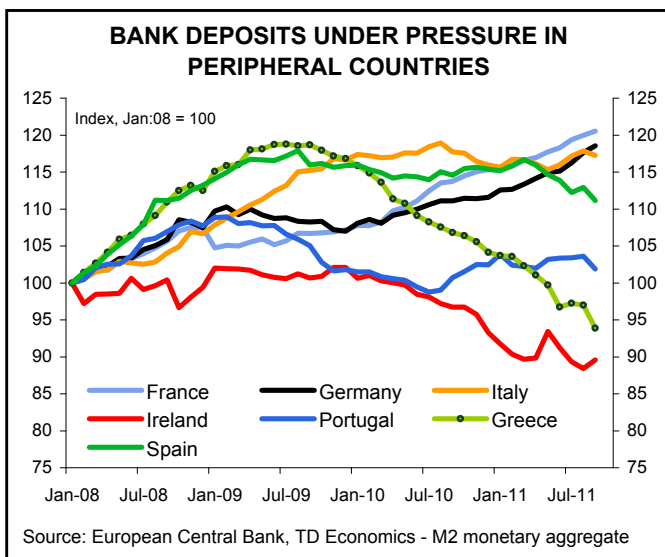
Our working assumption is that Greece will very likely default before the end of the first half of next year. Greece faces debt payments of €6.7 billion, €4 billion, and €2.5 billion in December, January and February, respectively; leading up to a major €14.4 billion payment on March 20th. A deepening recession will continue to undermine Greek fiscal tightening efforts, which, in turn, will complicate the disbursement of IMF/EU loans. Furthermore, the second

Greek debt swap has yet to be finalized, and failure to achieve a successful ending to that process could derail the entire second bail-out program.

An outright Greek default would trigger credit default swaps, weakening the global financial system. Under these circumstances, we believe the ECB will ultimately intervene buying sovereign bonds on a major scale, while continuing to provide ample liquidity to European banks. Our assumption is that this will avert a global financial crisis, but we must acknowledge that it is hard to assess the impact of the credit event. The next issue is whether there will be contagion leading other countries to default – like Portugal and Ireland. It may not even require a Greek default to intensify financial duress; sovereign debt downgrades of the main euro zone countries could do the trick.

Our base case expectation is that the policy response defuses the situation and contagion pressures abate. Even under this admittedly optimistic scenario, real economic activity will suffer dearly across the euro zone.

The deleveraging process that is taking place across the European banking system, combined with the banking funding squeeze, and the decline in deposits taking place in some of the peripheral euro zone countries will hinder economic growth. In particular, this will take place amidst significant fiscal adjustment. Apart from the recent interest rate cuts from the ECB, there has been no policy action aimed at jump-starting aggregate demand in the short term. The challenge is that when the banking system is shrinking its balance sheet, rate cuts are less effective at stimulating economic activity. In all, we forecast a 1.2% contraction in euro zone GDP in 2012, which compares with the projected

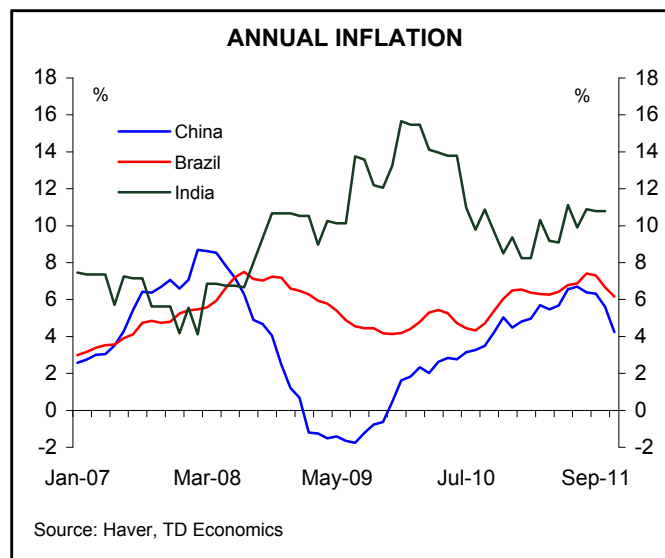


0.9% expansion in our September forecast. In 2013, the euro zone economy should return to growth, but only at a meager pace of 1.3%.

