# DOLLARS & SENSE

# TD Economics

January 26, 2017

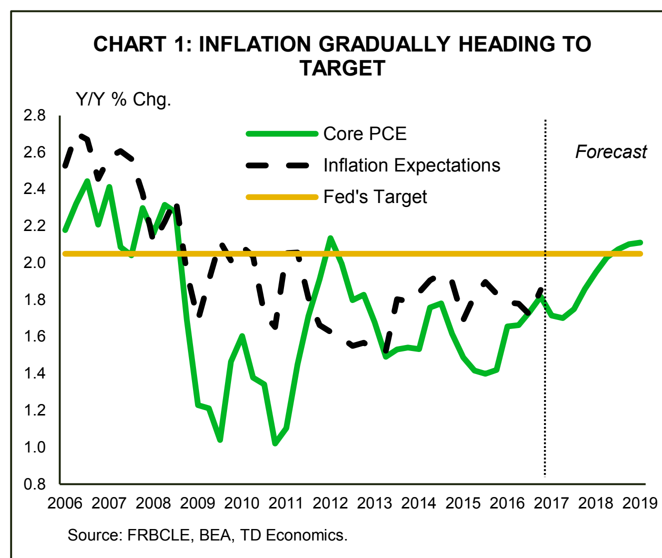
# DON'T STOP BELIEVING!

### Highlights

- Markets are holding on to that feeling. Fiscal policy and tax proposals appear forthcoming and popular opinion is that it is going to spur investment and profit growth.
- The truth is that fiscal policy at this mature stage of the economic cycle is an experiment. The actual proposals and consequences are uncertain. Notwithstanding, financial markets are pricing for an optimal outcome. Equities are at all-time highs and bond yields are priced for stable inflation.
- With respect to expectations for the Federal Reserve, we believe it is not behind the curve for inflation and that it can continue to gradually remove monetary accommodation over the coming year.
- The steady path of the Fed is warranted due to its influence on the U.S. dollar. Any effort made by the Fed to raise rates too quickly will cause the currency to appreciate. In this way, the dollar acts as a counter-weight to any dramatic change in fiscal or monetary policy.

The year has gotten off to a reflective start for financial markets. Domestic bond yields and equities have stabilized, even though much remains unresolved on the policy landscape. Reduced financial market volatility is a welcomed reprieve, especially considering the sharp upward movements in yields and equities that took hold toward the end of 2016. With the U.S. economy resting on a solid foundation, the entrepreneurial spirit and innovation ingrained in its history should be relied upon to carry the weight of the country. That said, policy change is forthcoming, and volatility could follow close behind. We have entered a new paradigm depicted by openness to fiscal policy that will shape the United States for years to come.

In looking at U.S. economic momentum, the factors that led us to upgrade inflation in early 2016 are bearing fruit (Chart 1). The level of employment slack has been steadily reduced, resulting in a groundswell of real wage gains, cutting into operating margins. However, markets are holding on to an optimistic feeling. The potential for significant corporate and income tax reform, topped off with hopes of a less burdensome corporate regulatory framework have lifted market expectations for overall profitability. In fact, with the consensus amongst analysts on earnings for the S&P 500 expected to rebound in 2017, the strength of the U.S. economy is evident.




Even the areas of the economy that have been pulling down the average growth rate are garnering market excitement. Business investment, which has declined at a rate not seen outside of recession, is poised to rebound. The Dodge Index that tracks construction and investment projects picked up in the fourth quarter. This Index historically leads overall private fixed investment by

Beata Caranci, VP & Chief Economist, 416-982-8067
James Orlando, Senior Economist, 416-413-3180

6-12 months (Chart 2). Likewise, the Architecture Billings Index reached its highest level since the financial crisis. The resilience of the global economy to adjust and continue to grow in the face of so many shocks appears to have boosted overall confidence in the future path for growth. This has played out in recent data on small business optimism, which sits at its highest level in a decade. Whether or not 'animal spirits' return in full form, we expect corporate investment in the U.S. to improve over the coming year.

