TD Bank Financial Group

TD Economics

Topic Paper

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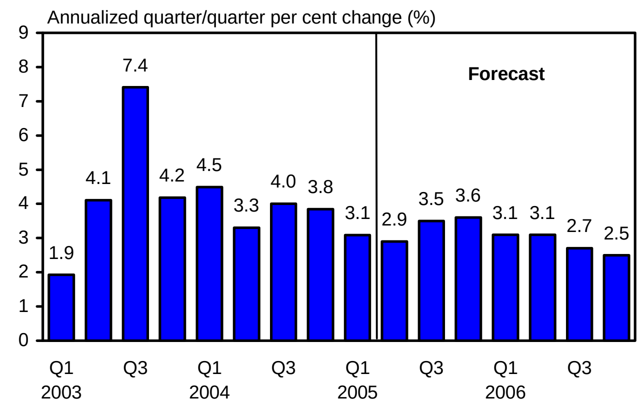
MODERATE GROWTH AHEAD FOR U.S. AND CANADIAN ECONOMIES

The latest data show that the U.S. economic expansion slowed significantly in the first half of 2005, but comments from the U.S. Federal Reserve suggest concern about evidence that price pressures are becoming increasingly evident. Meanwhile, reports from Statistics Canada show that the domestic Canadian economy is firing on all cylinders, but the performance of the national economy as a whole is being weighed down by weakness on the export front, which is struggling with the lagged impact of the past appreciation in the Canadian dollar. Given these developments, it is timely to review and update our forecasts for the Canadian and U.S. economies and discuss the implications for monetary policy in both countries.

U.S. economic expansion shifts down a gear

After posting robust growth of 4.4 per cent in 2004, the United States kicked off the New Year on a softer note, posting an annualized gain of 3.1 per cent in real GDP in the first quarter. And, there is good reason to believe that the second quarter could be close to the same, or even a bit weaker. The calculation of quarterly growth is heavily influenced by the handoff from the last month of the prior quarter, and the news on this front has not been good. All of the reports for March suggest a very weak performance heading into the second quarter. Moreover, significant inventory accumulation over that last three months hints that a portion of the stockpiling may have been unintentional. Even if businesses only slow the rate of their additions to inventory, it could still translate into more subdued growth in the second quarter. Having said that, it must be stressed that we don't have any actual data for the April-June period, implying that it is early days and we might be surprised once again by resiliency of the U.S. economy. As a result, we've pencilled annualized growth of 2.9 per cent in the second quarter – but acknowledge the risks that it could come in lower.

U.S. REAL GROSS DOMESTIC PRODUCT (GDP)



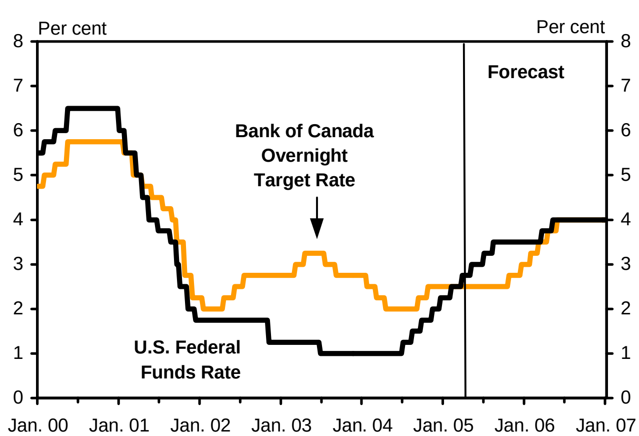
Forecast by TD Economics as at April 2005
Source: U.S. Bureau of Economic Analysis

