



TD Economics

The Weekly Bottom Line

August 22, 2008

HIGHLIGHTS

- Wholesalers and retailers present a mixed picture to close out Q2
- Canada on the edge of a technical recession
- CPI inflation up to 3.4% in July

With mostly second-tier economic data emanating from the U.S. this week, our focus lay mostly on Canadian data, which we think helps to frame answers to some key questions that have emerged in recent weeks. While inseparable, some of these questions relate to inflation while others pertain to economic growth. In the growth-related batch of questions, the near-term focus is on whether or not the Canadian economy will experience a technical recession, i.e. two consecutive declines in quarterly real GDP. Meanwhile, in the basket of questions pertaining to prices, of high interest are issues like: how high will Canadian inflation go, and when will it come back down to target?

Not much 'bling'

First, what to make of the risk that real GDP declined further in Q2? After losing much of its shine late in 2007 and then contracting by a slight 0.3% (annualized) in Q1, Canadian real GDP is expected to have grown in Q2, but just barely. Since our June forecast for a mere 0.4% gain and the Bank of Canada's (BoC) modest July forecast of 0.8%, the data have lined up well enough against both these forecasts to keep a 0-1% outcome as the most likely. Taken together, the last pieces of economic data before next week's release of the Q2 GDP figures did not do much to pin down whether growth in that quarter was slightly positive or slightly negative. They did, however, help to reduce the possibility of an outcome significantly

Recent TD Economics Research

August 21, 2008 - Canadian Consumer Price Index
 August 20, 2008 - Canadian Retail Sales
 August 20, 2008 - Bank of England Minutes
 August 19, 2008 - Canadian Wholesale Sales
 August 19, 2008 - U.S. Housing Starts

| RETAIL TRADE | | | | | | |
|--------------------------------|------------|------------|------------|------------|------------|------------|
| Annual average per cent change | | | | | | |
| | 98-07 | 2005 | 2006 | 2007 | 2008* | 2008F |
| CANADA | 5.3 | 5.6 | 6.4 | 5.8 | 4.8 | 4.0 |
| N. & L. | 5.3 | 1.2 | 3.7 | 9.5 | 7.6 | 6.8 |
| P.E.I. | 4.5 | 2.8 | 4.0 | 8.2 | 6.0 | 3.3 |
| N.S. | 4.1 | 2.2 | 6.3 | 4.0 | 5.6 | 4.6 |
| N.B. | 4.8 | 4.6 | 6.1 | 6.2 | 4.8 | 3.6 |
| Quebec | 4.9 | 5.1 | 5.1 | 4.3 | 4.8 | 3.6 |
| Ontario | 4.9 | 4.8 | 4.1 | 4.0 | 4.9 | 4.0 |
| Manitoba | 5.2 | 5.9 | 4.5 | 9.5 | 9.5 | 9.0 |
| Sask. | 5.3 | 5.2 | 6.5 | 12.9 | 13.9 | 13.1 |
| Alberta | 8.5 | 11.8 | 15.6 | 9.0 | 2.1 | 2.9 |
| B.C. | 4.5 | 4.4 | 6.8 | 7.2 | 3.2 | 2.7 |

* Year-to-date (Jan.-Jun.). F: Forecast by TD Economics as at June 2008
 Source: Statistics Canada

off forecast, meaning Q2 real GDP growth outside the (-1.0, +1.0) range. While wholesalers finished Q2 with a good 1.0% monthly increase in June sales volumes, retailers had a harder time of it and recorded a 0.4% decline in their sales volumes during the same month. Many retailers' overall receipts were boosted by higher prices, mostly at gasoline stations, but after stripping out price changes (which do not feed into calculations of real GDP), it becomes apparent that the retail story unfolding is one of less bang for your buck from a consumer's standpoint. Some retailers are able to offset lower volumes with higher prices, but times aren't rosy for the many that cannot, because of competitive pressures and/or weaker demand. Bucking the commonly held view, vehicle and overall retail sales held up fine in the first half of this year across Canada (yes, even in downtrodden Ontario) except B.C. and Alberta. After growing by 4.8% in the first half of this year, we think Canadian retail sales will slow to about a 3.0-3.5% pace of growth in the second half of this year. With sales receipts forecast to expand by 4% for this year as a whole, retailers are still looking at a decent year, albeit sub-par. Overall job and income growth are slowing, as are housing markets and, soon to follow, home-related purchases.

