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The Age of Uncertainty

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- **Economic uncertainty**
 - -Old debate: Great depression?
 - -New debate: Stagnation?
 - -Too big to fail
 - -Preconditions for recovery
 - -Downside risks
 - -“New Normal”
 - -Unusual sources of growth (US)
 - -Canadian structural advantage
 - -But same old economic linkage (CA)

OLD DEBATE: GREAT DEPRESSION #2?

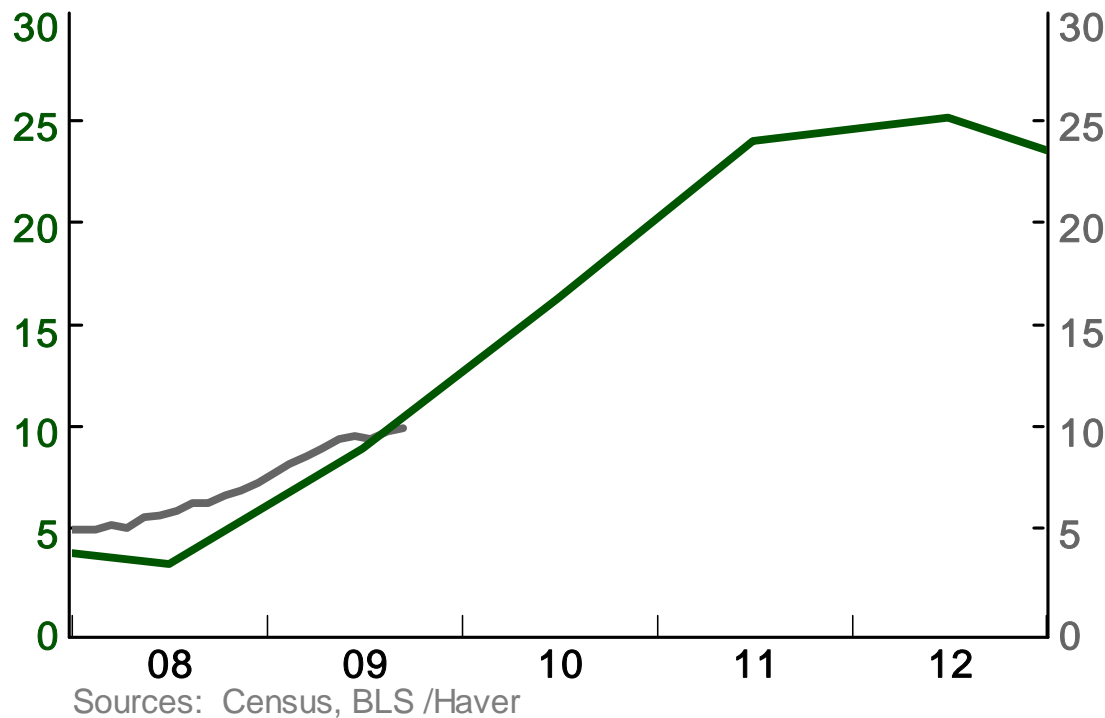


Securities

ECONOMIC UNCERTAINTY

Not Nearly as Severe This Time

Great Depression Unemployment Rate
Current Unemployment Rate



- ← It is no longer likely that the current slowdown will come even close to resembling the Great Depression.
- ← Aggressive government intervention places a cap on how bad conditions can get, and even the Fall '08 is unlikely to be revisited.

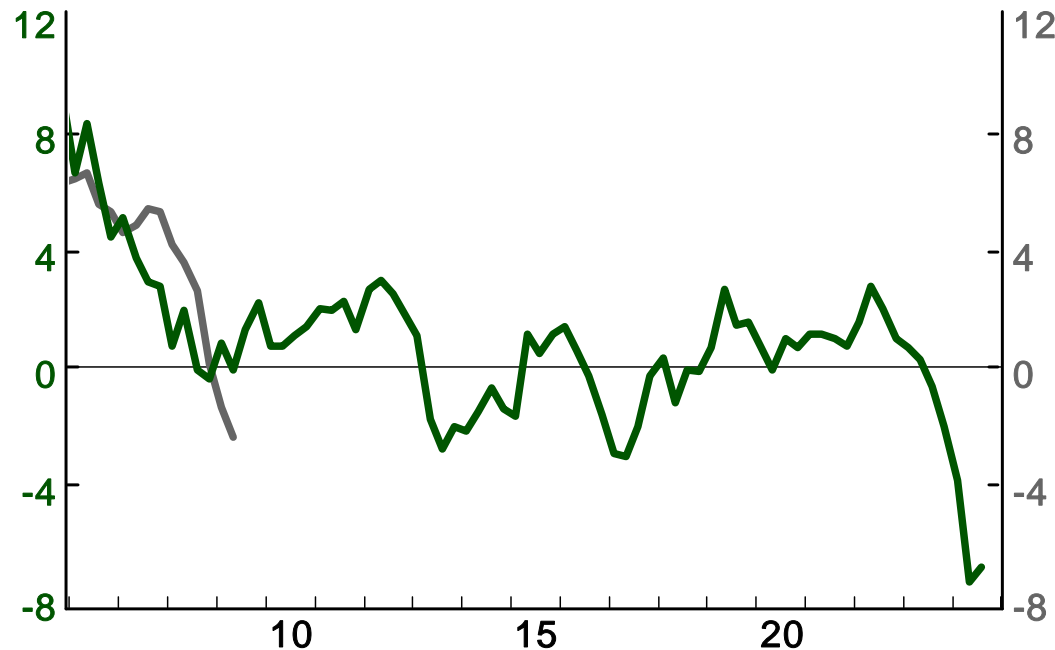
NEW DEBATE: STAGNATION ALA JAPAN?



