THE WEEKLY BOTTOM LINE

TD Economics

HIGHLIGHTS OF THE WEEK

June 16, 2017

United States

- Markets were mixed on the week, seemingly undecided on how to score continued headlines from Washington, disappointing U.S. economic data, and the Fed's confident tone accompanying its rate hike.
- The Fed anticipates that the recent softness in inflation to prove temporary. Its outlook for future rate hikes remained unchanged. We expect the process of reducing its balance sheet will begin in the fall, with a modest pace of rate hikes continuing thereafter.
- Other economic data this week was a tad on the soft side. But our outlook for the U.S. economy to post solid growth of 2.2% this year, and 2.1% next year has not changed, as a fundamentally strong consumer and better global growth help support the U.S. economy.

Canada

- Despite falling oil prices and soft equity markets, the loonie saw robust gains this week as investors digested a marked change in tone from the Bank of Canada.
- Bank of Canada communications this week suggested that the era of emergency level interest rates may end earlier than expected. It now appears likely that the first policy interest rate increase in more than six years will take place in October.
- Robust growth in recent quarters and a constructive outlook suggest that inflation is at or near a bottom, justifying the removal of some monetary accommodation. Only a gradual pace of policy rate increases is expected thereafter, reflecting the challenges still facing the Canadian economy.

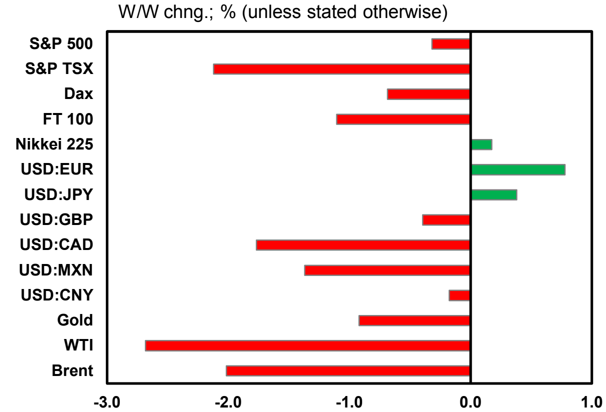
THIS WEEK IN THE MARKETS

	Current*	Week Ago	52-Week High	52-Week Low
Stock Market Indexes				
S&P 500	2,427	2,432	2,440	2,001
S&P/TSX Comp.	15,105	15,473	15,922	13,690
DAX	12,724	12,816	12,823	9,269
FTSE 100	7,453	7,527	7,548	5,950
Nikkei	19,943	20,013	20,177	14,952
Fixed Income Yields				
U.S. 10-yr Treasury	2.15	2.20	2.63	1.36
Canada 10-yr Bond	1.52	1.42	1.87	0.95
Germany 10-yr Bund	0.28	0.26	0.49	-0.19
UK 10-yr Gilt	1.01	1.01	1.52	0.52
Japan 10-yr Bond	0.06	0.06	0.12	-0.29
Foreign Exchange Cross Rates				
C$ (USD per CAD)	0.75	0.74	0.78	0.73
Euro (USD per EUR)	1.12	1.12	1.14	1.04
Pound (USD per GBP)	1.28	1.27	1.49	1.20
Yen (JPY per USD)	110.8	110.3	118.2	99.9
Commodity Spot Prices*				
Crude Oil ($US/bbl)	44.8	45.8	54.1	39.5
Natural Gas ($US/MMBtu)	2.92	2.98	3.76	2.03
Copper ($US/met. tonne)	5636.3	5779.5	6103.5	4528.5
Gold ($US/troy oz.)	1255.6	1266.6	1366.4	1128.4

*as of 10:15 am on Friday **Oil-WTI, Cushing, Nat. Gas-Henry Hub, LA (Thursday close price), Copper-LME Grade A, Gold-London Gold Bullion; Source: Bloomberg.

