



TD Economics

The Weekly Bottom Line

January 11, 2008

HIGHLIGHTS

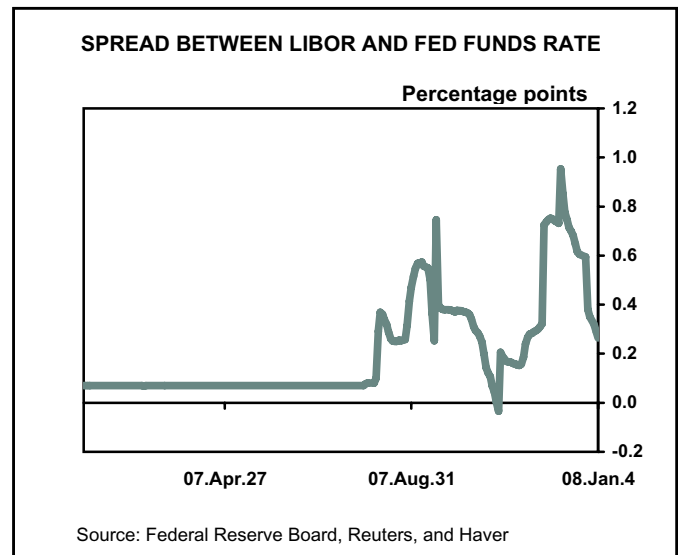
- U.S. recession fears grip markets, Fed stands ready to ease as required
- Canadian data disappoint, stage set for Bank cuts

Financial market chatter about the possibility of a U.S. recession became almost deafening this week. This is not surprising, given that some very high profile forecasters started off the New Year with predictions of back-to-back quarterly contractions in U.S. GDP in 2008. Market jitters were also fuelled by increased concerns about financial losses on credit default swaps. To make matters worse, the North American economic data have almost uniformly painted a picture of slowing economic growth. All of this has not been lost on policy makers, leading to dovish comments from Federal Reserve and Bank of Canada officials that point to further rate cuts and talk of fiscal stimulus measures in both countries.

U.S. economy: How low will you go?

While a U.S. downturn is a distinct possibility – in the December TD Quarterly Economic Forecast we stressed that the risks of a hard landing had become acute – a recession still does not look like the most likely scenario.

It is true that the disruption in credit markets is proving longer lasting than anticipated, but the evidence since the start of this year shows that the coordinated efforts by the central banks to provide liquidity are having the desired effect. This is evident in the narrowing spreads between interbank lending rates and official benchmark rates, but further improvement is still needed. And, there is still considerable uncertainty about the full extent of the financial



problems and the knock to the real economy. For example, as each difficulty is addressed, another raises its ugly head. The problem started off with subprime loans, spread to residential mortgage backed securities, then to structured investment vehicles that included non-residential loans and to asset backed commercial paper. Now there is concern about losses on credit default swaps (financial insurance contracts) and an unwillingness to buy commercial mortgage backed securities. Given this trend, several more months are likely to pass before the fallout is truly known.

Adding to the financial uncertainty, the economic data have been disappointing. But, up to this point, the statistics point to very weak growth – not a contraction. The trend, however, is not our friend at the moment. The ISM manufacturing report released on January 2nd dropped to 47.7, below the 50 mark that is the breakeven from growth. However, historically a 47.7 reading on the index is consistent with annualized real GDP growth of 1.8%.

The weak U.S. employment report on January 4th also fuelled bearish feelings. Although the meagre 18,000 payrolls added in December is roughly in keeping with economic growth of above 1%. The 0.3 percentage point increase in the unemployment rate is a bit more disturbing, as similar jumps in the past have occurred when the

Recent TD Economics Research

January 11, 2007 - Canadian International Trade
 January 11, 2008 - Canadian Employment
 January 10, 2008 - Global Markets
 January 10, 2008 - Provincial Economic Outlook
 January 9, 2008 - Canadian Housing Starts

economy is headed into, or in the midst of, a downturn. Nevertheless, the level matters as well. Even with the increase, the national unemployment rate is only 5%, below what many believed not too long ago thought was the non-accelerating inflation rate of unemployment. So, labour markets are still tight, which explains why wage growth in December was solid. The weaker labour market conditions also need to be confirmed. Remember that the initial reading on payrolls for August showed a 4,000 decline, but was revised to a 89,000 gain one month later. So, the next employment report on February 1st will be critical.

