

## Global Slowdown to rain on Canada's parade in 2012

- Expect real GDP growth of 1.7% in 2012 and 2.2% in 2013
- Market volatility and global economic slowdown are likely to persist at least through the first six months of 2012
- China and US will feel the pinch from reduced export demand and heightened financial stress
- Global economic growth will slow to 2.5% in 2012
- Export growth will be constrained and commodity prices are expected to face significant downward pressure, with WTI crude oil heading towards US\$80 per barrel
- CAD is anticipated to fall to about 90 US cents by mid year
- Maintain view that BoC will keep its short-term interest rate unchanged at 1% until early 2013
- Record household debt levels in Canada are likely to remain a key obstacle in economic growth over the medium term, currently the household debt-to-income ratio is at a record 151%
- The housing market will enter 2012 in a position of moderate overvaluation in existing home prices and an overhang of unsold inventory in the new home market
  - These excesses will unwind over the next few years, reflecting prospects for normalization in interest rate beginning in 2013
  - Residential investment will present a medium-term drag on growth, while home price declines will be an additional impediment to household spending
- The government will restrain spending over the next 5 years in the face of significant deficits

# QUARTERLY ECONOMIC FORECAST

## TD Economics



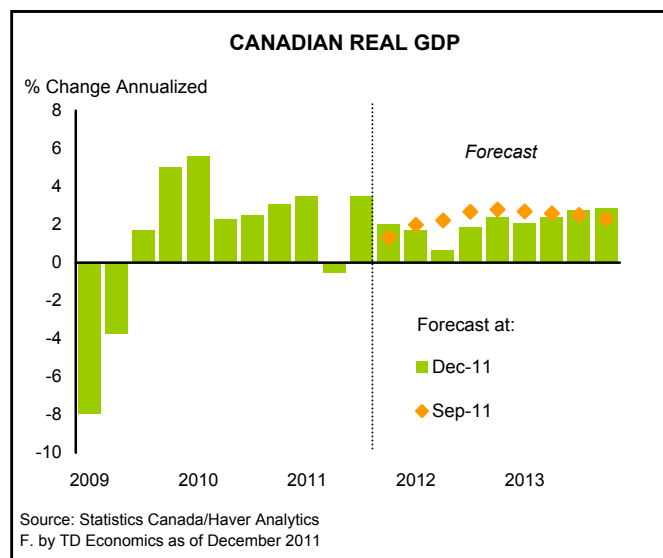
December 14, 2011

## GLOBAL SLOWDOWN TO RAIN ON CANADA'S PARADE IN 2012

### Highlights

- Canadian economic momentum over the second half of 2011 has been better than expected, led by a rebound in exports. Economic growth is projected to be 2.4% for the year as a whole.
- In 2012, an escalation of the European financial crisis and a deepening recession in the region will exert a significant drag on the global economy. Canada will be negatively impacted through weaker commodity prices, confidence and export growth. Labour markets will also soften as a result.
- Canadian economic activity is expected to improve in late 2012 and into 2013. Still, high household and government debt, rising interest rates and slowing housing activity will limit the speed of Canadian real GDP growth.
- Overall, since our last forecast in September, TD Economics has shaved 0.2 and 0.4 percentage points off its Canadian growth forecast for 2012 and 2013 respectively. We now expect real GDP growth of 1.7% in 2012 and 2.2% in 2013. The limited change to the 2012 annual growth reflects the momentum heading into next year.

After stalling in the second quarter of 2011, Canada's economic momentum has gained surprising strength in the second half of the year. Unfortunately, this momentum is unlikely to have staying power. Being a small open economy, much of Canada's performance depends on global events. And, the global economic and financial environment remains a key challenge for the Canadian economy. Given that we do not foresee a credible resolution to Europe's debt problems any time soon, the region's financial crisis is expected to worsen before decisive action is taken. It is impossible to predict politics, but given the heavy borrowing requirement in early 2012 of several of the European countries that are under financial pressure, we have assumed a deterioration of financial conditions and a significant European recession in the first half of next year. This leads to a weaker global economy that puts a damper on Canadian exports and consumer and business confidence. While we assume that the second half of 2012 will bring better news, real economic growth is still likely to slow to a paltry 1.7% for the year as a whole and the unemployment rate to move up to within the range of 7.5-8%. Canada's economic prospects are expected to brighten in 2013, with real GDP advancing by 2.2%.



