



December 14, 2011

### U.S. OUTLOOK - PROGRESS AMID PITFALLS

#### Highlights

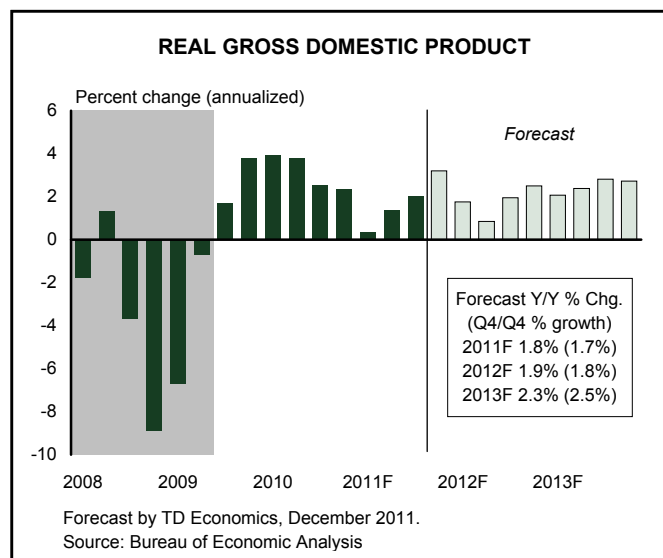
- The U.S. economy has shown some encouraging resilience over the last few months. After a fairly miserable first half of the year, the economy grew by 2.0% in the third quarter and is likely to accelerate to 3.2% growth in the final quarter of the year.
- The improvement in growth amidst the heightened political and financial turmoil of the summer reveals an economy that has proved to be more resilient than many had expected.
- Unfortunately, the recent momentum is unlikely to last and economic growth is expected to decelerate through the first half of 2012. Pulled down by a euro zone recession and accompanying global economic slowdown, as well as fiscal drag at both the federal and state and local levels, economic growth is likely to average 1.9% in 2012.
- In 2013, growth should improve to 2.3%. By then the housing market should be closer to resolving the overhang of distressed sales and steady job growth will allow for a faster pace of consumer spending. However, while the shackles are removed from the private sector, the public sector will become a more pronounced source of restraint as it begins a long process of reducing debt.

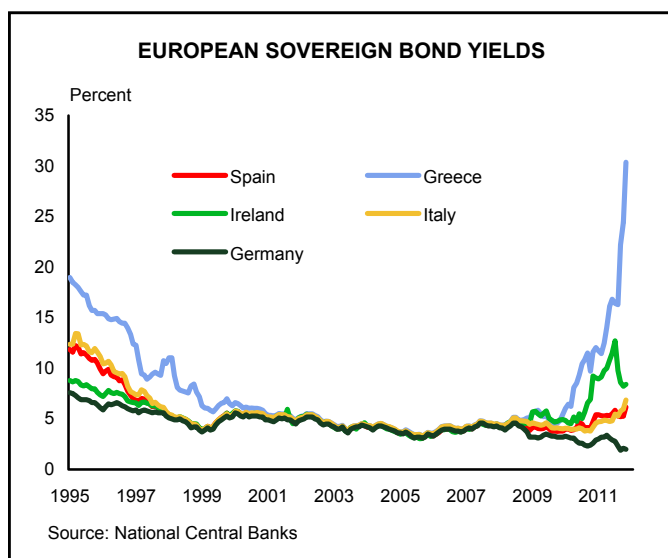
It may not be obvious, but the American economy has been getting better. After almost stalling in the first half of the year, U.S. growth has staged a comeback in the second half. Real GDP grew by 2.0% (annualized) in the third quarter. However, the relatively soft headline masked even stronger spending growth, with final sales rising by 3.6%.

The bounce back in sales was due in part to the alleviation of supply constraints that had slowed growth in the first half of the year. Vehicle sales in particular, were hit hard by the Japanese earthquake and tsunami and some rebound was expected. Still, the fact that overall spending increased so robustly amidst the heightened political and financial turmoil of the summer reveals an economy that has proved to be more resilient to the crisis of confidence than many had expected.