Asia: Downshifting to the tune of Europe

In Japan, real GDP posted a strong rebound during the third quarter on the back of solid fixed investments and net exports. The Japanese recovery should remain on track next year. However, the impact on Japanese exports stemming from the euro zone recession and weaker growth in emerging markets will lead to a slower improvement relative to our September forecast. In line with this, Prime minister Yoshihiko Noda has ordered the preparation of a supplementary budget, worth at least ¥2 trillion, to be enacted by the end of the fiscal year in March. These additional funds are intended to buffer the impact of the European recession, the strong yen, and the Thai floods on the Japanese economy. The yen has appreciated roughly 3% and 12% vis-à-vis the U.S. dollar and the euro, respectively, over the last six months, amidst financial volatility caused by the euro zone crisis. The latest available economic indicators suggest Japanese economic growth will ease during the fourth quarter. Exports lost some momentum in October, and industrial production will suffer during the remainder of the fourth quarter from supply chain disruptions caused by the natural disaster in Thailand. The Japanese economy is projected to contract 0.6% this year and bounce back to 2.2% growth in 2012 (relative to 3.1% in our previous forecast).

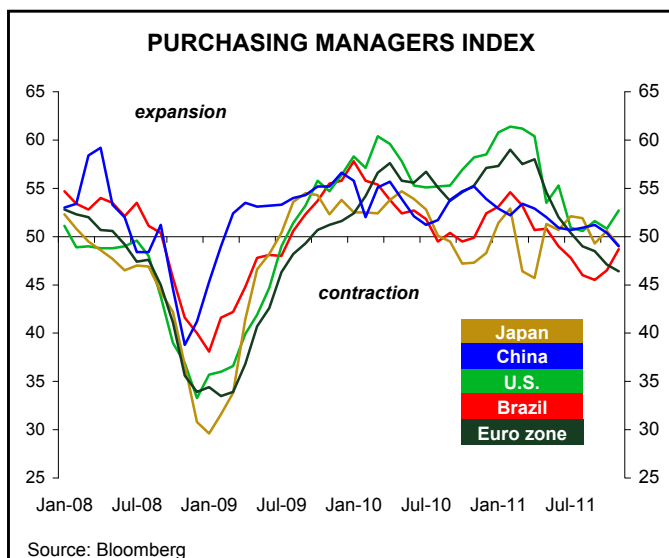
China's economy is also in the process of decelerating. Weaker exports to Europe and the rest of the advanced world will take a toll on Chinese economic growth in 2012. In addition, a deceleration in fixed investments stemming



from the cooling down of the property market will impact construction activity, further contributing to the slowdown in industrial production. The official PMI survey signaled a contraction in manufacturing activity in November, the first time since February 2009. On the positive side, abating inflationary pressures have already prompted the People's Bank of China to relax its monetary policy stance. In early December the central bank cut the required reserve ratio by 50 basis points to 21%, a measure that liberates some 400 billion renminbi (US\$ 63 billion) to be pumped into new credit. If inflation continues to decline – it dropped 1.4 percentage point to 4.2% in November – China's central bank will likely further ease its monetary policy next year. This and other policy initiatives will likely occur if Chinese authorities perceive a faster deceleration in economic growth. In all, we see the Chinese economy expanding 7.8% in 2012, down from 8.2% in our previous forecast. This is a soft landing for China, although the economy comes close to a hard landing that is represented by growth below 7%.

