



February 25, 2011

## HIGHLIGHTS

- Monday's release of Canadian real GDP is expected to show a solid advance of 3.0-3.5% in the final quarter of 2010, significantly stronger than the 2.3% TD Economics expected in December.
- The stronger-than-expected performance was largely driven by a 7.0 percentage point contribution from net trade, as exports advanced close to a stunning 30% annualized in the quarter. Moreover, a solid pace of retail spending in the quarter indicates that consumer spending is on track for a repeat performance of the prior quarter's gain.
- The momentum is expected to carry into the first half of 2011 with signs that the near-term economic prospects for the Canadian economy have improved.
- TD Economics now expects real GDP to grow at a moderately stronger pace than that expected in December.
- The upgrade to the near-term outlook is not expected to change the future path of Bank of Canada interest rate hikes as a number of factors argue for a slow-go approach to tightening monetary policy. Nonetheless, it does raise the risk that the Bank of Canada moves earlier or more aggressively.

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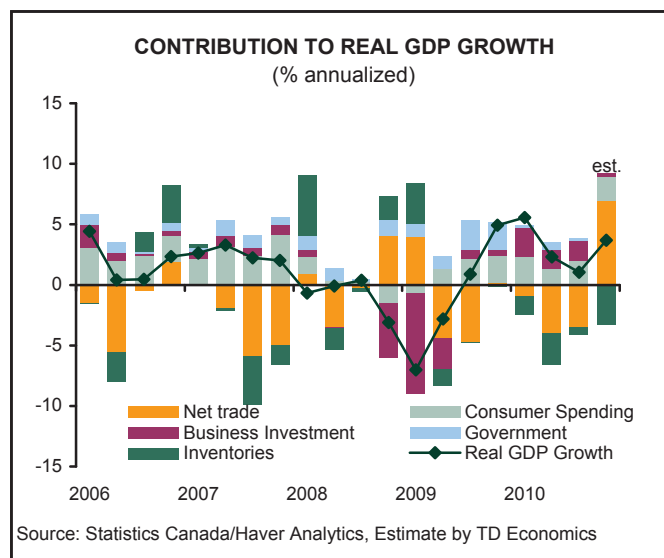
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## A LOOK AHEAD TO NEXT WEEK'S CANADIAN NATIONAL ACCOUNTS RELEASE

This week's retail sales report for December represented the last major bit of information ahead of this coming Monday's release of National Economic Accounts for the fourth quarter. Despite the disappointing 0.4% decline in real retail spending recorded in the final month of the year, the economy is estimated to have churned out a solid real GDP gain of 3.0-3.5% in the October-December period. This late-year rebound in economic growth from the average rate of about 1.5% in the prior two quarters leaves us more optimistic about the economy's likely growth path over the next few quarters.

### Net trade drives economic growth in Q4

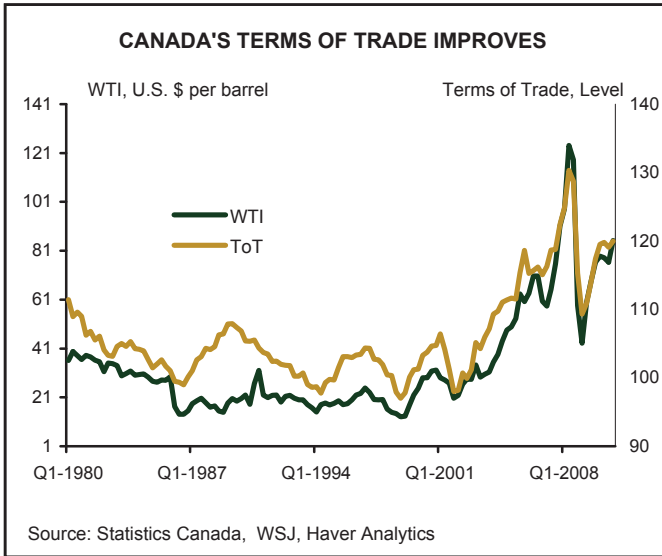
Underlying this respectable overall performance, a number of interesting shifts appear to have taken shape in the fourth quarter. Running through the key components of GDP on an expenditure basis, the overwhelming driver of growth late in the year was exports, which surged by a stunning rate of close to 30% annualized on a quarter/quarter basis. Much of this export strength was linked to robust U.S. and international demand for Canada's commodities rather than in Canada's traditional manufactured goods, such as autos and machinery and equipment. Nonetheless, this export surge, together with



Source: Statistics Canada/Haver Analytics, Estimate by TD Economics

a small pull-back in imports, left the real GDP contribution from net trade at a massive 7.0 percentage points – the largest contribution from net trade since the mid-1990s. Interestingly, monthly data released on both wholesale and manufacturing inventories suggest that the surge in international demand was largely unanticipated. Accordingly, the demand was likely accompanied by a draw down in inventories rather than being serviced by new production. The inventory drag is in sharp contrast to the prior few quarters, when inventory accumulation provided a major boost to growth.

