ECONOMIC FORECAST UPDATE

TD Economics

January 26, 2015

CANADIAN OUTLOOK UPDATE:
ECONOMIC FORECAST REVISED DOWN ON LOWER OIL PRICES

- Since the release of our December 2014 Quarterly Economic Forecast (QEF), oil prices have continued to slide. With global supply outstripping demand by a wide margin, TD Economics anticipates a low profile for oil prices over the forecast horizon. As a consequence, we have trimmed our outlook for real GDP growth for 2015 to 2.0%, down from 2.3% in our latest forecast in December (Chart 1). For 2016, we expect real GDP to increase by 2.2%.
- Lower oil prices will take a bite out of both output and incomes. While consumers will get some relief at the pumps, this benefit is more than offset by lower corporate profits and weaker income growth. Lower corporate profits will likely lead to a contraction in business investment and weaker employment growth relative to our December forecast. However, the story will play out very differently in various regions of the country, with oil-producing provinces bearing the brunt of the downward revisions (see the Provincial Economic Update).

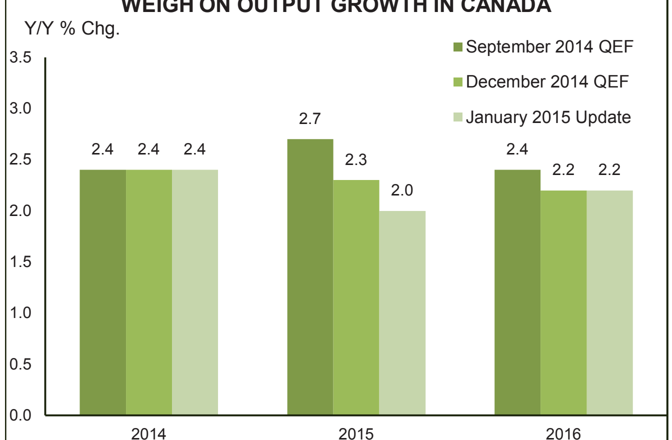
Oil prices plumb new depths

- Oil prices continue to search for a bottom. Since its June 2014 peak of nearly US$110 per barrel, the price of a barrel of West Texas Intermediate (WTI) has fallen to about US$47 in mid-January. As a result, our revised oil price forecast is much lower than it was in December. The per barrel price of WTI is now expected to average US$47 in 2015 and US$65 in 2016, down from our December projection of US$68 in 2015 and US$80 in 2016 (see our report Crude Oil Prices: Lower for Longer).

Lower oil prices dictate the drivers of growth

- While our expectation for annual growth has been revised down, the narrative is broadly similar to that presented in December. Indeed, the trends projected in our last forecast have become magnified. We continue to expect that business investment will be the weak spot in the outlook, led by a sharp contraction in the construction of non-residential structures due to reduced activity in the oil sector. The housing market is also projected to be a drag on growth, with changes in existing home sales and prices, as well as housing starts, forecast to tilt into negative territory.
- In contrast, household consumption growth should remain steady going forward, as weakness in some parts of the country is offset by strength in others. Falling gasoline prices should also help support consumption. Based on our revised oil price forecast, we project that the average Canadian household will

CHART 1: WEAKER OIL PRICE OUTLOOK TO WEIGH ON OUTPUT GROWTH IN CANADA



Sources: Statistics Canada, TD Economics.

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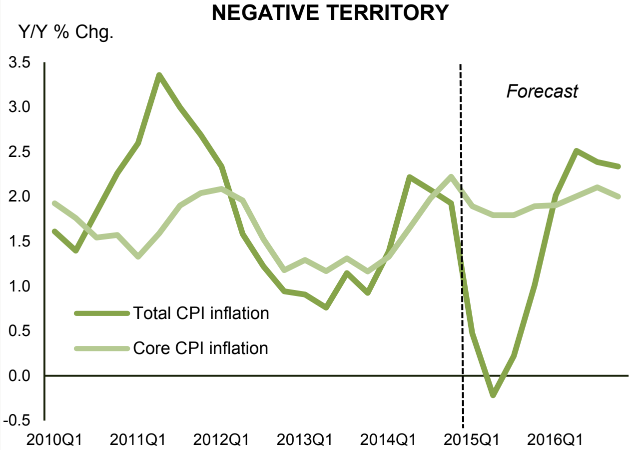
save around $875 at the pumps in 2015 – equivalent to total savings of roughly $12.3 billion.

