



**Bank  
Financial  
Group**

# TD Economics

## TD Quarterly Economic Forecast

June 18, 2008

### FORECASTERS AGREE TO DISAGREE ON IMPACT OF ECONOMIC SHOCKS

Since we're already mid-way through the year, it's not surprising that there is broad agreement among 26 analysts surveyed by Consensus Economics on the U.S. economic outlook for 2008. The median real GDP growth estimate is 1.6%, with about 70% of respondents coming within 0.3 percentage points of that value. This essentially means that the majority of forecasters are expecting the U.S. economy to grossly underperform its historical potential. TD Economics is near the middle of the road, expecting a negligible expansion of only 1.4% this year. This is where general agreement ends. Looking at 2009 estimates, there is significant dispersion of views for growth in real economic activity. The median estimate for real GDP growth is 2.0%, but now about 70% of respondents are scattered around a wider range of 0.7 percentage points on either side of that estimate. In this instance, we are aligned more with the pessimistic camp, expecting growth of 1.2% next year. Thus, the message from economists for 2009 is that the U.S. economy will either stagnate or surge back to life, which is of no use for those trying to get a handle on U.S. economic prospects.

There is method to this madness, however. The wide dispersion in forecasts is a reflection of the numerous shocks hitting the economy simultaneously. It is unprecedented to

#### HIGHLIGHTS

- **Canadian real GDP to post 1.0% gain in 2008, underperforming U.S. growth of 1.4%.**
- **Multitude of shocks hitting the U.S. economy leaves forecasters divided on the 2009 outlook.**
- **TD Economics is more aligned with the pessimistic camp on the U.S. outlook, expecting meager 1.2% growth in 2009.**
- **Canadian forecasters are in greater agreement with 2009 predictions. Most project reasonably solid domestic performances, so differences in forecasts are generally contained to that portion of the economy directly exposed to the United States - credit tightening and export demand.**
- **Canadian economy should post slightly stronger recovery in 2009 with 1.8% gain, giving Canada the upper hand relative to the U.S. economic performance.**

have a collision of an oil price shock, a 2-year decline in home prices and a credit crisis. As a result, there is quite a bit of uncertainty among forecasters on how long each of these shocks will linger on the economy, as well as the depth of each shock. For instance, oil forecasts for 2008 range from \$75-150/ barrel.

The greatest degree of uncertainty seems to reside with the credit crunch, for which history offers the least amount of assistance. If you believe that the credit crisis will not be a long, lingering problem, then the weight of history supports the view that the U.S. economy will bounce back smartly from all the shocks after about four quarters of

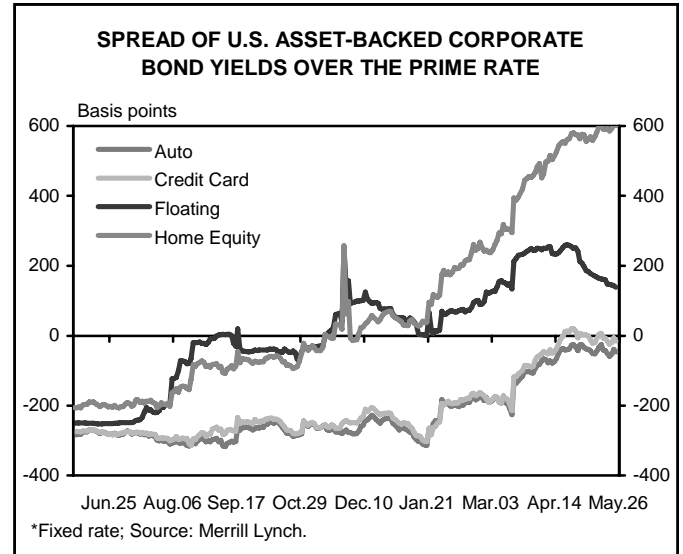
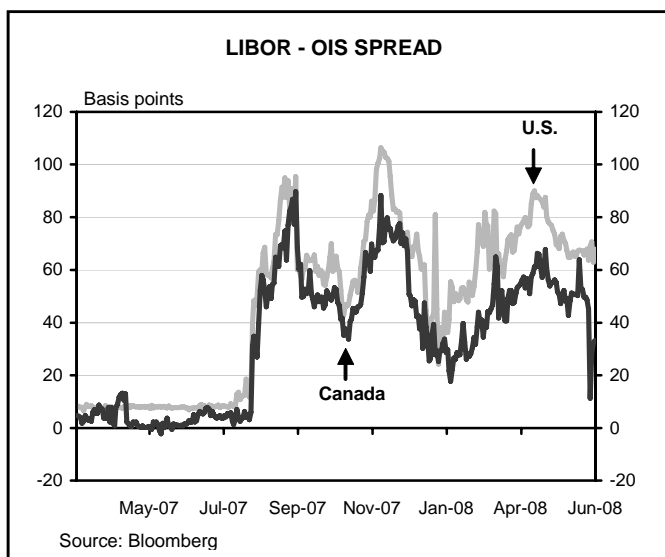
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stagnant growth. However, TD Economics (and we suspect other forecasters in the pessimistic camp) do not subscribe to this view. With banks battening down the hatches, we have yet to see the full effects of the credit crunch bleed into investment and household spending, a process that can take 1-2 years to play out even as credit conditions improve. And while this is going on, households will probably have to endure a further 10% drop in home prices, while coping with elevated energy costs.

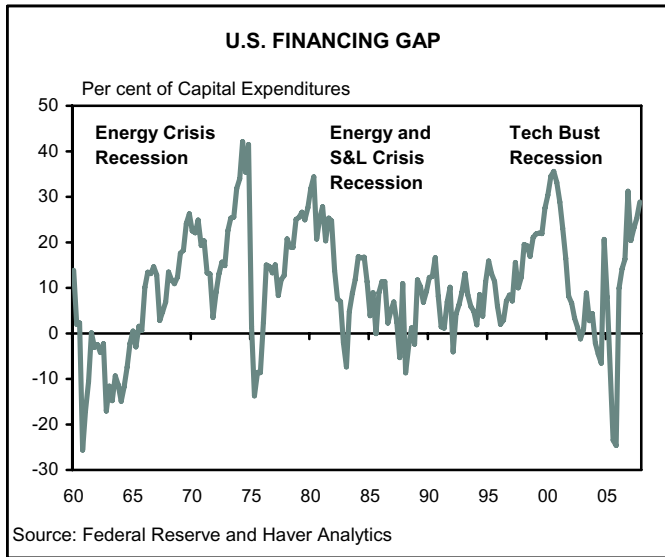
### Shock #1 – From credit crunch to financial munch

In simple terms, the higher the cost of credit, the more sparingly it is employed in the economy, which crimps household spending and corporate investment. Although the cost of funding has eased for financial firms relative to March when market jitters were ignited by the failure of Bear Stearns, it doesn't mean money is cheap. According to the Libor-OIS spread, financial institutions are still paying about 60 basis points more for funds than this time last year. A similar phenomenon is evident in asset-backed securities (ABS). These securities were instrumental in increasing the available supply of credit in the economy. Rather than financial institutions holding every loan as assets on their balance sheet until maturity, they could boost cash flow by selling a pool of the underlying assets (such as mortgages) into the market. Financial jitters surrounding rising bank loan losses due to the collapse of the housing market have made it exceedingly more expensive to use this channel as a way of boosting the available supply of funds. The graph above shows that a year ago, financial firms were able to sell various asset backed securities



below the prime rate, which then allowed them to recycle the cash flow back into the economy by lending it out for a profit at a slightly higher rate. Although it is fair to say that lending standards were too lax due to an oversupply of available funds, the market has definitely swung far to the other side of the spectrum. The spread on home equity ABS is now 600 basis points *above* the prime rate, providing a negative rate of return for financial firms to recycle the funds back into the market. And, the housing woes have leaked to other products. The interest rate spread with the prime rate on auto and credit card ABS is negligible. The process of financial deleveraging will likely continue on a longer term basis, as the banking system grapples with nonperforming loans and recapitalization. This is all to say that the process will restrict the available supply of credit and make it more expensive for borrowers, ultimately blunting the magnitude of the eventual economic rebound even as credit conditions improve.

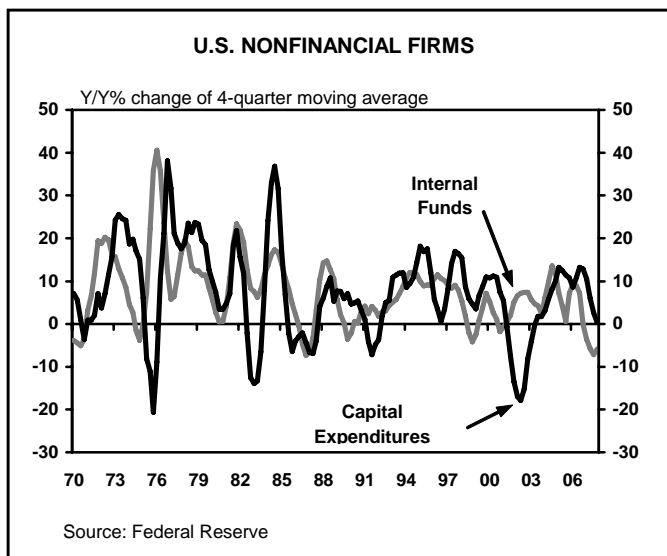
When financial firms pay more (or profit less) in their lending activity, the knock-on effects to non-financial firms and consumers can be quite long lasting. In the case of non-financial firms, the financing gap offers some insight here. This is the difference between the corporate sectors' cash flow and capital expenditures (i.e. investment in machinery and equipment). It is basically an indicator of how much investment corporations can finance without having to borrow from financial markets. The graph on the next page shows that about 30% of financing for capital expenditures among non-financial firms is occurring through external sources. This is a level that is high his-



torically and, in the past, has coincided with recession periods.

