TD Economics

Quarterly Economic Briefing

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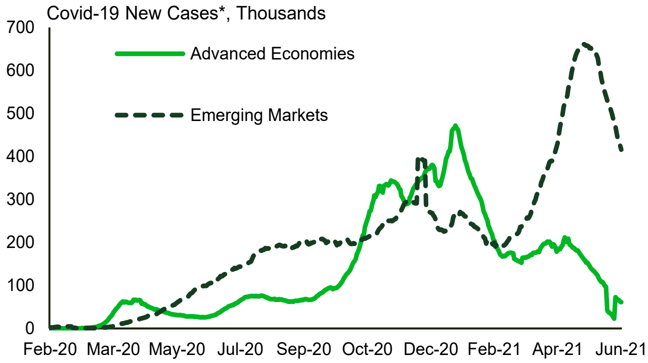
On a quarterly basis, TD Economics publishes a Q&A addressing issues relevant to the economic outlook. This quarter's briefing starts with progress on battling the pandemic globally and in North America. From there, it delves into fiscal policy developments, housing markets, commodity prices, inflation, and the financial outlook.

Questions & Answers

Chart 1: Cases Falling in Advanced Economies, Finally Cresting in Emerging Markets



*7-day moving average.
Source: OWID, TD Economics. Last observation: June 1, 2021.

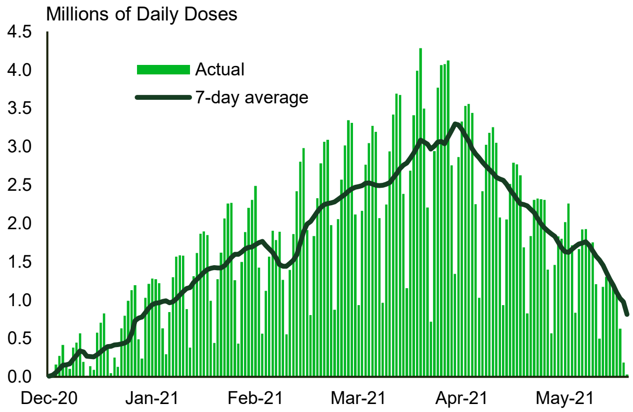
1. Covid-19 cases are stabilizing in advanced economies but surging in emerging markets. What are the implications for the global economy?

- As new cases ease in most advanced economies (AEs), the re-opening of economic activity is moving to the forefront. Most AEs are set for robust growth in the second half of this year, on the back of widespread vaccine distribution and policy support.
    - In Europe, a slow start to the vaccination campaign (outside of the UK) allowed for a third wave of the virus in several countries. This now appears to be subsiding. The EU Recovery Fund will also come on board through the summer, further supporting the recovery.
- Meanwhile, despite support from the COVAX facility, emerging markets (EMs) vaccination rates are well behind AEs, leading to sharp increases in cases that has only recently crested (Chart 1). In Brazil and India, the current wave of the virus has proven to be the worst yet, overwhelming healthcare systems and prompting authorities to introduce new restrictions and lockdowns. These countries are also likely to be the slowest to recover. And since Brazil and India are regional powerhouses, their slowdown will also affect the recovery of other countries in the region.
- China – the only major economy to register positive growth last year – has completed its V-shaped recovery. Chinese growth is now slowing, with deliberate tightening of monetary policy aimed at orchestrating a move back to a more balanced path. China's slowdown is not a surprise and was part of the natural course of action. European and North American economies are also bound to mirror similar outcomes once they reach China's stage of recovery.
- The economic risks have become more balanced relative to a few months ago. Ongoing restrictions, new virus variants, vaccine hesitancy and supply chain disruptions remain key downside growth risks in the near term. But, vaccine production and distribution are making strong headway. This, alongside additional policy support in some major economies and excess savings, provide a counterbalance on the upside.

2. How are vaccine rollouts progressing in North America and globally?

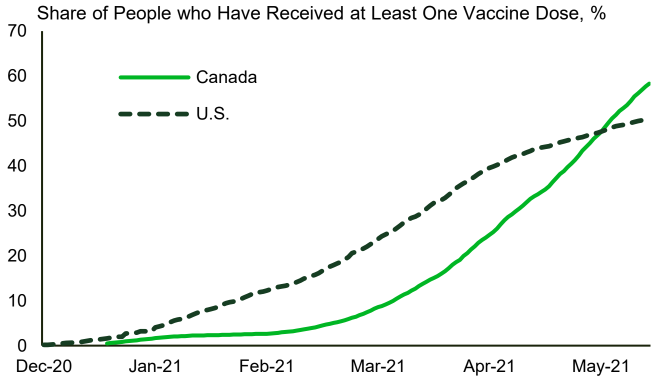
- Globally, vaccinations have picked up in Europe, but are still well behind North America with only 32% of the European population so far vaccinated. Elsewhere, the vaccine rollout in most EMs remains sluggish (some high-income EMs such as UAE and Chile are notable exceptions) and continues to lag AEs. At the current pace, it will take until at least mid-2022 for most EMs to vaccinate 70% of their populations. Some low-income EMs might even have to wait until early-2023 to hit this mark.
- In addition, there are now emerging concerns that some EM countries may have to "re-do" vaccination efforts depending on their vaccine access. Seychelles was noted as the world's most vaccinated nation at 72% of its population fully vaccinated. And yet, it experienced a spike in new virus cases in early May that caused lockdowns to be re-imposed. The government in Seychelles and the WHO have said that the majority of those testing positive had not been vaccinated or had only received one dose. Still, while tests are being conducted, it is speculated that the Sinopharm and AstraZeneca vaccines that were used in Seychelles may offer less protection, particularly against certain strains like that first detected in South Africa. This is one reason why South Africa has ceased using the AstraZeneca vaccine.
- The U.S. rollout has been centered around mRNA vaccines, with a speedy distribution peaking at over 3.2 million doses administered daily in early April (Chart 2). Although the pace of vaccination has since slowed considerably to around 1.0 million per day, the Biden administration maintains a goal of vaccinating 70% of U.S. adults with at least one dose by July 4th.