Domestically, the picture was considerably more mixed. The evidence suggests that the Canadian household continued to pull its weight in the fourth quarter, with consumer spending on track for a continued firm pace of growth in the fourth quarter. Despite the drop in retail sales in December, real retail spending was still up 5.2% in the fourth quarter as a whole, matching the prior quarter's gain. Note that retail



spending is only half the story of personal consumption expenditures— while the other half comes from spending on services. On that front, there is very little evidence that service spending was unduly weak in the quarter. For one, Canadian resale home sales bounced back from three quarters of declines in the fourth quarter, suggesting an uptick in demand for services like real estate agents, legal services, and financial services. Overall, consumer spending growth is tracking between 3.0-3.5%. While much of this spending was financed through higher personal disposable income (up an estimated 5% in Q4), part was undoubtedly debt financed. As such, the household debt-to-income ratio probably rose even higher from the last reported estimate of 148%.

On the flip side, weakness in business investment and government expenditures exerted an offsetting drag, leaving real domestic demand at a lackluster estimated rate of about 1%. An expected relatively flat performance in business investment spending was not particularly surprising since it followed an explosion in the first three quarters of the year. With much of Canadian business capital goods imported, the tapering off of spending provides a key explanation for why imports were weak. On the government side, we anticipate that spending fell back moderately in the fourth quarter, providing the first real indication that fiscal stimulus has begun to run its course.

With exports throwing the economy a lifeline in Q4, the overall growth rate returned to a more “normal” pace following the major wild ride since the economy began to recover in mid-2009. Interestingly, our real GDP growth estimate of 3.0-3.5% appears at odds with the picture painted by the monthly GDP at basic prices. The tracking for monthly GDP is pointing to more subdued growth of closer to 2.0%.

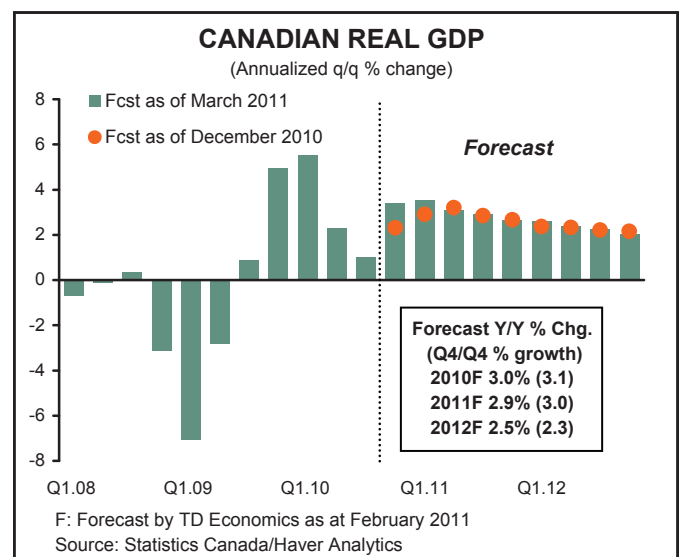
Given continuous revisions to the data, and methodological differences between the two measures, the tracking for monthly GDP can miss the mark for real GDP growth by up to 1.5 percentage points, particularly during periods when net trade contributes strongly to economic growth.

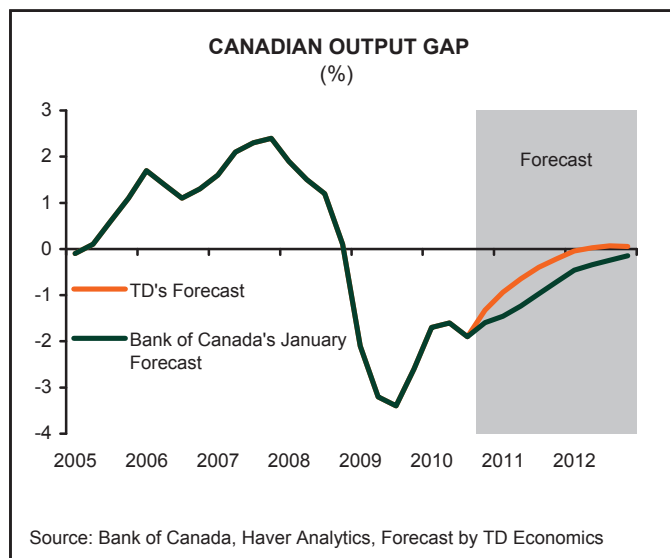
A final point on Q4 is that with commodity prices rising and Canada’s terms of trade improving, the income picture was even brighter than we had anticipated. By our estimate, nominal GDP probably rose at around 8%, which is considerably faster than the longer-term cruising speed of 4.5%. This had positive implication for corporate profits, which leading indicators suggest rose by a whopping 40% in the fourth quarter of 2010 – almost quadruple our December’s forecast.

