DOLLARS & SENSE
TD Economics

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ECONOMIC GROWTH IS STILL THE TRUMP CARD

Highlights

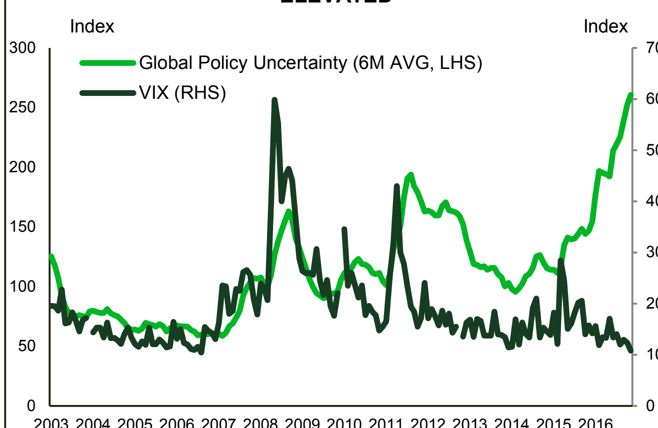
- We continue to live in a world of heightened political uncertainty, punctuated by media headlines on building White House tensions. When we look at the history of political uncertainty and its impact, the real worry for markets is whether it coincides with a downturn in economic fundamentals. Given the recent strength in global growth, economic fundamentals trump political risk.
- Likewise, the Federal Reserve would look past political clouds if there's no knock-on impacts to the real economy. U.S. growth is expected to bounce back above 3% in the second quarter, and financial conditions are actually easier today relative to when the Fed resumed its rate hike path back in late 2016. This allows the Fed to stay the course on raising rates, keeping a floor under the yield curve and potentially giving the greenback one last lift as we head into summer.

Last week was a reminder that you don't have to go to Disney World to ride a rollercoaster. Risk-off sentiment came quickly into the market due to evolving events with President Trump and the FBI probe on Russia. Although investors recovered their poise in subsequent days, the experience offers a snap-shot of what to expect should events unfold to undermine confidence in the government's ability to implement their "pro-growth" strategy. A distracted Congress or an inability to push forward on reforms that typically require leadership from the President will likely put this market into reverse very fast. This is the main hurdle we foresee as a possible risk that could cause the Fed's rate hike cycle to pause, because all other signals remain in place for an economy to push through the political noise.

The historical impact of politics

Over the last year, measures of political uncertainty have risen with a broad up-rise in populist movements that have succeeded in leaving a mark on the UK referendum and the U.S. election, while also creating angst around the outcomes of other European elections (Chart 1). A shake-up to the status quo typically breeds opacity on what the future holds, causing a reassessment of valuations and a potential sell-off in risk assets. However, this did not happen, bringing into question the predictive power of policy uncertainty. Our internal research has shown that for political uncertainty to matter, it must coincide with a change in the economic environment. That is, political uncertainty on its own doesn't matter. As in any dynamic system, if political

CHART 1: GLOBAL POLICY UNCERTAINTY STILL ELEVATED



Source: WSJ, PolicyUncertainty.com

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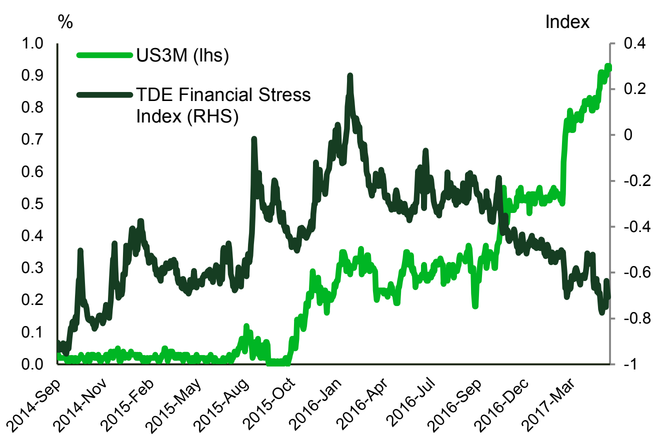
turmoil doesn't induce real change in economic behavior, markets need not react.

