Perspectives

For the period beginning January 1, 2018

AS GOOD AS IT GETS?

After a stellar year for the world economy in 2017, the main question is not whether the growth outlook is good or lacklustre. The real question is: how long can this last? How long can the equity bull market continue before it hits a bump in the road?

CIBC Asset Management

Asset Allocation Outlook as at January 1, 2018

Asset Class	Underweight		Neutral	Overweight	
	Significant	Moderate		Moderate	Significant
Equity Relative to Fixed Income			✓		
Fixed Income					
Canadian Money Market	✓				
Canadian Government Bond				✓	
Canadian Corporate Bond				✓	
International Government Bond		✓			
Equity					
Canadian Equity			✓		
U.S. Equity		✓			
International Equity (Developed Markets)				✓	
Emerging Markets				✓	

Currency (versus U.S. Dollar)	Underweight		Neutral	Overweight	
	Significant	Moderate		Moderate	Significant
Canadian Dollar			✓		
Euro		✓			
Japanese Yen		✓			
British Pound			✓		
Swiss Franc		✓			
Australian Dollar		✓			
Emerging Markets				✓	

Highlights

Fixed Income vs. Equity: For the moment, equities still look more attractive than bonds. It will take a more significant rise in yields to tip the balance in favour of fixed income.

Equity: Despite a run of very strong performance in emerging market equities, this geographic sector remains the most attractive due to its stabilizing fundamentals.

Fixed Income: Global bond yields will likely edge higher over the next year. Increasing inflationary pressure could come from shrinking output gaps in the U.S. and Canada, especially since higher energy prices are already driving headline inflation higher.

Currencies: Several factors will restrain the upside for the Canadian dollar—limited upside for oil prices, particularly Canadian oil prices, and NAFTA negotiations that will spill over well into 2018.

Expected Returns

Expected returns for the period beginning January 1, 2018	In Canadian Dollars			In Local Currency		
	Global Reflation	Policy Renormalization	Global Recession	Global Reflation	Policy Renormalization	Global Recession
Probabilities	15.0%	65.0%	20.0%	15.0%	65.0%	20.0%
Canada Money Market	1.5%	1.3%	0.8%	1.5%	1.3%	0.8%
Canadian Bond	-1.8%	0.8%	3.0%	-1.8%	0.8%	3.0%
Canadian Federal Govt. Bond	-1.5%	0.9%	5.2%	-1.5%	0.9%	5.2%
Canadian Corp. Bond	0.4%	1.3%	0.2%	0.4%	1.3%	0.2%
Canadian RRB	0.8%	-0.5%	3.0%	0.8%	-0.5%	3.0%
Canadian High Yield	4.5%	3.8%	-4.9%	4.5%	3.8%	-4.9%
International Govt. Bond	-7.5%	-2.4%	7.7%	-3.9%	-1.7%	4.9%
Canada Equity	13.8%	5.3%	-19.2%	13.8%	5.3%	-19.2%
United States Equity	7.6%	4.6%	-13.7%	10.5%	4.1%	-16.8%
International Equity	12.4%	5.8%	-18.5%	16.7%	7.8%	-18.3%
Emerging Equity	15.4%	8.8%	-24.5%	17.1%	9.5%	-21.3%

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Global Outlook

Policy Renormalization

In retrospect, 2017 turned out to be a stellar year for the world economy, as it shifted into higher gear and hit its strongest yearly growth in seven years. Against such a healthy economic backdrop, global investors remained in a cheery mood all year, with a very strong, and apparently insatiable, risk appetite. After all, why worry about central banks taking away the punch bowl when inflation is not an imminent threat? With optimism running high, global equity markets ended the year with hefty gains, reaching all-time record highs.

Looking at 2018, growth prospects look just as promising, with our in-house global real GDP growth projection at 3.6%. However, this doesn't mean that a replay of 2017 is in store for global investors. While it is true that inflation is still below the levels targeted by monetary authorities, it is also true that there is less and less slack in the world economy. The world's central bankers have a more difficult and challenging task in 2018.

For the U.S. Federal Reserve (Fed), the challenge will be to find the appropriate dose of policy tightening—especially with real short rates likely moving into positive territory for the first time in a decade. With its plan to drain excess reserves at a faster clip throughout the year, the Fed will also have to carefully monitor potential side-effects in the global financial system. The effects on U.S. dollar global funding conditions are particularly important to scrutinize. Whether it likes it or not, the Fed is the world's central bank and influences borrowing costs in the global financial system.

For other major central banks like the European Central Bank (ECB) and the Bank of Japan (BOJ), the objective will be to lift the "foot off the accelerator" without putting the economic expansion at risk. More precisely, the task at hand will be to significantly reduce asset purchases without creating havoc in financial markets—hopefully avoiding a replay of the U.S. "taper tantrum" episode in the summer of 2013.

For central bankers like the Chinese PBOC, the Bank of Canada (BoC), the Reserve Bank of Australia (RBA) and many others, upcoming decisions on the monetary policy front will be dictated by financial stability considerations. These banks will target both debt deleveraging and a soft landing in housing—a difficult balancing act.

