QUARTERLY ECONOMIC FORECAST

TD Economics

September 21, 2015

U.S. ECONOMIC OUTLOOK: GLOBAL HEADWINDS WILL NOT BLOW GROWTH OFF COURSE

Highlights

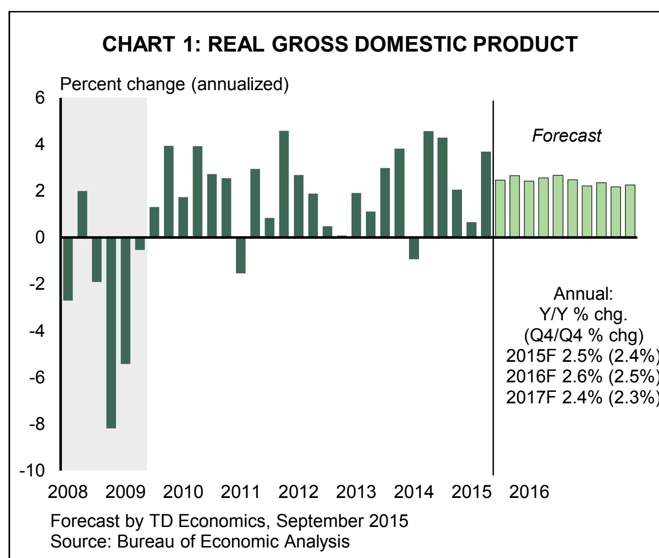
- Global headwinds have increased speed since our last Quarterly Economic Forecast in June. Slowing growth in China and concern over policymaker's management of its economy have led to tighter financial conditions and weaker global growth.
- Domestic oriented segments of the American economy continue to make strides. Housing and consumer spending activity have accelerated. With lower gasoline prices leaving even more cash in consumers' pockets, this is likely to continue.
- Strengthening domestic demand, weaker global demand, and a higher dollar mean that America will export less to the rest of the world and import more. This will weigh on real GDP growth, even as it helps to pull the rest of the world out of its funk.
- We expect the American economy to grow in a narrow range of 2.4% to 2.6% between 2015 and 2017. Over that period, the unemployment rate is expected to dip to 4.8% and the Fed is likely to engage in a gradual tightening cycle that will see the fed funds rate rise by roughly 75 basis points in 2016, and the same amount in 2017.

It has been a volatile summer in global financial markets. Concerns over economic growth in China and other emerging markets have led to sell offs across equity markets and driven up the value of the dollar, especially against emerging market currencies.

Developments on the global front represent the main changes to the U.S. economic outlook since our previous forecast in June. Slower global growth, a higher dollar and tighter financial conditions will weigh more heavily on U.S. economic activity than previously anticipated. While there are some offsetting factors – for example, lower oil and gasoline prices will leave more money in consumers' pockets – these are outweighed by the external influences.

Changes to the economic outlook also reflect revisions to the historical record. The economy performed better in the first half of the year than initially reported. In the second quarter, the economy grew by an impressive 3.7%, bringing the average growth rate for the first half to 2.2%, on par with the average pace over the course of the recovery. Better than anticipated growth in the first half of the year makes up for a slower growth trajectory in the second half. The downgrade to the growth outlook for the remainder of 2015 is due mainly to a slower pace of inventory accumulation following a significant build up in the second quarter.

All told, we expect the American economy to grow in a narrow range of 2.4% to 2.6% between 2015 and 2017. Over that period,



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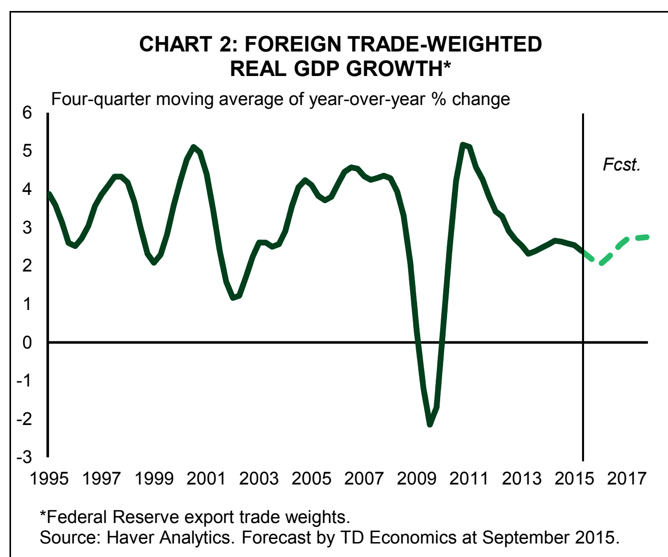
the unemployment rate is expected to dip to 4.8% and the Fed is likely to engage in a gradual tightening cycle that will see the fed funds rate rise by roughly 75 basis points in 2016 and again in 2017. This will keep the fed funds rate at a simulative setting of just 1.75%, well below the Federal Reserve long run expectation of 3.50%.