Even when we look at the history of impeachment of American Presidents, a market impact is not obvious relative to economic events that were simultaneously, and independently, unfolding. Equity volatility was present during both the Nixon and Clinton impeachment time frame. But, the causality of the volatility is hard to unpack from a U.S. economy that was already in recession during the height of the Watergate scandal. In Clinton's case, equity markets did sell off strongly, but this correction was muddied by market angst related to the Russian debt default, LTCM, and remnants of the Asian financial crisis. Recent political hot potatoes within the current administration have left only a minor mark on financial markets, discernible through the lingering impact on lower government bond yields and a depreciating greenback. But, here too, the influence is likely more to do with the economic backdrop than the political one. Treasury yields are capturing muted inflation expectations corresponding with data developments. Meanwhile, the Federal Reserve has signaled a very cautious approach to stopping asset reinvestment, and has not yet convinced market participants to back off from their low expectations on the future path of the Fed funds rate. Economic conditions have been the anchor to bond yield movements long before political waters were stirred on Capitol Hill.

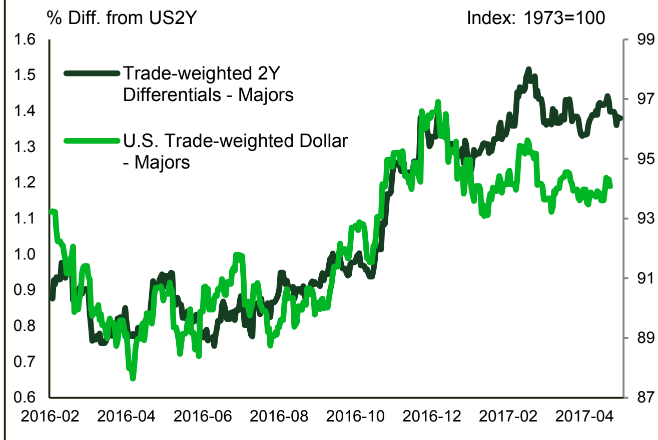
We use the TD Financial Stress Index (TD FSI) to gauge whether idiosyncratic events are turning into a significant market stress (Chart 2). In fact, the opposite is occurring. The index remains well below zero, meaning below-average stress exists in the system despite political flare-ups in recent weeks.

CHART 2: FINANCIAL CONDITIONS CONTINUE TO EASE AS THE FED HIKES



Source: FRB, TD Economics

CHART 3: U.S. DOLLAR PRICING IDIOSYNCRATIC RISK



Source: Bloomberg

Trump wanted a lower USD, and he's getting it

In spite of clear preferences from the U.S. administration for a lower greenback, political factors alone cannot take credit for the recent decline. First, the market is undertaking a rebalancing of foreign exchange portfolio positions from overbought levels on the U.S. dollar to a more neutral stance. This is in part occurring because growth convergence between major international economies and the U.S. has boosted confidence in these regions and their respective currencies. Further, calming political winds in the UK and Europe has caused a positive sentiment boost to the euro and pound. Both are trading at near 8-month highs. And, the currency adjustment hasn't been concentrated to just these crosses. The broad and major currency trade-weighted U.S. dollar indices have been declining since last December. This has been occurring even as interest rate differentials have remained elevated (Chart 3).

However, any significant further leg-down in the greenback will be hard to come by. Even with recent price action, the dollar should receive support from a Federal Reserve that will look past political noise that does not turn into a real economic impact. Their eyes will be firmly placed on economic fundamentals that continue to warrant further rate hikes, the next likely to be on June 14th. Our tracking for the second quarter is for a strong bounceback in real GDP to an annualized rate above 3%. Although consumer prices have teetered in recent months, leading indicators suggest a tailwind is building from accelerating intermediate producer prices, a weaker dollar and the ongoing push from wage growth holding within the 2-3% range. The Fed maintains more than sufficient justification to stay the course. With futures fully pricing in only one more hike in 2017 and another in 2018, markets may be underestimating the Fed once again. A re-pricing of the Fed, along with greater clarity on the normalization of the Fed's balance sheet in the coming months should cause an upward shift in the U.S. yield curve.

Where does the dollar go from here?

As we move through the year, our forecast is for the currencies of America's major trading partners to slowly chip away at their low valuations, but a floor is in place for the U.S. dollar to remain elevated to historical averages. Central bank policy rate differentials relative to the U.S. will stay stretched for the better part of the next two years. In other words, another major central bank is unlikely to follow the Federal Reserve's rate-hike lead until 2018, at the earliest. The consequence is that these currency crosses will keep trading below long-term equilibrium rates relative to the U.S. dollar for some time. Although some of the recent political risk in the U.S. is influencing this view by pulling forward the timing of this expected re-valuation, should risk recede, the greenback may have one last run left in it.

