



January 26, 2017

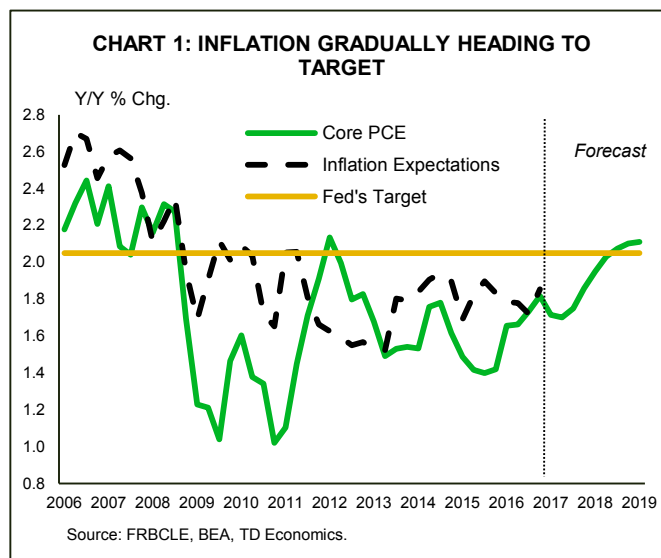
## DON'T STOP BELIEVING!

### 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.
- This path bodes well for the Bank of Canada. Inflation dynamics have disappointed of late, but steady growth should allow the Bank to keep policy rates steady.

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.

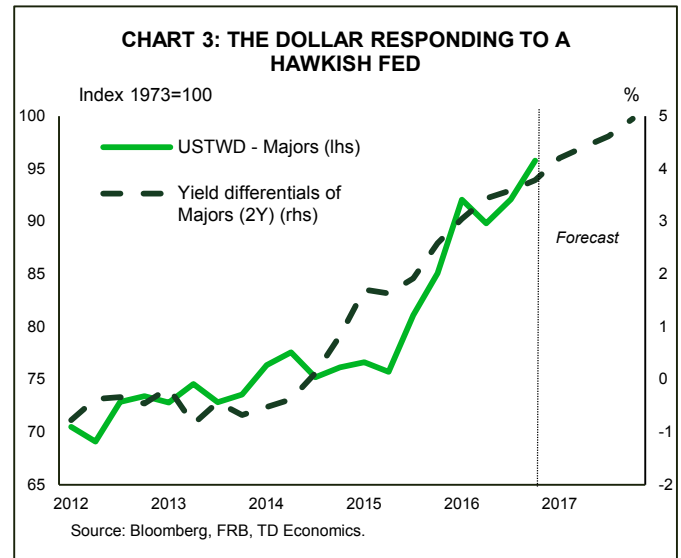


Even the areas of the economy that have been pulling down the average growth rate are garnering market excitement. Business investment, which has declined at a rate not seen outside of recession, is poised to rebound. The Dodge Index that tracks construction and investment projects picked up in the fourth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

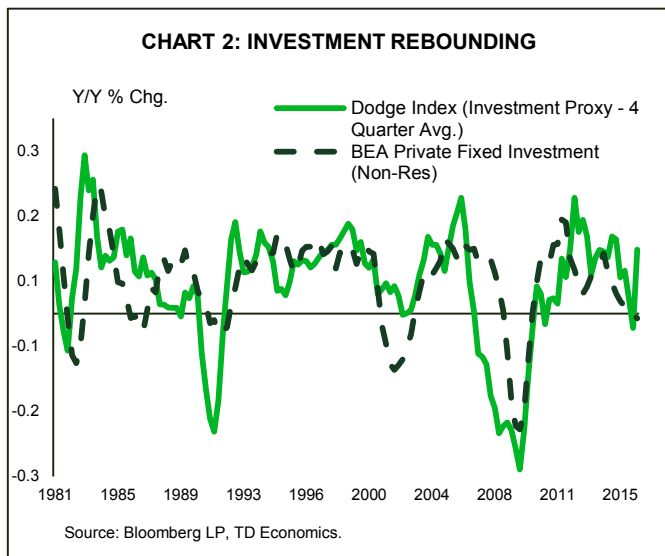
Awaiting the details of policy proposals have left most firmly positioned on the edge of their seats. Government spending can have long-lasting benefits to society when done right. It also has the ability to stunt growth, stoke high inflation, and burden future generations if done poorly. The uncertainty 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.