Chart 2: Rate of U.S. Vaccinations Peaked in Early April, Has Eased Since



Source: CDC, TD Economics.

Chart 3: Canada Has Surpassed the U.S. on Share of Population with at Least One Dose



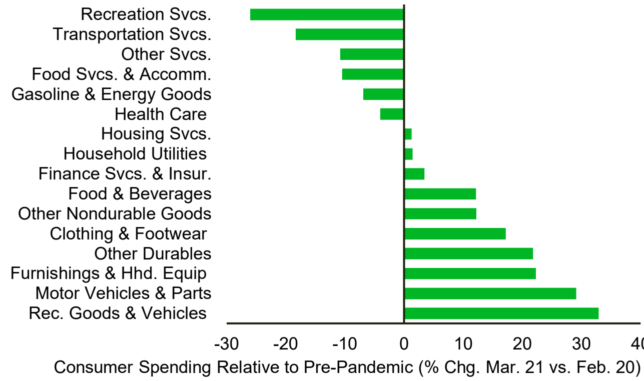
Source: OWID, TD Economics. Last observation: June 1, 2021.

- So far, 41% of the American population has been fully vaccinated, while over half have had at least one vaccine dose. Now that older and more eager populations have been vaccinated, the process will require greater effort. States are already loosening restrictions, and this could have the unintended impact of creating less urgency among the remaining unvaccinated population, particularly when coupled with strong evidence that the virus' spread has already slowed materially.
    - According to a survey taken at the end of April, the share of unvaccinated Americans who would be willing to be vaccinated was 20% – among the lowest across advanced economies. Other surveys note that the willingness to get vaccinated varies widely within the country, with communities in states like Hawaii, California, Washington, and those in the Northeast highly in favor of vaccinations, and the rest of the country generally less so. These country-wide differences are a hurdle toward reaching national herd immunity and speaks to efforts being made to create economic incentives towards vaccination. Several states have announced vaccine lotteries, while others are enticing people with discounts, ballgame tickets and other giveaways.
- Canada's vaccination plan has followed an under promise, overdeliver strategy. After a painfully slow start to the year, Canada's first-dose vaccination rate at around 60% has now surpassed the U.S. at just over 50% (Chart 3).
    - There is little in the way of regional variation in vaccine administration. Provincial vaccination rates are closely clustered around the national average. The percentage of first doses administered is slightly below the national average in Atlantic Canada, where some provinces had initially attempted to minimize the timeline between first and second doses. It is slightly above the national average in Quebec, which was the first province to extend timelines between first and second doses.
    - All provinces except for Manitoba have recently released reopening plans (see report). Ontario's plan stands out, representing the most cautious approach. . The first stage of the plan begins on June 14th. Some service providers may only open by late July, at the earliest. As a result, Ontario's economic rebound could be more drawn out in returning to pre-crisis employment levels.
- Relative to the U.S., Canada lags in the administration of second doses (6% vs. 41% in the U.S.) due to extended timelines of up to four months between doses. Official guidance has signaled that all willing adults will be fully vaccinated by the early fall. However, with Canada set to receive a cumulative 48-50 million doses by the end of June, more upside surprises could be in the cards.
- In addition, vaccine hesitancy appears to be less prevalent in Canada. Survey data from Imperial College's COVID-19 Behaviour Tracker suggests that 21.1% of Canada's unvaccinated adult population would be unwilling to receive one if offered, compared to a U.S. ratio of 28.2%. As a result, Canada may find greater success with herd immunity domestically, requiring a more tactical strategy on re-opening borders with countries that fail to meet that requirement.

