

FINANCIAL FIREWORKS MASK UNIMPRESSIVE ECONOMIES

- U.S. economy to slow from a lacklustre 1.7% pace in 2008 to a lethargic 1.1% pace in 2009
- Canadian GDP growth expected to improve slightly from 0.7% in 2008 to just 1.2% in 2009
- TD Economics believes the worst is in the rear-view mirror for the Canadian economy as a whole (however, the bar was set rather low after the economy contracted modestly in the first half of 2008)
- Softer housing markets and slower employment will weigh on Canadian households
- Bold action from the U.S. policymakers and global central banks addresses some major downside risks, but does little to stop the economic aftermath of tighter credit
- Global economic growth expected to slip from 3.7% in 2008 to 2.9% in 2009, slightly below the 3.0% threshold commonly associated with a global recession

TORONTO – Some core beliefs that have shaped the economic forecasts have recently been falling into place, states a report published today by TD Economics. These included the expectation that U.S. home prices would continue to fall, putting homeowners and financial institutions under stress, and leading to a broader slowdown in lending and consumer spending. “Exports have helped keep the U.S. economy afloat, but with lending and spending being crimped, the U.S. economy is on sinking ground,” explained Chief Economist Don Drummond. “Unfortunately, our pessimistic forecasts for the U.S. economy are playing out.”

With strong income growth and unemployment rates in Canada at generational lows, there has been a natural buffer to sustain the Canadian economy while battening down the hatches and preparing for the rocky ride. However, Drummond said, “Eventually, a recession in Canada’s biggest trading partner was going to wear down that domestic resilience. The Canadian economy may be more insulated than in the past, but with the U.S. in a tail spin, it just isn’t enough.”

TD Economics believes that the U.S. recession will be at its worst this winter. “The economic fallout in the U.S. will get worse before it gets better, so it’s likely to be a year before the pace of economic growth in Canada experiences a shallow recovery,” said Drummond. TD Economics believes an ongoing, though moderating, expansion in Canadian consumer and business sectors should be enough to keep the economy out of a recession.

Financial fears dampen U.S. holiday cheer

“Events over the last three weeks have certainly raised the risk that we have been too optimistic as venerable – yet vulnerable – financial institutions have disappeared,” said Drummond. More capital vanished from the financial sector and the already sky-high cost of raising funds leapt again. The news that the U.S. Government would take its involvement in the financial sector to an entirely new level was met by a wave of optimism in markets. “One way or another, there will still be a dead weight loss to be reckoned with,” said Drummond. TD Economics believes the TARP (Troubled Asset Relief Program) could help revive inter-bank lending sooner. But, institutions will still face large writedowns, their capital will still be depressed, and regional banks will still struggle. Meanwhile, the public sector will take on more risk, which will be a hit to national debt and taxpayers. “The short-term gain does not remove the long-term pain,” said Drummond.

Demand for credit has risen as U.S. households no longer have a ready source of funds in re-financing their ever-depreciating homes. Corporations in almost all countries need external funding for capital expenditures as retained earnings dwindle. “The fact that these needs would be denied or fulfilled at a high price was critical to our relatively pessimistic outlook,” explained Drummond, adding, “Although key elements of our storyline are falling into place, we face perhaps an even greater uncertainty looking ahead.”

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2...

TD Economics expects exports will be strong enough to keep the U.S. economy expanding in the third quarter of 2008, but by the fourth quarter, forecasts the U.S. economy will contract by 1.4% and only slowly recover into 2009. In addition to a retrenchment in consumer spending and ongoing contractions in home construction in the U.S., TD Economics forecasts the global economy will slip into a shallow recession as the result of a slump in a number of industrialized economies. Global GDP growth of 2.9% in 2009 is just below the 3.0% threshold which commonly defines a global recession. With diminished demand overseas, U.S. exports are likely to contribute less to economic growth. “The Farmer’s Almanac warns this will may be a colder than usual winter. The Economist’s Almanac warns the economy may follow credit markets into a deep freeze this winter,” said Drummond.

Canadian economy struggles with multiple drags

TD Economics cites the profound implications for the Canadian economy. Three-quarters of Canada’s trade is with the U.S., and two of the largest exports – forestry products and autos – are the most vulnerable to the housing and consumption weakness south of the border. “It is almost inconceivable that painful adjustments in our manufacturing sector have been completed,” said Drummond.

TD Economics warns that while the financial environment in Canada is superior to that in the U.S., it too is not immune to the U.S. financial meltdown. Almost a third of Canadian corporate funding comes from the U.S. market, so credit tightness there has a direct impact here. The cost to Canadian financial institutions of raising funds has also soared, although not to the full extent as for U.S. banks. Moreover, lower commodity prices will reverse much of the extraordinary income gains of recent years, particularly in Western Canada.

And, as if the cross-border effects were not enough, TD Economics’ new forecasts highlight some domestic headwinds. Notably, the Canadian housing sector has come off the boil, with prices moderating across Canada and the pace of new home construction returning to an average pace, but is not crashing American style. With higher costs and greater uncertainties, businesses are easing back on new capital investments and new hiring. Weaker income gains and slower employment growth will contribute to softer consumer spending than what was seen over the last year.

In all, these factors lead to a profile for the Canadian economy that resembles that of the American economy. “The Canadian and U.S. economies will continue to essentially move sideways until a fairly tepid recovery begins in the second half of 2009,” said Drummond, adding, “The party is definitely over, and no corner of the globe is left out of having to help clean up the mess.”

TD Economics’ Quarterly Economic Forecast can be found at www.td.com/economics

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