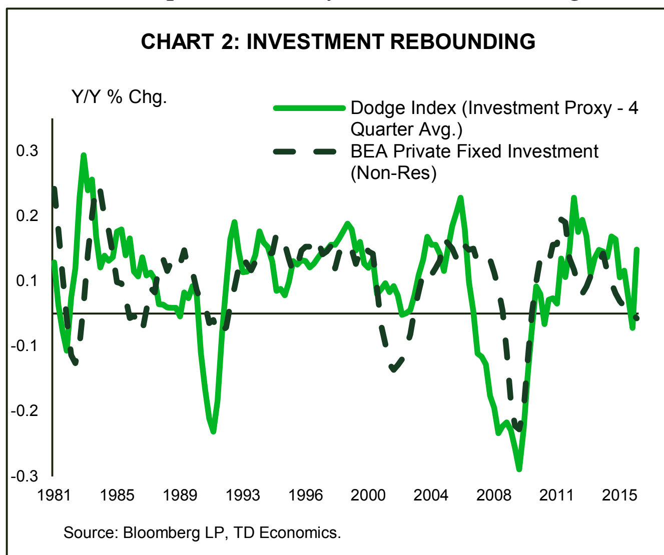
### Fiscal expansion: some will win, some will lose

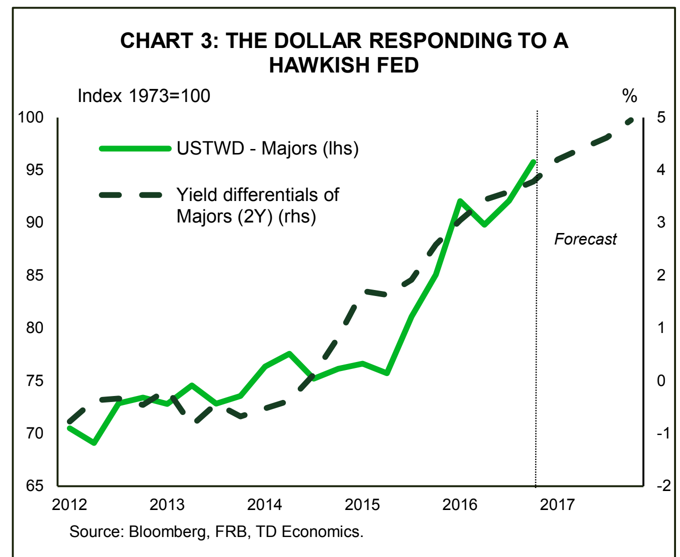
Despite past efforts to maintain fiscal restraint and keep debt levels in check, politicians around the world are promising spending programs in search for ways to nudge up the run rate of economic growth. The U.S. certainly has one of the most ambitious mindsets. Improving infrastructure can certainly hold water with economists, while a simplified and modernized American corporate tax structure has both logic and necessity on its side.

Awaiting the details of policy proposals have left most firmly positioned on the edge of their seats. Government spending can have long-lasting benefits to society when done right. It also has the ability to stunt growth, stoke high inflation, and burden future generations if done poorly. The uncertainty surrounding the impact of upcoming proposals is further complicated by the mature stage of this business cycle, where aggressive fiscal policy implementation is relatively untested for an advanced economy. With measures of future inflation converging to the Federal Reserve's 2% target, markets appear to be priced for an optimal outcome.

### The Fed: living in a lonely world

Inflation expectations may indeed drift even higher once policy plans are more concrete. Part of the reason for the muted level of expectations is due to the belief that the Federal Reserve is not behind the inflation curve. All evidence points to this being true. Even with the unemployment rate at 4.7%, the Fed's preferred measure of inflation - core PCE - has averaged less than 1% over the last three quarters (moving average of price change). By our assumptions, this measure will not reach target until late 2018. Fiscal policy might speed this up, but there's a fair bit of runway to reach 2% and a realistic timeline for the impact of policy implementation to be realized in the economy is roughly 12-18 months from now. What this means is that the Fed is not being rushed to remove monetary accommodation. The committee is committed to a gradual, non-disruptive, rate hiking cycle. After waiting 12 months between rate hikes, the data does not lend itself to an urgency to play catch-up. Yet, a slightly quicker pace than the past is reasonable based on the thickening foundation evident within labor market metrics. We believe the Fed will move from the prior path of a one-and-done hike per year, to once every six months. This offers market participants a transparent policy path, while also granting the Fed maximum flexibility should financial conditions tighten more than expected due to global or domestic events, or should inflation surprise to the upside.




