



**Bank
Financial
Group**

TD Economics

The Weekly Bottom Line

September 12, 2008

HIGHLIGHTS

- **U.S. and Canada trade for July disappoint**
- **Roller coaster week in financial markets**
- **Fannie & Freddie under conservatorship**

Economic data mostly took a back seat to financial market events this week, something economists have grown accustomed to since this drawn out episode of financial turmoil began more than a year ago.

Trade tides very slowly shifting

Nonetheless, there were some economic data of note. International trade positions were reported to have weakened in the month of July for both Canada and the U.S. Canada's trade surplus shrank more than expected, to \$4.9 billion from \$5.6 billion in June. Behind the shrinking surplus were export values that climbed by 2.2% (0.7% in volume) while imports surged by 4.6% (3.2% in volume). After declining for 3 out of the previous 4 months, the increase in export volumes is welcome. Furthermore, export values were not propped up by crude oil prices as in months prior, but stemmed mainly from machinery & equipment (+6.6%), industrial goods & materials (+5.0%) led by shipments of nickel and fertilizers. On the import side, Canadians' increased purchasing power abroad and appetite for imported vehicles was evident as automotive product imports climbed 9.5%.

In August, the decline in natural gas (-28%) and crude oil (-13%) prices continued unabated, which will likely depress Canada's trade surplus further. As for the contribution of exports to real GDP growth, it will not turn on a

dime nor a 4% weaker Canadian dollar (since January). But if the loonie behaves as we expect and falls further towards \$US 0.87 by the second quarter of next year, the implied 10% drop in the loonie (since January) would certainly provide some relief to exporters. However, declining export volumes will most likely continue to be a drag on real GDP growth over the next 12 months before turning the corner.

Meanwhile, the U.S. trade deficit widened more than expected in July to \$62.2 billion from \$58.8 billion in June. While the 3.3% increase in export values was in line with expectations, the surprise came from a 3.9% increase in import values. The drop in crude oil prices in the second half of July failed to make a dent in crude oil import values, which rose by 19%. Excluding petroleum, the U.S. trade deficit narrowed by 12.5%. We would expect the lower crude oil prices to be reflected in a narrower trade deficit in August. The massively outsized contribution of 3.1 percentage points to the 3.3% growth in U.S. real GDP recorded in Q2 will not be repeated. Exports should still contribute a significant share to overall U.S. economic growth but as the economies of Europe, Japan, and Canada slide in synchronized fashion, so will U.S. exports to these major markets. The recent significant and broadly based strengthening of the U.S. dollar will also eat away at strong U.S. export margins.

U.S. consumers blink

The third quarter is not looking pretty from a consumer spending perspective. With the unemployment rate up 1.5 percentage points from a year ago, labour market conditions continue to deteriorate. Homes are still depreciating significantly at about a 15% Y/Y pace and credit conditions are tight. CPI inflation should start to ease, but was still running at 5.6% Y/Y in July, the highest since 1991. Real personal disposable income and spending were down in July. The world's 'spender of last resort' and Atlas of the world economy, a.k.a. the American consumer, is showing early signs of finally buckling under the weight of these gale force winds. Retail sales for July were revised down

Recent TD Economics Research

September 12, 2008 - U.S. Retail Sales
 September 11, 2008 - Canadian International Trade
 September 10, 2008 - Natural Gas Outlook
 September 9, 2008 - Nausea, Heartburn, Indigestion,
 Upset Stomach, Fannie, Freddie
 September 9, 2008 - Canadian Housing Starts