MARKETS WEAKEN DESPITE FOMC CONFIDENCE

W/W chng.; % (unless stated otherwise)



Note: Data as of June 9, 11:25 ET. Change from end of prior week.
Sources: Bloomberg, TD Economics

GLOBAL OFFICIAL POLICY RATE TARGETS

	Current Target
Federal Reserve (Fed Funds Rate)	1.00 - 1.25%
Bank of Canada (Overnight Rate)	0.50%
European Central Bank (Refi Rate)	0.00%
Bank of England (Repo Rate)	0.25%
Bank of Japan (Overnight Rate)	-0.10%

Source: Central Banks.

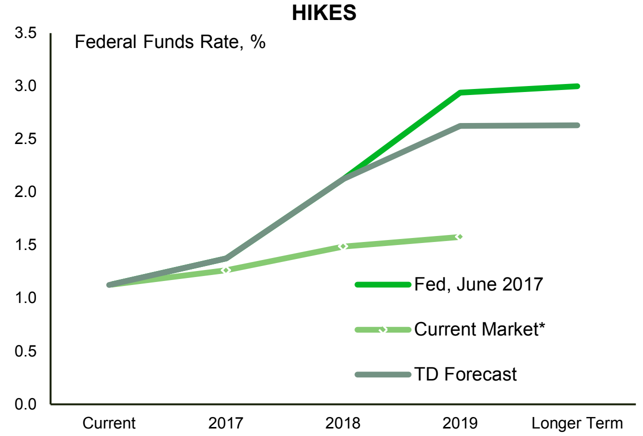
U.S. – FED CASTS VOTE OF CONFIDENCE ON US ECONOMY

Markets weakened on the week, focusing on some disappointing U.S. economic data instead of the Fed's confident tone accompanying its rate hike. The 25 basis-point increase in the fed funds rate was widely expected. More important was the vote of confidence cast by the Fed in its economic and inflation outlook. It left the number of rate hikes penciled in unchanged despite the loss of inflation momentum in recent months. The Fed also revealed more detailed plans for scaling back its holdings of Treasuries and MBS securities, describing the process for paring back the monthly amount of principal repayments it reinvests. We expect an announcement this September signaling this process to start in October. After that, the Fed is likely to next raise rates in December, and continue its gradual pace through 2018, provided the economy progresses as outlined in our latest forecast.

This was not a unanimous decision. President of the Minneapolis Fed, Neel Kashkari, dissented. He has written in the past that he is concerned about the Fed consistently missing on its inflation mandate, and would prefer to see more evidence that inflation pressures are building before hiking rates. He is not alone in this view. Many analysts suggest the Fed should wait to see greater evidence of inflation before acting to slow the economy. Financial markets aren't totally convinced either (Chart 1). Given that inflation has fallen short of the Fed's 2% target for the past five years, the skepticism is understandable.

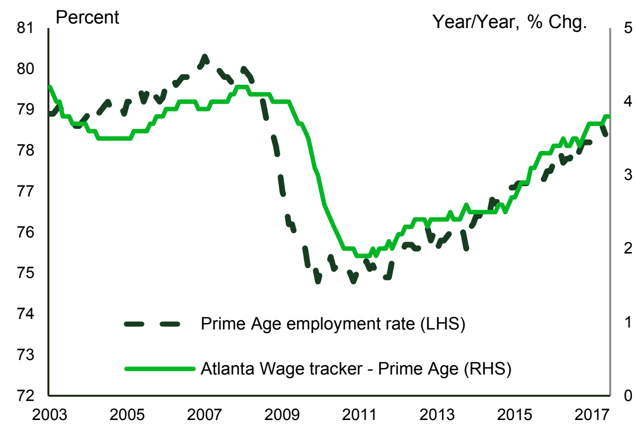
Like many things in the post-financial crisis recovery, inflation pressures are proving slow to materialize. This phenomenon is not confined to the United States either. As discussed in our new Quarterly Economic Forecast, inflation readings across the G7 and key emerging markets have come in below expectations. Some of this reflects a pull-back in oil prices, but underlying core inflation measures have also undershot forecasts.

