



TD Economics

The Weekly Bottom Line

May 16, 2008

HIGHLIGHTS

- Optimism grows in financial markets
- U.S. economy not out of the woods
- Canadian economy beginning to cool

In recent weeks, there has been a growing sense of optimism in financial markets that the worst may be over for the credit markets, and that the U.S. economy could escape from its housing woes with relatively minor bruises. Moreover, investors have been building in a likelihood that the Fed will need to hike interest rates by the end of the year. This week's developments kept these expectations alive.

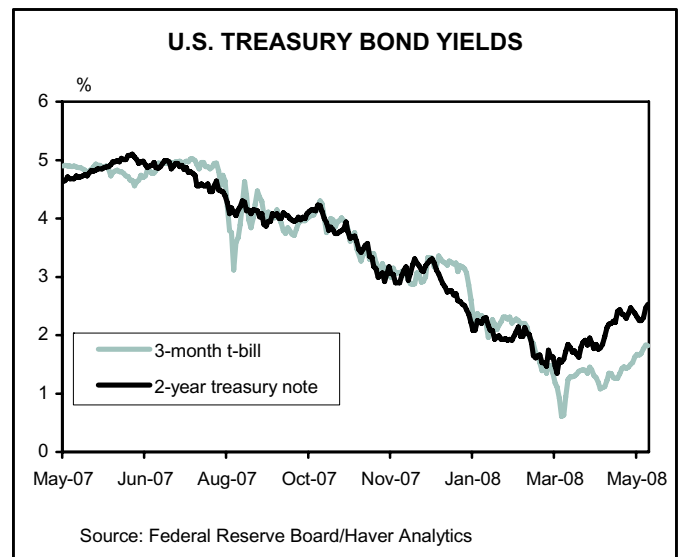
Optimism builds in financial markets

While the gains in equity markets simmered down a bit this week, the uptrend that has been in place since mid-March remained intact. Among North American markets, the NASDAQ led the way, with a 2.7% rise during the week. Similarly, bond markets continued to reflect this renewed confidence in the U.S. economy, as evidenced by a further rise in yields. More specifically, yields on the U.S. 3-month and 2-year maturities rose by 0.15 and 0.28 percentage points respectively, and are up by more than 1 percentage point from the lows hit in March. Likewise, Canadian bond yields have risen from their troughs recorded in March.

The improvement in financial markets has provided support to the U.S. dollar, and against a trade-weighted index of major currencies, it remained on somewhat firmer ground this week. While the strengthening of the greenback has been a negative development for commodities, prices have continued to defy gravity, supported by

Recent TD Economics Research

May 15, 2008 - Canadian Manufacturing Shipments
 May 14, 2008 - U.S. Consumer Price Index
 May 13, 2008 - U.S. Retail Sales Commentary



supply-related factors. Indeed, oil prices hovered in the US\$124-127 per barrel range as Iran threatened to cut supplies and a refinery in Scotland was closed for fire damage repairs. In addition to oil, natural gas and base metals prices also posted strong gains on the week, which contributed to an appreciation of the Canadian dollar, as it rose above parity for the first time since mid-March.

U.S. data releases provide market support

Key U.S. data releases were largely on the strong side of expectations this week. On the housing front, April starts surged 8.2%, while building permits jumped 4.9%. The rebound in housing starts stemmed entirely from the volatile multi-unit sector, which rose just enough to offset the drop seen in March. Still, the trend in starts has flattened over the past four months. On the consumer side, retail sales were down only 0.2% in April, and stripping away the auto component, sales actually rose by 0.5%. Given the numerous headwinds facing the U.S. consumer, it was surprising to see that 10 of 13 categories posted gains. Perhaps best of all, inflation came in below expectations in April. Core inflation – the Fed's favoured measure of inflation – was relatively subdued, edging up only 0.1% on the month, while headline inflation advanced 0.2%. The

main driver of inflation was food and beverage prices, however, declines in transportation, housing and recreation prices provided some offset. As such, it appears that price pressures in the U.S. may have started to ease.

