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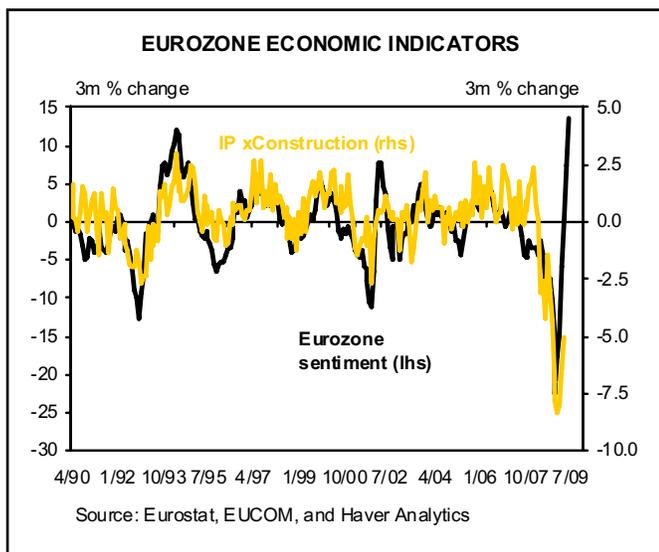
Observation

June 29, 2009

COULD THE EUROZONE ECONOMY SEE THE 'MOTHER OF ALL REBOUNDS?'

As the global economic recovery continues to take shape, the general consensus has been that the Eurozone would be a laggard. Our own forecasts have continued to highlight the likely tepid recovery in the Eurozone in 2010, as well. The ECB was less forthcoming in monetary stimulus. Eurozone governments provided smaller and less coordinated fiscal stimulus packages. Eurozone banks, which had lent big to Eastern Europe, would see their struggles tied to the economic prospects of Eastern European economies. The European labour market typically takes longer to adjust following a recession. And, the stronger euro will not be much help in offsetting weak domestic conditions with stronger exports from Eurozone, either.

But in many regards, we have seen these risks pared back over the last few months. So much so, that in our recent Quarterly Economic Forecast, we upgraded our forecast for the Eurozone economy to a 1.2% annualized growth rate in 2010, more than double the current consensus (<http://www.td.com/economics/qef/qefjun09.pdf>).



HIGHLIGHTS

- **Recent economic indicators suggest the Eurozone could see a very powerful rebound at the end of this year.**
- **This rebound could result in real GDP growth hitting a 4-5% annualized pace in the third or fourth quarter.**
- **The full recovery will still take time, but consensus forecasts seem to be lagging the full scope for economic growth in 2010.**
- **We believe the ECB is now firmly on hold, and in fact could be driven to hike rates very gradually beginning in the first half of next year.**

Risks from Eastern Europe were reduced with a large share of debt reportedly renegotiated and successfully rolled over. The European Central Bank, absolutely slow to respond to the downturn, did eventually catch up in providing stimulus. Last week, they effectively provided EUR442bn in one-year loans to over one thousand banks at just 1.00%. A large share was then redeposited and remains in cash, but that does provide much needed liquidity to the system.