CHART 1: MARKETS STILL SKEPTICAL ON FED HIKES



Source: Federal Reserve Board, Bloomberg, TD Economics.
*OIS curve: June 15, 2017.

CHART 2: WAGE PRESSURES BUILDING AS LABOR MARKET TIGHTENS



Source: FRB Atlanta, BLS, TD Economics

May's CPI report provided further sustenance for the doves. Core inflation posted its lowest reading in two years, at 1.7% y/y. There was an encouraging firming in core services price pressures, ending the cooling in the prior two month but core goods prices remained in deflationary territory.

There is evidence that goods price pressures are building further up the supply chain. Producer and import prices are both pointing to higher prices for consumer goods in the coming months, as the effect of past U.S. dollar appreciation starts to wane. Moreover, domestic wage pressures have picked up over the past two years as the labor market has tightened (Chart 2). With job growth continuing to put downward pressure on unemployment, this is likely to continue. Eventually rising wages will squeeze profit margins and put upward pressure on inflation.

At this stage in the cycle we expect consumer spending growth to be increasingly driven by income gains. As such, real consumer spending growth should run at a solid 2-2.5% pace over the next two years. Although the May retail data was a bit soft, this was in part due to weak inflation. It does not derail the Q2 real consumer spending rebound. Nor does it change our expectation that, barring an unforeseen shock, the U.S. expansion is set to continue.

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CANADA – BRIGHTER OUTLOOK SETS STAGE FOR MONETARY TIGHTENING

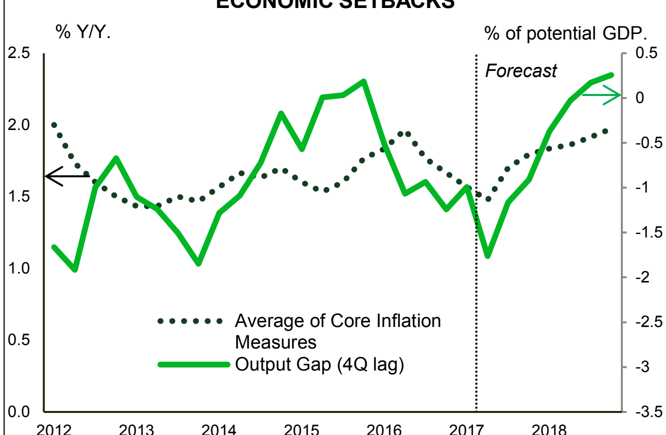
It was a somewhat volatile week for Canadian markets, with declining oil prices helping lead the S&P/TSX index lower. Still, the loonie shook off the oil softness, and stood out as the star of the show. It climbed nearly half a cent vs the greenback Monday afternoon, and strengthened as the week went on, up nearly one cent by mid-morning Friday.

The key driver for the loonie's strength was a marked shift in the tone of the Bank of Canada communications that served to bring forward market expectations of a policy rate increase, pushing longer-term interest rates modestly higher. The key trigger was a speech by Senior Deputy Governor Carolyn Wilkins (See our commentary). She suggested that the adjustment of the Canadian economy to lower oil prices was in the rear-view, and that despite persisting uncertainty "decisions must be taken" – marking a change in thinking.

Wilkins' speech nevertheless appeared to leave a bit of ambiguity around just how quickly the Bank of Canada may begin to remove stimulus. This was quickly erased the next day when Governor Stephen Poloz appeared on CBC Radio, stating that "...people need to be thinking about what their finances would look like were interest rates to be a little higher when they renew their mortgage." The rapid change in communication tone, coupled with the unusual clarity in Poloz's comments, points to a Bank that is getting ready to increase interest rates in the near future.