U.S. not out of the woods yet

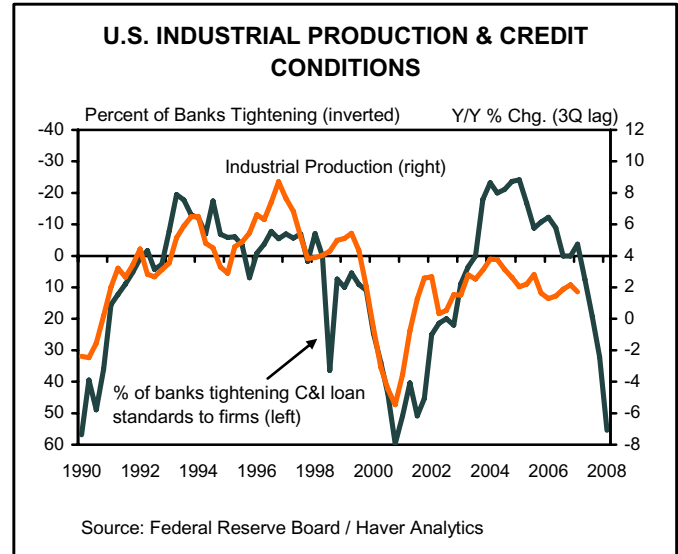
In the near term, there is a good chance that this optimism will continue, as the government rebate cheques will provide some stimulus in the economy. Indeed, these cheques could very well keep real GDP in positive territory during the second and third quarters. However, there are a number of reasons to believe that the U.S. economy is not out of the woods just yet.

- Businesses are faced with tighter credit conditions which will ultimately result in less output. In particular, after a dreadful reading in April, industrial production – which is closely related with tightening in credit conditions (see chart) – may have further room to fall.
- Non-residential construction is also likely to plunge, as it typically follows (with a lag) the trend in the Architecture Billings index, which fell sharply in the first quarter of this year.
- The housing market, despite this morning's gain, has yet to reach bottom. Overall activity remains lower than it was two months ago, with single-family starts at their lowest level in 17 years. Inventory of new homes is still at 11 months supply, while supplies of existing homes have risen to 10 months. Furthermore, the decline in existing home prices, -10% from peak to trough in the latest cycle (2005-08), is three times greater than the declines seen in previous housing-bust cycles, implying that the wealth effect will continue to exert negative pressure on U.S. consumers.
- The Fed is still concerned about market conditions, as Chairman Bernanke noted that markets are “far from normal”. At the same time, other Fed speakers continued to express concerns about inflation.
- While the fiscal stimulus package will provide consumers with some support in the very near term, high energy prices, falling home prices, tighter credit conditions and further job losses are bound to hit consumer spending patterns.

In sum, we believe markets may be getting ahead of themselves and that there is considerable risk that the Fed will cut rates again before year-end.

Canada showing signs of cooling

In Canada, indicators have been going the other way.



Following preliminary signs of slackening in the labour market in last week's jobs report, it appears as though the red-hot housing market is beginning to cool as well. Housing starts have come off their recent highs and are more in line with fundamentals, while the volume of existing home sales is now 6.1% lower than year-ago levels. And although existing home prices are still on the rise, the rate of growth this spring, at 3.2%, is still the slowest pace in over six years. Similarly, the price of new homes – as measured by the new housing price index – has slowed to 6.1%, the slowest pace since the end of 2005. While we do not expect a full blown housing market correction in Canada, a further slowdown is likely to take place over the course of the year.

The manufacturing sector, after gaining ground in the first two months of the year, took a hit in March, resulting in an 11.3% (annualized) slump in the volume of shipments during the first quarter. The auto sector was a key contributor to this decline, however with sluggish demand for motor vehicles in the U.S. – where 85% of Canadian-made autos are sent – this trend is not likely to abate any time soon. Likewise, the sky-high Canadian dollar and soaring energy prices will continue to leave the manufacturing sector struggling. Overall, March's weak manufacturing report will prove to be a drag on GDP in both the month of March and the overall quarter. Given all March data to date, it is quite possible that GDP will slip into the red for the month, leaving first quarter GDP relatively flat. This presents a downside risk to the Bank of Canada's latest published forecast of 1%, signaling a further easing in monetary policy is likely in the pipeline.