So, has the U.S. economy entered a renewed softpatch, or has it stumbled more significantly? In our opinion the odds favour the former. Domestic demand in the U.S. remains strong. Despite record energy prices, consumers kept their wallets open in the first quarter. Business investment slowed, but we believe it is likely to return to a robust pace in the coming quarters. Indeed, strong and highly liquid corporate balance sheets suggest that more robust capital outlays might be in the pipeline. And, it is possible that the recent moderation in investment reflects the end in December of a temporary provision allowing an accelerated write off of depreciation, which might have boosted investment late in 2004, stealing some strength from early 2005 and implying a bounce back could occur once the quarter-to-quarter distortion wanes. On the inventory front, even if there is a slower pace of accumulation in the second quarter, the drag on overall economic growth should prove to be temporary. Lastly, it must be stressed that financial conditions in the U.S. remain highly stimulative. The U.S. dollar has weakened significantly over the past two years and, even with the latest rate hikes by the U.S. Federal Reserve, the stance of monetary policy remains highly accomodative. As a result, we look for economic growth to pick up slightly in the second half of the year to an annualized pace of 3.5 per cent, before slowing gradually over the course of 2006 to back under 3 per cent by year-end.

Fed to edge rates higher

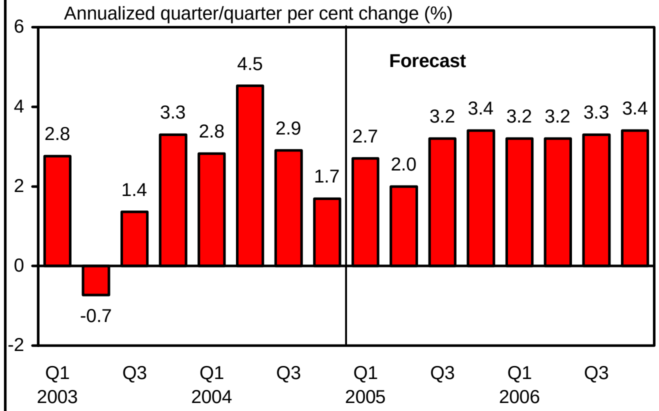
Even with the expected improvement in late 2005, there is no question that the U.S. economic expansion has slipped to a lower gear. Some will argue that this moderation in growth could prompt the U.S. Federal Reserve to pause in its tightening cycle. However, we feel that the Fed is most likely to continue raising rates at a gradual pace. There is increasing evidence of price pressures, some of which may reflect pass-through from elevated energy prices, but it also suggests that there is little slack in the U.S. economy. This does not mean that inflation is going to get out of hand. Indeed, we only expect core inflation to rise from 2.3 per cent in March to 2.6 per cent in December. But, the upward trend in inflation does imply that the current stance of monetary policy is still too stimulative if economic growth is going to return to a 3 per cent or better pace. At the same time, the Fed does not need to panic. We expect the central bank to raise rates at its next three policy meetings, lifting the fed funds rate to 3.50 per cent, and then pause until well into 2006, at which point a further 50 basis points of tightening may be in the cards.

BANK OF CANADA RATE AND FED FUNDS RATE



Actual data to April 27, 2005; Forecast by TD Economics as at Apr. 2005; Source: Bank of Canada, U.S. Federal Reserve Board

CANADIAN REAL GROSS DOMESTIC PRODUCT (GDP)



Forecast by TD Economics as at April 2005
Source: Statistics Canada

Canada on track to post modest growth first half of 2005

Turning to Canada, the monthly GDP data for January and February suggest that the economy expanded at a 2.5 to 3.0 per cent annualized pace in the first quarter of the year. However, that far from inspiring performance masks remarkable strength in the domestic economy, which has been partly offset by weakness on the export front, showing the lagged fallout from the past appreciation in the Canadian dollar.

