TD Bank Financial Group

TD Economics

Special Report

December 21, 2006

THE 2006 FORECAST TRACK RECORD

As the year draws to a close, it is timely to review how our 2006 economic and financial forecasts fared. We don't have the data for the full year yet, but our tracking for the remainder of 2006 should provide a good estimate of the annual average for the major economic and financial variables. On balance, the economic and financial themes played out quite close to those identified in our December 2005 Quarterly Economic Forecast, though there were some particular hits and misses that can provide lessons for the future.

HIGHLIGHTS

- **Key economic themes unfolded as expected.**
- **U.S. housing-led slowdown dominated economic story in 2006, but we modestly underestimated inflation and were premature on the timing of central bank rate cuts.**
- **As expected, global economy proved robust, but data revisions revealed much more momentum than anticipated.**
- **Canadian economy dampened by U.S. slowdown as predicted, but domestic economy proved stronger-than-expected, partly due to Alberta boom.**

U.S. housing-led slowdown

In December 2005, our major forecast theme was that an inversion of the U.S. yield curve would precede a sharp decline in housing activity that, in turn, would lead to a U.S. economic slowdown beginning in the second half of 2006 and continuing into the first half of 2007. This unfolded largely as expected, albeit with the slowdown kicking in a quarter early.

The yield curve did enter into a period of sustained inversion in early 2006 and housing activity plunged in the second quarter and continued to decline for the rest of the year. The retrenchment in housing created a significant drag on the economy, both through direct and indirect effects. As a result, real GDP growth slowed in the second quarter of 2006 and decelerated throughout the remaining two quarters of the year. On an average annual basis, U.S. economic growth is on track for 3.3% in 2006, only a tad slower than the 3.5% we had forecast. The weak performance late in the year also virtually guarantees a further moderation in early 2007, which was suggested in the forecast.

Looking at the details, the sharp drop in housing activity came as a shock to markets, but it was not surprising given the high degree of speculation and leverage by buyers. Residential investment is on-track to drop on a fourth quarter-over-fourth quarter basis by close to 12.7% in 2006, moderately faster than our predicted decline of 8%. Housing starts are expected to have fallen to 1.81 million units, again slightly below our projection of 1.86 million. Declining demand and rising supply of unsold homes had the expected impact on prices, falling 3.5% year-over-year in October, which is close to the 5% decline we had anticipated by year-end.

One of the key themes in the 2006 forecast was that the resulting loss of housing wealth effects would dampen personal spending, particularly on big-ticket items. Consumption growth did slow, dropping from 3.9% in 2004 and 3.5% in 2005 to 3.1% this year. The result was within spitting distance of our 2.9% call for 2006. However, there was a surprise in the details. Due to a remarkably strong performance in Q1 and particular resilience in Q3, outlays on consumer durables are poised to rise 4.7% this year, compared to our prediction of 2.7%, but we remain committed to our view and expect more modest spending growth on durables in 2007.

Based on strong balance sheets, high corporate profits and intense global competition, we predicated that business investment would rise by a robust pace of 7.9%. With a gain of 7.7% in 2006, the forecast hit close to the mark. However, there was some differences in the details, as machinery and equipment investment was weaker and non-residential investment was stronger than forecast.

In response to an economic slowdown, businesses traditionally experience an increase in inventories. Our forecast was for an increase from $29.8 billion in 2005 to $34.3 billion in 2006. However, there were significant revisions to last year's data and the buildup this year was greater than we anticipated, so the actual increase was from $19.6 billion to $48.3 billion.

A weaker U.S. dollar and robust global demand was expected to be a boost to U.S. exports and this did come to pass. We had forecast export growth of 5.9%, but it came in even stronger at 8.6%. Import growth similarly surprised on the upside, defying our prediction of 3.2% to rise 6.0%. These results reflected stronger-than-anticipated world economic conditions (which will be discussed later). It may also reflect the impact of globalization that has tended to fuel greater cross-border shipments.

The 2006 forecast argued that while housing would cool, consumer spending would not collapse due to continued healthy labour market conditions. This assumption was proven correct. Employment growth is likely to come in only 1/10th of a percentage point higher than the forecast at 1.4%, while the national unemployment rate fell to an average of 4.6% -- a half of a percentage point below our call. Meanwhile, personal disposable income growth accelerated from 4.1% in 2005 to 5.5% in 2006, which a bit less than our 5.9% prediction, but was still well above the pace of inflation.