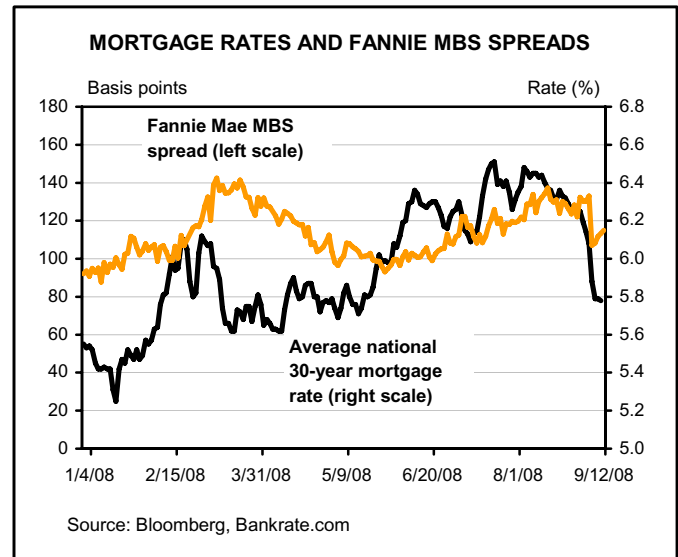
to -0.5%, from a previously reported -0.1%, and didn't fare much better in August with a -0.3%. The artificial boost from the fiscal stimulus package is now in the rear view mirror, and consumer spending will get worse before it gets better. On net, the best one can reasonably expect from U.S. economic activity in the second half of this year is a sluggish performance.

Sunday, bailout Sunday

The sour tone to most economic data emanating from Canada, the U.S., not to mention Europe and Japan, did nothing to support jittery financial markets this week. However, the focus lay clearly on the state of the global financial sector. American church-goers and football lovers might start to feel threatened that Sundays could get permanently hijacked by U.S. authorities that seem bent on making repeated major announcements on that day. The takeover of a collapsing Bear Stearns in March and the pledge to stand behind Fannie & Freddie were all announced on Sunday mornings, just preceding the opening of Asian markets. The latest dramatic announcement came this last Sunday as Treasury Secretary Hank Paulson fired the bazooka he hoped he wouldn't have to use.

Fannie Mae and Freddie Mac, which together own or guarantee half of all U.S. mortgages, are now under conservatorship, meaning the government has managerial control of the two entities without outright owning them. While Fannie & Freddie (FF) were not at immediate risk of going belly up, the Treasury favoured a swift approach to the likely prospect of continued and costly capital injections. It was widely understood that FF were simply too big to fail. We will spare the details here (two in-depth reports are available on our website), but in moving from an implicit backing of FF debt to explicit backing to managerial control, the U.S. Treasury accomplishes two important things. First, it shores up confidence by avoiding an improbable but potentially cataclysmic failure which could have led to nothing less than a meltdown of the global financial system. FF shares and debt are widely held by banks and investors around the world. Second, the move has significantly lowered the spreads at which FF borrow in the market (see chart). The end result and most positive near-term impact of this government takeover of FF is that conventional mortgage rates have come down by about 50 basis points (see chart), which could help support sagging home sales. However, before changing our outlook on home sales, we will have to wait and see how much lower (if at all) mortgage rates go and if these rates stick.

Medium and longer-term, the FF takeover is no pana-



cea. Accounting details are yet to be worked out, but some or all of the massive \$5.2 trillion FF debt will make its way onto an already ballooning federal debt. Between now and the end of 2009, FF will be allowed to expand their respective mortgage portfolios to \$850 billion (about 9% on average). But what are currently the only players in town will then have to shrink by 10% every year down to \$250 billion each. This will not limit the amount of mortgages they could guarantee, but the securitization of mortgages will be greatly limited in the foreseeable future unless private capital suddenly regains an appetite for it.

Markets initially took the news positively, but it is evident that this by itself does not put a floor under equities for example. Nor does it succeed in reigning in credit spreads permanently. In particular, the LIBOR-OIS spread is still widening, reflecting still tight inter-bank lending and attesting that the credit crunch is unfortunately still alive and kicking. Markets were rudely awakened to these realities just a day later after the FF announcement as another investment bank, this time Lehman Brothers, came under extreme duress. Now sitting between the sale block and the brink of a slow-motion collapse, Lehman is looking for a lifeline. Who still thinks we are nearly out of the woods? Those who see the light might run into a large tree trunk if they run too fast. Although direct Fed or Treasury involvement looks unlikely this time around, they will certainly help coax financial players into an orderly takeover of Lehman. Stay tuned. Yet another ground-breaking announcement which would again remind us that season changing injuries and significant upsets in the NFL are small potatoes.