- Further, we anticipate that exports will keep the Canadian economy buoyant over the next couple of years. Supported by a weak Loonie, solid demand south of the border, and lower prices at the pumps, we foresee that the non-energy export sector will have a competitive edge. However, limited spare capacity in the manufacturing sector will act as a moderate headwind to production over the forecast period, although this bodes well for prospective investment spending on machinery and equipment.
- The more modest economic forecast has led us to scale back our outlook for employment growth. As such, the unemployment rate can be expected tick up a couple of percentage points, reaching 6.9% at the end of 2015, before gradually drifting back down to close out 2016 at around 6.7%.

Incomes to be particularly hard hit

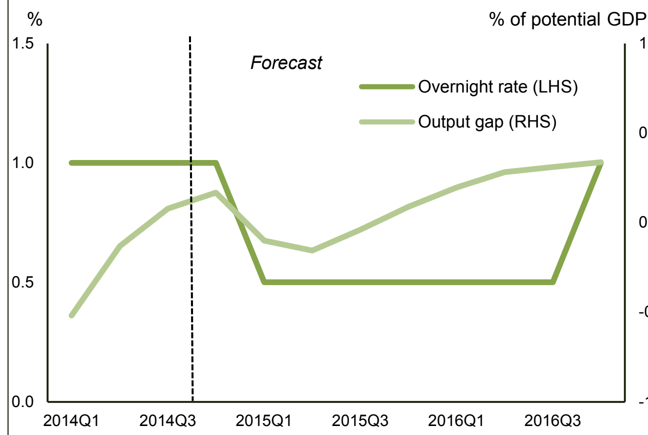
- The decline in oil prices will weigh particularly heavily on Canadian incomes in the near term. Underlying this weakness is an anticipated sharp decline in corporate profits and subdued household income growth in the near term. Growth in personal disposable income will also slow while the savings rate can be assumed to migrate lower. Lower incomes mean the federal government and provincial governments in oil-producing provinces can plan to see their revenues come in below the most recently published projections. Consequently, governments are expected to look for new ways of raising revenue or cutting expenses.

CHART 2: TOTAL INFLATION TO DIP INTO NEGATIVE TERRITORY



Sources: Statistics Canada, TD Economics.

CHART 3: ANOTHER RATE CUT EXPECTED DUE TO LOWER OIL PRICES



Sources: Bank of Canada, Statistics Canada, TD Economics.

Consumers to get some price relief

- While lower oil prices will have a negative impact on the Canadian economy, there is a silver lining. In addition to the savings Canadians can expect in 2015 from lower gasoline prices, the cost of natural gas and other home heating fuels have also come down. As a result, total Consumer Price Index (CPI) inflation is likely to plunge into negative territory in mid-2015, before heading north when oil prices start to recover (Chart 2). This comes at a time when core CPI inflation is forecast to remain close to the Bank's 2% target, as a weaker Loonie keeps import prices elevated.

Bank of Canada to cut one more time and then remain on hold until H2 2016

- The Bank of Canada unexpectedly cut the overnight rate by 25 basis points in mid-January, on the negative impact of lower oil prices on inflation and the real economy. At that time, it also signaled that it saw most of the risks to inflation to be tilted to the downside. Given our weaker oil price, inflation, and output forecast relative to the Bank, it therefore holds that we expect some of those downside risks to be realized. As such, we forecast that the Bank of Canada will cut the overnight rate by an additional 25 basis points at its next fixed announcement date in March (Chart 3). The Bank of Canada is subsequently assumed to remain on hold until the second half of 2016.
- The drop in oil and the cut in Canadian interest rates have weakened the Canadian dollar considerably. After cresting at around 94 US cents in early July, the Loonie

has since slid to only slightly above 80 US cents in late January. Looking ahead, we believe the Canadian dollar still has some ground to lose. The Bank of Canada is expected to cut one more time and then remain on hold, while the Federal Reserve is likely to raise rates in late 2015. This will shift interest rate spreads to the detriment of the Canadian dollar. Oil prices are also expected to head lower in the near term, perhaps dropping temporarily below US$40 and then will be slow to recover. This could push the Canadian dollar down towards 75 US cents in early 2016. Then, the currency should gradually recover, reflecting the anticipated rise in crude oil prices and a reversal of the Bank of Canada cuts in the second half of next year.

