TD Economics

Special Report

July 27, 2006

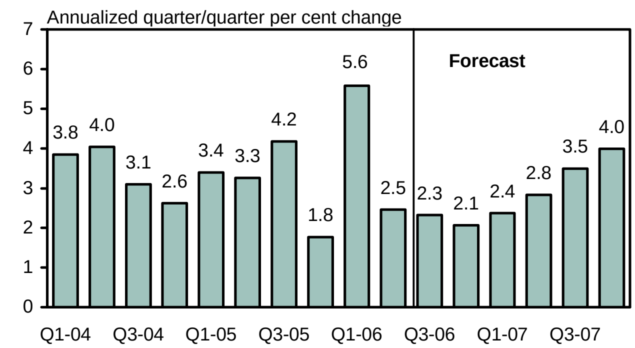
ECONOMIC & FINANCIAL UPDATE

The global economy has been performing remarkably well in recent years. World economic growth has been running at its strongest pace in more than three decades, fueling a dramatic rise in commodity prices, rapid growth in profits and better labour market opportunities. Booming economic conditions in China, India and a number of other emerging economies led the way, but the industrialized nations participated as well. For example, after more than a decade of stagnation, Japan turned a corner last year with its banking sector recapitalized, deflation drawing to a close and amid stronger domestic economic conditions. In Europe, the corporate sector has fared well, and although economic growth has been modest, there were signs of improvement in late 2005 and in the first half of 2006.

In North America, economic times have also been better than most people realize. Economic growth in both the United States and Canada has been solid, as unemployment fell to historically low levels and profits advanced at a robust pace. Also, domestic demand in the form of consumer spending and business investment has proven strong. In Canada, the main economic handicap has been the lagged fallout from a high-flying Canadian dollar. Although it has been a painful adjustment, businesses have coped well by cutting costs and boosting their productivity in order to limit their loss of competitiveness; as a result, the Canadian economy expanded at a healthy pace. Looking forward, however, it appears that economic conditions may be less robust.

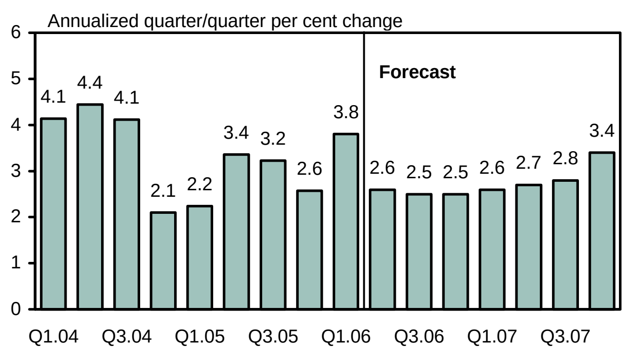
For a more in-depth economic and financial outlook, please refer to our June 14th issue of TD Quarterly Economic Forecast, available at www.td.com/economics/qef/qefjun06.pdf.

U.S. REAL GROSS DOMESTIC PRODUCT (GDP)



F: Forecast by TD Economics as at June 2006
Source: U.S. Bureau of Economic Analysis/Haver Analytics

CANADIAN REAL GDP



F: Forecast by TD Economics as at June 2006; Source: Statistics Canada/Haver Analytics