The dominant view moving into 2018 is that inflation still won't be a threat and that all these central banks have plenty of time on their side. However, the more the global economy surprises to the upside, the greater the risk that central banks will fall behind the curve. An important risk is if inflation shows its ugly head faster than generally expected, which would certainly spoil the party for global investors.

ALTERNATIVE SCENARIOS

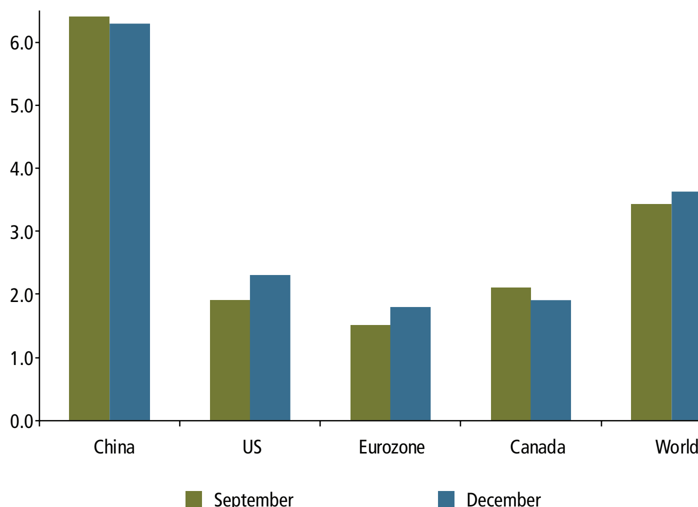
Global Recession

We suspect that the key *Global Recession* risk is more likely to emerge from the U.S., which is the most advanced in its business cycle. Financial stability risks could emerge from the corporate leverage build-up as interest coverage ratios fall with rising interest rates. Stronger wage increases would support the rise in inflation but could put downward pressure on corporate profitability. The pace of interest rate hikes and/or the shrinking of the Fed balance sheet could be more damaging than expected, causing a meaningful tightening in financial conditions. This could also spill over to smaller economies with overvalued real estate markets, creating financial stability risk.

Global Reflation

In our *Global Reflation* scenario, the buildup in inflationary pressure is strong enough to convince more central bankers to "lift a foot off the accelerator". For central banks already in tightening mode this implies more aggressive policy tightening over the forecast horizon. Stronger earnings growth would provide an offset to higher interest rates, supporting equity market valuation and providing stronger-than-expected equity returns but weaker fixed income. Constructive political developments in Italy could lead to improved business and consumer sentiment and stronger economic activity than in our central scenario.

Global Growth Projections:
September vs. December CAM Forecast



Source: CIBC Asset Management Inc.

Fixed Income Versus Equity

So Far, So Good—But For How Long?

Equity markets were strong in 2017, supported by a surprisingly resilient global economy. Cyclical markets outperformed defensive markets, commodity prices did well, and high-yield bonds were also strong performers. There is definitely a feeling that we witnessed a growth-driven bull market in 2017. In the latter stages of an economic expansion, P/E multiples often begin to contract, while earnings become responsible for delivering the returns. But this cycle has so far defied that pattern, as global market multiples have generally expanded in 2017.

Based on our forecasts, the global economy should continue to grow above potential, with a robust outlook indicated for all major economic regions. Global growth continues to be synchronized. While central banks are starting their normalization process, monetary conditions will remain loose, as central banks are expected to move slowly. As such, the tailwinds of easy financial conditions and synchronized growth are not threatened by any imminent catalyst for the immediate future. Furthermore, corporate earnings have been steadily improving and are expected to remain strong.

The main question at this point in the cycle is not whether the growth outlook is good or not. Rather, the question is: how long can it last? Even more pertinent is how long the bull market in equities can continue before it hits a bump in the road?

To answer this question, we need to look at what has been driving higher prices and whether these conditions will remain in place. Taking the U.S. equity market as fairly representative, we see an engine firing on all cylinders: sales growth has been improving, margins have been expanding and valuations have been rising.

Sales growth and margins together determine the outlook for earnings. Given our economic forecasts, we expect sales to remain buoyant. Margins, however, cannot be expected to grow forever. When margins are too high, competition kicks in and brings new players that act to arbitrage abnormal profits. Furthermore, the main input cost to corporations is labour. Since the late 1990s, the cost of labour has been declining relative to the size of the corporate sector, supporting a structural rise in margins. Globalization and automation have transformed the global economy and tilted the balance of power between labour and capital. With the job market now at full employment, this trend is slowly starting to reverse. However, this is a slow, secular process and, for the moment, margins are also subject to positive cyclical tailwinds. The bottom line—earnings should remain a key source of support for the equity market.

Equity valuations are historically rich. Stable inflation, low interest rates and strong profitability have been suggested as reasons for high equity valuation. We don't dispute this. In fact, our research shows that inflation and corporate profitability are the main drivers of equity valuation. The current conditions of high profitability and low inflation are ideal for equities. However, these relationships explain why P/Es are high today, not whether they should remain high tomorrow. As wage pressure builds, inflation should also start to rise and profit margins should decline, dragging down earnings. With rising inflation, interest rates would continue to normalize and the current justifications for high valuations would disappear.