The steady path of the Fed is also warranted due to its influence on the U.S. dollar (Chart 3). According to the Fed's own models, the 7% appreciation of the trade-weighted dollar over the past six months is equivalent to a near 50 bps hike in the fed funds rate. In this sense, the dollar is providing balance. However, should the Fed raise rates too fast, the dollar will surge and the U.S. will import disinflation via lower import prices. With the central banks

of its major trading partners likely on hold or even ease further in 2017, the Fed is living in a lonely world. It will necessarily be cautious in its decision to speed up the pace of the hiking cycle in the absence of convincing evidence on heated inflationary pressures. When governments inject uncertainty regarding economic impacts, it is particularly important for monetary policy to move with an even hand.

***Beata Caranci***
***VP & Chief Economist***

***James Orlando***
***Senior Economist***

## INTEREST RATE & FOREIGN EXCHANGE RATE OUTLOOK

| | | Spot Rate | 2016 | | | | 2017 | | | | 2018 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Jan-25 | Q1 | Q2 | Q3 | Q4 | Q1F | Q2F | Q3F | Q4F | Q1F | Q2F | Q3F | Q4F |
| **Interest Rates** | | | | | | | | | | | | | | |
| Fed Funds Target Rate | | 0.75 | 0.50 | 0.50 | 0.50 | 0.75 | 0.75 | 1.00 | 1.00 | 1.25 | 1.25 | 1.50 | 1.50 | 1.75 |
| 3-mth T-Bill Rate | | 0.49 | 0.21 | 0.26 | 0.29 | 0.51 | 0.65 | 0.90 | 0.90 | 1.15 | 1.15 | 1.40 | 1.40 | 1.65 |
| 2-yr Govt. Bond Yield | | 1.23 | 0.73 | 0.58 | 0.77 | 1.20 | 1.25 | 1.40 | 1.55 | 1.70 | 1.85 | 2.00 | 2.15 | 2.25 |
| 5-yr Govt. Bond Yield | | 1.98 | 1.21 | 1.01 | 1.14 | 1.93 | 1.95 | 2.05 | 2.15 | 2.25 | 2.35 | 2.50 | 2.55 | 2.65 |
| 10-yr Govt. Bond Yield | | 2.51 | 1.78 | 1.49 | 1.60 | 2.45 | 2.50 | 2.55 | 2.65 | 2.75 | 2.85 | 3.00 | 3.10 | 3.20 |
| 30-yr Govt. Bond Yield | | 3.10 | 2.61 | 2.30 | 2.32 | 3.06 | 3.15 | 3.20 | 3.25 | 3.35 | 3.40 | 3.50 | 3.55 | 3.65 |
| 10-yr-2-yr Govt Spread | | 1.28 | 1.05 | 0.91 | 0.83 | 1.25 | 1.25 | 1.15 | 1.10 | 1.05 | 1.00 | 1.00 | 0.95 | 0.95 |
| **Exchange rate to U.S. dollar** | | | | | | | | | | | | | | |
| Chinese Yuan | CNY per USD | 6.88 | 6.45 | 6.65 | 6.67 | 6.94 | 6.96 | 7.04 | 7.12 | 7.18 | 7.30 | 7.40 | 7.50 | 7.50 |
| Japanese yen | JPY per USD | 113 | 112 | 103 | 101 | 117 | 112 | 113 | 114 | 115 | 116 | 116 | 117 | 117 |
| Euro | USD per EUR | 1.07 | 1.14 | 1.10 | 1.12 | 1.06 | 1.06 | 1.08 | 1.10 | 1.12 | 1.14 | 1.15 | 1.15 | 1.16 |