ECONOMIC UNCERTAINTY

A Decade of Stagnation for the U.S.?

Japan: 1990-2000s Nom. GDP Y/Y
U.S. Nom. GDP Y/Y



Sources: CAO, BEA /Haver

- ← New debate is over whether recovery will be decade-long Japanese stagnation / 1937 scenario versus vigorous recovery.
- ← TD argues somewhere in the middle: economic growth is forthcoming but slack will remain until 2012-2013.
- ← Why no stagnation: lots of monetary and fiscal stimulus.
- ← Why no vigorous recovery: slack + lingering structural problems.

PRECONDITIONS FOR RECOVERY STARTING TO BE MET

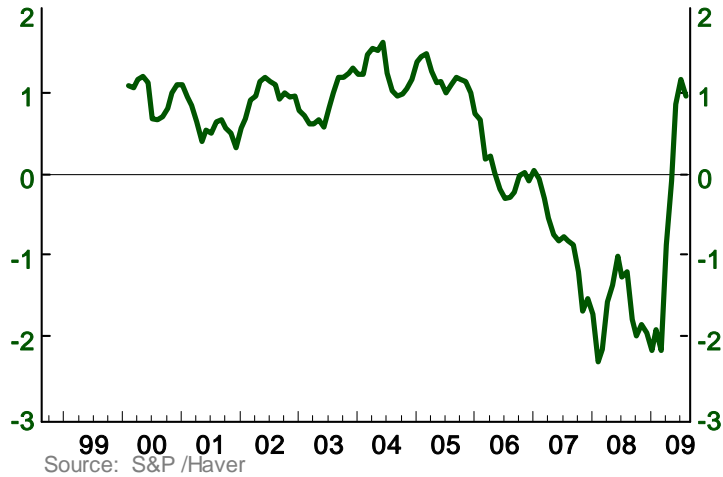


ECONOMIC UNCERTAINTY

Back in the Black

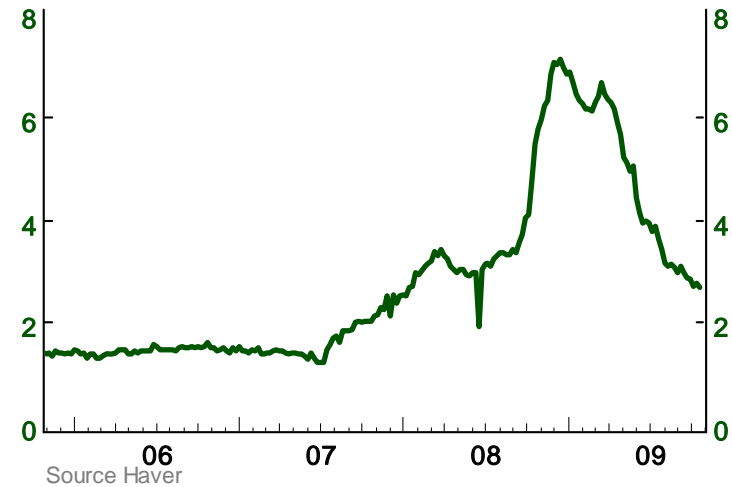
S&P/Case-Shiller Home Price Index: Composite 20

% Change - Period to Period SA, Jan-00=100



Systemic Risk is Down: No Return To Fall '08

10yr BBB-Treasury Spread (%)



Credit Standards Easing (Though Still Tight)

