TD Bank Financial Group

# TD Economics

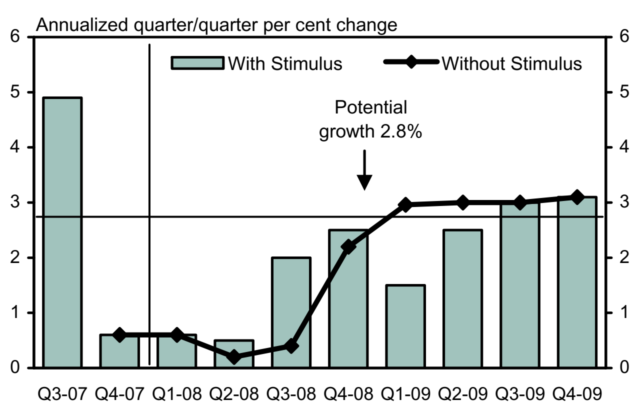
Special Report

February 5, 2008

# ECONOMIC STIMULUS AND THE U.S. OUTLOOK

A number of developments over the past six weeks have led us to revise our outlook for the U.S. economy. Continued deterioration in housing markets, volatility in equity markets and weakness in employment are expected to curb consumer spending and temper economic growth to a pace of 0.6% in the first half of 2008, from our original estimate of 0.9%. But hope is on the horizon. The feed through of past aggressive action by the U.S. Federal Reserve and the expected passage of a fiscal stimulus package in the range of $146 to $157 billion will bring significant relief to consumers in the second half of this year and into 2009. The dual contributions of fiscal and monetary stimulus will allow GDP growth to hold up at a modest rate of 1.8% in the second half of 2008. Although fiscal stimulus will have a short-term, transitory impact resulting in some payback to spending growth in 2009, by then the impact of past Fed rate cuts will have had a chance to pull up aggregate demand and the economy should be well on the road to recovery. We expect to see a return to near trend levels of economic growth by mid-year 2009.

**U.S. REAL GROSS DOMESTIC PRODUCT**




F: Forecast by TD Economics as at January 2008; Source: Bureau of Economic Analysis/Haver Analytics

### HIGHLIGHTS

- **We have adjusted our outlook for U.S. GDP growth reflecting recent economic data and in anticipation of the fiscal stimulus package in the second half of this year. GDP growth is expected to come in at a pace of 1.6% in 2008, improving to 2.2% in 2009.**
- **Continued housing troubles, volatility in equity markets and weak employment will curb consumer spending in the first half of the year.**
- **With housing subtracting from growth and consumer spending slowing, GDP will likely eke out gains of just 0.6% annualized in the first half of the year.**
- **A fiscal stimulus package in the range of $146 to $157 billion is expected to be passed by Congress in the next few weeks. The relief provided to consumers should help to bring consumer spending growth to a pace of 3.2% in the second half of the year.**

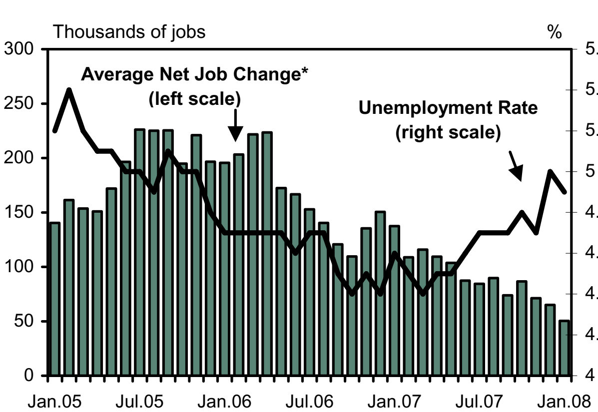
## Housing still in search of a bottom

Residential construction has been in a tail-spin since the second quarter of 2006. U.S. housing starts to date have fallen 56% from the peak and existing home prices have fallen over 8%. At the current depressed rate of sales it would take nearly 10 months to clear the supply of new and existing homes. In order to draw down this build up in inventories along side mounting foreclosures and tightened credit conditions, both housing starts and home prices still have further to fall. Residential construction is expected to subtract more than 1 percentage point from economic growth in the first half of 2008. Although aggressive rate cuts by the Federal Reserve should help to increase refinancing activity through the second half of the year and provide a floor under home prices, household wealth and consumer spending will still reflect the effects of battered home prices, and more recently volatility in equity markets.