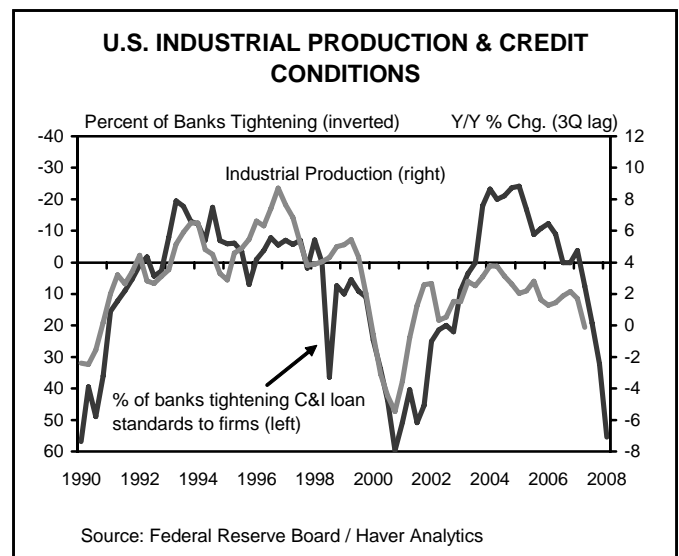
Why does this matter? Growth in internal funds moves in tandem with that of capital expenditures. Funding corporate investment via external sources is usually more costly because the lenders must be compensated for counterparty risk and monitoring. This means that the rate of return on that investment must now be benchmarked against a higher cost of funding. So as internal funds dwindle, investment is scaled back over the course of 1-2 years. The lag relationship reflects the time it takes to plan and implement investment projects. Today's financial situation will affect tomorrow's spending pattern.

The link between credit conditions and real economic activity is also captured in its influence on industrial pro-



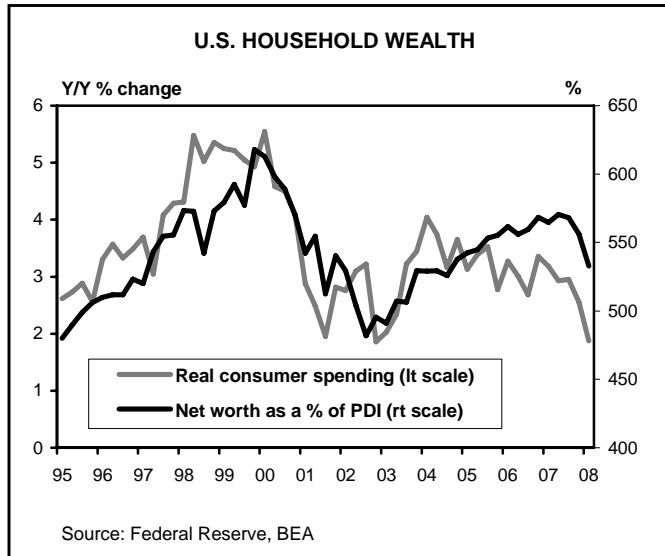
duction. A Federal Reserve survey conducted for the second quarter showed that the credit noose has tightened sharply around commercial and industrial loans, to the point that conditions are the most restrictive they've been since 2001 and 1990 (both recessionary periods). Not surprisingly, there is a close relationship between credit conditions and industrial production, suggesting that growth in the latter has plenty of room to fall over the next several months as businesses find it harder to access cheap credit.

The main message is not to think of the credit problems over the past year as a one-time event, that once resolved will immediately place the economy back into high growth mode. Relatively short-lived shocks can have longer lasting effects. The credit problems of today can act as a financial accelerator, whereby a shock is amplified or becomes long lasting by restricting firms through swings in their balance sheets and spending intentions.



**Shock #2 – Plunging real estate not a good spending-mate**

The financial accelerator concept also extends to households. Throughout the housing boom, homeowners increasingly used their homes as collateral, which amplified the impact of housing sector activity on the rest of the economy by strengthening the positive effect of rising house prices on consumption via increased household borrowing.<sup>1</sup> The opposite is now occurring amidst the longest and deepest home price decline in post-war history. Falling home prices are reducing the wealth in which homeowners can collateralize future loans, pulling spending away from the broader economy. And, we estimate that national home



prices still have about 10% more to fall before a bottom is reached. This means that households would not only endure an unprecedented third year of price declines, but the nominal deterioration in real estate assets would also be the largest on record. If our estimates are correct, home prices will have fallen a total of 20% from peak to trough on a national basis, with a number of states like Florida, California, Nevada and Arizona coping with larger declines. There are direct financial consequences of this deterioration in wealth that are unlikely to immediately reverse course once the housing market stabilizes. For instance, inflation-adjusted real estate assets declined by 4.5% (or \$726 billion) in the first quarter of this year compared to the same period last year. This marked the largest annual decline on record. It is estimated that about 5.5 cents is spent for every one dollar increase in real estate wealth. In this case, the reverse is true with negative wealth effects dampening spending. Wealth effects operate under a 1-2 year time lag, with estimates showing about 80% of the wealth effect is realized within one year.<sup>2</sup> Given our projections for further price declines in 2008, negative wealth effects will continue to dampen spending through 2009, and to a lesser extent in 2010.

We also can't dismiss the possibility that even in the recovery phase of this economic cycle, consumer spending will remain restrained as credit markets continue to scrutinize households and limit their access to cheaper forms of credit. Lending institutions are likely to be more risk averse in the recovery as they attempt to normalize debt default rates and recapitalize balance sheets. Our

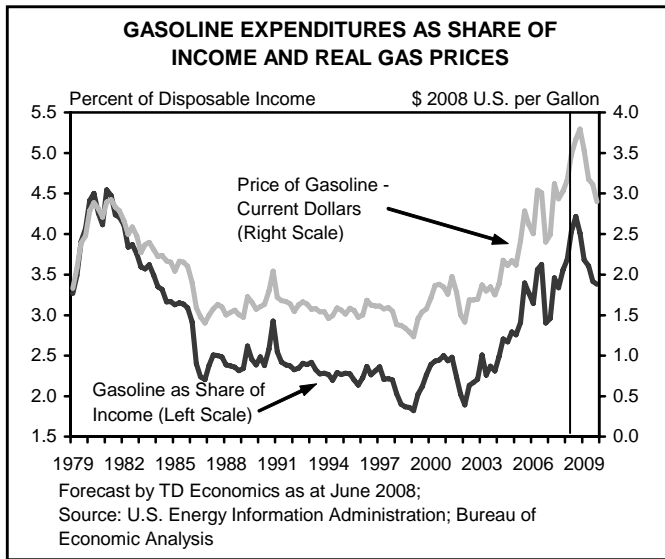
belief is that instead of getting the traditional pent-up demand pop in consumer spending that typically follows a recession, we will see a more muted pace of spending that will accelerate to a still- tepid 2.4% quarterly pace by the end of 2009.

### Shock #3 – Oil on the boil

There are a number of near-term constraints on consumer spending to consider in our forecast horizon, not the least of which is record oil prices, which more than doubled over the past year. Rapidly rising oil prices have a number of direct and indirect negative influences on the U.S. economy. In direct terms, we estimate consumers will spend \$90 billion more on gasoline this year than last, which leaves less money for discretionary spending. Corporations are going through a similar effect with higher input and delivery costs.

In terms of the indirect consequences, there are many, but here's a short-list. A rapid climb in oil prices makes it difficult to quickly adjust demand and production. It is costly to transfer resources in a timely manner from fuel-inefficient uses to fuel-efficient uses. As a result, capacity might sit idle while firms attempt to shift to cost-saving measures. In addition, when prices don't rise in a gradual, predictable fashion, firms have more difficulty fully hedging their energy costs, which further crimps production and profitability. We cannot rule out the possibility that uncertainty about future energy costs in today's volatile environment will make companies more cautious about making new capital investments. Investment intentions set in this environment can affect spending behaviour by firms throughout our forecast horizon. Likewise, households can absorb these impacts through greater job losses and/or rising price pressures on consumer goods. We need only look at headline CPI in the U.S., which has doubled to 4.2% growth since the start of 2007.

Fortunately, there is plenty of historical precedence to draw upon for guidance in estimating the impact of high oil prices on the economy through the end of 2009. In our view, some of the recent run-up in oil prices has not been a function of supply/demand forces, and thus partly reflects a shock that will reverse course by the end of this year. But, there is also a permanent aspect encompassed by the fact that the increase in oil demand pressures from rapidly expanding emerging markets like China and India is here to stay. On balance, our expectation is that oil will average \$110/barrel in 2008 and \$100/barrel in 2009 – though the

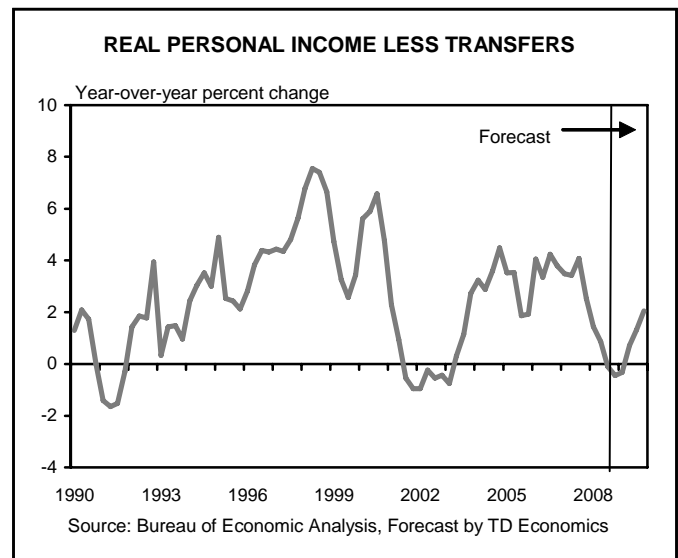


latter half of that year will exhibit greater price strength than the first half as demand pressures rise from a strengthening U.S. and global economy.<sup>3</sup> High oil prices tend to pull down the economy with a lag, so even with these lower levels in oil prices, we estimate a drag on U.S. GDP growth (q/q SAAR) of 1.5 percentage points in each of the remaining quarters of 2008 relative to what would have been the case without the oil pressures. This drag is expected to continue in the first half of 2009, shaving an additional 0.9 percentage points of GDP growth before the lagged impact of lower oil prices finally begins to be a small net positive on U.S. economic growth.

#### Shock #4 – Tax rebate won't change consumer fate

Amid the various negative shocks, the U.S. economy has the benefit of a well-publicized positive shock – fiscal stimulus. The government is sending out \$117 billion in rebate cheques to American households between May and July. We estimate that households will spend about 35 cents on the dollar over the second and third quarters. This will boost real consumer spending by \$60-70 billion annualized in each of those quarters. However, once the one-time impact is over, consumer spending will drop back to the status quo level, which means a negative quarter. In addition, the temporary boost to incomes will not be sufficient to mask the broader challenges of massive home asset deflation, ongoing job losses and elevated energy costs. In fact, by the fourth quarter of this year, we believe about 800,000 jobs will be shed relative to the same period last year. This will further crimp income growth, which is already showing signs of strain. Growth in real personal

income less transfers is trading water at just 1.4%, a full two percentage points less than the pace of income growth last year. Excluding transfer payments from the income measure has two benefits. First, it is one of the key measures that the National Bureau of Economic Research (NBER) uses to backdate recession periods. Second, it gives us an idea of underlying income momentum without the influence of temporary boosts from government transfer payments like the rebate cheques. Once the one-time impact of the fiscal stimulus disappears, households will be left with the reality that real income net of transfers is likely to contract, hitting a trough annual pace of -0.4% by the final quarter of this year and remaining in the red through the first quarter of 2009. This is not the stuff that consumer spending is made of. Consumers will have wobbly legs to stand on with the potent combination of weak income growth and negative wealth effects feeding through in 2009.