Recent economic data point to a further acceleration in growth in the final quarter of this year, but the drivers will shift slightly. After a drawdown in the third quarter, wholesale trade data suggests inventories rebounded in the fourth. While a deceleration in equipment and software investment will slow the pace of domestic demand growth, with continued support from net-exports, real GDP looks set to accelerate to 3.2% in the fourth quarter.

While there are a number of signs that recent momentum could carry into next year – job openings are on the rise, the unemployment rate is trending down and corporate profits relative to GDP are





at their highest level in over 60 years – the economy does not operate in isolation. In our previous forecast we identified two major risks to the U.S. outlook: the expanding financial crisis in Europe and fiscal restraint from Capitol Hill. On both fronts, the risks have intensified since September. Stresses on the European financial system have worsened and the chance of a Greek default is now more likely than not. At the same time, with the failure of the Joint Select Committee (JSC) on deficit reduction, premature fiscal tightening is an even graver risk than it was a few months ago.

Absent these developments, the evidence on the ground would suggest a pace of economic growth that would likely accelerate to roughly 3.0% or more. However, whereas it took a Japanese earthquake and a 20% rise in energy prices to knock growth off course in 2011, in 2012 a global economic slump and increasing fiscal drag will restrain U.S. growth to 1.9%. At this relatively slow pace of growth, the unemployment rate will remain modestly below 9.0% throughout the year.

We expect economic growth to improve to 2.3% in 2013. By then, the housing market should be closer to resolving the overhang of distressed sales and steady job growth will allow for a faster pace of consumer spending. Supported by continued low interest rates, an increase in confidence should also be supportive of business investment. However, while the shackles are removed from the private sector, the public sector will become a more pronounced source of restraint as it begins a long process of reducing debt.

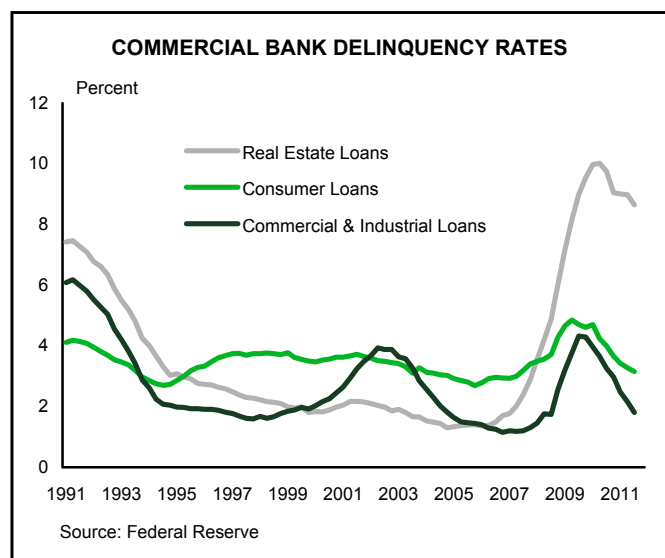
### The specter of default haunts Europe

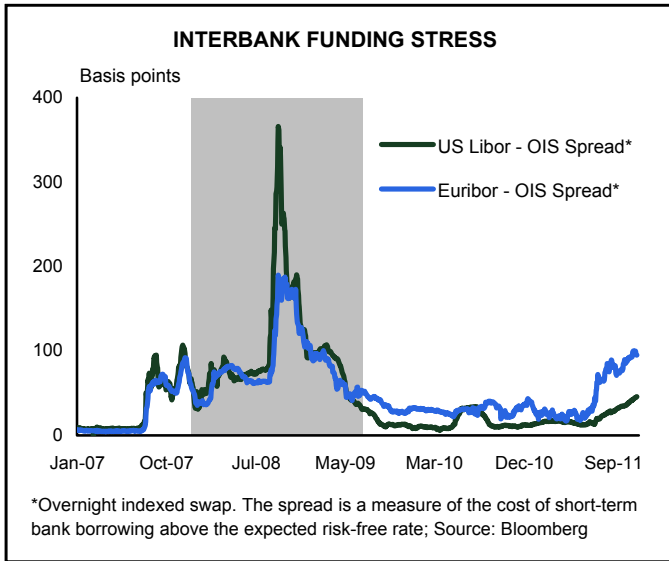
Before we get to U.S. fiscal risks, we must first address

the elephant in the forecast – the situation in Europe. Without a doubt, events in Europe present the most significant downside risk to the U.S. outlook. The convergence of sovereign debt and banking crises will pull the European economy into recession next year. We forecast a 1.2% contraction in euro zone GDP in 2012, which compares with a projected 0.9% expansion in our September forecast. In 2013, the euro zone economy should return to growth, but only by a meager pace of 1.3%.