3. How has the U.S. economic outlook shifted since March?

- The U.S. economy has outperformed our expectations in the first half of the year. Thanks to two rounds of fiscal stimulus and quick ramp-up in vaccinations, real GDP sprinted out of the starting blocks in the first quarter at 6.4% (annualized), above our March forecast (of 5%). Economic growth is tracking more than one percent higher than we had expected in our previous forecast over the first half of this year.
- The consumer was the biggest part of that story as spending surged by 11% (annualized) in the first quarter, propelled by a 49% jump in durable goods consumption. Generous government income supports have enabled consumers to keep spending despite high unemployment. And, given restrictions on services, they have shifted consumption to whatever products were accessible, from furniture to electronics to even homes.
- Business investment in equipment and intellectual property products also continued its impressive growth (+15%). Business IT equipment and software has been one of the brightest lights of the recovery.
- We expect the consumer's "freedom-induced demand spurt" will continue in the second quarter, spurred forward by the latest round of $1,400 payments. Households have built up over $2 trillion in excess savings through March and are well placed to keep spending as the economy re-opens. However, goods purchases are likely to pass the baton to services as restrictions ease (Chart 4). We forecast services spending to surge at a double-digit pace in the second quarter. Overall consumer spending growth is forecast to top 13%, anchoring an 11% advance in real GDP in the second quarter.

Chart 4: Tables Expected to Turn Towards Hard-Hit Services



Source: Bureau of Economic Analysis, TD Economics.

- While some of this growth may be a pull forward from what we had booked in the second half of the year, we expect growth for 2021 to be 7.0%, (up from 5.7% in March) and 4.5% in 2022. This growth upgrade was part of the story behind our decision to pull forward our expectation for the first rate hike by the Fed, departing widely from their current forward guidance (see Question 10).

4. What are the potential impacts from Biden's twin policy plans?

- President Biden has outlined his policy agenda to "Build Back Better" by spending roughly four trillion dollars over ten years on a host of infrastructure, research and development, education and childcare

Table 1: Tax Increases in Biden's Build Back Better Plans ($ billions, 2022-2031)

American Families Plan		Made in America Tax Plan	
Improve tax compliance & administration	718	Raise corporate income tax rate from 21% to 28%	858
Tax capital gains & dividends as income for >$1m, close carried interest loophole & various other measures	580	Revise the Global Minimum Tax regime	534
		Prevent corporate inversions	390
Raise top personal tax rate from 37% to 39.6%	132	15% minimum tax on book earnings of large corps.	148
Make permanent excess business loss limitation of noncorporate taxpayers	43	Eliminate tax preferences for fossil fuels	86
Total ($ trillions)	**1.5**	**Total ($ trillions)**	**2.0**

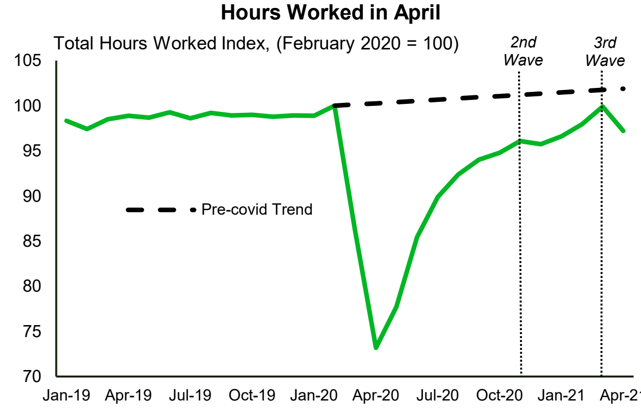
Source: The President's Budget (May 2021), TD Economics measures (see report). The administration estimates that this ambitious spending agenda will be paid for over 15 years through increases in corporate taxes and high-income taxpayers (see Table 1 above). The plans are unlikely to pass "as is", even under the reconciliation process, but we suspect a large element will be incorporated in the months ahead.

- Unlike the recently-enacted American Rescue Plan, which was intended to stimulate the economy in the short-term to counteract the damage from the pandemic, the policies in Biden's latest plan are an attempt to increase the productive capacity of the U.S. economy over the longer-term through investments in human and physical capital.
- As outlined, and depending on timing, these plans could modestly boost GDP growth starting in 2022, however, without much detail and with changes likely, any point estimates at this stage are highly uncertain. A very rough range would be that they could add around 0.3-0.5 percentage points to GDP growth in 2022, increasing slightly through 2023-24. Thereafter, there would be some fiscal drag as the peak spending years of infrastructure spending wind down.
  - Infrastructure spending typically has some of the highest multipliers of government spending, however, these sorts of projects take time to plan and execute. Infrastructure boosts the economy both in the construction phase, but also by hopefully increasing productivity in the economy over the medium term.
- Over the medium term, the American Family Plan (AFP) could help lift women's labor force participation rate through a combination of paid parental-leave income supports and direct funding for childcare. The U.S. has lagged its international peers over the past 20 years and, correspondingly, reflected the lowest female workforce participation rates in the G7 prior to the pandemic. As an example, if the U.S. had Canada's maternal participation rate, there would be 4.7 million more mothers in the labor force. While the AFP could move the needle on mother's engagement in the labor force, it is unlikely to close the gap with Canada and other countries on its own. Under the plan, maternity/parental leave in the U.S. would remain by far the lowest in the G7 at only 12 weeks (as set out in 1993's Family and Medical Leave Act). The next lowest is the UK, which provides 39 weeks of paid leave.