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UPCOMING KEY ECONOMIC RELEASES

Canadian Manufacturing Shipments - July

Release Date: September 16/08

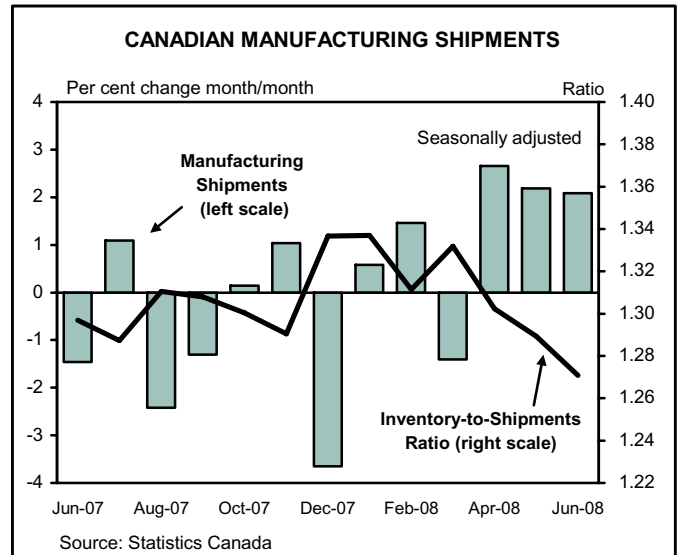
June Result: +2.1% M/M

TD Forecast: +1.5 % M/M

Consensus: +1.0% M/M

The Canadian manufacturing sector has chalked up its strongest performance in many years, with manufacturing shipments rising by over 2% M/M in each of the last three months. And while this surprising resiliency in the sector should taper off in the coming months, we do expect the momentum to continue for one more month. For July, we expect shipments to post another strong advance, rising by a further 1.5% M/M, on account of the strength in the export of automotive products and machinery and equipment. Looking ahead, however, shipments should moderate as the weakness in the Canadian and U.S. economies dampen demand for manufacturing products. Real shipments, however, have not tended to be as strong as the nominal number.

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U.S. Consumer Price Index - August

Release Date: September 16/08

July Result: core 0.3% M/M, 2.5% Y/Y;

all-items 0.8% M/M, 5.6% Y/Y

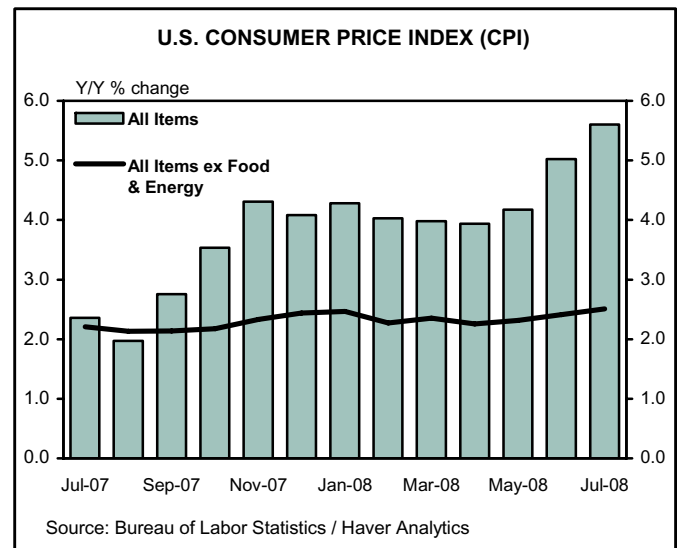
TD Forecast: core 0.2% M/M, 2.6% Y/Y;

all-items 0.1% M/M, 5.6% Y/Y

Consensus: core 0.2% M/M, 2.6% Y/Y;

