



# TD Economics

## TD Quarterly Economic Forecast

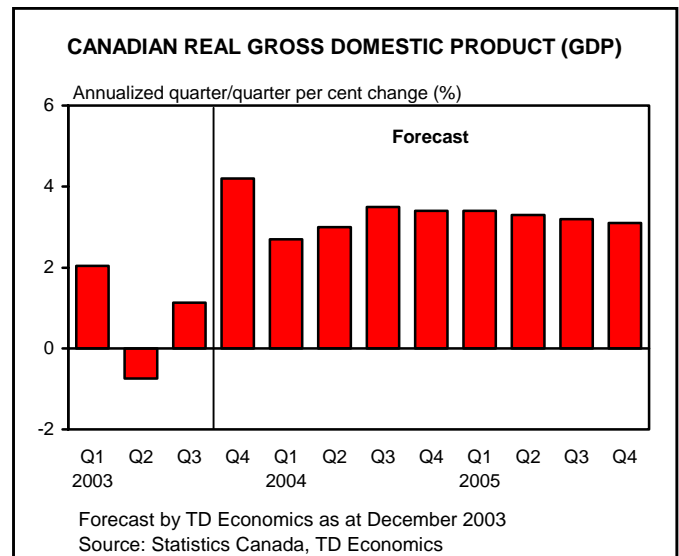
December 16, 2003

### DOWN BUT NOT OUT

## Stronger loonie will continue to weigh on economy – but a disaster it is not

The Canadian economy has certainly received its share of bumps and bruises since the beginning of the year – but in spite of all the talk of doom and gloom, it has managed to weather the onslaught remarkably well. With the fall-out from SARS, the restriction on beef exports triggered by a lone mad cow, the forest fires in B.C., and the power outage in Ontario, the Canadian economy has gone through a number of trials and tribulations – and the effect on growth has been significant. But, the most important shock of them all is without doubt the sharp appreciation of the Canadian dollar. The impact of the other shocks and calamities is behind us. The full effect of the rise in the currency is not. And, although the Canadian economy is still standing on its own two feet, the ongoing impact of the currency on economic growth remains a wild card.

The loonie's rise will inevitably continue to dampen growth, and especially so in the first half of 2004. But, there is no disaster in the making for the Canadian economy. There are important offsets to the loonie's rise, not the least of which is the strong rebound in U.S. growth.



As a result, we are expecting growth slightly above the economy's long-term trend of about 3 per cent for the better part of 2004. However, growth would likely have been at 4 per cent or more had it not been for the adjustment to the sudden strengthening of the loonie.

The impact of the loonie's rise on the outlook goes beyond the real growth story. Given Bank of Canada Governor David Dodge's recent musings, we are now expecting another 50 basis points of rate cuts – 25 at each of the Bank's next two Fixed Announcement Dates in January and March. Although further rate cuts did not appear to be on the radar screen at the time of the release of its *Monetary Policy Report* (MPR) in October, the Bank is now indicating that unless economic growth comes in "solidly" above potential – that is, at annualized quarterly rates of

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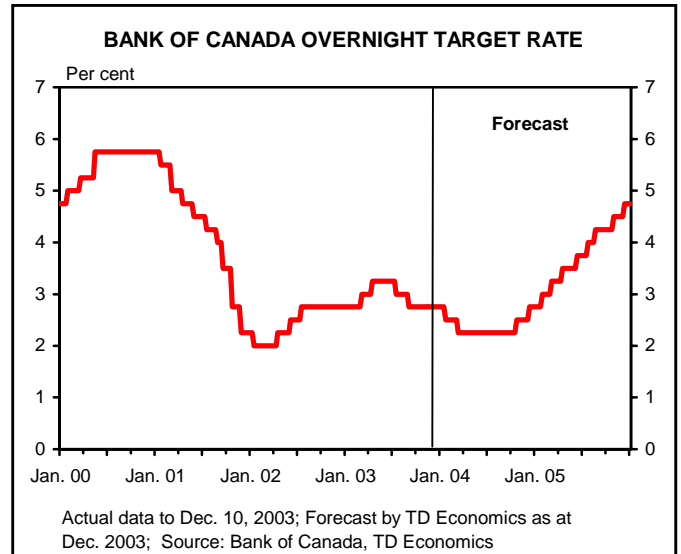
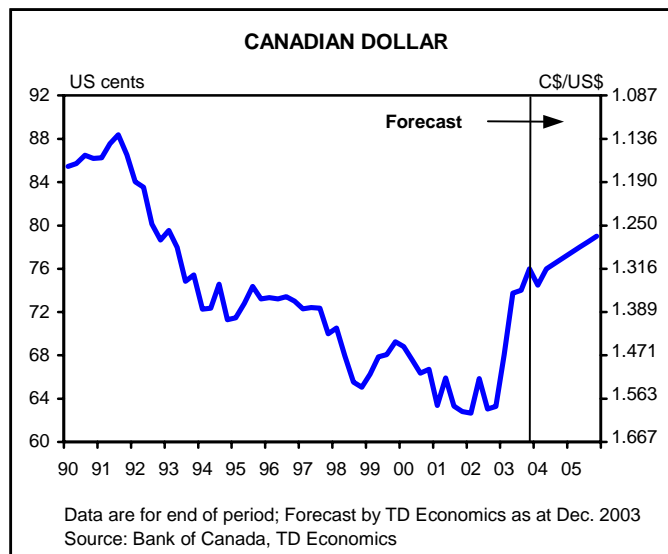
close to 4 per cent – further rate cuts will be in store.

So what is it that has changed since the MPR? The answer lies in the fact that the amount of excess slack in the economy – as measured by the output gap – is now wider than the Bank had expected. This is partly due to the fact that the third-quarter GDP growth tally of 1.1 per cent came in below the Bank's expectation of about 2.5 per cent. And, it is also partly due to the fact that GDP growth was substantially revised for the first two quarters of the year, with growth for the first quarter revised down by an annualized 0.7 percentage points, and the second quarter by an annualized 0.4 percentage points. As a result, the output gap is now 0.6 per cent wider than the Bank was expecting at the time of the release of the MPR. The Bank may have been able to live with growth rates slightly above potential at that time. Now, it will need to see Canada's economic performance come in significantly better than that to close the output gap in 2005.

### Loonie tunes

Although the Canadian economy is likely to hold up well over the course of next year, we do not expect growth to be "solidly" above 3 per cent. We expect growth to be "a bit" above 3 per cent on a fourth-quarter-over-fourth quarter basis. That should be interpreted as a positive outcome in the face of the adjustment in the economy to the flight of the loonie. One could easily imagine a worse scenario. But it is not quite good enough to close the output gap by the end of next year, and that is where the Bank of Canada is coming from.

The key issue in the outlook is the impact that the



loonie's gains will have on economic growth. For one, it is clear that the appreciation in the Canadian dollar has already had a significant impact on the Canadian economy. Exports have now fallen for four consecutive quarters – the longest string of declines on record (from 1961 onwards). As a result, the decline in exports alone has shaved two full percentage points off GDP growth over the past year. While that also reflects the struggles of the U.S. economy in late 2002 and early 2003, there is no doubt that the loonie's sharp rise played a big role in that weakness. Add to that the sharp drop in inventories recorded in the third quarter of the year – which has partly a side-effect of the power outage in Ontario – and GDP was only 1.0 per cent higher in the third quarter than it was a year earlier. In contrast, final domestic demand – the sum of consumer spending, business investment and government outlays – grew at a healthy 4.2 per cent pace during the same period.

Similarly – and not surprisingly – the heavily-export-oriented manufacturing sector has been battered, but the mainly domestically-oriented service sector of the economy has been plowing ahead. Manufacturing output has actually declined by 3.0 per cent on an annualized basis since the beginning of the year. However, that has been offset by ongoing gains in the service sector of the economy, which has expanded by 3.4 per cent. And, the housing market has been booming. The same picture is true on the job front, with the manufacturing sector losing jobs on balance this year, and the domestically-oriented service-sector industries holding their own. In other words, there has been very little spillover from the export-ori-

ented sector to the domestic economy.

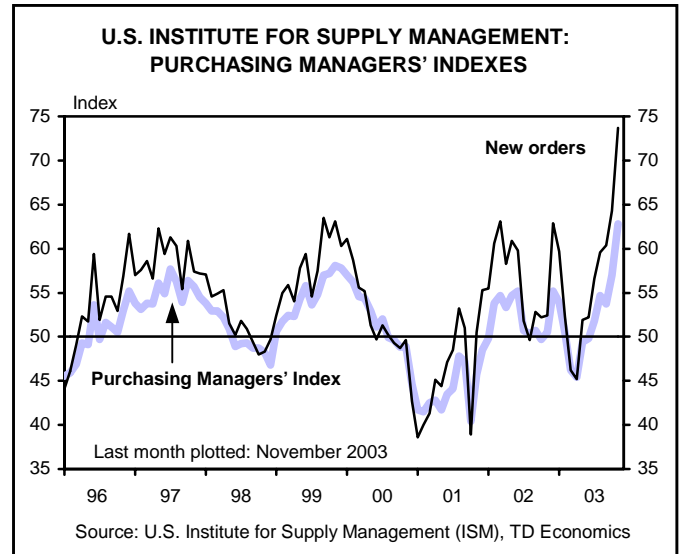
The bottom line: Had it not been for the drag from the export sector, Canada's growth performance would at least have been respectable over the past four quarters. Add back the impact of the other shocks, and it would have been quite simply buoyant.

### It's for real down south

The real issue is the extent to which the loonie's flight will continue to weigh on exports, and spill over to Canada's manufacturing industries. And, that much remains a huge question mark, with which the Bank of Canada is struggling as well. To be sure, traditional economic models would have predicted a much more dire outcome than the one that has been unfolding. And, that has not occurred – in large part because there have been positive offsets to the negative impact of the loonie's flight. But at the same time, Canada's economy appears much more resilient than it has been in the past.