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UPCOMING KEY ECONOMIC RELEASES

Canadian Consumer Price Index - April

Release Date: May 21/08

March Result: core 0.2% M/M, 1.3% Y/Y;

all-items 0.4% M/M, 1.4% Y/Y

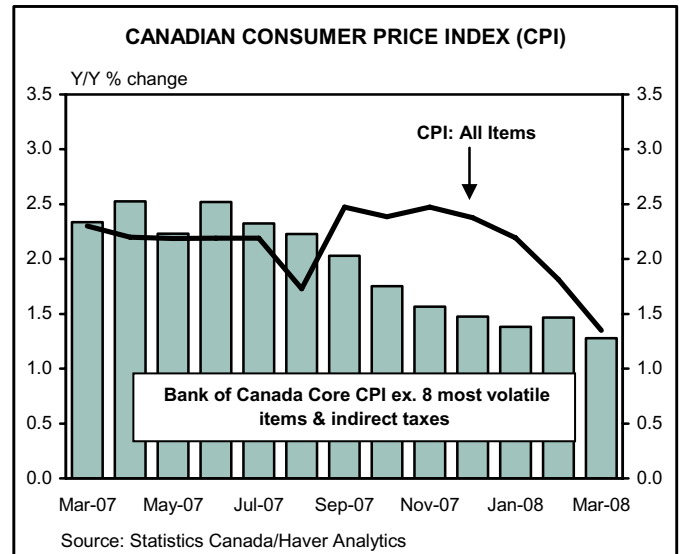
TD Forecast: core 0.0% M/M, 1.2% Y/Y;

all-items 0.3% M/M, 1.2% Y/Y

Consensus: core 0.2% M/M, 1.4% Y/Y;

all-items 0.4% M/M, 1.4% Y/Y

We're expecting to see Canadian headline inflation soften again in April, falling to only 1.2% on a year-ago basis. This would be the slowest rate of inflation that Canada has seen since January 2007, and excluding the 0.5 percentage points that the GST cut on January 1 "artificially" subtracts from the Y/Y figure, would still be well below the Bank of Canada's 2.0% target. Core CPI is also expected to soften to only 1.2% Y/Y, which would be its softest level since February 2004. On a monthly basis core CPI is expected to come in flat, but the softness is due to seasonal factors, and on a seasonally-adjusted basis we're expecting to see a 0.2% M/M gain. All-items



CPI is expected to be a little stronger on a seasonally-adjusted basis, with a 0.3% gain, thanks to the increase in energy prices during the month.

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Canadian Retail Sales - March

Release Date: May 22/08

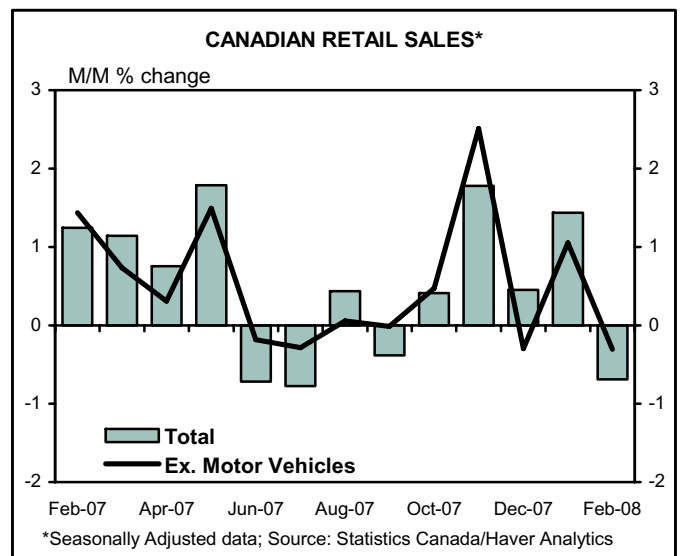
February Result: total -0.7%; ex-autos -0.3%