Bottom line

- In an oil-exporting economy such as Canada, the economic landscape changes dramatically when oil prices take a nose dive. While there are some positive offsets such as relief at the pumps, on balance the economic impact is negative. Provinces most dependent on oil revenues are expected to feel the lion's share of the pain. But, with oil prices expected to advance gradually from their current trough, there is some light at the end of tunnel, as far off as it may seem right now.

CANADIAN ECONOMIC OUTLOOK

Period-Over-Period Annualized Per Cent Change Unless Otherwise Indicated

	2014				2015				2016				Annual Average			4th Qtr/4th Qtr		
	Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	14F	15F	16F	14F	15F	16F
Real GDP	1.0	3.6	2.8	2.3	1.0	1.7	2.4	2.2	2.4	2.3	2.1	1.9	2.4	2.0	2.2	2.5	1.8	2.2
Consumer Expenditure	1.5	4.4	2.8	2.4	1.8	1.8	2.1	2.0	1.8	1.9	2.0	1.9	2.8	2.3	1.9	2.8	1.9	1.9
Durable Goods	1.6	14.9	12.6	3.6	2.2	1.9	1.8	2.1	1.9	2.0	1.9	2.0	5.8	4.3	2.0	8.0	2.0	1.9
Business Investment	-1.9	0.8	0.5	0.8	-4.5	-2.3	-0.6	2.0	3.4	4.1	3.8	3.5	-0.5	-1.3	2.4	0.0	-1.4	3.7
Non-Res. Structures	-0.3	0.5	-1.9	1.9	-8.5	-5.1	-2.4	1.7	3.9	4.9	4.6	4.1	0.0	-3.2	2.4	0.0	-3.7	4.3
Machinery & Equipment	-5.0	1.4	5.2	-0.8	1.8	2.0	2.2	2.5	2.7	2.9	2.7	2.6	-1.3	1.8	2.6	0.1	2.1	2.7
Residential Investment	-4.2	11.4	12.5	0.2	-4.7	0.4	0.5	-3.8	-0.6	1.0	-1.1	-0.3	2.5	0.9	-0.7	4.7	-1.9	-0.2
Government Expenditures	-0.7	1.4	0.3	-0.4	-0.2	0.0	0.2	0.5	1.2	1.2	1.4	1.5	-0.2	0.1	0.8	0.1	0.1	1.2
Final Domestic Demand	0.1	3.3	2.8	2.1	0.2	0.8	1.3	1.3	2.1	2.0	1.8	1.9	1.6	1.4	1.5	2.1	0.9	1.8
Exports	0.9	19.0	6.9	-3.6	6.5	7.0	7.9	7.5	6.7	5.0	4.0	3.4	5.1	5.6	6.1	5.5	7.2	4.8
Imports	-4.8	9.8	4.0	-1.2	4.2	4.5	4.4	4.4	4.3	3.9	3.4	3.2	1.4	3.6	4.1	1.8	4.4	3.7
Change in Non-Farm Inventories ($2007 Bn)	14.6	7.6	4.5	9.4	9.5	9.6	9.6	9.7	9.8	9.9	10.0	10.2	6.7	9.6	10.0	---	---	---
Final Sales	2.0	6.2	3.9	0.6	0.8	1.6	2.3	2.2	2.4	2.3	2.1	1.9	2.8	1.9	2.2	3.1	1.7	2.1
International Current Account Balance ($Bn)	-45.0	-39.6	-31.1	-48.9	-59.6	-65.6	-65.1	-60.9	-59.6	-54.2	-48.6	-39.7	-41.2	-62.8	-50.6	---	---	---
% of GDP	-2.3	-2.0	-1.6	-2.5	-3.0	-3.3	-3.3	-3.0	-2.9	-2.6	-2.3	-1.9	-2.1	-3.1	-2.4	---	---	---
Pre-tax Corp. Profits	22.9	7.7	11.6	-16.2	-26.6	-1.7	9.4	12.1	8.8	6.3	5.9	5.6	8.9	-7.4	7.7	5.5	-3.0	6.7
% of GDP	14.0	14.1	14.4	13.8	12.8	12.7	12.9	13.1	13.2	13.3	13.3	13.3	14.1	12.9	13.3	---	---	---
GDP Deflator (Y/Y)	1.9	2.2	2.0	1.2	-0.7	-1.2	-1.5	-0.3	1.0	2.2	3.0	3.2	1.8	-0.9	2.4	1.2	-0.3	3.2
Nominal GDP	6.7	3.9	4.7	-0.3	-1.5	0.2	2.9	4.4	5.4	5.8	5.6	5.2	4.3	1.1	4.7	3.7	1.5	5.5
Labour Force	0.1	0.5	0.9	0.8	1.1	1.0	1.0	0.9	0.8	0.9	0.8	0.7	0.6	1.0	0.9	0.6	1.0	0.7
Employment	0.4	0.3	1.4	2.0	1.0	0.8	0.6	0.7	0.9	1.0	0.9	0.8	0.8	1.1	0.9	1.0	0.7	0.9
Employment ('000s)	18.1	11.4	61.4	90.5	42.5	33.7	24.8	33.3	42.4	47.0	42.6	38.2	139	190	154	181	134	170
Unemployment Rate (%)	7.0	7.0	6.9	6.6	6.7	6.8	6.9	6.9	6.9	6.8	6.8	6.7	6.9	6.8	6.8	---	---	---
Personal Disp. Income	5.1	0.9	5.2	2.2	1.9	3.4	4.2	4.2	4.3	4.5	4.6	4.7	3.6	3.0	4.3	3.4	3.4	4.5
Pers. Savings Rate (%)	2.5	-2.0	2.6	3.8	3.9	4.4	4.6	4.5	4.5	4.5	4.5	4.7	4.2	4.4	4.5	---	---	---
Cons. Price Index (Y/Y)	1.4	2.2	2.1	1.9	0.5	-0.2	0.2	1.0	2.0	2.5	2.4	2.3	1.9	0.4	2.3	1.9	1.0	2.3
Core CPI (Y/Y)	1.3	1.7	2.0	2.2	1.9	1.8	1.8	1.9	1.9	2.0	2.1	2.0	1.8	1.8	2.0	2.2	1.9	2.0
Housing Starts ('000s)	175	197	195	189	184	182	174	169	174	178	178	176	189	177	177	---	---	---
Productivity: Real GDP / worker (Y/Y)	1.3	2.0	1.7	1.5	1.3	0.6	0.5	0.7	1.1	1.3	1.2	1.2	1.7	0.8	1.2	1.5	0.7	1.2