5. How is Canada's economy performing amid a difficult third wave?

- The near-term challenges of the pandemic's third wave have forced provinces to renew and tighten restrictions on activity. In late March and early April, large provinces such as Ontario, B.C., and Quebec imposed measures to limit non-essential businesses and the mobility of residents.
  - Economic data has reflected this impact, as GDP contracted by an estimated 0.8% month-on-month in April and total hours worked declined by 2.7%, the steepest drop since April 2020 (Chart 5).
  - As vaccines gain the upper hand against the virus, provinces are expected to gradually loosen restrictions. Any weakness experienced in the second quarter is expected to be offset by a strong rebound in the third quarter.
- Canada's economy has adapted to restrictions, which is lessening the broader negative economic impact. The end of 2020 and the start of 2021 both showed stronger-than-expected momentum despite business restrictions deepening within the larger provinces. Recent federal and provincial government budgets are also delivering strong fiscal supports across the nation.
  - The final quarter of 2020 produced an outsized 9.3% (annualized) pace of GDP growth, and the first quarter of this year was almost as good at 5.6%.
  - The federal and provincial governments unveiled new spending of around $150 billion over the next three years. Two-thirds, or $100 billion, of

Chart 5: The Third Wave Led to a Drop in Total Hours Worked in April



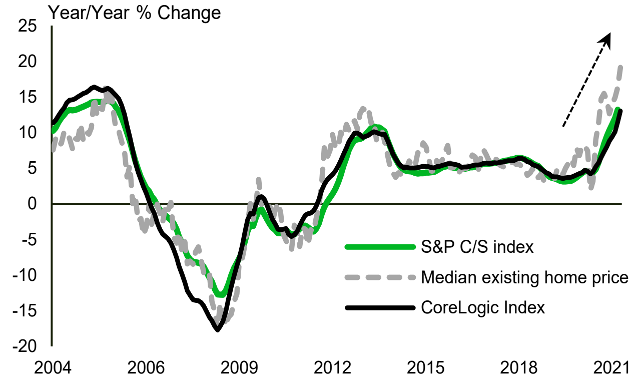
Source: Statistics Canada, TD Economics.

this spending is from the federal government. Similar to the U.S. experience, there is uncertainty around the timing of the spending and fiscal multipliers, but the new federal-provincial budget measures could translate into an additional real GDP boost of 0.3-0.6 percentage points this year and 0.4-1.0 percentage points next (see report).

6. When can we expect normalization in U.S. and Canadian housing markets?

- U.S. home sales surged to a 14-year high toward the end of last year, but have since eased considerably. The overriding theme is one of a shortage of inventory.
- Housing resale inventories currently sit at a little over one million, near record lows and down 20% from last year. Tight supply has resulted in sharp home price appreciation, with all key year-over-year metrics sitting in double-digit territory (Chart 6).
- The pace of U.S. home price growth continued to accelerate nationally according to the CoreLogic price index, but this has been driven by a handful of states In most states, home price gains have slowed from the red-hot pace at the end of last year.
  - Builders have ramped up the construction of homes, an element that should offer further price respite down the road. However, rising input costs pose an added challenge. Examples include the soaring costs of copper and lumber – particularly the latter, which is adding roughly $36,000 to the price of an average new single-family home. Tight market conditions increase the odds that costs are passed down to the consumer.
  - Coupled with an upward trend in mortgage rates, affordability challenges are likely to become more binding in the quarters ahead. This could tilt some demand back toward the rental market, particularly for lower-income households and those whose jobs require a physical presence in dense urban areas (i.e. those in the leisure and hospitality space). Leasing and online apartment search data already point to more typical rental demand patterns emerging in urban cores.
- In Canada, we've long argued that the frenzied pace of housing activity is unsustainable. After yet another record for sales and prices in the first quarter, the data in April stumbled.

Chart 6: All Key Home Price Metrics Have Surged to Double-Digit Year-over-year Territory



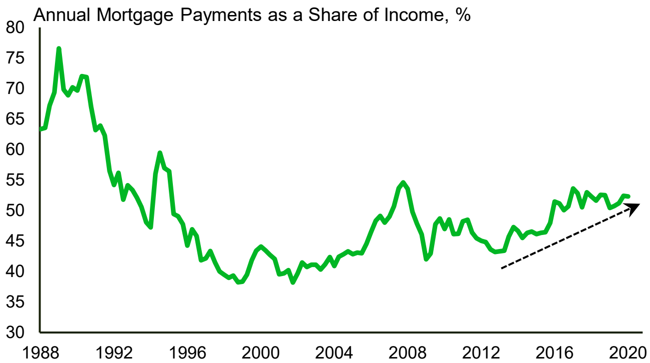
Source: NAR, S&P C/S, CoreLogic, TD Economics.