On the prices front, inflation came in a little hotter than anticipated and this had implications for the financial forecast. Headline CPI inflation is likely to average 3.2% vis-à-vis 2.8% in the outlook. More importantly, core CPI is expected to come in at 2.5%, which is well above our prediction of 1.9%. We tended to underestimate the gains in prices for services, particularly the imputed rent costs for homeowners and, to a lesser extent, medical services. Less slack in the economy, as reflected in the slightly lower-than-expected unemployment rate, and a greater than expected decline in the U.S. dollar that lifted import costs also played a role in putting upward pressure on prices. However, with economic growth dropping well below its potential pace of around 3.25%, the accumulating excess economic capacity should see inflation wane in the months ahead.

U.S. ECONOMIC INDICATORS
Annual per cent change unless otherwise indicated

	2005 Actual	2006 Fcst.*	2006 Est.^
Real GDP	3.2	3.5	3.3
Consumer Expenditure	3.5	2.9	3.1
Durable Goods	5.5	2.7	4.7
Business Investment	6.8	7.9	7.7
Non-Residential Structures	1.1	3.9	9.0
Machinery & Equipment	8.9	9.2	7.1
Residential Construction	8.6	-1.8	-4.2
Govt. Exp. on Goods & Svcs.	0.9	3.0	2.1
Final Domestic Demand	3.6	3.2	2.9
Exports	6.8	5.9	8.6
Imports	6.1	3.2	6.0
Change in Non-Farm Inventories ($96 Bn.)	19.6	34.3	48.3
Final Sales	3.5	3.4	3.0
Int'l Curr. Acct. Bal. ($Bn.)	-792	-824	-861
% of GDP	-6.4	-6.2	-6.5
Pre-tax Corporate Profits	12.5	12.8	21.0
GDP Chain-type Deflator	3.0	2.0	2.9
Employment	1.5	1.3	1.4
Unemployment Rate (%)	5.1	5.1	4.6
Productivity *	2.3	3.0	2.1
Real Pers. Disp. Inc. (PDI)**	1.2	3.9	2.7
Real PDI Per Person**	0.2	3.1	1.7
Consumer Price Index (CPI)	3.4	2.8	3.2
Housing Starts ('000 units)	2,073	1,857	1,813

Real GDP: Real gross domestic product; * Real private non-farm business output per hour;**After-tax income adjusted for inflation; *Fcst. as at Dec. 2005; ^Estimate as at Dec. 2006
Source: Bureau of Labor Statistics, Bureau of Economic Analysis, TD Economics

Fed slower to cut, Treasuries post greater volatility

On the financial front, the forecast called for the U.S. Federal Reserve to continue to raise rates early in the year, with the fed funds rate reaching a peak of 4.75% at the May 2006 FOMC meeting. Then, as evidence of the economic slowdown mounted, the Fed was expected to cut rates by 75 basis points by the end of the year, so that the

Fed funds rate would average 4.50%. In reality, the Fed hiked a half a percentage point more to 5.25%, with the last tightening coming in June. It then held the line of rates through the rest of the year, with the result that the overnight rate averaged close to 5%.

The tighter stance to monetary policy was a reflection of the Fed's concerns about the risks of an acceleration in inflation. Although inflation did not get out of hand and inflation expectations remained well anchored, core inflation as measured by both the core Consumer Price Index (CPI) and the core Personal Consumption Expenditure (PCE) deflator - the Fed's preferred measure - rose to slightly above the central bank's comfort level and delayed any policy response to the signs of slowing growth. The lesson here is that when the economy is operating at close to full capacity, the monetary authority will tend to hedge its bets to ensure that inflation remains under wraps. As a result, even as economic growth slows, any evidence of price pressures could forestall rate cuts, which is why the miss on the core inflation forecast played a key role in our mistimed easing in policy. Nevertheless, economic growth has been running at below potential for two quarters and it is likely to remain sub-par in the first half of 2007. In our opinion, this will eventually shift the Fed's perception of the inflation risks and lead to an easing in policy, with the result that the error in forecast is likely to prove to be a matter of timing.

With respect to U.S. bonds, we predicted that 10-year Treasuries would rise to a yield of 4.65% in the first half of the year and then would fall to 4.30% as the economy slowed, for an average of 4.50%. The profile proved correct, but the magnitude of the swings was greater and the average level was a touch higher. Yields rose to 5.15% and then fell to 4.44% by mid-December, for an average of 4.78%. This performance reflected the delay to the Fed rate cuts and greater market concerns about the risks of inflation. Similar to the Fed call, we believe that yields could dip modestly in the near-term, so the 4.30% may still be reached, but in early 2007 rather than in late 2006.