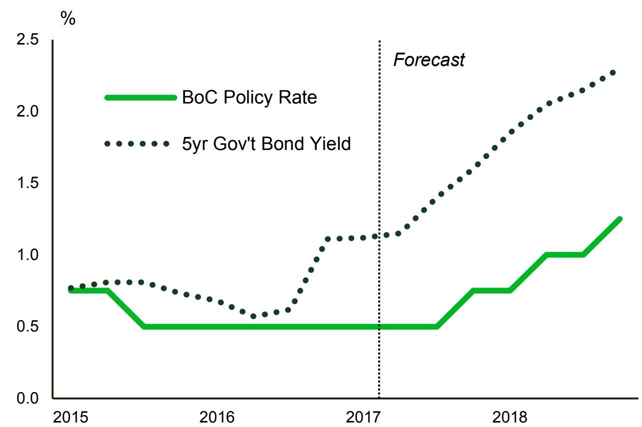
Is an increase in borrowing costs warranted? And if so, when and how quickly? The answer to the first question is a qualified "yes". The Canadian economy has been on a tear recently, posting 3.5% growth on average over the last three

CHART 1: SOFT INFLATION REFLECTS PAST ECONOMIC SETBACKS



Source: Bank of Canada, TD Economics.

CHART 2: AN EARLIER HIKE, BUT STILL CAUTIOUS PACE EXPECTED FROM THE BOC



Source: Bloomberg, Bank of Canada, TD Economics.

quarters. As outlined in the June edition of our Quarterly Economic Forecast, we expect growth to moderate slightly, but remain well above-trend through the remainder of this year. Clearly this is no longer an economy that requires emergency-level interest rates.

The qualification to the "yes" is related to inflation – not an unimportant detail given it is the sole monetary policy objective of the Bank. Despite robust growth, inflation remains stubbornly low, with the Bank of Canada's measures of core or "underlying" inflation ticking lower recently. Still, this is likely to be more of a backward-looking measure as history suggests that these tend to lag output (Chart 1). From this standpoint, inflation appears close to turning the corner. Given that monetary policy is set not for the economy of 'today', but rather that of 'tomorrow', it is only logical the Bank of Canada will want to get ahead of any inflationary pressures to ensure that inflation remains as near the 2% target as possible. The first step towards this goal will be to bring their policy interest rate off its recent lows, likely at the October monetary policy announcement.

Even if Poloz and company are taking a more aggressive near-term approach, it remains likely that caution will rule the day for subsequent policy increases. Business investment has only begun to come back in any meaningful sense, while the adjustment process in the key Ontario/Toronto housing markets has only just begun. As a result, we expect any future hikes to be only gradual, with the policy rate reaching just 1.25% by the end of next year (Chart 2).

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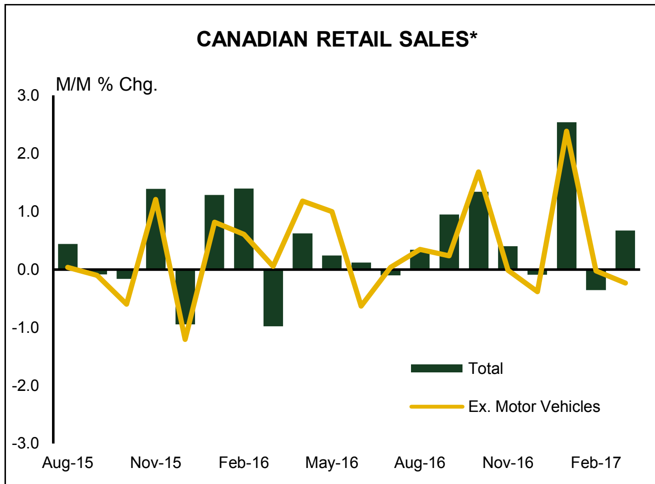
CANADA: UPCOMING KEY ECONOMIC RELEASES

Canadian Retail Sales - April*

Release Date: June 22, 2017
March Result: 0.7% m/m, ex-auto: -0.2% m/m
TD Forecast: -0.2% m/m, ex-auto: 0.3% m/m
Consensus: N/A

