DOLLARS & SENSE

TD Economics

May 9, 2013

EQUITIES ADVANCE WHILE COMMODITIES FACE HEADWINDS

Highlights

- The retreat in US equities that occurred in early-April seems to have been fleeting as the S&P 500 has rallied to new highs as of early-May. This was due to two developments. First, the Federal Reserve indicated that they are prepared to increase the pace of asset purchases should economic conditions deteriorate significantly. Second, a better-than-expected jobs report for April led to stronger optimism regarding the economic recovery.
- In our view, nothing has really changed. The economic data continue to point to a US economy that is coping with the effects of government sequestration. Once that impact wanes, economic growth should accelerate to a stronger pace by the second half of the year, prompting the Federal Reserve to end its asset purchase program by early next year.
- The other major development has been a downward revision to our outlook for commodities. Weakening global growth and a strengthening US dollar are largely the cause.

Since the last issue of Dollars & Sense, equities have experienced a tug of war, reflecting fluctuating perceptions over the economic recovery. After surpassing its pre-recession high in early-April, the S&P500 experienced a short-lived pullback later in the month. This may have partly reflected some profit taking by investors, but it also coincided with weak economic data that added to the view that economic growth in the second quarter was likely modest in the range of 1.0-1.5%. Moreover, investors became increasingly concerned about comments by the Federal Reserve suggesting that a scaling back of its bond buying program could be in the cards before long. There is no question that equity markets have been boosted by the liquidity provided to markets by QE3, so any unwinding of that program could be a headwind for risk assets.

However, the retreat proved fleeting. The S&P 500 reversed course and rallied to new highs in early-May in response to two developments. First, the Federal Reserve shifted its language in the communiqué accompanying the recent FOMC meeting. It adopted a symmetrical stance on bond buying. If economic conditions improve, then the pace of QE will be reduced. But, if economic conditions weakened, the Fed stands ready to increase its bond buying program. This reduced market speculation that QE would be wound down soon and also led markets to advance even on bad data. Second, equities rallied on better-than-expected payrolls growth in April and upward revisions to job creation in prior months. As job creation has been the missing ingredient to the economic recovery, the improved payroll numbers implied that the economy was weathering the government sequestration cuts.

Notwithstanding the gyrations in the market, the simple reality is that nothing has really changed. The week that the payrolls surprised on the upside was also a week that the manufacturing and non-manufacturing ISM indexes posted lower readings in April. These are some of the most timely economic reports that we get and the implication is that the economy is growing, but only slowly. Moreover, markets were cheered by the news that 165K payrolls were created, but while better than consensus, the

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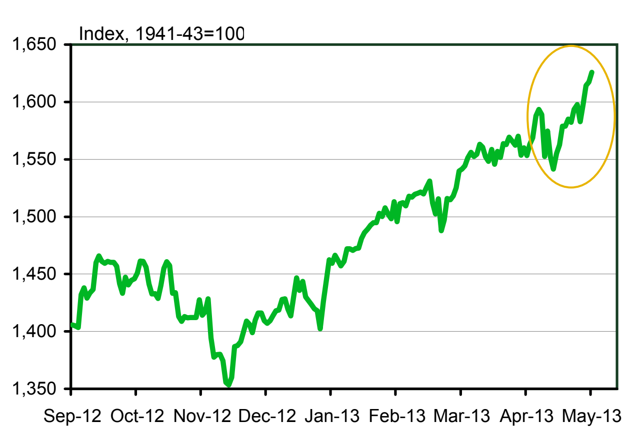
level is still very weak. 165K is not a strong number. We need something above 180k to 200k for a healthy outcome. Moreover, the Fed may have signaled that it could step up QE if needed, but the bar to doing is likely very high.

The good news is that the economic data reinforce the view of TD Economics that the economy is coping with the headwind of fiscal restraint. As the impact wanes in the coming quarters, we should see better economic growth in the range of 2.5-3.0% in the second half of 2013 and into 2014. We still feel that QE will be scaled back late in the year and wound down in the first half of 2014. That will be tough for equities, but the blow should be tempered by improving economic conditions.

So, our outlook for fixed income markets has not materially changed, although the economic growth fears in April have brought down the starting point for yields modestly. The more significant change in our outlook has been a lower profile for several commodities and a stronger outlook for the U.S. dollar.