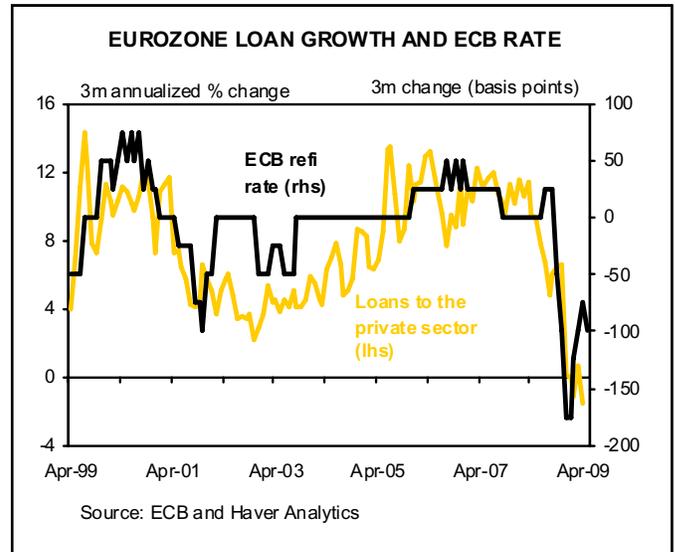
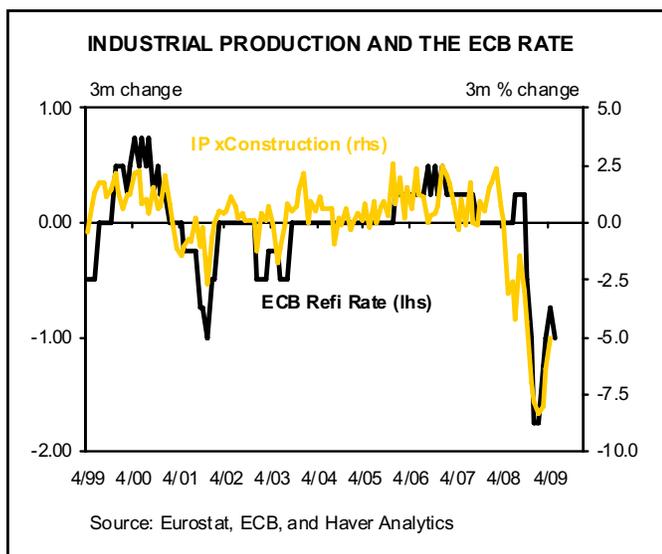
Less is MOAR

But in addition to these longer term helps, we have also seen evidence of the potential size of the economic rebound that will follow the worst post-war recession. With further evidence this morning from the Eurozone economic sentiment indicator, we think it is now appropriate to ask whether the Eurozone is on the verge of the 'Mother of All Rebounds (MOAR).' It is important not to mistake 'rebound' for 'recovery.' The recovery will be a long process to bring manufacturing levels back to pre-recession levels, to rehire workers laid off, and to restart capital in-

vestment once the current slack is taken up. The rebound will be a short-term bump coming in the Q3/Q4 period and will likely be largely driven by the inventory cycle.

The unprecedentedly steep decline in economic activity was exacerbated by the tremendous uncertainties over what the future would bring. Businesses scaled back more than they typically would and inventories in many cases were cut to almost nothing. Although the economic performance was the worst in the post-war world, the worst case was avoided for the Eurozone and global economy. As a result, positive sentiment seems to be returning to businesses, and with low inventories, some production will be needed. It's also useful to note here that the level of production and economic activity is still hugely below where it was before this recession began. But growth is growth, and sometimes the deeper the hole you're in, especially a hole driven by inventory decumulation, the steeper the economic rebound that is possible.

So how big could MOAR be? Looking at the correlation between economic sentiment and industrial production, industrial production (measured on a 3-month percentage change basis) could possibly recover to its strongest pace since the data began in 1990. It is important to see whether this trend is sustained in the next couple months of data, but this could translate into GDP growth of a 4-5% annualized pace in the third or fourth quarter of 2009. This would then set up the economy for an expansion much closer to the 1.2% pace we are forecasting for 2010 rather than the consensus view for less than half a percentage point or less. In fact, such a strong handoff would even pose an upside risk to our own optimistic forecast.



More or less ECB actions?

With the ECB's monthly rate decision on tap this Thursday, MOAR suggests that further stimulus from the ECB is off the table. In fact, typically industrial production of this magnitude would be associated with higher interest rates, not lower. We think the ECB will look through this initial rebound and to the size of the trend recovery in 2010 before raising rates. But, the ECB is arguably the most uncomfortable of the major central banks with having the level of the policy rate at an all-time low. So, as we highlighted in our summary of the last ECB press conference (<http://www.td.com/economics/comment/rk060409.pdf>), we do see the prospect that the ECB could begin to raise rates as early as the first quarter of 2010 depending on precisely how resilient the recovery remains at the end of this year. We would also look to the monthly MFI bank lending data (with the next release on June 30th), which has also served as a good indicator of ECB actions.

The level of interest rates will still be conducive to Eurozone economic growth, but we think the ECB's Governing Council will want to put some distance between themselves and the zero bound for interest rates sooner rather than later. It may even be that they take a siesta on the road to normalization, once they feel rates have been returned to an appropriate level of stimulus, and then wait for economic activity to catch up a bit. But, in the new paradigm for central bank actions, there has been some approval of the idea from ECB officials that interest rates can and should be used as a means of avoiding financial bubbles.

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