all-items 0.0% M/M, 5.5% Y/Y

The first payoff for U.S. consumers from the dramatic U-turn in energy prices is expected to show up in the August CPI report. In fact, with the price of gasoline, natural gas and heating oil all recording significant drops in August, the overall energy component is expected to post a fairly strong decline during the month, which we expect will contribute significantly to the moderation in the headline consumer price index. During the month, we expect consumer prices to rise by 0.1% M/M, its slowest pace since February, keeping the headline inflation rate (which has accelerated for three consecutive months) unchanged at 5.6% Y/Y. Core prices, however, are expected to rise by 0.2% M/M, with the rate of core consumer price infla-



tion accelerating to 2.6% Y/Y, which will be its highest level since February last year. This, too, should begin to unwind shortly.

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U.S. FOMC Interest Rate Decision

Release Date: September 16/08

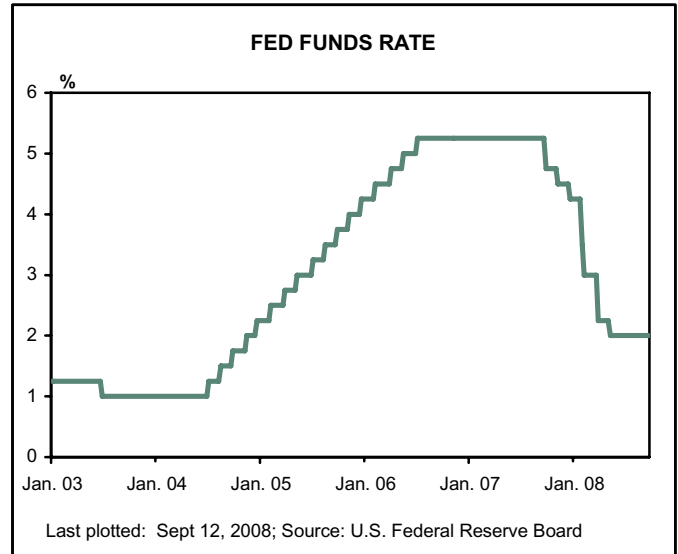
Current Rate: 2.00%

TD Forecast: 2.00%

Consensus: 2.00%

As has been the case in the past two FOMC meetings, we expect the Federal Reserve to keep the fed funds rate steady at 2% when the committee meets on September 16. With an unchanged policy rate almost fully priced in by the markets, and unanimously expected by economic forecasters, the focus of attention will doubtless be on the accompanying statement. In this regard, we are expecting the Fed to maintain the roughly balanced tone struck in the previous communiqué, highlighting both the downside risks to growth and perhaps repeating concerns about the elevated level of inflation. In terms of the policy stance, our expectation is for the Fed to remain coy on the actual monetary policy bias (as was the case in the last statement), offering few clues on the future direction of the policy rate, though we expect the overall assessment to be slightly softer than in the last statement.

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U.S. Housing Starts - August

