



**Bank
Financial
Group**

TD Economics

The Weekly Bottom Line

September 19, 2008

HIGHLIGHTS

- Volatile equity markets end the week unchanged
- Details of rescue plans continue to be released
- Ultimate goal is to prevent collateral damage

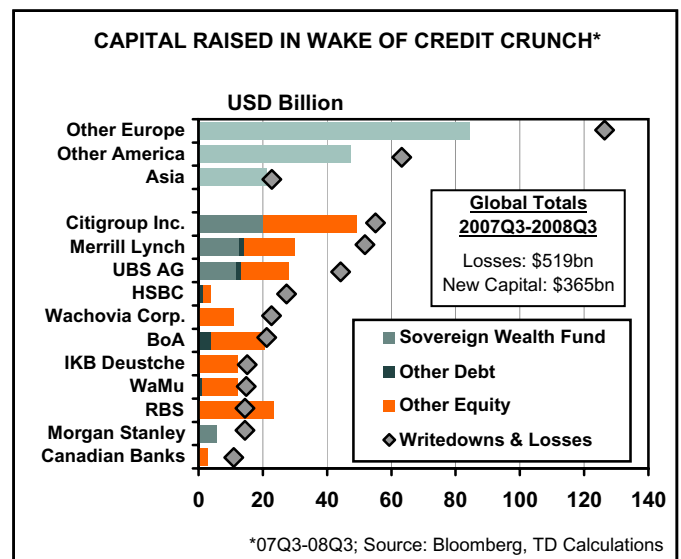
In the fog of war, it is important not to lose your head. This is a financial war being fought to restore confidence and ensure the ongoing operation of the global financial system and provision of credit – the lifeblood of the economy. If the bailout of Fannie and Freddie was the U.S. Treasury pulling out the bazooka, this week we have seen the unleashing of the Army, Navy, Air Force, Marines, Coast Guard, and Boy Scouts. Proposals made by U.S. authorities just on Friday amount to over \$1.2 trillion – almost the GDP of Canada. The details of the response will continue to evolve by the minute so we take this opportunity to explain what the battle plan is and will leave it to news sources to continue to fill in the details of the day-to-day campaigns.

The Battle Plan in “Lehmans” Terms

At its most basic level, the current problems resulted from two simultaneous innovations in the financial system. The first is the financial engineering revolution – of which mortgage securitization is but one example. Old finance said hold a stock or bond for a return relative to the risk. Now, derivatives allow for the ability to hedge risks associated with possible changes in interest rates, exchange rates, default rates – even the weather. This required the financial system to find ways to “financialize” more and more assets which weren’t commonly traded, like mortgages. The principle behind this was that finan-

Recent TD Economics Research

September 17, 2008 - U.S. Housing Starts
September 16, 2008 - U.S. FOMC Decision
September 16, 2008 - Canadian Manufacturing Shipments
September 16, 2008 - U.S. Consumer Price Index



cial players would have more liquidity and would be able to hold just the risks they felt comfortable with – no different than any individual investor rebalancing their portfolio to reflect their personal risk appetite. The second innovation was the expansion of risky lending – of which subprime mortgages was but one. For example, we have seen an increased holding of debts with lower credit rates relative to the past.