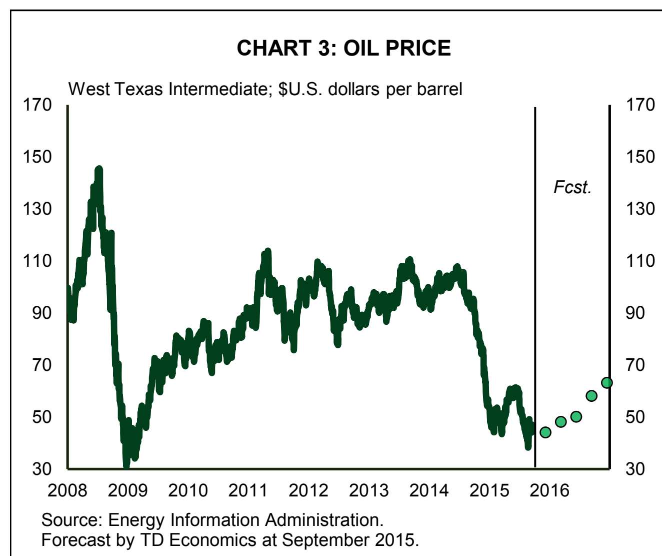
Global headwinds blowing harder

As our international forecast explains, the economic outlook in the rest of the world has deteriorated, especially in emerging markets and commodity-producing countries. China is a big part of the story. A collapsing stock market and a surprise move by central authorities to devalue the renminbi (in order to bring it closer in line with market forces) sent shock waves through financial markets in August.

The bigger question for China is how well policymakers can transition the economy away from debt-fueled investment growth to more sustainable consumer-driven demand. This comes at a time when structural challenges are also building – slowing productivity and an aging labor force mean a slower rate of trend economic growth. Unfortunately, recent policy blunders have cast doubt on the assumption that this will be a smooth transition.

China's economic slowdown may not in itself pose a major downside risk to U.S. economic growth. China accounts for just 10% of U.S. exports, but 23% of U.S. imports. The direct effect of the slowdown in China and depreciation in its currency is likely to be a relatively small widening in the trade deficit between the two countries. The bigger impact of China's slowdown is its effect on growth in the rest of the world and on the price of commodities.



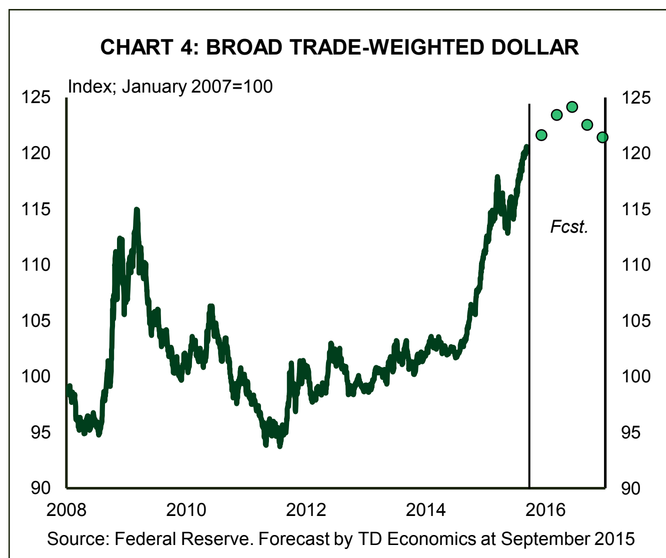


The fall in oil prices has a negative effect on two of America's closest trading partners – Canada and Mexico. Together these two countries make up over 35% of U.S. exports (and 25% of imports). Canada's economy experienced a technical recession in the first half of 2015 and is likely to rebound only modestly over the remainder of the year. Mexico has performed better, but the fall in oil price weakens government finances and will also weigh on future economic growth. In the case of both Canada and Mexico, much of the expected improvement in real GDP growth over the next two years comes from exports, as the countries benefit from their depreciating currencies and stronger U.S. demand.