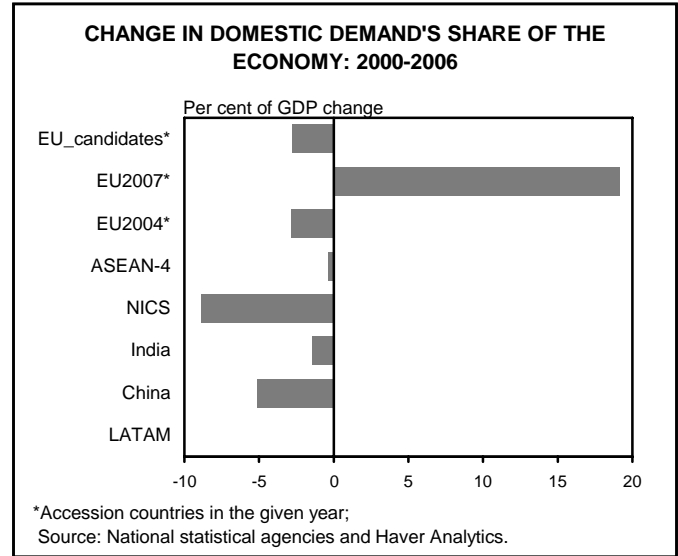
#### Exports offer the one true offset to the negative shocks

The depreciation of the U.S. dollar that started in 2002 has been a windfall to the export sector. Real exports have grown at a 7-10% annual pace over the past four years, marking the strongest string of gains in a decade. As a result, exports have been contributing about a percentage point to real GDP growth since 2003. We believe the export sector will remain a key contributor to growth in the American economy over the forecast horizon; however, there is a risk that some forecasters are overestimating the magnitude of the offset it can offer to the weak-

ness elsewhere. Slowing global growth will temper gains in American exports over the next 12-24 months.

When U.S. consumer demand slows, it impacts the performance of a number of world economies through trade links. For instance, nearly one-fifth of U.S. imports come from the European Union, and Asia accounts for nearly 40% of American imports, with about half of that coming from China. There is some credence to the view that increased domestic demand and investment spending within high-growth emerging markets (EM) has made them less reliant on the U.S. economy, but perhaps not to the extent that many assume. The graph below shows that a tight link still exists between growth in Asian emerging markets and U.S. consumer demand. Also, while many EMs are benefiting from stronger domestic demand conditions, the export sector has experienced a faster expansion, still supporting the view that many of these economies remain highly reliant on external demand, even though it's less than the past.

In addition to these global economic loops, a number of countries are purposely tapping on the brakes to domestic demand growth due to heightened inflationary concerns as commodity prices soar. For instance, the European Central Bank is poised to raise rates before the end of the summer. And, in the past month, more and more governments in emerging markets have announced reductions in energy subsidies, which will ultimately squeeze household and corporate budgets in those economies. To name a few, Sri Lanka will allow energy costs to rise 14-47% depending on the energy source, Indonesia will raise gasoline prices by 29% and India is lifting gasoline and diesel prices

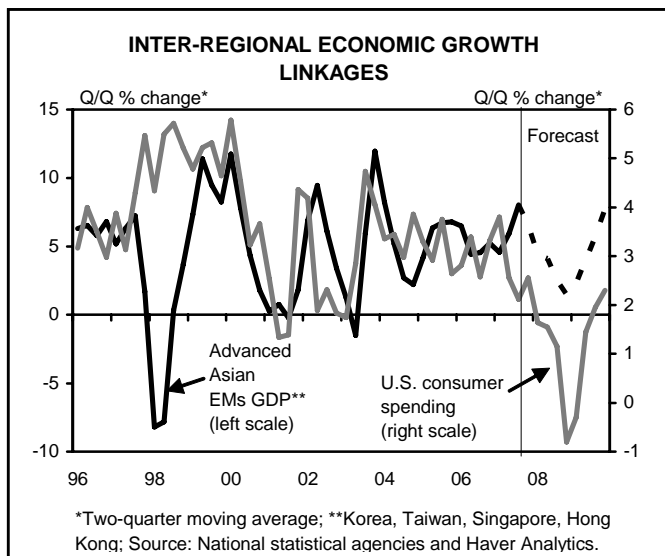


by 10%. Probably the most extreme is Malaysia, which completely removed gasoline subsidies, amounting to an estimated 40% increase in costs to users. The bottom line is that there is sufficient reason to expect a significant slowdown in the global economy, and already some countries, like India, are showing evidence of this.

In 2009, we believe the combination of international trade links and softer domestic conditions will cause world growth to slow to 3.2%. This is one-and-a-half percentage points less than what the U.S. export sector had the benefit of over the 2003-2007 period. As a result, exports are expected to expand by about 4.4% in 2009, almost half the pace in 2007. Likewise, over the remainder of this year and next, the export sector is expected to contribute 0.6 percentage points to real GDP growth, just over half of what it did in recent years.

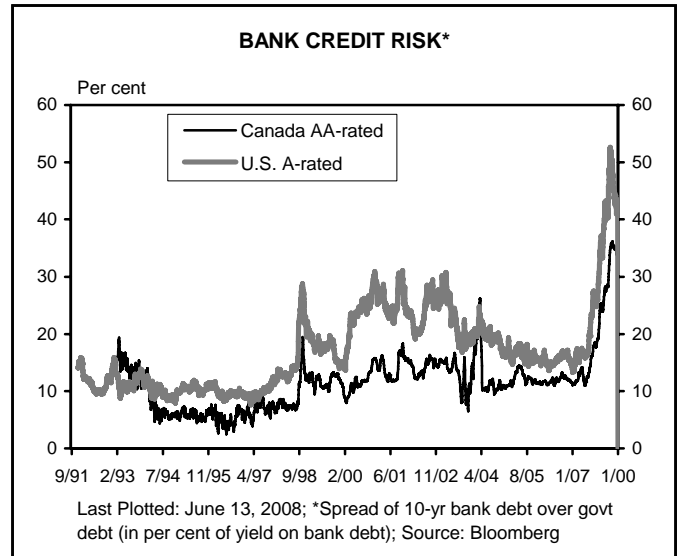
### What does this mean for Canada?

Canada has direct exposure to two of the shocks above – oil and credit tightening – and faces collateral damage to the export sector from a stagnating U.S. economy. On net, real GDP growth in Canada will struggle alongside the U.S. in 2008 at 1%, but show a stronger rebound in 2009 to 1.8%. Once again, we are at the low end of consensus estimates for real GDP growth in both years due to our more pessimistic view of the lingering weakness in the U.S. economy, and hence its impact on the Canadian export market. That said, there is not as much variance in 2009 GDP growth estimates for Canada, as is the case for U.S. estimates. This is probably attributed to the fact that most Canadian forecasters are estimating a reasonably solid



domestic performance, so there is only a portion of the economy that is directly exposed to the U.S. where there can be great variability in predictions. For instance, no estimation needs to be made on the magnitude and impact of negative housing wealth effects, since Canadian homeowners were not caught up in the U.S. housing bust. Rather, most forecasters are in agreement that Canadian homeowners will continue to enjoy a modest appreciation in values over the forecast period. The economic backdrop in Canada is also sound relative to the U.S., limiting the downside risks to GDP growth estimates. Employers are still actively hiring new workers in great numbers, wage growth is at record levels, credit default rates are low and inflation is holding below the central bank's target.

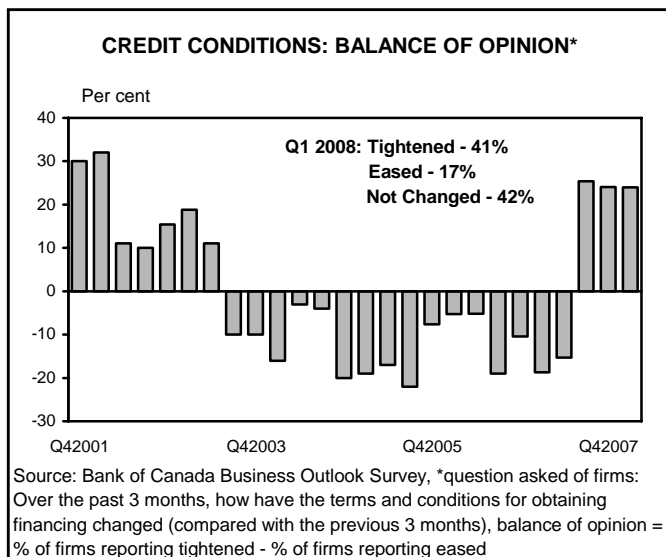
And, among one of the most topical issues of late – oil prices – Canada's net export position provides some insulation to the knock-on effects of sky high prices, though the impacts diverge greatly across the country. The Bank of Canada noted in its Monetary Policy Report in 2004 that the aggregate impact of higher oil prices on the economy is positive over the medium term due to increased output and capital investment by energy-producing firms. Naturally, this benefits regions like Alberta and Newfoundland and Labrador. However, in the short-term (a year or so), it can drag economic activity. Regions that do not have a significant stake in energy resources and production are left worse off due to the negative impact of higher input costs, and a reduction in manufacturing exports and consumer spending. On net for the country as a whole, the impact of higher oil prices is largely a wash, but there are huge important regional divides. In addition, there is a risk



that elevated oil prices could adversely impact the economy in 2009 if producers don't think the price surge is permanent, and hence don't accordingly adjust investment.

Over the forecast horizon, Canada will also continue to absorb the fallout from the credit crisis. Like the U.S., the Libor-OIS spread was blown out for Canadian banks following the credit turmoil that began last August. The wound has been slow to heal. The cost of funding remained high at a spread of 20-40 basis points in June compared to a low and steady 3-5 basis point range in prior years. As a result, credit conditions have tightened on this side of the border, which will have knock-on effects to investment and spending, just not to the same degree as their American counterparts because there is more support on the income side of the equation.

In particular, Canadian employers are continuing to churn out new job opportunities, providing a solid foundation beneath income growth. With five months of employment data already on the books, the die has largely been cast on this front. Employers have been averaging 24,000 new workers per month, with hourly wage growth of permanent employees averaging 4.6% – the highest on record (1997). With inflation holding below 2%, workers have had the benefit of a tidy real wage gain. Even with our expectation for softer job creation in Canada going forward (averaging about 5,000-7,000 positions per month), it will merely serve to restore wage growth to historical norms. For all of these reasons, consumer spending should prove more resilient in Canada, averaging a quarterly annualized pace of 2.7% over the forecast horizon.