Looking ahead, exports are likely to remain a drag on the economy, as businesses continue to adjust to the reality of a sustained stronger loonie. And, the news of softer economic growth Stateside and a possible unwanted increase in U.S. inventories in the first quarter also poses a downside risk to Canadian manufacturing shipments in the coming months. There was also rapid inventory accumulation in Canada during the second half of 2004, which suggests that businesses might restrain their addition to stockpiles in the coming months. Offsetting these potential negatives, we continue to expect solid consumer spending and strong business investment, with the latter reflecting the cheaper cost of imported machinery and equipment, strong corporate balance sheets, high levels of capacity usage, and the need to cut costs and boost productivity to cope with a strong currency. Putting it all together, the Canadian economy may experience a temporary pullback in economic growth towards an annualized 2 per cent pace in the second quarter, before accelerating once again to slightly above 3 per cent in the second half of this year and throughout 2006.

Bank of Canada on hold…for now

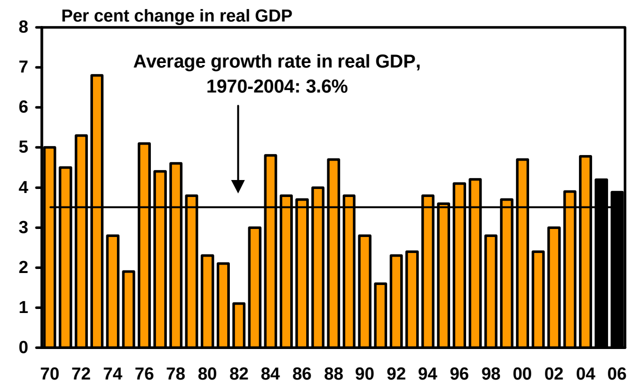
The implication is that the Canadian economy will continue to struggle with the fallout from a foreign exchange shock and the slack in the economy will not be exhausted quickly. Inflation pressures should also remain in abeyance, although there is a risk of some modest upward pressure on core inflation from the continuation of elevated energy prices. Against this backdrop, the Bank of Canada has the flexibility to leave rates on hold in the near-term, but will retain a bias towards tightening in the future. Indeed, once economic growth has accelerated to above a 3 per cent pace on a sustained basis, look for the Bank to return to raising rates. In our opinion, the most likely timeframe is for the Bank to renew its rebalancing of monetary policy in the fourth quarter of 2005, with two quarter point rate hikes. And, the tightening cycle is expected to continue over the course of 2006, with the overnight rate reaching 4 per cent.

Global economic growth slowing, but remains robust

In light of our updated U.S. and Canadian economic forecasts, it is worth spending a moment reviewing our outlook for the world economy.

The latest data from Continental Europe has been discouraging, with activity and confidence indicators pointing to weakness, but this is consistent with our prior expectations for the euro-zone to post lackluster economic growth of 1.6 per cent in 2005. The Japanese data have been more mixed, supporting our call for real GDP to rise at a subdued 1.3 per cent this year. The slower than anticipated performance by the U.S. economy does suggest

WORLD ECONOMIC GROWTH, 1970-2006



Forecast for 2005-06 by TD Economics as at April 2005
Source: International Monetary Fund

that the world's largest economy may grow by 3.4 per cent this year – down from our December forecast of 3.8 per cent and reducing our global tally for world real GDP growth by a tenth of a percentage point. The Canadian economy is expected to advance 2.6 per cent this year, a touch above our December forecast of 2.5 per cent. And, there is an upside risk in China, where the economy grew by 9.5 per cent in the first quarter, hinting that the rate of growth may exceed the 8.5 per cent prediction for this year.

Putting all of the pieces together, the world economy does appear to be in the midst of a mid-cycle moderation in economic growth, but the overall rate of expansion is still likely to prove robust. After expanding at a booming 5.1 per cent pace in 2004 – the strongest performance in almost three decades – it appears that world real GDP growth will slip to 4.1 per cent this year, representing a negligible change from our 4.2 per cent forecast last December and still representing the best back-to-back annual performance since the mid 1970s. But, this aggregate picture masks the prospects for only modest-to-moderate growth in the industrialized world, but continued strong gains in developing countries – particularly in Asia.

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