By counting on rising P/Es and margins, investors are living on borrowed time. When things are "as good as it gets", they rarely get any better. In a late cycle economy, imbalances rise until they become too great, at which point the cycle turns. There are certainly imbalances now in real estate prices, in equity and bond valuations and there is too much global debt. For now, with support from strong cyclical tailwinds, the expansion and bull market can continue—albeit with rising risks.

Bond yields will face offsetting forces: a strong economy and normalization of monetary policy on one side, weak inflation and productivity on the other side. As a result, yields should continue to gradually drift upward. Rising yields will eventually make bonds more attractive relative to equities. For the moment however, equities still look more attractive than bonds and it will take a more significant rise in yields to tip the balance.

Although the environment should remain supportive of credit, high-yield spreads are already very tight. Emerging market (EM) sovereign bond spreads are tight as well, but their improving fundamentals support tighter spreads. Furthermore, a number of EM central banks are actually cutting rates.

Equity Market Outlook

United States

U.S. equity valuations are elevated compared to their long-term averages. The S&P 500 cyclically-adjusted price-to-earnings ratio (Shiller P/E) is at levels that were only seen during the TMT bubble[1] over the past 40 years. The current 10-year average of real earnings that is used to compute this ratio is slightly biased downward, as it includes the Great Financial Crisis (2008-9). But even if our earnings projections contain aggressive assumptions, valuations are still high. Most likely a long period of weak returns would be required to bring P/Es down to more reasonable levels.

Other valuation tools lead to the same conclusions. There is a strong positive relationship between the price-to-book ratio (P/B) and return on equity (ROE). In the U.S., the P/B is now approximately 25% higher than the level implied from the ROE relationship. A similar analysis can be done on the relationship between P/E and interest rates, and produces similar conclusions. While we agree that lower interest rates justify higher valuation multiples, the current levels are still elevated, even after accounting for this effect.

The tax cuts recently voted by Congress will lead to a one-time boost to margins in 2018, which will likely offset some of the drag from structural forces. Tax cuts do not change the long-term outlook for a decline in margins; they will just delay the ongoing trend. Furthermore, tax cuts obviously have no impact on pre-tax margins, which are also elevated.

Europe

Europe is the continent where attractive valuation can still be found within developed markets. U.K. and eurozone equities offer a good risk premium. Those markets have lagged the U.S. in recent years because of concerns about Brexit, eurozone breakup, and a disappointingly slow economic recovery. The eurozone is far less advanced in the economic cycle than the U.S., and conditions are in place for the valuation gap to decrease. Equity market performance was disappointing in 2017 due to the strength of the euro, but we do not expect the currency to strengthen the same way in the next 12 months.

Overall, European companies have enjoyed a strong recovery in profitability, and net profit margins and return-on-equity have returned to long-term averages. This improvement is not totally priced-in relative to other regions of the world, creating an opportunity for investors. Brexit risks will continue to weigh on U.K. equities and most likely prevent their valuations from converging to fair value. However, eurozone equities are still supported by extremely loose monetary conditions, economies growing above potential, no inflationary pressures, and decreased political risks. They will be in the sweet spot to outperform in 2018.

Canada

Canadian equity valuations are more attractive than their U.S. peers, but still slightly overvalued. Their current cyclically-adjusted price-to-earnings ratio is above the long-term average, but this comes mainly from financial companies. This sector benefits from very stable earnings and a high dividend yield, which are attractive in the current low-yield environment. Financial companies look fairly valued when looking at their price-to-book compared to their current level of return on equity.

Commodity sectors are attractively valued. Margins in commodity sectors have recovered from the drop that followed the 2014 oil price decline. Net profit margins are now near their long-term average in the energy sector, and slightly above-average in the materials sector. As a result, commodities are no longer dragging down the aggregate index level of profitability.

Meanwhile, financial companies continue to enjoy high levels of profitability. Concerns about Canadian real estate did not materialize in 2017. More stress is expected in 2018 as new macroprudential rules will tighten the market. We expect a gradual erosion of margins. Overall, we are neutral on Canadian equities, as the relative attractiveness of commodity sectors is offset by potential risks for financial companies.

Emerging Economies

Despite a run of very strong performance in EM equities, these remain the most attractive due to their stabilizing fundamentals. The market has failed to recognize the changes that have taken place in the EM space since the financial crisis. Economies are more stable, their markets are less exposed to commodities and the U.S. dollar, and they are more exposed to consumer-related sectors.

In Asia, China is leading the way, transforming its economy toward consumers and the service sector, and implementing measures to cut excess capacity in mining and industrial sectors. Banks are resilient and have the capacity to absorb the losses that will come with this transformation. Profitability has improved in recent years, and Chinese equities are still cheap despite the good 2017 performance, as they were previously priced for a catastrophe. Emerging Asia is highly geared to the global economic cycle and benefits from the current synchronized world growth. European emerging markets are exposed to the eurozone recovery. While Latin America faces more difficult structural issues, good cyclical conditions and higher commodity prices will continue to support the region.