As stated above, the biggest negative influence on the Canadian economy will continue to flow from the export sector which has already contracted for three consecutive quarters. But even here the news isn't all glum. Once the U.S. economy shows signs of a sustained recovery in the second half of 2009, Canadian exporters will follow.

### Conclusion

Economic forecasters are caught within a highly tumultuous economic period for the U.S. and global economies. The outlook for 2009 is coloured by the number of shocks occurring simultaneously, as well as the magnitude of those shocks. The greatest forecasting uncertainty seems to center around the credit crunch, for which there is little historical precedence. We believe the impact from tight credit conditions will linger on the U.S. economy, and weigh down investment and consumer spending intentions through the forecast period. However, some forecasters have adopted the more traditional view that the U.S. will wade through a four-quarter period of weak growth before bouncing back smartly. History is certainly on their side.

If we had to consider only the one shock, we would probably agree. In this particular case, however, the record

deterioration in home prices alongside record oil and gasoline prices makes us more skeptical, especially now that the Federal Reserve is showing increasing reluctance to provide any additional monetary stimulus due to inflationary pressures. In fact, inflation pressures are heating up around the world, and the global economy is shifting away from a low inflation, low interest rate environment. This means that it is unrealistic to expect global growth to maintain the above-average performance of the past four years. So along the road to recovery in the U.S. economy, the one bright light – exports – will face a speed bump due to a slightly more challenging environment.

For Canada, all of this means buckle up for the ride. Canadian exporters will continue to feel the pain of the lingering weakness in the U.S. economy. Meanwhile, domestic demand growth will gear down in response to the tighter credit conditions and a softer job market. The good news is that Canadians households have one good leg to stand on. They will have to face neither deterioration in real estate wealth, nor a sharp slowdown or contraction in income growth. The same cannot be said of their American counterparts.

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### Endnotes

- <sup>1</sup> International Monetary Fund, World Economic Outlook, April 2008.
- <sup>2</sup> Belsky, Eric and Joel Prakken, NCRER "Housing wealth effects: housing as a component of household wealth", November 2004.
- <sup>3</sup> For further details on our view about oil supply/demand pressures see TD Economics special report "With all the Talk About Peak Global Oil Supply, What About Peak Oil Demand?."

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# GLOBAL ECONOMIC OUTLOOK

While the U.S. grapples with fallout from the subprime crisis, the global economy is gripped by a crisis of confidence. Inflation has surged in unison across all major regions of the world. As unemployment rates rise, and consumer spending and business investment ramp down, inflation typically recedes over time. However, confidence is waning that the global phenomenon of rising inflation will be tamed without higher than expected interest rates and weaker global economic growth. Moreover, policy makers whose actions take time to have an impact will have to decide on their response before all the facts are in.

Employment markets – although also a lagging indicator – have remained remarkably resilient. GDP surprises in the first quarter of 2008 were largely to the upside. And, ongoing emerging market (EM) demand has been responsible for at least part of the strength in oil prices. Diminished risks of a full-blown global financial crisis balanced with rising inflation risks has left our global forecast little changed. Output growth in 2008 is expected to be a tenth of a percent faster than in our March forecast while growth in 2009 is expected to be a tenth of a percent slower.

## Advanced Economies: Near-term Risks

The first quarter saw a couple of spectacular GDP performances in advanced economies. The Japanese economy expanded by 4.0% (q/q annualized), with the pace of private consumer spending doubling over the previous quarter and investment spending rising for the first time in a year. The German economy, meanwhile, saw its fastest quarterly gain in over a decade, as an investment boom drove the economy to expand by 6.3%. No good deed goes unpunished, though, and these are also the only two G-7 economies that we are forecasting will contract in the second quarter. Both have seen two months of very weak retail sales. The strengthening of both countries currencies seems to be passing through into weaker recent international trade performance. And, in the case of Japan, business investment still does not seem to have bottomed out. While the other major economies are less likely to contract in the near quarter, the overall pace of economic growth continues to show signs of an ongoing deceleration. The Italian economy has stagnated over the last six months and is unlikely to expand at a pace exceeding 1.0% over the next four quarters. Likewise, the U.K. housing crash is unlikely to support consumer spending at its 5.5% first quarter pace; and, coupled with six months of no export growth, it is likely to bleed significantly into the prospects for business investment, as well.

## Emerging Markets: Quality, not Quantity

The first quarter also saw some better than expected results in EMs, but the underlying quality of some of these expansions remains questionable. After seeing no growth in the last six months, the Singapore economy barreled back with a 15% expansion in Q1. Beneath the headline, however, consumer spending and construction continued to fall, and, coupled with business investment and net trade, contracted in the first quarter. In fact, GDP was driven by the phenomenal 450% annualized growth in transportation equipment – an acceleration over the 300% pace seen in Q4. So this economy, historically tied to U.S. consumer demand, is being driven by one volatile sector, and it is not alone. Hong Kong saw GDP growth relatively unchanged, but consumer spending and investment are now contract-

GLOBAL ECONOMIC OUTLOOK					
Annual per cent change unless otherwise indicated					
Real GDP	2007 Share* (%)	2006		Forecast	
		2006	2007	2008	2009
<b>World</b>	99.1	5.0	4.9	3.8	3.2
<b>North America</b>	25.5	3.0	2.3	1.4	1.3
United States	21.4	2.9	2.2	1.4	1.2
Canada	2.0	3.1	2.7	1.0	1.8
Mexico	2.1	4.8	3.3	2.5	2.1
<b>European Union (EU-27)</b>	23.7	3.0	2.9	1.7	1.4
Euro-zone (EU-13)	16.1	2.9	2.6	1.6	1.1
Germany	4.4	3.1	2.6	2.1	1.1
France	3.2	2.4	2.1	1.9	1.3
Italy	2.8	1.9	1.4	0.4	0.5
United Kingdom	3.3	2.9	3.0	1.6	1.2
EU accession members	3.4	3.1	3.7	2.4	2.4
<b>Asia</b>	35.5	7.5	7.6	6.2	5.5
Japan	6.6	2.4	2.0	1.5	1.2
Asian NIC's	3.7	5.6	5.6	4.3	3.7
Hong Kong	0.5	6.9	6.4	5.0	3.5
Korea	1.9	5.1	5.0	4.1	3.6
Singapore	0.3	8.2	7.7	5.3	4.7
Taiwan	1.1	4.9	5.7	4.1	3.8
Russia	3.2	7.4	8.1	6.5	5.5
Australia & New Zealand	1.4	2.7	3.9	2.7	2.5
Developing Asia	20.6	9.9	9.9	8.2	7.4
ASEAN-4	3.1	5.4	6.0	5.1	4.2
China	10.9	11.6	11.9	9.9	8.8
India	4.6	9.8	9.3	7.7	7.3
<b>Central/South America</b>	6.1	5.5	6.2	5.0	3.3
Argentina	0.8	8.5	8.7	7.0	4.8
Brazil	2.8	3.7	5.4	4.6	3.6
<b>Other Developing</b>	8.4	6.2	6.2	5.8	4.9

\*Regional wts. do not sum to 100% because some countries omitted  
Forecast as at June 2008  
Source: International Monetary Fund, national statistical agencies

ing, while the South Korean economy has seen consumers, businesses, and external demand wane. The fate of regional Asian economies will hinge on the continuing ability of the Chinese economy to avoid a hard landing. There seems to have been little economics impact from the recent earthquakes, and, supporting our long-stated belief that Chinese equities have little connection with economic performance, the local stock market is down 45% year-to-date while economic growth remains above 10%. Asian EMs appear to be gearing down faster than some other regions, but as advanced economies continue to ease off the gas, we are seeing measured slowdowns in many EMs globally.

### Central Banks: Managing Expectations

Softer global demand by year end will start to take the steam out of inflation, however central banks will remain concerned about the “what-if” scenario should this not be the case. History has shown that the long-term pain of reestablishing inflation expectations can be much more costly for an economy than the impact of some moderate, near-term tightening in monetary policy. While no central bank is likely to purposefully drive their economy into a recession in the name of price stability – history also shows the costs of over-tightening in the face of an energy shock – more recent experience with the tech bust and subprime crisis seems also to have emboldened central banks to talk strength to bubbles. A concert of central bank hawks will compound the already eroding oil demand to help ensure \$140 oil does not become \$200 oil.

The ECB seems poised to be the first G-7 central bank to flinch. Inflation is now 3.7%, nearly two percentage points above target. Even sharply slowing economies like Spain – where GDP growth has slowed for four straight quarters – has seen inflation skyrocket from 2.5% to 4.5% over that period. In Germany, while core inflation has remained stable, some pass-through from energy prices to wages appears to be taking place. As a result, this inflation targeting bank seems likely to raise rates once to 4.25%, but we still feel these rates will eventually be lowered in early 2009. While the Bank of England is an inflation targetter, as well, their remit offers a possible out as they are charged with returning inflation to target in a “reasonable time period” but “without creating undue instability in the economy.” While not as direct as the Fed’s dual mandate to manage inflation and employment, policy makers in the U.K. still have some discretion.

For EMs, this discretion has typically favoured growth over inflation. As a result, inflation expectations have less history of being well-anchored. Some EM central banks

have used their discretion wisely. Brazil has done a good job keeping inflation well contained while still promoting economic growth. Argentina and Venezuela, on the other hand, have not, and continue to be at risk for very hard landings. Asia as a region has generally followed very pro-growth policies, with many local economies just recently pulling back energy subsidies, and that will drive inflation even higher. Some, like India, are a bit more ahead of the curve while others, like Vietnam and Singapore, have more serious inflation issues. Given this region is also showing some of the largest risks for economic deceleration, regional central banks will likely receive some help in their fight against inflation. But, discretion, as the name suggests, is all in how you use it.

