TD Bank Financial Group

TD Economics

Foreign Exchange Outlook

February 15, 2005

CANADIAN DOLLAR

- **Canadian dollar to trade in an 80-83 U.S. cent range**

The Canadian dollar recently dipped below 80 U.S. cents for the first time since October 2004, but any further downside potential appears limited. The loonie's recent slide reflects two main factors. For one, while we still view the longer-term U.S. dollar bear market as intact, heightened risks that the Fed may shift to a more aggressive tightening path have provided the greenback with a solid boost – not only against the loonie, but against other major currencies as well. Notably, while the Canadian dollar has lost a fair amount of ground against the greenback since it peaked in late November at almost 85 U.S. cents, it has lost less ground against the euro, the pound, the yen and the Aussie dollar. The second factor is the shift in expectations regarding Bank of Canada policy. The Bank of Canada brought its tightening run to a halt in December, and markets have almost completely priced out any action at all from the central bank until mid-year – in sharp contrast to the opposite shift in expectations regarding Fed policy. From a near-term perspective, with the loonie's path remaining a key factor in the market's perception of the likely course of Bank of Canada policy, we would expect the currency to outperform the other majors during periods of U.S. dollar strength, and to underperform during periods of weakness.

In any event, we do not believe the U.S. dollar bear market to have run its course, and that will provide the loonie with a lift going ahead. Moreover, while the divergence between Canadian and U.S. monetary policy is for real, market expectations have run a bit too far. The Fed is unlikely to deviate from its "measured" pace of tightening, especially in the wake of the weak January Payrolls report. While the Bank of Canada is on hold for now – and will probably remain so in the first half of the year – it too, will get back on the tightening path later in 2005.

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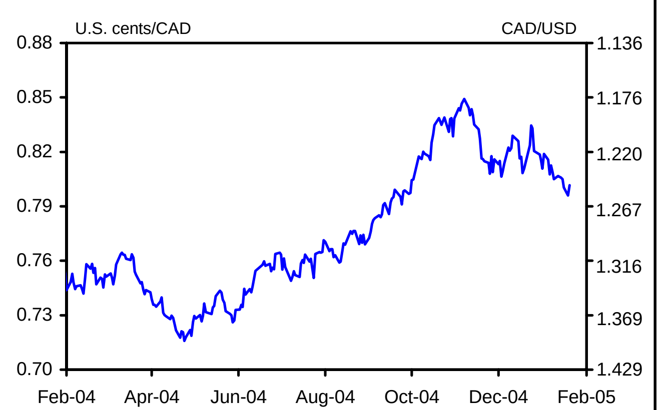
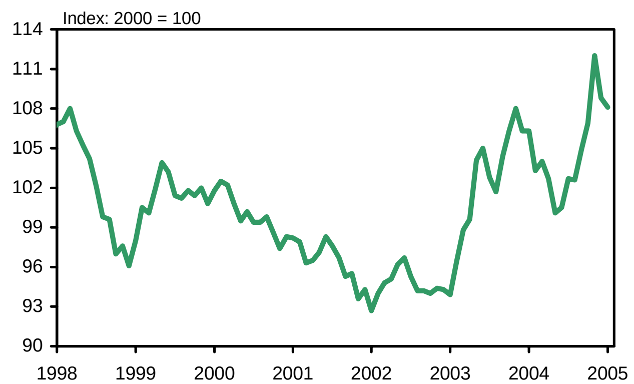


Source: Federal Reserve of New York, TD Economics



*Real broad effective exchange rate. Last month plotted: January 2005 Source: Global Insight, TD Economics

CANADIAN DOLLAR FUNDAMENTALS

Interest Rate Spreads	–	**Business Cycle**	N
Inflation Differential	N	**Fiscal Balances**	+
Current Account	+	**Politics**	N

Legend: - is negative, + is positive, N is neutral for currency

FX SPOTLIGHT: CANADIAN DOLLAR CROSS-RATES

The dominant currency market trend flagged in recent issues of Global Markets – namely, a further decline in the U.S. dollar precipitated by investors' uneasiness about the U.S. current account deficit – remains the over-arching theme of this month's FX forecasts. But, a narrow focus on the greenback overlooks developments in other cross-rates, one of the most interesting of which concerns the Canadian dollar. As the adjacent table makes clear, the loonie was one of the top performers versus the U.S. dollar in 2003, and it more than held its own in the middle of the Global Markets pack last year. But, several factors are now flashing negative for the currency – in particular, expectations for a less aggressive pace of tightening from the Bank of Canada and for a modest pullback in commodity prices. This should keep USD/CAD rangebound in 2005-06, implying that the loonie's performance versus other currencies will be largely a function of moves in their U.S. dollar exchange rates. With most of these currencies poised to continue strengthening versus the greenback, our expectation for little or no change in USD/CAD implies that the loonie is set to lose ground versus almost all of its Global Markets counterparts.