European financial conditions are likely to get worse before they get better. Should the situation in Europe lead to broader financial market contagion, it could have a negative impact on the U.S. banking system. Fortunately, the U.S. financial system is healthier than it has been in the recent past. U.S. financial institutions have raised a significant amount of capital and have less exposure to European debt than they (or their European counterparts) had to U.S. mortgage debt during the last crisis. Moreover, the tightening in credit that has taken place over the last several years has led to an improvement in credit quality in the United States. Outside of real estate, delinquency rates on consumer and business credit have returned to their pre-recession levels. Moreover, while financial strain in Europe has risen, credit growth has accelerated in the United States. Led by increases in commercial and industrial loans, commercial banks lending rose close to 5% (annualized) in the third quarter.

Nonetheless, the fact that there are as of yet few signs of significant financial disruption on this side of the Atlantic, there are reasons to be cautious. For one, the linkages between the U.S. and European financial systems run deep. European banks operating in the US are not likely to be





extending credit, as they will be focused on balance sheet improvement. For two, in the event that Greece defaults outright and triggers credit default swaps, the losses are likely to extend to the U.S. financial system as well. Finally, all of this will take place even as the real estate market in the United States remains a significant source of vulnerability for American financial institutions. Any tightening of credit would slow the much needed recovery in home sales necessary to move the housing market towards recovery. Should this stall out, the vicious cycle of greater home price declines pushing more homeowners under water and prompting more mortgage defaults and distressed sales, could be restarted.

Even in absence of major financial contagion, continued uncertainty will weigh on equity markets and heighten risk aversion, likely leading to forestalled purchases and investments in America. What is more, the recession in the euro zone alongside slower growth in emerging markets will also weigh on U.S. exports. Our global growth outlook has been revised down to 2.5% from our previous outlook of 3.2%, while the trade-weighted dollar is now expected to rise by 2.5% between now and the end of the second quarter of 2012. As a result, despite a strong hand-off in the fourth quarter, export growth is expected to decelerate from 6.9% in 2011 to 3.9% in 2012.

**Fiscal risks loom large on the outlook**

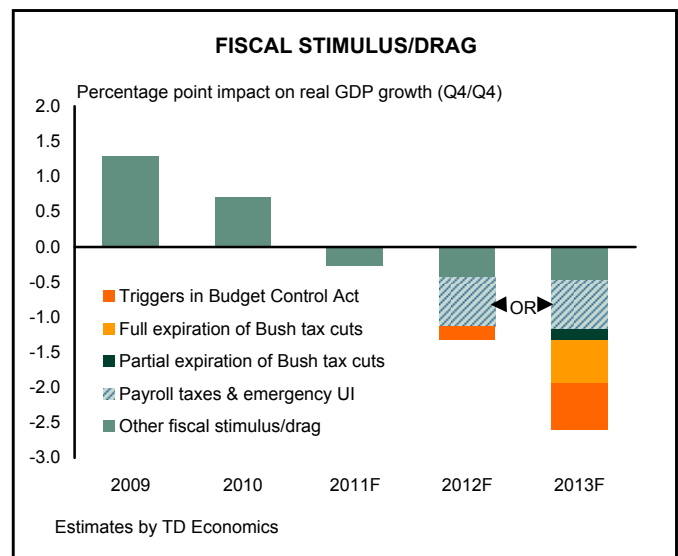
The other major impediment to U.S. growth over the next few years will be fiscal restraint. At the time of our last forecast in September, President Obama had just announced a plan for an American Jobs Act. At a total cost

of \$450 billion, the plan would have reduced payroll taxes on both employees and employers and raised spending on infrastructure products over the next several years. We did not build this plan into our September forecast as it had not been passed by Congress, but noted that should it be passed it would likely lift economic growth by around 0.8 percentage points.