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ECONOMIC INDICATORS FOR THE G-7 AND EUROPE					
	2005	2006	2007	Forecast	
				2008	2009
<b>Real GDP (Annual per cent change)</b>					
<b>G-7 (41.17%)*</b>	2.3	2.7	2.2	1.4	1.2
U.S.	3.1	2.9	2.2	1.4	1.2
Japan	1.9	2.4	2.0	1.5	1.2
EU-12	1.7	2.9	2.6	1.6	1.1
Germany	1.0	3.1	2.6	2.1	1.1
France	1.9	2.4	2.1	1.9	1.3
Italy	0.7	1.9	1.4	0.4	0.5
United Kingdom	1.8	2.9	3.0	1.6	1.2
Canada	2.9	3.1	2.7	1.0	1.8
<b>Consumer Price Index (Annual per cent change)</b>					
<b>G-7</b>	2.3	2.3	2.1	3.2	2.0
U.S.	3.4	3.2	2.9	4.2	2.5
Japan	-0.3	0.2	0.1	0.6	0.6
EU-12	2.2	2.2	2.1	3.2	1.9
Germany	1.9	1.8	2.3	2.7	1.6
France	1.9	1.9	1.6	3.3	2.0
Italy	2.2	2.2	2.0	3.2	1.4
United Kingdom	2.0	2.3	2.3	3.4	2.9
Canada	2.2	2.0	2.1	2.3	2.1
<b>Unemployment Rate (Per cent annual averages)</b>					
U.S.	5.1	4.6	4.6	5.4	6.2
Japan	4.4	4.1	3.9	4.2	4.7
EU-12	8.6	8.2	7.4	7.3	8.0
Germany	9.4	9.8	8.4	7.5	8.0
France	9.7	9.2	8.3	7.9	8.4
Italy	7.7	6.8	6.1	6.3	7.0
United Kingdom	4.8	5.3	5.3	5.3	5.9
Canada	6.8	6.3	6.0	6.1	6.6
*Share of 2006 world gross domestic product (GDP)					
Forecast as at June 2008					
Source: National statistical agencies, TD Economics					

## U.S. ECONOMIC OUTLOOK

In preparing a revised U.S. forecast, a key question is what has changed since the last quarterly projection? While it is easy to focus on the negative factors impacting the U.S. economy, not all developments in the past three months have been bad news. Foremost on the positive side of the ledger, financial conditions have materially improved. The timing of our last economic forecast coincided with the near collapse of a major investment bank and fears of widespread financial upheaval. As the smoke cleared and the Federal Reserve acted to limit the contagion, credit conditions gradually recovered and banks began the important process of recapitalizing. Moreover, economic growth in the first quarter managed to beat expectations with a gain of 0.9% annualized. Although households cut back spending on goods – both durable and non-durable – spending on

services continued at a steady pace, keeping consumption growth in positive territory. Finally, less than three months after the President signed the Economic Stimulus Act of 2008, over \$50 billion of tax rebate checks have already been delivered to households across the country – enough to provide an already visible boost to consumer spending just as it appeared that households were at risk of closing their wallets.

Unfortunately, along with the good news have come some negative developments. Foremost on this list is inflation. Since the publishing of our last Quarterly Economic Forecast on March 19<sup>th</sup> the price of crude oil has risen over \$30/barrel, pulling gas prices up to \$4.00 a gallon in several U.S. jurisdictions and threatening to eat away much of the economic stimulus. Headline inflation now looks likely to reach 4.6% on a year-over-year basis in the third quarter thanks to higher energy costs. Moreover, the labour market has continued to deteriorate. Estimates of employment were revised down through the first five months of the year and in May the unemployment rate shot up a whopping 0.5 percentage points. With unemployment rising and income growth slowing, there couldn't be a worse time for fuel prices to eat even more of households' already stretched dollars.

### What does it all mean?

So what does all this mean for the forecast? On balance, the front-loading of the economic stimulus package and the higher-than-expected economic growth in the first quarter are the biggest contributors to our upgraded forecast for 2008 of real GDP advancing 1.4% (up from 1.1%). Economic growth in the second quarter will come in at 1.3% aided by a 2.1% tax-rebate fuelled increase in consumer spending. Following that, inflationary pressures, slower income growth and tighter credit conditions will lead to a slower pace of growth through the remainder of the year. Economic growth is expected to come in only marginally positive in the third quarter, as households spend the remainder of the stimulus checks, before slipping into outright decline as spending returns to pre-stimulus levels. Growth in 2009 will underperform 2008 on an annual average basis, coming in at 1.2%. While growth will return to positive territory in the first half of the year, slower global growth is expected to lead to a slower pace of exports, while the recovery in domestic demand will prove very gradual. Growth is expected to pick up through mid-year

U.S. ECONOMIC INDICATORS				
Annual per cent change unless otherwise indicated				
	2006	2007	Forecast	
			2008	2009
<b>Real GDP</b>	2.9	2.2	1.4	1.2
<b>Consumer Expenditure</b>	3.1	2.9	1.4	0.8
Durable Goods	3.8	4.7	-2.1	-0.2
<b>Business Investment</b>	6.6	4.7	1.7	-2.4
Non-Residential Structures	8.4	12.9	4.0	-2.1
Machinery & Equipment	5.9	1.3	0.7	-2.5
<b>Residential Construction</b>	-4.6	-17.0	-22.1	-5.9
<b>Govt. Exp. on Goods &amp; Svcs.</b>	1.8	2.0	2.5	2.0
<b>Final Domestic Demand</b>	2.7	1.8	0.6	0.5
<b>Exports</b>	8.4	8.1	6.4	4.4
<b>Imports</b>	5.9	1.9	-0.6	0.6
<b>Change in Non-Farm Inventories (\$96 Bn.)</b>	41.7	-0.1	-15.8	3.2
<b>Final Sales</b>	2.8	2.5	1.5	1.0
<b>Int'l Curr. Acct. Bal. (\$Bn.)</b>	-811	-739	-749	-674
% of GDP	-6.2	-5.3	-5.2	-4.5
<b>Pre-tax Corporate Profits</b>	13.2	2.7	-3.0	6.9
<b>GDP Chain-type Deflator</b>	3.2	2.7	2.4	2.5
<b>Employment</b>	1.8	1.1	0.0	-0.1
<b>Unemployment Rate (%)</b>	4.6	4.6	5.4	6.2
<b>Productivity *</b>	1.0	1.9	2.6	2.0
<b>Real Pers. Disp. Inc. (PDI)**</b>	3.1	3.1	1.7	0.3
<b>Real PDI** Per Person</b>	2.1	2.2	0.8	-0.6
<b>Consumer Price Index (CPI)</b>	3.2	2.9	4.2	2.5
<b>Housing Starts (mn units)</b>	1.81	1.34	0.92	0.90
Real GDP: Real gross domestic product; * Real private non-farm business output per hour; ** After-tax income adjusted for inflation; Forecast by TD Economics as at June 2008; Source: Bureau of Labor Statistics, Bureau of Economic Analysis, TD Economics				

as housing stabilizes and credit conditions return to normal.

### Fiscal stimulus aside, households in rough shape

The deterioration in consumer finances precipitated by the housing collapse and evident most spectacularly in the close to 50% rise in home foreclosures is unprecedented in its occurrence outside of a broader economic downturn. The rapid rise in consumer debt – mostly in the form of debt backed by real estate – is now cooling in response to weaker household demand and reduced willingness to lend by many financial institutions. One of the major uncertainties surrounding this particular business cycle is how the deleveraging currently taking place in the household and financial sectors will unfold and what long-term impact this will have on economic growth. In the near term, the answer is fairly clear – a deteriorating job market, rapidly rising energy prices, falling household net-worth and restricted credit is a recipe for a significant downturn in household spending. Our near-term economic forecast reflects this expectation. Consumer spending will pick up to 2.1% in the second quarter due only to the influx of close to \$70 billion in direct to household stimulus checks. Without the stimulus real consumer spending would be in a state of decline through the second and third quarters of this year.

But perhaps the more important question is what happens to spending a little bit further down the road – in our case through the last half of the forecast period? To answer this it helps to have some historical context. Since 1980, real consumer spending has increased at an annual average rate of 3.4%, outpacing real disposable-income and GDP growth, both of which grew by 3.0% in the same time period. As spending growth outpaced overall production, the savings rate fell from 10% in 1980 to just above 0% in 2007. Through this period households “saved” through their appreciating assets and even while the savings rate fell, household net-worth grew at an annual rate of 7.1%.

So, how to read the historical record? On the one hand, if we’re looking for a long-run pace of consumer spending growth it would appear that something around 3.4% would be a pretty good bet. On the other hand, we know that this was accompanied by rising net-worth. In an environment where net-worth is at best rising only marginally – what do we expect to happen to consumer spending? It is our belief that in these circumstances we are in for a more prolonged period of slower spending. For one, household wealth acts on consumer spending with a lag, meaning that the

U.S. ECONOMIC INDICATORS				
Fourth-quarter-over-fourth-quarter per cent change				
	Q4-06	Q4-07	Forecast	
			Q4-08	Q4-09
<b>Real GDP</b>	2.6	2.5	0.4	2.4
<b>Real Final Sales</b>	3.0	2.8	0.3	2.1
<b>Employment</b>	1.6	0.9	-0.6	0.3
Real GDP: Real gross domestic product; Forecast by TD Economics as at June 2008; Source: Bureau of Labor Statistics, Bureau of Economic Analysis, TD Economics				

deterioration already observed in household net-worth will continue to impact consumer spending into 2009. Secondly, with a still substantial build up of inventories in the housing market, home prices will likely continue to fall through the first half of 2009, putting continued downward pressure on spending. By the final quarter of 2009, we expect spending growth to improve to 2.4% – but a return to growth rates above 3.0% is beyond our forecast horizon.

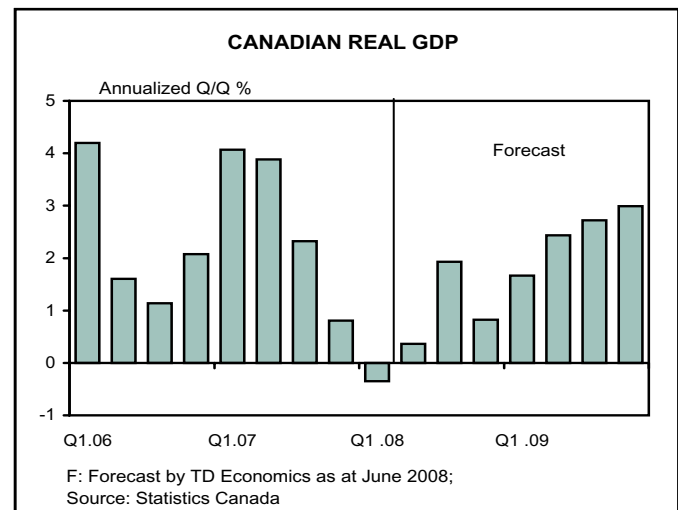
### Business also facing constraints

Tighter lending standards will also weigh on business investment. The Federal Reserve loan officer survey confirms that in addition to households, lenders have also tightened conditions on commercial and industrial lending. Businesses now face a near perfect storm of slowing demand, higher input costs and restricted availability of credit. Slower profit growth has already pushed non-financial businesses into a need to borrow to finance investment and with higher borrowing costs and tighter standards it is only a matter of time before this shows up in slower business investment. Already, the architectural billings index (which correlates well with non-residential structures investment and has fallen by 18.8% in the first quarter) points to a decline in non-residential structures spending. Spending on equipment and software has also decelerated and fell into negative territory in the first quarter of this year. Typically a slowdown in investment follows the slowdown in consumer spending. While demand from abroad has supported U.S. businesses through the slowdown so far, slower global growth will add to the domestic pressures on U.S. businesses. All told, we expect non-residential fixed investment to decline over the remainder of this year and through the first half of 2009 before moving back into positive territory in the second half of the year.