Approving C&I Loans ; Senior Loan Officer Survey

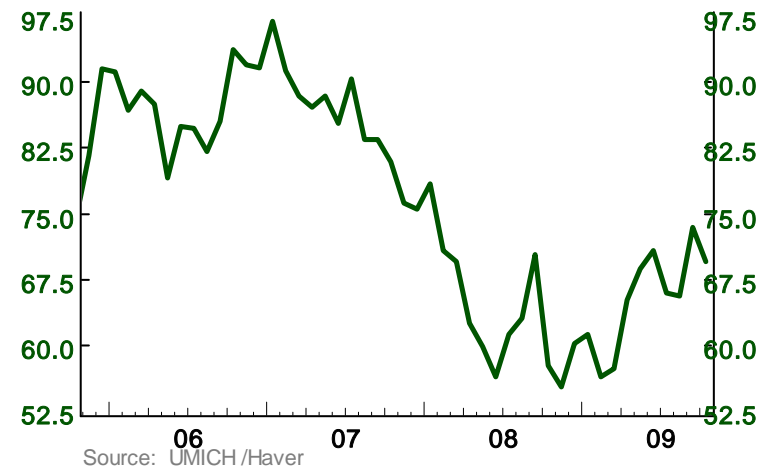
NSA, % Bal



Consumer Confidence Edging Up

University of Michigan: Consumer Sentiment

NSA, Q1-66=100



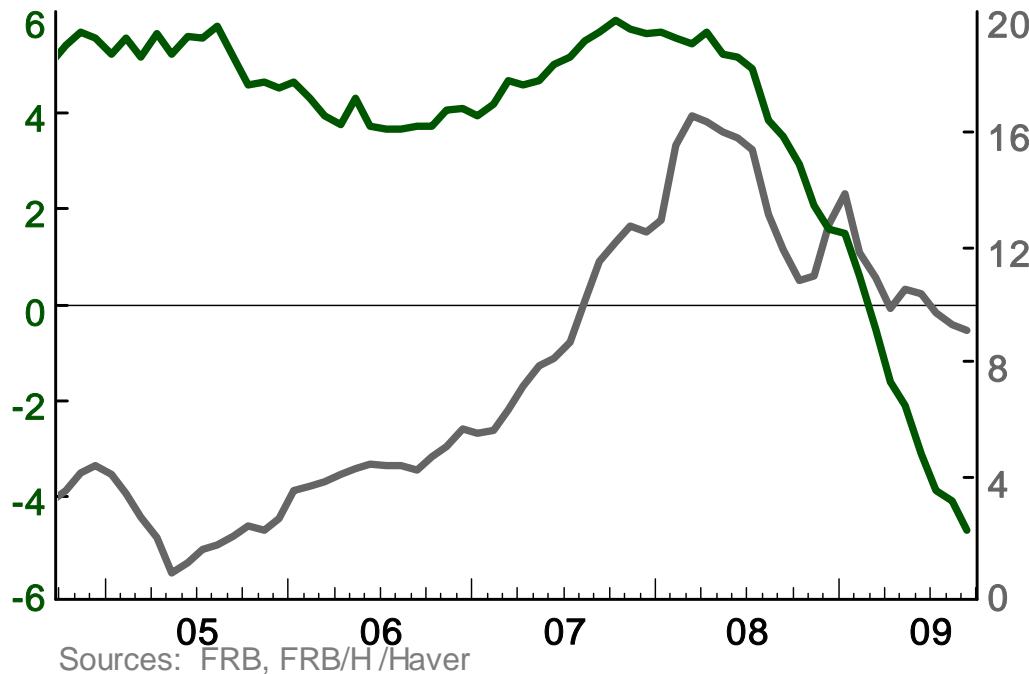
BUT: IMPEDIMENTS REMAIN



ECONOMIC UNCERTAINTY

Risks Remain

Consumer Credit Outstanding (Y/Y)
U.S. Money Supply (M2M Y/Y)



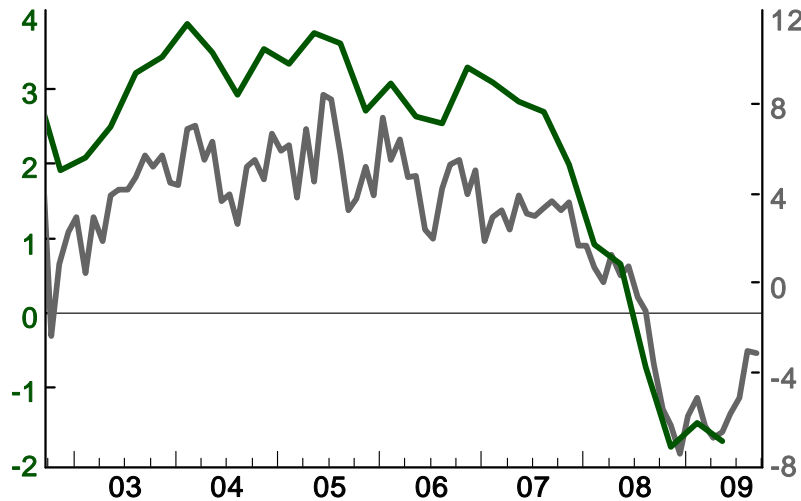
- ← US Money supply is growing significantly less quickly.
- ← This is probably due to a shift away from money market funds and as unparalleled stimulus starts to fade. But it is a risk.
- ← Consumer credit is shrinking ever-more quickly in the U.S.
- ← It is not clear what % is due to less supply versus demand, but it will limit the economic recovery.



- Economic recovery normally takes twice as long after financial crisis.
- Credit transmission mechanisms continue to be constrained.
- Productivity growth assumptions may be over-estimated due to pre-crunch excesses.
- Lack of business investment during crunch = slower prod growth later
- Employee skills erode through inaction... long recession = loss of labour quality
- Additional regulation and possibly protectionism in future
- **Bottom line: Economic slack remains until 2012, potential GDP growth ~2%**

Consumer Spending Inching Back

Real Personal Consumption Expenditures Y/Y%
Retail Sales Ex Gasoline Y/Y%



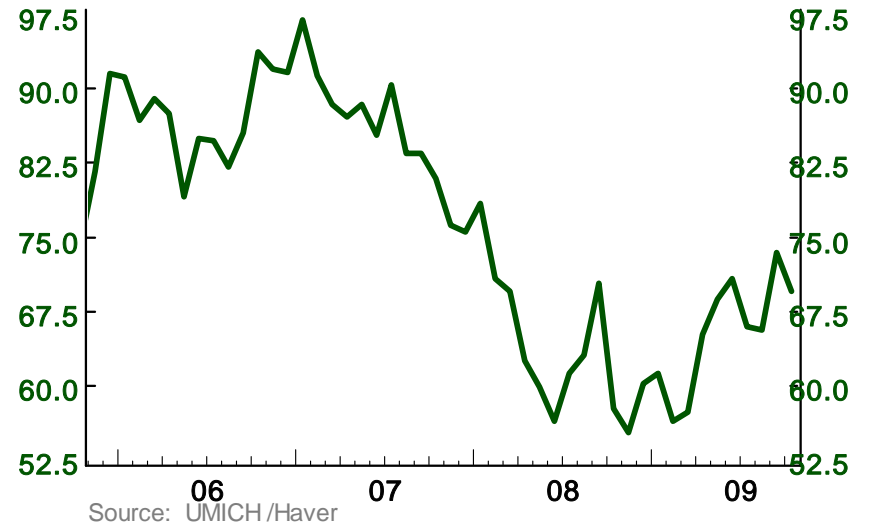
Source Haver

- Further influenced by confidence, which is edging up very slowly.
- Further influenced by debt burden, which is lightening (but could deteriorate as rates rise).
- Overall, consumer spending can begin to grow slowly, but much work to be done boosting personal savings rate and adjusting to heavy debt loads. Will not sustain recovery alone.