Global economy proves robust

Before turning to Canada, let's finish the track record on the international front. In December 2005, the main theme was that the global economy would largely shrug off the U.S. slowdown and continue to post strong economic growth of around 4.2%, which is well above its historical average. China and India were to remain at the top of the growth rankings. Japan's economic expansion was expected to slow towards a 2% pace, while economic growth in Europe was projected to accelerate towards 2%.

TD ECONOMIC 2006 FINANCIAL FORECASTS & ACTUALS

	Dec. 2005	2006 Forecast			Actual		
		Peak	Year-end	Average	Peak	Current	Average
Canada							
Overnight rate	3.25	4.00	3.50	3.75	4.25	4.25	4.02
2-year Bond	3.80	4.25	3.95	4.15	4.45	3.97	4.05
5-Year Bond	3.87	4.35	4.05	4.20	4.53	3.93	4.12
10-Year Bond	3.93	4.40	4.15	4.30	4.63	4.03	4.22
30-Year Bond	4.02	4.50	4.40	4.45	4.67	4.09	4.28
U.S.							
Fed funds rate	4.25	4.75	4.00	4.50	5.25	5.25	4.97
2-year Bond	4.41	4.75	4.20	4.50	5.16	4.72	4.80
5-Year Bond	4.35	4.70	4.25	4.50	5.10	4.56	4.73
10-Year Bond	4.39	4.65	4.30	4.50	5.15	4.59	4.78
30-year Bond	4.51	4.75	4.50	4.65	5.21	4.72	4.87
FX rates to U.S. dollar							
Canadian dollar	0.864	0.880	0.830	0.854	0.910	0.873	0.880
Japanese yen	116	120	113	116	120	118	116
Euro	1.2	1.22	1.22	1.21	1.33	1.32	1.25
U.K. pound	1.77	1.74	1.74	1.74	1.98	1.97	1.84

Peak and average derived from monthly averages, Current is as at Dec. 20. Forecast asat Dec. 2005

Source: Bank of Canada, U.S. Federal Reserve, Haver Analytics, TD Economics

The story came true, but the final numbers differed in a number of key ways. Our current tracking puts world real GDP on-track to rise 5.1% this year, 0.9 percentage points faster than predicted. While at face value this looks like a significant miss, a big part of the explanation arose from major revisions to the economic data. For example, world economic growth in 2005 was revised upwards to 4.8% from 4.3% and in 2004 to 5.4% from 5.0%, which is a cumulative 0.9 percentage points higher than at the time of the forecast.

China and India did take the lead two positions, but China looks to have grown 10.3% in 2006 compared to our forecast of 8.5%. This reflects an almost 1 percentage point upward revision to China's growth rate in 2005 and our erroneous belief that the Chinese authorities would successfully implement their stated intention to moderate the pace of expansion this year.

India also topped our expectation by more than a percentage point, which also appears to be due to a 1 percentage point revision to 2005 economic growth and to more momentum than anticipated in 2006, but the main story of the continuing Indian economic boom was on the money.

The Japanese economy has performed close to expectations, with real GDP poised to rise 2.0%. Interestingly, the Japanese economy was outperforming our forecast until the third quarter when data revisions wiped out the additional gains. Deflation has waned and domestic demand did firm as predicted in 2006, but the latter lost momentum late in the year.

We forecast that European economic growth would accelerate in 2006 and the gains would be broad based. This did occur and the widespread gains were better than anticipated. Instead of expanding by 1.9%, real GDP in Continental Europe came in at around 2.7%. The biggest surprise was in Germany, which posted growth of around 2.6%, compared to a forecast of 1.7%. It is likely that a large part of this outperformance came from additional purchases being made before the consumption tax hike at the start of 2007.

WORLD ECONOMIC OUTLOOK
Annual per cent change unless otherwise indicated

Real GDP	2005 actual	2006 Fcst.*	2006 Est.^
World	4.8	4.2	5.1
United States	3.2	3.5	3.3
Canada	2.9	3.0	2.7
Mexico	3.0	3.3	4.4
Euro-zone (EU-12)	1.3	1.9	2.7
Germany	1.1	1.7	2.6
France	1.2	2.0	2.0
Italy	0.1	1.3	1.8
United Kingdom	1.9	2.1	2.5
Asia	7.2	6.6	7.1
Japan	1.9	2.1	2.0
Asian NIC's	4.6	4.4	5.1
Hong Kong	7.3	5.0	6.4
Korea	4.0	4.7	4.9
Singapore	6.4	5.2	7.6
Taiwan	4.1	3.5	4.3
Developing Asia	9.0	6.9	8.9
ASEAN-4	5.2	5.0	4.9
China	10.2	8.5	10.3
India	8.5	7.0	8.1
Central/South America	4.6	3.4	4.5
Argentina	9.2	6.5	7.0
Brazil	2.3	3.2	3.0
Other Developing	5.8	5.6	5.7