  - Across Canada, home sales slid 13% in April, driven by steep declines in B.C. and Ontario. Falling demand also weighed on average home prices, which dropped 4% on the month. However, a big unknown is the extent to which the third wave of the pandemic negatively influenced this data and the outcome may prove temporary.
  - Even after April's moderation, sales and prices levels in these markets remain at exceptionally elevated levels. Data in the next few months will give a clearer indication of whether April's pullback was merely a breather or the start of the cooling trend.
- In the second half of 2021, we continue to anticipate a lower trend in home sales on the back of tighter stress test rules, deteriorated affordability (Chart 7) and slightly higher interest rates. However, home prices are likely to remain resilient, particularly in the detached market under structurally tight inventories alongside the anticipated improvement in the job market.

7. How are global supply chains disruptions impacting the U.S. and Canada?

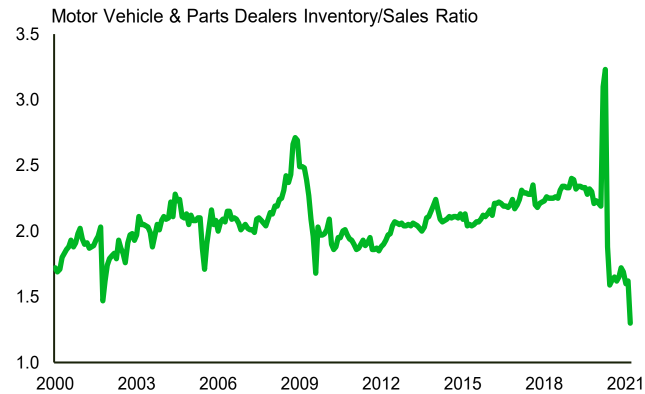
- High shipping costs and disruptions to global supply chains are causing production delays for American manufacturers, weighing on output, and putting upward pressure on consumer prices just as demand for these goods has surged. Due to the global nature of supply chains, until the pandemic has subsided across the world, these kinds of shortages and disruptions are likely to continue.

Chart 7: Canadian Housing Affordability is Deteriorating



Note: Affordability metric assumes 20% downpayment, amortized over 25 years with a 5-year fixed mortgage rate. Source: Statistics Canada, CMHC, CREA, TD Economics.

Chart 8: Auto Dealer Inventories at Record Lows



Source: Census Bureau, TD Economics.

  - One high-profile example is the global semiconductor shortage, which has held back production of motor vehicles in the U.S. since the start of the year. Motor vehicle assemblies improved slightly in March but remain about 13% below their trend level in the six months prior to the pandemic. At the same time, consumer demand for vehicles has rebounded sharply, and this has led the retail inventories-to-sales ratio to fall to a very low level (Chart 8). If production challenges continue, it could weigh on the pace of vehicle sales going forward.

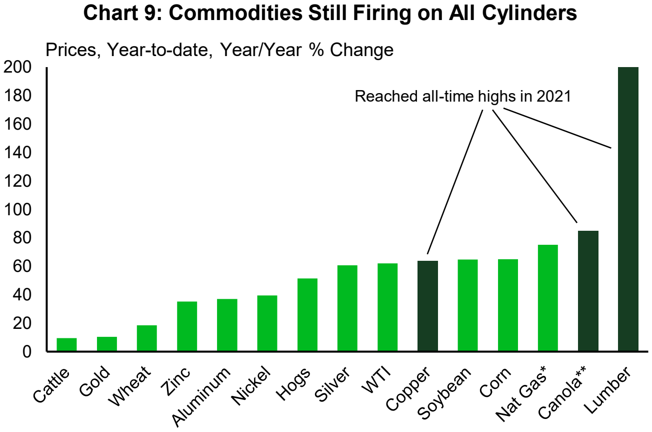
- New vehicle prices accelerated earlier in the pandemic but are up just 1.6% versus pre-pandemic levels (February 2020). Used vehicle prices, on the other hand, have shot up over 20% since the pandemic, which has likely been influenced by the reduced availability of new dealer supply, along with a desire to maintain a brand and model preference.
  - Several American companies have outlined price hikes in response to rising material costs. For example, appliance maker, Whirlpool, is phasing in price increases of between 5%-12% at least until the end of June. Meanwhile, American conglomerate, Proctor & Gamble has said that price increases will range from mid-to-high single digit percentages and will go into effect in mid-September. So, the impact of these developments on CPI inflation is not a matter of 'if' but 'when'.
- Meanwhile, businesses are already reducing their dependence on global supply chains. While this would indeed make them less vulnerable, it could also push up prices in the medium to long-term for themselves and consumers. It could also make exporters less competitive.
- It is a similar story for Canada. The global semiconductor shortage has led to a slowdown in production in the automotive industry. Since December 2020, manufacturing sales of motor vehicles and motor vehicle parts have fallen by 14% and 7%, respectively
- Manufacturers are drawing down existing inventories to deal with these input shortages. Inventories for the transportation manufacturing industry is at its lowest level since mid-2019, due to a drawdown in the remaining stock of raw material and other supplies. Solving these supply constraints is likely to take several more months. In the meantime, further reopening of the economy is likely to continue to stoke price pressures in these areas.