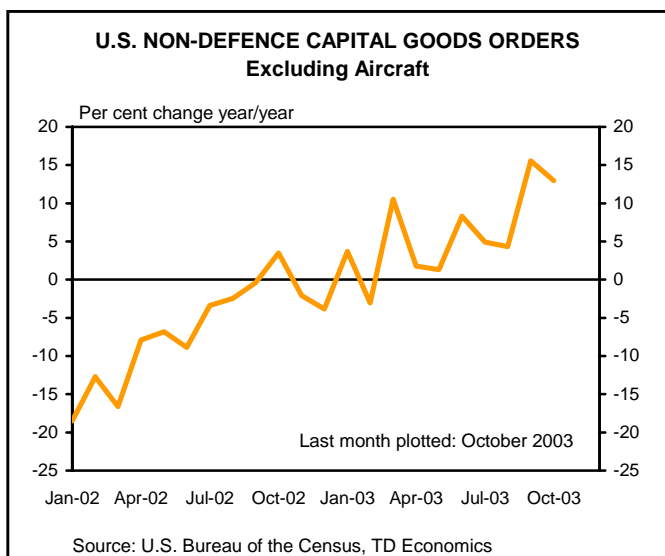
So how might the picture unfold over the next few quarters? Inevitably, the stronger dollar will continue to weigh on Canada's export sector – and the currency is still expected to gain ground in 2004, albeit at a much more gradual pace. Manufacturing will continue to struggle. At the same time, however, there is good reason to expect the economy to hold its own, and most service-sector industries will continue to benefit from fairly resilient domestic spending.

The first big offset to the drag from the stronger Canadian dollar lies in the fact that it really does look as if the U.S. recovery is for real this time around. The U.S.



economy grew at a stunning 8.2 per cent annualized rate in the third quarter of 2003, and is squarely on track for growth of more than 4 per cent in the fourth quarter as well. Although tax cuts and rebates were responsible for a big share of the third-quarter growth spurt, the fiscal kick – which will be only temporary – was not the whole story. The real piece of good news is that U.S. business investment grew for a second consecutive quarter in the July-September period. The key to a sustained rebound in the U.S. economy is not consumer spending – consumers never let go in the first place. It is business investment. And, it really does appear as if the recovery in business spending is for real – this is not just a short-lived pop. In fact, all of the ingredients for a rebound in the business sector of the economy have fallen into place.

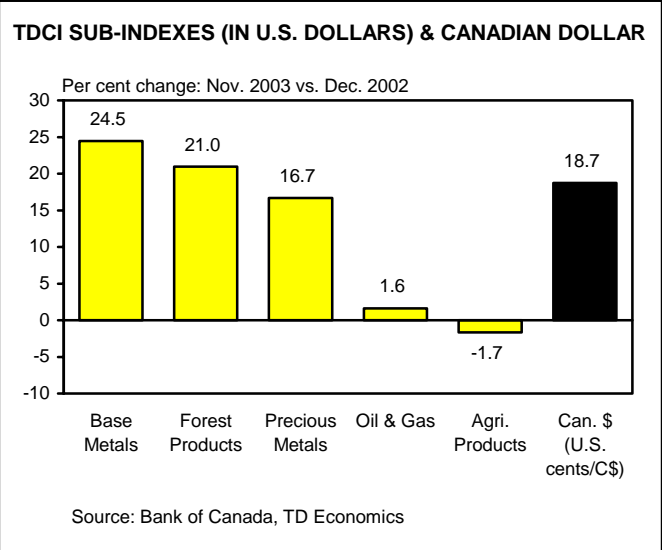
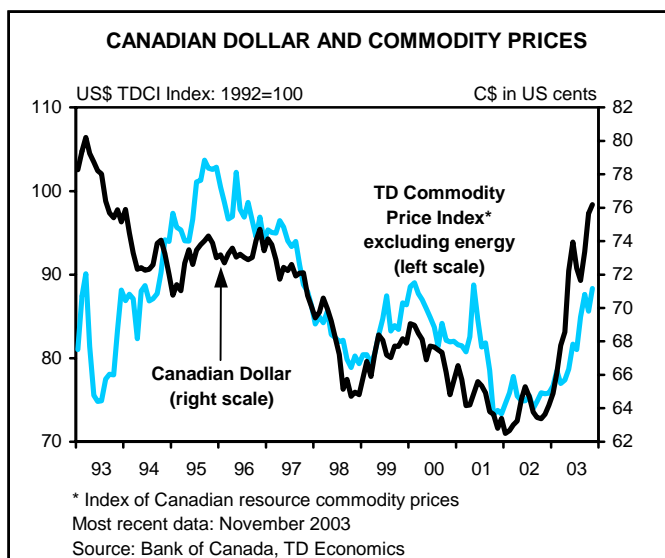
- Financial conditions are extremely accommodative, which has never failed to jump-start the economy in the past. With the Fed Funds rate at a mere 1.0 per cent, the Fed's monetary policy settings are adding a huge dose of fuel to the economy. Bond yields are still well below neutral levels. Corporate bond spreads are shrinking. Equity prices have recovered. And, last but not least, the U.S. dollar, which has been the source of so much angst for the manufacturing sector, has lost more than 20 per cent of its value.
- Corporate profits are back with a vengeance. Profits have grown at a stunning average annualized pace of more than 35 per cent in the first three quarters of this year. Moreover, the pricing power of U.S. companies has slowly been improving, while unit



labour costs have continued to tumble, thanks to ongoing productivity gains.

- The balance sheet ratios of U.S. corporations have been improving, thanks in part to rising equity values and improved cash flow.
- Recent high-frequency indicators also point to a recovery in business spending. Orders of non-defence capital goods excluding aircraft – a reliable leading indicator of business investment – are running at a double-digit year-over-year rate, compared to outright declines in the opening months of this year. The ISM index of manufacturing activity is at its highest level in 20 years, while the forward-looking new orders component is at its second highest level ever.

Moreover, employment has started to grow again, although admittedly, the pace of job growth remains unimpressive. Still, with the business sector of the U.S. economy turning, it is only a matter of time – and a short one at that – before the pace of employment growth accelerates. Given the pace of demand growth, U.S. businesses can only squeeze so much out of the existing workforce without hiring more workers. The recent surge in temporary help and the declining trend in jobless claims also points to a continued improvement in labour market conditions. And, with stronger job growth in store, wages still growing at a respectable clip of about 2.5 per cent, and another round of tax refunds slated for January 2004, the odds that consumers will let go are remote. Put it all together, and a strong tow from the U.S. appears to be in the bag.



### Other offsets to the impact of the loonie's flight

There are also a number of other offsets that will help to alleviate the drag from the stronger loonie. First and foremost, a stronger dollar not only increases the U.S. dollar price of Canadian exports, but also lowers the Canadian dollar price of imports from the U.S. In other words, it makes imported goods more affordable. Not only does this benefit consumers to the extent that the lower prices are passed through, but it provides a direct offset on the cost side of the ledger for those businesses that purchase a lot of imported materials in their production runs. Of note, the lion's share of business purchases of machinery and equipment is imported. Moreover, the import content of Canadian exports – that is the share of imported goods used in the production of Canada's exports – has risen substantially during the 1990s. By the end of the decade, imported goods made up about one-third of the content of Canada's exports, compared to about one-quarter in the late 1980s.

In addition, not every sector will be affected to the same extent. For example, among manufacturing industries, the auto sector is the most heavily export-oriented on a gross basis. But, once we net out the import content, autos are pushed down a few rungs – not surprising given the huge amount of two-way trade in that sector – while forest products take over the top spot.

Second – and just as important – commodity prices have risen by more than 16 per cent during the course of the year (based on the TD U.S. dollar commodity price index). For commodity producers in many sectors, such as base metals and forest products, the gains in commod-

ity prices have produced complete offsets to the appreciation in the value of the currency. In others, the offset has been only partial. But in any event, most commodity producers have not felt anything close to the impact on Canadian dollar prices – and therefore on revenues – that would have been implied by the currency's gains.

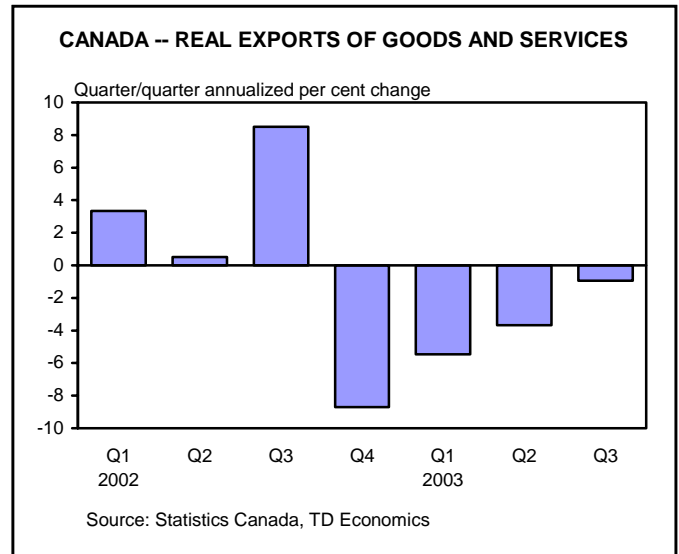
There are other less obvious offsets as well, although most of the evidence is anecdotal, and therefore, impossible to quantify. For example, many firms hedge their foreign exchange exposure, which protects them against unexpected movements in the currency. In addition, it seems that very few companies had been banking on a 63 U.S. cent loonie in the first place. Business plans were drawn up on the basis of a somewhat stronger currency – something closer to 68 or 69 U.S. cents. Therefore, part of the shock from the currency's gains has not been a shock at all.

Even past history has to be put into context. The Canadian dollar appreciations of the early 1980s and early 1990s occurred against a backdrop of rising – and sky-high – interest rates. The economy was not benefiting from the same low interest-rate environment that it is now – and consequently, was more vulnerable.

And, finally, it is important to recall that while the adjustment is a problem, the level itself is not – we have been there many times over the past two decades. Moreover, once we take relative price levels into consideration, the real exchange rate – a more accurate measure of competitiveness – is still lower than it was at any time over the 1980s and 1990s except for the period from 1997 onwards.