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INTEREST RATE & FOREIGN EXCHANGE RATE OUTLOOK

		Spot Rate	2016				2017				2018			
		May-26	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Interest Rates														
Fed Funds Target Rate		1.00	0.50	0.50	0.50	0.75	1.00	1.25	1.50	1.50	1.50	1.75	2.00	2.25
3-mth T-Bill Rate		0.91	0.21	0.26	0.29	0.51	0.76	1.15	1.40	1.40	1.40	1.65	1.90	2.15
2-yr Govt. Bond Yield		1.29	0.73	0.58	0.77	1.20	1.27	1.55	1.70	1.95	2.10	2.25	2.40	2.55
5-yr Govt. Bond Yield		1.77	1.21	1.01	1.14	1.93	1.93	2.15	2.35	2.55	2.75	2.95	3.00	3.05
10-yr Govt. Bond Yield		2.23	1.78	1.49	1.60	2.45	2.40	2.40	2.60	2.80	3.00	3.20	3.25	3.30
30-yr Govt. Bond Yield		2.90	2.61	2.30	2.32	3.06	3.02	3.15	3.25	3.35	3.40	3.50	3.60	3.65
10-yr-2-yr Govt Spread		0.94	1.05	0.91	0.83	1.25	1.13	0.85	0.90	0.85	0.90	0.95	0.85	0.75
Exchange rate to U.S. dollar														
Chinese Yuan	CNY per USD	6.86	6.45	6.65	6.67	6.94	6.88	7.04	7.12	7.18	7.20	7.22	7.10	7.00
Japanese yen	JPY per USD	111	112	103	101	117	111	112	112	110	110	108	105	105
Euro	USD per EUR	1.12	1.14	1.10	1.12	1.06	1.07	1.10	1.11	1.12	1.14	1.16	1.18	1.20
U.K. pound	USD per GBP	1.28	1.44	1.32	1.30	1.23	1.25	1.26	1.28	1.29	1.30	1.33	1.36	1.38
Swiss franc	CHF per USD	0.97	0.96	0.98	0.97	1.02	1.00	0.97	0.99	0.99	0.97	0.95	0.96	0.96
Canadian dollar	CAD per USD	1.35	1.30	1.30	1.31	1.34	1.33	1.34	1.32	1.31	1.31	1.30	1.30	1.29
Australian dollar	USD per AUD	0.75	0.77	0.74	0.77	0.72	0.76	0.72	0.73	0.74	0.75	0.75	0.75	0.75
NZ dollar	USD per NZD	0.71	0.69	0.71	0.73	0.70	0.70	0.64	0.64	0.64	0.64	0.64	0.64	0.64
Exchange rate to Euro														
U.S. dollar	USD per EUR	1.12	1.14	1.10	1.12	1.06	1.07	1.10	1.11	1.12	1.14	1.16	1.18	1.20
Japanese yen	JPY per EUR	124	128	113	114	123	119	123	124	123	125	125	124	126
U.K. pound	GBP per EUR	0.87	0.79	0.83	0.86	0.86	0.85	0.87	0.87	0.87	0.88	0.87	0.87	0.87
Swiss franc	CHF per EUR	1.09	1.09	1.08	1.09	1.07	1.07	1.07	1.10	1.11	1.11	1.10	1.13	1.15
Canadian dollar	CAD per EUR	1.50	1.48	1.44	1.47	1.42	1.43	1.47	1.47	1.47	1.49	1.51	1.53	1.55
Australian dollar	AUD per EUR	1.50	1.48	1.48	1.47	1.46	1.40	1.53	1.52	1.51	1.52	1.55	1.57	1.60
NZ dollar	NZD per EUR	1.58	1.65	1.55	1.54	1.52	1.53	1.72	1.73	1.75	1.78	1.81	1.84	1.88
Exchange rate to Japanese yen														
U.S. dollar	JPY per USD	111	112	103	101	117	111	112	112	110	110	108	105	105
Euro	JPY per EUR	124	128	113	114	123	119	123	124	123	125	125	124	126
U.K. pound	JPY per GBP	142	162	136	132	144	140	141	143	142	143	144	143	145
Swiss franc	JPY per CHF	114.1	117.3	105.0	104.4	114.9	111.4	115.5	113.1	111.1	113.4	113.7	109.4	109.4
Canadian dollar	JPY per CAD	82.6	86.7	79.0	77.2	87.0	83.6	83.6	84.8	84.0	84.3	83.1	81.1	81.4
Australian dollar	JPY per AUD	82.8	86.3	76.4	77.6	84.4	85.1	80.6	81.8	81.4	82.5	81.0	78.8	78.8
NZ dollar	JPY per NZD	78.5	77.9	73.2	73.8	81.3	78.0	71.7	71.7	70.4	70.4	69.1	67.2	67.2