Consumer spending growth is set to take a pause in April as a slowdown in auto sales will contribute to a 0.2% m/m decline in retail sales, offsetting a sizeable tailwind from gasoline prices. Auto sales are forecast to cool from their record month, which should allow the ex-autos metric to post a modest 0.4% advance. Most of this increase is attributable to higher gasoline prices while the soft employment report for April (-30k full time jobs) may dampen core retail sales. There may also be some modest impact from the anxiety surrounding the housing market – building material sales are likely to decline modestly on the announcement of new regulations for the Toronto market, which have caused a slowdown in both residential construction and resales. The impact of rising consumer prices should see retail volumes come in weaker than nominal sales, though we view some giveback as a healthy development after an 8% annualized increase in the first quarter.

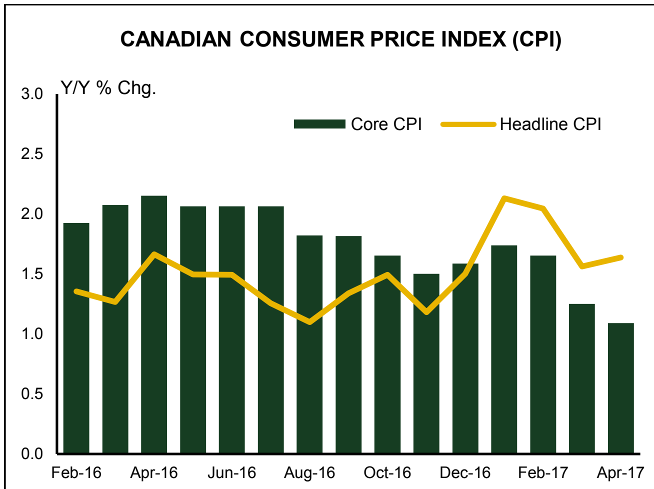


*Seasonally Adjusted
Source: Statistics Canada / Haver Analytics

Canadian Consumer Price Index - May*

Release Date: June 23, 2017
April Result: 0.4% m/m
TD Forecast: 0.2% m/m
Consensus: N/A

We expect a slight moderation in May CPI to 1.5% y/y, with lower gasoline prices driving a further deceleration (y/y) in energy prices. We see potential for food prices to climb further out of deflation though lingering competitiveness pressures are likely to limit the rebound. While we expect core metrics to stabilize and eventually move higher in the coming months, another slip in May cannot be excluded given the long lagged effects of material slack. That latter case, if realized, should be faded given the Bank of Canada's recent comments and shift in tone.



Source: Statistics Canada / Haver Analytics

*Forecast by Rates and FX Strategy Group. For further information, contact TDRates&FXCommoditiesResearch@tdsecurities.com