### Businesses still getting pinched

None of this changes the fact that Canadian companies will no longer be benefiting from the massive competitive boost that a mega-weak currency can provide. Canada's export competitiveness will obviously be affected down the road, no matter how much companies hedge or how they plan. The need to adjust from a 63 cent dollar to the reality of a 76 cent loonie over such a short period of time does imply a cost. And, that will obviously weigh on economic growth over the next few quarters. Moreover, the housing and auto sectors – two of Canada's traditional export markets – will be among the weakest in the U.S. over the next year. Finally, the currency's appreciation has not yet run its course – we expect it to strengthen further over the forecast period. The good news, however, is that the appreciation will be much more muted than what



we have seen thus far, with the Bank of Canada poised to cut interest rates, and the Fed likely to start raising rates during the summer months. As a result, we expect the loonie to end 2004 at 77 U.S. cents – only slightly above its current level. In contrast to this year's surge in the exchange rate, the more gradual pace of appreciation in 2004 will leave firms with much more wiggle room to adjust.

### Modest growth in store – but there are risks

The bottom line is that the Canadian economy will not experience the same growth spurt that will be occurring in the U.S. over the next few quarters. In fact, the Canadian economy will be significantly underperforming its U.S. counterpart, especially in the first half of 2004. However, that does not mean that Canadian growth will be weak – and certainly, the second half of next year should be stronger than the first, as the impact of the loonie's flight dissipates. All told, while we are not expecting a great year for the Canadian economy, we are not looking for a bleak one either. From the Bank of Canada's standpoint, growth will be strong enough to take a bit of a bite out of the output gap before the end of the year, but will not come close to eliminating it. And, a downshift to that sort of outlook is all the Bank of Canada will need to nudge rates lower.

There are, however, significant risks to the forecast, the bulk of which are related to one factor – the exchange rate and its impact on the economy. Although we have seen a 20 per cent appreciation in the Canadian dollar before, we have never seen it occur over such a short period of time. The fact that we are quite simply in uncharted

territory makes the forecast subject to a greater degree of uncertainty than would normally be the case. Second, we do not really have a firm grip on where the Canadian dollar is headed from here on – which explains why there is now such a broad array of forecasts for the loonie's value over the next 12 months.

Based on the traditional historical impact of currency appreciations, we should already be seeing more of an impact from the stronger dollar. The fact that we are not has led us to put more weight on the offsets than would otherwise have been the case. However, it could well be that the dollar's appreciation will bite with more of a lag this time around – and that the brunt of the fallout from the appreciation will hit more forcefully over the next few quarters. In that case, the outcome would be weaker than we are anticipating.

But, there are upside risks as well. The economy seems to have been holding up remarkably well in recent months, and it could well be that the combined impact of low interest rates, rising commodity prices, strong U.S. growth

and lower prices for imported inputs is playing a larger role than we have factored in. In turn, that would imply a stronger growth profile for 2004.

Finally, the Canadian dollar's future path is a huge question mark. Nobody – absolutely nobody – forecast the move that we have seen since the beginning of the year. One has to acknowledge that *any* currency forecast is *always* subject to a high degree of uncertainty. Rate cuts from the Bank of Canada and investor enthusiasm surrounding the rebound in U.S. growth could certainly clip the loonie's wings. At the same time, however, the currency could still receive a significant push higher as mounting U.S. fiscal and current account deficits cause investors to sour on the U.S. dollar. In this case, it would not take much to push the loonie above 80 U.S. cents.

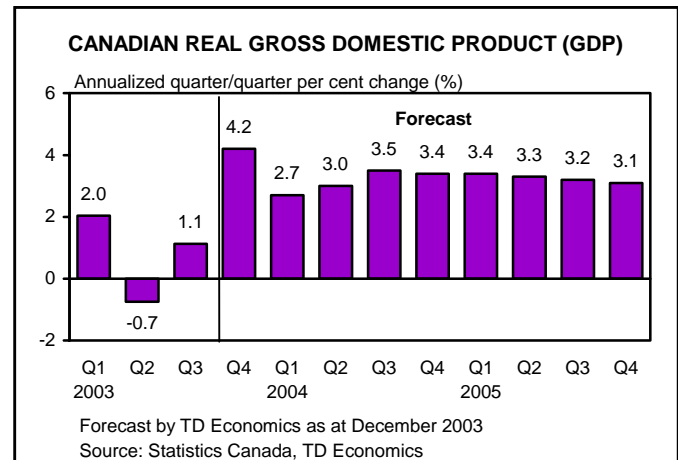
The bottom line? There may be more uncertainty than usual surrounding the outlook, but we feel that the risks to our forecast are equally balanced on both sides.

*Don Drummond 416-982-2556*  
*Marc Lévesque 416-982-2557*

# CANADA'S ECONOMIC OUTLOOK

The Canadian economy grew at a meagre 1.1 per cent annualized rate in the third quarter, in line with our forecast, but certainly well below what could be characterized as healthy growth. However, while the raw number was weak, there are a number of reasons why the third quarter should not be viewed solely in a negative light. In fact, given the various hurdles that were successfully surmounted, the Canadian economy still appears fairly robust, and as a result, prospects going forward are all the brighter.

First, it is reassuring that the Ontario blackout, British Columbia forest fires, and mad cow disease were unable to bully the economy into negative territory despite shaving more than 1.5 percentage points off GDP growth. Had



it not been for these shocks, the economy would easily have charted a gain of close to 3 per cent. Moreover, while the appreciation of the Canadian dollar continued to drag down exports, the 0.9 per cent decline was not as severe as one could have expected. Close to a year into the loonie's appreciation and still no economic doomsday.

And finally, both consumer and business spending growth were exceptionally robust in the third quarter, at 5.1 and 13.2 per cent, respectively. This strength was not reflected in overall GDP growth, largely because production was unable to match the torrid pace of demand. This resulted in plummeting inventory levels, which chopped a whopping 4.6 percentage points from third quarter growth. Part of this decline in inventories was caused by idle factories thanks to the Ontario blackout, but the enthusiasm of the spending surge was also to blame. The net result of all this is that we can expect excellent output growth in the near term as companies race to replenish depleted inventories. This looks to provide a sizeable pop to fourth quarter GDP, virtually assuring clearance of the 4 per cent mark.

The real question is what happens once this one-time inventory boost melts away. As 2004 starts to unfold, the Canadian dollar will continue to weigh down the economy. At the same time, however, the combined might of strong U.S. demand and rising commodity prices will provide an important offset to the loonie's drag. Meanwhile, domestic demand should continue to plow ahead, fuelled by ultra-low interest rates and respectable income growth. As a result, the negative impact on exports will dissipate as Canadian firms adjust to the stronger dollar. We call for a general strengthening in economic growth over 2004, with

CANADA'S ECONOMIC INDICATORS				
Annual per cent change unless otherwise indicated				
	2002	Forecast		
		2003	2004	2005
<b>Real GDP</b>	3.3	1.6	2.8	3.3
<b>Consumer Expenditure</b>	3.4	3.9	3.9	3.6
Durable Goods	8.5	5.0	4.3	4.8
<b>Business Investment</b>	-6.0	2.5	7.5	5.7
Non-Residential Structures	-10.4	-0.7	2.7	3.3
Machinery & Equipment	-3.2	4.2	9.4	6.8
<b>Residential Construction</b>	14.2	7.1	0.6	-0.1
<b>Govt. Exp. on Goods &amp; Svcs.</b>	3.0	3.5	3.4	3.4
<b>Final Domestic Demand</b>	2.9	3.8	4.0	3.6
<b>Exports</b>	-0.1	-2.9	0.9	2.8
<b>Imports</b>	0.6	3.8	3.7	3.4
<b>Change in Non-Farm Inventories</b>				
(\$97 Bn.)	6.7	7.4	7.6	7.5
<b>Final Sales</b>	2.4	1.1	2.8	3.4
<b>Int'l Curr. Acct. Bal. (\$Bn.)</b>	23.4	25.2	24.2	26.4
% of GDP	2.0	2.1	1.9	1.9
<b>Pre-tax Corporate Profits</b>	4.3	9.2	4.1	5.4
<b>GDP Chain-type Deflator</b>	1.0	3.7	2.5	2.4
<b>Employment</b>	2.2	2.2	1.9	1.6
<b>Unemployment Rate (%)</b>	7.6	7.6	7.4	7.1
<b>Productivity*</b>	1.1	-0.6	0.9	1.7
<b>Real Pers. Disp. Income (PDI)**</b>	2.7	1.6	3.7	4.3
<b>Real PDI** Per Person</b>	1.7	0.7	2.9	3.5
<b>Consumer Price Index</b>	2.2	2.7	1.5	1.9
<b>Housing Starts ('000 units)</b>	206	220	200	185

Real GDP: Real gross domestic product; \*Real GDP per employee  
\*\*After-tax income adjusted for inflation; Forecast by TD Economics as at Dec. 2003; Source: Statistics Canada, Bank of Canada, Canada Mortgage and Housing Corporation, TD Economics.

GDP growth in the first half of the year at just under 3 per cent annualized before pushing upward to 3.4 per cent growth in the second half – not exactly an economic boom, but nothing to grumble about.

### All eyes on exports

Certainly, the issue *du jour* for the Canadian economy remains the exchange rate. With the Canadian dollar up by about 20 per cent on the year, it would be foolish to discount the effect of the dollar upon the economy – already, exports have declined for four consecutive quarters. Despite this, the negative repercussions have not been nearly as sizeable as first feared. First, strong U.S. demand has prevented exports from falling too sharply – and this strength is likely to continue to lift Canada's fortunes over the next year. In addition, rising commodity prices have managed to cushion about two-thirds of the blow of the dollar on Canada's resource-based industries. With commodity prices expected to continue to rise next year – albeit only modestly – there will continue to be an offset on that front as well.

Although we anticipate further gains for the dollar, they will be more modest than what we have seen to date. The loonie should reach 77 cents by the end of 2004, and 79 cents by the end of 2005. But the message is clear – the bulk of the Canadian dollar's movement is over. Correspondingly, exports should rise through 2004 and 2005 – albeit slowly – as firms realign their operations to the new reality.

In the meantime, falling import prices and rising slack in the Canadian economy have caused inflation to come tumbling down below the Bank of Canada's target of 2 per cent. With core inflation currently at 1.8 per cent and further declines virtually certain as the pop in consumer prices in the first quarter of 2003 unwinds, inflationary concerns are, for now, a thing of the past. We expect inflation to eventually reach 2.0 per cent in the second half of 2005, but no sooner.