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

GLOBAL STOCK MARKETS

	Price May-26	30-Day % Chg.	YTD % Chg.	52-Week High	52-Week Low
S&P 500	2,415	1.1	17.3	2,415	2,001
DAX	12,577	0.9	28.3	12,807	9,269
FTSE 100	7,548	3.7	15.0	7,548	5,924
Nikkei	19,687	3.2	12.8	19,962	14,952
MSCI AC World Index*	465	1.9	11.4	465	380

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

COMMODITY PRICE OUTLOOK															
	Price	52-Week	52-Week	2016				2017				2018			
	May-26	High	Low	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Crude Oil (WTI, $US/bbl)	49	54	40	33	45	45	49	52	52	55	55	56	56	57	57
Natural Gas ($US/MMBtu)	3.06	3.76	1.77	1.97	2.13	2.85	3.02	2.99	3.10	3.15	3.20	3.25	3.25	3.30	3.30
Gold ($US/troy oz.)	1266	1366	1128	1182	1259	1335	1216	1218	1260	1275	1275	1300	1300	1325	1325
Silver (US$/troy oz.)	17.3	20.6	15.7	14.9	16.8	19.6	17.1	17.5	17.3	17.8	17.8	18.5	18.5	19.3	19.3
Copper (cents/lb)	259	277	204	212	215	216	240	264	256	257	256	260	260	265	265
Nickel (US$/lb)	4.10	5.28	3.82	3.86	4.00	4.65	4.90	4.66	4.24	4.50	4.75	5.00	5.00	5.25	5.25
Aluminum (Cents/lb)	89	89	70	69	71	73	78	84	87	84	84	86	86	84	84
Wheat ($US/bu)	6.29	7.13	5.41	5.89	6.06	5.73	6.48	6.53	6.40	6.50	6.70	6.80	6.85	6.85	6.90

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

INTERNATIONAL INTEREST RATE OUTLOOK													
	Spot Rate	2016				2017				2018			
	May-26	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Germany													
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.25	-0.25
3-mth T-Bill Rate	-0.83	-0.59	-0.68	-0.80	-0.99	-0.85	-0.90	-0.80	-0.75	-0.75	-0.75	-0.60	-0.55
2-yr Govt. Bond Yield	-0.68	-0.52	-0.66	-0.68	-0.88	-0.67	-0.70	-0.55	-0.45	-0.40	-0.25	-0.05	0.10
5-yr Govt. Bond Yield	-0.39	-0.33	-0.57	-0.58	-0.54	-0.33	-0.35	-0.25	-0.15	-0.10	0.05	0.25	0.40
10-yr Govt. Bond Yield	0.33	0.15	-0.13	-0.12	0.20	0.36	0.55	0.85	1.00	1.30	1.55	1.70	1.75
30-yr Govt. Bond Yield	1.16	0.84	0.83	0.78	0.94	1.11	1.45	1.60	1.80	1.85	2.05	2.15	2.20
10-yr-2-yr Govt Spread	1.01	0.67	0.53	0.56	1.08	1.03	1.25	1.40	1.45	1.70	1.80	1.75	1.65
United Kingdom													
Bank Rate	0.25	0.50	0.50	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-mth T-Bill Rate	0.32	0.51	0.46	0.32	0.32	0.17	0.25	0.25	0.25	0.25	0.25	0.25	0.25
2-yr Govt. Bond Yield	0.09	0.44	0.10	0.10	0.05	0.10	0.20	0.35	0.40	0.45	0.50	0.65	0.70
5-yr Govt. Bond Yield	0.47	0.84	0.35	0.22	0.47	0.52	0.75	0.80	0.85	0.90	1.00	1.05	1.15
10-yr Govt. Bond Yield	1.02	1.42	0.87	0.75	1.45	1.10	1.35	1.50	1.55	1.75	1.90	2.00	2.00
30-yr Govt. Bond Yield	1.65	2.29	1.70	1.49	1.87	1.73	1.95	2.10	2.15	2.35	2.45	2.50	2.55
10-yr-2-yr Govt Spread	0.93	0.98	0.77	0.64	1.40	1.00	1.15	1.15	1.15	1.30	1.40	1.35	1.30

F: Forecasts by TD Bank Group, May 2017; Forecasts are end-of-period; Source: Bloomberg.