TD Economics

Special Report

November 27, 2007

WEAKER U.S. ECONOMIC OUTLOOK TO PROMPT FED CUTS

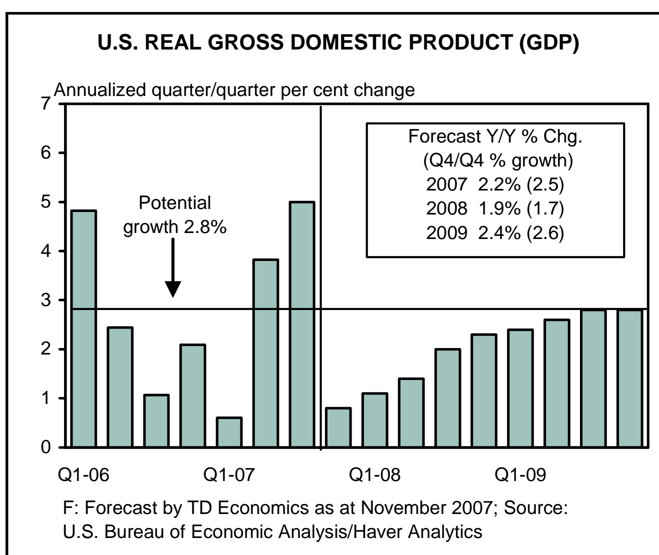
HIGHLIGHTS

- **We have downgraded our outlook for the U.S. economy**
- **Real GDP expected to expand by 1.9% in 2008 and 2.4% in 2009**
- **Federal Reserve expected to deliver 75 basis points in rate cuts in the next three meetings**

Our outlook on the U.S. economy has soured since the release of the Quarterly Economic Forecast in early October. Credit conditions have failed to improve and the housing market has moved deeper into the red, placing the economic risks disproportionately to the downside. As such, we have downgraded our U.S. real GDP forecast for 2008 to 1.9% (from 2.4%) and have cut the 2009 outlook to 2.4% (from 3.1%). We also feel conditions are ripe for the Federal Reserve to deliver another 75 basis points in cuts over the next three meetings. The economic estimates are our initial impressions. Once the preliminary estimates for third quarter GDP are released on Thursday, we will undertake a more rigorous assessment of the data and release a full set of forecast figures in the upcoming Quarterly Economic Forecast in mid-December.

There were three motivating factors that prompted the cuts to our U.S. economic growth and interest rate outlook.

First, we had hoped that the issues surrounding the credit crunch would have been largely resolved by now, but this is not the case. For instance, the TED spread has widened in November from 108 basis points at the start of the month to the 188-195 basis points range in recent days. This is similar to the levels seen in August, at the height of the credit crunch. The TED spread measures the difference between the three-month U.S. Treasury bill and the three-month LIBOR. Elevated readings indicate an increased level of risk aversion in the market, as investors flock to short-term T-bills, which are considered risk-free, while LIBOR rates are more representative of the credit quality of corporate borrowers. Most of the spread widening has come through increased demand for T-bills, but LIBOR rates have also started to creep up.



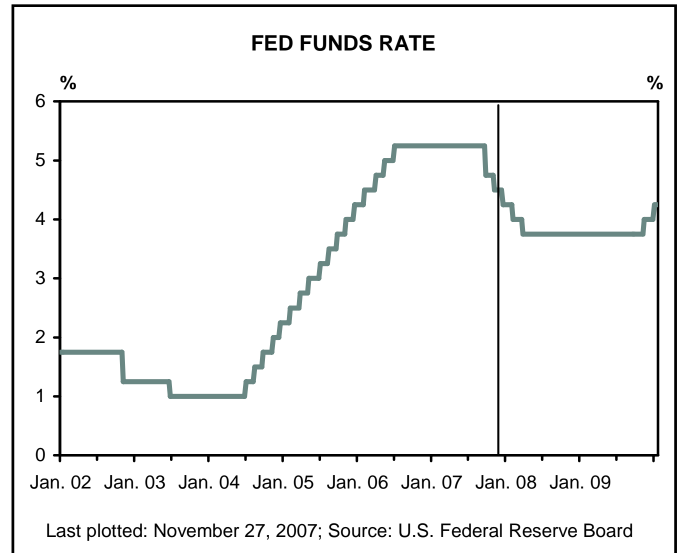
F: Forecast by TD Economics as at November 2007; Source: U.S. Bureau of Economic Analysis/Haver Analytics