### Booming domestic demand

Although the hit on exports from the stronger dollar will not be the disaster some had feared, the bottom line is that economic growth in 2004 will come from domestic demand, not from international trade.

- Consumer spending added quite a kick to third quarter GDP, with durable goods spending growing at a gigantic 17.0 per cent annualized rate. Clearly, this torrid pace of spending on big-ticket items cannot be sustained. Nonetheless, we think that already high em-

CANADA'S ECONOMIC INDICATORS					
Fourth-quarter-over-fourth-quarter per cent change					
	Q4-01	Q4-02	Forecast		
			Q4-03	Q4-04	Q4-05
<b>Real GDP</b>	1.4	3.5	1.6	3.2	3.2
<b>Real Final Sales</b>	3.5	1.0	1.9	3.1	3.3
<b>Employment</b>	0.4	3.3	1.6	1.9	1.3

Real GDP: Real gross domestic product; Forecast by TD Economics as at Dec. 2003; Source: Statistics Canada, TD Economics.

ployment levels, respectable job growth, and robust wage gains will fuel healthy disposable income growth. Continued low interest rates will also help keep consumers flocking to the malls. While spending on durables will lag, overall consumer spending is still expected to advance at a good clip.

- The business sector of Canada's economy remains in good shape – as illustrated by the strong gains in corporate profits and business investment in the third quarter. Although struggles on the export front will keep the growth in business investment short of double-digit territory, spending is expected to remain robust. The manufacturing sector may still be struggling, but rising commodity prices have provided a huge boost to corporate profits within Canada's resource industries, and most of Canada's service-sector industries are doing well. Even the SARS-affected sectors are slowly recovering. Meanwhile, corporate balance sheets are in good shape and financial conditions remain favourable, with interest rates expected to remain extremely low, corporate bond spreads narrowing, and equity prices recovering.

Faster inventory accumulation will also add to the picture. First, the depletion we saw in the third quarter must be restocked, and second, with future economic growth looking bright on both sides of the border, companies will be more willing to maintain a healthy stock of inventory to ensure they can keep pace with demand. This will provide a big boost to the last quarter of 2003 and a gentle upward nudge to 2004 growth.

In short, growth over the next year may not be stellar, but as the economy finally finds some traction thanks to synchronized consumer and business spending, greater inventory accumulation, and the waning impact of the loonie, we may finally inch past the economy's long-term trend rate of about 3 per cent by the second half of 2004.

*Eric Lascelles 416-982-6420*

# CANADA'S INDUSTRIAL OUTLOOK

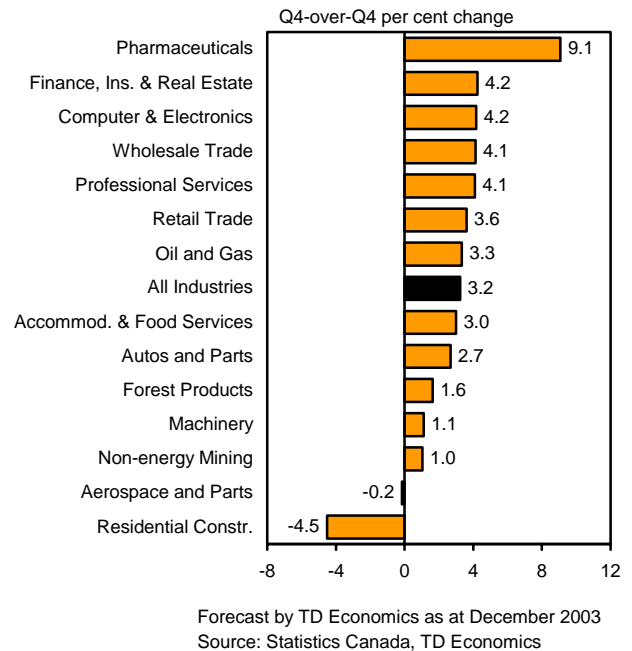
*Due to a number of conceptual differences, TD Economics' Industrial Outlook is based on a measure of real GDP that differs from the more frequently-used measure presented on pages 7-8.*

As the New Year approaches, the worst appears to be behind Canada's major industries. Notably, a reviving U.S. economy and the unwinding of a number of temporary factors that held back sector performances in the spring and summer of this year (i.e., SARS, the lone case of mad cow, and Ontario's power blackout) are likely to lift production levels by an average of 4 per cent at annual rates in the fourth quarter. Looking ahead, continuing robust U.S. expansion as well as prospects for healthy gains in domestic consumer spending and business investment are expected to set the stage for stronger real output growth of 3 per cent on average in the 2004-05 period compared to this year's 2-per-cent turnout. Still, with the strong Canadian dollar and a forecast slowdown in homebuilding activity to weigh on the goods-producing sector, look for overall growth to be heavily tilted towards the service side over the forecast period.

## Manufacturing facing an uphill battle

The bounce back in U.S. economic growth since mid-2003 has been a timely development for Canada's export-oriented manufacturing sector, which had been paring back production and employment earlier this year in the wake of the nearly 20-per-cent surge in the loonie's value since last December. And, with inventories in Canada now at lean levels, the continued solid U.S. demand picture over the forecast period should translate into renewed output growth in the lion's share of manufacturing industries in 2004-05. Leading the way will be the pharmaceutical industry, which is expected to return to the top spot in 2004-05, led by the advances in generic drug production. Moreover, the gradual recovery on tap in North American business investment spending is projected to pull Canada's recently-beleaguered computer and electronics industry along for the ride. And, in the all-important automotive industry, North American light-vehicle sales are expected to bounce back modestly in 2004, assisted in part by ongoing generous buyer incentives, which should trig-

## PERFORMANCE OF CANADA'S INDUSTRIES IN 2004



## CANADA: REAL GDP AT BASIC PRICES BY INDUSTRY

Fourth-quarter-over-fourth-quarter per cent change

			Forecast		
	2001	2002	2003	2004	2005
<b>ALL INDUSTRIES</b>	0.8	3.9	2.0	3.2	3.0
<b>GOODS INDUSTRIES</b>	-4.6	4.1	0.7	2.2	2.6
Manufacturing	-8.1	6.0	-1.1	2.4	2.9
Oil and Gas	0.3	1.6	4.8	3.3	2.8
Non-energy Mining	1.8	-3.3	11.9	1.0	3.3
Construction	6.0	1.4	4.2	0.2	1.6
Agriculture	-10.3	1.3	18.2	1.8	3.0
Other Primary*	-4.9	4.7	-12.4	3.5	2.7
Utilities	-3.4	3.2	-5.4	4.4	2.0
<b>SERVICE INDUSTRIES</b>	3.5	3.8	2.5	3.7	3.2
Wholesale Trade	2.8	9.0	5.2	4.1	3.6
Retail Trade	4.9	3.5	2.9	3.6	3.0
Transportation Services	-3.3	4.2	-1.3	3.3	3.1
Finance, Ins. & Real Estate	5.5	3.2	3.6	4.2	3.2
Professional Services	2.1	4.4	3.1	4.1	3.8
Telecommunications Services	10.3	3.8	0.4	3.3	4.2
Administrative Services	5.2	5.7	3.3	4.6	4.5
Accommod. & Food Services	-0.7	1.6	-2.6	3.0	2.6
Public Services	2.4	2.9	2.1	2.9	2.8
Other Services	4.4	3.1	2.3	3.6	2.9

\* Logging, fishing, hunting and trapping

Forecast by TD Economics as at December 2003

Source: Statistics Canada, TD Economics

AUTOMOTIVE SALES AND PRODUCTION					
	Thous. of units 2002	Per cent change year/year			
		Actual 2002	Forecast		
		2003	2004	2005	
<b>SALES OF LIGHT VEHICLES</b>					
<b>NORTH AMERICA</b>	19,492	-0.6	-2.2	1.8	1.5
<b>Canada</b>	1,703	8.4	-5.5	3.2	0.9
<b>United States</b>	16,813	-1.8	-1.8	1.5	1.3
<b>Mexico</b>	976	6.9	-3.1	5.1	5.3
<b>PRODUCTION OF LIGHT VEHICLES</b>					
<b>NORTH AMERICA</b>	16,367	5.7	-3.5	2.4	1.8
<b>Canada</b>	2,599	3.8	-4.4	2.6	1.6
<b>United States</b>	12,017	7.6	-2.1	2.3	1.7
<b>Mexico</b>	1,752	-3.1	-11.6	2.9	2.7

Forecast by TD Economics as at December 2003  
Source: DesRosiers Automotive Reports, Ward's, TD Economics

ger higher Canadian output of motor vehicles and parts.

Still, for a number of manufacturing industries that compete toe-to-toe with U.S. companies either south or north of the 49<sup>th</sup> parallel and/or do not benefit from cheaper U.S. imports in their production processes, the better news on the U.S. growth front will provide little comfort, especially with the loonie expected to gain even further ground in 2004-05. In this environment, the machinery, metal products and forestry industries are expected to struggle the most. And, while producers of lumber products might benefit from a drop in U.S. duties, if a resolution is achieved to the softwood-lumber dispute, an expected slowdown in North American homebuilding activity will erect another roadblock in their near-term path.

### Primary industries to fare well

Despite the headwinds exerted by the surge in the Canadian dollar, the primary industries managed to record sizzling growth in real output of roughly 6.5 per cent in 2003. For one, U.S.-dollar prices rose in lockstep with the Canadian dollar, preserving profit margins in the lion's share of resource industries. And, second, output increased in most industries. In particular, hefty gains were recorded in the agricultural industry, reflecting in part the return to more normal levels of production following three years of drought, and in non-energy mining. Lastly, with oil and gas prices at especially lofty levels this year, pro-

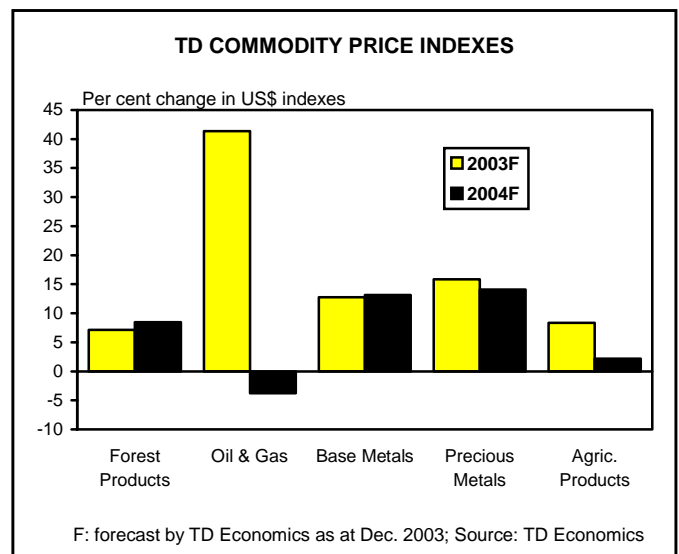
ducers ramped up drilling activity.