8. Are we poised for a commodity super-cycle?

- Commodity markets continue to fire on all cylinders (Chart 9). Copper, considered a bellwether of global economic growth, recently joined lumber, canola, iron ore, and palladium in breaching all-time highs. This persistent upswing in prices has prompted speculation that a new commodity super-cycle is underway.
- However, commodity super-cycles are few and far between. They can last for a decade or longer and are driven by a structural transformation in demand that is met with a lagged supply response. The massive demand impetus from China's industrialization characterizes the most recent super-cycle, which lasted from the mid-1990s to the late-2000s. This time around, fiscal stimulus, the clean energy transition process, and recent underinvestment in the commodity sector have been front and center in reigniting calls for a super-cycle.

- We suspect that for most commodities, the recent movements have been driven by a temporary supply-demand mismatch. The rebound in global economic growth has been coming in far stronger than expected, lifted further by ambitious fiscal stimulus announcements. Meanwhile, pandemic-driven production constraints and supply chain disruptions continue to act as a tailwind to prices. And finally, financial forces have joined in to amplify these imbalances. Namely, a weak greenback and rising inflation expectations have lifted speculative appetite for the commodity complex.
- Against this backdrop, the forces driving prices may indeed extend towards the end of the year, but that would still make them temporary in nature. For instance, OPEC+ is gradually tapering its production quotas as demand picks up. At the same time, planting and acreage should respond to surging crop prices. Housing markets in the U.S. are showing early signs of cooling, easing pressure on lumber markets in the coming quarters, which will also coincide with slowly rebounding production in sawmills. Zooming out from these idiosyncrasies, China, a key contributor to the commodity bull market, has been one of the first economies to tighten its policy levers. In turn, a subsequent moderation in Chinese commodity demand should follow.
- While this is the "umbrella" view, there has been underinvestment in certain parts of the commodity sector that will have more lingering effects. Copper markets are a case in point. Not only is the metal expected to be the among largest beneficiaries of a scale-up in green infrastructure spending, but the lack of mine development in recent years will likely result in a medium-term shortfall. This could sow the seeds for a supercycle in copper and some of its base metal peers, especially if these fiscal stimulus plans forge ahead. While still early days, the same cannot be said for other parts of the complex yet, such as energy and agriculture, where lead times for investment projects are shorter and productivity has increased in the past decade.

Chart 9: Commodities Still Firing on All Cylinders



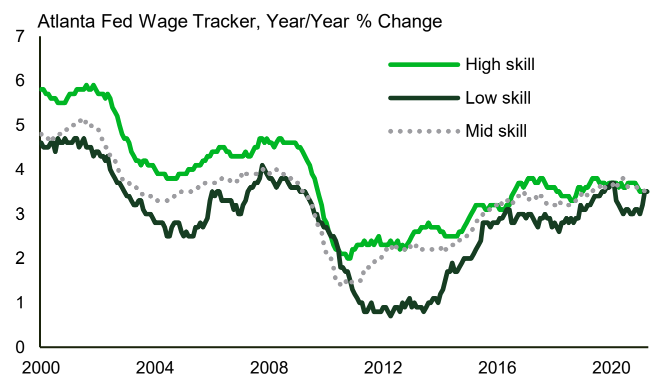
*Natural gas prices are Henry Hub cash prices ** Canola prices converted from C$ to US$.
Source: CME, Bloomberg, Random Lengths, WSJ, FT, EIA, ICE, FRB, TD Economics.

9. Will inflationary pressures be sustained?

- This is the most asked, yet most difficult question to answer. After ten years of inflation undershooting the Fed's 2% target, the combination of unprecedented fiscal and monetary stimulus and pandemic-related supply constraints will almost certainly cause U.S. inflation to remain above that mark over the remainder of this year and likely into the next. Still, supply bottlenecks will not last forever and labor market constraints are likely to diminish as the pandemic ends and extraordinary policy supports wane. Above all, following a surge in demand as the economy reopens, growth is likely to return to a trend that puts less upward pressure on prices. Getting the timing exactly right is difficult, but as long as inflation expectations remain well anchored – and they appear to be – inflation is likely to return to the 2% mark over the medium-term horizon.
- In April, U.S. CPI inflation rose to 4.2% year-on-year, while the core measure (excluding food and energy) accelerated to 3%, the highest rate since 1996. However, some of the increase reflected the comparison to depressed levels a year ago (i.e. base-year effects). Relative to the pre-recession price level in February 2020, core consumer prices are up a moderate 2.2%.
    - April's CPI jump was driven in large part by used vehicle prices, which rose 10% on the month and accounted for over one third of the headline increase in prices. This was the largest one-month increase in used vehicle prices ever.
    - A rapid shift in consumer demand towards services that were previously shuttered. In particular, areas related to travel (airfares, rental cars, hotels) accounted for another 22% of April's monthly movement. And, while core services prices are playing catch up, they remain below where they would have been if pre-pandemic trends continued.

