June 18, 2013

U.S. OUTLOOK: ON THE CUSP OF SOMETHING GREAT?

Highlights

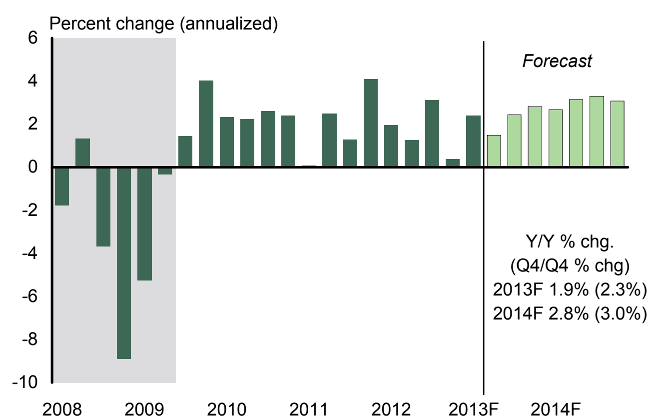
- The American economy grew by 2.4% (annualized) in the first quarter of this year. Economic growth was roughly in line with its post-recession average, but occurred in an environment of significantly higher payroll taxes and reduced government spending.
- The outlook for the U.S. economy is framed by the increasing resiliency and confidence of its private sector up against ongoing fiscal consolidation and relatively weak global growth. The result is an economy that is likely to grow by 1.9% in 2013, but improve to 2.8% in 2014 as these weights lift.
- Home price growth continued to accelerate through the first four months of 2013 and reached 12% year-over-year in April. Home price growth is likely to decelerate as more supply is brought on line, but will continue to support consumer spending through the forecast horizon.
- Increased economic optimism has brought forward expectations for the Federal Reserve to end its ongoing asset purchases. With fiscal drag weighing on near-term growth alongside relatively weak inflation, the Fed is likely to begin tapering its program later this year and end their purchases outright in the first quarter of 2014.

We can finally say that this is an exciting time for the U.S. economy. Buoyed by improving balance sheets, consumers have a newfound sense of optimism. In spite of tax hikes, they have increased their spending. Home prices are rising across the country and housing construction has followed suit. After several years of deleveraging and restraint, private demand is on the cusp of shifting into a higher gear. The improvement in economic prospects has led to speculation that the Federal Reserve may finally be ready to ease off the monetary pedal.

However, while the Promised Land (or in Fed Speak, "substantial improvement in the outlook") may be getting closer, we're not there yet. The acceleration in private spending is offset by a deep contraction in the public sector. Government spending has subtracted an average of 1.2 percentage points from growth over the last two quarters. This is unlikely to improve over the remainder of this year. This summer, sequestration will result in the furlough (unpaid days off) of hundreds of thousands of federal workers. Meanwhile, the prospects for exports to provide a meaningful offsetting influence is dimmed by the reality of slow global growth and a European economy that will barely emerge from recession this year. This will put the entire onus on American households and businesses to drive growth forward.

The tug of war between strengthening private demand and

REAL GROSS DOMESTIC PRODUCT



Forecast by TD Economics, June 2013
Source: Bureau of Economic Analysis

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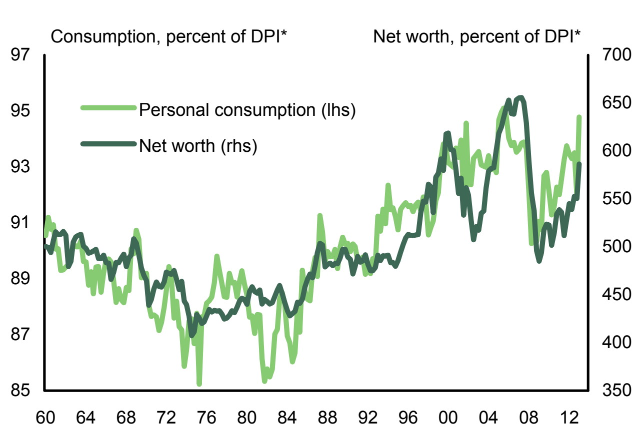
fiscal drag has left our forecast for real GDP growth unchanged from the March estimate of 1.9% for 2013. As fiscal drag diminishes and the global backdrop improves, U.S. economic growth is expected to accelerate to 2.8% in 2014.