Release Date: September 17/08

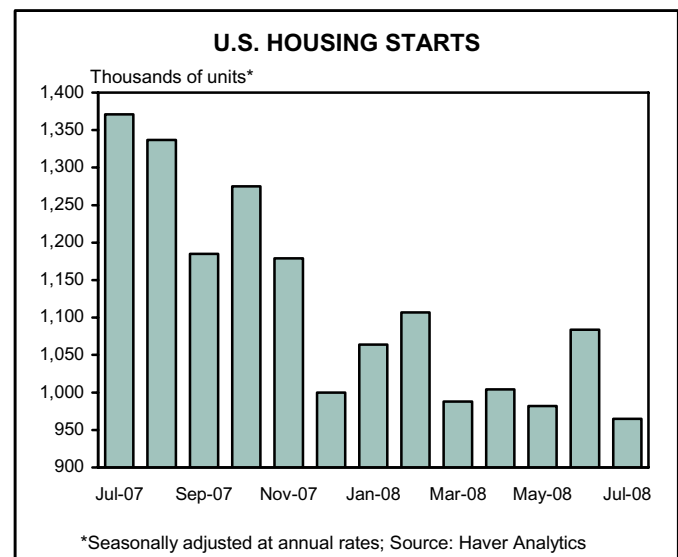
July Result: 965K

TD Forecast: 960K

Consensus: 950K

The U.S. housing sector has been in a state of malaise for the better part of two years, and there is little to suggest that we are likely to see any meaningful turnaround anytime soon. In particular, with the inventory of unsold homes remaining well above historical norms, tighter lending conditions limiting the availability of credit to potential home buyers and falling home prices constraining entrance into the housing market, new residential activity is unlikely to improve much. At the same time, it is fair to say that this measure has stopped falling sharply. For August, we expect the number of residential starts to fall marginally to 960K (from 965K in July), reflecting some moderation in the extent of the decline in starts.

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Canadian Wholesale Sales - July

Release Date: September 18/08

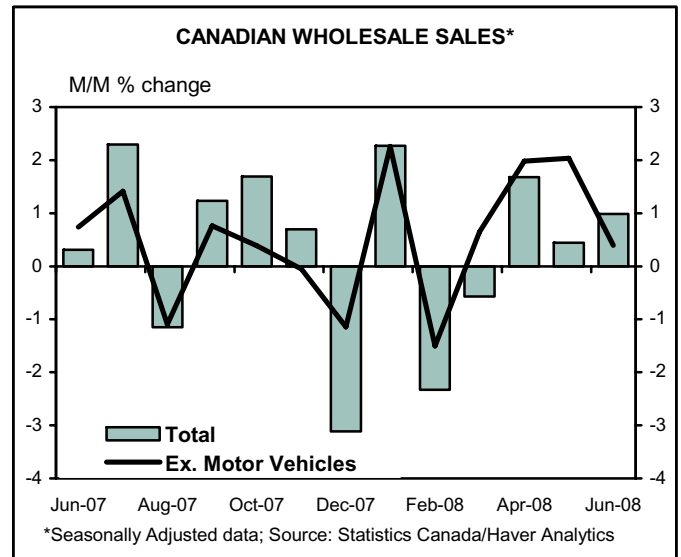
June Result: total +2.0% M/M

TD Forecast: total +0.8% M/M

Consensus: total +0.5% M/M

After a stellar performance in the second quarter, Canadian wholesale activity is expected to ease up on the gas this month with sales expected to rise by 0.8% M/M in July, following the robust 2.0% M/M advance in June. The increase in sales should come from the surprising strength in the automotive sector, which has remained fairly buoyant in the past few months. Prices will also likely play a big role in this increase, which will mean that in real terms sales may perhaps come in closer to flat on the month. Beginning July, we suspect that wholesale sales could moderate on account of the strains arising from weakening domestic and U.S. demand.

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RECENT KEY ECONOMIC INDICATORS
September 8 - September 12, 2008