- We expect inflation pressures to continue to reflect the dislocations between supply and demand in the coming months. As vaccinated Americans start to move around the country and spend on services, capacity in a number of industries has not had a chance to respond. And, let's face it, these tourism, hospitality and restaurant sectors have been "burned" before by gearing up activity, only to be clamped back down due to virus developments. So, supply adjustments require businesses to have confidence in the sustainability of that demand, in addition to needing the time to adjust staffing, equipment and processes.
- Unfortunately, there isn't a historic period, particularly since central banks started targeting inflation, where demand has shifted as rapidly between goods and services, against the constraints of an ongoing pandemic (school closures, companies who reduced staff now need to rapidly hire).
    - Demobilization post-WWII has often been noted as a period of comparable shifts. Inflation, which was rising at double-digit rates during the war, accelerated above 10% in 1947, before falling to negative territory in 1949 as the economy entered recession. Inflation was benign through most of the 1950s and 1960s even as economic growth surged.
    - The rapid inflation of the 1970s also has some parallels today in the contribution of an oil price supply shock (on an economy much more dependent on the resource than the economy of today), but it also followed a decade of what is now considered to be overly easy fiscal and monetary policy and a reluctance among policy makers to react to the supply shock with tighter policy, thereby perpetuating its impact. Inflation was ultimately crushed by a Federal Reserve with a single-minded focus on bringing it lower even at the expense of economic growth.
- Typically, economists look at labor market slack and wage pressures as a guide to inflation pressures, particularly for services. Like many pandemic trends, the signals are mixed.
    - In the worrisome column, job openings are at record levels, despite high unemployment, suggesting an increasing inability of employers to fill positions.
    - Wage pressures appear to be stronger at the lower end of the wage spectrum. The Atlanta Fed Wage tracker, which controls for compositional shifts, shows accelerating wage gains for "low-skilled" workers as of April (Chart 10). This makes sense given many of these jobs that need to be done in person have become more difficult and dangerous during the pandemic.
    - In the comforting column, there are many workers still sitting on the sidelines, implying a reserve level of labor market slack that is likely to return to the workforce once the pandemic ends. The exit from the labor force during the current pandemic has been larger and more sudden than during the 2008 recession, and even in that situation, participation recovered – though it took several years. The rebound this time is likely to be swifter. As the health crisis eases, schools re-open, and expanded unemployment benefits expire, more workers are likely to return to the job market, taming upward pressure on wages.
- In Canada, inflationary pressures have so far been subdued though they did accelerate in April. Overall consumer price inflation rose to 3.4% y/y in April, up from 2.2% in March, with the increase driven primarily by energy prices.
- Core prices also moved higher in April with two of three of the Bank of Canada's preferred measures – CPI-trim and CPI-median – rising to 2.3% in April, up from 2.1% in March. The CPI-common measure also moved higher, rising to 1.7% from 1.5% in March.

Chart 10: Early Evidence of Wage Pressures in Low-Skill Occupations



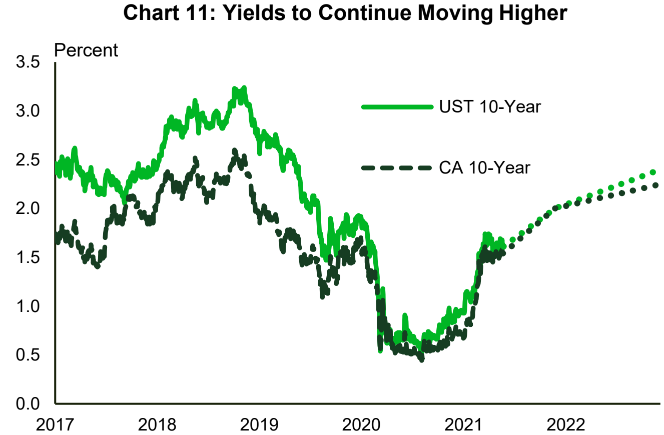
*The data are 12-mo. moving averages of monthly median wage growth for each category.
Source: Atlanta Fed. TD Economics.

- Just like the U.S., strains to the supply chain, semiconductor shortages, and improving consumer demand are contributing to higher prices in some sectors of the economy. As of the first quarter of this year, passenger vehicle prices were 3.1% higher than what they were a year ago, up from 2.5% in the fourth quarter of last year. Prices could move higher in the coming months until those supply chain issues get addressed.
- Canada's more subdued inflation is a function of the fact that the economy hasn't been able to reopen as swiftly as the U.S. and so those supply side price-pressures are likely just waiting in the wings.
- As in the U.S., the alleviation of supply chain constraints and the reabsorption of workers into the labour market is likely to mitigate inflation pressures. What is more, the strength in the Canadian dollar is a disinflationary force that is likely to restrain inflation in Canada relative to its level stateside.