Economic expansion to moderate

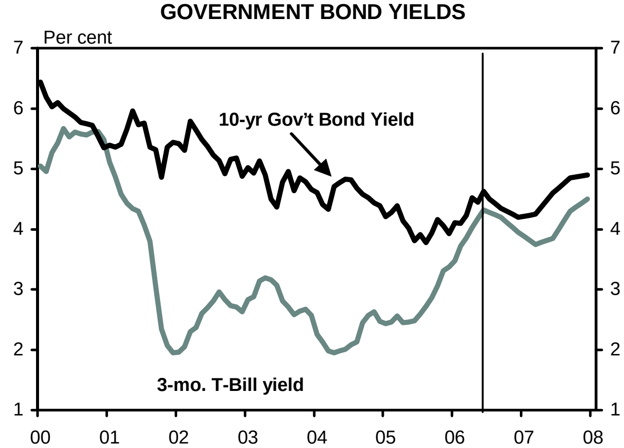
In the United States, the U.S. Federal Reserve has raised interest rates considerably from their 1.00 per cent trough in order to ensure that inflation remains in check. The result of these higher interest rates means that monetary policy could act as a headwind to the economy going forward. In addition to tempering consumer spending, and to a lesser extent business investment, higher interest rates are cooling U.S. real estate markets. This is likely to dampen consumer spending as the powerful wealth effects arising from past home price increases, mortgage refinancing and cashing-out of home equity wanes. As a result, TD Economics believes that the average annual pace of U.S. economic growth in 2007 will likely slacken. However, a hard landing is not anticipated and some improvement can be reasonably expected in the latter part of the year.

Any moderation in U.S. economic growth will impact other economies. Softer U.S. demand would likely dampen international exports, leading to slower economic growth in the major U.S. trading partners. However, given the momentum in world expansion, the overall pace of global growth is expected to remain above its historical average, and there is little chance that the Chinese and Indian boom could be derailed. Canada could be adversely affected, as exports represent roughly 40 per cent of the economy and as 85 per cent of Canadian shipments head Stateside. Simultaneously, the Canadian economy will be feeling the lagged effect of the Bank of Canada's rate hikes delivered in late 2005 and in 2006, which suggests some moderation in consumer spending and housing markets. Overall, the annual pace of Canadian economic growth is forecasted to slow modestly in 2007, but this national perspective masks the likelihood of continued above-average growth in Western Canada, and a sub-par performance in Central Canada and parts of Atlantic Canada.

Financial implications

This economic backdrop has many financial implica-

CANADIAN 3-MONTH T-BILL RATES & 10-YEAR GOVERNMENT BOND YIELDS



Actual data to: June 2006; Forecast by TD Economics as at July 2006; Source: Haver/Federal Reserve Board

Bottom Line

- Monetary policy could act as a headwind to the economy going forward
- Overall pace of global growth anticipated to remain above historical average
- Average annual pace of U.S. and Canadian economic growth in 2007 predicted to slow modestly
- Modest pace for corporate profits growth predicted in 2007
- Commodity prices vulnerable to a correction
- Interest rates likely to decline in late 2006 and early 2007
- U.S. dollar likely to lose ground relative to other major currencies
- Canadian dollar forecasted to remain strong
- Economic slowdown should be mild and transitory

tions.

First, weaker economic growth suggests a modest pace of corporate profit growth in 2007. However, strong corporate balance sheets should allow the majority of firms to ride out any weaker economic times.

Second, commodity prices are vulnerable to a further correction, as a slowdown in the world's largest economy – the United States – could result in softer global demand for raw materials. Having said that, price levels should remain high, supported by strong demand from Asia. Some commodities may also break from the general trend. So, while oil prices could drop, natural gas prices are forecast to rise – barring another extraordinarily mild winter.

Third, interest rates are likely to decline in late 2006 and early 2007. Weaker economic growth would lower the risks of inflation, leading to a rally in bonds. There is also a possibility that the Federal Reserve and the Bank of Canada could cut rates to limit the slowdown. However, as economic conditions gradually recover, interest rates would most likely rise once again.

Fourth, the U.S. dollar is likely to lose ground relative to the other major currencies, including the Japanese yen and the euro. The Canadian dollar could also benefit from U.S. dollar weakness, but in recent years the dominant driver behind movements in the exchange rate has been commodity prices. Nevertheless, even if commodity prices decline as anticipated, the Canadian dollar should remain strong and it will likely hold well above its estimated fair value of 82 U.S. cents.

Weakness will pass

Lastly, it should be stressed that the economic slowdown should prove mild and transitory. While economic and financial volatility may be present, the underlying fundamentals should remain positive. Unemployment is forecast to remain low, interest rates are anticipated to remain modest by historical standards, and income is likely to continue to rise. As a result, households, businesses and investors should not panic if there are signs of economic moderation, as the economies should recover in the near future.

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