- ← Consumers are needed to ignite private demand. This is dependent on 3 things:
- ← 1) Wealth: has stabilized but at lower level.
- ← 2) Income: labour income quite bad, govt income good
- ← 3) Credit: improving, but still constrained.

Consumer Confidence Edging Up

University of Michigan: Consumer Sentiment
NSA, Q1-66=100



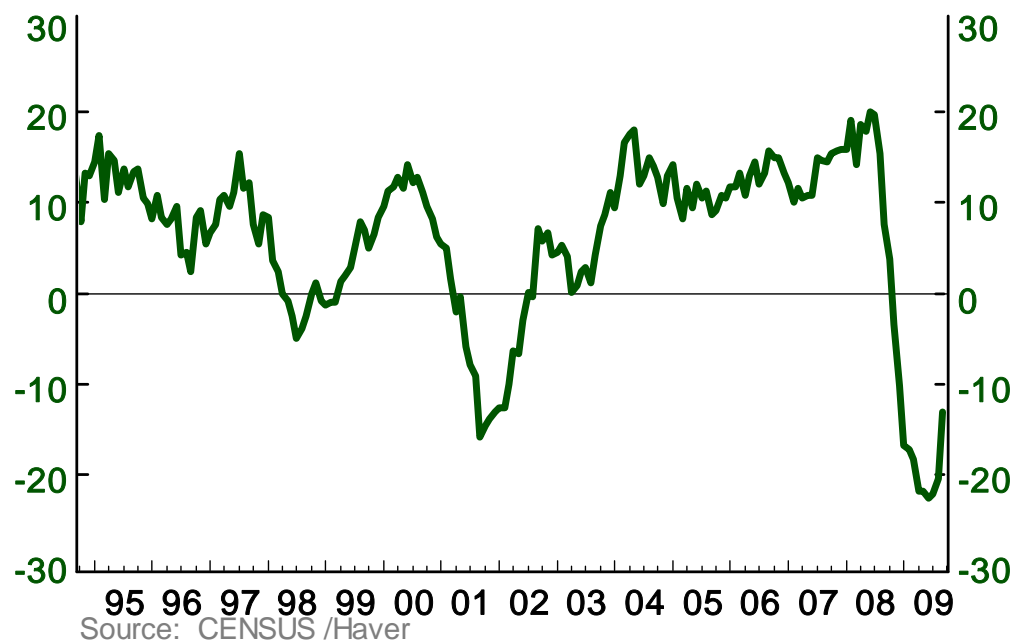
Source: UMich /Haver



Exports Need to Rebound on Weak USD

Exports: Goods and Services, BOP Basis

% Change - Year to Year SA, Mil.\$



- ← U.S. exports are not a large fraction of the economy, but they will be needed to achieve escape velocity.
- ← The U.S. is the only economy in the world that can create a virtuous circle of falling USD and rising exports, allowing for an export-driven economic recovery.
- ← The U.S. outlook is thus intimately tied to the rest of the world.

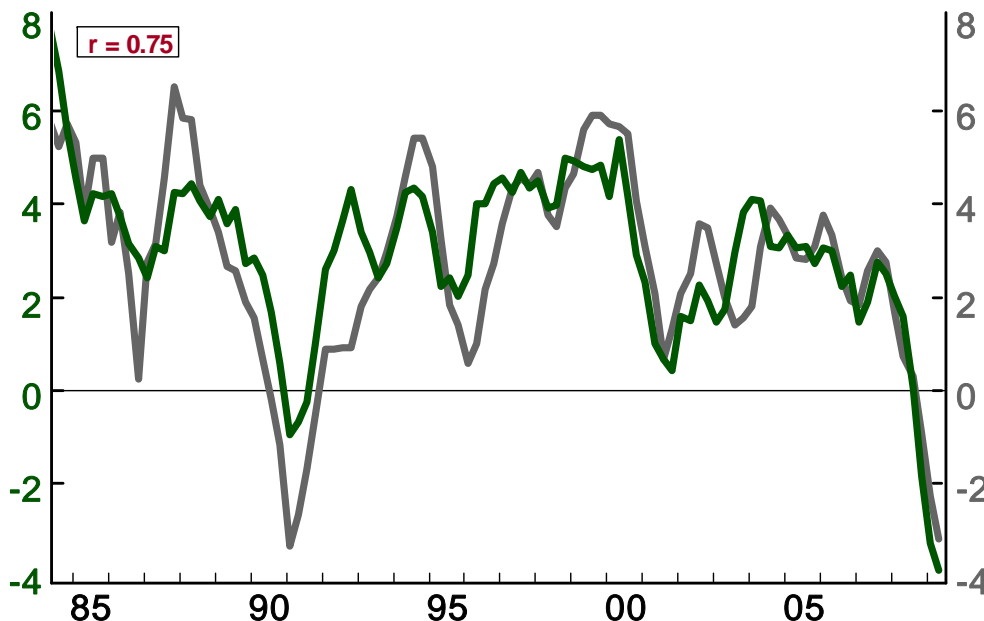


- Canada has several structural advantages:
 - Healthy banking sector
 - Healthy housing sector
 - Low government debt burden
 - Less volatile financial markets / less inclination to blow bubbles
 - Linkage to commodity prices
 - Linkage to U.S. economy
- These help CAD and Canadian assets outperform
- But they may not help the economy itself outperform