Rising wealth and improved confidence support consumer spending

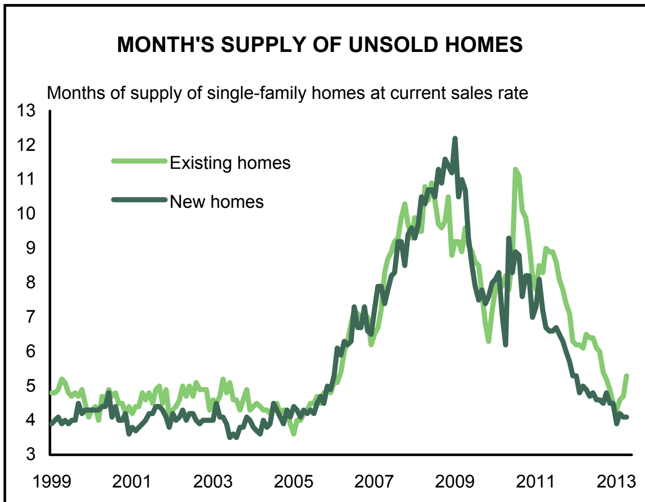
Consumer spending burst out of the gates in the first quarter, rising by 3.4% (annualized). The increase is particularly impressive given that it occurred alongside a payroll tax increase that cut close to 4 percentage points from disposable income growth. Some of the increase in spending was related to one-off seasonal influences, such as an outsized gain in heating consumption due to a colder than usual winter. But, even excluding energy, consumption rose by a robust 2.7%.

The resilience of consumer spending is evidence that the negative impact of deleveraging is waning and rising household wealth is providing an offset to the drag from fiscal policy. Indeed, household net worth rose 9.6% in the first quarter relative to a year-ago and is now 3.4% higher than its pre-recession peak. The initial rebound in wealth was largely due to gains in financial assets; but, over the last year, real estate assets have represented 36% of the gains.

Home prices opened the second quarter with a bang, accelerating 12% from year-ago levels in April. The increase reflects a housing market that has moved back into seller's territory. Inventories of unsold homes are at historically low levels, with many complaining of too little supply. At the same time, demand has been supported by investors and cash buyers. According to the National Association of Realtors, cash sales represent around 30% of sales; the majority of these are investors.



*Disposable personal income
Source: Federal Reserve. Bureau of Economic Analysis



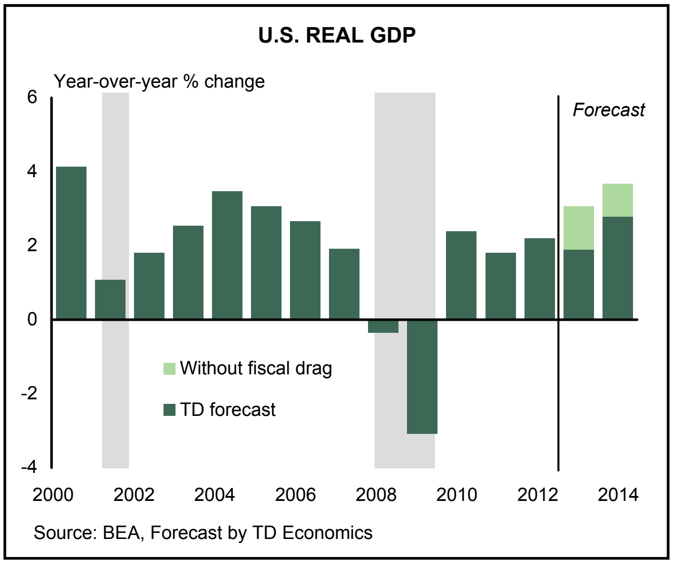
Source: National Association of Realtors, Census Bureau.

While investor demand has helped to firm prices, it's unlikely the current heady pace of price appreciation will persist as this demand is satiated. However, the risk of a retracement in prices is limited given that the strongest gains have come in states where price declines were the most severe during the recession. In Nevada, for example, prices fell 60% peak-to-trough. They have increased 25% since, but remain close to 50% below their previous peak. More importantly, fundamentals remain supportive in most markets, with still-healthy affordability alongside lean supply relative to demographic requirements.