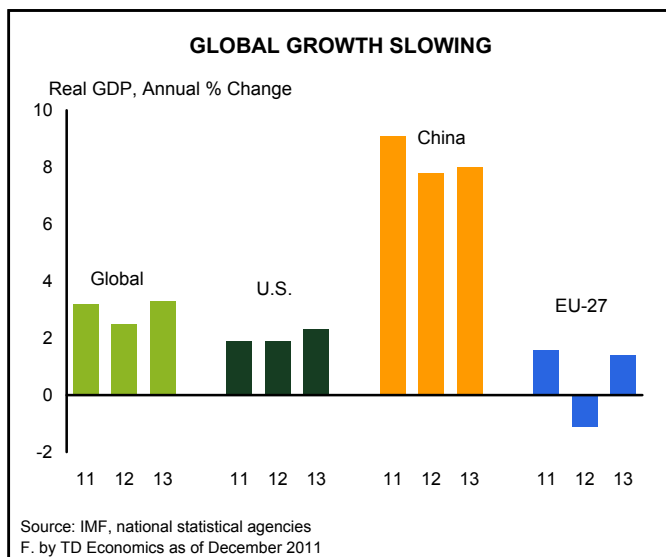
### Recent economic rebound masks fragile fundamentals

Despite elevated international financial and economic stress, the Canadian economy continues to beat expectations in the second half of 2011. Real GDP advanced 3.5% (annualized) in the third quarter, following a slight contraction in the prior quarter. The rebound was largely due to the reversal of temporary negative factors that weighed on growth in the second quarter. The re-opening of energy plants and the fading of supply chain disruptions contributed to a strong one-time bounce back in Canadian exports. However, cracks continued to form under the surface. Consumer spending growth was tepid for a third straight quarter, while businesses reined in spending on capital investment for the first quarter since 2009.

With the momentum in exports and manufacturing fading in the final quarter of the year, we expect Canada's rate of expansion to cool to a still-solid 2% in the October-December period. In particular, labour markets have softened as businesses have become increasingly reluctant to hire given the uncertain international backdrop. The unemployment rate climbed to 7.4% in November, after hitting a 3-year low of 7.1% in September. Meanwhile, wage growth has not kept up with inflation, putting additional strain on Canadian households. Both businesses and consumers appear to be ending 2011 on a more cautious note.

### Global economic slowdown to weigh on Canadian real GDP in first half of 2012

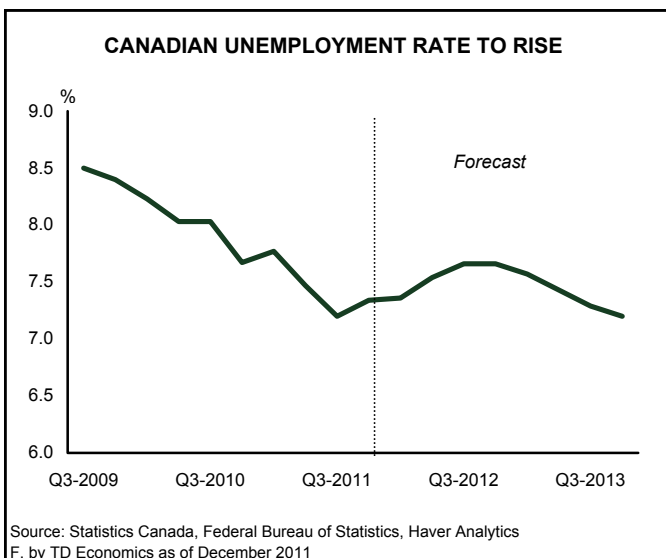
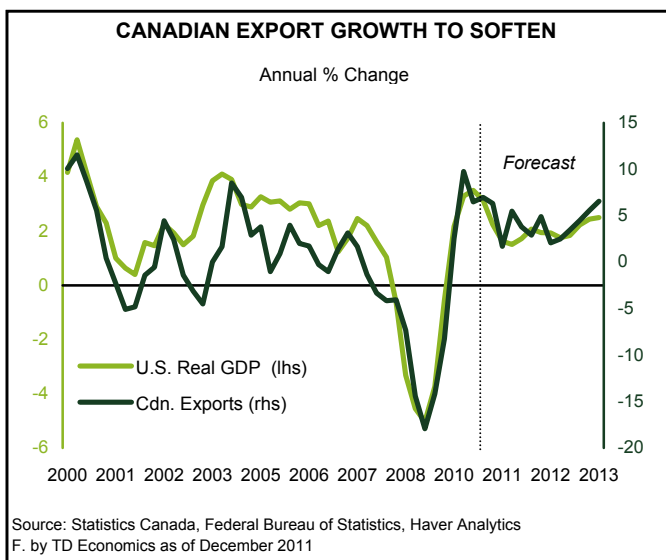
While we have upgraded our view on the second half of 2011, the same cannot be said for 2012. Soft domestic conditions are likely to be met with a continued escalation



