



TD Economics

The Weekly Bottom Line

November 9, 2007

HIGHLIGHTS

- **Canadian dollar marches higher**

In the early years of the 21st century, as Canadians busied themselves at work and drove the unemployment rate to an all-time low, the Canadian dollar was simultaneously being pushed up. At first, this appreciation seemed orderly and gradual, but then concerns and questions arose. How much of the loonie's rise was a reflection of the need of the U.S. dollar to weaken in order to address the American's large current account deficit? How much was a reflection of China's fear of floating, which foisted undue appreciation on the loonie that should have befallen the renminbi? And why do policymakers appear to be complacent? The pandemonium has been palpable, but the fallacies have flown faster than the facts.

The day Asian currencies worth stood still

The U.S. current account deficit is a reflection of the fact that Americans import more than they export, and over time, the U.S. dollar adjusts to make those imports more expensive and exports cheaper. The depreciation of the U.S. dollar since 2002 then has been part of the natural global economic stabilizers. The U.S. dollar has depreciated by 20% since 2002 on a trade-weighted basis against all its trading partners. This depreciation has generally been stronger against commodity-rich countries given their relative economic out-performance (40% against the Canadian dollar and Norwegian krone and 45% against the Australian dollar and South African rand) than it has against other major currencies (35% against the euro and 30% against the British pound). The concern, however, is

that the currencies of Japan and China have been much less responsive. To address the U.S. deficit in the 1980s, the larger trading partners saw larger U.S. dollar depreciation. This time, the opposite has been true (see chart).

Moreover, changes in exchange rates are not enough to balance the imbalances in global trade. Consumer price inflation in Canada and the other major trading partners of the U.S. has generally been slower than inflation in the U.S. since 2002. Outside of the movements in currencies, this means the price of U.S. exports has generally been rising faster than prices in other major markets. Because of this, the U.S. dollar has had to depreciate even more (a real depreciation) to offset this loss in purchasing power and affect the actual flow of trade. Couple this with the fact that U.S. economic growth has outpaced that of other advanced nations in 12 of the last 15 years and improving the U.S. deficit has been slow going.

Invasion of the loonie watchers

The appreciation of the loonie against the greenback this year, however, has outpaced every other major currency. There are certainly economic reasons for this. While the U.S. economy grew by only 2.2% in the first half of the year, the Canadian economy grew by 3.6%. The pace of Canadian housing starts this year has been slightly faster than in 2006 – whereas U.S. housing starts are down nearly 30% since end-2006. The risks to inflation from strong domestic growth persuaded the Bank of Canada to hike interest rates by 25bps earlier this year while the Federal Reserve – with risks from housing and subprime – has cut U.S. rates by 75bps. Commodity prices have moved in Canada's favour, as well. While non-energy commodity prices have fallen since the spring, they are still up over 4% from where they started the year. Energy prices, meanwhile, are up 30%, with half of that coming just since August.

This rapid gain in oil prices has surprised even the markets. Since August, futures markets have been consistently expecting oil prices to fall by 1-2% one month out. Instead, the actual gains have averaged 8%-10%, result-

Recent TD Economics Research

November 9, 2007 - Canadian International Trade
November 8, 2007 - Canadian Housing Starts
November 6, 2007 - Global Markets
November 6, 2007 - CDOs, Wherefore Art Thou CDOs?
November 5, 2007 - U.S. ISM Non-Manufacturing Index

ing in a large surprise for financial markets. Looking ahead, futures markets continue to expect oil prices will be 1% lower this time next month and 10% lower this time next year. Our own forecasts suggest oil prices may ease by even more than this by end-2008. So there should be some relief for the loonie over the next 12 months.

Even with the strong near-term economic fundamentals, then, the Canadian dollar has clearly overshot the mark. It should not currently be trading in the \$1.06-\$1.10 range and has tracked oil prices recently more than usual. Yes, commodity prices have risen this year, but the gains reported above – weighted by their Canadian production shares – have actually been less than the gains when weighted by global production shares. In other words, the prices of the commodities Canada produces have increased less than the commodities the rest of the world produces. In periods of rapid price changes, it is not uncommon for currencies to overshoot the mark and only later, ease back off to a more sustainable level. This appears to be what is underway now in Canada.