All told, rising home prices will continue to support consumer spending through the forecast. The contribution goes beyond the traditional wealth effect. Rising home prices reduce the number of mortgage holders who owe more than their home is worth. This has undoubtedly contributed to the improvement in consumer confidence. It also helps to improve access to credit and encourages builders and households who have been sitting on the sidelines when prices were declining to return to the market. This, in turn, helps create a virtuous cycle that feeds into jobs and consumer spending.

Fiscal drag and policy uncertainty have not gone away

The resilience of the consumer in the first quarter does not negate the drag coming from fiscal policy. Government spending directly cut economic growth by 1.0 percentage point in the first quarter, with 65% of the drag coming from



the defense sector.

The bad news is that it's not over yet. Sequestration came into effect in March, making it really a second and third quarter story. Even with the defense cuts already made, the Department of Defense recently announced that, beginning in July, 680,000 civilian employees will have to take 11 unpaid days off work – one day a week for 11 weeks. Non-defense agencies will see similar furloughs. Altogether the number of workers facing furloughs is likely to stretch into the millions. With this in mind, budget cuts are likely to subtract an average of 1.3 percentage points from quarterly growth over the remainder of this year, with the second quarter taking the brunt of the impact.

In addition to sequestration, further policy uncertainty remains a risk to the outlook. The statutory debt-ceiling extension expired in May and while unanticipated revenues have allowed the Treasury to continue to fund itself, the clock runs out again in October/November. At the same time, Congress has yet to agree on passing a fiscal 2014 budget and must continue to rely on "continuing resolutions" to fund the government. The most recent resolution will also expire in October. If history is any guide, a temporary solution will be found to both of these issues, which unfortunately means they will persist as risks in upcoming outlooks.

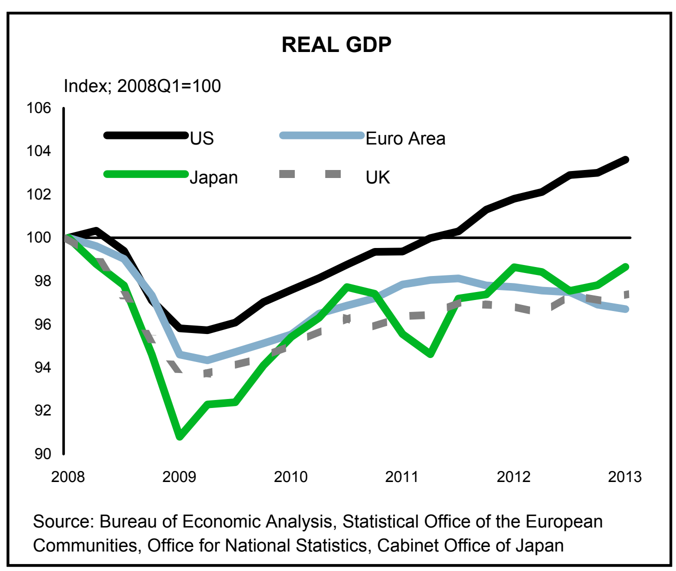
Global environment remains challenging

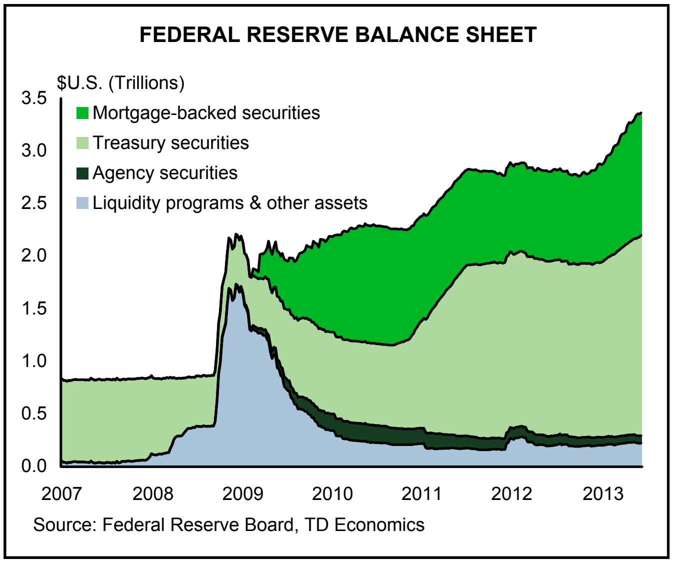
As unsatisfactory as the economic recovery has been in the United States, it has been a cakewalk next to most of America's peers. Even with growth of just 2.2% in 2012, the U.S. was the fastest growing country in the G7. It is likely to retain this title again in 2013. Recent European data point to continued economic weakness. While the European Central Bank has lowered interest rates, credit remains tight in periphery countries and the continent is likely to emerge slowly from recession over the second half of 2013.