We expect that price conditions in Canada's primary sector will remain favourable over the near term. More specifically, in light of the improving global demand picture, the TD Commodity Price Index is expected to climb by a further 3.1 per cent in U.S. dollar terms (2.4 per cent in Canadian-dollar terms) during 2004, with increases in prices broadly distributed across the various industries. Nonetheless, look for output gains to moderate significantly in 2004, on the heels of this year's banner showing.

### Construction forecast mixed

As we pointed out in TD Economics' December 3<sup>rd</sup> report: *Canada's Housing Market – No Bubble, No Trouble*, housing activity stood out as one of the positive surprises in 2003, with housing starts jumping to a 14-year high of 220,000 units. But, while the report presents the case that the housing market is still in good shape, some tapering off in residential construction activity appears to be in the cards down the road, as interest rates creep higher by the second half of 2004, and pent-up demand from first-time buyers is exhausted. Still, at 200,000 units in 2004 and 185,000 units in 2005, the pace of starts will remain well above the demographically-driven level of about 170,000 units, and well-above the average of 160,000 units posted over the past decade.

The slowdown in homebuilding activity in 2004-05 is expected to be offset by a moderate pickup on the non-residential side. Notably, rising government infrastructure spending will give a shot in the arm to engineering work. In contrast, 2004-05 is expected to see anemic



growth in commercial and industrial construction, in view of the continued high level of vacancy rates in major downtown office markets, and the sluggish pace of expansion likely to be recorded in manufacturing.

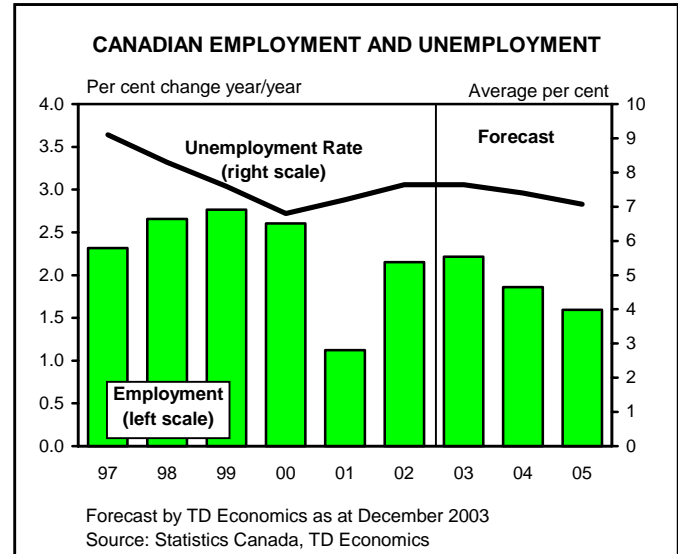
### Consumer-oriented service industries to step it up

The consumer-oriented industries of retail and wholesale trade and accommodation and food services had a challenging year in 2003. Demand waned in response to the series of unanticipated developments such as SARS, a surge in the Canadian dollar, and heightened overall economic uncertainty. Accordingly, businesses lost pricing power. So, while the retail and wholesale trade industries still managed to record increases in sales *volumes*, aggressive price discounts could not prevent a drop in activity in the accommodation and food industry. In contrast, wholesalers reliant on trade in computer hardware and software fared better in 2003.

For 2004-05, overall conditions are likely to improve in the consumer-oriented industries. Most importantly, job creation is expected to remain supportive to Canadian consumer spending, and we assume that fewer nasty surprises will jump out of the woodwork. As well, while the price environment will remain tough, a modicum of pricing power will return to these industries over the forecast period. Still, the rising Canadian dollar will continue to pose a challenge for businesses that are dependent on steady flows of U.S. tourists for revenues.

### Outlook bright for professional and administrative services

Both the professional and administrative services industries provide direct support to the business community for a range of activities. The professional services industry comprises computer-systems designers, legal and accounting services, and advertising services, while the administrative services industry is made up of a whole range of activities, including call centres, corporate travel serv-



ices, security services, collection agencies, and garbage disposal. Look for Canada's professional and administrative industries to remain close to the top of the industrial growth charts in 2004-05. For one, both industries will receive support from rising corporate profits and higher business spending. As well, the recent loss in export competitiveness from the rising Canadian dollar presents an opportunity for professional and administrative specialists, as export-oriented businesses look for ways to save money by outsourcing services. On the flip side, the slowdown in homebuilding activity will exert some drag on activity in some professional services industries, namely in the areas of legal and architectural services.

### Public services – steady as she goes

Rising spending at federal, provincial and local levels is likely to spur moderate growth in public services industries in the 2004-05 period. New injections into health care are expected to lead the way over the forecast period, and to a lesser extent, education and infrastructure.

*Derek Burleton 416-982-2514*

## U.S. ECONOMIC OUTLOOK

As the year draws to a close, a rash of robust economic data is dispelling any lingering pessimism about the strength of the U.S. economic recovery. Topping the list is the recent upward revision to U.S. third-quarter GDP growth, which showed that the U.S. economy expanded at a remarkable 8.2-per-cent annualized pace in the quarter. The data confirm that the U.S. economy is responding to the generous array of stimulus – both monetary and fiscal – that has been applied throughout the year. But, without a doubt, the most encouraging development since our last quarterly forecast has been the unexpectedly strong revival in U.S. business investment. A turnaround was expected on this front, but it has materialized more quickly and more forcefully than hoped. With U.S. consumers continuing to spend, the housing market still

The U.S. Bureau of Economic Analysis (BEA) is in the midst of releasing the results of its benchmark revisions to the U.S. national income and product accounts. These revisions are done only once every 4-5 years, and they are substantial, involving not just the regular annual statistical revisions, but also changes to definitions and classifications of GDP, to bring the national accounts into line with the changing structure of the U.S. economy. The BEA began releasing the revisions on December 10, but a complete data set will not be available until later this month. Consequently, while the basic shape of the forecast described below is unlikely to change, when the full data set is available in January 2004, TD Economics will review the forecast and produce updated tables.

U.S. ECONOMIC INDICATORS				
Annual per cent change unless otherwise indicated				
	2002	Forecast		
		2003	2004	2005
<b>Real GDP</b>	2.4	3.1	4.6	3.6
<b>Consumer Expenditure</b>	3.1	3.1	3.8	3.2
Durable Goods	7.3	7.5	8.6	4.5
<b>Business Investment</b>	-5.7	2.6	12.2	10.5
Non-Residential Structures	-16.4	-6.3	0.5	3.2
Machinery & Equipment	-1.7	5.5	15.7	12.4
<b>Residential Construction</b>	3.9	9.1	1.4	-5.9
<b>Govt. Exp. on Goods &amp; Svcs.</b>	4.4	3.4	3.1	1.1
<b>Final Domestic Demand</b>	2.4	3.3	4.4	3.2
<b>Exports</b>	-1.6	1.3	8.3	12.9
<b>Imports</b>	3.7	3.8	8.0	6.8
<b>Change in Non-Farm Inventories (\$96 Bn.)</b>	4.1	0.1	31.2	27.0
<b>Final Sales</b>	1.8	3.1	4.3	3.6
<b>Int'l Curr. Acct. Bal. (\$Bn.)</b>	-481	-557	-606	-596
% of GDP	-4.6	-5.1	-5.3	-5.0
<b>Pre-tax Corporate Profits</b>	7.6	18.8	16.8	7.0
<b>GDP Chain-type Deflator</b>	1.1	1.6	0.8	0.9
<b>Employment</b>	-1.1	-0.2	1.2	1.9
<b>Unemployment Rate (%)</b>	5.8	6.0	5.9	5.6
<b>Productivity *</b>	5.4	4.1	3.5	1.9
<b>Real Pers. Disp. Inc. (PDI)**</b>	4.2	2.5	4.3	2.3
<b>Real PDI** Per Person</b>	3.3	1.6	3.4	1.4
<b>Consumer Price Index</b>	1.6	2.3	1.3	1.5
<b>Housing Starts ('000 units)</b>	1,711	1,800	1,751	1,610
Real GDP: Real gross domestic product; * Real GDP per hour, ** After-tax income adjusted for inflation; Forecast by TD Economics as at December 2003; Source: Bureau of Labor Statistics, Bureau of Economic Analysis, TD Economics				

strong, and exports now picking up in response to rising global demand, the U.S. economy is firing on all cylinders heading into the New Year. As a result, we expect real GDP growth in the United States to reach 4.6 per cent on average next year, with the expansion decelerating to a still-impressive rate of 3.6 per cent in 2005.

### Business investment coming back to life

One of the key themes of the U.S. economic outlook for 2004-05 is the recovery in business investment. After growing by a healthy 7.3 per cent (annualized) in the second quarter, U.S. business investment accelerated to 14 per cent in the third quarter, led by an 18.4-per-cent surge in spending on machinery and equipment. One factor behind the growth is a powerful rebound in corporate profits, which grew by about 50 per cent in both the second and third quarters of the year. After several years of restructuring, U.S. firms are in better financial health, and with equity markets on the rise, the combination of stronger balance sheets and improved financial conditions is creating an attractive investment environment. Factor in the accelerated depreciation allowances contained in the 2003 tax package – set to expire in 2005, with the aim of encouraging firms to front-load new investment – and the stage is set for business spending on machinery and equipment to continue growing at double-digit rates well into 2005. Spending on structures is still lagging behind, and progress in this area is expected to remain slow, given the considerable amount of plant and office space that remains vacant – one of the key components of the spare capacity

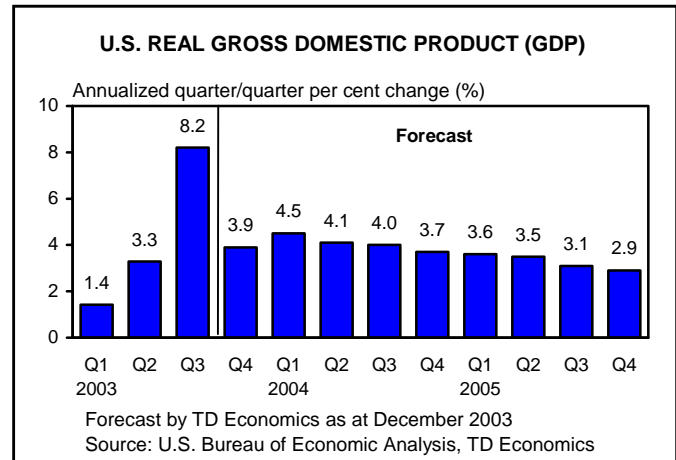
still evident in the U.S. economy. However, by 2005, non-residential investment is expected to stage a modest recovery, growing by about 3 per cent on average.