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## CANADA'S ECONOMIC OUTLOOK

The Canadian economy did not jump into 2008, but rather tip toed out the back door. Real GDP contracted by an annualized 0.3% in the first quarter, almost bang on our March QEF forecast of -0.4%. It marked the first time the economy has gone in reverse in over four years and it came as a bit of a surprise to some, since Canada's economic performance grossly underperformed that of the United States. We believe this theme will be repeated in the second quarter, as a retreat in exports bites into economic activity. However, there is still plenty to be optimistic about in Canada. Most households will not face the challenges of deteriorating housing wealth or jobs, two key issues that plague their neighbors to the south. This gives Canadians a secure leg to stand on, even as the export sector continues to struggle. As a result, Canadian GDP growth will turn in a soft 1.0% gain in 2008, but



domestic demand is expected to track a respectable 2.5% quarterly pace throughout the year. Real GDP growth in 2009 will improve to 1.8%, as a modest recovery in export demand gets underway in the second half of that year.

### Consumers in a good position to weather the storm

Consumers are at the heart of every economy in the industrialized world. In Canada, they represent about two-thirds of total economic activity and thus wield considerable influence over the outlook. So far this year, the economic backdrop has been extremely supportive for consumer spending growth, but we don't think the current environment is sustainable. In the first four months of this year, employers have averaged an impressive 24,000 new hires per month, and hourly wage growth for permanent employees has climbed to a record 4.6%. With inflation holding below 2%, workers have had the benefit of a tidy real wage gain. However, the lagging nature of the labour market has put it out of sync with the economy, which slowed to a crawl in the fourth quarter of last year (+0.8%) and contracted outright at the start of this year. Going forward, we believe net new job creation will average about 5,000-7,000 per month, which will temper wage growth. Even so, the rug will not be pulled out from under the consumer, as we estimate that real after-tax income growth will average 4.5% this year before slowing to 2% in 2009.

In addition, the average Canadian household will not have their confidence and wealth undermined by falling home prices (as is the case in the U.S.). Nevertheless, households will probably begin to show more cautious behaviour in spending towards home furnishings and renova-

CANADA'S ECONOMIC INDICATORS					
Annual per cent change unless otherwise indicated					
	2005	2006	2007	Forecast	
				2008	2009
<b>Real GDP</b>	2.9	3.1	2.7	1.0	1.8
<b>Consumer Expenditure</b>	3.7	4.3	4.5	4.0	2.6
Durable Goods	5.1	7.6	7.1	7.4	2.2
<b>Business Investment</b>	12.1	9.9	3.5	3.6	3.9
Non-Residential Structures	10.0	8.9	-0.4	0.0	2.8
Machinery & Equipment	13.8	10.6	7.1	6.8	4.9
<b>Residential Construction</b>	3.4	2.2	3.0	-0.6	0.5
<b>Govt. Exp. on Goods &amp; Svcs.</b>	1.5	3.8	3.7	3.8	3.2
<b>Final Domestic Demand</b>	4.4	4.8	4.2	3.6	2.8
<b>Exports</b>	1.8	0.6	1.0	-2.6	0.4
<b>Imports</b>	7.1	4.6	5.5	3.0	3.2
<b>Change in Non-Farm Inventories (\$97 Bn.)</b>	10.3	10.0	12.6	2.7	3.5
<b>Final Sales</b>	2.4	3.3	2.6	1.7	1.8
<b>Int'l Curr. Acct. Bal. (\$Bn.)</b>	26.5	20.2	13.6	26.2	32.9
% of GDP	1.9	1.4	0.9	1.6	2.0
<b>Pre-tax Corporate Profits</b>	10.4	5.3	3.3	6.6	3.3
<b>GDP Chain-type Deflator</b>	3.4	2.5	3.1	3.1	1.6
<b>Employment (%)</b>	1.4	1.9	2.3	1.6	0.5
<b>Employment ('000)</b>	223	314	380	269	82
<b>Unemployment Rate (%)</b>	6.8	6.3	6.0	6.1	6.6
<b>Productivity*</b>	1.9	1.1	0.3	-0.6	1.3
<b>Real Pers. Disp. Income (PDI)**</b>	2.8	5.5	4.1	4.5	1.7
<b>Real PDI** Per Person</b>	1.8	4.4	3.1	3.5	0.7
<b>Consumer Price Index</b>	2.2	2.0	2.1	2.3	2.1
<b>Core CPI</b>	1.7	2.0	2.1	1.6	1.8
<b>Housing Starts ('000 units)</b>	224	229	228	221	211

Real GDP: Real gross domestic product; \*Real GDP per employee  
\*\*After-tax income adjusted for inflation; Forecast by TD Economics as at June 2008; Source: Statistics Canada, Bank of Canada, Canada Mortgage and Housing Corporation, Haver Analytics

tions, as the housing boom of the past seven years winds down in 2008. Existing home prices are tracking 5% growth in the first five months of this year, half the pace seen this time in 2007. A large part of this deceleration is due to a dramatic cooling in what use to be the hottest markets in the nation – Calgary and Edmonton. We knew it was just a matter of time before this would happen, our only concern going forward is regarding the length and depth of a fall in prices. After cumulative home price gains of 45-65% over the past two years, it would not surprise us to see a modest peak-to-trough pull back in the range of 8-10% in Calgary and Edmonton. While this type of pull back would barely nibble into the massive price appreciation that has accumulated over past years, we would still expect it to result in less spending on renovations and home décor. Excluding Alberta home trends from the Canadian outlook, homeowners in the rest of the nation should see prices appreciate at a modest pace of 3%. Any way you slice the data, one thing is clear. Canadians will not suffer the massive price declines that are occurring south of the 49<sup>th</sup> parallel. Overall, consumer spending should prove resilient in Canada, averaging a quarterly annualized pace of 2.7% over the forecast horizon.

#### More pain in store for export sector

The distressed export sector continues to take a pound of flesh from economic activity. The January-March period marked the third consecutive quarter in which the sector has contracted, and this time it chewed 1.4 annualized percentage points off real GDP growth. There was one unique factor in the data. A strike at an auto parts producer, American Axle, in the United States disrupted shipments and production in Canada. Excluding autos from real exports, the sector showed a 10.7% annualized gain in the quarter, rather than an 5.1% contraction. Unfortunately, this does not mean we'll see a smart export recovery in the second quarter. First, the auto strike did not end until mid-May, which came too late in the quarter to have a large influence on the overall trend. Second, April data revealed severe and broad-based weakness across export industries, suggesting the troubles of the sector are not a one-off event that will be corrected with the resolution of a strike. In fact, the mathematical reality of an extremely weak hand-off in March (-3.5%) and another soft start to the second quarter in April (-1.7%) suggests exports will again be a key detractor to economic growth in the second quarter. The third quarter performance will likely get a lift

CANADA'S ECONOMIC INDICATORS						
Fourth-quarter-over-fourth-quarter per cent change						
	Q4-04	Q4-05	Q4-06	Q4-07	Forecast	
					Q4-08	Q4-09
<b>Real GDP</b>	11.9	3.0	2.2	2.8	0.9	2.5
<b>Real Final Sales</b>	10.3	3.9	3.0	1.1	2.2	2.5
<b>Employment (%)</b>	1.6	1.6	1.9	2.4	0.9	0.5
Real GDP: Real gross domestic product; Forecast by TD Economics as at June 2008; Source: Statistics Canada, Haver Analytics						

from the resumption of auto shipments following the strike, but this will only be a short-term impact, as the realities of a high Canadian dollar and weakening demand south of the boarder will dominate the outlook thereafter. For 2008 as a whole, exports should contract by about 2.6%, which would be the worst year since the U.S. recession in 2001. As the U.S. economy gains a stronger underbelly in 2009, Canadian exports should follow with a modest recovery of 0.4% growth. While this doesn't seem like much of a recovery, the second half of next year should produce quarterly annualized export growth rates in the 3-3.5% range.

#### Inventories a wild card

A large part of the deterioration in real GDP in the first quarter was attributed to a \$17 billion swing in inventories that shaved more than 4 percentage points from annualized growth. While we had expected inventories to be reigned in after considerable stockpiling at the end of 2007, the magnitude certainly outstripped anything we've seen in recent history. Looking at the data back to 1992, this was the largest inventory swing to take place in a single quarter. Like exports, inventories were partly affected by the strike in the U.S., but the bottom line is that the ratio of inventory-to-sales remained unchanged at elevated levels relative to the past four years because sales also failed to meet expectations. This leads us to believe that firms will exhibit cautious behaviour in inventory management and will not replenish stock levels to any great degree over the forecast horizon. And, we cannot dismiss the possibility that there could be yet another large drawdown in a single quarter or perhaps spread over a couple of quarters as firms try to lower their inventory-to-sales ratios.

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# FINANCIAL OUTLOOK

## Switching Gears

A profound change of focus has occurred over the past few weeks, as the financial markets discourse has shifted from economic growth concerns to inflation risk. This change in gears has been most pronounced in the U.S., where the unabated rise in oil prices, as well as healthy increases in other commodity prices, seems to dominate headlines. It has increasingly become an issue for Canadian monetary policy officials as well.

In Canada, the about-face occurred in early June when the Bank of Canada defied expectations for a 25bps rate cut and left the overnight rate unchanged at 3.00%. The tone of the Bank's communiqué was neutral to slightly hawkish and left the markets with the distinct impression that they are in no hurry to change rates. The Bank specifically mentioned that "global growth has been stronger and commodity prices have been sharply higher than expected." As such, the most likely direction for the overnight rate is for higher, not lower rates.

Since the Bank took this change of tact, market expecta-

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tations have shifted significantly. The case for keeping rates on hold is now even more acute. The Bank's emphasis on inflation risk means a heightened focus on the inflation data. And on that front, there is certainly just cause for concern.

Commodity prices will likely impact Canadian inflation. The Bank of Canada noted that "if current levels of energy prices persist, total CPI inflation will rise above 3 per cent later this year." And indeed, all indications seem to point to that end. WTI crude oil prices hit a new intraday high of just over \$139 / bbl in mid June and other energy prices remain elevated. That will surely impact headline CPI.