All told, relative to June we have brought down our expectations for trade-weighted foreign GDP growth by 0.3 percentage points annually in 2015 and 2016.

Dollar picks up steam against developing economy currencies

The other development on the external front is the magnitude of the rise in the dollar. Up until recently, the dollar's rise had been more prominent against major advanced trading partners. Between the start of 2014 and the end of the second quarter of this year, the dollar had risen 19% against major trading partners (Euro Area, Canada, Japan, United Kingdom, Switzerland, Australia), but rose less than 10% against other trading partners in the developing world (the biggest being Mexico and China). This changed in August when the dollar lost ground against advanced currencies, but rose appreciably against those in developing economies. As a result, the trade-weighted dollar is poised to end the third quarter up almost 5% since the end of the second quarter.



The continued rise in the dollar will accentuate the difficult environment facing U.S. exporters. However, the more recent appreciation against developing economies also means a larger disinflationary impulse going forward. Due to the fact that America imports more from developing economies than it exports, there is a greater negative impact on consumer prices from an appreciation against developing market currencies relative to those in advanced economies. The good news is that while this is likely to imply greater import growth, this is at least partially offset by greater gains in consumer purchasing power.

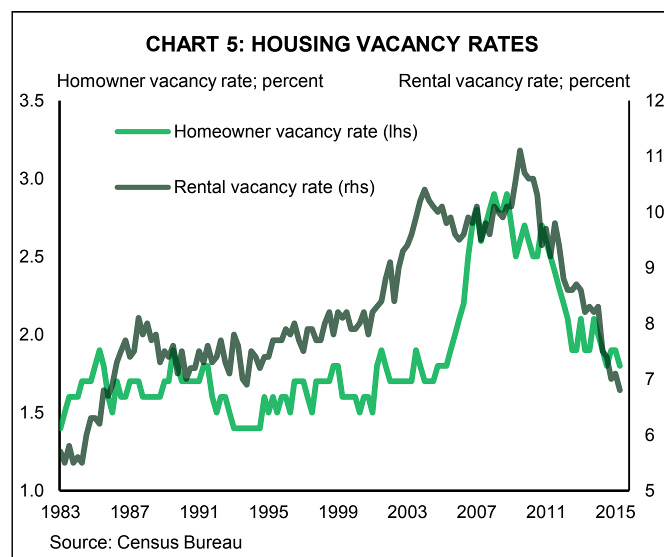
All told, we expect net exports to subtract 0.6 percentage points from economic growth in both 2015 and 2016. For 2016, this impact is 0.3 percentage points higher than previously anticipated. As global growth improves and the dollar gives up some of its gains, the drag from net exports is expected to narrow to 0.4 percentage points in 2017.

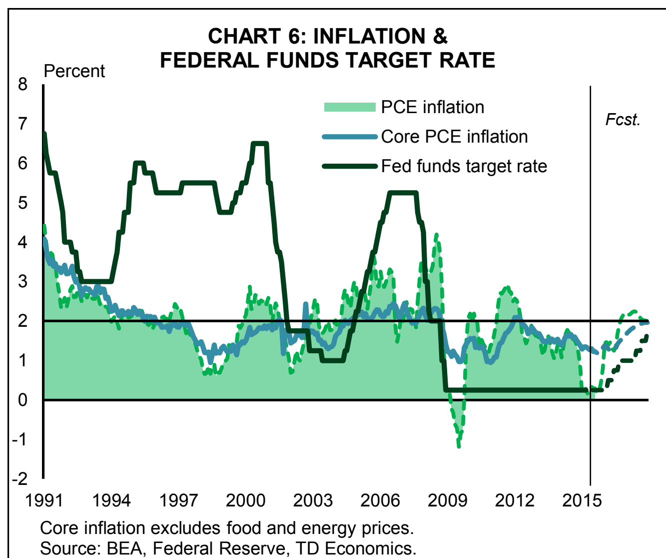
Domestic demand fundamentals remain strong

These disinflationary forces will deliver some offsetting benefits to the U.S. economy. As a result of the higher dollar and second leg down in energy prices, we have lifted our expectation for real consumer spending growth. Whereas in June, the average household was set to save $700 at the gas pumps relative to last year, they will now save over $900. As there is a lag between when the savings occur and when they show up in spending, the largest upside to spending will take place over the course of 2016. This boost to spending is set to occur alongside further improvements in job creation and wage growth. Putting it all together, we expect real consumer spending growth to accelerate to 3.3% in 2016, up from 3.1% in 2015.