### Timeline of Events Driving the European Financial Crisis

- European financial conditions expected to deteriorate further in early 2012.
- Greece will very likely default in the first half of next year; it seems probable that this will trigger credit default swaps, weakening the global financial system.
- Faced with the risk of a financial crisis that could very well rival the 2008/2009 crisis, political leaders are expected to be pushed into taking bold actions.
- We believe the European Central Bank will ultimately intervene, buying sovereign bonds on a major scale, while continuing to provide ample liquidity to European banks. These pressures will help ease financial pressures in late 2012.
- Ultimately, Germany and the ECB will likely accept that the central bank must become a lender of last resort and likely also launch something akin to Eurobonds. The latter action will necessitate further progress politically towards a fiscal union, although it will take years to ultimately materialize.

in the European financial crisis. Implementing a plan to deal with Europe's debt problems has been a challenge for political leaders. And so, the crisis goes on. TD Economics believes that the crisis will worsen before things get better, particularly as major debt-laden economies have a significant amount of debt to roll over in the first half of next year. As such, we have made some assumptions on how the crisis will play out over the next year (see text box). Of course, political leaders could come to the rescue sooner than expected and help avoid a financial calamity. However, in our view any credible resolution will take some time to execute and will likely include a Greek debt restructuring to be sustainable. Moreover, regardless of how the fiscal crisis plays out, Europe appears headed for a significant recession, which will have global knock-on effects. As such, market volatility and a global economic slowdown are likely to persist at least through the first six months of 2012. Major economies, such as China and the U.S., will feel the pinch from reduced export demand and heightened financial stress. As a result, global economic growth will slow to 2.5% in 2012, representing a significant downward revision from our forecast of 3.2% in September. At the world level, this is the equivalent of stalling. For further details please see TD Economics "Global Quarterly Economic Outlook" and



“U.S. Quarterly Economic Outlook”.

These external events will likely have significant consequences for the Canadian economy. Export growth will be constrained and commodity prices are expected to face significant downward pressure, with WTI crude oil prices heading down towards US\$80 per barrel. In this environment, the Canadian dollar is anticipated to fall to about 90 U.S. cents by mid year, cushioning some of the blow on Canadian exports. More generally, a further flare-up in financial market turbulence early next year won't be lost on the confidence of households and businesses. In the context of global uncertainty, risk adverse Canadian businesses are likely to shy away from making large outlays and hiring. As a consequence, we have also downgraded our forecast for real GDP growth to just 1% over the first six months of 2012, half the rate envisaged at the time of our last forecast

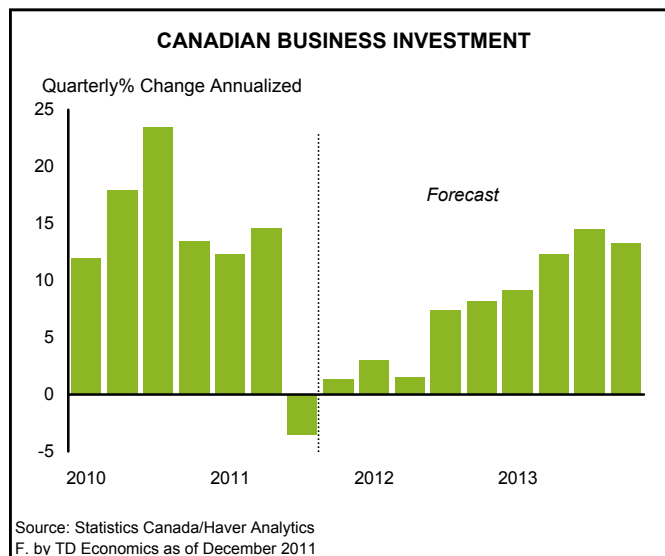
in September.