Dr. Strangelove (or how I learned to stop worrying and love the loonie)

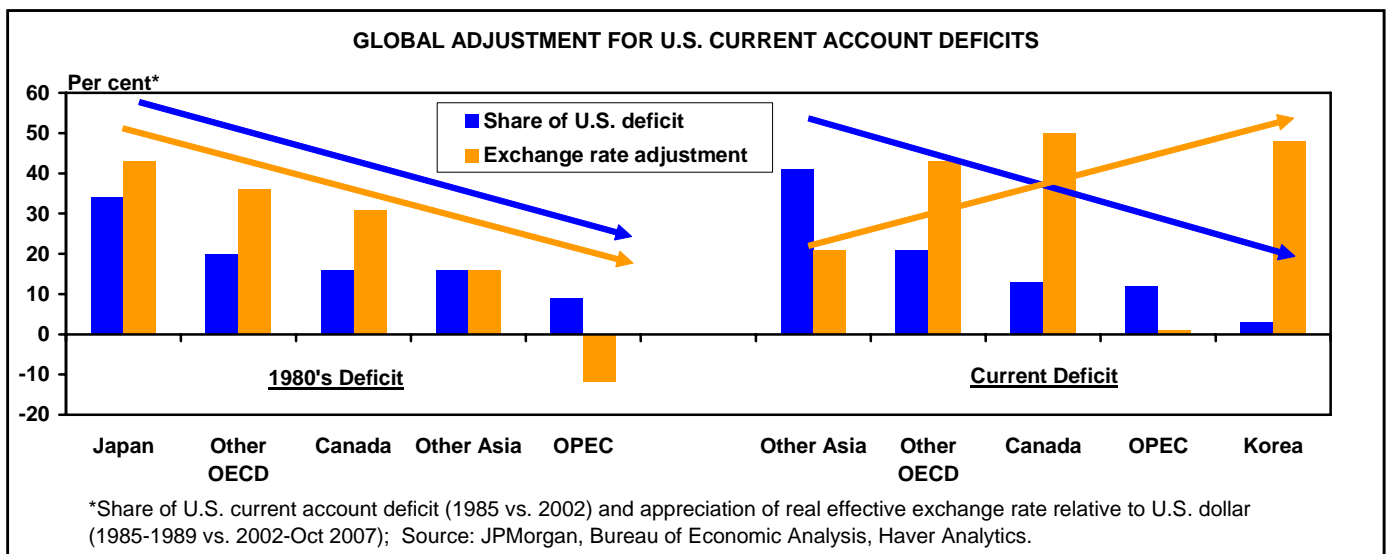
So if the Canadian dollar has overshot, what can policymakers do? The answer appears to be – very little right now. In the 1980s’s, G-7 leaders announced their intentions to coordinate interventions in currency markets at first to cause the U.S. dollar to depreciate (Plaza Accords) and then later to stop the process (Louvre Accords). But the size of currency markets then was much smaller, so the relative size of the intervention was bigger.

Words can be stronger than deeds, though, and any intervention must be credible. First, it must involve China.

But it is no secret that China would like to diversify out of some of their U.S. holdings. Markets this week keyed off of a Chinese official’s affirmation of just this intention. Unfortunately, this official has no control over China’s FX strategy or asset management plans so it’s not clear it means anything new, but the shot to credibility is there. China is doubly hesitant because the appreciation of the yen that helped reduce the U.S. current account deficit in the 1980s also helped send the Japanese economy into a period of recessions and deflation that they have yet to shake. Second, there should also be some expectation of higher U.S. interest rates or weaker domestic demand relative to the rest of the world. But, Bernanke’s comments this week to the U.S. Congress sounded rather dovish, while ECB President Trichet – in keeping European rates unchanged – said that the risks to growth lie on the downside whereas the risks to inflation are “fully confirmed to lie on the upside.” As a result, even if it were to happen, we would likely not see a credible underbelly to any intervention attempt until 2008.