Three months later and not only is there virtually no chance of the American Jobs Act passing Congress, but the Joint Select Committee has failed and Congress is currently at an impasse on whether to extend last year’s payroll tax cut and emergency unemployment benefits. What is more, Congress has yet to pass a 2012 appropriations bill and continues to operate on temporary continuing resolutions, the most recent of which expires on December 16th, posing the threat of a disruptive government shutdown.

Mercifully, there are positive signs of progress on passing a 2012 budget and there appears to be willingness on both sides of the aisle to reach a near-term agreement on the tax extensions. However, if these measures are allowed to expire, this would reduce economic growth by a further 0.7 percentage points in 2012 with the bulk of the impact absorbed in the first half of the year. It is in part due to this realization that we expect policymakers to come to an agreement to extend the tax cut. But, as evidenced by the failure of the JSC, we must state that there are considerable risks surrounding this expectation.

The risks to the outlook from fiscal policy do not end there. The JSC’s failure to reach an agreement means that under current law, steep automatic spending cuts are



scheduled for January 2013. While we anticipate that the automatic spending caps will be reversed or replaced with less front-loaded cuts before they come into effect, the mere anticipation of the sequester is likely to make some reductions in government spending unavoidable. Given that the fiscal year begins in October of 2012, government departments will have already built the impending cuts into their operating budgets. To account for this, we have built in an expected additional 0.2 percentage point drag in late 2012. This headwind, in combination with spending cuts as part of the debt-ceiling deal, reductions in infrastructure spending and declines in state and local government aid will likely reduce economic growth by 0.6 percentage points in 2012.

While gridlock is likely to continue to characterize the U.S. political scene over the next year, the election in late 2012 may serve as a catalyst for more decisive post-election action on some of the outstanding fiscal questions facing the United States. Importantly however, the number of questions will not diminish. In 2013 not only will Congress once again have to deal with an expiring payroll tax (assuming they extend it this year), but they will also have to deal with the expiration of the 2003 Bush tax cuts. The bottom line is that fiscal policy is likely to be a drag on economic growth for many years to come. And, while the federal government absolutely needs to address its long term deficit issues, there is a risk that they will cut spending too much and too soon, sucking demand out of the economy at a time when the private sector is still finding its feet.

### **Bottom Line**

The economic outlook is clouded by the political landscape, both in the U.S. and in Europe. While we remain hopeful that policymakers in Europe will avoid a catastrophic breakup of the euro and that U.S. policymakers will come up with a deal to avoid raising taxes in January, the dependence of these outcomes on political decisions makes this an even more uncertain outlook than usual.

Even without these risks, a relatively deep recession in Europe and spending cuts already imbedded in current legislation will present a significant drag on growth over the next two years. At the same time, as in our previous forecasts, growth will also be restrained by a slow pace of resolution in the housing market.

Given the relatively weak growth prospects, pressure will remain on the Federal Reserve to continue to support the recovery. The Fed is nearly certain to maintain its commitment to keeping rates on hold until at least mid-2013, and we would not be surprised if they are on hold even longer than this. Moreover, should financial conditions in Europe worsen more than expected; there is a high probability of further quantitative easing next year.

All told, the U.S. economy continues to grow, and has even shown some encouraging resilience over the last few months. Still, while progress has been made, pitfalls continue to mark the road to recovery.