*Regional wts. do not sum to 100% because some countries omitted
*Forecast as at Dec. 2005;^ Estimate as at Dec. 2006
Source: International Monetary Fund, national statistical agencies

Export-led Canadian slowdown

The major economic trends in Canada were largely as forecast. In December 2005, we suggested that the Canadian economy would face headwinds emanating from the U.S. slowdown. Exporters (particularly in the non-commodity manufacturing industries) would be hard-pressed to cope with weaker U.S. demand at the same time as adjusting to a strong currency. However, domestic demand would remain strong. Housing markets were expected to cool, but avoid the same degree of weakness Stateside, and consumers would keep their wallets open, albeit not as open as in 2005. Slowing economic growth would lead to an end of Bank of Canada rate hikes early in the year and set the stage for rate cuts. Canadian bonds would track their U.S. counterparts, with yields rising and then falling. The Canadian dollar was forecast to appreciate early in 2006 and then give up some of its gains.

In the actual event, Canadian economic growth did slow. Real GDP is likely to advance 2.7%, which is only a touch below the 3.0% we predicted. The profile was also in-line with the forecast, as growth decelerated as the year progressed.

The weakness was concentrated in exports that rose a mere 1% this year, below our forecast of 5.4%, and within the manufacturing sector, which experienced significant job losses (as suggested in the forecast). The challenging environment for manufacturers was expected to lead to additional inventory accumulation. This did occur, but at an even greater rate than expected, which is consistent with the weaker export performance.

As anticipated, the domestic side of the Canadian economy proved robust. Consumer spending is poised to rise 3.9% in 2006, above our 2.5% forecast, while residential construction did in fact cool, but it still rose 2.2% versus our expectation for a 0.3% decline. The economic climate was expected to be favourable to business investment, with support coming from strong profits, a high exchange rate and international competition. We predicted a vigorous gain of 7.1%, when business investment actually proved even stronger with an increase of 8.2%. Favourable fiscal balances for the federal and some provincial governments also helped fuel a 3.4% increase in government spending, which was a tad slower than our 4% prediction. Putting all of the pieces together, final domestic demand advanced 4.5% in 2006, which is an outstanding performance by any measure and more than a percentage point faster than our 3.3% call.

Just as in the U.S., a healthy labour market was forecast to prove robust and provide a key support to the economy. If anything, the Canadian labour market surprised a bit on the upside. Employment rose 1.9% versus our call for 1.5%, and the unemployment rate fell 0.3 percentage point lower than we forecast to 6.3%.

The story on the inflation front came in largely as anticipated. Headline inflation was marginally hotter at 2.0% vis-à-vis our call for 1.8%, but core inflation averaged 1.9%, which was right on the forecast. One key difference was that the forecast anticipated slowing core inflation over the course of the year, but in fact core inflation picked up to marginally above 2%. This may have had an influence on the conduct of monetary policy, which will be discussed in a moment.

The greater strength in the domestic economy, the labour market and the late-year rise in core inflation was largely a reflection of booming economic conditions in Alberta. In December 2005, we highlighted that there would be significant regional differences to the economic story. Alberta was expected to lead on the economic front by a wide margin and with the rest of the west experiencing above average growth. However, we did not fully appreciate just how dramatic the boom would be and how Alberta would shape the national economic statistics. Indeed, a drop in the Alberta unemployment rate towards 3% and +40% year-over-year home price gains in Calgary and Edmonton were not anticipated by any forecasters heading into this year.

CANADA'S ECONOMIC INDICATORS

Annual per cent change unless otherwise indicated

	2005 Actual	2006 Fcst.*	2006 Est.^
Real GDP	2.9	3.0	2.7
Consumer Expenditure	3.9	2.5	3.9
Durable Goods	5.8	1.3	5.9
Business Investment	9.4	7.1	8.2
Non-Residential Structures	7.9	5.3	7.5
Machinery & Equipment	10.5	8.0	8.8
Residential Construction	3.2	-0.3	2.2
Govt. Exp. on Goods & Svcs.	2.7	4.0	3.4
Final Domestic Demand	4.5	3.3	4.5
Exports	2.1	5.4	1.0
Imports	7.1	5.3	5.1
Change in Non-Farm Inventories ($97 Bn.)	12.4	6.2	13.8
Final Sales	2.5	3.3	2.8
Int'l Curr. Acct. Bal. ($Bn.)	31.8	29.6	24.6
% of GDP	2.3	2.1	1.7
Pre-tax Corporate Profits	10.6	6.5	5.3
GDP Chain-type Deflator	3.2	2.0	2.1
Employment (%)	1.4	1.5	1.9
Employment ('000)	220	245	308
Unemployment Rate (%)	6.8	6.6	6.3
Productivity*	2.0	1.4	0.8
Real Pers. Disp. Income (PDI)**	2.5	4.0	4.6
Real PDI Per Person**	1.5	3.2	3.6
Consumer Price Index	2.2	1.8	2.0
Core CPI	1.6	1.9	1.9
Housing Starts ('000 units)	224	195	230