| U.K. pound | USD per GBP | 1.26 | 1.44 | 1.32 | 1.30 | 1.23 | 1.22 | 1.22 | 1.24 | 1.29 | 1.33 | 1.35 | 1.36 | 1.37 |
| Swiss franc | CHF per USD | 1.00 | 0.96 | 0.98 | 0.97 | 1.02 | 1.01 | 1.01 | 1.01 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 |
| Canadian dollar | CAD per USD | 1.31 | 1.30 | 1.30 | 1.31 | 1.34 | 1.35 | 1.35 | 1.34 | 1.34 | 1.33 | 1.32 | 1.31 | 1.31 |
| Australian dollar | USD per AUD | 0.76 | 0.77 | 0.74 | 0.77 | 0.72 | 0.72 | 0.72 | 0.73 | 0.74 | 0.75 | 0.75 | 0.75 | 0.75 |
| NZ dollar | USD per NZD | 0.73 | 0.69 | 0.71 | 0.73 | 0.70 | 0.65 | 0.64 | 0.64 | 0.64 | 0.64 | 0.64 | 0.64 | 0.64 |
| **Exchange rate to Euro** | | | | | | | | | | | | | | |
| U.S. dollar | USD per EUR | 1.07 | 1.14 | 1.10 | 1.12 | 1.06 | 1.06 | 1.08 | 1.10 | 1.12 | 1.14 | 1.15 | 1.15 | 1.16 |
| Japanese yen | JPY per EUR | 122 | 128 | 113 | 114 | 123 | 119 | 122 | 125 | 129 | 132 | 133 | 134 | 135 |
| U.K. pound | GBP per EUR | 0.85 | 0.79 | 0.83 | 0.86 | 0.86 | 0.87 | 0.89 | 0.89 | 0.87 | 0.86 | 0.85 | 0.85 | 0.85 |
| Swiss franc | CHF per EUR | 1.07 | 1.09 | 1.08 | 1.09 | 1.07 | 1.07 | 1.09 | 1.11 | 1.12 | 1.14 | 1.15 | 1.15 | 1.16 |
| Canadian dollar | CAD per EUR | 1.40 | 1.48 | 1.44 | 1.47 | 1.42 | 1.43 | 1.46 | 1.47 | 1.50 | 1.52 | 1.51 | 1.51 | 1.51 |
| Australian dollar | AUD per EUR | 1.42 | 1.48 | 1.48 | 1.47 | 1.46 | 1.47 | 1.50 | 1.51 | 1.51 | 1.52 | 1.53 | 1.53 | 1.54 |
| NZ dollar | NZD per EUR | 1.47 | 1.65 | 1.55 | 1.54 | 1.52 | 1.63 | 1.69 | 1.72 | 1.75 | 1.78 | 1.79 | 1.80 | 1.81 |
| **Exchange rate to Japanese yen** | | | | | | | | | | | | | | |
| U.S. dollar | JPY per USD | 113 | 112 | 103 | 101 | 117 | 112 | 113 | 114 | 115 | 116 | 116 | 117 | 117 |
| Euro | JPY per EUR | 122 | 128 | 113 | 114 | 123 | 119 | 122 | 125 | 129 | 132 | 133 | 134 | 135 |
| U.K. pound | JPY per GBP | 143 | 162 | 136 | 132 | 144 | 137 | 138 | 141 | 148 | 154 | 157 | 158 | 160 |
| Swiss franc | JPY per CHF | 113.4 | 117.3 | 105.0 | 104.4 | 114.9 | 110.9 | 111.9 | 112.9 | 115.0 | 115.5 | 116.0 | 116.5 | 117.0 |
| Canadian dollar | JPY per CAD | 86.7 | 86.7 | 79.0 | 77.2 | 87.0 | 83.0 | 83.7 | 85.1 | 85.8 | 86.8 | 87.9 | 88.9 | 89.7 |
| Australian dollar | JPY per AUD | 85.8 | 86.3 | 76.4 | 77.6 | 84.4 | 80.6 | 81.4 | 83.2 | 85.1 | 86.6 | 87.0 | 87.4 | 87.8 |
| NZ dollar | JPY per NZD | 82.7 | 77.9 | 73.2 | 73.8 | 81.3 | 72.8 | 72.3 | 73.0 | 73.6 | 73.9 | 74.2 | 74.6 | 74.9 |

F: Forecast by TD Economics, January 2017; Forecasts are end-of-period; Source: Federal Reserve, Bloomberg.