**Momentum expected to carry into the first half of 2011**

The momentum from the fourth quarter is expected to carry forward into the first half of 2011, with growth expected to come in moderately stronger than we had predicted in December of last year. Here is why we are feeling a bit more upbeat about economic growth over the next six months:

- Given that businesses likely met the surge in export demand through a draw down in inventories, the inventory-to-sales ratio has likely returned to a more normal level. As such, a rebuilding of inventories through the first half of 2011 would be required to keep up with the future expected pace of sales growth.
- The speed of the U.S. recovery is starting to pick up, and we are feeling a bit more optimistic about Canada’s trade prospects over 2011. A lesson learned from the final quarter in 2010 is while a high Canadian dollar may act as a headwind to demand for Canadian



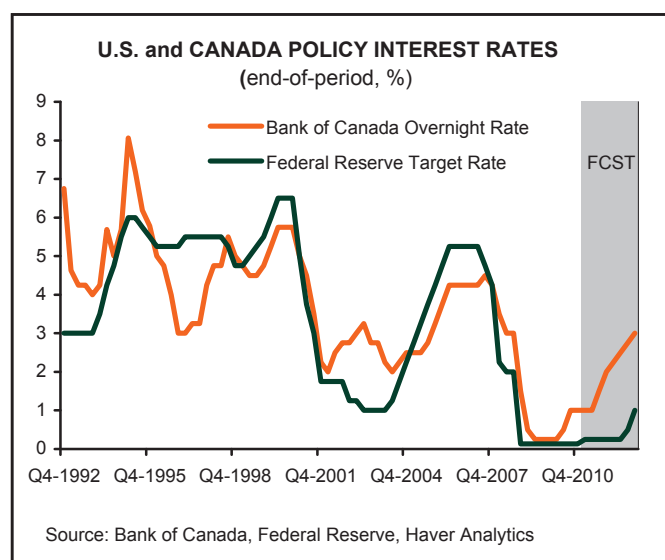


made goods, the Canadian export sector can still benefit from improving U.S. and global consumption of durable goods and commodities.

- Households are well positioned to continue to take advantage of record low interest rates in light of job market improvements and equity market gains. We anticipate that consumers will continue to ramp up spending on goods, services and housing over the first half of 2011 to beat out the expected future rise in interest rates and tightening in mortgage insurance rules.
- Strong profitability is typically a precursor to robust business investment and employment. Indeed, the Bank of Canada outlook survey in the final quarter of last year indicated strong intentions among Canadian businesses to invest in machinery and equipment and their labour force. As such, business investment is expected to be a bright spot for the Canadian economy over 2011.
- Government spending will remain a weak spot for the Canadian economy, as finance ministers at all levels focus on spending restraint to work down large deficits.

### Implications for the Bank of Canada

Overall, our call for the Canadian economy to advance at 3.5% over the final quarter of 2010 and into the first half of 2011 is significantly stronger than the Bank of Canada's January call for growth of 2.5-2.8% over that period. This suggests that the slack in the Canadian economy will be eaten up quicker than predicted in January's Monetary Policy Report. Nonetheless, we are still comfortable with our view that the Bank of Canada will remain on hold until July, and then move cautiously with 25 basis point hikes at each of the next meetings through 2011 and 2012. For one, we expect the U.S. Federal Reserve will remain on hold until mid-2012. This has implications for how far the Bank of Canada can/will raise interest rates in Canada, in light of the potential impact on the Canadian dollar. More importantly, at an annual rate of 1.4% in January, the Bank of Canada's core measure of inflation remains well below its 2.0% target. Despite the upgrade to the real GDP forecast in 2011, we still expect that beyond the next six months economic growth will moderate to a range of 2.0-2.5% as a high Canadian dollar, government spending restraint, rising interest rates, high household debt and a soft housing market act as headwinds to real GDP activity. This in turn will work to keep inflationary pressures under wraps over the medium term. Nonetheless, the brighter economic outlook certainly raises the risk that the Bank of Canada moves earlier, or more aggressively with interest rates.





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