TD Forecast: total +0.4%; ex-autos +0.6%

Consensus: total +0.4%; ex-autos +0.4%

We're expecting to see Canadian retail sales bounce back in March, after a dismal performance in February with broad-based declines. We suspect that some of the weakness that month may be due to the ferocious winter weather, causing Canadians to hunker down indoors and avoid heading out into the snow unnecessarily, so a rebound is in order. For total sales we're expecting to see a 0.4% increase, but ex-autos sales should be a little stronger with a 0.6% gain, as they won't be affected by the 0.5% decline in new motor vehicle sales. Both figures, however, are likely to be boosted by stronger sales at gasoline stations, since prices were up 3.6% in March. This means that real retail sales are likely to come in closer to flat, so we'll have to look for other sources of strength for March GDP.

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RECENT KEY ECONOMIC INDICATORS

May 12-May 16, 2008

Date	Economic Indicators	Data for	Units	Current	Prior	
Canada						
May 15	Manufacturing Shipments	Mar.	% change	-1.6	1.3	R▼
May 16	New Motor Vehicle Sales	Mar.	% change	-0.5	-3.2	
United States						
May 13	Retail Sales	Apr.	% change	-0.2	0.2	
May 13	Retail Sales Less Autos	Apr.	% change	0.5	0.4	R▲
May 13	Business Inventories	Mar.	% change	0.1	0.5	R▼
May 14	MBA Mortgage Applications	9-May	% change	2.9	15.6	
May 14	Consumer Price Index (CPI)	Apr.	% change	0.2	0.3	
May 14	CPI - excl. food and energy	Apr.	% change	0.1	0.2	
May 14	CPI Core Index	Apr.	Index	214.4	214.176	
May 15	Initial Jobless Claims	10-May	thousands	371.0	365.0	
May 15	Empire Manufacturing	May	% change	-3.2	0.6	
May 15	Industrial Production	Apr.	% change	-0.7	0.2	R▼
May 15	Capacity Utilization	Apr.	%	79.7	80.4	R▼
May 15	Philadelphia Fed Index	May	Index	-15.6	-24.9	
May 16	Housing Starts	Apr.	Thousands	1,032.0	954.0	R▲
May 16	Building Permits	Apr.	Thousands	978.0	932.0	R▲
May 16	U. Michigan Consumer Confidence (prelim.)	May	Index	59.5	62.6	

Source: Bloomberg, TD Economics

UPCOMING NORTH AMERICAN ECONOMIC CALENDAR

May 19-May 23, 2008

Release Date	Economic Indicators	Data for Period	Units	Consensus Forecast	Prior
Canada					
May 20	International Securities Transactions	Mar.	\$C, blns	1.5	3.8
May 20	Wholesale Sales	Mar.	% change	0.5	-1.8
May 21	Consumer Price Index (CPI)	Apr.	Y/Y % chg.	1.4	1.4
May 21	Bank of Canada CPI Core	Apr.	Y/Y % chg.	1.4	1.3
May 21	Leading Indicators	Apr.	% change	0.1	0.0
May 22	Retail Sales	Mar.	% change	0.4	-0.70
May 22	Retail Sales excl. autos	Mar.	% change	0.4	-0.3
May 22	<i>Bank of Canada Governor Carney speaks on principles for liquid markets in New York.</i>				
May 22	<i>Bank of Canada holds press conference.</i>				
United States					
May 19	Leading Indicators	Apr.	% change	-0.1	0.1
May 20	Producer Price Index	Apr.	% change	0.4	1.1
May 20	Producer Price Index excl. food and energy	Apr.	% change	0.2	0.2
May 21	MBA Mortgage Applications	16-May	% change	n/a	2.9
May 21	<i>Fed releases minutes from April 29-30 Federal Open Market Committee (FOMC)</i>				
May 22	Weekly Initial Jobless Claims	17-May	thousands	370.0	371
May 22	<i>Fed Governor Kroszner speaks to Conference of State Bank Supervisors.</i>				
May 23	Existing Home Sales	Apr.	US\$, mlns	4.85	4.9