Consumer spending will not be the only part of the domestic economy to add to growth. The housing market has also shown signs of heating up, with existing home sales continuing to break through new post-recession highs. Perhaps even more encouraging, household formation is trending strongly upward. According to the Census Bureau, there were over 1.5 million households created between the second quarter of this year and the same quarter a year ago – the strongest growth since 2006. So far, all of these households have been renters. The homeownership rate continued to decline in the quarter. Still, the rise in the propensity of people to form independent households is a firm step in the right direction. Construction continues to run behind the rate of household formation, especially within the rental segment, where the vacancy rate has fallen to a 30 year low. This gap should begin to close through the forecast. We expect housing starts to steadily rise through the forecast period, reaching 1.5 million by the end of 2017 – roughly in line with underlying household formation and depreciation.

Finally, with the continued improvement in the labor market and housing market, the outlook for state and local governments is also looking better. There has already been evidence of this over the last several months. State and local governments have added an average of 26k jobs to U.S. payrolls over the last three months ending in August – the fastest pace in seven years. While austerity is unlikely to turn into largesse and overall government spending will continue to underperform the rest of the economy, it is still expected to contribute modestly to annual economic growth – adding an average of 0.2 percentage points over the forecast





Core inflation excludes food and energy prices.
Source: BEA, Federal Reserve, TD Economics.

horizon. Relative to the net drag of 0.3 percentage points that it has averaged since the recession ended in 2009, this is a welcomed change.

A maturing economic recovery

Another increasingly important factor for the outlook relates to the economy's potential to expand. As the level of economic slack diminishes, so too does the capacity for the economy to outgrow its structural rate, which we estimate at around 2.0%.

The maturing economic recovery is evident in the labor market, where the measured unemployment rate at 5.1% is approaching estimates of its long run structural rate. In normal circumstances, unemployment hitting the structural rate would imply that there was no longer any excess slack left in the labor market. In all likelihood, "shadow" slack still remains in the form of discouraged workers that are currently considered outside of the labor force. And, the lack of significant wage pressures suggests that the unemployment rate can continue to drift lower.

The tighter labor market is likely to draw more workers into it, pushing up the participation rate amongst core working-age people and offsetting the exit of older workers. At the same time, faster labor force growth will limit further downside to the unemployment rate and allow job growth to run above its longer run trend. This is the impetus to maintaining economic growth above 2.0% through the forecast. Nonetheless,as the economy gets closer to full employment, job growth will slow. From its current pace over 200k a month, we expect job growth to slow to 120k a month by the fourth quarter of 2017.

Rate hikes are not far away

In the meeting that everyone had been waiting for, the Federal Reserve left its policy rate on hold. The decision was not an easy one. One the one hand, the improvement in the unemployment rate and broader economy argued for a hike, but on the other, limited inflation and tightening financial conditions supported the decision to wait. We expect the balance to continue to shift toward rate hikes. As we have outlined, the domestic economy has the strength to withstand the external headwinds to growth. With continued job growth and labor market tightening, wages will pick up and inflation will follow. While the pace of tightening will be gradual and the end point is likely to be much lower than it has been historically, the process is likely to begin before long. As Janet Yellen has commented, further improvement in the labor market will serve to bolster the Fed's confidence that inflation will return to its 2% target.

Bottom line

The economic outlook has developed broadly in line with the themes laid out in previous forecasts. While external headwinds are blowing stronger than previously, domestic fundamentals remain strong. This will be sufficient to keep U.S. growth above its trend rate and further absorb remaining labor market slack. As the labor market tightens further, inflation will begin to move up. This is all the Fed will need to see to begin a gradual rate hiking cycle.

