Perspectives

For the period beginning April 1, 2017

A TRICKY BALANCING ACT

Despite the enormous number of headlines focused on U.S. President Trump, the global economy continues to improve in the background. As a result, equity markets have been well supported and continued to push higher. Bond yields have stabilized after their sharp rise in late 2016.

Under our somewhat benign global outlook—we project around 3% global growth over the next 12 months—central banks will be left to manage a difficult balancing act. Following years of aggressive monetary stimulus, the question of scaling back this support may have unintended consequences. This will be a risk to monitor over the coming year.

Asset Allocation Outlook as at April 1, 2017

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				✓	

CIBC Asset Management

Highlights

Fixed Income vs. Equity: With a continued economic expansion and interest rates facing gradual upward pressure, equities should remain more attractive than bonds.

Equity: Emerging Asian equity markets remain our preferred global equity region, but European equities currently offer good potential for catch-up growth at a reasonable price.

Fixed Income: Bond yields in the United States and Canada are expected to head higher, but the rise in yields should be modest.

Currencies: We expect limited and selective U.S. dollar strength while a select number of emerging market currencies could provide attractive returns.

Expected Returns

Expected returns for the period beginning April 1, 2017	In Canadian Dollars			In Local Currency		
	U.S. Renormalization	Balancing Act	Global Recession	U.S. Renormalization	Balancing Act	Global Recession
Probabilities	15.0%	65.0%	20.0%	15.0%	65.0%	20.0%
Canada Money Market	0.6%	0.5%	0.3%	0.6%	0.5%	0.3%
Canadian Bond	0.1%	2.4%	6.5%	0.1%	2.4%	6.5%
Canadian Federal Govt. Bond	-0.7%	1.5%	6.2%	-0.7%	1.5%	6.2%
Canadian Corp. Bond	1.5%	3.1%	3.9%	1.5%	3.1%	3.9%
Canadian RRB	3.3%	2.0%	7.8%	3.3%	2.0%	7.8%
Canadian High Yield	5.3%	4.3%	-8.0%	5.3%	4.3%	-8.0%
International Govt. Bond	-7.1%	1.6%	18.2%	-2.8%	-1.6%	5.9%
Canada Equity	15.7%	6.0%	-16.2%	15.7%	6.0%	-16.2%
United States Equity	5.2%	3.6%	-8.7%	10.5%	2.3%	-14.8%
International Equity	13.5%	11.6%	-9.7%	16.2%	8.2%	-16.5%
Emerging Equity	13.9%	10.9%	-20.3%	18.2%	11.5%	-18.4%

Global Outlook

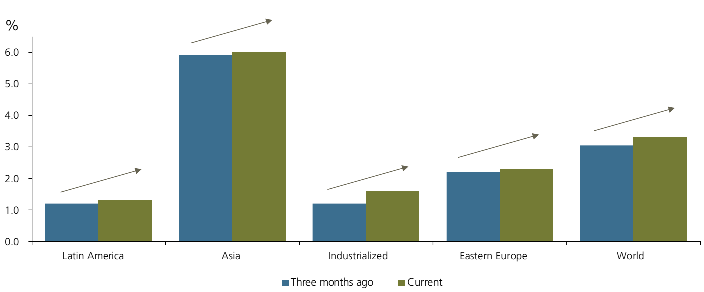
Balancing Act

The main conclusions following our quarterly team forecast sessions were twofold. The global economic expansion will continue at a moderate pace—around 3% over the next 12 months—and core inflation will remain low but gradually move towards central banks' respective targets. With about three months of experience with the new Trump administration, some of the political uncertainties that investors were facing in December have started to dissipate, reducing the range of potential economic outcomes and the risk to financial markets. For example, protectionist rhetoric was replaced by more constructive discussion around building a North American trading powerhouse between NAFTA partners. However, the difficulty of building consensus around policy objectives such as health care or tax reform means that financial market expectations about fiscal stimulus may continue to come down over the coming months. This would fit with our below-consensus U.S. growth forecast. We remain skeptical about the ability of the new administration to enact meaningful stimulus in 2017, given the existing budget constraints and the complexities of health care and tax reform in general.

