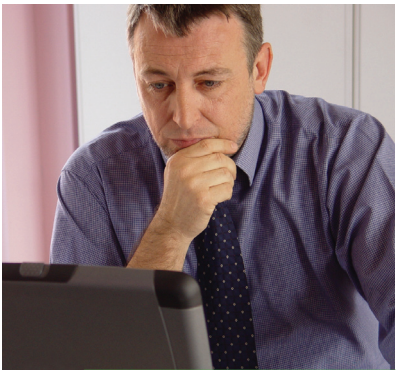




# Business Insights

Information and analysis from TD Commercial Banking

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Be mindful of the risks, but plan for the future.

## Risk-filled economic environment persists

By Craig Alexander, Senior Vice-President and Chief Economist, TD Bank Group

At the start of 2011, TD Economics argued that the outlook was for continued global growth, but in a risk-filled environment that would lead to heightened financial market volatility. The risks included the fiscal challenges in Europe and the seemingly inevitable debt default by Greece; the fragility of the U.S. recovery and America's fiscal challenges; and the efforts by developing countries to slow their economies to combat inflation.

Over the course of 2011, all of these risks played out. The outcome was tepid economic growth in the advanced world and slowing but still strong growth in emerging markets. It also led to a lower-for-longer interest rate environment in all developed nations.

The natural question is, where do we go from here? It is almost impossible to be a forecaster in this environment. The crystal balls are unbelievably cracked and cloudy. TD Economics feels that the most likely scenario is for continued growth, but that the global economy will continue to be buffeted by ongoing uncertainty and financial risks.

### Moderating growth in emerging markets

Asia and Latin America are likely to continue to experience a moderation of economic growth. Demand for emerging market exports from the advanced world will rise, but slowly. The implication is that emerging market economies will become more dependent upon domestic economic growth or trade with other emerging nations.

Against this backdrop, inflation is likely to remain a threat, so policies will be geared towards slower, but still rapid, economic growth. In addition, some emerging economies may continue to experience an appreciation of their currencies, as they absorb capital inflows seeking higher returns. Chinese authorities are also likely to continue accepting a gradual strengthening of the renminbi, so long as inflationary pressures remain high.

### Global economies fraught with risk

In Japan, rebuilding from the early 2011 natural disaster, will buoy economic growth but leave the economy relatively fragile.

The European outlook is fraught with risk. If the European authorities lose control over managing a Greek debt default, the outcome could be a financial crisis similar to the one experienced in late 2008. The main risk is that a disorderly default could lead other nations to default as well, and this would weaken European banks' balance sheets. If this causes financial institutions to fail, it could lead to another credit crisis.

The European leaders announced a new plan to address the crisis in late October, but it is not clear how it will be implemented or if it will be sufficient. One thing that is clear is that the fiscal austerity pursued on the continent is likely to produce a renewed recession for the euro zone. Efforts to address the U.K. fiscal deficit are also likely to virtually halt economic growth.

### Some bright spots in the U.S.

Despite worries that the financial turmoil would

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# Risk-filled economic environment persists

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derail the U.S. economy in the second half of 2011, the economic activity data have pointed to continued economic growth. As long as Europe avoids a banking crisis, the odds favour an ongoing gradual expansion for the U.S. economy. High unemployment, the vast overhang of properties for sale in the real estate market (particularly from the enormous number of foreclosures), and fiscal challenges all suggest that the U.S. economy will continue to struggle to deliver sustained growth above its long-term trend rate of about 2.5%.

## Export growth to slow in Canada

The Canadian economy will be deeply affected by the international environment. Exports make up more than a third of the Canadian economy, and almost three-quarters of them go to the U.S. At the same time, moderating economic growth in emerging markets will limit the upside to commodity prices. The implication is that Canadian export growth will likely not be booming.

During the recession and the early stages of the recovery, the Canadian economy received considerable support from robust domestic demand. However, given the high level of personal indebtedness, the Canadian consumer cannot be a strong engine for growth. This leads to the view that the Canadian economy will likely experience only moderate growth in 2012.

## How the markets will react

From a financial perspective, this outlook has many implications. First, volatility will remain a dominant theme as financial markets assess how

all the risks are playing out. Second, interest rates will remain lower for longer. As a result, cash investments are likely to continue to post significant losses once inflation is taken into account.

Bond yields will remain very low, perhaps providing preservation of capital but not providing scope for wealth accumulation. The environment of remarkably low interest rates makes equities appear attractive on a relative basis, but investors need to be able to stomach the swings in the market. One could also make the case that blue-chip, dividend-paying stocks might be considered part of the income segment of portfolios, since the after-tax return on dividends may exceed returns on bonds.

## Building for the future

The bottom line is that the global economy is still struggling to address the imbalances that developed over the 1990s and early 2000s. There are many legacies to the financial crisis of 2008/2009 as well.

Policymakers are struggling to address these challenges amidst considerable market volatility and risks to the economic outlook. The main message to businesses and investors is that they cannot wait for the uncertainty to clear in order to invest.

Economic risks will be with us for a long time. Businesses must build for the future. Investors will still need to put their money to work, and staying in cash is not a long-term option. Ultimately, it is like driving in the fog. You might want to be more careful than normal, but you still have to make the trip. ■

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