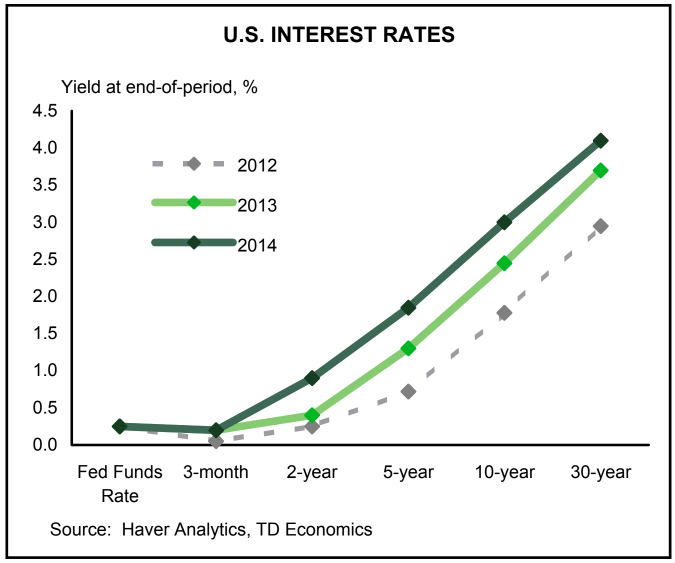
While emerging markets will perform better, we have downgraded our forecast for growth in several economies, including those in South America and in developing Asia. This is mainly the result of spill over effects from a modest economic deceleration in China, relative to our previous forecast. Overall, we expect global growth of 2.9% in 2013 and 3.6% in 2014, down 0.2 percentage points in both years from our forecast in March. For more details please see our global QEF.

This limits the prospects for a meaningful pick-up in export growth. Adding to the difficulties of exporters, the U.S. dollar has gained strength recently and is likely to continue to rise in the months ahead. The strength in the dollar is in part due to policy actions abroad, particularly those in Japan aimed at pulling the country out of deflation and moribund economic growth. The dollar has risen 12% against the yen since the start of this year and is up 28% from its trough in September 2011. While Japan represents a small share of America's total trade basket, on a trade weighted basis, the U.S. dollar has risen over 2% since the start of this year.

The combination of relatively weak global growth and a strengthening domestic economy means that imports are likely to outpace exports over the second half of this year, leading net-exports to subtract from economic growth. As the global backdrop improves in 2014, this drag should diminish, but net-trade is unlikely to become a major source of growth over the forecast horizon.







When to taper?

Optimism about the pace of economic recovery has put attention back on the Federal Reserve's asset purchase program. This has created some strange developments in financial markets where good news is sometimes greeted as bad news since it is thought to bring forward Fed tapering.

The Fed has committed to continue buying bonds "until the outlook for the labor market has improved substantially." Unfortunately, it is not entirely clear what "substantially" means. The U.S. economy has generated an average of 176k jobs a month over the last year. The Fed would likely prefer to see this number closer to 200k. At the same time, recent inflation data has moved further and further below the Fed's 2.0% target, giving them more room for caution.

The challenge for the Fed will be to communicate its perceptions on the economy and the timing of QE withdrawal, while simultaneously not prompting market participants to front-load exit policy expectations that result in a counter-productive sharp increase in yields. Adding to the delicacy of the situation is the fact that lags in monetary policy require the Fed to set policy based on growth expectations that are 12-18 months out. This makes disentangling the impact of fiscal drag from the underlying momentum in the economy all the more important. If, as we expect, fiscal drag is reducing economic growth by just short of 1.5 percentage points, then as this lifts, underlying economic strength is in the 3% to 4% range, rather than the 2% currently being observed.