The expected path for the Fed bodes well for the Bank of Canada. Over the last few months, measures of core inflation in Canada have been steadily declining. This reflects a Canadian economy that is slowly attempting to find its footing as it moves out of its commodity complex to a service oriented nation. The level of economic and employment slack in the economy has caused the Bank of Canada to note that an interest rate cut remains part of their

dialogue. Our view is that the benefits of such an action and likelihood are low at this time. This is especially true with the Federal Reserve raising rates, which causes increased spread differentials between the U.S. and Canada. Higher policy rates in the U.S. will put pressure on the Canadian dollar, which should benefit domestic competitiveness and support inflation temporarily. That said, there is a very real threat of adverse U.S. policy action by way of renegotiation of [NAFTA](#). A trade shock would reduce long-term potential growth for Canada, result in a cut by the Bank of Canada, and cause significant depreciation of the Canadian dollar. Ideally, cooler heads will prevail and the Canadian economy will keep chugging along. In the absence of a trade shock, the economy has sufficient momentum to allow the Bank of Canada to remain on hold and keep Canadian dollar in its mid-70 cent range.

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## INTEREST RATE OUTLOOK

	Spot Rate	2016				2017				2018			
	Jan-25	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
<b>CANADA</b>													
Overnight Target Rate	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.50
3-mth T-Bill Rate	0.46	0.45	0.48	0.53	0.46	0.50	0.50	0.50	0.50	0.50	0.50	0.50	0.60
2-yr Govt. Bond Yield	0.82	0.54	0.52	0.52	0.74	0.65	0.70	0.75	0.80	0.85	0.95	1.00	1.10
5-yr Govt. Bond Yield	1.18	0.68	0.57	0.62	1.11	1.15	1.20	1.25	1.35	1.50	1.75	1.80	1.90
10-yr Govt. Bond Yield	1.83	1.23	1.06	1.00	1.72	1.75	1.80	1.85	1.95	2.05	2.25	2.35	2.45
30-yr Govt. Bond Yield	2.46	2.00	1.72	1.66	2.31	2.40	2.45	2.50	2.60	2.70	2.90	3.00	3.10
10-yr-2-yr Govt Spread	1.01	0.69	0.54	0.48	0.98	1.10	1.10	1.10	1.15	1.20	1.30	1.35	1.35
<b>U.S.</b>													
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
<b>CANADA - U.S SPREADS</b>													
Can - U.S. T-Bill Spread	-0.03	0.24	0.22	0.24	-0.05	-0.15	-0.40	-0.40	-0.65	-0.65	-0.90	-0.90	-1.05
Can - U.S. 10-Year Bond Spread	-0.69	-0.55	-0.43	-0.60	-0.73	-0.75	-0.75	-0.80	-0.80	-0.80	-0.75	-0.75	-0.75

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

## 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
S&P/TSX Composite	15,644	2.1	6.9	15,644	12,087
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 developed and emerging markets  
Source: Bloomberg.

## COMMODITY PRICE OUTLOOK

	Price Jan-25	52-Week High	52-Week Low	2016				2017				2018			
				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).

FOREIGN EXCHANGE OUTLOOK														
Currency	Exchange rate	Spot Price Jan-25	2016				2017				2018			
			Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
<b>Exchange rate to U.S. dollar</b>														
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
<b>Exchange rate to Euro</b>														
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
<b>Exchange rate to Japanese yen</b>														
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
<b>Exchange rate to Canadian dollar</b>														
U.S. dollar	USD per CAD	0.77	0.77	0.77	0.76	0.75	0.74	0.74	0.75	0.75	0.75	0.76	0.76	0.77
Japanese yen	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
Euro	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
U.K. pound	CAD per GBP	1.65	1.87	1.72	1.71	1.66	1.65	1.65	1.66	1.73	1.77	1.78	1.78	1.78
Swiss franc	CHF per CAD	0.76	0.74	0.75	0.74	0.76	0.75	0.75	0.75	0.75	0.75	0.76	0.76	0.77
Australian dollar	AUD per CAD	1.01	1.00	1.03	0.99	1.03	1.03	1.03	1.02	1.01	1.00	1.01	1.02	1.02
NZ dollar	NZD per CAD	1.05	1.11	1.08	1.05	1.07	1.14	1.16	1.17	1.17	1.18	1.18	1.19	1.20

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