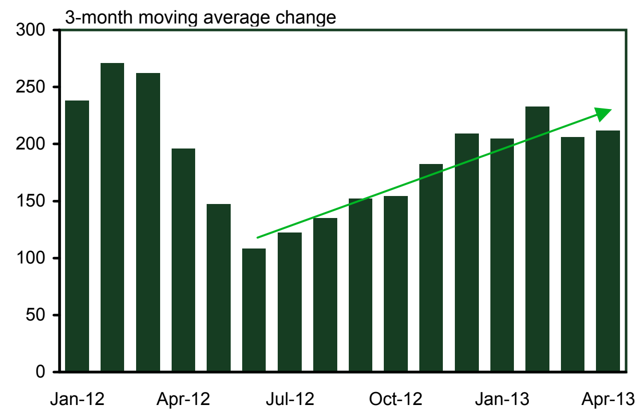
On the commodity front, financial markets have had to adjust their expectations on China's economic growth, and therefore future commodity demand. China's economic expansion has sifted down a gear and is unlikely to accelerate materially. Indeed, the Chinese government has made it clear that it prefers economic growth in the 7-8% range. However, when the government said they were aiming for roughly 7.5% growth, markets had previously assumed that the economy would exceed the target as it has in the past. Now there is a realization that the government intends to deliver on the target. This has led to a correction in commodity prices and we have lowered our price forecasts for gold and

S&P 500 INDEX



Source: Wall Street Journal

U.S. EMPLOYMENT



Source: Bureau of Labor Statistics

base metals, but the talk of an end to the commodity super cycle seems a bit overdone. Make no mistake the emerging nations will need enormous amount of raw materials to support their future economic development. However, the level of demand is going to be lower than what was previously assumed. And, the high level of prices will partly reflect the fact that the cost of production in the commodity sector have increased. We continue to view a future improvement in global economic growth as supportive to commodity prices, it is just that the gains will be modest.

The second factor weighing on commodities has been the rally in the U.S. dollar. The Bank of Japan's plan to double its monetary base by purchasing a laundry list of assets, from Japanese government bonds to ETFs and REITs, has pushed the Yen to a 4-year low. The dollar-yen exchange rate has risen by more than 25%, from roughly 77.5 Yen per USD to nearly 100 Yen per USD, since September. Alongside more modest appreciations against the Pound and the Euro, the major currency trade-weighted US dollar has risen by roughly 6% since then. All else equal, a rising Greenback naturally creates downward pressure on commodity prices given the majority are priced in the global reserve currency. In essence, the attack on commodities is two-pronged. The US dollar's slow upward trek is also not anticipated to desist. With Japan's asset purchase program not even having started yet, the eventual balance sheet expansion of Japan's central bank will undoubtedly send hot money flows towards USD-denominated assets. Indeed, TD Economics has revised our forecast for the trade-weighted US dollar upwards to reflect these recent dynamics, and we expect a 4-5% appreciation from current levels until the end of 2014.