What we are seeing is an adjustment, not a battle. The U.S. trade deficit in September surprisingly shrank in spite of rising oil prices, while the Canadian trade surplus eased below \$3bn on a large increase in imports. The pace of recent changes makes it hard for exporters to plan and it could weigh further on Canadian economic growth in 2008 if not quickly unwound. This is not a war of the worlds, however, and there is no reason to run for the hills. A run for a border state to get a good deal at a shopping mall? Maybe.

Richard Kelly, Economist 416-982-2559



UPCOMING KEY ECONOMIC RELEASES

U.S. Retail Sales - October

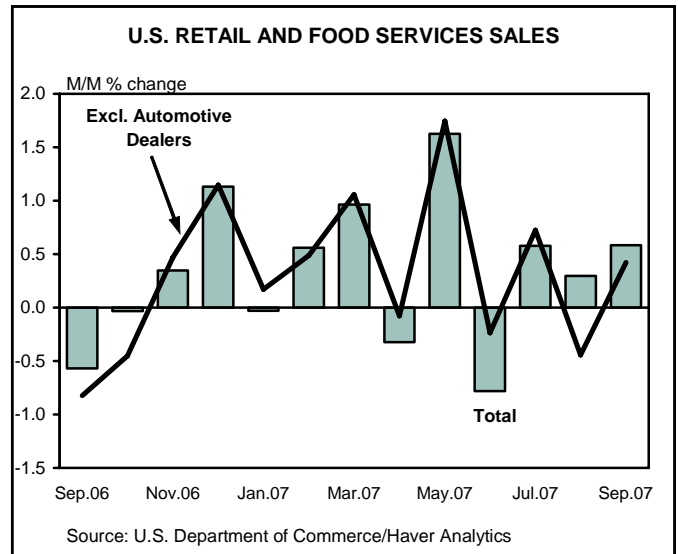
Release Date: November 14/07

TD Forecast: total 0.0%; ex-autos +0.2%

Consensus: total +0.2%; ex-autos +0.3%

We're expecting to see a soft month for U.S. retail sales in October, with total retail sales coming in flat, and ex-autos sales increasing by a mere 0.2%. Our soft forecast comes from weak same store sales, which fell for the second month in a row in October, coming in at -0.8%. And, the 1.1% drop in car sales during the month will depress the total sales figure. Since gasoline prices were flat during the month of October, we don't expect to see any major price effects. But with gas prices up about 25% on a Y/Y basis, higher energy prices will certainly bite into consumers' budgets, and put a damper on spending.

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U.S. Consumer Price Index - October