F: Forecast by TD Economics as at January 2015.

Sources: Statistics Canada, Bank of Canada, Canada Mortgage and Housing Corporation, Haver Analytics.

INTEREST RATE OUTLOOK

	2014				2015				2016			
	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
CANADA												
Overnight Target Rate	1.00	1.00	1.00	1.00	0.50	0.50	0.50	0.50	0.50	0.50	0.50	1.00
3-mth T-Bill Rate	0.90	0.94	0.92	0.91	0.45	0.45	0.45	0.45	0.45	0.45	0.75	0.95
2-yr Govt. Bond Yield	1.07	1.10	1.13	1.01	0.50	0.55	0.60	0.85	1.05	1.20	1.35	1.65
5-yr Govt. Bond Yield	1.71	1.53	1.63	1.34	0.80	0.95	1.10	1.35	1.55	1.75	1.90	2.10
10-yr Govt. Bond Yield	2.46	2.24	2.15	1.79	1.35	1.65	1.70	1.90	2.05	2.20	2.30	2.40
30-yr Govt. Bond Yield	2.96	2.78	2.67	2.33	2.00	2.25	2.30	2.45	2.55	2.65	2.70	2.80
10-yr-2-yr Govt Spread	1.39	1.14	1.02	0.78	0.85	1.10	1.10	1.05	1.00	1.00	0.95	0.75
U.S.												
Fed Funds Target Rate	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.75	1.00	1.00	1.00	1.25
3-mth T-Bill Rate	0.05	0.04	0.02	0.04	0.10	0.20	0.40	0.65	0.70	0.85	0.95	1.15
2-yr Govt. Bond Yield	0.44	0.47	0.58	0.67	0.50	0.80	1.00	1.25	1.40	1.65	1.90	2.00
5-yr Govt. Bond Yield	1.73	1.62	1.78	1.65	1.30	1.65	1.80	2.05	2.10	2.20	2.45	2.50
10-yr Govt. Bond Yield	2.73	2.53	2.52	2.17	1.80	2.10	2.10	2.30	2.40	2.50	2.70	2.75
30-yr Govt. Bond Yield	3.56	3.34	3.21	2.75	2.35	2.50	2.50	2.60	2.70	2.75	2.80	2.85
10-yr-2-yr Govt Spread	2.29	2.06	1.94	1.50	1.30	1.30	1.10	1.05	1.00	0.85	0.80	0.75
CANADA - U.S SPREADS												
Can - U.S. T-Bill Spread	0.85	0.90	0.90	0.87	0.35	0.25	0.05	-0.20	-0.25	-0.40	-0.20	-0.20
Can - U.S. 10-Year Bond Spread	-0.27	-0.29	-0.37	-0.38	-0.45	-0.45	-0.40	-0.40	-0.35	-0.30	-0.40	-0.35