Canada and U.S. Closely Intertwined

U.S. Real GDP Y/Y%
Canada Real GDP Y/Y%

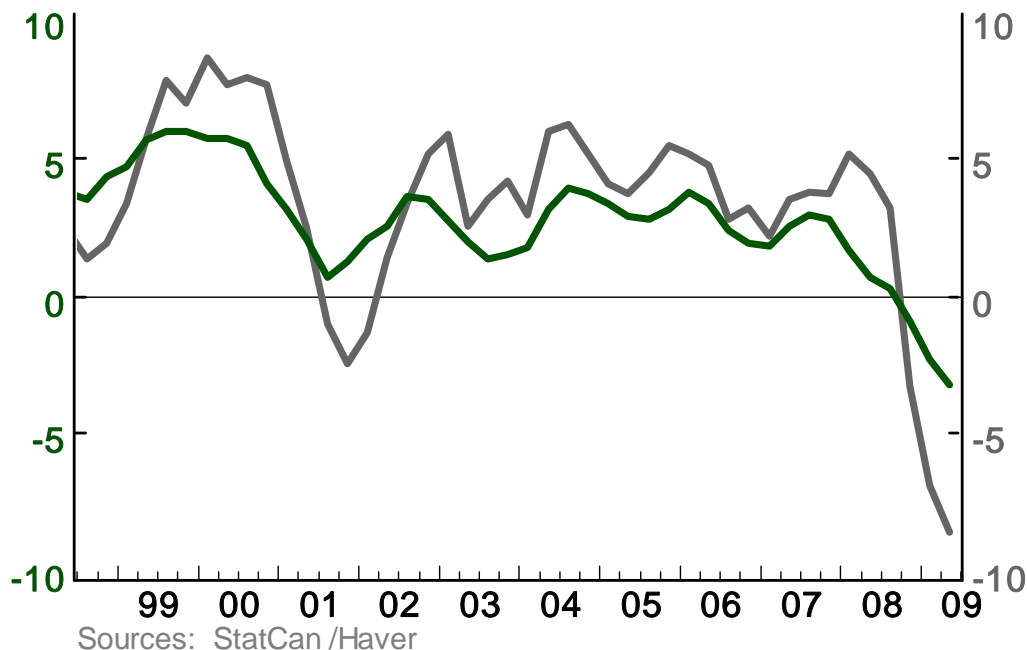


Sources: BEA, StatCan /Haver

- ← Going into the credit crunch it looked like Canada and the U.S. could decouple given a lack of serious problems in the Canadian banking and housing markets.
- ← However, this was not to be. The linkage arguably grew even tighter than normal due to three factors:
 - ← 1) trade flows
 - ← 2) financial market linkages
 - ← 3) confidence linkages
- ← USDCAD muffles whatever difference is left.

GDI To Bounce Back Sharply

Canada: Y/Y real GDP
 Canada: Y/Y real GDI

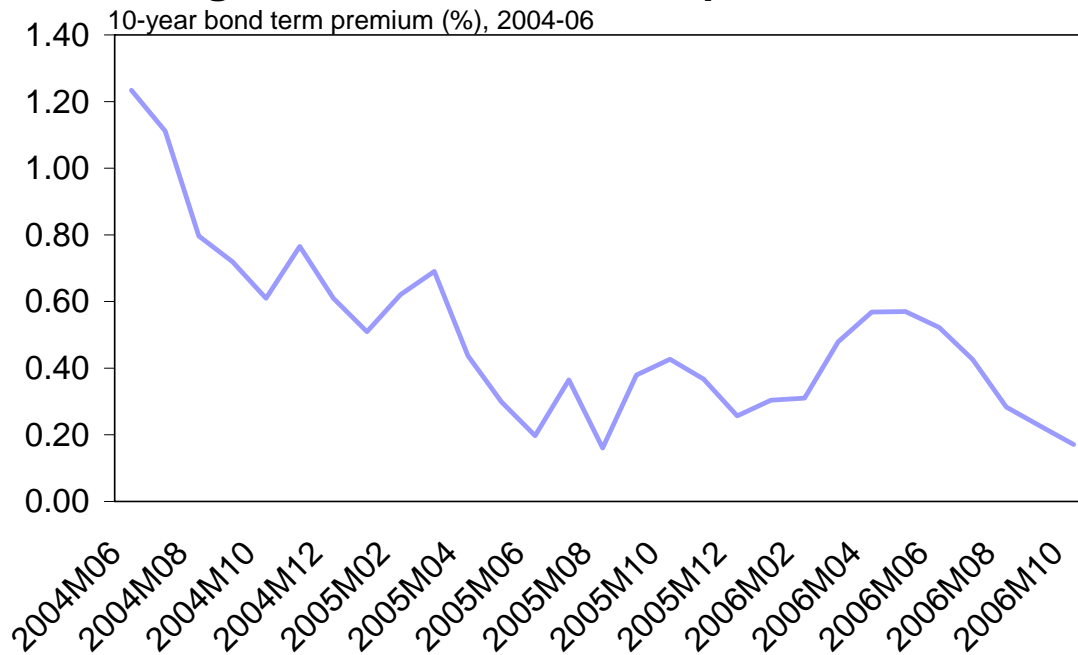


- ← Because of Canada's strong Terms of Trade effects, Gross Domestic Income (GDI) is arguably a superior measure of economic health compared to GDP.
- ← GDI was far stronger than GDP during the good years.
- ← It was then much, much weaker during the worst of the recession.
- ← It will probably emerge somewhat stronger once again than GDP, and this aids in the outlook for Canada, and offsets CAD strength woes.
- ← Lower productivity in Canada also (perversely) lends a favorable interpretation to Cdn GDP given smaller negative output gap.