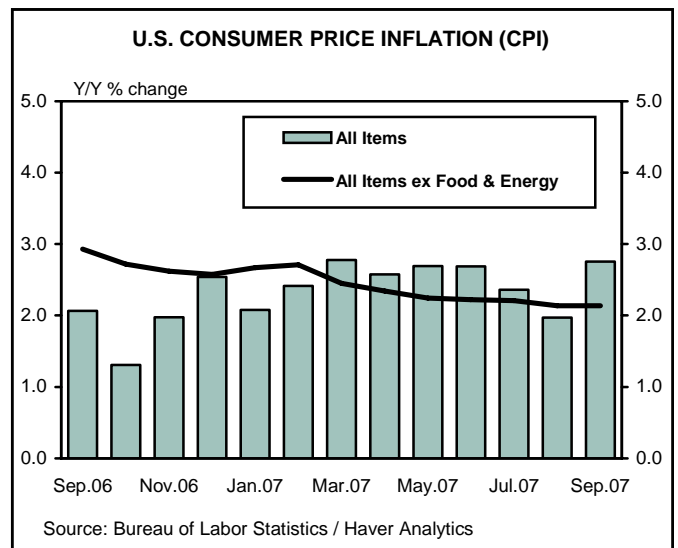
Release Date: November 15/07

TD Forecast: all-items +0.5% M/M, 3.8% Y/Y; core +0.2% M/M, 2.2% Y/Y

Consensus: all-items +0.3% M/M, 3.5% Y/Y; core +0.2% M/M, 2.2% Y/Y

We expect to see a strong pick-up in all-items inflation in October, with a huge 0.5% M/M gain, driving the Y/Y measure up to 3.8%, from 2.8% in September. This is largely due to higher energy prices, as fuel oil and natural gas prices both increased rather sharply during the month. And if recent patterns continue, then food prices will likely add to the uptick in headline inflation as well. For core CPI we're expecting to see a more moderate 0.2% M/M increase, which will push the Y/Y figure up a notch to 2.2% from 2.1% in September. But given the extent of the recent increases in energy prices, the Fed will be keeping a close eye on core inflation, watching for signs of pass-through.

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Canadian Manufacturing Shipments - September

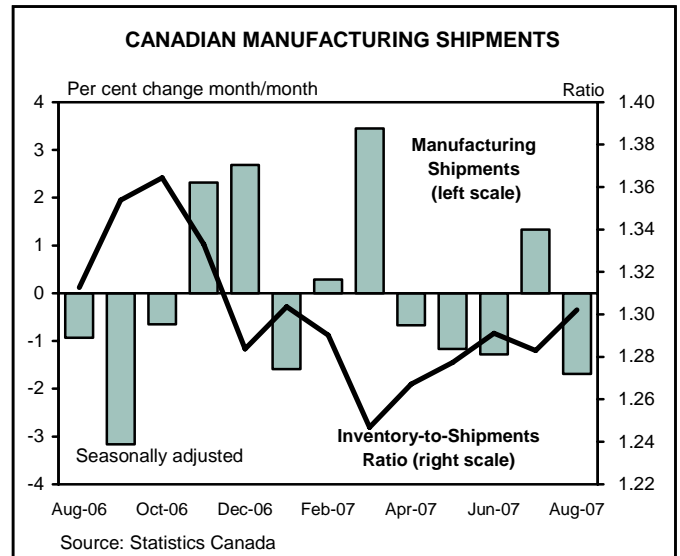
Release Date: November 15/07

TD Forecast: -1.0%

Consensus: -0.4%

We're expecting to see a second consecutive monthly decline in Canadian manufacturing shipments in September, with shipments falling by 1.0%, since most indicators are pointing to a slowdown in manufacturing activity during the month. In the U.S., we saw durable good shipments fall by 2.0% M/M, and the ISM manufacturing index drop from 52.9 to 52.0. And in Canada, exports of industrial goods and materials and machinery and equipment both fell rather substantially, and new orders of manufactured goods were down 5.0% in the prior month. Meanwhile, exports of automotive products were up 2.3% in September, so that should help to support manufacturing shipments, but won't be enough to make up for the softness in other sectors. On the upside, the manufacturing data should be much stronger in real terms, once the negative price effects from September are stripped out.

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RECENT KEY ECONOMIC INDICATORS November 5- 9, 2007

Date	Economic Indicators	Data for	Units	Current	Prior	
Canada						
Nov. 6	Building Permits	Sept.	% change	-1.7	1.7	R ▲
Nov. 6	Ivey Purchasing Managers Index	Oct.	Index	57.1	56.0	
Nov. 8	Housing Starts	Oct.	Thousands	219.5	281.3	R ▲
Nov. 8	New Housing Price Index	Sept.	% Chg.	0.3	0.4	
Nov. 9	International Merchandise Trade Balance	Sept.	C\$, blns	4.1	4.3	R ▲
United States						
Nov. 5	ISM Non-Manufacturing	Oct.	Index	55.8	54.8	
Nov. 7	Non-farm Productivity (prelim.)	Q3-07	Ann. % chg.	4.9	2.2	R ▼
Nov. 7	Unit Labour Costs (prelim.)	Q3-07	Ann. % chg.	-0.2	2.2	R ▲
Nov. 7	Wholesale Inventories	Sept.	% Chg.	0.8	0.7	R ▲
Nov. 8	Weekly Initial Jobless Claims	3-Nov	Thousands	317	330	R ▲
Nov. 9	Trade Balance	Sept.	US\$, blns	-56.5	-56.8	R ▲
Nov. 9	University of Michigan Consumer Confidence	Nov.	Index	75.0	80.9	