Putting the pieces together, we remain of the view that the most likely scenario is that U.S. economic growth in the first half of 2008 will be extremely modest at only slightly above an annualized 1%. Conditions should improve in the second half of the year and by mid-year the full impact of the financial turmoil should be recognized.

We could be wrong and the downside risks could easily play out. Keep in mind that our base case is so close to a flat reading on growth, it really would not take much for a negative reading to occur in one, or more, quarters. In fact, there probably isn't much difference between minimal growth and a modest contraction. If the economy does contract, however, the most likely outcome is a mild recession. Why? Past deep recessions have been characterized by an overtightening of monetary policy to check inflation, whereas this time around the Fed is already easing and providing liquidity. On this front, the Fed provided a strong signal this week that more rate cuts are coming.

In a speech, Fed Chairman Bernanke recognized the on-going financial problems and the potential dampening impact on the economy. Despite lingering inflation risks, it was evident that weakening economic conditions would trump all other considerations. Moreover, he was clear about the need to be proactive and concluded by saying that the Fed was "ready to take substantive additional action as needed to support growth and to provide adequate insurance against downside risks." Based on these comments and the economic outlook, we expect the Fed to cut rates at each of their next three meetings, and the firmness of Bernanke's remarks certainly make it possible that the Fed could be more aggressive than simply cutting in their traditional quarter point increments.

There is also a good chance of fiscal stimulus measures. This week there was considerable speculation that tax cuts or spending measures may be announced in President Bush's State of the Union address on January 28th. The prevailing economic concerns and the fact that it's an election year would support some sort of announcement.

Canada: Going along for the ride

Although the financial market worries are concentrated on the United States, there should be little doubt that the Canadian economy cannot decouple from weakness in its major trading partner. The financial problems are far less acute in Canada, but the impact of recent credit developments will be a constraining factor in the months ahead. The economic data also point to slowing economic growth.

Friday's labour force survey for December showed considerable weakness, with the loss of 18.7 thousand jobs during the month. This was largely payback for unsustainably strong job creation in the prior months and the unemployment rate was unchanged at a low 5.9%. Nevertheless, much of the strong job creation last year came from the public sector that cannot be maintained in the coming year. Meanwhile, private paid employment failed to increase in the past 11 months and there is little scope for recovery in the near term. All of which is to say that labour markets are likely to weaken further. News that manufacturing lost a considerable 33,200 jobs last month is also unsurprising, as this is the sector that is bearing the brunt of the U.S. slowdown and is struggling with the strong Canadian dollar and competition from emerging economies. While exports increased in November, they fell 1.1% year-over-year and they are likely to decline in the months ahead.

The weakness in international trade will also be accompanied by softening domestic demand growth. This week brought news that housing starts plunged to 187.5 thousand units in December and that building permits fell 9.9% in November. Poor weather conditions distorted starts last month, but the data are still consistent with our expectation of cooler Canadian real estate markets this year.

All of this adds to our view that Canadian economic growth will be quite soft in the first half of 2008. This is probably appreciated by the Bank of Canada, which is why Governor Dodge and Deputy Governor Kennedy provided dovish comments this week, which we believe signals that the Bank will cut rates by a quarter point at each of its next two fixed announcement dates (January 22nd and March 4th).

If we are wrong and the U.S. economy does fall into recession, Canada's economic fortunes will be diminished and the Bank will ease by more. However, given the relative strength on the domestic side of the economy and the high level of many commodity prices, it is unlikely that Canada will experience a similar contraction – just as Canada outperformed the U.S. in 2001.

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UPCOMING KEY ECONOMIC RELEASES