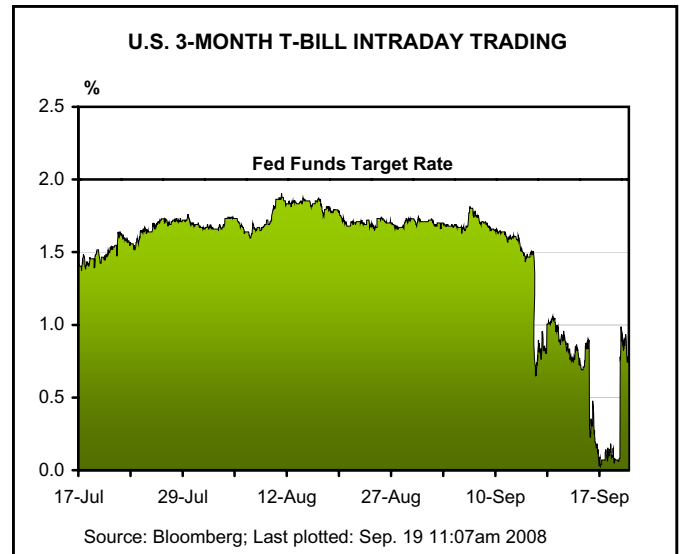
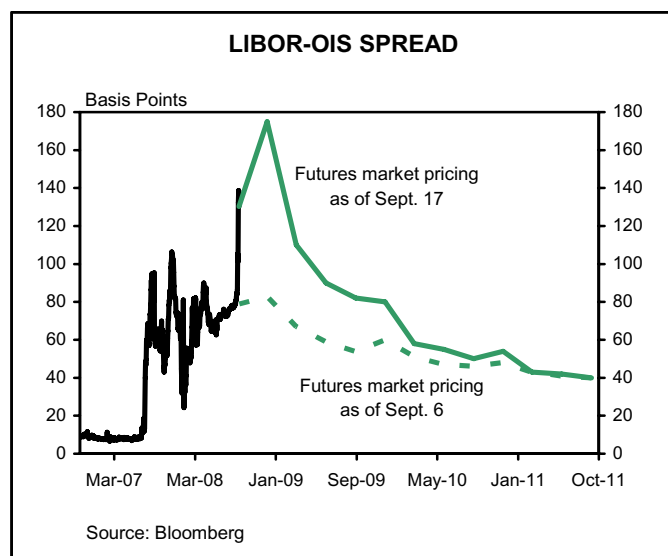
If we had seen just one of these innovations and not the other, it is doubtful we would have the current problems. Had financial engineering continued but lending standards stayed the same, the mortgages packaged off into financial markets would have been of high quality. Had financial institutions lowered their lending standards but been forced to hold those loans, the lenders that made bad decisions would have suffered and those that didn’t would have been spared. But put together, the combination was deadly. Not only that, they obviously fed on each other. A lender no longer cared that the borrower might not be able to pay the mortgage, because three months down the line, an investment bank in the U.K. would be holding the mortgage on the Las Vegas property, not the lender. The regulatory environment did not evolve with the times, and the

financial sector was like a toddler who touches a hot stove because they don't know any better. It may fall on deaf ears in the current environment, but much of the financial engineering has been a good thing, but as the saying goes, garbage in, garbage out.

Contagion Moves Merrill Along

The ongoing problem then is not that risky lending is continuing – because the pace of lending is fading across most industrialized countries – but that it is already done, already distributed throughout globally, and now must be removed. This is why the current proposal by the U.S. government does offer some promise, albeit large risks remain. The financial problems emanating from the financialization of mortgages are still ultimately tied to the U.S. housing market and will not stop until it reaches a bottom. That offers two solutions – either wait for the housing market to bottom, which we think will take at least another year and a further 5-10% decline in home prices, or remove the direct exposure of the financial system to those financial instruments by removing them from their balance sheets.

The ideal solution would be to let the market work itself out over time. In fact, if the recent disruptions cause prices to fall faster in the near term, the impact could be to bring the housing bottom sooner as attractive levels of home prices come earlier. However, the rapid financial consolidation and failure of Lehman and AIG risked cascading losses and threatened the day-to-day operation of the system. Yields on three-month U.S. T-bills at one point this week dropped to 0% – so give the government \$100 and they promised to give it back in three months. That's it.



It's a Nice Day for a White Wedding

The lesson from successful responses to past financial crises is that the functions of the financial system must continue to avoid collateral damage to third parties. For example, when Lehman Brothers declared bankruptcy, they still had four years left on their lease for office space in London. Not a problem for the real estate company which had insured themselves against the small chance of a Lehman default – except, they insured themselves through AIG, which collapsed the next day. But while the functions are key, the players can and will change as the shotgun mergers this week demonstrate. The plan moving through Congress now to buy up bad debts will not abruptly end the U.S. recession – caused by this financial crisis but with legs of its own now – but it does offer the promise of alleviating some pains and allowing the healing to begin. In fact, several of the U.S. administration's actions to date with Fannie, Freddie, and AIG stand to make a profit if the government's rescue plan succeeds. They are invested so heavily now that everything must be done to ensure success.