Date	Economic Indicators	Data for	Units	Current	Prior	
Canada						
Sep 8	Building Permits	Jul.	M/M % chg.	1.8	-5.3	
Sep 9	Housing Starts	Aug.	Thousands	211.0	186.5	
Sep 10	Labour Productivity	Q2	Q/Q % chg.	-0.2	-0.6	R▼
Sep 11	International Merchandise Trade	Jul.	\$C, blns	4.9	5.6	R▼
Sep 11	New Housing Price index	Jul.	M/M % chg.	0.1	0.1	
Sep 12	Capacity Utilization Rate	Q2	%	78.9	79.6	R▼
United States						
Sep 8	<i>Fed Governor Fisher Speaks in Austin at Community Forum</i>					
Sep 8	Consumer Credit	Jul.	US\$, blns	4.6	11.0	R▼
Sep 9	Pending Home Sales	Jul.	M/M % chg.	-3.2	5.8	R▲
Sep 9	Wholesale Inventories	Jul.	% change	1.4	0.9	R▼
Sep 9	ABC Consumer Confidence	7-Sep	Index	-47.0	-47.0	
Sep 10	MBA Mortgage Applications	Sep 5	% change	9.5	7.5	
Sep 11	Trade Balance	Jul.	US\$, blns	-62.2	-58.8	R▼
Sep 11	Import Price Index	Aug.	Y/Y % chg.	16.0	20.1	R▼
Sep 11	Initial Jobless Claims	6-Sep	Thousands	445.0	451.0	R▲
Sep 11	Continuing Claims	30-Aug	Thousands	3525.0	3403.0	R▼
Sep 11	<i>Fed Governor Kohn Comments on Financial Regulation at Brookings</i>					
Sep 12	Producer Price Index	Aug.	Y/Y % chg.	9.6	9.8	
Sep 12	Producer Price Index (Ex. Food & Energy)	Aug.	Y/Y % chg.	3.6	3.5	
Sep 12	Advance Retail Sales	Aug.	% change	-0.3	-0.5	R▼
Sep 12	Retail Sales Less Autos	Aug.	% change	-0.7	0.3	R▼
Sep 12	U. of Michigan Confidence Index	Sep.	Index	-73.1	63.0	
Sep 12	Business Inventories	Jul.	% change	1.1	0.8	R▲