U.S. Retail Sales - December

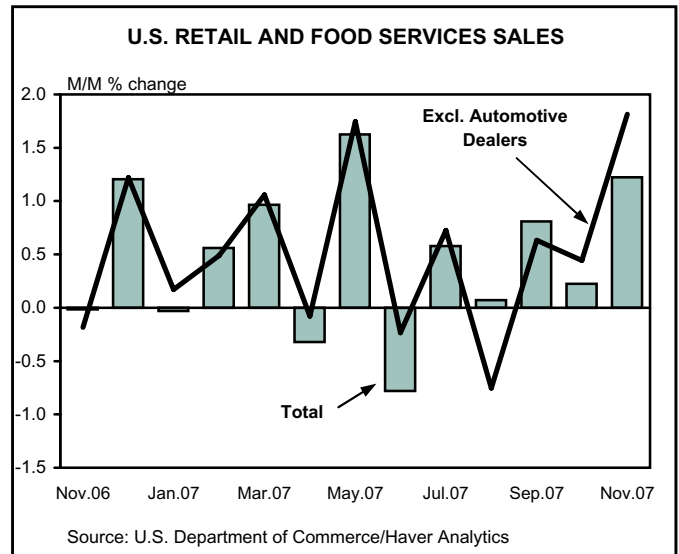
Release Date: January 15/08

TD Forecast: total -0.3%; ex-autos -0.4%

Consensus: total +0.1%; ex-autos +0.1%

We're expecting to see a soft month for U.S. retail sales in December after November's unsustainable gains. We're forecasting that total retail sales will fall by 0.3%, and that ex-autos sales will fall by 0.4%, since auto sales showed a modest gain during the month. We know that same-store sales fell by 1.5% in December, erasing most of the prior month's 1.7% gain. Other downward pressure will come from sales at gasoline stations, since gas prices were down 2.0% during the month. And with the labour market weakening substantially in December, that does not bode well for the holiday shopping season.

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U.S. Consumer Price Index - December

Release Date: January 16/08

TD Forecast: core +0.2% M/M, 2.4% Y/Y;

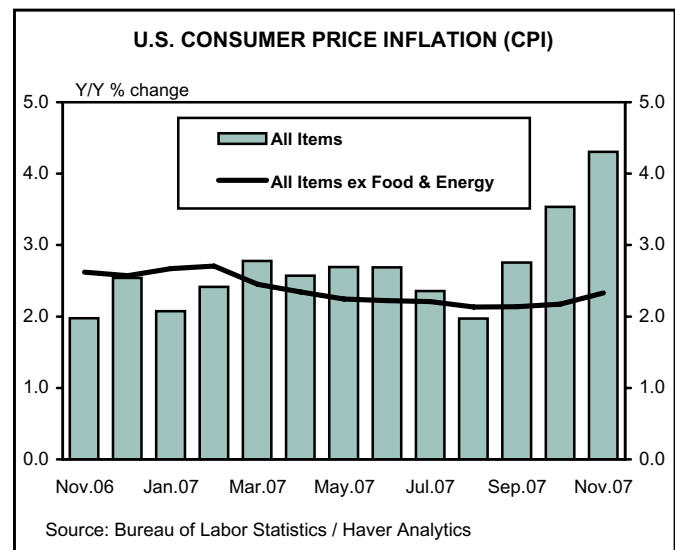
all-items +0.2% M/M, 4.1% Y/Y

Consensus: core +0.2% M/M, 2.4% Y/Y;

all-items +0.2% M/M, 4.1% Y/Y

We're expecting to see core CPI come in with a 0.2% M/M gain, pushing the Y/Y measure up to 2.4%. This would be the highest Y/Y rate of core CPI since March 2007. And given the strength in recent trends, the risks are likely tilted to the upside. For all-items inflation we're also expecting to see a 0.2% M/M gain, but base effects will leave all-items CPI much higher than core CPI at 4.1%. Energy prices weren't much of a factor in December, with natural gas prices flat and fuel oil and gasoline prices slightly weaker. But food prices will likely continue to be strong, with a depreciating U.S. dollar and a global surge in a food prices.

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Canadian Manufacturing Shipments - November