RECENT KEY ECONOMIC INDICATORS: JUNE 12-16, 2017							
Release Date		Economic Indicator/Event	Data for Period	Units	Current	Prior	
United States							
Jun 13		NFIB Small Business Optimism	May	Index	104.5	104.5	
Jun 13		Producer Price Index Ex Food and Energy	May	M/M % Chg.	0.3	0.4	
Jun 13		Producer Price Index Final Demand	May	M/M % Chg.	0.0	0.5	
Jun 14		Retail Sales Ex Auto and Gas	May	M/M % Chg.	0.0	0.5	R▲
Jun 14		Retail Sales Advance	May	M/M % Chg.	-0.3	0.4	
Jun 14		Real Avg Hourly Earning	May	Y/Y % Chg.	0.6	0.3	
Jun 14		Consumer Price Index Ex Food and Energy	May	Index	1.7	1.9	
Jun 14		Consumer Price Index	May	Index	1.9	2.2	
Jun 14		Business Inventories	Apr	M/M % Chg.	-0.2	0.2	
Jun 14		FOMC Rate Decision (Upper Bound)	Jun 14	%	1.3	1.0	
Jun 15		Import Price Index ex Petroleum	May	Index	0.0	0.3	R▼
Jun 15		Empire Manufacturing	Jun	M/M % Chg.	19.8	-1.0	
Jun 15		Export Price Index	May	Y/Y % Chg.	1.4	3.2	R▲
Jun 15		Initial Jobless Claims	Jun 10	Thsd	237.0	245.0	
Jun 15		Industrial Production	May	Y/Y % Chg.	0.0	1.1	R▲
Jun 15		Capacity Utilization	May	Thsd	76.6	76.7	
Jun 15		Manufacturing (SIC) Production	May	Y/Y % Chg.	-0.4	1.0	R▲
Jun 15		NAHB Housing Market Index	Jun	Index	67.0	69.0	R▼
Jun 16		Housing Starts	May	Thsd	1092.0	1156.0	R▼
Jun 16		Building Permits	May	Thsd	1168.0	1228.0	R▼
Canada							
Jun 14		Teranet/National Bank HPI	May	Y/Y % Chg.	13.9	13.4	
Jun 15		Manufacturing Sales	Apr	M/M % Chg.	1.1	0.8	R▼
Jun 15		Existing Home Sales	May	M/M % Chg.	-6.2	-1.7	
International							
Jun 13	UK	Consumer Price Index	May	Index	2.9	2.7	
Jun 13	CH	Retail Sales	May	Y/Y % Chg.	10.7	10.7	
Jun 14	UK	ILO Unemployment Rate 3Mths	Apr	%	4.6	4.6	

Source: Bloomberg, TD Economics.

UPCOMING ECONOMIC RELEASES AND EVENTS: JUNE 19-23, 2017							
Release Date	**Time***		**Economic Indicator/Event**	**Data for Period**	**Units**	**Consensus Forecast**	**Last Period**
			United States				
Jun 19	8:00		*Fed's Dudley Holds Business Rountable in Plattsburgh, NY*				
Jun 19	19:00		*Fed's Evans Speaks in New York*				
Jun 20	3:15		*Fed's Fischer Speaks in Amsterdam*				
Jun 20	7:45		*Fed's Rosengren to Speak at Macroprudential Conference*				
Jun 20	8:30		Current Account Balance	1Q	Blns	-124.9	-112.4
Jun 20	15:00		*Fed's Kaplan Speaks in San Francisco*				
Jun 21	10:00		Existing Home Sales	May	Mlns	5.55	5.57
Jun 22	8:30		Initial Jobless Claims	Jun 17	Thsd	-	237.0
Jun 23	9:45		Markit US Manufacturing PMI	Jun	Index	-	52.7
Jun 23	9:45		Markit US Services PMI	Jun	Index	-	53.6
Jun 23	10:00		New Home Sales	May	Thsd	598.0	569.0
Jun 23	12:40		*Fed's Mester Speaks in Cleveland*				
			Canada				
Jun 20	8:30		Wholesale Trade Sales	Apr	M/M % Chg.	-	0.9
Jun 22	8:30		Retail Sales Ex Auto	Apr	M/M % Chg.	-	-0.2
Jun 22	8:30		Retail Sales	Apr	M/M % Chg.	-	0.7
Jun 23	8:30		Consumer Price Index Core- Common	May	Y/Y % Chg.	-	1.3
Jun 23	8:30		Consumer Price Index Core- Median	May	Y/Y % Chg.	-	1.6
Jun 23	8:30		Consumer Price Index Core- Trim	May	Y/Y % Chg.	-	1.3
Jun 23	8:30		Consumer Price Index NSA	May	M/M % Chg.	-	0.4
Jun 23	8:30		Consumer Price Index	May	Index	-	1.6
			International				
Jun 22	20:30	JN	Nikkei Japan PMI Mfg	Jun	Index	-	53.1
Jun 23	4:00	EZ	Markit Eurozone Manufacturing PMI	Jun	Index	-	57.0

* Eastern Standard Time. Source: Bloomberg, TD Economics.