The day AIG's stocks tumbled and the government moved in to help, the share prices of its competitors rose, and shockingly, at the time of writing this, the S&P500 is up for the week. For all the fireworks, what we have seen is a massive and rapid restructuring – albeit a volatile and confusing one. A collapse would be much more costly, both for the financial sector and, more importantly, for the economy. Creative finance got us into this mess, but there is no reason it can't be used to get us out. As the saying goes, when life gives you Lehmans, make Lehmanade.

Richard Kelly, Senior Economist 416-982-2559

UPCOMING KEY ECONOMIC RELEASES

Canadian Retail Sales - July

Release Date: September 22/08

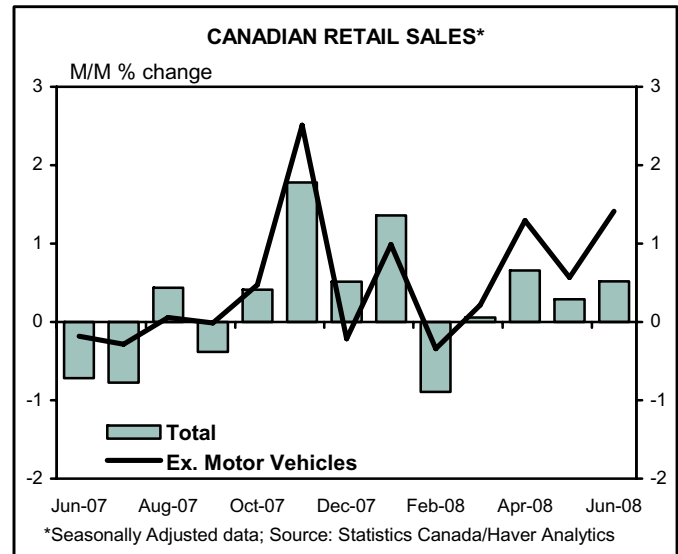
June Result: total +0.5% M/M; ex-autos +1.4% M/M

TD Forecast: total +0.3% M/M; ex-autos +0.1% M/M

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

With elevated gasoline prices, sluggish labour market conditions in that month and a softening housing sector providing the backdrop for Canadian consumers, we expect retail spending activity to come off the boil in July and eke out a meagre 0.3% M/M gain in July, following the 0.5% M/M increase in retail activity in June. Excluding autos, retail sales are likely to rise by only 0.1% M/M, following the very brisk 1.4% M/M surge in June. Looking ahead, with the Canadian economy appearing to have hit a soft patch and consumers' budgets continuing to be squeezed, we expect retail sales to remain tepid.

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Canadian Consumer Price Index - August

Release Date: September 22/08

July Result: core 0.1% M/M, 1.5% Y/Y;

all-items 0.3% M/M, 3.4% Y/Y

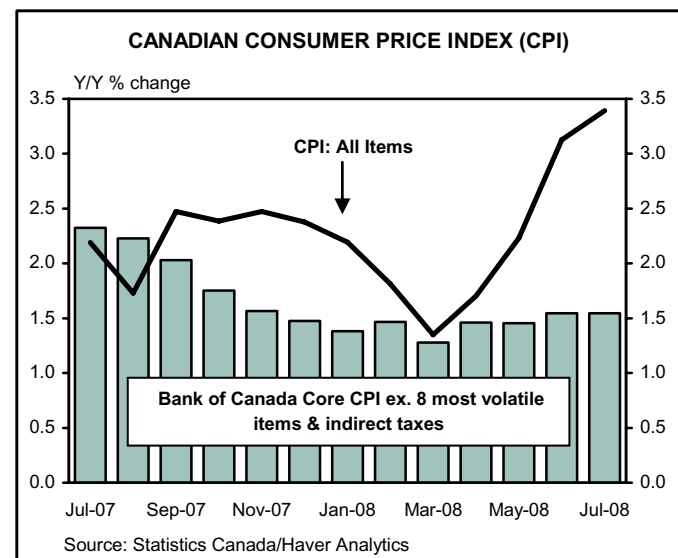
TD Forecast: core 0.0% M/M, 1.5% Y/Y;