We anticipate that by September, the worst of sequestration will have passed, revealing a sturdier foundation to the economy. The Fed will have sufficient evidence to begin tapering their asset purchases, with the goal to end the program outright in the first quarter of 2014. (For more on the Federal Reserve's exit strategy please see our Special Report).

Bottom line

The U.S. economy has shown true grit in a tough environment of tax hikes and uncooperative global growth. Policy choices – both fiscal and monetary – remain central to the economic outlook. On the fiscal side, sequestration is the single biggest drag on near-term economic growth. On the monetary side, the Federal Reserve must balance its commitment to support the labor market with the risk that its policies may increasingly lead to unintended consequences. With an improved economic outlook, the pressure to ease off its stimulus program will increase. As recent movements in financial markets have shown, this will not go unnoticed. As we move to the next phase in the recovery, keep your seat belts fastened, it will be a bumpy ride.

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U.S. ECONOMIC OUTLOOK:

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

	2012				2013				2014				Annual Average			4th Qtr/4th Qtr		
	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	12	13F	14F	12	13F	14F
Real GDP	2.0	1.3	3.1	0.4	2.4	1.5	2.4	2.8	2.7	3.2	3.3	3.1	2.2	1.9	2.8	1.7	2.3	3.0
Consumer Expenditure	2.4	1.5	1.6	1.8	3.4	2.0	2.6	2.8	2.5	2.7	2.9	2.6	1.9	2.4	2.6	1.8	2.7	2.7
Durable Goods	11.5	-0.2	8.9	13.6	8.2	3.6	8.0	7.7	6.5	7.6	8.1	7.2	7.8	7.8	7.2	8.3	6.9	7.3
Business Investment	7.5	3.6	-1.8	13.1	2.2	2.2	7.8	6.5	5.7	7.3	7.9	7.3	8.0	4.7	6.6	5.5	4.7	7.0
Non-Res. Structures	12.8	0.6	0.0	16.7	-3.5	2.1	4.2	1.6	4.2	6.0	5.5	6.3	10.8	3.1	4.2	7.3	1.1	5.5
Equipment & Software	5.4	4.8	-2.6	11.8	4.6	2.3	9.3	8.5	6.3	7.8	8.9	7.6	6.9	5.4	7.5	4.7	6.1	7.7
Residential Construction	20.6	8.4	13.6	17.6	12.0	11.0	11.6	17.6	19.2	19.4	22.2	20.4	12.1	13.1	18.0	14.9	13.0	20.3
Govt. Consumption & Gross Investment	-3.0	-0.7	3.9	-7.0	-5.0	-3.2	-2.1	-0.9	-0.7	-0.5	-0.2	-0.3	-1.7	-3.1	-1.0	-1.8	-2.8	-0.4
Final Domestic Demand	2.2	1.4	1.9	1.5	1.9	1.3	2.5	2.9	2.7	3.1	3.4	3.1	2.0	1.8	2.8	1.8	2.1	3.1
Exports	4.4	5.2	1.9	-2.8	0.8	3.5	3.0	4.8	5.9	6.7	7.6	7.1	3.4	1.5	5.6	2.1	3.0	6.8
Imports	3.1	2.8	-0.6	-4.2	1.9	2.3	3.6	4.9	5.5	6.0	6.7	6.9	2.4	0.9	5.3	0.2	3.2	6.3
Change in Non-Farm Inventories	56.9	41.4	60.3	13.3	38.3	41.7	43.4	44.5	44.3	46.5	42.8	45.5	43.0	42.0	44.7	---	---	---
Final Sales	2.4	1.7	2.4	1.9	1.8	1.4	2.4	2.8	2.7	3.1	3.4	3.0	2.1	1.9	2.8	2.1	2.1	3.0
International Current Account Balance ($Bn)	-553	-485	-434	-424	-473	-423	-434	-437	-428	-429	-420	-421	-474	-442	-424	---	---	---
% of GDP	-3.6	-3.1	-2.7	-2.7	-3.0	-2.6	-2.7	-2.7	-2.6	-2.5	-2.5	-2.4	-3.0	-2.7	-2.5	---	---	---
Pre-tax Corporate Profits including IVA&CCA	-10.4	4.7	9.9	9.6	-8.4	0.5	3.4	4.9	5.0	5.2	5.7	5.2	6.8	1.8	4.6	3.1	-0.1	5.3
% of GDP	12.3	12.3	12.4	12.7	12.3	12.3	12.2	12.2	12.2	12.2	12.3	12.3	12.4	12.3	12.2	---	---	---
GDP Deflator (Y/Y)	2.0	1.7	1.6	1.8	1.6	1.3	1.2	1.4	1.6	1.9	1.8	1.9	1.8	1.4	1.8	1.8	1.4	1.9
Nominal GDP	4.2	2.8	5.9	1.4	3.6	2.0	4.7	4.6	4.6	5.0	5.3	5.1	4.0	3.3	4.6	3.5	3.7	5.0
Labor Force	1.6	0.6	0.1	1.5	-0.2	0.4	0.9	0.8	1.1	1.1	1.2	1.3	0.9	0.5	1.0	0.9	0.5	1.2
Employment	2.4	1.4	1.2	1.6	1.9	1.6	1.6	1.8	1.6	1.8	2.0	2.0	1.7	1.6	1.8	1.6	1.7	1.9
Change in Empl. ('000s)	771	451	409	545	645	523	541	604	556	619	680	702	2,237	2,184	2,390	2,176	2,313	2,558
Unemployment Rate (%)	8.3	8.2	8.0	7.8	7.7	7.6	7.5	7.4	7.3	7.2	7.0	6.9	8.1	7.6	7.1	---	---	---
Personal Disp. Income	6.3	2.9	2.3	10.6	-7.5	3.1	4.7	4.4	3.5	4.5	4.7	5.0	3.5	1.8	4.2	5.5	1.1	4.4
Pers. Savings Rate (%)	3.6	3.8	3.6	5.3	2.3	2.8	2.7	2.7	2.6	2.6	2.5	2.7	4.1	2.6	2.6	---	---	---
Cons. Price Index (Y/Y)	2.8	1.9	1.7	1.9	1.7	1.3	1.3	1.3	1.4	2.1	2.1	2.1	2.1	1.4	1.9	1.9	1.3	2.1
Core CPI (Y/Y)	2.2	2.3	2.0	1.9	1.9	1.7	1.7	1.8	1.8	2.0	2.1	2.1	2.1	1.8	2.0	1.9	1.8	2.1
Housing Starts (mns)	0.71	0.74	0.78	0.90	0.96	0.93	1.00	1.05	1.10	1.17	1.24	1.32	0.78	0.99	1.21	---	---	---
Productivity: Real Output per hour (y/y)	0.5	0.8	1.6	0.6	0.9	0.3	-0.2	0.5	0.7	1.2	1.3	1.4	0.9	0.4	1.2	0.6	0.5	1.4