Even core CPI has been trending higher and is poised

INTEREST RATE OUTLOOK													
	Spot Rate 6/16/2008	2007				2008				2009			
		Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
<b>CANADIAN FIXED INCOME</b>													
Overnight Target Rate (%)	3.00	4.25	4.25	4.50	4.25	3.50	3.00	3.00	3.00	3.00	3.00	3.25	3.75
3-mth T-Bill Rate (%)	2.70	4.20	4.40	4.01	3.84	1.97	2.60	2.70	2.70	2.70	3.00	3.35	3.85
2-yr Govt. Bond Yield (%)	3.37	3.98	4.59	4.08	3.75	2.62	3.20	3.15	3.10	3.20	3.40	3.70	4.05
5-yr Govt. Bond Yield (%)	3.60	4.02	4.56	4.21	3.87	2.91	3.50	3.50	3.50	3.60	3.80	4.05	4.35
10-yr Govt. Bond Yield (%)	3.85	4.11	4.56	4.34	3.99	3.44	3.80	3.80	3.90	4.00	4.15	4.35	4.65
30-yr Govt. Bond Yield (%)	4.18	4.20	4.49	4.44	4.10	3.94	4.15	4.25	4.35	4.40	4.45	4.60	4.80
10-yr-2-yr Govt. Spread (%)	0.48	0.13	-0.03	0.26	0.24	0.82	0.60	0.65	0.80	0.80	0.75	0.65	0.60
<b>U.S. FIXED INCOME</b>													
Fed Funds Target Rate (%)	2.00	5.25	5.25	4.75	4.25	2.25	2.00	2.00	2.00	2.00	2.00	2.50	3.00
3-mth T-Bill Rate (%)	2.00	5.06	4.81	3.91	3.27	1.37	1.80	1.75	1.80	1.90	2.00	2.60	3.10
2-yr Govt. Bond Yield (%)	2.93	4.57	4.86	3.98	3.05	1.58	2.65	2.50	2.40	2.40	2.70	3.15	3.65
5-yr Govt. Bond Yield (%)	3.66	4.53	4.92	4.24	3.44	2.44	3.35	3.20	3.15	3.20	3.40	3.75	4.15
10-yr Govt. Bond Yield (%)	4.21	4.64	5.02	4.59	4.02	3.41	4.00	3.90	3.90	3.95	4.10	4.30	4.65
30-yr Govt. Bond Yield (%)	4.76	4.84	5.12	4.84	4.45	4.29	4.60	4.60	4.60	4.55	4.55	4.65	4.85
10-yr-2-yr Govt. Spread (%)	1.28	0.07	0.16	0.61	0.97	1.83	1.35	1.40	1.50	1.55	1.40	1.15	1.00
<b>CANADA-U.S. SPREADS</b>													
3-mth T-Bill Rate (%)	0.70	-0.86	-0.41	0.10	0.57	0.60	0.80	0.95	0.90	0.80	1.00	0.75	0.75
2-yr Govt. Bond Yield (%)	0.44	-0.59	-0.27	0.10	0.70	1.04	0.55	0.65	0.70	0.80	0.70	0.55	0.40
5-yr Govt. Bond Yield (%)	-0.06	-0.51	-0.36	-0.03	0.43	0.47	0.15	0.30	0.35	0.40	0.40	0.30	0.20
10-yr Govt. Bond Yield (%)	-0.36	-0.53	-0.46	-0.25	-0.03	0.03	-0.20	-0.10	0.00	0.05	0.05	0.05	0.00
30-yr Govt. Bond Yield (%)	-0.58	-0.64	-0.63	-0.40	-0.35	-0.35	-0.45	-0.35	-0.25	-0.15	-0.10	-0.05	-0.05

f. Forecast by TD Economics as at June 2008; All forecasts are for end of period. Source: Bloomberg, TD Economics

to rise further. In April, core CPI rose 0.4% M/M, pushing the three month annualized trend up to 2.9% from 2.2% in March. Looking ahead, the Canadian dollar is expected to lose ground against the U.S. dollar. We expect the loonie to trade around 95 U.S. cents by the end of 2008 and slip to 92 U.S. cents by the end of 2009. Thus the downward impact of a strong Canadian dollar on inflation is likely to fade. In combination with how Canadian core CPI is defined, which includes some food products such as bread and meat, the spate of global food inflation is more likely to feed through to core inflation.

Also arguing for steady rates is that the impact that the credit crunch has had on the Canadian economy has not been as bad as feared. A number of credit spreads have narrowed toward historical norms, which is encouraging. Moreover, Canadian mortgage rates have declined, suggesting previous rate cuts are feeding through to consumers.

The Bank of Canada has indicated a preference for keeping rates steady, but the wildcard is how GDP unfolds. The export sector is threatened given softening U.S. demand, but recent data also suggest consumption could be at risk too, given trends in durables consumption.

Nevertheless, we think that the Bank will do what it can to avoid making any interest rate moves in the near term, raising rates only when the economy is back on track. To us, that means the overnight rate will remain at 3.00% until the second half of 2009. By that time, the economy should be ready for a series of rate hikes, leaving the overnight rate at 3.75% by the end of 2009. Given our less aggressive view, we expect bond yields to fall, as the Bank does not deliver rate hikes according to market expectations. In the near term, this means a steeper yield curve, which will eventually flatten as the Bank starts to tighten rates.

### Birds of a Feather Flock Together

Just a few short months ago, the prevailing concern was whether the U.S. economy would slip into recession. While the economy has softened measurably, it has yet to show signs of cratering. The fiscal stimulus has come earlier than expected, and has been put to good use, if the latest retail sales figures are any indication. However, recent inflation data build a rather pressing case for rate hikes in the U.S. Inflation is running hotter than the Fed would like, with recent headline CPI rising 0.6% M/M in April, which pushed the annual rate to 4.2%.

Food and energy prices remain particularly worrisome in the U.S, as they continue to weigh on already beleaguered consumers. Gasoline prices have crested \$4/gallon and food prices are rising at a 5.0% Y/Y pace. In this environment, a flock of inflation hawks on the FOMC have been quick to call for higher rates.

Clearly, the dual mandate of the Fed seems to be favouring the inflation side of the scale, rather than the growth issues. The market is pricing in rate hikes by the end of 2008, but we think the timing is too aggressive. The economy is still fragile and the pace of credit market repair has been slow. Moreover, some price pressures should be alleviated as the economy slows further. This will buy the Fed some leeway to decide the appropriate time to hike rates.

In our view, the Fed is likely to remain on hold though 2008 and early 2009, leaving the fed funds rate at 2%. Based on our expectation that the Fed will deliver rate hikes slower than the market anticipates, bond yields should fall in the near term, and the curve should steepen until the second half of 2009 when the Fed delivers a handful of rate hikes to leave the fed funds rate at 3% by year end.

*Charmaine Buskas 416-982-3297*

FOREIGN EXCHANGE OUTLOOK														
Currency	Exchange Rate	Spot Price 6/16/2008	2007				2008				2009			
			Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Canadian dollar	USD per CAD	0.975	0.894	0.930	1.005	1.002	0.992	0.980	0.960	0.950	0.950	0.940	0.930	0.920
Canadian dollar	CAD per USD	1.026	1.119	1.065	0.995	0.998	1.008	1.020	1.042	1.053	1.053	1.064	1.075	1.087
Japanese yen	JPY per USD	107.9	118	123	115	112	104	108	108	106	106	104	104	102
Euro	USD per EUR	1.541	1.337	1.354	1.410	1.459	1.562	1.600	1.550	1.500	1.450	1.420	1.400	1.370
U.K. pound	USD per GBP	1.956	1.978	2.009	2.014	1.985	1.987	1.975	1.890	1.829	1.790	1.753	1.750	1.713
Swiss franc	CHF per USD	1.048	1.214	1.221	1.170	1.133	1.034	1.000	1.013	1.033	1.062	1.085	1.086	1.109
Australian dollar	USD per AUD	0.940	0.809	0.840	0.875	0.875	0.944	0.940	0.940	0.920	0.920	0.900	0.900	0.880
Mexican peso	MXN per USD	10.33	11.05	10.81	10.92	10.90	10.47	10.35	10.35	10.40	10.50	10.50	10.55	10.55

f. Forecast by TD Economics as at June 2008; All forecasts are for end of period; Source: Federal Reserve of New York, TD Economics