Emerging Markets: Leading EMs will find challenges in managing the downturn

Other emerging markets have also seen some moderation in their rates of expansion. In India, GDP growth dropped from 8.5% y/y in the second quarter to 6.7% y/y during the third quarter. Combined, Europe and China account for roughly 30% of Indian exports. Thus, the deceleration in global growth will make a deeper dent on Indian economic growth in 2012. Furthermore, continued financial stress in Europe will curtail investment inflows into the Asian country. This will occur against a backdrop of resilient

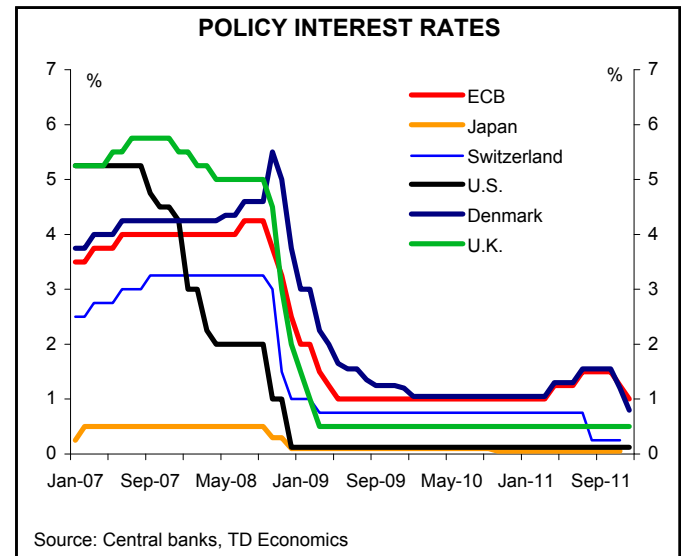


inflationary pressures, which have caused the Reserve Bank of India to keep its policy interest rate at 7.5% thus far. We foresee GDP growth decelerating to 7.0% in 2012 (from 7.6% this year), and edging slightly higher to 7.2% in 2013.

In Brazil, real GDP growth fell one percentage point to 2.2% y/y in the third quarter due to a marked slowdown in domestic demand. Brazilian industrial production has been losing ground in recent months, and in October, it was down 2.7% from the previous year. Inflation has fallen of late, reaching 6.2% in November. This, in combination with the deterioration in the global economic outlook caused the Brazilian central bank to cut interest rates by a full percentage point since September. Worsening global economic conditions have also impacted the Brazilian real, which has depreciated roughly 16% vis-à-vis the U.S. dollar since July. A weaker currency will boost Brazilian exports, but could also limit how much room the central bank will have over the coming months to keep lowering the policy rate. In all, we project Brazilian GDP will decelerate very little (a mere 0.1 percentage points) to 3.3% growth in 2012, and then will regain speed as the world economy accelerates in 2013 and the country ramps up infrastructure investment ahead of the 2014 Soccer World Cup and the 2016 Olympic Games.

North America: Gaining strength, but not immune to Europe's woes

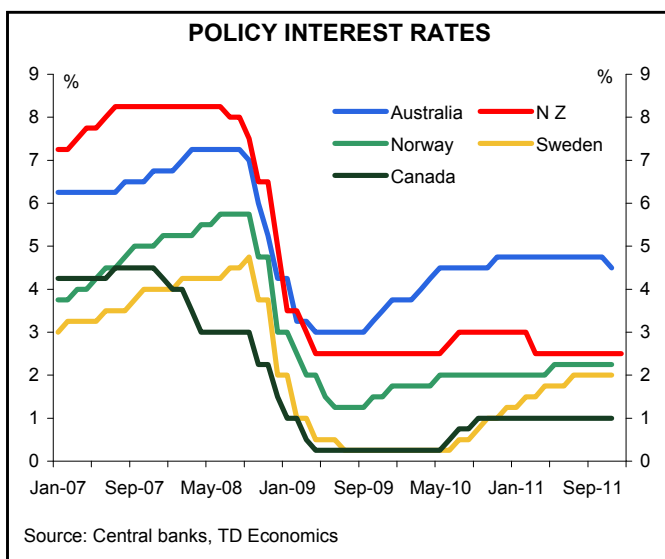
The U.S. economy has shown resilience over the last few months. After a fairly miserable first half of the year, the economy grew by 2.0% in the third quarter and is likely to accelerate to 3.2% growth in the final quarter of the year. Moreover, there are a number of signs that recent momen-