## GLOBAL STOCK MARKETS

| | Price Jan-25 | 30-Day % Chg. | YTD % Chg. | 52-Week High | 52-Week Low |
|---|---|---|---|---|---|
| S&P 500 | 2,298 | 1.5 | 11.6 | 2,298 | 1,829 |
| DAX | 11,806 | 3.1 | 20.4 | 11,806 | 8,753 |
| FTSE 100 | 7,164 | 1.4 | 9.1 | 7,338 | 5,537 |
| Nikkei | 19,058 | -1.9 | 9.2 | 19,594 | 14,952 |
| MSCI AC World Index* | 436 | 3.2 | 4.6 | 436 | 353 |

*Weighted equity index including both developing and emerging markets.
Source: Bloomberg

## COMMODITY PRICE OUTLOOK

| | Price | 52-Week | 52-Week | 2016 | | | | 2017 | | | | 2018 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Jan-25 | High | Low | Q1 | Q2 | Q3 | Q4 | Q1F | Q2F | Q3F | Q4F | Q1F | Q2F | Q3F | Q4F |
| Crude Oil (WTI, $US/bbl) | 52 | 54 | 26 | 33 | 45 | 45 | 50 | 52 | 52 | 55 | 55 | 56 | 56 | 57 | 57 |
| Natural Gas ($US/MMBtu) | 3.25 | 3.76 | 1.49 | 1.97 | 2.13 | 2.85 | 2.85 | 3.15 | 3.15 | 3.25 | 3.25 | 3.30 | 3.30 | 3.30 | 3.30 |
| Gold ($US/troy oz.) | 1201 | 1366 | 1115 | 1182 | 1259 | 1335 | 1240 | 1250 | 1250 | 1275 | 1280 | 1300 | 1300 | 1350 | 1350 |
| Silver (US$/troy oz.) | 17.0 | 20.6 | 14.2 | 14.9 | 16.8 | 19.6 | 17.4 | 17.3 | 17.8 | 18.3 | 18.8 | 19.0 | 19.0 | 19.5 | 19.5 |
| Copper (cents/lb) | 269 | 270 | 202 | 212 | 215 | 216 | 229 | 225 | 225 | 226 | 227 | 230 | 230 | 235 | 235 |
| Nickel (US$/lb) | 4.45 | 5.28 | 3.45 | 3.86 | 4.00 | 4.65 | 4.97 | 5.10 | 5.00 | 4.75 | 4.75 | 5.00 | 5.00 | 5.25 | 5.25 |
| Aluminum (Cents/lb) | 85 | 85 | 67 | 69 | 71 | 73 | 77 | 74 | 74 | 76 | 76 | 78 | 78 | 78 | 78 |
| Wheat ($US/bu) | 6.67 | 7.13 | 5.41 | 5.89 | 6.06 | 5.73 | 6.40 | 6.50 | 6.50 | 6.60 | 6.60 | 6.70 | 6.80 | 6.85 | 6.90 |

F: Forecast by TD Economics, January 2017; Forecasts are period averages; E: Estimate. Source: Bloomberg, USDA (Haver).

This report is provided by TD Economics. It is for informational and educational purposes only as of the date of writing, and may not be appropriate for other purposes. The views and opinions expressed may change at any time based on market or other conditions and may not come to pass. This material is not intended to be relied upon as investment advice or recommendations, does not constitute a solicitation to buy or sell securities and should not be considered specific legal, investment or tax advice. The report does not provide material information about the business and affairs of TD Bank Group and the members of TD Economics are not spokespersons for TD Bank Group with respect to its business and affairs. The information contained in this report has been drawn from sources believed to be reliable, but is not guaranteed to be accurate or complete. This report contains economic analysis and views, including about future economic and financial markets performance. These are based on certain assumptions and other factors, and are subject to inherent risks and uncertainties. The actual outcome may be materially different. The Toronto-Dominion Bank and its affiliates and related entities that comprise the TD Bank Group are not liable for any errors or omissions in the information, analysis or views contained in this report, or for any loss or damage suffered.