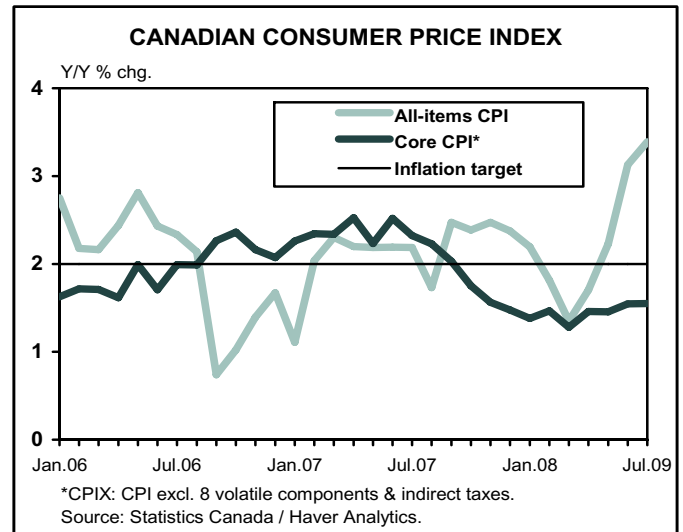
As for the bigger picture, a technical recession is in the

cards, but it is one of multiple cards, so we are still in the land of probabilities. We could go on ad nauseam as to what a recession 'really' is, and why the 'two consecutive quarterly real GDP contractions' definition is much too narrow. But we would probably be doing so at the cost of sounding like an aging professor berating the younger generation for not 'getting it'. Furthermore, we are also quite mindful of the media-grabbing impact that a negative print on Q2 real GDP growth would have. The scale of reaction is unfortunately not evenly balanced between ever-so-slightly positive growth (say +0.1%) and a slight contraction (say -0.1%). As discussed at length in a recent "Market Musing" from TD Securities Economics Strategy, we believe the risk of a Q2 contraction in real GDP is significant at 35%, but that readers should treat it as if it were actually the most likely scenario, so as not to be caught off guard by any market gyrations if it were to materialize. If it does not, we doubt that a Q2 expansion of 0.5-1.0% would be anything to write home about either. The one thing that is clear is that while the Canadian economy is certainly not experiencing stagflation comparable to that of the late 1970s, it is suffering through a bout of what can reasonably be dubbed a 'stagflation lite' episode. Indeed, Canadian economic growth has been stagnant since Q4 of last year, and the outlook is that it will continue to move mostly sideways, similarly to the U.S. economy, until the second half of 2009. Which takes us to issues related to inflation, in particular: how high will it go, and how long will it stay there?

Plop, Plop, Fizz, Fizz

The surge in commodity and energy prices recorded earlier in the year is making its uneasy way through the world's economies as they experience high inflation rates. In the process of absorbing this commodity price shock, so far Canada only seems to be having a mild case of indigestion, which is much better than what can be said about most other countries. A big part of this is because large parts of the country are commodity exporters and clear benefactors of high commodity prices. While the adjustment is painful for many industries, there are few indications as of yet that other regions of Canada are choking on these higher commodity prices.

In July, the U.S. CPI inflation rate stood at 5.6%, much higher than Canada's CPI inflation rate of 3.4%. While each headline inflation rate is uncomfortable from the perspective of each country's respective central bank, core inflation rates have stayed lower, with the latest (July) readings at 2.5% in the U.S. and 1.5% in Canada. Since commodity prices started retreating in July, it now looks less



likely that 4% inflation will be breached in Canada. However, it might be premature to call a peak to inflation at 3.4% in July. Base effects (price declines in 2007) suggest that gasoline and food prices will continue to bubble on a year-over-basis until November, with headline inflation likely to remain in the 3.0-3.5% range throughout much of the second half of this year - assuming commodity prices continue to edge down as per our view. If commodity prices stagnate (increase) post-August, then inflation would near (breach) the 4.0% mark towards year-end.

As for core inflation, we think it will gradually edge up towards 2.0% by year-end. Both headline and core inflation measures should then ease off to below 2.0% by the second quarter of 2009. Since much of the downside risks to inflation and growth seem to be playing out, mostly through lower commodity prices, vis-à-vis the BoC MPR Update of July, does this imply the BoC will change its policy stance and lower the overnight interest rate further? Given that the current real (inflation-adjusted) overnight rate is negative, how much more accommodative could it get? There might be about 50 basis points of easing room left, but not much more. It would take more than a small negative print on Q2 real GDP growth for the BoC to switch to an easing stance. Another significant job loss figure in August - although we expect +5,000-10,000 net new jobs - would most certainly raise a few highbrows at the BoC after July's massive 55,000 net employment drop. The next interest rate decision meeting is set for Sept. 3rd, where we expect them to remain on hold. Beforehand and prior to the release of Q2 GDP and August employment data, the BoC will have an opportunity to signal its intentions for its October meeting at a speech this upcoming Tuesday (Aug 26th), where we will be all ears.