The table below shows Canadian dollar cross-rates by geographic region, which we expect will be the primary dimension along which currency trends diverge in 2005-06. In keeping with our long-held view that China will revalue the renminbi by 10 per cent in late 2005, thereby triggering an upward re-alignment in USD exchange rates across the Asian-Pacific region, we expect the loonie's decline to be most pronounced versus the Asian currencies. A smaller pullback is in store versus the European currencies, which are likely to strengthen more modestly versus the greenback in 2005-06, following their steep climb over the last two years. The Canadian dollar is expected to hold steady versus the Aussie dollar, as the latter falls prey to the same factors dogging the loonie – *i.e.*, falling commodity prices and less favourable interest-rate spreads versus the United States. And, in the Latin American bloc, CAD will split the difference, weakening versus the peso as MXN finally finds its legs versus the U.S. dollar, but holding its own versus the real as BRL/USD gives up some of its recent gains.

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PER CENT CHANGE VERSUS U.S. DOLLAR*

2003		2004	
Australian dollar	33.7	Korean won	15.2
Brazilian real	22.3	Brazilian real	9.2
Canadian dollar	**22.3**	Swiss franc	8.9
Swedish krona	20.8	Swedish krona	8.7
EU-12 euro	20.1	EU-12 euro	8.1
Swiss franc	11.8	U.K. pound	7.7
U.K. pound	10.9	**Canadian dollar**	**7.1**
Japanese yen	10.8	Japanese yen	3.9
Korean won	-0.5	Australian dollar	3.5
Mexican peso	-7.3	Mexican peso	0.2

*Year-end to year-end; Source: Federal Reserve of New York

CANADIAN DOLLAR VS. TD GLOBAL MARKETS CURRENCIES

Exchange Rate	Quote	Exchange Rates						Per cent change in Canadian dollar					
		2001	2002	2003	2004	2005f	2006f	2001	2002	2003	2004	2005f	2006f
Dollar bloc:													
U.S. dollar	USD/CAD	62.79	63.29	77.38	82.89	83.00	83.00	-5.8	0.8	22.3	7.1	0.1	0.0
Australian dollar	AUD/CAD	122.7	112.5	102.9	106.5	106.0	105.1	2.3	-8.3	-8.5	3.5	-0.5	-0.9
Asia-Pacific:													
Chinese renminbi	CNY/CAD	5.20	5.24	6.41	6.86	6.18	6.18	-5.8	0.8	22.3	7.1	-9.9	0.0
Japanese yen	JPY/CAD	82	75	83	85	78	71	7.9	-8.7	10.3	3.1	-8.7	-9.6
Korean won	KRW/CAD	825	751	923	858	780	734	-2.3	-9.0	22.9	-7.0	-9.1	-6.0
Europe:													
EU-12 euro	CAD/EUR	1.417	1.657	1.628	1.643	1.639	1.687	-0.7	-14.4	1.8	-0.9	0.3	-2.9
U.K. pound	CAD/GBP	2.316	2.543	2.306	2.319	2.341	2.343	-3.2	-8.9	10.3	-0.6	-0.9	-0.1
Swiss franc	CHF/CAD	1.042	0.876	0.958	0.941	0.940	0.925	8.8	-16.0	9.4	-1.7	-0.2	-1.6
Swedish krona	SEK/CAD	6.566	5.503	5.568	5.489	5.401	5.188	17.9	-16.2	1.2	-1.4	-1.6	-4.0
Latin America:													
Mexican peso	MXN/CAD	5.75	6.60	8.70	9.30	8.96	8.72	-10.4	14.8	31.8	6.9	-3.6	-2.8
Brazilian real	BRL/CAD	1.45	2.24	2.24	2.20	2.28	2.24	11.6	54.3	0.0	-1.9	3.9	-1.8

f: Forecast by TD Economics as at February 2005; All forecasts are for end of period; Source: Federal Reserve of New York, TD Economics

U.S. DOLLAR

- **U.S. dollar to resume weakening**

After falling to a seven-year low at the end of 2004, the trade-weighted U.S. dollar has rallied since the beginning of 2005, rising by more than 2 per cent according to the Fed's broad index. The dollar has been buoyed by several factors. First, while the Fed has tightened monetary policy by 150 basis points since last summer, central banks around the globe have reacted to last year's weakness in the dollar – and the accompanying rise in their own currencies – by holding the line on rates. As a result, the greenback is getting support from the emergence of more favourable interest-rate spreads versus currencies like the Canadian dollar and the euro. Second, there has been some encouraging news on capital flows, including reports that a number of U.S. firms may take advantage of a one-time window to repatriate overseas profits in 2005 at a much-reduced tax rate (5.25 per cent versus the usual 35 per cent). Third, Fed officials, including Chairman Greenspan, are sounding much more optimistic about the United States' ability to attract sufficient foreign capital to finance its current account deficit.