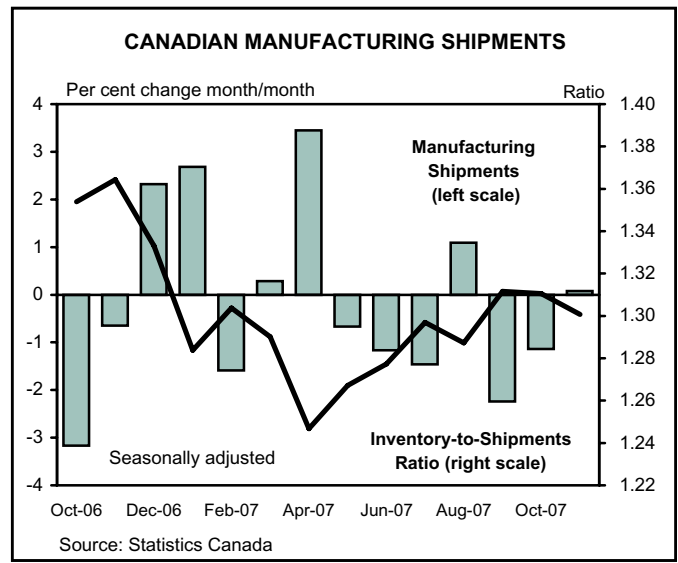
Release Date: January 18/08

TD Forecast: +0.8%

Consensus: +0.3%

We're expecting to see a strong print for manufacturing shipments for November, with a 0.8% gain. Looking at the export data for the same month, it appears that manufactured goods from Canada were in strong demand, with large gains in exports of automotive products, machinery and equipment, and industrial goods and materials. Price effects will also be a positive factor, since the industrial product price index increased by 0.6% during the month. However, this strength will not likely last into December, since new orders of manufactured goods have fallen for the last three months, so the shipments data will eventually slow accordingly.

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RECENT KEY ECONOMIC INDICATORS

January 7-11, 2008

Date	Economic Indicators	Data for	Units	Current	Prior	
Canada						
Jan. 9	Housing Starts	Dec.	Thousands	187.5	233.3	R ▲
Jan. 10	New Housing Price Index	Nov.	% Chg.	0.5	0.1	
Jan. 10	Building Permits	Nov.	% change	-9.9	7.3	R ▲
Jan. 11	Unemployment Rate	Dec.	Per cent	5.9	5.9	
Jan. 11	Net Change in Employment	Dec.	Thousands	-18.7	42.6	
Jan. 11	International Merchandise Trade Balance	Nov.	C\$, blns	3.7	3.1	R ▼
United States						
Jan. 10	Weekly Initial Jobless Claims	5-Jan	Thousands	322	337	R ▲
Jan. 10	Wholesale Inventories	Nov.	% Chg.	0.6	0.0	
Jan. 11	Trade Balance	Nov.	US\$, blns	-63.1	-57.8	

Source: Bloomberg, TD Economics

UPCOMING NORTH AMERICAN ECONOMIC CALENDAR

January 14-18, 2008

Release Date	Economic Indicators	Data for Period	Units	Consensus Forecast	Prior
Canada					
Jan. 14	New Motor Vehicle Sales	Nov.	% change	-1.0	-1.4
Jan. 14	<i>Business Outlook Survey released</i>				
Jan. 17	International Securities Transactions	Nov.	\$C, blns	n/a	-24.3
Jan. 18	Manufacturing Shipments	Nov.	% change	0.3	0.1
United States					
Jan. 15	Producer Price Index (PPI)	Dec.	% change	0.2	3.2
Jan. 15	PPI excl. food and energy	Dec.	% change	0.2	0.4
Jan. 15	Retail Sales	Dec.	% change	0.1	1.2
Jan. 15	Retail Sales ex. autos	Dec.	% change	0.1	1.8
Jan. 15	Empire Manufacturing Survey	Jan.	Index	9.8	10.3
Jan. 16	Consumer Price Index (CPI)	Dec.	% change	4.1	1.9
Jan. 16	CPI - excl. food and energy	Dec.	% change	2.4	4.3
Jan. 16	Industrial Production	Dec.	% change	-0.1	0.3
Jan. 16	Capacity Utilization	Dec.	Per cent	81.3	81.5
Jan. 16	<i>Fed's Beige Book released</i>				
Jan. 17	Housing Starts	Dec.	Thousands	1,150	1,187
Jan. 17	Building Permits	Dec.	Thousands	1,138	1,162
Jan. 17	Weekly Initial Jobless Claims	12-Jan	Thousands	334	332
Jan. 17	<i>Fed Chairman Bernanke testifies on the economic outlook before the House Budget committee</i>				
Jan. 17	Philadelphia Fed Index	Jan.	Index	-1.7	-1.6
Jan. 17	<i>Dallas Fed President Fisher speaks on global trade in Philadelphia, PA</i>				
Jan. 17	<i>Atlanta Fed President Lockhart speaks on the U.S. economic outlook in Montgomery, AB</i>				
Jan. 18	<i>Richmond Fed President Lacker speaks on the economic outlook in Richmond, VA</i>				
Jan. 18	U. Michigan Consumer Confidence (prelim.)	Jan.	Index	75.0	75.5
Jan. 18	Leading Indicators	Dec.	% change	-0.1	-0.4