E | F: Estimate | Forecast by TD Bank Group as at January 2015. All forecasts are end-of-period. Source: Bloomberg, Bank of Canada, Federal Reserve.

FOREIGN EXCHANGE OUTLOOK

Currency	Exchange rate	2014				2015				2016			
		Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Exchange rate to U.S. dollar													
Japanese yen	JPY per USD	103	101	110	120	120	121	123	125	125	125	127	127
Euro	USD per EUR	1.38	1.37	1.26	1.21	1.10	1.05	1.00	0.96	1.00	1.00	1.05	1.05
U.K. pound	USD per GBP	1.67	1.71	1.62	1.56	1.47	1.42	1.37	1.39	1.45	1.47	1.48	1.48
Exchange rate to Canadian dollar													
U.S. dollar	USD per CAD	0.91	0.94	0.89	0.86	0.81	0.80	0.79	0.77	0.75	0.79	0.82	0.85
Japanese yen	JPY per CAD	93.2	94.9	97.9	103.3	97.2	96.8	97.2	96.3	93.8	98.8	104.1	108.0
Euro	CAD per EUR	1.52	1.46	1.42	1.40	1.36	1.31	1.27	1.25	1.33	1.27	1.28	1.24
U.K. pound	CAD per GBP	0.54	0.55	0.55	0.55	0.55	0.56	0.58	0.55	0.52	0.54	0.55	0.58

E | F: Estimate | Forecast by TD Bank Group as at January 2015. All forecasts are end-of-period. Source: Federal Reserve, Bloomberg, TDBG.

COMMODITY PRICE FORECASTS

	2014				2015				2016				Annual Average		
	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	2014	2015F	2016F
Crude Oil (WTI, $US/bbl)	99	103	98	73	40	42	50	55	60	65	65	70	93	47	65
Natural Gas ($US/MMBtu)	5.17	4.59	3.94	3.83	3.20	3.10	3.30	3.60	3.80	3.40	3.50	3.70	4.38	3.30	3.60
Gold ($US/troy oz.)	1294	1289	1282	1201	1250	1290	1290	1300	1300	1300	1325	1325	1266	1283	1313
Silver (US$/troy oz.)	20.5	19.7	19.7	16.5	17.5	17.8	18.8	19.5	19.5	19.5	19.8	19.8	19.1	18.4	19.6
Copper (cents/lb)	319	308	317	301	250	270	285	285	280	280	285	285	311	273	283
Nickel (US$/lb)	6.64	8.38	8.42	7.19	6.90	8.00	9.00	9.50	11.00	12.00	12.50	12.50	7.66	8.35	12.00
Aluminum (Cents/lb)	77	82	90	89	79	85	90	90	90	90	100	100	85	86	95
Wheat ($US/bu)	9.32	8.90	8.43	8.05	7.90	7.80	8.00	8.15	8.25	8.40	8.55	8.75	8.68	7.96	8.49

E | F: Estimate | Forecast by TD Bank Group as at January 2015. All forecasts are period averages. Source: Bloomberg, USDA (Haver).

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