tum could carry into next year: job openings are on the rise and corporate profits relative to GDP are at their highest level in over 60 years. However, the euro zone recession and ongoing financial upheaval will be a major headwind to U.S. economic growth. This, combined with the fiscal drag at both the federal and state and local levels, will likely restrain growth to just below 2.0% in 2012. As a result, the unemployment rate will hover modestly under 9.0%.

We expect economic growth in the U.S. to improve to 2.3% in 2013. By then, the housing market should have absorbed a sizeable share of the overhang of distressed properties and steady job growth will allow for a faster pace of consumer spending. Supported by continued low interest rates, an increase in confidence should underpin business investment. However, the public sector will continue to offer a counterweight as it becomes a more pronounced source of restraint in 2013.

In line with the U.S. economic performance, Canada's economy has gained surprising strength in the second half of the year after stalling in the second quarter. Unfortunately, this momentum is unlikely to have staying power. The European recession will impact Canadian real GDP growth in 2012 through softer trade, lower commodity prices and reduced consumer and business confidence. Meanwhile, record household debt and a slight overvaluation in the housing market have left domestic demand more vulnerable to external shocks. As a result, we expect a notable slowing in domestic spending growth. Overall, we anticipate subdued economic growth of 1.7% for the year as a whole and the unemployment rate to trend up towards a range of 7.5-8%. Canada's economic prospects are expected to brighten



alongside the global economic recovery in 2013, with real GDP advancing by 2.4%. Follow the links for details on our [U.S.](#) and [Canadian](#) forecast.

Risks clearly on the downside

The global balance of risks is tilted to the downside. A unilateral Greek default could prove impossible to manage for European authorities, as it could spread fast across the European banking system. Such an event would have global financial reverberations, which a priori are very difficult to gauge. The ensuing flight to safety out of risk assets would materially impact emerging markets, exacerbating the economic downturn.

On the upside, if European leaders manage to convince financial markets that they are effectively working towards fiscal integration and somehow they also afford to keep supporting Greece despite missing program targets, then the euro zone recession could prove shallower. Under that scenario, the knock on effects on emerging markets would be smaller. In addition, if U.S. policymakers find common ground on fiscal issues and lay out a fiscal plan that addresses the medium term challenges removing undue pressure from the economy in the short term, then the U.S. economy could gather a faster pace of expansion.

Final remarks

The slowing of the global economy and the likely high degree of financial volatility will lead commodity prices to pull back in the coming months. However, so long as a European banking crisis is avoided, we expect the absolute level of commodity prices to remain relatively high. If a

European financial crisis is not avoided, commodities could revisit their 2008 lows.

This outlook augurs for lower inflation across the world. It creates more scope for monetary policy easing in the emerging markets. We anticipate further rate cuts by the ECB and likely another round of quantitative easing by the Federal Reserve.

The bottom line is that we are treading across a minefield. If Europe takes the wrong step, it will set off a global financial crisis. It should be noted that there is virtually no fiscal room across advanced economies to buffer the impact of such an outcome, and monetary policy is largely a spent force. This means the ability of the global economy to ride out of the storm is significantly less than it was in 2008, which is why it is so important that European leaders stop talking and start acting. Even if a European financial crisis is checked, we expect weaker economic conditions to prevail heading into 2012 and through at least the first half of the following year. The dominant financial theme is likely to be heightened volatility.