Second, housing data continue to deteriorate, suggesting a deeper setback than originally forecast. Although we have been in the pessimistic camp when in came to the U.S. housing market, the data continue to overshoot on the downside. Resale home inventories for single family homes moved higher in recent months to almost a two decade high and building permits continue to tumble. As evidence by the Case-Shiller home price index for September, prices are firmly in the red across major cities, with most 3-month trends deteriorating. The implication is that the downturn in housing will extend through 2008 and prices may still be hard-pressed to advance in any meaningful way in 2009. This has the potential to generate deeper

negative wealth effects that could bite into consumer spending.

Third, we are taking into account the potential for deeper impacts from credit write-offs. Ongoing loan loss announcements by lending institutions is already contributing to market volatility that could further erode consumer confidence and equity wealth effects. However, the ultimate concern is that institutions could start to over-restrict credit flows to businesses and consumers. The October Senior Loan Officer Opinion Survey conducted by the Federal Reserve indicated that institutions have tightened their lending standards and terms on commercial, industrial, consumer and mortgage loans (be it prime, nontraditional or subprime). While the behaviour of lending institutions thus far has not been overly restrictive, it is a prime risk to the U.S. economic outlook that could crimp business and consumer spending behaviour. The Federal Reserve definitely wants to be ahead of this curve, because these are the type of forces that can lead to a more severe downturn.

The question then becomes: why aren't we expecting a recession? The risks are high at about 35-40%, but they do not trump the base-case scenario. Fed easing will take the fed funds rate down to 3.75% in the first quarter of 2008. Assuming 2% inflation, a real rate of 1.75% is quite low and should provide economic stimulus by shoring up market confidence and loosening credit conditions. History and economic theory show that when real interest rates are below real GDP growth, it usually provides stimulus to business investment, consumer spending and housing. In addition, not all sectors in the U.S. economy are doom and gloom. The decline in the U.S. dollar over the past five years is providing significant stimulus to the export sector. In fact, a strong expansion in exports has been more than offsetting the direct drag to GDP growth from residential investment – a first in fifty years during periods when housing was in a tailspin. Over the forecast horizon, we believe the U.S. economy will continue to benefit from the underpinnings of the export sector, which will help temper some of the economic fallout from the housing sector. (A detailed report on the U.S. export sector will be released on Thursday). Most importantly, while the risks to consumer spending are on the downside, we have yet to see any cracks in the armor. Workers remain in demand, with the last FOMC Beige Book highlighting a shortage of skilled workers and continued upward pressure on wages. The unemployment rate is so low that even our view for



Last plotted: November 27, 2007; Source: U.S. Federal Reserve Board

an up-tick above 5% in 2008 will not inhibit an economic rebound once the clouds part in the housing sector. Meanwhile, retailers have reported encouraging activity in holiday sales, leaving no evidence that the consumer is about to capitulate. While consumer spending should slow in the months ahead, rumors of imminent demise have consistently been proven wrong and we believe this will continue to be the case.

Given that we expect real interest rates will be as low as 1.75% next year, it will only be a matter of time before the Federal Reserve will want to normalize rates again in order to prevent a repeat scenario of excess liquidity. We believe that this is most likely to occur in late-2009, with rates rising 50 basis points. On the surface, this may seem contradictory to our view of average annual GDP growth of 2.4% in that year. However, this masks the pick-up in growth that occurs in the second half of the year when the economic expansion returns to a pace consistent with potential growth. And, we may be even a little on the soft side with these estimates. The U.S. economy has a history of strong rebounds that overshoot potential rates. The low interest rate environment in 2008 can certainly set the stage for such a rebound in 2009. Gauging from Fed estimates, potential real GDP growth appears to be in the 2.5-2.8% range. As the economy regains momentum, the Fed will have sufficient reason to take rates back to a more neutral stance.

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