### Employment growth no longer much of a support to consumer spending

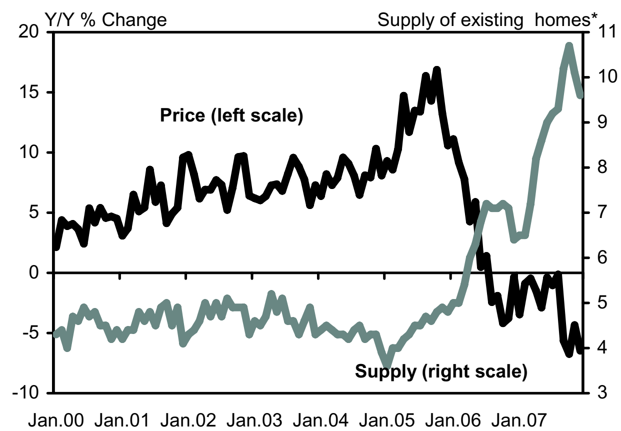
Continued income and employment growth in 2007 allowed households to keep on spending even in the face of rising energy costs and falling home prices. Real personal incomes grew by a healthy 3.1% in 2007, contributing strongly to the 2.9% increase in real personal expenditures in the year. Unfortunately, employment growth is showing clear signs of decelerating. 17,000 jobs exited payrolls in January and though this was met with a slight drop in the rate of unemployment, the jobless rate is up 0.5 percentage points from March of 2007. Perhaps even more troubling is the slowdown in the six-month trend in private monthly job growth, which fell to an average of 50,000 new jobs, its slowest pace since 2003. With real income growth (before the fiscal stimulus) likely to slow to half the pace observed in 2007 and with the continued negative wealth impacts from falling home prices, income and employment growth won't be the force they once were in supporting consumer spending.

**U.S. EMPLOYMENT**




Seasonally adjusted data; * 6 month average change in non-farm payrolls; Source: U.S. Department of Labor/Haver Analytics

**U.S. EXISTING HOME PRICES & HOME SUPPLY**




*Month supply; Source: Bloomberg, National Association of Realtors, Haver Analytics

### Fiscal stimulus to the rescue

Relief though will come in the second half of this year. While the $146 billion stimulus package passed by the House of Representatives and the $157 billion package proposed by the U.S. Senate differ on specifics, the likelihood of a significant fiscal stimulus package including direct income tax rebates to consumers in the range of $100 billion now appears to be a sure bet. The impact of the stimulus package depends largely on how much of it consumers choose to spend and how much of it they save (or use to pay off debt). Households who have relied on their house as their main source of savings and who are now facing falling home values have a greater inclination to save their rebate checks. As a conservative estimate, we have assumed that consumers save the majority (60%) of their rebates and spend the remaining 40% through the latter half of 2008. As checks should begin to reach American households by June, we expect the additional $40 billion to boost personal consumption growth by 4 percentage points (annualized) to (4.5%) in the third quarter and by an additional 1 percentage point to (3.0%) in the fourth quarter.

While there will be an immediate and direct impact to consumer spending from the tax rebates, the impact on headline GDP growth will likely be less pronounced. Looking at the tax rebate experience of 2001, the resulting rise in consumer spending that occurred in the last quarter of the year was met with a significant drawdown in inventories. The change in non-farm private inventories subtracted 1.9 percentage points from GDP growth in the fourth quarter of 2001 though this was quickly reversed in the next quarter as enough time lapsed for businesses to rebuild stock levels. It is likely that a similar situation will play out this year and this relationship between the quick surge in spending and the drawdown in inventories is expected to mute the impact to overall GDP growth in the third quarter. The other factor that will militate against the influence of consumer spending on headline growth is the significant portion of discretionary consumer spending met through imported goods. As spending increases in the third quarter, this is likely to show up via increased import growth in the second half of the year.

Since the fiscal stimulus is temporary in nature, consumer spending will necessarily return to the pre-stimulus trend level in subsequent months. From a growth perspective this results in "payback" to consumer spending growth in the first few quarters of 2009. Nonetheless, by this time a return to normalcy in credit conditions and a slow improvement in housing markets, combined with the impact of the 225 plus basis point cuts in interest rates over the past five months and an anticipated quarter basis point cut in March will provide greater support to consumer spending.

### The bottom line

Since the release of our Quarterly Economic Forecast, the near term risks to the U.S. economy have risen, leading us to downgrade our outlook for the first half of 2008. With the economic slowdown now making its way to employment growth, the prospects for consumer spending have become more precarious. Spending growth is likely to slow to around 1% the first half of the year, and reduce overall economic growth to a pace of 0.6%. However, a significant fiscal stimulus package totaling close to 1% of personal consumption expenditure will provide support to spending through the latter half of 2008. All told, economic growth is likely to come in at a moderate pace of 1.6% in 2008, improving to 2.2% in 2009.