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GLOBAL ECONOMIC OUTLOOK					
Annual per cent change unless otherwise indicated					
2007 Share*		2010	Forecast		
Real GDP	(%)		2011	2012	2013
World	99.1	4.6	3.2	2.5	3.3
North America	25.5	3.2	2.0	2.1	2.4
United States	21.4	3.0	1.8	1.9	2.3
Canada	2.0	3.2	2.4	1.7	2.2
Mexico	2.1	5.5	4.0	3.8	4.1
European Union (EU-27)	23.7	1.9	1.6	-1.1	1.4
Euro-zone (EU-16)	16.1	1.8	1.4	-1.2	1.3
Germany	4.4	3.6	2.9	-0.8	1.5
France	3.2	1.4	1.5	-1.2	1.4
Italy	2.8	1.2	0.4	-1.3	1.2
United Kingdom	3.3	1.5	1.0	-1.0	1.4
EU accession members	3.4	2.6	2.9	-0.7	1.7
Asia	35.5	7.4	5.2	5.2	5.3
Japan	6.6	4.5	-0.6	2.2	1.9
Asian NIC's	3.7	8.3	4.3	4.2	4.3
Hong Kong	0.5	6.5	5.0	4.5	4.4
Korea	1.9	6.1	3.6	4.0	4.2
Singapore	0.3	13.9	5.5	4.3	4.2
Taiwan	1.1	11.0	4.7	4.5	4.4
Russia	3.2	4.0	3.7	3.8	4.2
Australia & New Zealand	1.4	2.7	2.0	3.4	3.5
Developing Asia	20.6	9.0	7.7	6.7	6.9
ASEAN-4	3.1	6.9	4.7	4.5	4.9
China	10.9	10.3	9.1	7.8	8.0
India	4.6	8.7	7.6	7.0	7.2
Central/South America	6.1	5.6	4.0	3.5	3.9
Argentina	0.8	8.1	7.8	4.8	3.9
Brazil	2.8	7.5	3.4	3.3	4.3
Other Developing	8.4	4.3	2.7	2.6	2.5

*Regional wts. do not sum to 100% because some countries omitted
Forecast as at December 2011
Source: International Monetary Fund, national statistics agencies

ECONOMIC INDICATORS FOR THE G-7 AND EUROPE				
	2010	Forecast		
		2011	2012	2013
Real GDP (Annual per cent change)				
G-7 (41.17%)*	3.0	1.4	1.0	1.9
U.S.	3.0	1.8	1.9	2.3
Japan	4.5	-0.6	2.2	1.9
EU-17	1.8	1.4	-1.2	1.3
Germany	3.6	2.9	-0.8	1.5
France	1.4	1.5	-1.2	1.4
Italy	1.2	0.4	-1.3	1.2
United Kingdom	1.5	1.0	-1.0	1.4
Canada	3.2	2.4	1.7	2.2
Consumer Price Index (Annual per cent change)				
G-7	1.4	2.5	1.7	1.5
U.S.	1.7	3.2	1.7	1.7
Japan	-0.7	-0.2	0.2	0.3
EU-17	1.6	2.7	2.4	1.8
Germany	1.2	2.5	2.3	1.7
France	1.7	2.2	2.1	1.8
Italy	1.6	2.8	2.4	1.6
United Kingdom	3.3	4.5	2.7	1.5
Canada	1.8	2.9	1.7	1.8
Unemployment Rate (Per cent annual averages)				
U.S.	9.6	9.0	8.8	8.6
Japan	5.1	4.6	4.4	4.4
EU-17	10.1	10.0	10.3	10.4
Germany	7.1	6.0	6.3	6.7
France	9.8	9.8	10.1	9.8
Italy	8.4	8.2	8.8	9.0
United Kingdom	7.8	8.1	8.7	8.5
Canada	8.0	7.4	7.6	7.4

*Share of 2007 world gross domestic product (GDP)
Forecast as at December 2011
Source: National statistics agencies, TD Economics

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