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UPCOMING KEY ECONOMIC RELEASES

U.S. Durable Goods Orders – July

Release Date: August 27/08

June Result: total 0.8% M/M;
ex-transportation +2.0% M/M

TD Forecast: total -0.5% M/M;
ex-transportation -1.3% M/M

Consensus: total +0.1% M/M;
ex-transportation -0.5% M/M

Despite the fiscal stimulus-driven rebound in U.S. economic activity in Q2 dollar-induced export demand, the underlying weakness in U.S. business activity remains in place. We expect activity to remain subdued in the com-

ing months. Our call is for durable goods orders to decline by 0.5% M/M decline in July, following the 0.8% M/M gain in June. Excluding transportation, orders are expected to fall by a more profound 1.5% M/M, due in part to a shift in the aerospace industry. Indeed, despite the modest improvement in the auto-related sectors in June, we believe that the unwillingness of business to embark on new investment project will continue to weigh on durable goods orders.

Millan Mulraine 416-308-2911

U.S. Personal Income and Spending - July

Release Date: August 29/08

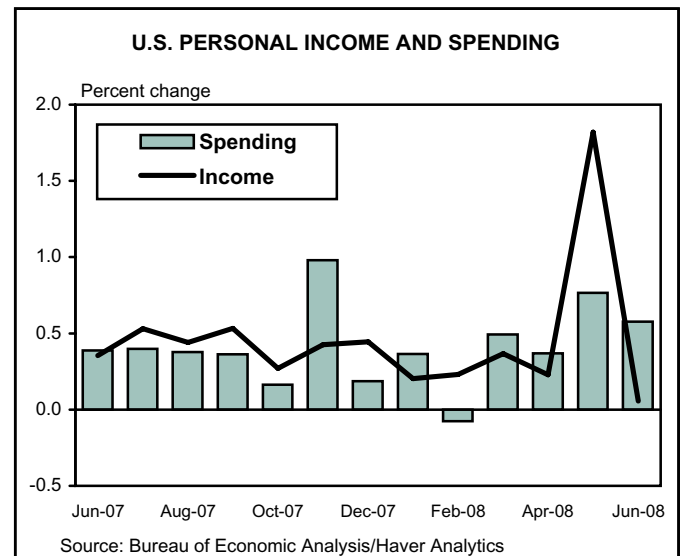
June Result: income +0.1% M/M, spending +0.6% M/M; core PCE deflator +0.3% M/M, +2.3% Y/Y

TD Forecast: income +0.2% M/M; spending +0.4% M/M; core PCE deflator +0.3% M/M, 2.4% Y/Y

Consensus: income 0.0% M/M; spending 0.3% M/M; core PCE deflator 0.3% M/M, 2.4% Y/Y

July represents an inflection point after which the U.S. fiscal stimulus impact may start to wane. As a result, spending could still be somewhat elevated at +0.4% M/M, but income itself is likely to be modest at +0.2% M/M. August could be considerably worse on both fronts, as the true nature of the U.S. economy once again reveals itself, driven by close to 500K jobs already lost in the U.S. since January, an unemployment rate heading towards 6%, and home prices falling by 16% over the past year. In terms of inflation, core PCE prices are expected to increase at a rather robust pace of 0.3% M/M – the same as the monthly gain in core CPI – with the annual core PCE inflation rate remaining flat at 2.4% Y/Y.