Real GDP: Real gross domestic product; *Real GDP per employee
**After-tax income adjusted for inflation; *Fcst. by TD Economics as at Dec. 2005;^Fcst. by TD Economics as at Dec. 2006;
Source: Statistics Canada, Bank of Canada,
Canada Mortgage and Housing Corporation, Haver Analytics

Turning to the financial front, the December 2005 forecast had the Bank of Canada hiking rates to a peak of 4.00% in the second quarter of 2006. In the actual event, the rate tightening cycle included one final hike to 4.25%, but this is a narrow miss for the forecast when one considers that the Bank hiked a total of seven times compared to our expectation of six increases. However, we misjudged the timing of rate cuts. Just like in the U.S. forecast, we predicted that the Bank would ease policy before the end of the year, when in fact it held rates unchanged. This reflected the strength of the domestic Canadian economy that left the Bank concerned about the inflation risks even when economic growth slowed. The Bank also revised down its estimate of the potential pace of economic growth - a development that implied that as economic growth slowed less slack would accumulate. Nevertheless, we believe that the forecast error was one of timing and, as the inflation risks diminish, the Bank is expected to cut rates by 50 basis points in the spring of 2007.

In terms of bond yields, our prediction was for 10-year Government of Canada yields to rise to a peak of 4.40% in early 2006 and then drop to 4.15% by year end to average 4.30%. In actuality, they climbed to 4.63% and then fell to below 4% temporarily in December, averaging around 4.22% for the year. So, the forecast profile was right, but the volatility was more extreme and the average came in marginally below the forecast.

On the commodity front, the December forecast argued that a slowdown in the world's largest economy would lead to a commodity price correction. We had called for a substantial 14.7% decline in the TD Commodity Price Index. The actual drop was 22.9%, but the forecast error must be judged in the context of the extreme volatility of commodity prices. Nevertheless, some of the individual commodity prices proved extremely difficult to forecast accurately. Lumber prices were expected to be particularly hard hit by the U.S. housing-led slowdown. They were sideswiped, but prices fell harder than predicted. Crude oil prices followed the anticipated profile of rising early in the year and then falling, but the peak was higher than forecast and the subsequent retreat ended the year above our call of US$50. As a result, crude oil will average close to US$66 a barrel, $10 higher than projected. Base metals completely defied gravity and our predictions by surging higher in 2006, amid tight supply conditions and greater-than-anticipated global economic growth.

The Canadian dollar started 2006 at around 86 U.S. cents and we thought it would climb to 88 U.S. cents before falling to 83 U.S. cents by year-end. The reality was an increase to 91 U.S. cents before edging back to 87 U.S. cents. So, the profile was right and the 5 U.S. cent pullback came close to the mark, but from a higher starting point. Our assumption was that the currency would weaken in response to a pullback in commodity prices, but the decline would be limited by weakness in the U.S. dollar. These factors did indeed play their expected roles and strong merger and acquisition activity provided an added lift.

Conclusions and lessons

Overall, the major economic and financial themes for 2006 unfolded largely as anticipated. However, there were a few areas where the accuracy of the explicit forecast numbers fell short. In general, there were two key sources of the misses. First, in several cases we still believe that the outcomes will unfold, but the timing now looks more likely to be in early 2007. Second, there were a handful of surprises that impacted a wide range of indicators. The global economy had greater momentum than we were led to believe heading into 2006, so it is not surprising that oil and base metals were firmer than anticipated. Domestic Canadian economic conditions were slightly stronger than we predicted virtually across the board due to our underestimating the extent of the Alberta boom. And, by modestly underestimating the underlying price pressures in the U.S. and Canadian economies at a time that they were operating at close to full capacity, we jumped the gun in terms of when rate cuts would occur, which, in turn, impacted financial markets and economic activity through a large numbers of channels. As an aside, it was also driven home this year just how critical it is to accurately predict the output gap if one is to understand the future direction to monetary policy. This means that forecasters need to not only get the economic growth projection correct, but also must accurately predict productivity and the central bank's estimate of potential.

Craig Alexander, VP & Deputy Chief Economist
416-982-8064