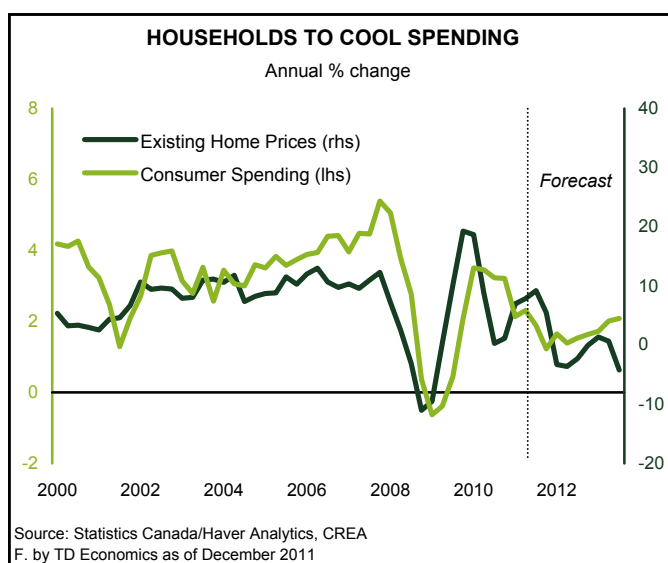
With the weakened near-term profile, we maintain our view that the Bank of Canada will keep its short-term interest rate unchanged at 1.00% until early 2013. At the same time, the current low level of the overnight rate (only 0.75 percentage points off its effective floor) leaves the central bank with little downward room to maneuver without embarking on unconventional policy measures. As such, barring a domestic economic contraction, we are not expecting interest rate cuts in the coming months.

**A snap back in GDP expected for the second half of 2012**

If Europe is to avoid a financial calamity, decisive actions will have to be implemented. Under the assumption that these actions occur by mid-year, the stage will be set for a recovery in confidence and global growth. While the Canadian dollar is expected to rally in lockstep with improved global conditions, Canadian exports will expand on the back of firming U.S. economic growth. Demand in emerging markets is also anticipated to post a recovery, pulling commodity prices along for the ride. Meanwhile, Canadian businesses have been stashing cash to help shore up balance sheets and are now holding record levels of it. Once the international outlook improves, this is money they will have ready to deploy on investment and hiring.

Still, there will be limits to how fast economic activity snaps back in Canada. There will be lingering effects from the European recession. Domestically, record household debt levels in Canada are likely to remain a key obstacle to economic growth over the medium term. The household debt-to-income ratio is at a record 151%. Households have





shown some borrowing restraint, with the pace of household debt growth in the 2010-11 period slowing to half the rate recorded during 2002-09. But, even taking into account TD Economics' forecast for moderate borrowing and spending growth, slow gains in after-tax income are likely to keep the debt-to-income ratio on a modest upward track.

Not unrelated to the household debt story, housing activity is likely to be a sore spot for the Canadian economy over the medium term. Low interest rates and improved affordability over the last three years lifted housing demand sharply, as a surprisingly high number of first time homebuyers jumped into the market. This helped underpin a hefty pace of new homebuilding, particularly in the condo markets of major urban centres. The housing market will enter 2012 in a position of moderate overvaluation in existing home prices and an overhang of unsold inventory in the new home market. We anticipate that these excesses will unwind over the next few years, partly reflecting prospects for a normalization in interest rates beginning in 2013. As such, residential investment will likely represent a medium-term drag on growth, while home price declines will be an additional impediment to household spending as consumers feel their wealth diminishing.

Lastly, Canadian governments at all levels are currently facing significant deficits. Canadian governments at all levels have stated their strong commitment to balancing budgets within a reasonable time frame. Most intend to do so by restraining spending over the next five years. And, the European financial crisis demonstrates the importance of responsible fiscal policy.

All said, we expect Canadian economic growth to aver-

age 2.1% in the second half of 2012, and 1.7% for the year as a whole. In 2013, real GDP is forecasted to advance at a healthier, but still gradual rate of 2.2%. This pace of real economic activity is consistent with a gradual decline in the unemployment rate to 7.2% by the end of 2013.

### Conclusions and Risks

The prospects for a deep European recession in the first half of 2012 have led us to downgrade our global and Canadian real GDP growth forecast for the year. We now expect Canadian economic growth to slow to a modest rate in 2012 and reaccelerate as the global economy recovers in 2013. Nonetheless, the underlying story of gradual real GDP expansion, a relatively elevated unemployment rate of more than 7% and an extended period of low interest rates has not changed.