INTEREST & FOREIGN EXCHANGE RATE OUTLOOK

		Spot Rate	2012				2013				2014			
		May-07	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Interest Rates														
Fed Funds Target Rate		0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
3-mth T-Bill Rate		0.05	0.07	0.09	0.10	0.05	0.07	0.15	0.20	0.20	0.20	0.30	0.40	0.40
2-yr Govt. Bond Yield		0.22	0.33	0.33	0.23	0.25	0.25	0.28	0.30	0.35	0.40	0.50	0.60	0.80
5-yr Govt. Bond Yield		0.75	1.04	0.72	0.62	0.72	0.77	0.90	1.00	1.10	1.25	1.35	1.45	1.65
10-yr Govt. Bond Yield		1.78	2.23	1.67	1.65	1.78	1.87	2.10	2.20	2.30	2.50	2.70	2.80	3.00
30-yr Govt. Bond Yield		3.00	3.35	2.76	2.82	2.95	3.10	3.15	3.40	3.50	3.75	3.95	4.05	4.10
10-yr-2-yr Govt Spread		1.56	1.90	1.34	1.42	1.53	1.62	1.82	1.90	1.95	2.10	2.20	2.20	2.20
Exchange rate to U.S. dollar														
Japanese yen	JPY per USD	99	82	80	78	87	94	98	100	100	102	102	105	110
Euro	USD per EUR	1.31	1.33	1.27	1.29	1.32	1.28	1.35	1.35	1.30	1.28	1.25	1.22	1.20
U.K. pound	USD per GBP	1.55	1.60	1.57	1.61	1.63	1.52	1.59	1.59	1.55	1.52	1.49	1.49	1.46
Swiss franc	CHF per USD	0.94	0.90	0.95	0.94	0.92	0.95	0.93	0.96	1.00	1.02	1.04	1.07	1.08
Canadian dollar	CAD per USD	1.00	1.00	1.02	0.98	1.00	1.02	1.06	1.06	1.09	1.11	1.11	1.09	1.08
Australian dollar	USD per AUD	1.02	1.04	1.02	1.04	1.04	1.04	1.05	1.04	1.03	1.02	1.00	0.98	0.98
NZ dollar	USD per NZD	1.31	0.82	0.80	0.83	0.83	0.84	0.84	0.84	0.84	0.82	0.80	0.78	0.78
Exchange rate to Euro														
U.S. dollar	USD per EUR	1.31	1.33	1.27	1.29	1.32	1.28	1.35	1.35	1.30	1.28	1.25	1.22	1.20
Japanese yen	JPY per EUR	130	104	103	98	105	122	132	135	130	131	128	128	132
U.K. pound	GBP per EUR	0.84	0.84	0.81	0.79	0.81	0.85	0.85	0.85	0.84	0.84	0.84	0.82	0.82
Swiss franc	CHF per EUR	1.23	1.21	1.20	1.20	1.21	1.23	1.25	1.30	1.30	1.30	1.30	1.30	1.30
Canadian dollar	CAD per EUR	1.31	1.31	1.30	1.25	1.29	1.33	1.44	1.44	1.41	1.42	1.39	1.33	1.29
Australian dollar	AUD per EUR	1.28	1.24	1.27	1.21	1.25	1.27	1.29	1.30	1.26	1.26	1.25	1.25	1.22
NZ dollar	NZD per EUR	1.55	1.60	1.62	1.55	1.58	1.58	1.61	1.61	1.55	1.56	1.56	1.56	1.54
Exchange rate to Japanese yen														
U.S. dollar	JPY per USD	99	82	80	78	87	94	98	100	100	102	102	105	110
Euro	JPY per EUR	130	104	103	98	105	122	132	135	130	131	128	128	132
U.K. pound	JPY per GBP	153	125	127	124	131	143	156	159	155	155	152	156	161
Swiss franc	JPY per CHF	105.3	86.2	85.6	81.7	87.3	99.2	105.8	103.8	100.0	100.4	98.1	98.5	101.5
Canadian dollar	JPY per CAD	98.6	79.2	79.3	79.0	82.0	91.5	92.1	94.0	92.0	91.8	91.8	96.6	102.3
Australian dollar	JPY per AUD	100.9	83.7	80.9	81.7	84.5	95.8	102.9	104.0	103.0	104.0	102.0	102.9	107.8
NZ dollar	JPY per NZD	83.7	64.9	63.4	63.6	66.9	77.0	82.3	84.0	84.0	83.6	81.6	81.9	85.8

F: Forecast by TD Bank Group as at April 2013; All forecasts are end-of-period: Source: Federal Reserve, Bloomberg, TDBG.

GLOBAL STOCK MARKETS

	May-07	30-Day % Chg.	YTD % Chg.	52-Week High	52-Week Low
S&P 500	1,626	4.7	14.0	1,626	1,278
DAX	8,182	6.8	7.5	8,182	5,969
FTSE 100	6,557	4.9	11.2	6,557	5,260
Nikkei	14,180	10.5	36.4	14,180	8,296
MSCI AC World Index*	371	4.3	9.2	371	291

* Is a weighted equity index including both developing and emerging markets

Source: Bloomberg

COMMODITY PRICE FORECASTS																		
	Price	52-Week	52-Week	2012				2013F				2014F				Annual Average		
	May-07	High	Low	Q1	Q2	Q3	Q4	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F	2012	2013F	2014F
Crude Oil (WTI, $US/bbl)	95	99	78	103	93	92	88	94	85	88	90	95	92	95	95	94	89	94
Natural Gas ($US/MMBtu)	3.88	4.38	2.17	2.45	2.28	2.88	3.40	3.35	3.65	3.25	3.75	3.90	4.00	3.90	4.25	2.75	3.50	4.01
Gold ($US/troy oz.)	1452	1790	1348	1690	1612	1655	1717	1632	1480	1550	1460	1425	1375	1350	1300	1668	1531	1363
Silver (US$/troy oz.)	23.9	35.0	22.8	32.6	29.5	30.0	32.6	30.1	25.5	27.0	25.0	24.5	23.4	23.1	22.1	31.17	26.90	23.26
Copper (cents/lb)	329	379	307	376	357	350	359	360	330	345	335	335	325	325	315	361	343	325
Nickel (US$/lb)	6.91	8.50	6.66	8.91	7.77	7.42	7.70	7.85	7.30	7.65	8.00	8.00	8.60	8.50	8.20	7.95	7.70	8.33
Aluminum (Cents/lb)	85	100	82	99	90	87	91	91	88	98	96	96	96	100	100	92	93	98
Wheat ($US/bu)	9.01	10.89	8.77	9.54	9.36	9.90	10.05	9.32	9.20	9.50	9.40	9.35	9.25	9.00	8.75	9.71	9.36	9.09

F: Forecast by TD Bank Group as at April 2013; All forecasts are period averages; Source: Bloomberg, USDA (Haver).