- **Central Bank uncertainty**
 - -Less transparency
 - -Inflation risks
 - -Mandate
 - -Leaning into asset bubbles
 - -Reflating balance sheets
 - -Political interference
 - -Rule-based monetary policy
 - -Exit Strategy
 - -Sequence of central banks

Declining Term Premium Accompanied Fed Hikes



Source: U.S. Federal Reserve

- ← Central banks have learned to care about the term premium.
- ← In 1994, central banks gave little information to markets and the term premium became too high.
- ← In 2004-06, central banks overcompensated with excessive transparency, resulting in a tiny term premium, forcing investors to seek ever-more risk.
- ← This time, central banks will likely shift from transparency to translucency, and ensure that the term premium does not grow too small.

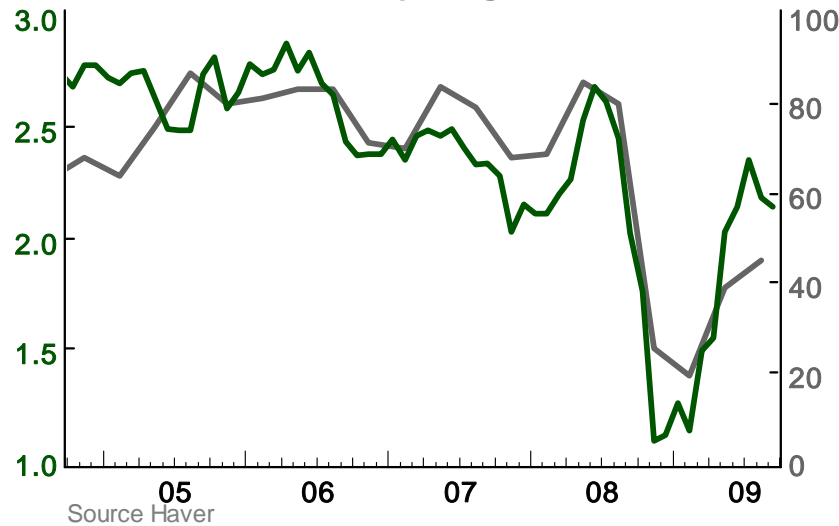
INFLATION IN THE FUTURE



CENTRAL BANK UNCERTAINTY

Cdn Inflation Expectations Rising

Market Inflation Expectations (Breakevens)
Bus Outlook Surv: % expecting CPI >2%

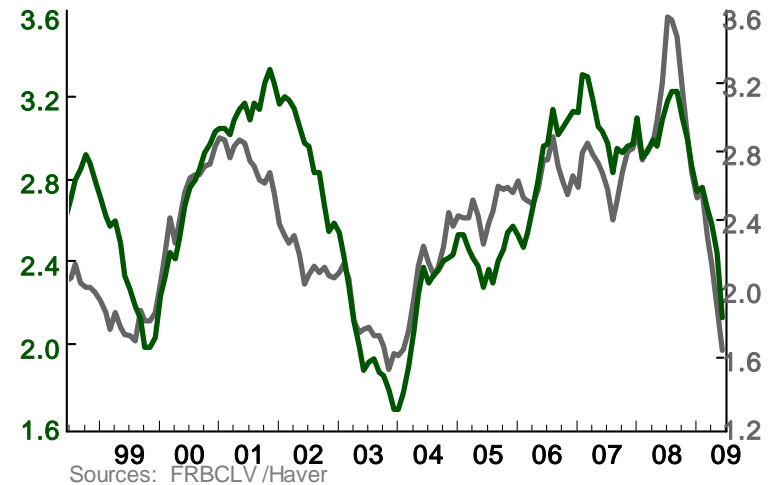


- ← Canadian and U.S. breakevens narrowed to unprecedented lows and have since bounced sharply back.
- ← But on an absolute basis, inflation expectations are still relatively modest, and lower than pre-crunch. This may be skewed by excess demand for TIPS/RRB

- Alternate inflation measures are falling even more quickly than traditional measures. This is true for both CA and US.
- With an economy in recession, core CPI should be closer to 1% than 2%.

Alternate Measures Edging Down

Cleveland Median CPI Y/Y%
Cleveland Trimmed-Mean CPI Y/Y%





-Central Bank Mandates

-Leaning into Asset Bubbles

- Carney comments at Jackson Hole
- International comments by others
- Canadian housing