Source: Bloomberg, TD Economics

UPCOMING NORTH AMERICAN ECONOMIC CALENDAR November 12-16, 2007

Release Date	Economic Indicators	Data for Period	Units	Consensus Forecast	Prior
Canada					
Nov. 14	Leading Indicators	Oct.	% change	0.3	0.4
Nov. 14	New Motor Vehicle Sales	Sept.	% change	-2.0	2.8
Nov. 14	<i>Bank of Canada Senior Deputy Governor Jenkins gives speech on "Canada & Ontario in the Global Economy: Challenges in a Changing World" at the Ontario Economic Summit in Niagara-on-the-Lake, ON</i>				
Nov. 15	Manufacturing Shipments	Sept.	% change	-0.4	-1.7
United States					
Nov. 13	<i>Fed Governor Kroszner speaks at a bank conference in New York, NY</i>				
Nov. 14	<i>Dallas Fed President Fisher speaks on the U.S. outlook in Sydney, Australia</i>				
Nov. 14	Producer Price Index (PPI)	Oct.	% change	0.3	1.1
Nov. 14	PPI excl. food and energy	Oct.	% change	0.2	0.1
Nov. 14	Retail Sales	Oct.	% change	0.2	0.6
Nov. 14	Retail Sales ex. autos	Oct.	% change	0.3	0.4
Nov. 14	<i>Fed Chairman Bernanke speaks at the Cato Institute Monetary Conference in Washington, D.C.</i>				
Nov. 14	Business Inventories	Sept.	% change	0.3	0.1
Nov. 15	Consumer Price Index (CPI)	Sept.	% change	0.3	0.3
Nov. 15	CPI - excl. food and energy	Sept.	% change	0.2	0.2
Nov. 15	Empire Manufacturing Survey	Nov.	Index	20.0	28.8
Nov. 15	Weekly Initial Jobless Claims	10-Nov	Thousands	320	317
Nov. 15	<i>Chicago Fed President Evans gives welcome remarks at the Chicago Fed's conference in Chicago, IL</i>				
Nov. 15	Philadelphia Fed Index	Nov.	Index	5.0	6.8
Nov. 15	<i>Kansas City Fed President Hoenig speaks on the U.S. economic outlook in Santa Fe, NM</i>				
Nov. 16	Industrial Production	Sept.	% change	0.1	0.1
Nov. 16	Capacity Utilization	Sept.	Per cent	82.0	82.1
Nov. 16	<i>Atlanta Fed President Lockhart speaks on the Southeast economy in Montreal, Quebec</i>				