Overall, conditions for further outperformance remain in place for 2018 in emerging markets. Barring an unexpected and destabilizing strengthening of the USD, EM should continue to outperform.

Global Equity Returns Follow Economic Cycles

Sources: Thomson Reuters Datastream, CIBC Asset Management Inc.

Commodity Insight

The price of West Texas Intermediate (WTI) crude oil closed over $60/bbl in the fourth quarter, the highest level since mid-2015. WTI prices were higher by 12.5% in 2017. The improvement in price was largely a result of the November OPEC meeting, where its members, along with Russia, agreed to extend production cuts into 2018. While this deal was largely anticipated, it does continue the drawdown of oil inventories and will ultimately provide more long-term stability to oil prices.

Specifically, the OPEC meeting extended the 1.8 million barrels/day (MB/D) production cut agreed upon in 2016. It also included an option to revisit the deal in June 2018, depending on supply and demand factors at that time. In addition, Nigeria and Libya introduced a production cap of 2.8 MB/D (collectively). This is important because these two countries were exempt from the previous deal and were allowed to increase production last year. Some market participants perceived that as a risk which

offset the original production cut agreement. The inclusion of Nigeria and Libya in the current OPEC production cuts should help further balance the oil market.

Looking at 2018, we will be monitoring three key areas: 1) Compliance with the OPEC production cuts. Historically, OPEC members have cheated on production quotas and Russia had earlier communicated that it may want to lift production cuts. Adherence from all members will be important in stabilizing the oil market. 2) U.S. exploration and production (E&P) capital budgets. U.S. shale producers have been relentless in increasing oil production, even at low oil prices—this has been a key contributor to the oversupply in oil over the past several years. As producers are still finalizing their 2018 spending programs, we estimate U.S. oil could grow 0.7-1 MB/D, based on current prices. 3) Geopolitical risk. What has been somewhat underappreciated are the existing geopolitical tensions and lack of risk premium in oil prices as tensions mount in major oil-producing regions. These include the Kurdistan region's fight for independence in Iraq, President Trump attempting to decertify the Iran nuclear deal, and ongoing civil violence in Venezuela, Nigeria and Libya.

Fixed Income Outlook

Interest Rate Normalization Continues

For most of the fourth quarter, global bond yields remained fairly well-behaved. For example, U.S. bond yields fluctuated in a tight range, hovering between 2.30% and 2.40%. Positive economic surprises, the lack of inflationary pressure and low financial market volatility kept the *Goldilocks*[2] environment intact.

Monetary policymakers in developed markets continue to move towards renormalization. The ECB announced asset purchase reductions that will begin in January 2018 and remain effective during the first nine months of the year. As expected, the Fed increased the fed funds rate by 0.25% in December. The Bank of England hiked its policy rate from 0.25% to 0.50% as well. Finally, the BOJ has been more ambiguous about its intentions, but rethinking its yield curve-control policy is becoming imperative, in our opinion, as bond-buying constraints are growing.

Going forward, further global monetary policy renormalization could prove to be more challenging for sovereign bondholders. Most valuation measures indicate that sovereign bonds are expensive. Quantitative tightening in the U.S. and a decrease in asset purchases in Europe could become real game changers, as they will eliminate important sources of demand for sovereign bonds. Moreover, increasing inflationary pressure could come from shrinking output gaps in the U.S. and Canada, especially since higher energy prices are already driving headline inflation higher. In this environment, global bond yields should edge higher over the forecast horizon. In the U.S. and Canada, our twelve-month base case scenario calls for 10-year sovereign bond yields hitting 2.75% and 2.30% respectively.

Currency Markets

U.S. Dollar

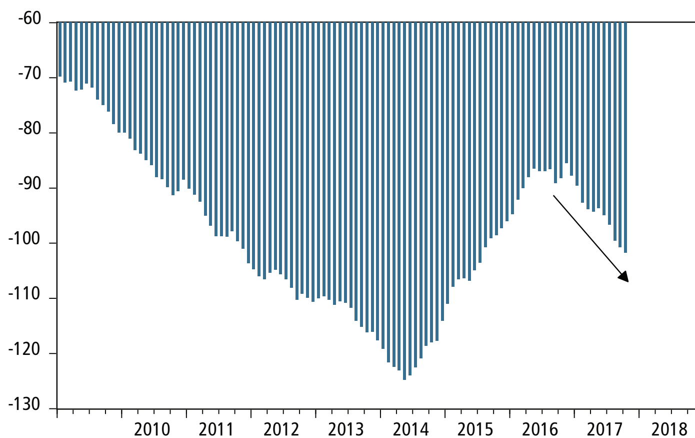
For the first time in more than six years, the U.S. dollar's bull market was seriously challenged in 2017. On a trade-weighted basis, the U.S. dollar depreciated by more than 5% over the last year, owing to shifting relative monetary policy expectations. Is this just a shorter-term countertrend pullback or the start of a secular trend reversal? Judging by year-end market positioning, the consensus view seems to be that more U.S. dollar weakness lies ahead. However, with the Fed expected to shrink its balance sheet at a faster pace than last year while gradually hiking rates, we think it is too early to turn bearish on U.S. dollar prospects. Having said this, any U.S. dollar strength over the coming year is expected to be limited and thinly based. A widespread appreciation is not likely. Instead, we project a shift into consolidation mode, implying increased volatility in foreign exchange markets throughout the year.