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<b>U.S. ECONOMIC OUTLOOK:</b>																		
<i>Period-Over-Period Annualized Per Cent Change Unless Otherwise Indicated</i>																		
	2011				2012				2013				Annual Average			4th Qtr/4th Qtr		
	Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	11F	12F	13F	11F	12F	13F
<b>Real GDP</b>	0.4	1.3	2.0	3.2	1.8	0.9	2.0	2.5	2.1	2.4	2.8	2.7	1.8	1.9	2.3	1.7	1.8	2.5
<b>Consumer Expenditure</b>	2.1	0.7	2.3	2.7	2.0	1.8	1.9	2.4	1.9	2.3	2.7	2.6	2.3	2.1	2.2	1.9	2.0	2.4
Durable Goods	11.8	-5.3	5.5	14.7	4.6	4.1	5.5	6.0	2.3	5.4	7.1	6.2	8.1	6.0	4.9	6.4	5.1	5.2
<b>Business Investment</b>	2.1	10.3	14.8	5.9	3.6	2.9	3.8	7.6	7.6	8.2	7.5	7.1	8.8	5.9	6.9	8.2	4.4	7.6
Non-Res. Structures	-14.4	22.6	12.6	3.5	1.6	2.9	4.3	5.1	3.7	4.4	4.6	5.2	4.6	5.2	4.3	5.2	3.5	4.5
Machinery & Equipment	8.7	6.3	15.6	6.9	4.3	2.8	3.6	8.5	9.1	9.7	8.6	7.9	10.3	6.1	7.9	9.3	4.8	8.8
<b>Residential Construction</b>	-2.5	4.2	1.6	3.0	5.1	1.9	3.7	4.2	5.9	7.6	8.2	9.7	-1.8	3.4	5.9	1.6	3.7	7.9
<b>Govt. Consumption &amp; Gross Investment</b>	-5.9	-0.9	-0.1	-0.4	-1.5	-2.1	-1.2	-1.3	-1.6	-1.7	-1.8	-1.5	-1.9	-1.1	-1.6	-1.9	-1.5	-1.7
<b>Final Domestic Demand</b>	0.4	1.3	3.0	2.4	1.5	1.2	1.6	2.2	1.9	2.3	2.5	2.5	2.0	1.8	2.0	1.8	1.6	2.3
<b>Exports</b>	7.9	3.6	4.3	6.5	3.4	1.8	3.8	4.6	6.7	8.0	8.6	8.7	6.9	3.9	6.3	5.5	3.4	8.0
<b>Imports</b>	8.3	1.4	0.5	3.9	3.3	3.8	4.0	4.3	5.3	5.6	6.1	6.0	4.9	3.2	5.1	3.5	3.9	5.8
<b>Change in Non-Farm Inventories</b>	49.1	39.1	-8.5	6.7	12.7	13.6	27.9	36.4	40.1	36.1	38.1	36.5	21.6	22.7	37.7	---	---	---
<b>Final Sales</b>	0.0	1.6	3.6	2.7	1.5	0.8	1.4	2.2	1.9	2.5	2.7	2.8	2.1	1.9	2.1	2.0	1.5	2.5
<b>International Current Account Balance (\$Bn)</b>	-494	-493	-420	-441	-443	-458	-463	-466	-466	-461	-456	-448	-462	-458	-458	---	---	---
% of GDP	-3.3	-3.3	-2.8	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.8	-2.8	-2.7	-3.1	-2.9	-2.8	---	---	---
<b>Pre-tax Corporate Profits including IVA&amp;CCA</b>	4.2	13.7	8.5	0.7	2.1	1.0	1.7	2.0	2.3	3.3	4.5	4.8	7.9	3.0	2.7	6.6	1.7	3.7
% of GDP	12.6	12.9	13.0	12.9	12.9	12.8	12.8	12.7	12.6	12.6	12.6	12.6	12.9	12.8	12.6	---	---	---
<b>GDP Deflator (Y/Y)</b>	1.8	2.1	2.4	2.0	1.9	1.8	1.6	2.0	1.9	1.9	1.9	1.9	2.1	1.8	1.9	2.0	2.0	1.9
<b>Nominal GDP</b>	3.1	4.0	4.6	3.5	3.8	2.9	3.9	4.4	4.0	4.3	4.7	4.7	3.9	3.7	4.2	3.8	3.8	4.4
<b>Labor Force</b>	-1.5	0.6	0.3	1.1	1.0	1.0	1.0	1.1	1.1	1.1	1.2	1.2	-0.2	0.9	1.1	0.1	1.0	1.1
<b>Employment</b>	1.3	1.4	0.9	1.3	1.1	0.8	1.4	1.6	1.5	1.6	1.8	1.9	1.0	1.1	1.5	1.2	1.2	1.7
<b>Change in Empl. ('000s)</b>	422	467	297	408	361	263	461	528	497	537	598	631	1,328	1,492	2,049	1,594	1,613	2,263
<b>Unemployment Rate (%)</b>	8.9	9.1	9.1	8.8	8.7	8.8	8.8	8.8	8.7	8.6	8.5	8.4	9.0	8.8	8.6	---	---	---
<b>Personal Disp. Income</b>	5.2	2.8	0.2	2.8	3.9	3.1	3.9	4.6	0.9	4.7	5.0	4.6	3.4	3.0	3.6	2.7	3.9	3.8
<b>Pers. Savings Rate (%)</b>	5.0	4.8	3.8	3.8	3.8	3.6	3.6	3.7	3.0	3.1	3.2	3.2	4.4	3.7	3.2	---	---	---
<b>Cons. Price Index (Y/Y)</b>	2.2	3.3	3.8	3.4	2.4	1.7	1.3	1.4	1.4	1.6	1.8	2.0	3.2	1.7	1.7	3.4	1.4	2.0
<b>Core CPI (Y/Y)</b>	1.1	1.5	1.9	2.1	2.1	1.9	1.7	1.8	1.8	1.7	1.8	1.8	1.6	1.9	1.8	2.1	1.8	1.8
<b>Housing Starts (mns)</b>	0.58	0.57	0.61	0.62	0.63	0.65	0.66	0.68	0.71	0.74	0.77	0.82	0.60	0.65	0.76	---	---	---
<b>Productivity:</b>																		
<b>Real Output per hour (y/y)</b>	1.2	0.9	1.0	0.9	1.1	1.2	0.9	0.7	0.8	1.0	1.0	1.0	1.0	1.0	0.9	0.9	0.7	1.0

