



TD Economics

Special Report

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RESILIENT U.S. CONSUMERS TO KEEP FED ON HOLD THROUGH 2007

The U.S. housing market and the knock-on effects to wealth are unfolding exactly in line with our expectation; however, consumer spending is proving to be far more resilient than we had initially anticipated. This has prompted an upward revision to our real GDP forecasts for the fourth of 2006 and first quarter of 2007, as well as the removal of all rate cuts (50 basis points) from our financial outlook for the year (see upcoming release of Global Markets).

Consumers hold strong

The 5.6% surge in real consumer spending in the first quarter of 2006 was thought to have been the American consumer's swan song, with growth in future purchases positioned to sag under a collapsing housing market. And for a while, it looked to be true. Consumer spending growth showed tentative signs of softening in the middle two quarters of the year, with average quarterly gains of 2.7% compared to average advances of 3.6% over the prior nine quarters. But, a probable 4% pace in the final quarter of

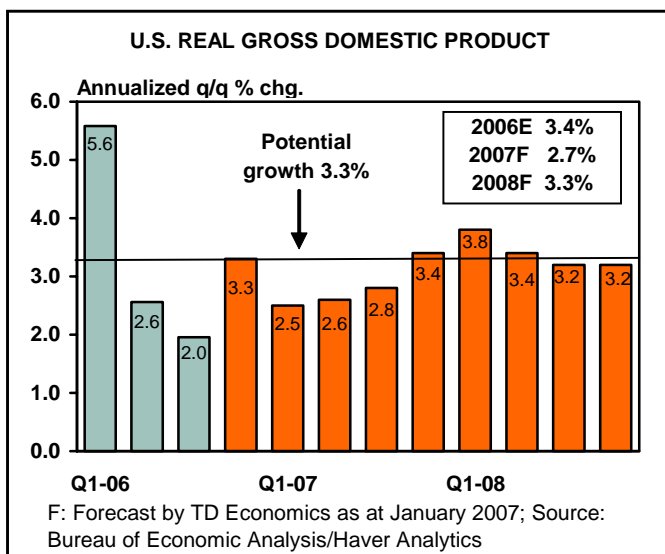
HIGHLIGHTS

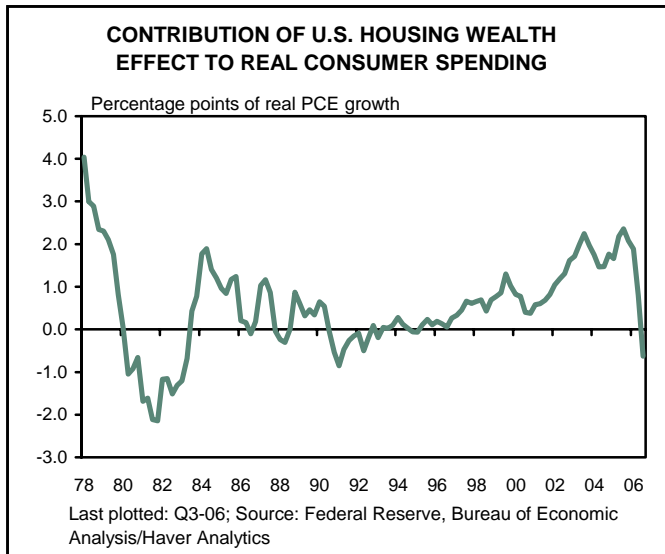
- **Resilient consumer has prompted an upward revision to U.S. real GDP forecast for Q4-06 and Q1-07**
- **50 basis points in cuts removed from financial outlook. Fed to remain on hold through the year**

the year has bucked the budding trend. The hand-off to the first quarter of 2007 may also be better-than-expected, resulting in an upwardly revised 2.5-3% quarterly pace in real consumer spending in that quarter (from our prior forecast of 2.0%). As a result, that amount of slack in the U.S. economy is far less than we had anticipated at this stage in the cycle, especially since most indicators – such as the unemployment rate and capacity utilization – are pointing to relative economic tightness.