Of course there are a number of risks to that outlook, as much depends on how the European crisis unfolds over the next few months. On the downside, the global economy could turn out to be weaker than projected if policymakers in the U.S. and Europe fail to deal with their fiscal problems, resulting in a renewed global financial crisis as deep as the 2008/2009 experience. On the other hand, European leaders could address their fiscal problems faster than expected, restoring market confidence and leading to a sharp global economic rebound. There is considerable potential for an improved international outlook to support stronger Canadian exports and business investment. However, we would be concerned if stronger Canadian economic growth was the result of more robust housing activity and a pick-up in household credit growth.

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## CANADIAN ECONOMIC OUTLOOK

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

	2011				2012				2013				Annual Average			4th Qtr/4th Qtr		
	Q1	Q2	Q3	Q4F	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	11F	12F	13F	11F	12F	13F
<b>Real GDP</b>	3.5	-0.5	3.5	2.0	1.7	0.5	1.8	2.4	2.0	2.4	2.7	2.8	2.4	1.7	2.2	2.1	1.6	2.5
<b>Consumer Expenditure</b>	-0.1	2.1	1.2	1.7	1.6	1.0	1.8	2.1	2.0	2.2	2.1	2.0	1.9	1.6	2.0	1.2	1.6	2.1
Durable Goods	-6.5	2.1	-1.5	3.0	1.8	-5.0	1.0	2.5	3.5	4.0	2.0	1.9	0.4	0.3	2.3	-0.8	0.0	2.8
<b>Business Investment</b>	12.3	14.6	-3.6	1.3	3.0	1.5	7.4	8.2	9.1	12.3	14.5	13.2	11.7	3.1	9.8	5.9	5.0	12.3
Non-Res. Structures	10.3	-0.9	4.4	-0.5	1.0	-0.5	3.5	6.0	7.0	7.5	7.8	8.2	9.3	1.4	6.2	3.2	2.5	7.6
Machinery & Equipment	14.5	32.7	-11.0	3.1	5.0	3.5	11.2	10.4	11.2	17.0	21.0	18.0	14.1	4.8	13.3	8.7	7.5	16.7
<b>Residential Investment</b>	6.7	1.6	10.9	4.0	-1.0	-5.0	0.4	2.3	-0.5	-7.4	-7.9	-5.6	2.7	1.1	-2.8	5.8	-0.9	-5.4
<b>Government Expenditures</b>	4.4	0.9	0.0	0.6	0.4	0.4	0.1	0.1	-0.4	-0.1	-0.1	-0.1	1.3	0.4	-0.1	0.4	0.3	-0.1
<b>Final Domestic Demand</b>	1.5	3.1	0.9	1.6	1.3	0.5	1.9	2.3	2.0	2.1	2.3	2.3	2.8	1.4	2.0	1.8	1.5	2.2
<b>Exports</b>	6.2	-6.4	14.4	2.1	1.9	1.0	2.6	3.9	6.4	5.2	6.9	7.8	4.3	2.9	5.0	3.8	2.3	6.6
<b>Imports</b>	8.4	13.6	-3.2	1.0	0.6	0.4	3.0	2.6	5.9	5.1	5.5	5.4	6.4	1.3	4.4	4.7	1.7	5.5
<b>Change in Non-Farm Inventories (\$2002 Bn)</b>	7.1	17.5	7.1	7.5	7.8	6.5	7.0	6.5	5.6	7.5	8.0	7.0	9.8	7.0	7.0	---	---	---
<b>Final Sales</b>	0.3	-3.8	6.9	2.1	2.0	0.8	1.9	3.0	2.2	2.5	3.2	3.5	2.0	2.1	2.5	1.3	1.9	2.9
<b>International Current Account Balance (\$Bn)</b>	-41.4	-64.5	-48.5	-53.8	-31.6	-34.1	-33.5	-30.4	-28.3	-27.8	-25.3	-20.9	-52.1	-32.4	-25.6	---	---	---
% of GDP	-2.4	-3.8	-2.8	-3.1	-1.8	-1.9	-1.9	-1.7	-1.6	-1.5	-1.4	-1.1	-3.0	-1.8	-1.4	---	---	---
<b>Pre-tax Corp. Profits</b>	20.5	-7.8	18.1	1.6	-4.0	-8.2	14.7	7.5	7.4	7.6	13.8	8.5	13.0	1.4	8.2	7.4	2.1	9.3
% of GDP	12.0	11.7	12.0	12.0	11.8	11.5	11.8	11.9	12.0	12.1	12.4	12.5	11.9	11.8	12.2	---	---	---
<b>GDP Deflator (Y/Y)</b>	2.9	3.4	3.4	2.1	1.4	1.1	1.2	1.4	1.6	1.6	1.7	1.9	3.0	1.3	1.7	2.1	1.4	1.9
<b>Nominal GDP</b>	7.7	2.1	4.6	3.0	2.6	1.8	3.5	3.9	3.8	4.1	4.7	5.0	5.4	2.9	3.9	4.3	3.0	4.4
<b>Labour Force</b>	2.6	0.8	0.1	0.8	1.0	1.0	1.2	1.2	1.3	1.2	1.3	1.5	1.0	0.9	1.2	1.1	1.1	1.3
<b>Employment</b>	2.4	2.0	1.2	0.3	0.9	0.2	0.7	1.2	1.7	1.8	1.9	1.9	1.6	0.8	1.4	1.5	0.7	1.8
<b>Employment ('000s)</b>	101	87	50	13	39	9	30	52	74	79	83	84	272	130	252	251	130	319
<b>Unemployment Rate (%)</b>	7.8	7.5	7.2	7.3	7.4	7.5	7.7	7.7	7.6	7.4	7.3	7.2	7.4	7.6	7.4	---	---	---
<b>Personal Disp. Income</b>	2.6	3.2	-0.2	2.8	3.0	1.9	2.8	3.4	3.7	4.1	4.0	4.1	2.9	2.4	3.6	2.1	2.8	4.0
<b>Pers. Savings Rate (%)</b>	4.3	4.1	3.5	3.3	3.2	3.1	3.1	3.2	3.3	3.4	3.4	3.5	3.8	3.1	3.4	---	---	---
<b>Cons. Price Index (Y/Y)</b>	2.6	3.4	3.0	2.7	2.1	1.7	1.4	1.5	1.6	1.8	1.9	1.9	2.9	1.7	1.8	2.7	1.5	1.9
<b>Core CPI (Y/Y)</b>	1.3	1.6	1.9	2.0	1.8	1.5	1.4	1.3	1.5	1.6	1.8	1.8	1.7	1.5	1.7	2.0	1.3	1.8
<b>Housing Starts ('000s)</b>	178	192	205	193	188	175	180	182	178	173	169	167	192	181	172	---	---	---
<b>Productivity:</b>																		
<b>Real GDP / worker (Y/Y)</b>	0.9	0.6	0.9	0.6	0.5	1.2	1.0	0.8	0.7	0.8	0.7	0.7	0.7	0.9	0.7	0.6	0.8	0.7