F: Forecast by TD Economics as at December 2011

Source: U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, TD Economics

### INTEREST RATE OUTLOOK

	2011				2012				2013			
	Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Fed Funds Target Rate (%)	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.75	1.00
3-mth T-Bill Rate (%)	0.09	0.01	0.02	0.05	0.10	0.10	0.10	0.10	0.10	0.15	0.80	1.10
2-yr Govt. Bond Yield (%)	0.82	0.46	0.24	0.25	0.25	0.30	0.35	0.50	0.80	0.95	1.15	1.55
5-yr Govt. Bond Yield (%)	2.27	1.76	0.95	0.90	0.85	1.10	1.40	1.55	1.65	1.70	1.95	2.10
10-yr Govt. Bond Yield (%)	3.47	3.16	1.91	2.10	1.90	2.20	2.65	2.75	2.75	2.80	3.00	3.25
30-yr Govt. Bond Yield (%)	4.51	4.37	2.91	3.05	2.80	3.30	3.90	4.00	4.05	4.10	4.20	4.30
10-yr-2-yr Govt. Spread (%)	2.65	2.70	1.67	1.85	1.65	1.90	2.30	2.25	1.95	1.85	1.85	1.70

f: Forecast by TD Economics as at December 2011; All forecasts are for end of period; Source: Bloomberg, TD Economics

### FOREIGN EXCHANGE OUTLOOK

Currency	Exchange Rate	2011				2012				2013			
		Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Canadian dollar	CAD per USD	0.97	0.96	1.05	1.04	1.09	1.11	1.09	1.05	1.03	1.01	1.00	0.98
Japanese yen	JPY per USD	83.1	80.5	77.0	76.0	78.0	78.0	83.0	85.0	88.0	88.0	90.0	90.0
Euro	USD per EUR	1.42	1.45	1.34	1.30	1.28	1.22	1.25	1.30	1.30	1.30	1.35	1.35
U.K. pound	USD per GBP	1.60	1.61	1.56	1.53	1.52	1.47	1.52	1.59	1.57	1.57	1.69	1.69
Swiss franc	CHF per USD	0.92	0.84	0.91	0.94	0.95	1.02	1.00	1.00	1.00	1.00	0.96	0.96
Australian dollar	USD per AUD	1.03	1.07	0.97	1.00	0.98	0.95	0.97	1.00	1.00	1.00	0.97	0.95
NZ dollar	USD per NZD	0.76	0.83	0.76	0.78	0.76	0.76	0.79	0.81	0.81	0.81	0.79	0.80

f: Forecast by TD Economics as at December 2011; All forecasts are for end of period; Source: Federal Reserve, Bloomberg, TD Economics