F: Forecast by TD Economics as at June 2013

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

INTEREST RATE OUTLOOK

	2012				2013				2014			
	Q1	Q2	Q3	Q4	Q1	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	0.25	0.25
3-mth T-Bill Rate (%)	0.07	0.09	0.10	0.05	0.07	0.05	0.10	0.20	0.20	0.20	0.20	0.20
2-yr Govt. Bond Yield (%)	0.33	0.33	0.23	0.25	0.25	0.25	0.30	0.40	0.45	0.60	0.70	0.90
5-yr Govt. Bond Yield (%)	1.04	0.72	0.62	0.72	0.77	0.90	1.15	1.30	1.35	1.55	1.70	1.85
10-yr Govt. Bond Yield (%)	2.23	1.67	1.65	1.78	1.87	2.00	2.30	2.45	2.50	2.75	2.90	3.00
30-yr Govt. Bond Yield (%)	3.35	2.76	2.82	2.95	3.10	3.15	3.50	3.70	3.80	4.00	4.10	4.10
10-yr-2-yr Govt. Spread (%)	1.90	1.34	1.42	1.53	1.62	1.75	2.00	2.05	2.05	2.15	2.20	2.10

f: Forecast by TD Economics as at June 2013; All forecasts are for end of period; Source: Bloomberg, TD Economics