### Housing market still robust

As for residential investment, it rocketed ahead by almost 23 per cent in the third quarter, as the U.S. housing market continued to defy gravity. This robust pace of expansion cannot continue. Housing starts clocked in at an annualized pace of 1,960 thousand units in October, which compares with a demographically driven rate (*i.e.*, the rate needed to keep pace with household formation) of roughly 1,575 thousand units – signifying that the pace of new starts is unsustainably strong. However, while residential investment is expected to decelerate, the slowdown will be modest, at first. With the U.S. Federal Reserve having indicated in December that it is in no hurry to raise interest rates, mortgage refinancing activity – an important driver of the recent strength in the housing market – will not dry up as quickly as might have been feared. And, once financial markets begin to sense that a tightening in monetary policy is imminent, rising bond yields will drive up mortgage rates, likely leading to a final burst of activity, as homeowners seek to wring a last few advantages out of the low-interest rate environment.

### Consumer spending growth to decelerate in 2004-05

Consumer spending racked up another strong performance in the third quarter of 2003, fuelled by a double-digit gain in purchases of durable goods. U.S. consumers have been benefiting from low interest rates and the implementation of the Bush tax package, which has boosted personal disposable income (PDI) growth. A second round of effects from the tax cuts will give spending another lift early next year, as households receive higher income tax refunds – reflecting the fact that the tax package, implemented in July 2003, was made retroactive to the beginning of the year. However, that should mark the high point for consumer spending growth, for two reasons. First, PDI growth is expected to slow sharply in the middle of next year, as the effects of the tax relief fall out of the equation. Second, the U.S. labour market has been slow to create jobs. U.S. employment growth is expected to gather steam over the course of 2004, as firms find they cannot meet demand simply by squeezing more productivity out of their existing workforce. However, the cautious pace of hiring to date, coupled with weaker PDI growth, will see consumer spending growth decelerate in 2004-05, as business investment takes over as the leading driver of economic growth.



<b>U.S. ECONOMIC INDICATORS</b>					
Fourth-quarter-over-fourth-quarter per cent change					
	Q4-01	Q4-02	Forecast		
			Q4-03	Q4-04	Q4-05
<b>Real GDP</b>	0.1	2.9	4.2	4.1	3.3
<b>Real Final Sales</b>	1.6	1.7	4.1	4.1	3.3
<b>Employment</b>	-1.1	-0.4	-0.1	1.9	1.7

Real GDP: Real gross domestic product; Forecast by TD Economics as at December 2003; Source: Bureau of Labor Statistics, Bureau of Economic Analysis, TD Economics

### Budget and current account deficits to remain an issue

The U.S. budget and current account deficits have been in the spotlight this year, fingered as the primary cause of the decline in the U.S. dollar. TD Economics discussed this issue in a recent topic paper, entitled *The U.S. dollar correction*, available on the TD Economics website. Suffice it to say here that a weaker dollar, coupled with a rebound in global demand, is helping boost U.S. export growth – and, a continuation of this trend in 2004-05 should result in a modest narrowing in the current account deficit. However, the primary source of that deficit – dissaving by the government sector, captured in the budget deficit – shows no sign of abating. By late 2004 and through 2005, the withdrawal of fiscal stimulus, as the effects of the 2003 tax package wear off, will exert a small drag on the economy, but the current forecast assumes no new measures to reduce spending outright. That implies that the U.S. budget deficit will remain a cloud on the horizon – a problem that will remain to be addressed another day.

*Gillian Manning 416-982-2559*

## FINANCIAL OUTLOOK

U.S. bond yields have risen over the last quarter, as fixed-income markets reacted to compelling signs of a strong rebound in U.S. economic growth. The economic revival quashed fears of deflation, increased the inflation premium demanded by investors and fuelled speculation that the Fed would begin tightening monetary policy soon. Looking ahead, the yields on Treasuries are likely to grind higher, but the Fed will not be aggressive in hiking rates.

### Fed to take a gradual approach

The members of the policy-setting FOMC committee continue to stress that rates can be left at current levels for a 'considerable' period of time. They justify this stance on the grounds that there is ample slack in the U.S. economy and that inflation will remain subdued. The implication is that the Fed is prepared to let economic growth run at well above its potential pace for several quarters before beginning to raise rates. But, make no mistake –

the next move for the fed funds rate is up.

The fed funds overnight rate currently stands at a rock bottom 1 per cent, which should be viewed as an emergency level that was introduced to stem disinflationary pressures. As the economic and disinflation risks abate, the Fed will have to tighten monetary policy, likely beginning with 100 basis points of rate hikes – delivered in quarter point increments – in the second half of 2004. However, this tightening will not significantly dampen economic growth. It is important to stress that it is the level, not the direction, of rates that matters for the economy. The fed funds rate is currently 350 basis points below its neutral position, so the main message is that the Fed will simply be pushing less hard on the accelerator in late 2004. The true rebalancing in monetary policy is likely to occur over the course of 2005, when the slack in the U.S. economy will have been largely absorbed.

INTEREST RATE OUTLOOK													
	Spot Rate 12/12/2003	2003				2004				2005			
		Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
<b>CANADIAN FIXED INCOME</b>													
Overnight Target Rate (%)	2.74	3.00	3.25	2.75	2.75	2.25	2.25	2.25	2.75	3.25	3.75	4.25	4.75
3-mth T-Bill Rate (%)	2.65	3.15	3.08	2.59	2.65	2.25	2.25	2.35	2.85	3.35	3.85	4.30	4.75
2-yr Govt. Bond Yield (%)	3.06	3.76	3.01	2.96	3.10	3.10	3.25	3.35	3.70	4.10	4.45	4.80	5.10
5-yr Govt. Bond Yield (%)	4.18	4.56	3.61	3.77	4.20	4.25	4.40	4.50	4.75	5.05	5.30	5.50	5.65
10-yr Govt. Bond Yield (%)	4.74	5.15	4.45	4.56	4.75	4.80	4.95	5.10	5.30	5.55	5.75	5.90	5.95
30-yr Govt. Bond Yield (%)	5.28	5.55	5.10	5.14	5.30	5.35	5.40	5.65	5.75	5.85	5.90	6.00	6.05
10-yr-2-yr Govt. Spread (%)	1.68	1.39	1.44	1.60	1.65	1.70	1.70	1.75	1.60	1.45	1.30	1.10	0.85
<b>U.S. FIXED INCOME</b>													
Fed Funds Target Rate (%)	1.00	1.25	1.00	1.00	1.00	1.00	1.00	1.50	2.00	2.50	3.00	3.50	4.00
3-mth T-Bill Rate (%)	0.91	1.11	0.86	0.95	0.95	1.00	1.00	1.60	2.10	2.60	3.10	3.60	4.00
2-yr Govt. Bond Yield (%)	1.83	1.50	1.30	1.47	1.85	1.95	2.20	2.70	3.10	3.50	3.90	4.30	4.60
5-yr Govt. Bond Yield (%)	3.22	2.71	2.41	2.83	3.25	3.40	3.60	3.95	4.25	4.55	4.85	5.10	5.25
10-yr Govt. Bond Yield (%)	4.24	3.80	3.51	3.94	4.25	4.40	4.60	4.85	5.10	5.35	5.60	5.75	5.80
30-yr Govt. Bond Yield (%)	5.09	4.82	4.55	4.89	5.10	5.15	5.25	5.55	5.65	5.75	5.85	5.95	6.00
10-yr-2-yr Govt. Spread (%)	2.42	2.30	2.21	2.47	2.40	2.45	2.40	2.15	2.00	1.85	1.70	1.45	1.20
<b>CANADA-U.S. SPREADS</b>													
3-mth T-Bill Rate (%)	1.74	2.04	2.22	1.64	1.70	1.25	1.25	0.75	0.75	0.75	0.75	0.70	0.75
2-yr Govt. Bond Yield (%)	1.23	2.26	1.71	1.49	1.25	1.15	1.05	0.65	0.60	0.60	0.55	0.50	0.50
5-yr Govt. Bond Yield (%)	0.96	1.85	1.20	0.94	0.95	0.85	0.80	0.55	0.50	0.50	0.45	0.40	0.40
10-yr Govt. Bond Yield (%)	0.50	1.35	0.94	0.62	0.50	0.40	0.35	0.25	0.20	0.20	0.15	0.15	0.15
30-yr Govt. Bond Yield (%)	0.19	0.73	0.54	0.26	0.20	0.20	0.15	0.10	0.10	0.10	0.05	0.05	0.05
f: Forecast by TD Economics as at December 2003; All forecasts are for end of period													
Source: Federal Reserve of Bank of New York, TD Economics													

### Canadian bonds to outperform

Canadian bond yields have also been rising over the past quarter, but Canadian bonds have outperformed their U.S. counterparts, with the result that Canada-U.S. interest rate spreads have narrowed. Both of these trends are expected to continue in the coming months.

Signs of stronger economic growth will boost Canadian yields, but the increase will be more modest than that south of the border. First, with the U.S. federal government running a record deficit, supply pressures are likely to weigh on U.S. bonds. In contrast, the Canadian federal government will be running a budget roughly in balance. Second, stronger economic growth Stateside will likely spark a greater increase in the inflation premium in U.S. bonds. Third, and most important, while the Fed stays on hold in early 2004, recent comments by the Bank of Canada suggest that it may cut rates.