Canadian Dollar

The Canadian dollar closed the year on a strong note, gaining roughly 5% against the U.S. dollar for the year as a whole. The strengthening of the Canadian dollar in 2017 can essentially be linked to two developments: the Canadian economy's stronger-than-expected recovery and the Bank of Canada's decision to deliver two back-to-back policy rate hikes. Moving into the new year, the forces at work are not expected to be as supportive for the Canadian currency. For one thing, Canadian monetary authorities are not expected to tighten monetary policy as much as the U.S. Federal Reserve, owing to concerns over financial stability. For another, we see limited upside for oil prices, particularly Canadian oil prices, which are trading at a large discount to U.S. oil prices. With NAFTA negotiations spilling over well into 2018, the Canadian dollar's upside will also be capped by uncertainty over an eventual agreement, or non-agreement, on the trade front.

Canadian Dollar Strengthening Is Already Hurting

Canadian non-oil trade balance (12m) - CAD Billion



Source: CIBC Asset Management Inc.

Euro

The top-performing currencies of 2017 have undeniably been the euroblock currencies. With the euro gaining solid ground against the greenback (+13%), other European currencies such as the Czech koruna, the Polish zloty and the Hungarian forint managed to perform as well or better. The main reason euroblock currencies did so well in 2017 relates to relative monetary policy renormalization. However, 2018 is shaping up to be a different story.

With the euro now trading close to the upper band of its mid-term trading range, the relevant question now becomes: are additional renormalization steps expected from the ECB moving into 2018? As argued in the European economic section, the ECB is expected to further reduce its asset purchases in 2018. However, given the lack of inflationary pressures, it will likely stick to its sub-zero rate policy over the forecast horizon. As a consequence, from this point on, the euro's upside seems more limited.

Japanese Yen

In retrospect, the Bank of Japan is probably very pleased that the Japanese yen has not retraced the ground lost after the "QQE with yield curve control" policy was introduced in late 2016. Since then, the USD-JPY bilateral exchange rate has remained fairly well-behaved, fluctuating in a relatively tight trading range around 112.

This was the big story of 2017 because, in sharp contrast with many other central banks in the developed world, the Bank of Japan had no reason to consider policy renormalization. Given the lack of inflationary pressures in Japan, it's tempting to conclude that 2018 will end up looking a lot like 2017. After all, with the BOJ's inflation target still well out-of-reach, the BOJ should keep its QQE with yield curve control policy in place a lot longer. The problem, however, is the Yield Curve Control policy is proving to be costly. With no change in the current policy settings, the Bank of Japan will hold more than 60% of the JGB market in 2018. In short, we anticipate policy changes also taking place in Japan, translating into increased volatility in the Japanese exchange rate.

Bitcoin: Real Currency or Speculative Investment?

Bitcoin: *A type of digital currency in which encryption techniques are used to regulate the generation of units of currency and verify the transfer of funds, operating independently of a central bank.*[3]

Bitcoin is a cryptocurrency that uses a blockchain to record and verify transactions. A blockchain can be thought of as a database or a digital accounting ledger. The Bitcoin software was released in early 2009 by a mysterious creator who went by the name of Satoshi Nakamoto.

The advantage of a blockchain is that it is decentralized and works on a peer-to-peer framework, without central control or government authority. Once a transaction is recorded, it is almost impossible to retroactively delete or change it.

Let's put aside for the moment many of the practical questions that come up when Bitcoin is discussed such as:

Where do new Bitcoins come from?
Where do I buy Bitcoin?
Can I lose Bitcoin or have it stolen?
Can Bitcoin be counterfeited?
What can I buy with Bitcoin?

This is a complicated but topical subject. As currency managers, here are some of our initial thoughts on Bitcoin.

Is Bitcoin Here to Stay?

When assessing Bitcoin's potential as a currency, it is useful to remember the traditional roles that currencies play:

1) Store of Value: Bitcoin has a very short history. This makes it difficult to assess the soundness of its architecture or its ability to act as a store of value in the longer term—it has not really been tested. Although it has gained a lot of ground since inception and soared in past few months, Bitcoin remains full of risks.

Theoretically, anyone could launch a cryptocurrency or new technology that competes with Bitcoin and has the potential to make Bitcoin and/or blockchain obsolete. Other cryptocurrencies already exist (Ether, Monero, Bitcoin cash) but Bitcoin remains the most popular choice for the moment. Sovereign states might try to prohibit the use of cryptocurrencies as a way to maintain their own monopoly on issuing fiat currencies[4] and their privilege of seigniorage and the benefits that entails.