Source: Bloomberg, TD Economics

UPCOMING NORTH AMERICAN ECONOMIC CALENDAR
September 15 - September 19, 2008

Release Date	Economic Indicators	Data for Period	Units	Consensus Forecast	Prior
Canada					
Sep 15	New Motor Vehicle Sales	July	M/M % chg.	-0.4	-1.0
Sep 16	Manufacturing Shipments	July	M/M % chg.	1.0	2.1
Sep 18	Leading Indicators	Aug.	M/M % chg.	0.0	0.0
Sep 18	Wholesale Sales	July	M/M % chg.	--	2.0
United States					
Sep 15	Empire Manufacturing	Sept.	% change	1.0	2.8
Sep 15	Industrial Production	Aug.	Y/Y % chg.	-0.3	0.2
Sep 15	Capacity Utilization Rate	Aug.	%	79.6	79.9
Sep 16	Consumer Price Index (CPI)	Aug.	Y/Y % chg.	5.5	5.6
Sep 16	CPI Ex Food and Energy	Aug.	Y/Y % chg.	2.6	2.5
Sep 16	<i>Fed's Open Market Committee Meets on Interest Rates, Economy</i>				
Sep 16	NAHB Housing Market Index	Sept.	Index	17.0	16.0
Sep 16	<i>Federal Reserve Open Market Committee Meeting</i>				
Sep 16	FOMC Rate Decision	14-Sept.	%	2.0	2.0
Sep 16	ABC Consumer Confidence	14-Sept.	Index	--	-47.0
Sep 17	MBA Mortgage Applications	12-Sept.	% change	--	9.5
Sep 17	Current Account Balance	2Q	US\$, blns	-172.2	-176.4
Sep 17	Housing Starts	Aug.	Thousands	950.0	965.0
Sep 17	Building Permits	Aug.	Thousands	925.0	937.0
Sep 18	Initial Jobless Claims	13-Sept.	Thousands	440.0	445.0
Sep 18	Continuing Claims	6-Sept.	Thousands	--	3,525.0
Sep 18	Philadelphia Fed Index	Sept.	Index	-10.0	-12.7
Sep 18	Leading Indicators	Aug.	% change	-0.2	-0.7
Sep 19	<i>Fed's Evans Speaks on Economy at Swiss Central Bank Conference</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	
Sep 15	8:30	Canada	New Motor Vehicle Sales	July	M/M % chg.	-0.4	-1.0	
	8:30	U.S.	Empire Manufacturing	Sept.	% change	1.0	2.8	
	9:15	U.S.	Industrial Production	Aug.	Y/Y % chg.	-0.3	0.2	
	9:15	U.S.	Capacity Utilization Rate	Aug.	%	79.6	79.9	
Sep 16	1:00	Japan	Consumer Confidence	Aug.	Index	--	31.6	
	2:00	Germany	Consumer Price Index	Aug.	Y/Y % chg.	3.1	3.1	
	4:30	U.K.	CPI (YoY)	Aug.	Y/Y % chg.	4.6	4.4	
	4:30	U.K.	Retail Price Index	Aug.	Y/Y % chg.	5.0	5.0	
	5:00	Germany	ZEW Survey - Economic Sentiment	Sept.	Index	-52.8	-55.5	
	5:00	Germany	ZEW Survey - Current Situation	Sept.	Index	-16.5	-9.2	
	5:00	EU-12	ZEW Survey - Economic Sentiment	Sept.	Index	-53.5	-55.7	
	5:00	EU-12	Euro-Zone CPI	Aug.	Y/Y % chg.	3.8	3.8	
	8:30	Canada	Manufacturing Shipments	July	M/M % chg.	1.0	2.1	
	8:30	U.S.	Consumer Price Index (CPI)	Aug.	Y/Y % chg.	5.5	5.6	
	8:31	U.S.	CPI Ex Food and Energy	Aug.	Y/Y % chg.	2.6	2.5	
	9:00	U.S.	<i>Fed's Open Market Committee Meets on Interest Rates, Economy</i>					
	13:00	U.S.	NAHB Housing Market Index	Sept.	Index	17.0	16.0	
	14:15	U.S.	<i>Federal Reserve Open Market Committee Meeting</i>					
14:15	U.S.	FOMC Rate Decision	14-Sept.	%	2.0	2.0		
17:00	U.S.	ABC Consumer Confidence	14-Sept.	Index	--	-47.0		
Sep 17	4:30	U.K.	<i>Bank of England Minutes</i>					
	4:30	U.K.	Jobless Claims Change	Aug.	Thousands	23.0	20.1	
	6:00	U.K.	<i>CBI September Industrial Trends Survey Released</i>					
	7:00	U.S.	MBA Mortgage Applications	12-Sept.	% change	--	9.5	
	8:30	U.S.	Current Account Balance	2Q	US\$, blns	-172.2	-176.4	
	8:30	U.S.	Housing Starts	Aug.	Thousands	950.0	965.0	
	8:30	U.S.	Building Permits	Aug.	Thousands	925.0	937.0	
19:50	Japan	Tertiary Industry Index	July	% change	0.4	0.8		
Sep 18	2:00	Japan	Machine Tool Orders	Aug.	Y/Y % chg.	--	-14.2	
	4:30	U.K.	Retail Sales	Aug.	Y/Y % chg.	1.6	2.1	
	4:30	U.K.	M4 Money Supply	Aug.	Y/Y % chg.	10.4	11.2	
	8:30	Canada	Leading Indicators	Aug.	M/M % chg.	0.0	0.0	
	8:30	Canada	Wholesale Sales	July	M/M % chg.	--	2.0	
	8:30	U.S.	Initial Jobless Claims	13-Sept.	Thousands	440.0	445.0	
	8:30	U.S.	Continuing Claims	6-Sept.	Thousands	--	3,525.0	
	10:00	U.S.	Philadelphia Fed Index	Sept.	Index	-10.0	-12.7	
	10:00	U.S.	Leading Indicators	Aug.	% change	-0.2	-0.7	
16:45	NZ	Current Account Balance	2Q	NZ\$, blns	-3.500	-2.160		
Sep 19	--	Germany	Import Price Index	Aug.	Y/Y % chg.	--	0.6	
	1:00	Japan	Leading Index CI	July	Index	--	91.6	
	1:00	Japan	Coincident Index CI	July	Index	--	103.3	
	2:00	Germany	Producer Prices	Aug.	Y/Y % chg.	8.3	8.9	
	19:00	U.S.	<i>Fed's Evans Speaks on Economy at Swiss Central Bank Conference</i>					
		AU	Conference Board Leading Index	July	% change	--	-0.5	

* Eastern Standard Time; Sources: Bloomberg, TD Economics

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