all-items -0.3% M/M, 3.3% Y/Y

Consensus: core 0.1% M/M, 1.6% Y/Y;

all-items -0.2% M/M, 3.5% Y/Y

After surging to 3.4% Y/Y last month (from 1.4% Y/Y in March), we expect the first signs of the moderation in Canadian consumer prices to emerge in August, on account of the dramatic retreat in global commodity prices and the developing slack in the domestic economy. Indeed, with energy prices heading lower, and wage pressures continuing to ease, August should perhaps be the turning point for Canadian consumer inflation. On a monthly basis, the headline index is expected to fall 0.33% M/M (down 0.08% M/M on a seasonally adjusted basis), bringing the annual inflation rate down to 3.3% Y/Y. The non-seasonally adjusted Bank of Canada core inflation measure, however, is expected to remain unchanged on the month (rising by 0.1% M/M on a seasonally adjusted



basis), with the annual rate of core consumer price inflation remaining unchanged for the fifth straight month at 1.5% Y/Y.

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U.S. Durable Goods Orders – August

Release Date: September 25/08

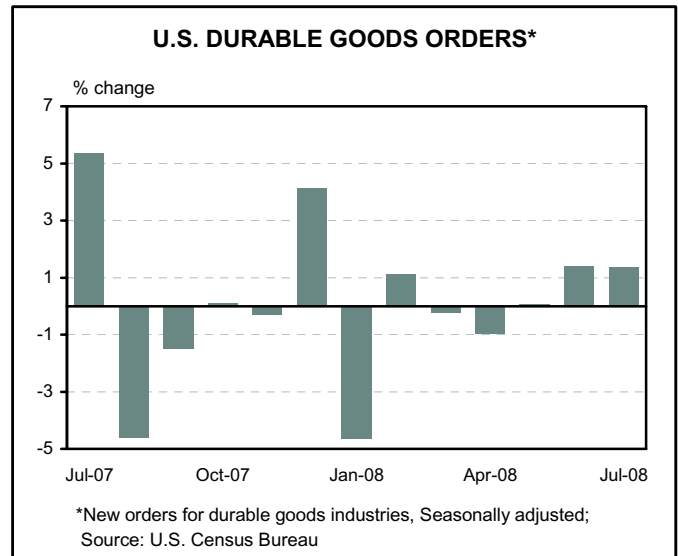
July Result: total 1.3% M/M; ex-transportation 0.7% M/M

TD Forecast: total -1.5% M/M; ex-transportation -0.5% M/M

Consensus: total -1.4% M/M; ex-transportation -0.4% M/M

After fairly strong back-to-back gains in durable goods orders in June and July, we expect orders to fall back down to earth in August. In particular, with weakening export demand and a sluggish domestic economy, our call is for new durable goods orders to decline for the first time since April, posting a 1.5% M/M drop in August, despite the boost coming from aircraft orders. Excluding transportation, we expect a more moderate 0.5% M/M drop in orders. In the coming months, with the U.S. economy continuing to weaken and export demand waning, we expect new durable orders to moderate further.

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RECENT KEY ECONOMIC INDICATORS
September 15 - September 19, 2008