2) Means of Exchange: Bitcoin is not really being used as a means of exchange at this time. Unlike major currencies, the value of Bitcoin is extremely volatile (and therefore highly unpredictable), making it very risky to use as a store of value for the future purchase of goods and services. Although Bitcoin has been in an impressive rally this year, it has also seen multiple 30%+ corrections. Bitcoin is so volatile that Fortune magazine recently published an article entitled "5 Big Bitcoin Crashes: What We Learned." All five Bitcoin crashes discussed in the article have occurred since 2013!

Until it is more stable and its use is more convenient and widespread, Bitcoin won't be seen as a reliable means of exchange. However, we have witnessed other disruptive technologies that have rapidly changed the landscape once they reach "critical mass" (e.g. the use of Uber as opposed to taking a taxi, streaming or downloading music versus the purchase of CDs).

3) Monetary Policy Instrument: Bitcoin is not issued by a government. It has no inflation or trade balance data or any other economic fundamentals associated with it on which to base a currency valuation. It is difficult for anyone (including ourselves) to calculate a fair value and determine if the currency is cheap or expensive. Bitcoin holders do not receive interest payments and that makes it more expensive to hold relative to many currencies that do pay an interest rate. The difficulty in establishing a fair value for Bitcoin increases its pricing uncertainty and has led to the large price volatility observed since its creation.

Because of its distinctiveness when compared to traditional currencies, Bitcoin does not lend itself well to our investment process, which is fundamentally driven. However, the recent introduction by the Chicago Mercantile Exchange of a Bitcoin futures contract might help it gain more acceptance in the financial community. With a futures contract, banks can "bet" on the price of Bitcoin without holding the underlying Bitcoins. This should bring new/different players into the market who don't want to deal with the complications of holding Bitcoins. But the futures contract will also allow investors to short Bitcoin (bet on the price going down); previously this was difficult to do. Some analysts think this could finally put downward pressure on the price.

The biggest shortfall we can see with Bitcoin (or any of the other cryptocurrencies) is the lack of a large stable "guarantor". Major fiat currencies such as the U.S. or Canadian dollar have a government behind them to back their use as the sole means of exchange for that country. Cryptocurrencies lack a major proponent that can be relied upon to sustain and expand their use as a means of exchange.

Our Current Opinion

As currency managers, we are staying on the sidelines for the moment, but will continue to assess the developments in the cryptocurrency world. At this point, Bitcoin seems to be more a speculative phenomenon than a real currency opportunity. However, we are keeping an open mind. Disruptive forces continue to manifest in global politics, business, media and society as a whole. One year ago, the U.S. election proved that "the impossible" can happen. These are interesting times.

Regional Outlook

Canada

- **Canadian economic growth is projected to average 1.9% in 2018, a forecast somewhat below consensus and not far above potential. This will limit the buildup of inflationary pressures.**
- **Upcoming monetary policy-setting decisions by the Bank of Canada will be dictated by financial stability considerations, targeting both household debt deleveraging and a soft landing in housing.**

Years of ultra-accommodative monetary conditions have allowed two major imbalances in the Canadian economy to build. Canada has excessive household debt accumulation and a still-bubbly and overvalued housing market. As a result, upcoming monetary policy-setting decisions by the Bank of Canada will be dictated by financial stability considerations, targeting both household debt deleveraging and a soft landing in housing. Needless to say, this should prove to be a very difficult balancing act.

Over the last decade, Canadian household debt has increased so much that Canada now ranks as the second most indebted country[5], right after Australia. The heavier the debt load becomes, the bigger the impact of rising interest rates, owing to fast-rising debt servicing costs. Fully aware of this, the Bank of Canada has few other options but to be very prudent and renormalize interest rates at a slow pace. This would result in a widening of policy stance with the Federal Reserve.

Delivering interest rate increases at a very gradual pace is also required for the BoC to successfully engineer a soft landing in Canadian housing. Let's not forget that this is exactly what the Fed tried to do in the mid-2000s, when it ended up triggering a housing recession in 2006. To avoid such a turn of events this time around, Canadian monetary authorities will have to be relatively prudent.

We expect inflationary pressures to remain contained as a result of the projected consumer-led slowdown in Canadian economic growth. Last year, consumer spending got an extra boost from a material increase in short-term consumer credit and a sharp drop in the savings rate. Looking forward, these tailwinds will likely materially recede.

For all these reasons, the Bank of Canada will likely be unable to follow the Fed step-by-step in its 2018 tightening campaign.

United States

- **In 2018, U.S. real GDP growth is projected to average +2.3%. Headline CPI inflation is expected to reach 2.0%.**
- **For the first time in a decade, Fed policy will be moving back towards more restrictive territory, with real rates turning positive.**

After spending seven years on the sidelines, the Fed launched a tightening campaign in late 2015. Since then, policy rates have been gradually raised five times—from a low of 0.25% to 1.50% in late 2017. Looking ahead to 2018, U.S. monetary authorities are expected to stay in tightening mode, increasing short rates by another 75 basis points. If this forecast materializes, it will be the first time in over a decade that real U.S. short-term interest rates move back into positive territory. In other words, for the first time since the 2008 financial crisis, U.S. domestic monetary policy stance will no longer qualify as accommodative. While this reflects the fact that the U.S. economy is on a much more solid footing, it also means that the risk of a Fed policy mistake will rise moving into 2018. Yet the Federal Reserve faces an economy that continues to operate above its economic potential. This reduces the slack and increases the risk of an overheating of its economy that could eventually force a faster-than-expected tightening if it does not continue to normalize its monetary policy settings.