FOREIGN EXCHANGE OUTLOOK

Currency	Exchange Rate	2012				2013				2014			
		Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Canadian dollar	CAD per USD	1.00	1.02	0.98	1.00	1.02	1.06	1.06	1.09	1.11	1.11	1.09	1.08
Japanese yen	JPY per USD	82	80	78	87	94	98	100	100	102	102	105	110
Euro	USD per EUR	1.33	1.27	1.29	1.32	1.28	1.35	1.35	1.30	1.28	1.25	1.22	1.20
U.K. pound	USD per GBP	1.60	1.57	1.61	1.63	1.52	1.59	1.59	1.55	1.52	1.49	1.49	1.46
Swiss franc	CHF per USD	0.90	0.95	0.94	0.92	0.95	0.93	0.96	1.00	1.02	1.04	1.07	1.08
Australian dollar	USD per AUD	1.04	1.02	1.04	1.04	1.04	0.96	0.97	0.96	0.95	0.94	0.92	0.91
NZ dollar	USD per NZD	0.82	0.80	0.83	0.83	0.84	0.81	0.83	0.83	0.82	0.80	0.78	0.78

f: Forecast by TD Economics as at June 2013; All forecasts are for end of period; Source: Federal Reserve, Bloomberg, TD Economics

GLOBAL ECONOMIC OUTLOOK				
Annual per cent change unless otherwise indicated				
	2011 Share*		Forecast	
Real GDP	(%)	2012	2013	2014
World	99.8	2.9	2.9	3.6
North America	23.0	2.3	2.0	2.8
United States	19.1	2.2	1.9	2.8
Canada	1.8	1.7	1.7	2.4
Mexico	2.1	4.0	3.2	3.7
European Union (EU-27)	19.9	-0.5	-0.4	1.3
Euro-zone (EU-16)	14.3	-0.5	-0.5	1.2
Germany	3.9	0.9	0.4	1.7
France	2.8	0.0	-0.1	1.0
Italy	2.3	-2.4	-1.5	0.5
United Kingdom	2.9	0.3	1.0	1.5
EU accession members	2.8	-0.8	-0.8	2.0
Asia	39.0	5.2	5.0	5.2
Japan	5.6	2.0	1.4	1.4
Asian NIC's	3.9	1.7	2.8	3.8
Hong Kong	0.4	1.5	2.9	3.7
Korea	2.0	2.1	2.9	3.7
Singapore	0.4	1.3	2.0	4.2
Taiwan	1.1	1.3	2.8	3.8
Russia	3.0	3.6	3.4	3.7
Australia & New Zealand	1.3	3.4	2.7	2.9
Developing Asia	25.1	6.7	6.4	6.6
ASEAN-4	3.3	6.3	5.4	5.3
China	14.4	7.8	7.6	7.5
India	5.7	5.1	5.0	6.2
Central/South America	8.7	2.6	3.2	3.6
Argentina	0.9	1.9	2.5	3.1
Brazil	2.9	0.9	2.5	3.1
Other Developing	9.3	2.6	2.9	3.0

*Regional wts. do not sum to 100% because some countries omitted
Forecast as at June 2013
Source: IMF, TD Economics

ECONOMIC INDICATORS FOR THE G-7 AND EUROPE			
		Forecast	
	2012	2013	2014
Real GDP (Annual per cent change)			
G-7 (38.35%)*	1.4	1.2	2.1
U.S.	2.2	1.9	2.8
Japan	2.0	1.4	1.4
EU-17	-0.5	-0.5	1.2
Germany	0.9	0.4	1.7
France	0.0	-0.1	1.0
Italy	-2.4	-1.5	0.5
United Kingdom	0.3	1.0	1.5
Canada	1.7	1.7	2.4
Consumer Price Index (Annual per cent change)			
G-7	1.9	1.2	1.7
U.S.	2.1	1.4	1.9
Japan	0.0	-0.1	0.7
EU-17	2.5	1.4	1.5
Germany	2.1	1.6	1.7
France	2.2	1.1	1.7
Italy	3.3	1.5	1.9
United Kingdom	2.8	2.7	2.1
Canada	1.5	1.2	1.7
Unemployment Rate (Per cent annual averages)			
U.S.	8.1	7.6	7.1
Japan	4.4	4.2	4.3
EU-17	11.4	11.8	11.7
Germany	5.5	5.5	5.6
France	10.2	10.9	10.9
Italy	10.7	11.9	12.2
United Kingdom	7.9	7.6	7.3
Canada	7.3	7.1	7.0

*Share of 2011 world gross domestic product (GDP)
Forecast as at June 2013
Source: National statistics agencies, TD Economics