Date	Economic Indicators	Data for	Units	Current	Prior	
Canada						
Sep 15	New Motor Vehicle Sales	July	M/M % chg.	-0.8	-1.3	R▼
Sep 16	Manufacturing Shipments	July	M/M % chg.	2.7	1.9	R▼
Sep 18	Leading Indicators	Aug.	M/M % chg.	0.2	0.0	R▲
Sep 18	Wholesale Sales	July	M/M % chg.	2.3	2.0	
United States						
Sep 15	Empire Manufacturing	Sept.	% change	-7.4	2.8	
Sep 15	Industrial Production	Aug.	Y/Y % chg.	-1.1	0.1	R▼
Sep 15	Capacity Utilization Rate	Aug.	%	78.7	79.7	R▼
Sep 16	Consumer Price Index (CPI)	Aug.	Y/Y % chg.	5.4	5.6	
Sep 16	CPI Ex Food and Energy	Aug.	Y/Y % chg.	2.5	2.5	
Sep 16	<i>Fed's Open Market Committee Meets on Interest Rates, Economy</i>					
Sep 16	NAHB Housing Market Index	Sept.	Index	18.0	16.0	
Sep 16	<i>Federal Reserve Open Market Committee Meeting</i>					
Sep 16	FOMC Rate Decision	14-Sept.	%	2.00	2.00	
Sep 16	ABC Consumer Confidence	14-Sept.	Index	-41.0	-47.0	
Sep 17	MBA Mortgage Applications	12-Sept.	% change	33.4	9.5	
Sep 17	Current Account Balance	2Q	US\$, blns	-183.1	-175.6	R▼
Sep 17	Housing Starts	Aug.	Thousands	895.0	954.0	R▼
Sep 17	Building Permits	Aug.	Thousands	854.0	937.0	
Sep 18	Initial Jobless Claims	13-Sept.	Thousands	455.0	445.0	
Sep 18	Continuing Claims	6-Sept.	Thousands	3478.0	3533.0	R▲
Sep 18	Philadelphia Fed Index	Sept.	Index	3.8	-12.7	
Sep 18	Leading Indicators	Aug.	% change	-0.5	-0.7	
Sep 19	<i>Fed's Evans Speaks on Economy at Swiss Central Bank Conference</i>					