### Bank of Canada to cut, before tightening, in 2004

The Bank of Canada has repeatedly indicated that it expects the Canadian economy largely to shrug off the negative impact from the stronger Canadian dollar. This is evident in the last Monetary Policy Report, from which it could be inferred that the Bank is forecasting Canadian economic growth at a healthy pace of 3.8 per cent over the four quarters of 2004. However, this outlook may prove to be a tad optimistic. If the data disappoint in the coming weeks, the stage could be set for an easing in monetary policy. Indeed, recent comments by Governor Dodge implied that rate cuts would be warranted if economic growth was not 'solidly' above potential. In our opinion, the key question is whether there will be enough evidence that

growth is falling short of the Bank's forecast by the January 20<sup>th</sup> fixed policy announcement date. Dodge's remarks give the impression that the Bank is already cognizant of the risks to its outlook, so we have included a quarter point reduction in the overnight rate at each of the January 20<sup>th</sup> and March 2<sup>nd</sup> policy decisions.

While an easing by the Bank appears to be in the cards in early 2004, so too is a tightening before year-end. As the Canadian economy gradually adjusts to the prior appreciation in the Canadian dollar, and with the domestic economy remaining robust, economic growth is likely to accelerate in the second half of next year. Moreover, the Bank will be mindful that changes in interest rates largely affect the economy with a 12-18 month lag. Consequently, the prospects for above 3 per cent growth in 2005 are likely to prompt the Bank of Canada to begin raising rates in the fourth quarter of 2004 and throughout the following year.

### Limited upside to the Canadian dollar

This outlook suggests that changes in monetary policy will take some of the wind out of the Canadian dollar. The currency is likely to dip to below 75 U.S. cents in the first quarter of 2004 in response to the narrowing in Canada-U.S. short-term interest rate spreads. This retracement may prove short-lived, as the loonie is expected to receive a lift from a further weakening in the U.S. dollar over the course of next year. However, the gains will be limited by the fact that the Fed will start tightening monetary policy before the Bank in the second half of 2004. Overall, the Canadian dollar is expected to end 2004 at close to 77 U.S. cents, before creeping up to 79 U.S. cents in 2005.

*Craig Alexander 416-982-8064*

FOREIGN EXCHANGE OUTLOOK												
Currency	Exchange Rate	Spot Price 12/12/2003			2004				2005			
			Q3	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Canadian dollar	USD per CAD	0.760	0.740	0.760	0.745	0.760	0.765	0.770	0.775	0.780	0.785	0.790
Canadian dollar	CAD per USD	1.315	1.351	1.316	1.342	1.316	1.307	1.299	1.290	1.282	1.274	1.266
Japanese yen	JPY per USD	107.7	111	108	109	108	107	105	104	103	102	100
Euro	USD per EUR	1.228	1.165	1.230	1.240	1.260	1.280	1.300	1.320	1.340	1.350	1.350
U.K. pound	USD per GBP	1.747	1.662	1.783	1.784	1.800	1.816	1.831	1.846	1.861	1.862	1.849
Swiss franc	CHF per USD	1.265	1.319	1.258	1.250	1.234	1.219	1.202	1.186	1.169	1.163	1.167
Australian dollar	USD per AUD	0.743	0.680	0.745	0.740	0.745	0.750	0.755	0.760	0.765	0.770	0.770
Mexican peso	MXN per USD	11.24	11.00	11.25	11.20	11.10	11.00	10.90	10.80	10.70	10.60	10.50

f: Forecast by TD Economics as at December 2003; All forecasts are for end of period; Source: Federal Reserve of New York, TD Economics

<b>CANADIAN ECONOMIC OUTLOOK</b>																
Period-Over-Period Annualized Per Cent Change Unless Otherwise Indicated																
	2003		2004				2005				Annual Averages			4th Qtr/4th Qtr		
	Q3	Q4 F	Q1 F	Q2 F	Q3 F	Q4 F	Q1 F	Q2 F	Q3 F	Q4 F	2003F	2004F	2005F	2003F	2004F	2005F
<b>Real GDP</b>	1.1	4.2	2.7	3.0	3.5	3.4	3.4	3.3	3.2	3.1	1.6	2.8	3.3	1.6	3.2	3.2
<b>Consumer Expenditure</b>	5.1	4.3	3.4	3.4	3.7	3.9	3.7	3.5	3.4	3.2	3.9	3.9	3.6	4.3	3.6	3.5
Durable Goods	17.0	1.3	2.0	2.3	4.0	6.2	5.5	4.5	4.3	3.9	5.0	4.3	4.8	5.5	3.6	4.5
<b>Business Investment</b>	13.2	7.2	6.4	7.8	8.4	5.6	5.4	5.1	4.7	4.0	2.5	7.5	5.7	6.8	7.0	4.8
Non-Res. Structures	4.4	1.8	2.0	3.5	3.9	3.5	3.3	3.2	3.0	2.9	-0.7	2.7	3.3	2.8	3.2	3.1
Machinery & Equipment	18.8	6.7	8.5	9.9	10.5	6.5	6.3	6.0	5.4	4.5	4.2	9.4	6.8	8.3	8.8	5.5
<b>Residential Construction</b>	18.2	-1.2	-2.8	-2.5	-2.2	-1.3	0.8	1.0	1.2	1.4	7.1	0.6	-0.1	5.6	-2.2	1.1
<b>Government Expenditure on Goods &amp; Services</b>	1.3	3.2	3.5	3.6	3.7	3.8	3.4	3.2	3.0	3.0	3.5	3.4	3.4	3.4	3.6	3.1
<b>Final Domestic Demand</b>	5.7	3.8	3.4	3.6	3.9	3.7	3.7	3.5	3.4	3.2	3.8	4.0	3.6	4.4	3.7	3.4
<b>Exports</b>	-0.9	-0.3	1.7	2.2	2.7	2.8	2.9	2.9	3.0	3.0	-2.9	0.9	2.8	-2.6	2.3	2.9
<b>Imports</b>	-2.1	5.6	4.2	4.0	3.7	3.6	3.4	3.3	3.3	3.2	3.8	3.7	3.4	3.5	3.9	3.3
<b>Change in Non-Farm Inventories (\$97 Bn)</b>	-3.4	6.3	7.2	7.5	7.7	7.8	7.6	7.5	7.5	7.5	7.4	7.6	7.5	---	---	---
<b>Final Sales</b>	6.1	1.4	2.4	2.9	3.5	3.4	3.5	3.4	3.2	3.1	1.1	2.8	3.4	1.9	3.1	3.3
<b>International Current Account Balance (\$Bn)</b>	29.3	23.2	23.0	23.6	24.8	25.4	26.3	26.1	26.4	27.0	25.2	24.2	26.4	---	---	---
% of GDP	2.4	1.9	1.8	1.9	1.9	1.9	2.0	1.9	1.9	2.0	2.1	1.9	1.9	---	---	---
<b>Pre-tax Profits</b>	21.2	5.7	5.2	5.5	5.7	5.2	5.6	5.4	5.2	5.1	9.2	4.1	5.4	3.9	5.4	5.3
% of GDP	11.9	11.8	11.8	11.8	11.8	11.8	11.7	11.7	11.7	11.7	11.9	11.8	11.7	---	---	---
<b>GDP Deflator</b>	3.3	3.3	2.5	2.8	2.8	2.8	2.6	2.1	1.9	2.0	3.7	2.5	2.4	3.0	2.7	2.1
<b>Nominal GDP</b>	4.6	7.4	5.2	5.8	6.5	6.3	6.0	5.4	5.2	5.1	5.4	5.4	5.8	4.7	5.9	5.4
<b>Labour Force</b>	1.5	1.8	1.6	1.3	1.7	1.5	1.2	0.8	0.7	1.6	2.2	1.6	1.2	1.6	1.6	1.1
<b>Employment</b>	0.4	3.3	1.5	1.8	2.5	1.9	1.4	1.2	1.2	1.3	2.2	1.9	1.6	1.6	1.9	1.3
<b>Unemployment Rate (%)</b>	7.9	7.6	7.6	7.5	7.3	7.2	7.2	7.1	7.0	7.1	7.6	7.4	7.1	---	---	---
<b>Personal Disp. Income</b>	3.1	6.7	4.7	5.6	6.8	6.9	6.4	6.3	5.8	5.6	3.4	5.3	6.3	3.9	6.0	6.0
<b>Pers. Savings Rate (%)</b>	1.3	1.6	1.6	1.7	1.9	2.1	2.3	2.5	2.6	2.6	1.9	1.8	2.5	---	---	---
<b>Consumer Price Index (Y/Y)</b>	2.1	1.5	0.6	1.7	1.8	1.8	1.8	1.9	2.0	2.0	2.7	1.5	1.9	1.5	1.8	2.0
<b>Housing Starts ('000)</b>	231	226	208	201	197	195	195	190	180	175	220	200	185	---	---	---
<b>Productivity:</b>																
<b>Real GDP per worker (Y/Y)</b>	-0.6	0.0	0.4	0.9	1.0	1.2	1.4	1.6	1.8	1.9	-0.6	0.9	1.7	0.0	1.2	1.9

F: Forecast; Forecast by TD Economics as at December 2003.

Source: Statistics Canada, Bank of Canada, Canada Mortgage and Housing Corporation, TD Economics.