<b>CANADIAN ECONOMIC OUTLOOK</b>																		
Period-Over-Period Annualized Per Cent Change Unless Otherwise Indicated																		
	2007				2008				2009				Annual Average			4th Qtr/4th Qtr		
	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	07	08F	09F	07	08F	09F
<b>Real GDP</b>	4.1	3.9	2.3	0.8	-0.3	0.4	1.9	0.8	1.7	2.4	2.7	3.0	2.7	1.0	1.8	2.8	0.9	2.5
<b>Consumer Expenditure</b>	3.8	5.8	4.2	7.5	3.2	2.8	2.2	2.1	2.5	2.8	3.3	3.3	4.5	4.0	2.6	5.3	2.6	3.0
Durable Goods	4.6	15.0	-1.4	11.5	16.5	1.8	1.5	1.1	2.4	2.8	3.2	3.4	7.1	7.4	2.2	7.3	5.0	2.9
<b>Business Investment</b>	-2.6	3.5	4.8	5.6	2.2	2.9	3.3	3.6	4.2	4.2	4.3	4.4	3.5	3.6	3.9	2.8	3.0	4.3
Non-Res. Structures	-3.1	-7.7	-4.3	-3.5	3.5	2.1	2.3	2.5	2.8	3.1	3.3	3.4	-0.4	0.0	2.8	-4.7	2.6	3.1
Machinery & Equipment	-2.2	14.2	13.2	14.0	1.1	3.9	4.2	4.6	5.4	5.2	5.1	5.3	7.1	6.8	4.9	9.6	3.4	5.2
<b>Residential Construction</b>	11.0	4.7	4.1	1.8	-6.8	-0.5	1.0	0.5	0.9	0.8	-0.5	-0.8	3.0	-0.6	0.5	5.4	-1.5	0.1
<b>Government Expenditure on Goods &amp; Services</b>	3.0	2.7	7.2	5.8	2.6	2.8	2.6	3.1	3.4	3.5	3.1	3.0	3.7	3.8	3.2	4.6	2.8	3.3
<b>Final Domestic Demand</b>	3.3	4.9	5.1	6.3	2.3	2.6	2.4	2.4	2.8	3.0	3.1	3.0	4.2	3.6	2.8	4.9	2.5	3.0
<b>Exports</b>	0.8	2.5	-1.1	-7.4	-4.1	-1.4	1.9	-2.0	-1.2	1.4	3.3	3.4	1.0	-2.6	0.4	-1.4	-1.4	1.7
<b>Imports</b>	1.1	4.9	20.6	8.6	-10.0	5.2	2.9	3.1	3.0	3.0	3.3	3.6	5.5	3.0	3.2	8.6	0.1	3.2
<b>Change in Non-Farm Inventories (\$97 Bn)</b>	5.8	5.2	19.9	19.4	2.4	3.2	2.3	3.1	4.3	4.1	2.9	2.9	12.6	2.7	3.5	---	---	---
<b>Final Sales</b>	3.2	4.4	-3.2	0.2	6.0	0.1	2.1	0.5	1.3	2.5	3.2	3.0	2.6	1.7	1.8	1.1	2.2	2.5
<b>International Current Account Balance (\$Bn)</b>	15.8	28.5	7.0	3.1	22.2	31.8	27.3	23.6	25.2	29.2	35.6	41.6	13.6	26.2	32.9	---	---	---
% of GDP	1.1	1.9	0.5	0.2	1.4	2.0	1.7	1.5	1.6	1.8	2.1	2.5	0.9	1.6	2.0	---	---	---
<b>Pre-tax Corp. Profits</b>	4.1	4.4	4.1	0.1	9.9	16.5	3.1	0.2	2.9	2.0	4.2	4.7	3.3	6.6	3.3	3.1	7.2	3.5
% of GDP	13.3	13.2	13.3	13.1	13.3	13.6	13.7	13.6	13.6	13.6	13.5	13.5	13.2	13.6	13.5	---	---	---
<b>GDP Deflator (Y/Y)</b>	2.8	3.5	2.6	3.5	3.2	3.3	3.5	2.5	1.6	0.8	1.6	2.4	3.1	3.1	1.6	3.5	2.5	2.4
<b>Nominal GDP</b>	10.6	9.0	1.4	4.9	4.6	5.6	1.7	0.7	3.4	4.5	5.8	6.0	5.9	4.1	3.5	6.4	3.1	4.9
<b>Labour Force</b>	3.5	1.3	1.4	2.5	1.9	1.2	1.1	1.2	1.1	0.9	0.8	1.0	2.0	1.6	1.0	2.2	1.3	1.0
<b>Employment (%)</b>	3.7	1.5	1.7	2.9	2.0	0.8	0.5	0.4	0.4	0.4	0.5	0.6	2.3	1.6	0.5	2.4	0.9	0.5
<b>Employment ('000s)</b>	151	63	73	120	86	36	21	17	18	19	22	25	380	269	82	406	160	84
<b>Unemployment Rate (%)</b>	6.1	6.1	6.0	5.9	5.9	6.1	6.2	6.3	6.4	6.5	6.6	6.7	6.0	6.1	6.6	---	---	---
<b>Personal Disp. Income</b>	9.7	1.8	5.5	5.9	8.5	5.7	3.0	3.4	3.4	1.5	3.5	4.2	5.7	5.7	3.2	5.7	5.1	3.1
<b>Pers. Savings Rate (%)</b>	3.9	2.3	2.5	1.9	2.8	3.3	3.3	3.5	3.4	2.8	2.4	2.2	2.7	3.2	2.7	---	---	---
<b>Cons. Price Index (Y/Y)</b>	1.8	2.2	2.2	2.4	1.8	2.0	2.6	3.0	2.9	1.9	1.7	2.0	2.1	2.3	2.1	2.4	3.0	2.0
<b>Core CPI (Y/Y)</b>	2.3	2.4	2.2	1.6	1.4	1.5	1.6	2.0	2.0	1.7	1.7	2.0	2.1	1.6	1.8	1.6	2.0	2.0
<b>Housing Starts ('000s)</b>	226	228	243	214	234	214	221	214	210	218	208	206	228	221	211	---	---	---
<b>Productivity:</b>																		
<b>Real GDP / worker (Y/Y)</b>	-0.3	0.9	0.7	0.1	-0.4	-1.2	-0.8	-0.1	0.7	1.3	1.5	2.0	0.3	-0.6	1.3	0.1	-0.1	2.0

F: Forecast by TD Economics as at June 2008

Source: Statistics Canada, Bank of Canada, Canada Mortgage and Housing Corporation, Haver Analytics

## U.S. ECONOMIC OUTLOOK

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

	2007				2008				2009				Annual Average			4thQtr/4th Qtr		
	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	07	08F	09F	07	08F	09F
<b>Real GDP</b>	0.6	3.8	4.9	0.6	0.9	1.3	0.1	-0.8	1.4	2.1	2.8	3.1	2.2	1.4	1.2	2.5	0.4	2.4
<b>Consumer Expenditure</b>	3.7	1.4	2.8	2.3	1.0	2.1	0.2	-1.8	1.2	1.7	2.2	2.4	2.9	1.4	0.8	2.6	0.3	1.9
Durable Goods	8.8	1.7	4.5	2.0	-6.2	-2.3	-6.0	-5.1	1.6	3.1	3.8	4.4	4.7	-2.1	-0.2	4.2	-4.9	3.2
<b>Business Investment</b>	2.1	11.0	9.3	6.0	-0.2	-1.4	-3.8	-4.7	-3.4	-1.7	1.0	2.1	4.7	1.7	-2.4	7.1	-2.6	-0.5
Non-Res. Structures	6.4	26.2	16.4	12.4	1.1	-3.7	-5.8	-5.0	-1.9	-0.2	1.8	2.3	12.9	4.0	-2.1	15.1	-3.4	0.5
Machinery & Equipment	0.3	4.7	6.2	3.1	-0.9	-0.3	-2.8	-4.5	-4.1	-2.4	0.6	2.0	1.3	0.7	-2.5	3.6	-2.1	-1.0
<b>Residential Construction</b>	-16.3	-11.8	-20.5	-25.2	-25.5	-21.8	-20.1	-15.9	-4.3	2.9	10.6	15.7	-17.0	-22.1	-5.9	-18.6	-20.9	6.0
<b>Govt. Consumption &amp; Gross Investment</b>	-0.5	4.1	3.8	2.0	2.0	2.7	2.2	2.0	2.0	1.9	1.8	1.7	2.0	2.5	2.0	2.3	2.2	1.8
<b>Final Domestic Demand</b>	1.7	2.1	2.5	1.3	-0.1	0.9	-0.6	-1.9	0.7	1.5	2.3	2.6	1.8	0.6	0.5	1.9	-0.4	1.8
<b>Exports</b>	1.1	7.5	19.1	6.5	2.8	5.0	4.4	4.0	3.3	4.8	5.6	5.9	8.1	6.4	4.4	8.4	4.0	4.9
<b>Imports</b>	3.9	-2.7	4.4	-1.4	-2.6	0.7	0.4	-2.8	0.4	2.2	2.8	3.1	1.9	-0.6	0.6	1.0	-1.1	2.1
<b>Change in Non-Farm Inventories (\$96 Bn)</b>	-5.8	1.3	26.0	-21.7	-13.6	-21.1	-15.7	-12.7	-5.3	2.1	5.7	10.1	-0.1	-15.8	3.2	---	---	---
<b>Final Sales</b>	1.3	3.6	4.0	2.4	0.7	1.5	-0.1	-1.0	1.1	1.8	2.6	2.9	2.5	1.5	1.0	2.8	0.3	2.1
<b>International Current Account Balance (\$Bn)</b>	-793	-760	-710	-692	-699	-788	-779	-730	-702	-683	-666	-647	-739	-749	-674	---	---	---
% of GDP	-5.9	-5.5	-5.1	-4.9	-4.9	-5.5	-5.4	-5.0	-4.8	-4.6	-4.4	-4.3	-5.3	-5.2	-4.5	---	---	---
<b>Pre-tax Corporate Profits including IVA&amp;CCA</b>	4.4	26.8	-4.9	-12.4	1.3	-9.6	3.5	-3.7	10.8	10.7	17.0	17.8	2.7	-3.0	6.9	2.5	-2.2	14.1
% of GDP	11.4	11.9	11.6	11.1	11.1	10.7	10.7	10.6	10.7	10.9	11.2	11.5	11.5	10.8	11.1	---	---	---
<b>GDP Deflator (Y/Y)</b>	2.9	2.7	2.4	2.6	2.2	2.2	2.6	2.7	2.7	2.5	2.4	2.2	2.7	2.4	2.5	2.6	2.7	2.2
<b>Nominal GDP</b>	4.9	6.6	6.0	3.0	3.5	4.2	2.6	1.9	4.2	4.2	4.9	5.1	4.9	3.8	3.7	5.1	3.0	4.6
<b>Labour Force</b>	1.2	-0.1	1.0	1.2	0.0	1.1	-0.4	0.7	0.6	0.7	0.7	0.7	1.1	0.5	0.5	0.8	0.3	0.7
<b>Employment</b>	1.2	0.9	0.8	0.8	-0.3	-0.5	-0.8	-0.7	-0.1	0.3	0.4	0.5	1.1	0.0	-0.1	0.9	-0.6	0.3
<b>Change in Empl. ('000s)</b>	395	316	259	272	-111	-169	-276	-241	-22	104	137	172	1,527	-24	-194	1,242	-798	391
<b>Unemployment Rate (%)</b>	4.5	4.5	4.7	4.8	4.9	5.3	5.5	5.7	6.0	6.2	6.3	6.4	4.6	5.4	6.2	---	---	---
<b>Personal Disp. Income</b>	9.1	3.4	5.9	4.9	5.3	16.6	-6.7	0.8	4.9	3.8	3.4	4.3	5.7	5.3	2.8	5.8	3.6	4.1
<b>Pers. Savings Rate (%)</b>	1.0	0.3	0.4	0.2	0.6	2.9	0.2	0.1	0.5	0.5	0.3	0.3	0.5	1.0	0.4	---	---	---
<b>Cons. Price Index (Y/Y)</b>	2.4	2.6	2.4	4.0	4.2	4.1	4.6	4.1	3.4	2.8	2.0	1.8	2.9	4.2	2.5	4.0	4.1	1.8
<b>Core CPI (Y/Y)</b>	2.6	2.3	2.1	2.3	2.4	2.3	2.4	2.2	2.0	1.9	1.9	1.8	2.3	2.3	1.9	2.3	2.2	1.8
<b>Housing Starts (mns)</b>	1.45	1.46	1.30	1.15	1.04	0.96	0.84	0.84	0.84	0.86	0.91	0.98	1.34	0.92	0.90	---	---	---
<b>Productivity:</b>																		
<b>Real Output per hour (y/y)</b>	0.6	1.0	2.9	2.9	3.3	3.4	2.2	1.7	1.7	1.5	1.9	2.7	1.9	2.6	2.0	2.9	1.7	2.7

F: Forecast by TD Economics as at June 2008

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