Nevertheless, the rebound is expected to be short-lived. Although the Bush Administration has presented a much tighter budget for fiscal 2005/06, it has yet to be approved by Congress. And, in the meantime, the Congressional Budget Office's latest projections for the federal budget deficit – not the baseline numbers, but the alternative scenarios, which factor in increased military spending and a continuation of the 2001/03 tax cuts – show little improvement over the next decade, implying correspondingly dim prospects for a near-term narrowing in the current account deficit. This should put renewed downward pressure on USD throughout 2005-06, spurring central banks to continue diversifying their reserves out of dollars. Adding it all up, an 8-per-cent depreciation in the broad trade-weighted greenback between now and the end of 2006 looks like a conservative bet.

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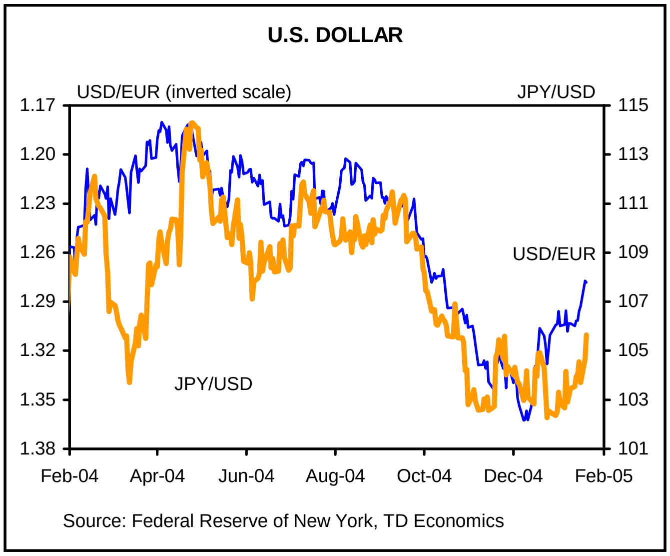

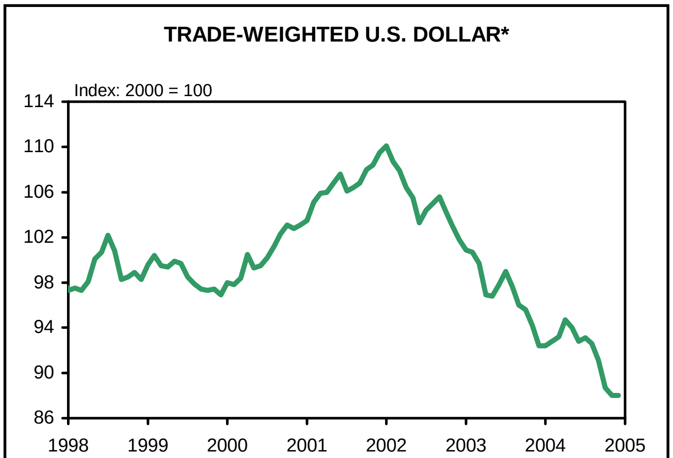

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U.S. DOLLAR FUNDAMENTALS

Interest Rate Spreads	+	**Business Cycle**	+
Inflation Differential	–	**Fiscal Balances**	–
Current Account	–	**Politics**	N

Legend: - is negative, + is positive, N is neutral for currency

CANADIAN DOLLAR OUTLOOK													
	Spot Price	2004				2005				2006			
	2/14/2005	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
CAD per USD	1.234	1.310	1.341	1.265	1.206	1.250	1.235	1.220	1.205	1.205	1.205	1.205	1.205
USD per CAD	0.810	0.763	0.746	0.791	0.829	0.800	0.810	0.820	0.830	0.830	0.830	0.830	0.830
JPY per CAD	85	80	82	87	85	82	81	80	78	76	75	72	71
CAD per EUR	1.602	1.610	1.633	1.571	1.643	1.625	1.630	1.634	1.639	1.651	1.663	1.675	1.687
CAD per GBP	2.33	2.410	2.430	2.288	2.319	2.372	2.362	2.351	2.341	2.341	2.342	2.342	2.343

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U.S. DOLLAR OUTLOOK													
	Spot Price	2004				2005				2006			
	2/14/2005	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Trade-wtd. USD	110.1	113.4	115.8	113.9	108.1	109.7	108.6	107.4	103.4	102.9	102.3	101.5	101.0
JPY per USD	104.9	104	109	110	103	103	100	97	94	92	90	87	85
USD per EUR	1.298	1.229	1.218	1.242	1.362	1.300	1.320	1.340	1.360	1.370	1.380	1.390	1.400
USD per GBP	1.892	1.840	1.813	1.809	1.922	1.898	1.913	1.928	1.943	1.943	1.944	1.944	1.944

f: Forecast by TD Economics as at February 2005; All forecasts are for end of period; Source: Federal Reserve of New York, TD Economics