U.S. ECONOMIC OUTLOOK:

Period-Over-Period Annualized Per Cent Change Unless Otherwise Indicated

	2015				2016				2017				Annual Average			4th Qtr/4th Qtr		
	Q1	Q2	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	15F	16F	17F	15F	16F	17F
Real GDP	0.6	3.7	2.5	2.7	2.4	2.6	2.7	2.5	2.2	2.4	2.2	2.3	2.5	2.6	2.4	2.4	2.5	2.3
Consumer Expenditure	1.7	3.1	3.2	3.1	3.3	3.5	3.2	2.8	2.3	2.5	2.3	2.2	3.1	3.3	2.7	2.8	3.2	2.4
Durable Goods	2.0	8.2	7.0	4.1	6.6	7.3	6.5	5.6	4.3	4.2	3.8	3.7	6.1	6.3	4.9	5.3	6.5	4.0
Non-Res. Fixed Investment	1.6	3.2	4.8	3.9	3.6	4.8	5.2	4.5	4.0	3.6	3.1	2.7	3.3	4.3	4.0	3.4	4.5	3.3
Non-Res. Structures	-7.4	3.2	0.4	1.8	2.1	3.5	4.2	4.0	4.5	4.0	3.8	3.3	-0.6	2.5	4.0	-0.6	3.4	3.9
Equipment & IPP*	4.3	3.1	6.1	4.5	4.0	5.1	5.4	4.7	3.8	3.6	2.8	2.5	4.5	4.7	4.0	4.5	4.8	3.2
Residential Construction	10.1	7.8	8.8	12.5	12.7	12.3	12.7	12.3	9.6	8.1	6.6	4.7	8.8	11.8	9.6	9.8	12.5	7.2
Govt. Consumption & Gross Investment	-0.1	2.6	2.3	1.8	1.5	1.6	1.5	1.1	1.1	1.2	1.1	0.9	0.9	1.7	1.2	1.7	1.4	1.1
Final Domestic Demand	1.7	3.2	3.4	3.3	3.4	3.7	3.5	3.1	2.6	2.7	2.4	2.2	2.9	3.4	2.8	2.9	3.4	2.4
Exports	-6.0	5.2	2.3	2.8	1.9	2.9	4.0	4.4	5.6	5.3	5.0	6.0	1.7	2.9	4.9	1.0	3.3	5.5
Imports	7.1	2.8	1.0	6.1	7.4	9.1	8.6	7.6	6.6	5.9	5.0	4.4	5.1	6.5	6.7	4.2	8.2	5.5
Change in Private Inventories	112.8	121.1	74.7	69.0	63.2	55.9	51.3	48.5	44.0	39.1	35.1	34.0	94.4	54.7	38.1	---	---	---
Final Sales	-0.2	3.5	3.7	2.8	2.6	2.8	2.8	2.6	2.3	2.5	2.3	2.3	2.4	2.9	2.5	2.4	2.7	2.3
International Current Account Balance ($Bn)	-454	-414	-400	-407	-443	-496	-556	-620	-679	-723	-757	-774	-419	-529	-733	---	---	---
% of GDP	-2.6	-2.3	-2.2	-2.2	-2.4	-2.7	-2.9	-3.2	-3.5	-3.7	-3.8	-3.9	-2.3	-2.8	-3.7	---	---	---
Pre-tax Corporate Profits including IVA&CCA	-21.1	9.8	-1.3	-1.0	0.3	0.9	2.1	2.4	2.7	3.6	3.5	3.5	-1.4	0.9	2.8	-4.1	1.4	3.3
% of GDP	11.4	11.5	11.3	11.2	11.1	11.0	10.9	10.8	10.8	10.8	10.8	10.7	11.4	11.0	10.8	---	---	---
GDP Deflator (Y/Y)	1.0	1.0	1.0	1.3	1.9	1.9	2.0	2.2	2.1	2.1	2.0	2.0	1.1	2.0	2.1	1.3	2.2	2.0
Nominal GDP	0.8	5.9	4.4	4.0	4.7	4.6	5.1	4.7	4.2	4.4	4.2	4.3	3.6	4.6	4.5	3.7	4.8	4.3
Labor Force	2.0	0.4	-0.2	1.0	1.1	1.2	1.1	1.1	1.1	1.1	1.0	0.9	0.8	0.9	1.1	0.8	1.1	1.0
Employment	2.2	1.7	2.0	1.7	1.5	1.6	1.4	1.3	1.2	1.1	1.1	1.0	2.1	1.6	1.2	1.9	1.5	1.1
Change in Empl. ('000s)	778	610	717	595	542	556	516	482	437	408	384	359	2,951	2,294	1,784	2,700	2,095	1,588
Unemployment Rate (%)	5.6	5.4	5.2	5.1	5.0	4.9	4.8	4.8	4.8	4.8	4.8	4.8	5.3	4.9	4.8	---	---	---
Personal Disp. Income	1.9	3.5	4.2	4.1	4.3	4.3	4.8	4.3	3.9	4.2	4.1	4.2	3.5	4.3	4.2	3.4	4.4	4.1
Pers. Saving Rate (%)	5.2	4.8	4.7	4.9	4.6	4.4	4.1	3.9	3.8	3.7	3.7	3.6	4.9	4.3	3.7	---	---	---
Cons. Price Index (Y/Y)	-0.1	0.0	0.1	0.4	1.8	1.7	2.2	3.0	2.9	2.9	2.5	2.3	0.1	2.2	2.7	0.4	3.0	2.3
Core CPI (Y/Y)	1.7	1.8	1.8	1.8	1.8	1.6	1.8	1.9	2.1	2.2	2.3	2.3	1.8	1.8	2.2	1.8	1.9	2.3
Core PCE price index (Y/Y)	1.3	1.3	1.2	1.2	1.3	1.3	1.4	1.6	1.7	1.9	1.9	2.0	1.3	1.4	1.9	1.2	1.6	2.0
Housing Starts (mns)	0.98	1.16	1.18	1.21	1.25	1.31	1.37	1.42	1.45	1.49	1.52	1.53	1.13	1.34	1.50	---	---	---
Real Output per hour (y/y)**	0.6	0.7	0.2	1.0	1.5	1.0	1.1	1.1	1.2	1.4	1.4	1.6	0.6	1.2	1.4	1.0	1.1	1.6