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Canadian Real GDP - Q2/08

Release Date: August 29/08

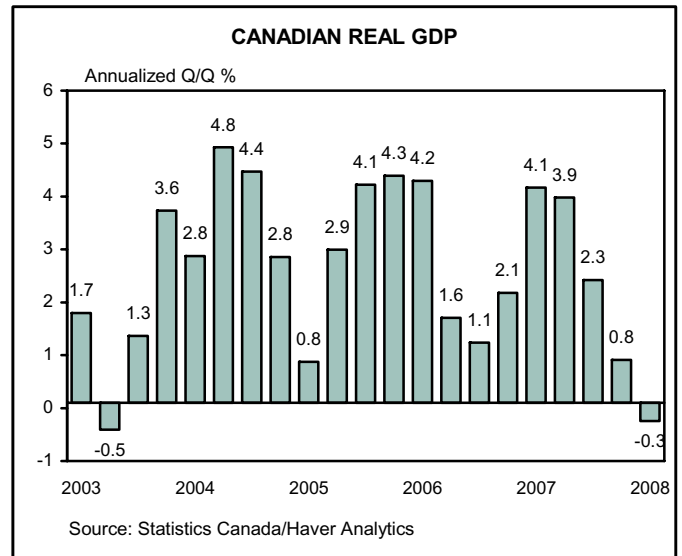
Q1 Result: -0.3%

TD Forecast: +0.4%

Consensus: +0.6%

The Canadian economy appears set to squeak out a slightly positive reading in the second quarter of 2008, with a +0.4% annualized gain. Contributing to this, consumer spending and business investment should be so-so, inventory accumulation could be mixed (but with a high degree of uncertainty), while net exports will be sour. There are considerable risks underlying this report, with a non-trivial chance that Q2 GDP could be outright negative, which would make for a second-consecutive quarter of negative GDP in Canada. This would fulfill a popular definition of a “recession”, and no doubt result in much hand-wringing. We are not convinced that the Canadian economy is truly quite as soft as this report is likely to portray, but this is not likely to filter into the market’s interpretation.

Eric Lascelles 416-982 8979



RECENT KEY ECONOMIC INDICATORS August 18 - August 22, 2008

| Date | Economic Indicators | Data for | Units | Current | Prior | |
|----------------------|--|----------|------------|---------|--------|----|
| Canada | | | | | | |
| Aug 20 | Leading Indicators | Jul. | M/M % chg. | 0.0 | 0.0 | |
| Aug 20 | Retail Sales | Jun. | M/M % chg. | 0.5 | 0.3 | R▼ |
| Aug 20 | Retail Sales (Ex. Autos) | Jun. | M/M % chg. | 1.4 | 0.6 | R▲ |
| Aug 21 | Consumer Price Index | Jul. | Y/Y % chg. | 3.4 | 3.1 | |
| Aug 21 | Consumer Price Index (Core) | Jul. | Y/Y % chg. | 1.5 | 1.5 | |
| United States | | | | | | |
| Aug 19 | Producer Price Index | Jul. | Y/Y % chg. | 9.8 | 9.2 | |
| Aug 19 | Producer Price Index (Ex. Food & Energy) | Jul. | Y/Y % chg. | 3.5 | 3.0 | |
| Aug 19 | Housing Starts | Jul. | Thousands | 965.0 | 1084.0 | R▲ |
| Aug 19 | Building Permits | Jul. | Thousands | 937.0 | 1138.0 | R▲ |
| Aug 19 | <i>Fed Governor Fisher Speaks in Aspen on U.S. Economy</i> | | | | | |
| Aug 19 | ABC Consumer Confidence | 17-Aug | Index | -49.0 | -50.0 | |
| Aug 20 | MBA Mortgage Applications | 15-Aug | % change | -1.5 | -1.5 | |
| Aug 21 | Initial Jobless Claims | 16-Aug | Thousands | 432.0 | 445.0 | R▼ |
| Aug 21 | Continuing Claims | 9-Aug | Thousands | 3362.0 | 3379.0 | R▼ |
| Aug 21 | Philadelphia Fed Index | Aug. | % change | -12.7 | -16.3 | |
| Aug 21 | Leading Indicators | Jul. | % change | -0.7 | 0.0 | R▲ |
| Aug 22 | <i>Fed Governor Bernanke Speaks on Financial Stability at Jackson Hole</i> | | | | | |