Source: Bloomberg, TD Economics

G-7 ECONOMIC RELEASES AND EVENTS

Date	Time*	Country	Economic Indicator/Event	Data for Period	Units	Consensus Forecast	Last Period
May 19	0:00	Japan	<i>Bank of Japan Monetary Policy Meeting</i>				
	10:00	US	Leading Indicators	Apr.	% change	-0.1	0.1
	---	Japan	<i>Bank of Japan Target Rate</i>		<i>Overnight rate</i>	<i>0.50</i>	<i>0.50</i>
May 20	2:00	Japan	<i>Bank of Japan Monthly Report</i>				
	5:00	EU	ZEW Survey - Economic Sentiment	May	Index	-44.2	-44.8
	5:00	Germany	ZEW Survey - Economic Sentiment	May	Index	-37.0	-40.7
	5:00	Germany	ZEW Survey - Current Situation	May	Index	32.0	33.2
	8:30	US	Producer Price Index	Apr.	% change	0.4	1.1
	8:30	US	Producer Price Index excl. food and energy	Apr.	% change	0.2	0.2
	8:30	Canada	International Securities Transactions	Mar.	\$C, blns	1.5	3.8
	8:30	Canada	Wholesale Sales	Mar.	% change	0.5	-1.8
May 21	4:00	Germany	IFO - Business Climate	May	Index	102.0	102.4
	4:00	Germany	IFO - Current Assessment	May	Index	108.0	108.4
	4:00	Germany	IFO - Expectations	May	Index	96.4	96.8
	4:30	UK	<i>Bank of England Minutes</i>				
	7:00	US	MBA Mortgage Applications	16-May	% change	n/a	2.9
	7:00	Canada	Consumer Price Index (CPI)	Apr.	Y/Y % chg.	1.4	1.4
	7:00	Canada	Bank of Canada CPI Core	Apr.	Y/Y % chg.	1.4	1.3
	8:30	Canada	Leading Indicators	Apr.	% change	0.1	0.0
	14:00	US	<i>Fed releases minutes from April 29-30 Federal Open Market Committee (FOMC)</i>				
	19:50	Japan	All Industry Activity Index	Mar.	% change	-0.2	-1.4
	19:50	Japan	Merchandise Trade Balance	Apr.	¥, blns	739.0	1,118.6
May 22	4:30	UK	Retail Sales	Apr.	% change	-0.5	-0.4
	4:30	UK	Total Business Investment (prelim.)	Q1-08	Y/Y % change	5.5	1.7
	6:00	UK	<i>UK CBI May Monthly Industrial Trends</i>				
	8:30	US	Weekly Initial Jobless Claims	17-May	thousands	370.0	371.0
	8:30	Canada	Retail Sales	Mar.	% change	0.4	-0.7
	8:30	Canada	Retail Sales excl. autos	Mar.	% change	0.4	-0.3
	9:15	US	<i>Fed Governor Kroszner speaks to Conference of State Bank Supervisors.</i>				
	13:20	Canada	<i>Bank of Canada Governor Carney speaks on principles for liquid markets in New York.</i>				
19:50	Japan	<i>Bank of Japan Policy Meeting Minutes for April</i>					
May 23	2:45	France	Consumer Spending	Apr.	% change	0.5	-1.7
	3:00	France	Purchasing Managers Index (mfg.) (prelim.)	May	Index	51.0	51.1
	3:00	France	Purchasing Managers Index (serv.) (prelim.)	May	Index	52.9	52.8
	3:30	Germany	Purchasing Managers Index (mfg.)	May	Index	53.2	53.6
	3:30	Germany	Purchasing Managers Index (serv.)	May	Index	54.0	54.9
	4:00	EU	Purchasing Managers Index (mfg.)	May	Index	50.5	50.7
	4:00	EU	Purchasing Managers Index (serv.)	May	Index	51.7	52.0
	4:30	UK	Gross Domestic Product (GDP)	Q1-08	Q/Q % change	0.4	0.4
	10:00	US	Existing Home Sales	Apr.	US\$, mlns	4.85	4.9

* Eastern Standard Time; Sources: Bloomberg, TD Economics

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