Source: Bloomberg, TD Economics

G-7 ECONOMIC RELEASES AND EVENTS

Date	Time*	Country	Economic Indicator/Event	Data for Period	Units	Consensus Forecast	Last Period
Nov. 11	19:30	AU	<i>Reserve Bank Quarterly Monetary Policy statement released</i>				
	19:50	Japan	Current Account Balance	Sept.	¥, blns	2,689.2	2,081.0
	23:00	Japan	<i>Bank of Japan Monetary Policy meeting held</i>				
	23:30	Japan	Bankruptcies	Oct.	Y/Y % chg.	n/a	1.7
Nov. 12	18:50	Japan	Real Gross Domestic Product (prelim.)	Q3-07	Q/Q % chg.	0.5	-0.3
	---	Japan	<i>Bank of Japan Target Rate</i>		<i>Overnight rate</i>	<i>0.50</i>	<i>0.50</i>
Nov. 13	2:00	Japan	<i>Bank of Japan Monthly Report released</i>				
	2:45	France	Consumer Price Index	Oct.	Y/Y % Chg.	2.0	1.5
	4:30	U.K.	Consumer Price Index	Oct.	Y/Y % chg.	1.9	1.8
	4:30	U.K.	Retail Price Index excl. Mortgages (RPIX)	Oct.	Y/Y % chg.	3.0	2.8
	5:00	EU-12	ZEW Survey - Economic Sentiment	Nov.	Index	n/a	-19.0
	5:00	Germany	ZEW Survey - Economic Sentiment	Nov.	Index	-20.0	-18.1
	5:00	Germany	ZEW Survey - Current Situation	Nov.	Index	66.9	70.2
	5:00	EU	Industrial Production	Sept.	% change	-0.2	1.2
	5:00	EU	<i>European Commission GDP Forecasts table released</i>				
	13:00	U.S.	<i>Fed Governor Kroszner speaks at a bank conference in New York, NY</i>				
Nov. 14	2:00	Germany	Real Gross Domestic Product (prelim.)	Q3-07	Q/Q % chg.	0.7	0.3
	2:45	France	Real Gross Domestic Product (prelim.)	Q3-07	Q/Q % chg.	0.7	0.3
	2:45	France	Trade Balance	Sept.	Eur\$, blns	n/a	-1.7
	4:00	U.S.	<i>Dallas Fed President Fisher speaks on the U.S. outlook in Sydney, Australia</i>				
	5:00	EU	Real Gross Domestic Product (prelim.)	Q3-07	Q/Q % chg.	0.6	0.3
	5:30	U.K.	<i>Bank of England Quarterly Inflation report released</i>				
	8:30	U.S.	Producer Price Index (PPI)	Oct.	% change	0.3	1.1
	8:30	U.S.	PPI excl. food and energy	Oct.	% change	0.2	0.1
	8:30	Canada	Leading Indicators	Oct.	% change	0.3	0.4
	8:30	Canada	New Motor Vehicle Sales	Sept.	% change	-2.0	2.8
	8:30	U.S.	Retail Sales	Oct.	% change	0.2	0.6
	8:30	U.S.	Retail Sales ex. autos	Oct.	% change	0.3	0.4
	8:45	Canada	<i>Bank of Canada Senior Deputy Governor Jenkins gives speech on "Canada & Ontario in the Global Economy: Challenges in a Changing World" at the Ontario Economic Summit in Niagara-on-the-Lake, ON</i>				
	9:10	U.S.	<i>Fed Chairman Bernanke speaks at the Cato Institute Monetary Conference in Washington, D.C.</i>				
	10:00	U.S.	Business Inventories	Sept.	% change	0.3	0.1
	16:45	NZ	Retail Sales	Oct.	% change	0.5	0.2
19:30	AU	<i>Reserve Bank monthly bulletin released</i>					
Nov. 15	4:00	EU	<i>European Central Bank publishes November monthly report</i>				
	4:30	U.K.	Retail Sales	Oct.	% change	0.1	0.6
	5:00	EU-12	Consumer Price Index	Oct.	Y/Y % chg.	2.6	2.6
	8:30	U.S.	Consumer Price Index (CPI)	Sept.	% change	0.3	0.3
	8:30	U.S.	CPI - excl. food and energy	Sept.	% change	0.2	0.2
	8:30	Canada	Manufacturing Shipments	Sept.	% change	-0.4	-1.7
	8:30	U.S.	Empire Manufacturing Survey	Nov.	Index	20.0	28.8
	8:30	U.S.	Weekly Initial Jobless Claims	10-Nov	Thousands	320	317
	9:45	U.S.	<i>Chicago Fed President Evans gives welcome remarks at the Chicago Fed's conference in Chicago, IL</i>				
	12:00	U.S.	Philadelphia Fed Index	Nov.	Index	5.0	6.8
	18:50	Japan	<i>Bank of Japan monetary policy meeting minutes released for October</i>				
19:30	U.S.	<i>Kansas City Fed President Hoenig speaks on the U.S. economic outlook in Santa Fe, NM</i>					
Nov. 16	5:00	EU	Trade Balance	Sept.	Eur, blns	n/a	1.3
	9:15	U.S.	Industrial Production	Sept.	% change	0.1	0.1
	9:15	U.S.	Capacity Utilization	Sept.	Per cent	82.0	82.1
	10:00	U.S.	<i>Atlanta Fed President Lockhart speaks on the Southeast economy in Montreal, Quebec</i>				

* Eastern Standard Time; Sources: Bloomberg, TD Economics

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