Source: Bloomberg, TD Economics

UPCOMING NORTH AMERICAN ECONOMIC CALENDAR August 25 - August 29, 2008

| Release Date | Economic Indicators | Data for Period | Units | Consensus Forecast | Prior |
|----------------------|---|-----------------|------------|--------------------|--------|
| Canada | | | | | |
| Aug 28 | Current Account | Q2 | \$C, blns | 8.0 | 5.6 |
| Aug 29 | Industrial Product Prices | Jul. | M/M % chg. | 1.0 | 1.3 |
| Aug 29 | Raw Materials Price Index | Jul. | M/M % chg. | 0.2 | 4.4 |
| Aug 29 | Gross Domestic Product (annualized) | Q2 | Q/Q % chg. | 0.5 | -0.3 |
| United States | | | | | |
| Aug 25 | Existing Home Sales | Jul. | Millions | 4.9 | 4.9 |
| Aug 26 | S&P/CaseShiller Home Price Index | Jun. | Index | -- | 168.5 |
| Aug 26 | Consumer Confidence | Aug. | Index | 53.0 | 51.9 |
| Aug 26 | New Home Sales | Jul. | Thousands | 525.0 | 530.0 |
| Aug 26 | House Price Index | Jun. | M/M % chg. | -0.4 | -0.3 |
| Aug 26 | Richmond Fed. Manufacturing Index | Aug. | Index | -10.0 | -16.0 |
| Aug 26 | <i>Minutes of Aug. 5 FOMC Meeting</i> | | | | |
| Aug 26 | ABC Consumer Confidence | 24-Aug | Index | -- | -49.0 |
| Aug 27 | MBA Mortgage Applications | Aug 22 | % change | -- | -1.5 |
| Aug 27 | Durable Goods Orders | Jul. | % change | 0.1 | 0.8 |
| Aug 27 | Durable Goods Orders (Ex. Transportation) | Jul. | % change | -0.5 | 2.0 |
| Aug 27 | <i>Atlanta Fed Governor Lockhart to Speak on Inflation at Georgia State</i> | | | | |
| Aug 28 | Gross Domestic Product (annualized) | Q2 | Q/Q % chg. | 2.8 | 1.9 |
| Aug 28 | Personal Consumption | Q2 | % change | 1.6 | 1.5 |
| Aug 28 | Initial Jobless Claims | 23-Aug | Thousands | -- | 432.0 |
| Aug 28 | Continuing Claims | 16-Aug | Thousands | -- | 3362.0 |
| Aug 29 | Personal Income | Jul. | % change | 0.0 | 0.1 |
| Aug 29 | Personal Spending | Jul. | % change | 0.3 | 0.6 |
| Aug 29 | Personal Consumption Expenditure Deflator | Jul. | Y/Y % chg. | 4.5 | 4.1 |
| Aug 29 | Core Personal Consumption Expenditure | Jul. | Y/Y % chg. | 2.4 | 2.3 |
| Aug 29 | Chicago Purchasing Managers Index | Aug. | Index | 49.8 | 50.8 |
| Aug 29 | U of Michigan Confidence Index | Aug. | Index | 62.0 | 61.7 |