F: Forecast by TD Economics as at December 2011

Source: Statistics Canada, Bank of Canada, Canada Mortgage and Housing Corporation, Haver Analytics

FINANCIAL INDICATOR OUTLOOK												
<i>end-of-period level</i>												
	2011				2012				2013			
	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
<b>CANADIAN FIXED INCOME</b>												
Overnight Target Rate (%)	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.00	1.25	1.75	2.00	2.50
3-mth T-Bill Rate (%)	0.96	0.90	0.82	0.90	0.90	0.90	0.95	1.00	1.30	1.80	2.10	2.60
2-yr Govt. Bond Yield (%)	1.83	1.59	0.89	0.95	0.95	1.00	1.20	1.40	1.80	2.20	2.70	3.10
5-yr Govt. Bond Yield (%)	2.77	2.33	1.40	1.40	1.35	1.60	1.95	2.20	2.40	2.60	3.00	3.30
10-yr Govt. Bond Yield (%)	3.35	3.11	2.16	2.20	2.10	2.20	2.80	3.00	3.25	3.40	3.60	3.70
30-yr Govt. Bond Yield (%)	3.76	3.55	2.77	2.75	2.80	2.90	3.30	3.60	3.80	3.85	4.05	4.10
10-yr-2-yr Govt. Spread (%)	1.52	1.52	1.27	1.25	1.15	1.20	1.60	1.60	1.45	1.20	0.90	0.60
<b>GLOBAL CURRENCIES</b>												
USD per CAD	1.03	1.04	0.95	0.96	0.92	0.90	0.92	0.95	0.97	0.99	1.00	1.02
USD per EUR	1.42	1.45	1.34	1.30	1.28	1.22	1.25	1.30	1.30	1.30	1.35	1.35
JPY per USD	83.1	80.5	77.0	76.0	78.0	78.0	83.0	85.0	88.0	88.0	90.0	90.0
F: Forecast by TD Economics as at December 2011												
Source: Statistics Canada, Bank of Canada, Bloomberg												



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