*Intellectual proprty products. **Non-farm business sector. F: Forecast by TD Economics, September 2015

Source: U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, TD Economics

INTEREST RATE OUTLOOK

	2015				2016				2017			
	Q1	Q2	Q3*	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Fed Funds Target Rate (%)	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.00	1.00	1.25	1.50	1.75
3-mth T-Bill Rate (%)	0.03	0.01	-0.02	0.20	0.40	0.65	0.80	0.85	0.90	1.10	1.35	1.60
2-yr Govt. Bond Yield (%)	0.56	0.64	0.67	0.85	1.05	1.35	1.50	1.60	1.70	1.85	2.05	2.30
5-yr Govt. Bond Yield (%)	1.37	1.63	1.44	1.60	1.75	2.00	2.15	2.25	2.35	2.45	2.60	2.85
10-yr Govt. Bond Yield (%)	1.94	2.35	2.13	2.30	2.45	2.60	2.70	2.75	2.80	2.85	2.95	3.10
30-yr Govt. Bond Yield (%)	2.93	2.93	3.11	3.15	3.20	3.30	3.40	3.45	3.50	3.55	3.65	3.65
10-yr-2-yr Govt. Spread (%)	1.38	1.71	1.46	1.45	1.40	1.25	1.20	1.15	1.10	1.00	0.90	0.80

F: Forecast by TD Economics, September 2015; All forecasts are for end of period; Source: Bloomberg, TD Economics.
*Spot rate on September 18th, 2015

FOREIGN EXCHANGE OUTLOOK

Currency	Exchange Rate	2015				2016				2017			
		Q1	Q2	Q3*	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Canadian dollar	CAD per USD	1.27	1.25	1.32	1.33	1.37	1.37	1.35	1.33	1.28	1.25	1.20	1.20
Japanese yen	JPY per USD	120	122	120	124	130	132	127	124	122	120	120	120
Euro	USD per EUR	1.07	1.12	1.13	1.16	1.10	1.06	1.10	1.12	1.15	1.15	1.20	1.20
U.K. pound	USD per GBP	1.49	1.57	1.55	1.53	1.57	1.58	1.67	1.60	1.62	1.64	1.77	1.74
Swiss franc	CHF per USD	0.97	0.94	0.97	0.95	0.96	0.98	0.96	0.95	0.94	0.94	0.95	0.95
Australian dollar	USD per AUD	0.76	0.77	0.72	0.68	0.68	0.67	0.67	0.69	0.70	0.70	0.74	0.76
NZ dollar	USD per NZD	0.75	0.68	0.64	0.62	0.62	0.61	0.59	0.59	0.58	0.58	0.60	0.61