CANADIAN INDUSTRIAL OUTLOOK												
REAL GROSS DOMESTIC PRODUCT BY INDUSTRY*												
	Level \$Bns 2002	Share of Output 2002	Annual average per cent change					4thQtr/4thQtr change				
			2001	2002	Forecast			2001	2002	Forecast		
					2003	2004	2005			2003	2004	2005
<b>ALL INDUSTRIES</b>	992.3	100.0%	1.7	3.2	2.2	2.9	3.2	0.8	3.9	2.0	3.2	3.0
<b>GOODS INDUSTRIES</b>	310.6	31.3%	-1.8	1.4	1.3	1.8	2.6	-4.6	4.1	0.7	2.2	2.6
<b>PRIMARY INDUSTRIES</b>	54.2	5.5%	-2.1	-3.0	6.4	3.3	3.0	-2.8	1.1	6.5	2.6	2.9
Agriculture	12.0	1.2%	-9.8	-7.6	20.0	4.0	2.8	-10.3	1.3	18.2	1.8	3.0
Oil and Gas	24.8	2.5%	1.4	-1.3	4.5	3.7	3.0	0.3	1.6	4.8	3.3	2.8
Non-energy Mining	9.3	0.9%	2.2	-2.7	3.2	7.4	3.6	1.8	-3.3	11.9	1.0	3.3
Other Primary**	8.1	0.8%	-3.9	-1.4	-4.4	-4.5	2.6	-4.9	4.7	-12.4	3.5	2.7
<b>MANUFACTURING</b>	177.4	17.9%	-3.8	2.6	-0.4	1.5	2.9	-8.1	6.0	-1.1	2.4	2.9
Autos and Parts	19.3	1.9%	-9.5	7.7	-0.2	3.0	1.8	-4.2	8.4	0.5	2.7	1.3
Aerospace and Parts	6.7	0.7%	14.0	-2.7	-13.2	-7.0	3.3	4.9	-4.0	-16.1	-0.2	3.5
Forest Products	23.8	2.4%	-3.6	5.4	2.5	0.0	2.3	-6.2	10.5	-1.5	1.6	2.3
Food Products	16.7	1.7%	5.5	2.3	-1.2	2.2	3.0	6.3	-0.4	-0.6	3.1	2.6
Pharmaceuticals	4.7	0.5%	30.9	21.2	10.4	7.0	8.0	20.3	26.5	2.7	9.1	7.3
Plastics & Rubber	10.4	1.0%	3.0	10.2	1.9	3.0	3.7	2.6	9.7	3.3	1.6	4.0
Computer & Electronics	10.1	1.0%	-26.9	-13.9	0.2	4.0	5.4	-42.8	2.2	3.8	4.2	5.5
Machinery	11.3	1.1%	-4.3	2.0	-3.4	0.0	2.8	-7.2	7.2	-5.3	1.1	2.9
Metal Products	25.5	2.6%	-1.4	3.6	-0.4	0.8	2.5	-4.7	5.0	-1.1	1.6	2.8
Other Manufacturing	49.0	4.9%	-3.7	1.0	-0.7	1.8	2.6	-10.6	5.2	-1.1	2.4	2.8
<b>CONSTRUCTION</b>	52.5	5.3%	6.4	1.8	3.5	1.2	1.4	6.0	1.4	4.2	0.2	1.6
Residential	18.3	1.8%	10.2	14.8	6.7	-1.0	-2.0	9.6	15.3	5.2	-4.5	-1.0
Non-res. & Engineering	34.2	3.4%	4.8	-4.1	1.8	2.5	3.2	4.4	-5.0	3.6	2.9	2.9
<b>UTILITIES</b>	26.4	2.7%	-2.5	2.3	-2.6	1.0	2.5	-3.4	3.2	-5.4	4.4	2.0
<b>SERVICE INDUSTRIES</b>	681.8	68.7%	3.4	4.0	2.6	3.3	3.4	3.5	3.8	2.5	3.7	3.2
Wholesale Trade	59.5	6.0%	2.8	7.8	5.7	4.2	3.9	2.8	9.0	5.2	4.1	3.6
Retail Trade	55.5	5.6%	3.8	5.6	2.7	3.1	3.2	4.9	3.5	2.9	3.6	3.0
Transportation Services	45.9	4.6%	-1.0	1.3	0.0	1.6	3.3	-3.3	4.2	-1.3	3.3	3.1
Telecommunications Services	23.1	2.3%	8.9	6.8	1.5	1.9	4.1	10.3	3.8	0.4	3.3	4.2
Finance, Ins. & Real Estate	199.0	20.1%	4.3	4.5	2.7	4.3	3.7	5.5	3.2	3.6	4.2	3.2
Professional Services	43.5	4.4%	4.6	3.2	3.4	3.7	3.9	2.1	4.4	3.1	4.1	3.8
Administrative Services	21.5	2.2%	4.9	5.1	4.0	4.3	4.6	5.2	5.7	3.3	4.6	4.5
Accommod. & Food Services	23.2	2.3%	2.5	0.5	-2.8	2.4	2.9	-0.7	1.6	-2.6	3.0	2.6
Public Services	159.7	16.1%	2.2	2.6	2.7	2.6	2.8	2.4	2.9	2.1	2.9	2.8
Other Services	50.9	5.1%	4.3	4.2	2.5	3.0	3.3	4.4	3.1	2.3	3.6	2.9

Forecast by TD Economics as at December 2003

\* Measured at basic prices in 1997 dollars; \*\* Logging, fishing, hunting and trapping

Source: Statistics Canada, TD Economics

## U.S. ECONOMIC OUTLOOK

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

			2004				2005				Annual Averages			4thQtr/4thQtr		
	Q3	Q4 F	Q1 F	Q2 F	Q3 F	Q4 F	Q1 F	Q2 F	Q3 F	Q4 F	2003F	2004F	2005F	2003F	2004F	2005F
<b>Real GDP</b>	8.2	3.9	4.5	4.1	4.0	3.7	3.6	3.5	3.1	2.9	3.1	4.6	3.6	4.2	4.1	3.3
<b>Consumer Expenditure</b>	6.4	1.5	4.7	3.7	3.5	3.5	3.3	3.2	2.8	2.4	3.1	3.8	3.2	3.4	3.8	2.9
Durable Goods	26.5	-6.7	15.9	6.1	3.1	3.2	6.5	5.5	3.1	2.4	7.5	8.6	4.5	9.5	6.9	4.4
<b>Business Investment</b>	14.0	9.0	14.6	12.9	12.4	11.2	11.0	9.8	8.4	6.8	2.6	12.2	10.5	6.3	12.8	9.0
Non-Res. Structures	0.2	-3.5	0.6	1.7	2.0	3.0	4.3	4.0	2.6	2.2	-6.3	0.5	3.2	-0.5	1.8	3.3
Machinery & Equipment	18.4	12.8	18.8	16.1	15.3	13.4	12.7	11.4	9.9	8.0	5.5	15.7	12.4	8.3	15.9	10.5
<b>Residential Construction</b>	22.7	8.9	-7.0	-2.1	-3.9	-5.4	-6.7	-7.7	-6.7	-4.3	9.1	1.4	-5.9	11.9	-4.6	-6.4
<b>Govt. Consumption &amp; Gross Investment</b>	1.3	4.5	3.6	2.2	1.6	0.5	0.9	1.1	1.0	1.0	3.4	3.1	1.1	3.6	2.0	1.0
<b>Final Domestic Demand</b>	6.8	3.1	4.9	4.1	3.7	3.4	3.2	3.0	2.7	2.3	3.3	4.4	3.2	4.1	4.0	2.8
<b>Exports</b>	11.0	4.4	7.2	10.5	12.7	13.1	14.0	13.6	12.2	10.1	1.3	8.3	12.9	3.2	10.9	12.4
<b>Imports</b>	1.5	10.3	10.6	7.3	6.8	7.5	7.0	7.1	6.3	3.4	3.8	8.0	6.8	3.4	8.0	6.0
<b>Change in Non-Farm Inventories (\$96 Bn)</b>	-14.4	28.0	34.0	31.6	29.5	29.6	28.2	27.7	28.0	24.0	0.1	31.2	27.0	---	---	---
<b>Final Sales</b>	8.0	2.3	4.3	4.2	4.1	3.7	3.7	3.5	3.1	3.0	3.1	4.3	3.6	4.1	4.1	3.3
<b>International Current Account Balance (\$Bn)</b>	-541	-577	-607	-608	-605	-603	-600	-603	-594	-588	-557	-606	-596	---	---	---
% of GDP	-4.9	-5.2	-5.4	-5.3	-5.2	-5.1	-5.1	-5.0	-4.9	-4.8	-5.1	-5.3	-5.0	---	---	---
<b>Pre-tax Profits including IVA&amp;CCA</b>	56.0	9.1	15.3	10.3	6.7	2.3	7.5	10.4	8.0	4.5	18.8	16.8	7.0	28.7	8.6	7.6
% of GDP	9.1	9.2	9.4	9.5	9.5	9.5	9.6	9.7	9.8	9.8	8.6	9.5	9.7	---	---	---
<b>GDP Deflator</b>	1.7	0.8	0.9	0.5	0.5	0.5	1.1	1.1	1.1	0.9	1.6	0.8	0.9	1.4	0.6	1.0
<b>Nominal GDP</b>	10.0	4.7	5.4	4.6	4.5	4.2	4.8	4.6	4.2	3.8	4.7	5.4	4.5	5.7	4.7	4.3
<b>Labour Force</b>	-0.4	1.1	1.1	1.1	1.2	1.3	1.3	1.2	1.3	1.2	1.1	1.0	1.2	1.2	1.2	1.2
<b>Employment</b>	-0.2	0.8	1.4	1.9	1.9	2.3	2.3	1.6	1.5	1.2	-0.2	1.2	1.9	-0.1	1.9	1.7
<b>Unemployment Rate (%)</b>	6.1	6.0	6.0	5.9	5.8	5.7	5.5	5.5	5.6	5.7	6.0	5.9	5.6	---	---	---
<b>Personal Disp. Income</b>	9.9	1.6	11.1	3.7	1.0	4.6	4.0	3.6	3.9	3.9	4.5	5.5	3.6	4.8	5.0	3.8
<b>Pers. Savings Rate (%)</b>	3.4	3.2	4.3	4.1	3.3	3.3	3.2	2.9	2.8	2.8	3.3	3.8	2.9	---	---	---
<b>Consumer Price Index (Y/Y)</b>	2.2	2.0	1.4	1.5	1.2	1.2	1.2	1.4	1.6	1.7	2.3	1.3	1.5	2.0	1.2	1.7
<b>Housing Starts ('000)</b>	1,875	1,848	1,807	1,779	1,732	1,686	1,644	1,614	1,607	1,574	1,800	1,751	1610	---	---	---
<b>Productivity:</b>																
<b>Real GDP per hour (Y/Y)</b>	4.7	4.8	5.2	4.1	2.6	2.4	1.9	1.9	1.9	2.1	4.1	3.5	1.9	4.8	2.4	2.1

F: Forecast by TD Economics as at December 2003

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