GLOBAL ECONOMIC OUTLOOK					
<i>Annual per cent change unless otherwise indicated</i>					
2007 Share*		Forecast			
Real GDP	(%)	2010	2011	2012	2013
<b>World</b>	99.1	4.6	3.2	2.5	3.3
<b>North America</b>	25.5	3.2	2.0	2.1	2.4
United States	21.4	3.0	1.8	1.9	2.3
Canada	2.0	3.2	2.4	1.7	2.2
Mexico	2.1	5.5	4.0	3.8	4.1
<b>European Union (EU-27)</b>	23.7	1.9	1.6	-1.1	1.4
Euro-zone (EU-16)	16.1	1.8	1.4	-1.2	1.3
Germany	4.4	3.6	2.9	-0.8	1.5
France	3.2	1.4	1.5	-1.2	1.4
Italy	2.8	1.2	0.4	-1.3	1.2
United Kingdom	3.3	1.5	1.0	-1.0	1.4
EU accession members	3.4	2.6	2.9	-0.7	1.7
<b>Asia</b>	35.5	7.4	5.2	5.2	5.3
Japan	6.6	4.5	-0.6	2.2	1.9
Asian NIC's	3.7	8.3	4.3	4.2	4.3
Hong Kong	0.5	6.5	5.0	4.5	4.4
Korea	1.9	6.1	3.6	4.0	4.2
Singapore	0.3	13.9	5.5	4.3	4.2
Taiwan	1.1	11.0	4.7	4.5	4.4
Russia	3.2	4.0	3.7	3.8	4.2
Australia & New Zealand	1.4	2.7	2.0	3.4	3.5
Developing Asia	20.6	9.0	7.7	6.7	6.9
ASEAN-4	3.1	6.9	4.7	4.5	4.9
China	10.9	10.3	9.1	7.8	8.0
India	4.6	8.7	7.6	7.0	7.2
<b>Central/South America</b>	6.1	5.6	4.0	3.5	3.9
Argentina	0.8	8.1	7.8	4.8	3.9
Brazil	2.8	7.5	3.4	3.3	4.3
<b>Other Developing</b>	8.4	4.3	2.7	2.6	2.5

\*Regional wts. do not sum to 100% because some countries omitted  
 Forecast as at December 2011  
 Source: International Monetary Fund, national statistics agencies

ECONOMIC INDICATORS FOR THE G-7 AND EUROPE				
	2010	Forecast		
		2011	2012	2013
<b>Real GDP (Annual per cent change)</b>				
<b>G-7 (41.17%)*</b>	3.0	1.4	1.0	1.9
U.S.	3.0	1.8	1.9	2.3
Japan	4.5	-0.6	2.2	1.9
EU-17	1.8	1.4	-1.2	1.3
Germany	3.6	2.9	-0.8	1.5
France	1.4	1.5	-1.2	1.4
Italy	1.2	0.4	-1.3	1.2
United Kingdom	1.5	1.0	-1.0	1.4
Canada	3.2	2.4	1.7	2.2
<b>Consumer Price Index (Annual per cent change)</b>				
<b>G-7</b>	1.4	2.5	1.7	1.5
U.S.	1.7	3.2	1.7	1.7
Japan	-0.7	-0.2	0.2	0.3
EU-17	1.6	2.7	2.4	1.8
Germany	1.2	2.5	2.3	1.7
France	1.7	2.2	2.1	1.8
Italy	1.6	2.8	2.4	1.6
United Kingdom	3.3	4.5	2.7	1.5
Canada	1.8	2.9	1.7	1.8
<b>Unemployment Rate (Per cent annual averages)</b>				
U.S.	9.6	9.0	8.8	8.6
Japan	5.1	4.6	4.4	4.4
EU-17	10.1	10.0	10.3	10.4
Germany	7.1	6.0	6.3	6.7
France	9.8	9.8	10.1	9.8
Italy	8.4	8.2	8.8	9.0
United Kingdom	7.8	8.1	8.7	8.5
Canada	8.0	7.4	7.6	7.4

\*Share of 2007 world gross domestic product (GDP)  
 Forecast as at December 2011  
 Source: National statistics agencies, TD Economics

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