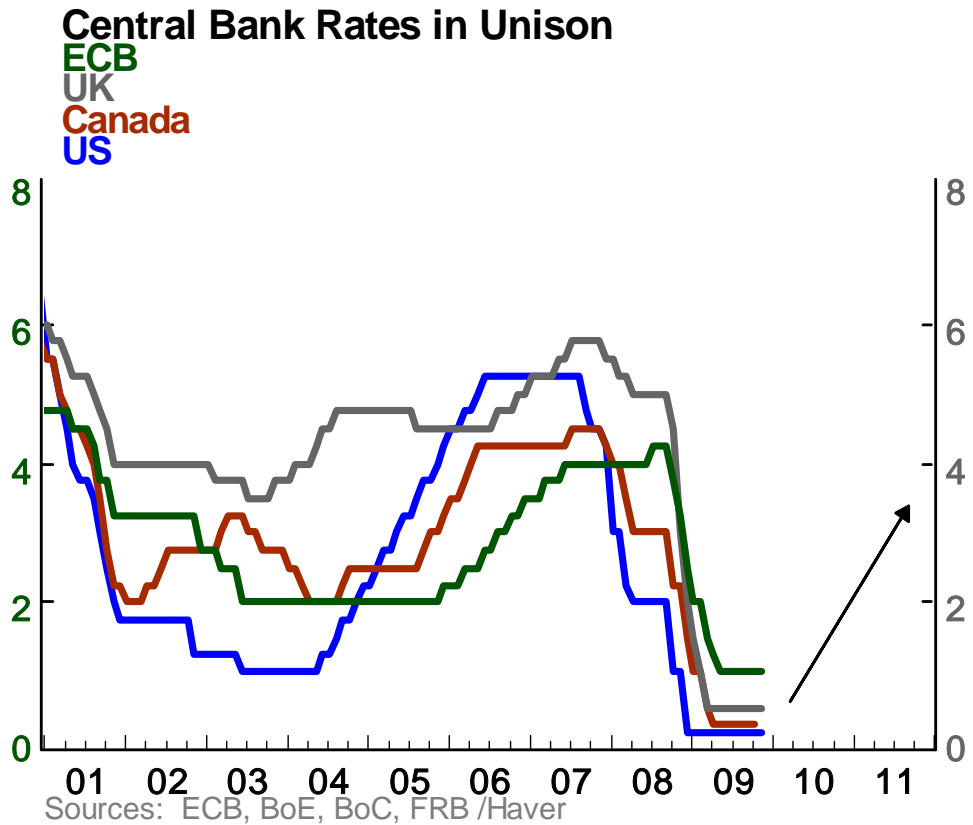
-Reflating Balance Sheets

- higher asset prices = good for recovery?

-Political interference

-Rule-based monetary policy

-Exit Strategies



- All central banks cut in approximate unison.
- Rate hiking will occur in a similar timeframe, also.
- Exceptions: Australia, Norway.
- Risk: Coordinated hiking to stymie FX market?



■ **Financial Market Implications**

- Volatility
- FX
- Bonds
- Equities
- Commodities

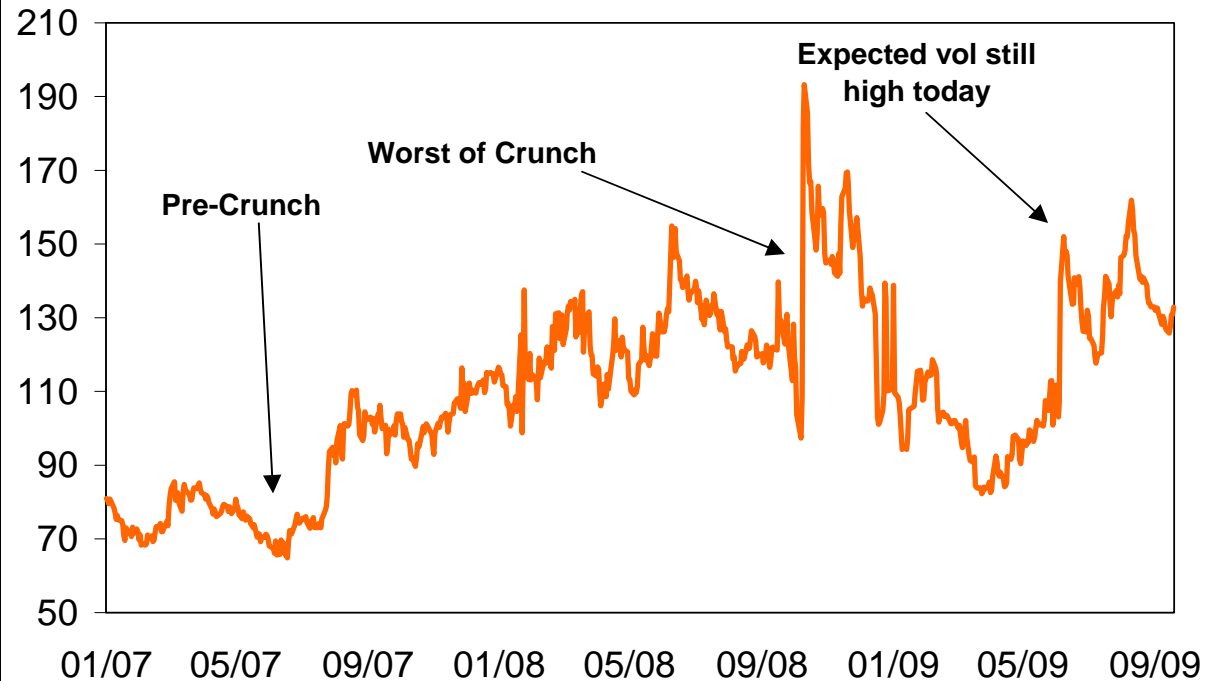
...BUT BOND VOL IS STILL SOMEWHAT ELEVATED



FIN MKT IMPLICATIONS

- Although the VIX and other forms of anticipated equity volatility are down, bond market volatility remains stubbornly fairly high.
- This makes some sense based on c.b. uncertainty, inflation uncertainty, and bond supply uncertainty.
- It also suggests that one must still be careful in pursuing risk trades despite diminished leverage.