The Fed's decisions to tighten policy stance will affect more than just U.S. domestic credit conditions— they also matter for non-U.S. entities that have borrowing needs in U.S. dollars. For instance, think of a non-U.S. corporation borrowing to fund their U.S. operations—these entities will also see their cost of funding rise. Fed policy is unique because the U.S. dollar is "the" reserve currency of the world and the main funding currency for global transactions. U.S. dollar borrowing/funding needs outside of the U.S. are quite substantial, with offshore U.S. dollar credit amounting to 11 trillion USD or 30% of total U.S. dollar credit. This means that when the Fed tightens credit conditions, the implications are global.

In addition, there is a big difference between 2018 and 2017, with regard to Fed policy. While the Fed started to shrink its balance sheet in late 2017, it plans on draining excess reserves at a faster pace in 2018.

With the Fed expected to slowly but surely tighten U.S. credit conditions, it is difficult to be more upbeat about U.S. economic growth prospects. Our twelve-month forecast calls for +2.3% average real GDP growth and 2.0% headline CPI inflation for 2018.

Europe

- **The eurozone economic expansion is projected to continue in 2018, with real GDP growth averaging 1.8%. Unfortunately, this won't be enough to bring inflation back in line with the ECB's implicit target.**
- **The ECB will be obliged to continue with its sub-zero policy rate throughout 2018, while ending its asset purchase program (QE).**

From a growth standpoint, 2017 turned out to be a very good year for the eurozone economy. Real GDP growth averaged more than 2.2%—the eurozone's best showing in more than six years. While the ECB probably deserves a pat on the back for this solid economic performance, it is still much too early for eurozone monetary authorities to declare victory on the inflation front. Inflation is still well below the ECB's implicit target and, according to most forecasters (including the ECB and ourselves), it will stay below target for another two years. This is both a major disappointment and a source of concern for the ECB, implying that it will have to keep its monetary policy stance accommodative for considerably longer. For 2018, this means sticking to the sub-zero policy rate, while ending the asset purchase program (QE).

Last October, the ECB announced that its asset purchases would be cut by half starting in early 2018. By doing this, the ECB has bought more time. However, the reality is that, even under the new QE policy settings, the ECB will soon run out of sovereign bonds to buy (i.e. hitting limits). Moving into the second half of 2018, the ECB will have little option but to announce the end of its asset purchase program—this could be a game changer.

Since it was implemented in 2015, the ECB's QE policy has not been without major side-effects. By design, it created wide excess demand conditions in eurozone sovereign bond markets, exerting downward pressures on bond yields across the whole yield curve. Thanks to the QE policy, government borrowing costs dropped substantially, alleviating concerns about fiscal sustainability in the eurozone. As the ECB increasingly lightens up on its bond purchases moving into 2018, supply/demand conditions in the bond market should start renormalizing and allow for a rise in bond yields. The consensus view remains that this rise will be gradual and well-contained. However, the risk is for a replay of the U.S. "taper tantrum" episode in the summer of 2013, when the bond market pulled back violently. While this might not be an issue for strong and fiscally-sound economies like Germany, it could prove more problematic for the more fragile and fiscally-challenged economies like Italy.

The bottom line is that we are adding shades of grey to an otherwise very rosy outlook for the eurozone. The eurozone economy is expected to grow above its potential over the next four quarters, with widening growth differentials between the strong economies (e.g. Germany) and weaker economies (e.g. Italy). This promises to be a difficult balancing act for the ECB as it may reopen potential risk in terms of financial and fiscal stability.

China

2018 - A Year of Slower Growth

- **Our projection for real GDP stands at 6.3% by Q4 2018. This is consistent with the government's re-orientation away from minimum growth targets while adding financial risk management as a top priority.**
- **The central bank will continue to manage monetary policy with a neutral policy stance as long as inflation permits. PBOC policy rates are likely to remain accommodative to support traditional lending channels.**

The Chinese economy will experience some slowing of growth after a period of acceleration in 2017. Our projection for real GDP growth is 6.3% by Q4 2018, down from an average of 6.8% in 2017. This is consistent with the government re-orientation away from rigid minimum growth targets, with the addition of financial risk management as a top priority. Within this transition, the environment is likely to remain one of continued economic rebalancing, with consumption growing faster than investment. Currently, Chinese consumer sentiment is robust, bolstered by a healthy labour market and a solid rise in household asset prices. This will support another year of solid expansion in household expenditures. Investment activity, on the other hand, is marred by continued weakness related to mining and some manufacturing sectors. As a result, investment in these industries will continue to underperform, particularly in areas with supply overcapacity. Investment spending related to the economy's service sector will, in part, offset this drag. Residential construction activity will also experience lacklustre performance in 2018 due to the impact of tight macroprudential rules in the housing market. That said, we do expect some easing of macroprudential measures later in the year. Finally, trade activity is expected to continue to expand in 2018—however the contribution to growth is expected to fade going forward.