Source: Bloomberg, TD Economics

G-7 ECONOMIC RELEASES AND EVENTS

| Date | Time* | Country | Economic Indicator/Event | Data for Period | Units | Consensus Forecast | Last Period |
|--------|-------|--------------------------|---|-----------------|------------|--------------------|-------------|
| Aug 25 | 10:00 | U.S | Existing Home Sales | Jul. | Millions | 4.9 | 4.9 |
| | 18:45 | NZ | Trade Balance | Jul. | | -538.0 | -223.0 |
| Aug 26 | 2:00 | Germany | Gross Domestic Product | Q2 | Y/Y % chg. | 3.1 | 1.8 |
| | 2:00 | Germany | Imports | Q2 | Y/Y % chg. | -3.0 | 3.5 |
| | 2:00 | Germany | Exports | Q2 | Y/Y % chg. | -1.0 | 2.4 |
| | 4:00 | Germany | IFO - Business Climate | Aug. | Index | 97.2 | 97.5 |
| | 9:00 | U.S. | S&P/CaseShiller Home Price Index | Jun. | Index | -- | 168.5 |
| | 10:00 | U.S. | Consumer Confidence | Aug. | Index | 53.0 | 51.9 |
| | 10:00 | U.S. | New Home Sales | Jul. | Thousands | 525.0 | 530.0 |
| | 10:00 | U.S. | House Price Index | Jun. | M/M % chg. | -0.4 | -0.3 |
| | 10:00 | U.S. | Richmond Fed. Manufacturing Index | Aug. | Index | -10.0 | -16.0 |
| | 14:00 | U.S. | <i>Minutes of Aug. 5 FOMC Meeting</i> | | | | |
| | 17:00 | U.S. | ABC Consumer Confidence | 24-Aug | Index | -- | -49.0 |
| 21:30 | NZ | NBNZ Business Confidence | Aug. | Index | -- | -43.2 | |
| Aug 27 | 7:00 | U.S. | MBA Mortgage Applications | Aug 22 | % change | -- | -1.5 |
| | 8:30 | U.S. | Durable Goods Orders | Jul. | % change | 0.1 | 0.8 |
| | 8:30 | U.S. | Durable Goods Orders (Ex. Transportation) | Jul. | % change | -0.5 | 2.0 |
| | 8:35 | U.S. | <i>Atlanta Fed Governor Lockhart to Speak on Inflation at Georgia State</i> | | | | |
| | -- | EU-12 | Consumer Price Index (EU Harmonized) | Aug. | Y/Y % chg. | 3.4 | 3.5 |
| | 20:00 | AU | Conference Board Leading Index | Jun. | % change | -- | -0.1 |
| 23:00 | NZ | M3 Money Supply | Jul. | Y/Y % chg. | -- | 7.4 | |
| Aug 28 | -- | Germany | Consumer Price Index | Aug. | Y/Y % chg. | 3.2 | 3.3 |
| | 2:00 | U.K. | Nation-wide House Prices | Aug. | Y/Y % chg. | -9.6 | -8.1 |
| | 3:55 | Germany | Unemployment Rate | Aug. | % | 7.8 | 7.8 |
| | 4:00 | France | Purchasing Managers Index (Retail) | Aug. | Index | -- | 51.3 |
| | 4:00 | Germany | Purchasing Managers Index (Retail) | Aug. | Index | -- | 46.4 |
| | 4:00 | EU-12 | Purchasing Managers Index (Retail) | Aug. | Index | -- | 46.0 |
| | 8:30 | Canada | Current Account | Q2 | \$C. blns | 8.0 | 5.6 |
| | 8:30 | U.S. | Gross Domestic Product (annualized) | Q2 | Q/Q % chg. | 2.8 | 1.9 |
| | 8:30 | U.S. | Personal Consumption | Q2 | % change | 1.6 | 1.5 |
| | 9:30 | U.S. | Initial Jobless Claims | 23-Aug | Thousands | -- | 432.0 |
| | 10:30 | U.S. | Continuing Claims | 16-Aug | Thousands | -- | 3362.0 |
| | 18:45 | NZ | Building Permits | Jul. | M/M % chg. | -- | -20.1 |
| | 19:30 | Japan | Jobless Rate | Jul. | % | 4.1 | 4.1 |
| | 19:30 | Japan | Household Spending | Jul. | Y/Y % chg. | -1.8 | -1.8 |
| | 19:30 | Japan | Consumer Price Index | Jul. | Y/Y % chg. | 2.2 | 2.0 |
| | 19:50 | Japan | Industrial Production | Jul. | Y/Y % chg. | 0.6 | 0.0 |
| | 19:50 | Japan | Retail Trade | Jul. | Y/Y % chg. | 1.3 | 0.3 |
| Aug 29 | 0:00 | Japan | Vehicle Production | Jul. | Y/Y % chg. | -- | 4.5 |
| | 1:00 | Japan | Housing Starts | Jul. | Y/Y % chg. | 15.0 | -16.7 |
| | 5:00 | EU-12 | Euro-zone Unemployment Rate | Jul. | % | 7.3 | 7.3 |
| | 5:00 | EU-13 | Euro-Zone Consumer Price Index | Aug. | Y/Y % chg. | 4.0 | 4.1 |
| | 5:00 | EU-14 | Business Climate indicator | Aug. | Index | -0.3 | -0.2 |
| | 5:00 | EU-15 | Consumer Confidence Indicator | Aug. | Index | -20.0 | -20.0 |
| | 8:30 | Canada | Industrial Product Prices | Jul. | M/M % chg. | 1.0 | 1.3 |
| | 8:30 | Canada | Raw Materials Price Index | Jul. | M/M % chg. | 0.2 | 4.4 |
| | 8:30 | Canada | Gross Domestic Product (annualized) | Q2 | Q/Q % chg. | 0.5 | -0.3 |
| | 8:30 | U.S. | Personal Income | Jul. | % change | 0.0 | 0.1 |
| | 8:30 | U.S. | Personal Spending | Jul. | % change | 0.3 | 0.6 |
| | 8:30 | U.S. | Personal Consumption Expenditure Deflator | Jul. | Y/Y % chg. | 4.5 | 4.1 |
| | 9:45 | U.S. | Core Personal Consumption Expenditure | Jul. | Y/Y % chg. | 2.4 | 2.3 |
| | 10:00 | U.S. | Chicago Purchasing Managers Index | Aug. | Index | 49.8 | 50.8 |
| | 10:00 | U.S. | U of Michigan Confidence Index | Aug. | Index | 62.0 | 61.7 |

* Eastern Standard Time; Sources: Bloomberg, TD Economics

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