F: Forecast by TD Economics, September 2015; All forecasts are for end of period; Source: Federal Reserve, Bloomberg, TD Economics.
*Spot rate on September 18th, 2015

GLOBAL ECONOMIC OUTLOOK					
Annual per cent change unless otherwise indicated					
	2014 Share*		Forecast		
Real GDP	(%)	2014	2015	2016	2017
World	99.9	3.4	3.1	3.4	3.5
North America	19.6	2.4	2.4	2.6	2.4
United States	16.1	2.4	2.5	2.6	2.4
Canada	1.5	2.4	1.2	2.0	1.9
Mexico	2.0	2.1	2.3	3.0	3.5
European Union (EU-28)	17.2	1.5	1.9	2.1	2.0
Euro-zone (EU-17)	12.1	0.9	1.6	1.8	1.7
Germany	3.4	1.6	1.6	1.9	1.7
France	2.4	0.4	1.1	1.6	1.6
Italy	2.0	-0.4	0.8	1.3	1.2
United Kingdom	2.4	3.0	2.5	2.4	2.1
EU accession members	2.7	2.6	2.9	2.8	2.9
Asia	41.8	5.2	4.6	4.8	4.9
Japan	4.4	-0.1	0.7	1.1	0.4
Asian NIC's	3.4	3.3	2.0	2.4	2.6
Hong Kong	0.4	2.5	2.4	2.4	2.5
Korea	1.6	3.3	2.4	2.7	3.0
Singapore	0.4	2.9	2.1	2.0	2.0
Taiwan	1.0	3.7	1.2	2.0	2.1
Russia	3.3	0.6	-3.8	-0.3	1.5
Australia & New Zealand	1.2	2.8	2.3	2.7	2.9
Developing Asia	29.5	6.8	6.6	6.3	6.3
ASEAN-4	4.7	4.5	4.4	4.6	4.8
China	16.3	7.3	6.8	6.2	5.9
India**	6.8	7.3	7.6	7.9	8.2
Central/South America	6.7	1.1	-0.5	1.0	2.1
Brazil	3.0	0.1	-2.5	-0.3	1.2
Other Developing	13.6	3.2	2.8	3.3	3.5
Other Advanced	1.0	2.2	1.6	1.8	1.8

*Share of world GDP on a purchasing-power-parity basis.
Forecast as at September 2015. **Forecast for India refers to FY.
Source: IMF, TD Economics.

ECONOMIC INDICATORS FOR THE G-7 AND EUROPE				
		Forecast		
	2014	2015	2016	2017
Real GDP (Annual per cent change)				
G-7 (32.7%)*	1.7	1.9	2.1	1.9
U.S.	2.4	2.5	2.6	2.4
Japan	-0.1	0.7	1.1	0.4
EZ	0.9	1.6	1.8	1.7
Germany	1.6	1.6	1.9	1.7
France	0.2	1.1	1.6	1.6
Italy	-0.4	0.8	1.3	1.2
United Kingdom	3.0	2.5	2.4	2.1
Canada	2.4	1.2	2.0	1.9
Consumer Price Index (Annual per cent change)				
G-7	1.5	0.3	1.7	2.2
U.S.	1.6	0.1	2.2	2.7
Japan	2.7	0.6	0.5	1.8
EZ	0.4	0.2	1.5	1.5
Germany	0.8	0.3	1.6	1.5
France	0.6	0.2	1.6	1.5
Italy	0.2	0.3	1.4	1.2
United Kingdom	1.5	0.1	1.8	2.1
Canada	1.9	1.0	1.9	2.1
Unemployment Rate (Per cent annual averages)				
U.S.	6.2	5.3	4.9	4.8
Japan	3.6	3.4	3.2	3.2
EZ	11.6	11.0	10.7	10.6
Germany	5.0	4.7	4.5	4.4
France	10.3	10.3	10.2	10.0
Italy	12.7	12.3	11.9	11.7
United Kingdom	6.2	5.5	5.4	5.3
Canada	6.9	6.9	6.9	6.7

*Share of 2014 world gross domestic product (GDP)
Forecast as at September 2015
Source: National statistics agencies, TD Economics

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