The central bank will continue to manage policy with a neutral policy stance as long as inflation remains comfortably below the 3% target. This stance is warranted to support traditional lending channels, as policy-makers tighten regulations and rein in credit growth in the non-traditional financial system. In our base case scenario for 2018, consumer price inflation is expected to rise but will likely remain below the current target of 3%. In the event that inflation surprises on the upside, a more challenging environment for growth would develop. Policy-makers would likely be vigilant by hiking policy rates and pursuing more restrictive monetary policy.

Long-Term Capital Market Returns

We have updated our assessment of 10-year expected returns for major financial market asset classes. This section highlights our major conclusions and presents an overview of the inputs we use for the forecast.

Capital markets outlook—three takeaways:

- The most attractive asset classes remain emerging market equity and emerging market sovereign bonds, even accounting for the fact that they are riskier. Prospects are further increased when factoring in the expected long-term movements in currencies.
- Equity prospects in advanced economies are lacklustre, held back by low starting dividend yields, modest projected sales growth and, for the U.S., by expensive valuations.
- Investing in bonds in advanced economies is expected to provide low returns, owing mostly to the effects of monetary policy normalization stances. Higher policy rates should lower bond prices more than usual due to elevated durations prevailing in most economies (due to bond convexity, interest rate movements have more impact on bond prices when interest rates are low); the implementation of extra-loose monetary policy stances had the opposite effect.

The macroeconomic outlook behind our capital markets outlook:

- A well-anchored view of macroeconomic prospects is necessary for assessing returns of financial assets over the long term.
- We have detailed long-term economic projections for more than 30 economies, allowing us to identify key drivers of financial asset returns, such as long-term neutral policy rates, interest rates paths, and sales growth.
- Real GDP growth prospects are weak for advanced economies, hovering in most cases within a 1-1.7% range for the next 10 years, on average.
- Economic growth prospects are better in emerging economies, mostly owing to "catch-up growth", as living standards gradually converge towards those of advanced economies. Also, emerging markets have made progress in recent years in the implementation of key structural reforms and in the transition away from a reliance on exports and commodities, paving the road for sustainable macroeconomic performance.

Four factors are projected to shape the economic outlook over the long term:

- Less favourable demographic prospects in almost all economies
- Weak productivity growth, reflecting the diminishing effects of technological advances on productivity growth (despite the implementation of several structural reforms in many economies)
- Increasing debt-servicing costs, the product of monetary policy renormalization in many economies, will restrain the spending of households, corporations and governments, particularly in highly indebted economies
- Weak demand for capital, owing to the impact of the above-mentioned factors

Expected Returns of Major Asset Classes – Next 10-year averages

Asset Classes	Expected Nominal Next 10-Year Returns (%)	
	CAD	Local Currency
Fixed Income (total returns)		
Canadian Money Markets	2.0	
Canadian 10-y Government Bond	2.4	
Canadian Corporate Bonds	2.6	
U.S. Money Market	2.6	2.9
U.S. 10-y Treasury	2.7	3.0
U.S. Corporate Bonds	3.1	3.4
U.S. High Yield Bonds	4.7	5.0
JPM World Gov. Bonds (advanced economies)	2.5	1.7
JPM Emerging Government Bond	7.9	7.2
Equity		
Canada	3.1	
U.S.	1.0	1.3
MSCI EAFE	3.8	2.8
MSCI Emerging Economies	8.6	8.0
MSCI World	2.1	1.9
Canadian Inflation	1.9	

Source: CIBC Asset Management Inc. calculations; asset classes weights from JP Morgan and MSCI. January 2018

Signposts

Economic indicators that will help us determine if our ***Policy Renormalization*** scenario is occurring as expected:

Canadian Signposts

- Employment growth, wage growth
- Housing activity and property prices
- NAFTA negotiations
- Oil impact on trade balance (energy vs. non-energy)

Chinese Signposts

- Housing sales, prices and housing starts
- Inflation
- GDP growth mix (industrial production vs. retail sales vs. services)
- Lending to households and businesses
- North Korea geopolitical tension

U.S. Signposts

- Core PCE inflationary pressures
- Wage growth (best measure is Employment Cost Index)
- Domestic oil production trend (following OPEC agreement)
- New orders versus inventories
- Capital goods orders (monitor investment growth)

Other Market Signposts

- European bank lending
- European inflation
- Brexit negotiations
- Italian elections
- Global Purchasing Managers' Indices
- U.K. commercial real estate activity

[1] Technology, media and telecom bubble of 1999-2001, also known as the "tech bubble".

[2] In the so-called *Goldilocks* environment, the economy is neither too hot nor too cold

[3] https://en.oxforddictionaries.com/definition/bitcoin

[4] Fiat money is currency that a government has declared to be legal tender, but is not backed by a physical commodity. Examples of fiat currencies are the Canadian and U.S. dollars, euro, Japanese yen.

[5] Source: OECD. The OECD found Canada's household debt ranked as the highest among the 35 developed and developing countries the group monitors.

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