10. How are central banks reacting to the higher inflation outlook?

- With economic data in the U.S. and Canada exceeding expectations, the amount of time it will take for these economies to fully heal from the pandemic has diminished. Both the Federal Reserve and the Bank of Canada (BoC) have responded to the inflow of positive data by upgrading their economic forecasts for this year and beyond.
- For the Federal Reserve, its Summary of Economic Projections shows the median Fed voter sees the unemployment rate dropping below full employment in 2022 and believes core PCE inflation is poised to accelerate above 2% this year. Based on this outlook, the Fed will have met its broad policy mandate by the end of 2022 – a year earlier than it previously predicted.
- This economic outlook would typically imply that the Fed should start hiking its policy rate at the end of 2022. Though the Fed is hesitant to admit it, we have penciled in the first hike at that time. More importantly, market pricing reflects this likelihood, which feeds directing into government bond yields. By extension, we see the 10-year yield rising toward 2% by the end of the year, and eventually reaching roughly 2.40% next year (Chart 11).
- Our forecast for the Bank of Canada parallels that of the Fed. The Bank's recent Monetary Policy Report (MPR) upgraded its outlook, stating that the economy is on track to fully recover from the pandemic in the second half of 2022. In the previous MPR, this objective was only expected to be met in 2023. This opens the door for the BoC to hike rates alongside the Fed at the end of next year. This has been the motivating factor for higher yields in Canada. With the 10-year Canada government bond yielding 1.5%, this is consistent with our view of the start of the rate hiking cycle. Over the coming months, we expect this pricing to become further entrenched, pushing the 10-year close to 2% by the end of this year and reaching 2.25% by the end of next year.
- Further supporting our yield call is the expectation that central banks will make substantial adjustments to their Quantitative Easing (QE) programs. We have already seen the Bank of Canada reduce the amount of weekly government bond purchases (to CA$3 billion a week). The Fed on the other hand has not signalled a change in policy and has been expanding its balance sheet by US$120 billion a month. It remains committed to QE until "substantial further progress has been made toward the Committee's maximum employment and price stability goals". Though the economy is still in a state of transition, by the end of this year, we believe that the 'substantial progress' the Fed is looking for will have been achieved. In turn, we expect a communication shift that can stoke further volatility in yields.

Chart 11: Yields to Continue Moving Higher

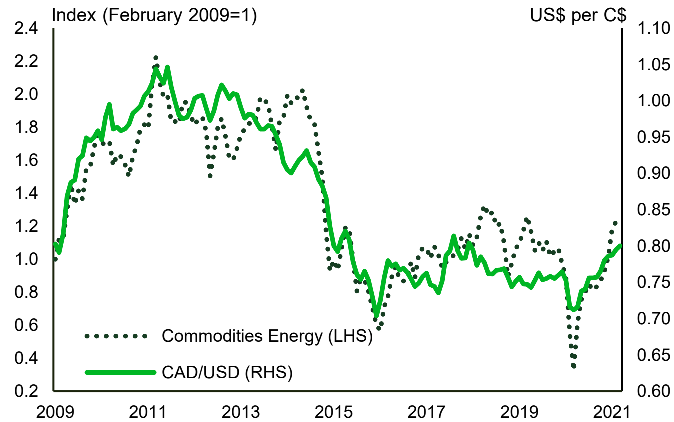


Source: Federal Reserve Board, Bank of Canada, TD Economics.

11. Is there more room for the Canadian dollar to rally?

- Yes, but not much. The Canadian dollar has been the strongest performing G10 currency against the U.S. dollar this year. This is occurring on the back of two strong narratives that favour CAD. The first is related to the Bank of Canada. As we noted above, it has telegraphed an earlier exit from policy objectives and this clarity contrasts to that of the Fed. For this reason, market participants have been much more confident in pricing rate hikes for the BoC than the Fed. Consequently, Canadian yields up until the 5-year tenor are higher than U.S. equivalents and this helps to favour demand for Canadian dollars. The last time yield differentials favoured Canada to this degree, the loonie topped out at 84 U.S. cents, compared to 83 U.S. cents today.
- The second influence on CAD is the boom in commodity prices, and as noted earlier, this has a bit more of a wild-card factor behind it (Chart 12). Year-to-date, the Bank of Canada's commodity indices (both Energy and Non-Energy) are up 37% and 21%, respectively. Canada has always been a "commodity currency" to international investors, and nothing has changed on that front. Canada's rich commodity resources has corresponded with a surge in export volumes and prices among Canadian manufacturers.

Chart 12: CAD to Follow Energy Prices



Source: Federal Reserve Board, Bank of Canada, TD Economics.

- With interest rate differentials already signaling that the BoC will lead the Fed, and commodity prices having accelerated so much, there shouldn't be much more room for the CAD to appreciate from its current level versus the USD. However, of the two influences, the commodity cycle is the bigger wildcard that could cause a currency overshoot to fundamentals. We suspect the Bank of Canada would display some discomfort with this, particularly if it erodes Canada's export performance outside of the commodity space. Although they don't directly control the currency, they could use their communication to try to jawbone market expectations down.