Having said that, we caution against assuming that the current spending pace represents the status quo for 2007. Consumers respond with a lag to an evolving economic environment, and growth rarely, if ever, peter out in a predictable smooth pattern. For instance, growth in home furnishing purchases accelerated in 2006 compared to 2005, which seems counterintuitive to the rapid and severe deterioration in home sales. But in all probability, some of these purchases were the offshoot of home sales in the prior year. By extension, home-related purchases in 2007 are now vulnerable to downward pressure in relation to the 2006 housing collapse.

What's more, housing wealth effects are estimated to feed through with a 1-to-1 ½ year lag, meaning that the peak impact may not occur until mid-2007. In fact, the graph on page 2 indicates that home wealth is already not contributing to consumer spending growth as in the past.



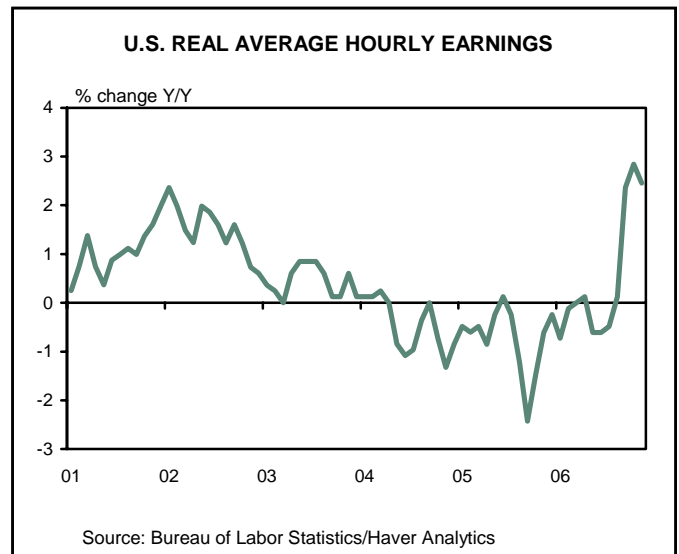


This is what we predicted would happen, raising the question as to why consumer spending won't ease to a greater extent.

Incomes and yields to the rescue

We believe two factors will support spending: wages and bond yields. As we noted in the October 2006 topic paper "The Decline and Fall of the U.S. Housing Market", total wages in the economy amount to over \$4 trillion, which is more than five times the amount of mortgage equity withdrawal. When all is said and done, the stability and strength of household incomes are the more important determinants of spending growth and consumer confidence. In this context, real average hourly earnings are running at the fastest clip since late-1998. Meanwhile, after-tax incomes are getting an additional boost from plummeting energy costs. After being squeezed for two years, consumer wallets enjoyed an additional \$31 billion in real after-tax dollars over the September-November period. With oil and natural gas prices dropping further in the first half of January, households will continue to get a break on energy costs. However, the impact may not be quite as dramatic as the past quarter, since a return to frigid seasonal temperatures means that households will have to delve out more money for increased heat consumption in general.

The subdued interest rate environment is the second important factor providing a floor under consumer spending growth. Bond yields have remained stubbornly low, below the 5.25% fed funds rate. As such, household bud-



gets aren't getting squeezed as much as thought through financing costs. For instance, mortgage rates have actually declined since the summer. The average 1-year adjustable rate in December was more than a quarter point below levels registered in July, while the longer term 5-year rate was nearly a full percentage point below the summer level.

Looking at the most common mortgage term – 30 years – households are getting an even bigger break, especially when compared to historical experience. Taking inflation into account, the last time the real fed funds rate was held at the equivalent level to today (1996-97), real 30-year mortgage rates were, on average, more than 1.6% higher than current levels. That's a significant difference in the amount of income households get to keep at the end of the day. On a \$100,000 mortgage, the cost savings is \$92 a month.

So in the end, we're not convinced that a collapsing housing market is inconsequential on consumer behaviour. However, powerful offsets are emanating from the labour market, energy prices and borrowing costs. If this continues to be the case through 2007, consumer spending growth will remain partially shielded from deteriorating wealth effects, and the economy will track a reasonably healthy, but still sub-par 2.5-3.0% quarterly pace, before accelerating into 2008. In this environment, the Fed is unlikely to feel any urgency to cut rates.

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