Source: Bloomberg, TD Economics

G-7 ECONOMIC RELEASES AND EVENTS

Date	Time*	Country	Economic Indicator/Event	Data for Period	Units	Consensus Forecast	Last Period
Jan. 14	2:45	France	Current Account	Nov.	Eur\$, blns	n/a	-2.7
	5:00	EU	Industrial Production	Nov.	% change	-0.8	0.4
	8:30	Canada	New Motor Vehicle Sales	Nov.	% change	-1.0	-1.4
	10:30	Canada	<i>Business Outlook Survey released</i>				
Jan. 15	2:45	France	Consumer Price Index	Dec.	Y/Y % Chg.	2.5	2.4
	4:30	U.K.	Consumer Price Index	Dec.	Y/Y % chg.	2.7	2.6
	4:30	U.K.	Retail Price Index excl. Mortgages (RPIX)	Dec.	Y/Y % chg.	3.1	3.2
	5:00	EU-12	ZEW Survey - Economic Sentiment	Jan.	Index	-38.0	-35.7
	5:00	Germany	ZEW Survey - Economic Sentiment	Jan.	Index	-40.0	-37.2
	5:00	Germany	ZEW Survey - Current Situation	Jan.	Index	59.5	63.5
	8:30	U.S.	Producer Price Index (PPI)	Dec.	% change	0.2	3.2
	8:30	U.S.	PPI excl. food and energy	Dec.	% change	0.2	0.4
	8:30	U.S.	Retail Sales	Dec.	% change	0.1	1.2
	8:30	U.S.	Retail Sales ex. autos	Dec.	% change	0.1	1.8
	8:30	U.S.	Empire Manufacturing Survey	Jan.	Index	9.8	10.3
	18:50	Japan	Machine Orders	Nov.	Y/Y % chg.	-1.2	3.3
	18:50	Japan	Current Account Balance	Nov.	¥, blns	1,860.9	2,229.1
	Jan. 16	2:00	Japan	Machine Tool Orders (prelim.)	Dec.	Y/Y % chg.	n/a
5:00		EU	Consumer Price Index	Dec.	Y/Y % chg.	3.1	3.1
8:30		U.S.	Consumer Price Index (CPI)	Dec.	% change	4.1	1.9
8:30		U.S.	CPI - excl. food and energy	Dec.	% change	2.4	4.3
9:15		U.S.	Industrial Production	Dec.	% change	-0.1	0.3
9:15		U.S.	Capacity Utilization	Dec.	Per cent	81.3	81.5
14:00		U.S.	<i>Fed's Beige Book released</i>				
16:45		NZ	Consumer Price Index	Q4-07	Q/Q % chg.	n/a	0.5
21:30		AU	Unemployment Rate	Nov.	Per cent	4.4	4.5
21:30		AU	Net Change in Employment	Nov.	Thousands	20.0	52.6
23:30		Japan	Bankruptcies	Dec.	Y/Y % chg.	n/a	11.1
Jan. 17	4:00	EU	<i>European Central Bank publishes January monthly report</i>				
	5:00	EU	Trade Balance	Nov.	Eur, blns	5.5	6.1
	8:30	Canada	International Securities Transactions	Nov.	\$C, blns	n/a	-24.3
	8:30	U.S.	Housing Starts	Dec.	Thousands	1,150	1,187
	8:30	U.S.	Building Permits	Dec.	Thousands	1,138	1,162
	8:30	U.S.	Weekly Initial Jobless Claims	12-Jan	Thousands	334	332
	10:00	U.S.	<i>Fed Chairman Bernanke testifies on the economic outlook before the House Budget committee</i>				
	12:00	U.S.	Philadelphia Fed Index	Jan.	Index	-1.7	-1.6
	12:30	U.S.	<i>Dallas Fed President Fisher speaks on global trade in Philadelphia, PA</i>				
	13:15	U.S.	<i>Atlanta Fed President Lockhart speaks on the U.S. economic outlook in Montgomery, AB</i>				
	16:45	NZ	Retail Sales	Nov.	% change	n/a	-0.7
Jan. 18	4:30	U.K.	Retail Sales	Dec.	% change	0.2	0.4
	8:20	AU	<i>Australian Reserve Bank Governor Stevens speaks in London, England</i>				
	8:00	U.S.	<i>Richmond Fed President Lacker speaks on the economic outlook in Richmond, VA</i>				
	8:30	Canada	Manufacturing Shipments	Nov.	% change	0.3	0.1
	10:00	U.S.	U. Michigan Consumer Confidence (prelim.)	Jan.	Index	75.0	75.5
	10:00	U.S.	Leading Indicators	Dec.	% change	-0.1	-0.4

* Eastern Standard Time; Sources: Bloomberg, TD Economics

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