Source: Bloomberg, TD Economics

UPCOMING NORTH AMERICAN ECONOMIC CALENDAR

September 22 - September 26, 2008

Release Date	Economic Indicators	Data for Period	Units	Consensus Forecast	Prior
Canada					
Sep 22	Retail Sales	Jun.	M/M % chg.	1.0	2.8
Sep 22	Retail Sales (Ex. Autos)	Jun.	M/M % chg.	0.3	1.4
Sep 23	Consumer Price Index	Aug.	Y/Y % chg.	--	3.4
Sep 23	Bank of Canada CPI Core	Aug.	Y/Y % chg.	--	1.5
United States					
Sep 22	<i>Fed Governor Fisher Speaks in Texas on U.S. Economy, Finance Industry</i>				
Sep 23	Richmond Fed. Manufacturing Index	Sept.	Index	--	-16.0
Sep 23	House Price Index	July	M/M % chg.	-0.2	0.0
Sep 23	ABC Consumer Confidence	21-Sept.	Index	--	-41.0
Sep 24	MBA Mortgage Applications	19-Sept.	% change	--	33.4
Sep 24	Existing Home Sales	Aug.	Millions	4.95	5.0
Sep 24	<i>Bernanke testifies at Congress Joint Economic Committee</i>				
Sep 25	Durable Goods Orders	Aug.	% change	-1.4	1.3
Sep 25	Initial Jobless Claims	20-Sept.	Thousands	--	455.0
Sep 25	Continuing Claims	13-Sept.	Thousands	--	3,478.0
Sep 25	New Home Sales	Aug.	Thousands	515	515.0
Sep 25	<i>Fed Governor Evan, ECB's Gonzalez-Paramo Give Welcoming Remarks</i>				
Sep 25	<i>Paulson, Bernanke Testify on Fannie Takeover at House Panel</i>				
Sep 25	<i>Fed Governor Warsh Speaks at Chicago International Banking Conference</i>				
Sep 26	<i>Fed Governor Fisher Speaks to Investors, Economists in New York</i>				
Sep 26	Personal Consumption	2Q F	% change	1.7	1.7
Sep 26	U. of Michigan Confidence Index	Sept.	Index	71.5	73.1
Sep 26	<i>St. Louis Fed's Bullard To Speak at Tennessee Economic Meeting</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 22	19:50	Japan	All Industry Activity Index	July	% change	0.8	-0.9
	19:50	Japan	<i>BoJ Monetary Policy Meeting Minutes for August</i>				
	21:30	AU	New Motor Vehicle Sales	Aug.	Y/Y % chg.	--	-4.1
	8:30	Canada	Retail Sales	Jun.	M/M % chg.	0.3	0.5
	8:30	Canada	Retail Sales (Ex. Autos)	Jun.	M/M % chg.	0.3	1.4
	11:30	U.S.	<i>Fed Governor Fisher Speaks in Texas on U.S. Economy, Finance Industry</i>				
Sep 23	2:45	France	Consumer Spending	Aug.	% change	0.4	1.0
	3:00	France	Purchasing Managers Index (Services)	Sept.	Index	47.7	48.0
	3:00	France	Purchasing Managers Index (Manufacturing)	Sept.	Index	46.0	45.8
	3:30	Germany	Purchasing Managers Index (Services)	Sept.	Index	50.7	51.4
	3:30	Germany	Purchasing Managers Index (Manufacturing)	Sept.	Index	49.2	49.7
	4:00	EU-12	Purchasing Managers Index (Services)	Sept.	Index	48.0	48.5
	4:00	EU-12	Purchasing Managers Index (Composite)	Sept.	Index	47.8	48.2
	4:00	EU-12	Purchasing Managers Index (Manufacturing)	Sept.	Index	47.3	47.6
	7:00	Canada	Consumer Price Index	Sept.	Y/Y % chg.	3.5	3.4
	7:00	Canada	Bank of Canada CPI Core	Sept.	Y/Y % chg.	1.6	1.5
	10:00	U.S.	Richmond Fed. Manufacturing Index	Sept.	Index	-15	-16
	10:00	U.S.	House Price Index	July	M/M % chg.	-0.3	0.0
	10:00	U.S.	<i>Paulson, Bernanke Testify on Credit Turmoil at Senate Panel</i>				
17:00	U.S.	ABC Consumer Confidence	21-Sept.	Index	--	-41	
Sep 24	2:45	France	Business Confidence Indicator	Sept.	Index	97	98
	2:45	France	Production Outlook Indicator	Sept.	Index	-35	--
	4:00	Germany	IFO - Business Climate	Sept.	Index	94.1	94.8
	4:00	Germany	IFO - Current Assessment	Sept.	Index	101.9	103.2
	4:00	Germany	IFO - Expectations	Sept.	Index	87.3	87.0
	10:00	EU	Current Account Balance	Jul.	Eur. blns	--	-8.2
	7:00	U.S.	MBA Mortgage Applications	19-Sept.	% change	--	33.4
	10:00	U.S.	Existing Home Sales	Aug.	Millions	4.95	5.0
	10:00	U.S.	<i>Bernanke testifies at Congress Joint Economic Committee</i>				
	19:50	Japan	Merchandise Trade Balance	Aug.	¥, blns	112.5	172.4
Sep 25-30		U.K.	Nation-wide House Prices	Sept.	Y/Y % chg.	-12.8	-10.5
Sep 25	8:30	U.S.	Durable Goods Orders	Aug.	% change	-1.5	1.3
	8:30	U.S.	Initial Jobless Claims	20-Sept.	Thousands	--	455
	8:30	U.S.	Continuing Claims	13-Sept.	Thousands	--	3478
	10:00	U.S.	New Home Sales	Aug.	Thousands	512	515
	10:40	U.S.	<i>Fed Evan, ECB's Gonzalez-Paramo Give Welcoming Remarks</i>				
	12:00	U.S.	<i>Paulson, Bernanke Testify on Fannie Takeover at House Panel</i>				
	13:00	U.S.	<i>Fed's Warsh Speaks at Chicago International Banking Conference</i>				
	19:00	U.S.	<i>Fed's Fisher Speaks to Investors, Economists in New York</i>				
	19:30	Japan	Tokyo CPI excl. perishables	Sept.	Y/Y % chg.	1.4	1.5
19:45	NZ	Real Gross Domestic Product	Q2-08	Q/Q % chg.	-0.4	-0.3	
Sep 26	--	Germany	Consumer Price Index	Sept.	Y/Y % chg.	2.8	3.1
	2:45	France	Consumer Confidence Indicator	Sept.	Index	-47	--
	2:45	France	Gross Domestic Product	2Q F	Y/Y % chg.	1.1	1.1
	8:30	U.S.	Personal Consumption	2Q F	% change	1.7	1.7
	10:00	U.S.	<i>St. Louis Fed's Bullard To Speak at Tennessee Economic Meeting</i>				

* Eastern Standard Time; Sources: Bloomberg, TD Economics

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