Expected Bond Market Volatility



Note: U.S. 1yr1yr swaption vol. Source: Bloomberg

USD WEAK



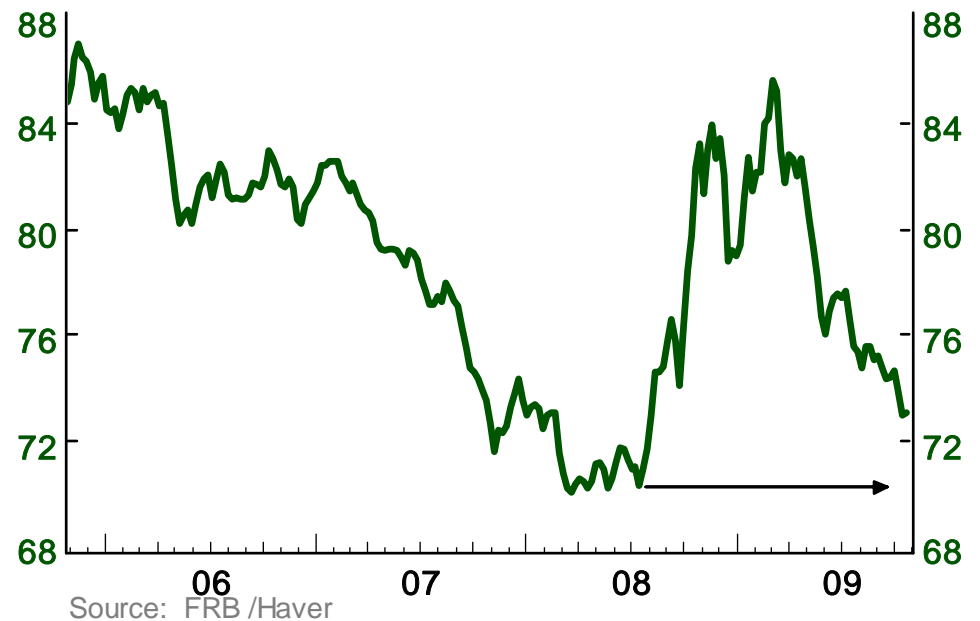
FIN MKT IMPLICATIONS

- **U.S. Dollar:**
- U.S. dollar weakness is likely to persist due to three key factors:
 - 1) slightly higher commodity prices
 - 2) ongoing decline in risk aversion
 - 3) subtle shift away from USD reserves
 - 4) bond supply concerns
- USD still stronger than Sept 2008, so safe-haven bid has yet to be fully unwound, let alone bond supply concerns.
- U.S. economy will build recovery on exports.
- Risk of disorderly unwind?

USD Still Has Safe Haven Bid

Trade-Weighted USD (Major Currency)

Avg, 3/73=100



CAD STRONG

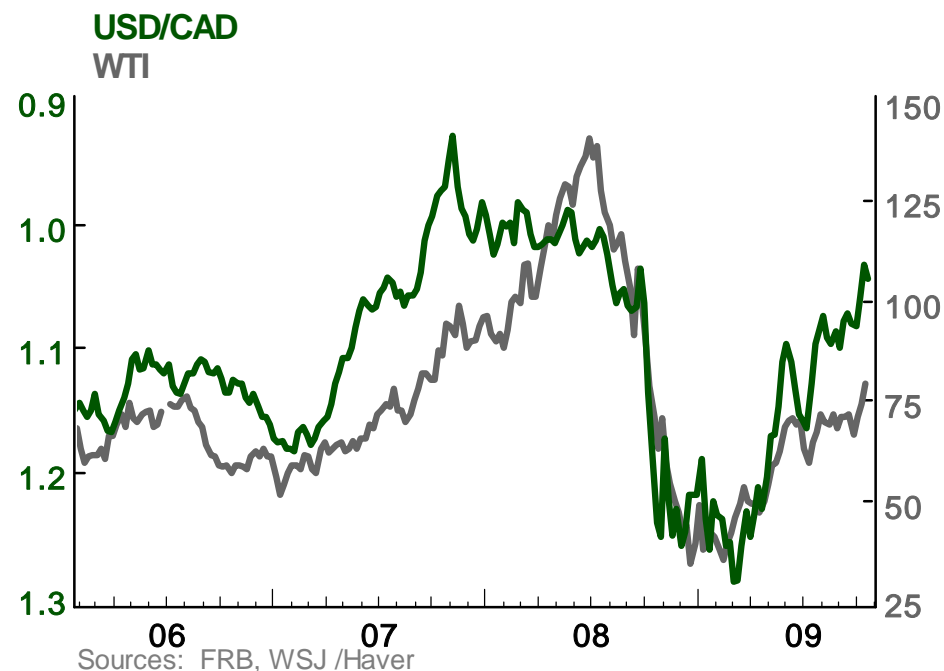


Securities

FIN MKT IMPLICATIONS

- Canadian dollar can rise further for several reasons:
 - 1) strong commodity prices
 - 2) USD softness / safe haven unwind
 - 3) Canadian structural strength
 - 4) Shift in intl reserve assets to CA
- Parity (and slightly beyond) remains a viable target in the coming months, though not a sustainable one.
- PPP in Canada is more like 1.20, but CAD should generally be stronger even over long term due to demand-supply issues with commodities and US imbalances.
- BoC unlikely to intervene, but will continue to revise econ fcst down as CAD proves damaging.

CAD Moving on More Than Just Oil



- Challenge with CAD is that it matters more than most currencies from an economics perspective.

Bonds

- -Higher yields
- -Flatter curves (though steeper than historical)
- -Narrower credit spreads

Equities

- -No need to fall, but limited room to rise

Commodities

- -General upward trend
- -Natural gas – Oil split persists
- -Gold may be too far
 - -Risk aversion
 - -Inflation expectations
 - -USD
- Generally more moderate behavior



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