***James Marple, Economist***
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**U.S. ECONOMIC OUTLOOK**

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

| | 2007 | 2008 | | | | 2009 | | | | Annual Average | | | 4th Qtr / 4th Qtr | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Q4F | Q1F | Q2F | Q3F | Q4F | Q1F | Q2F | Q3F | Q4F | 07 | 08F | 09F | 07 | 08F | 09F |
| **Real GDP** | 0.6 | 0.6 | 0.5 | 2.0 | 2.5 | 1.5 | 2.5 | 3.0 | 3.1 | 2.2 | 1.6 | 2.2 | 2.5 | 1.4 | 2.5 |
| **Consumer Expenditure** | 2.0 | 1.0 | 0.8 | 4.5 | 3.0 | 0.1 | 2.0 | 3.0 | 3.2 | 2.9 | 1.9 | 2.1 | 2.5 | 2.3 | 2.1 |
| Durable Goods | 4.2 | 0.8 | 0.7 | 6.4 | 4.3 | 0.4 | 2.3 | 5.9 | 6.0 | 4.8 | 2.8 | 3.3 | 4.8 | 3.0 | 3.6 |
| **Business Investment** | 7.5 | 2.1 | 3.1 | 2.7 | 2.5 | 3.2 | 3.9 | 5.1 | 5.3 | 4.8 | 4.8 | 3.5 | 7.4 | 2.6 | 4.4 |
| Non-Res. Structures | 15.8 | 0.9 | 3.2 | 2.2 | 2.3 | 2.6 | 2.6 | 3.1 | 3.3 | 13.2 | 7.5 | 2.6 | 16.0 | 2.2 | 2.9 |
| Machinery & Equipment | 3.7 | 2.7 | 3.0 | 3.0 | 2.6 | 3.6 | 4.6 | 6.2 | 6.4 | 1.4 | 3.5 | 4.0 | 3.7 | 2.8 | 5.2 |
| **Residential Construction** | -23.9 | -29.9 | -26.0 | -9.7 | -3.1 | 1.8 | 4.9 | 6.9 | 7.3 | -16.9 | -22.0 | -1.2 | -18.3 | -17.9 | 5.2 |
| **Final Domestic Demand** | 1.4 | 0.0 | 0.1 | 3.3 | 2.5 | 0.8 | 2.2 | 3.0 | 3.2 | 1.8 | 1.3 | 2.1 | 1.9 | 1.5 | 2.3 |
| **Exports** | 3.9 | 5.1 | 6.2 | 6.2 | 6.3 | 6.6 | 6.7 | 7.6 | 8.3 | 7.9 | 7.1 | 6.7 | 7.7 | 5.9 | 7.3 |
| **Imports** | 0.3 | 2.7 | 2.8 | 5.0 | 12.4 | 2.5 | 5.0 | 7.2 | 7.4 | 2.0 | 3.0 | 6.0 | 1.4 | 5.6 | 5.5 |
| **Change in Non-Farm Inventories ($96 Bn)** | -3.4 | 4.9 | 9.8 | -30.7 | 2.3 | 10.2 | 15.5 | 19.4 | 20.2 | 8.3 | -3.4 | 16.3 | --- | --- | --- |
| **Final Sales** | 1.9 | 0.1 | 0.4 | 3.4 | 1.3 | 1.2 | 2.3 | 2.9 | 3.1 | 2.4 | 1.8 | 2.0 | 2.7 | 1.3 | 2.4 |
| **Labour Force** | 1.2 | 0.5 | 0.8 | 0.6 | 0.7 | 0.7 | 0.7 | 0.7 | 0.8 | 1.1 | 0.8 | 0.7 | 0.8 | 0.6 | 0.7 |
| **Employment** | 0.8 | 0.5 | -0.2 | -0.6 | 0.2 | 0.4 | 0.2 | 0.5 | 0.9 | 1.3 | 0.5 | 0.2 | 1.1 | 0.0 | 0.5 |
| **Change in Empl. ('000s)** | 285 | 184 | -76 | -193 | 70 | 140 | 65 | 179 | 323 | 1,824 | 667 | 295 | 1,494 | -15 | 706 |
| **Unemployment Rate (%)** | 4.8 | 4.9 | 5.2 | 5.5 | 5.7 | 5.8 | 6.0 | 6.1 | 6.1 | 4.6 | 5.3 | 6.0 | --- | --- | --- |
| **Housing Starts (mns)** | 1.15 | 1.06 | 1.00 | 0.98 | 0.97 | 0.99 | 1.01 | 1.04 | 1.06 | 1.35 | 1.00 | 1.03 | --- | --- | --- |

F: Forecast by TD Economics as at January 2008
Source: U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, TD Economics