Uncertainties outside the U.S. have also diminished somewhat. In Europe, political nationalism risk and euro demise seem to be receding following the Netherlands election results, French voter intentions and the outlook for German elections. While the Brexit timeline has officially started, this is expected to have a more regional impact than a global systemic risk. In China, the continuous economic rebalancing remains a long-term challenge, but our evaluation is that the authorities still have the resources and flexibility to manage this transition. A major disruption will likely be avoided over the next 12 months, at least until the major Communist party congress in the fall.

Under this somewhat benign global outlook, central banks will be left to manage a difficult balancing act. Following years of aggressive monetary stimulus, which created distortions in places such as the real estate sector (whether in Sydney, Stockholm or Toronto), the question of scaling back monetary stimulus may have unintended consequences. This will be a risk to monitor over the coming year.

CAM growth forecast for 2017Q2 to 2018Q1: Spring vs. winter forecast



Alternative Scenarios

U.S. Renormalization

Stronger U.S. fiscal stimulus and higher-than-expected infrastructure spending in China could provide enough stimulus to push global economic activity higher than in our *Balancing Act* central scenario. This would bring faster-than-expected renormalization of U.S. monetary policies. Stronger earnings growth would provide an offset to higher interest rates, supporting equity market valuation and provide stronger-than-expected returns. We have limited this renormalization to the U.S. economy. However, recent signs of strength in the Japanese and European economies and reduced slack in their labour markets may lead to a renormalization of monetary policy outside the U.S. as well. Given that market action has already priced-in part of this outcome, there is little to gain, for the moment, in positioning portfolios along the lines of this scenario. The risks are for a move towards the other two scenario outcomes (*Balancing Act* or *Global Recession*) as we enter the second half of the year.

Global Recession

Under this scenario, the world economy slows more than projected in the baseline scenario (*Balancing Act*), making it difficult to avoid a global recession as economic activity remains relatively modest. This more-negative scenario could be triggered by a number of potential events: trade frictions as the new American administration targets Asian economies to reduce the large trade deficit, European uncertainty related to the start of Brexit negotiations and/or problems related to the Italian banking recapitalization efforts and/or extreme political parties winning the French or German elections. Any one of these developments could lead to lower-than-expected economic activity in the eurozone, exacerbating the uncertainty as Brexit negotiations and political uncertainty begin.

Also, already coping with a profit recession, U.S. nonfinancial corporations would be even harder hit moving into the next 12 months—owing to weaker growth abroad. The hit on profitability would be severe enough to force corporate America to lay off workers and cap wage increases: the perfect recipe to produce a retrenchement in consumer spending. Under such conditions, the Fed would be forced to rapidly abandon its renormalization policy and start planning steps to cushion the potential economic downturn.

Fixed Income Versus Equity

Little room for disappointment

Despite the enormous number of headlines focused on U.S. President Trump, the global economy continues to improve in the background. As a result, equity markets have been well supported and continued to push higher. Bond yields have stabilized after their sharp rise in late 2016. While economic growth is an important factor driving equity prices, investors should keep in mind that this is not the indicator to watch to flag a turning point. The acceleration (or deceleration) in growth (i.e. the change in the change) is more timely. The good news is, based on this indicator, it is too early to signal the end of the current economic upswing. However, there are early signs that the growth acceleration is slowing.

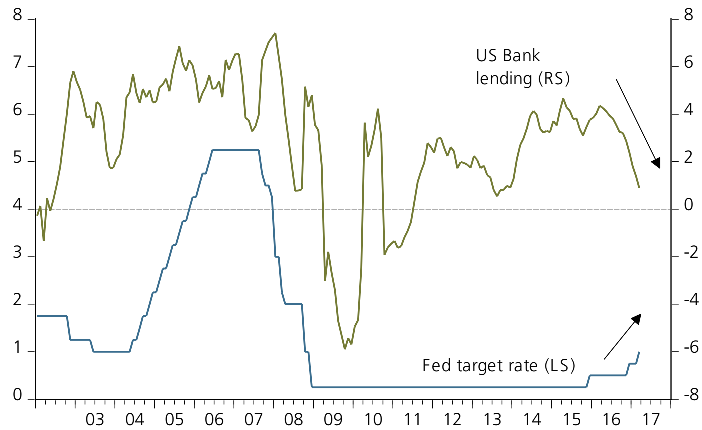
Our economic forecasts show that the U.S. economy should continue to grow at a decent pace. In fact, the U.S. economy is expected to continue to grow at a rate above its long-run average, continuing to remove the slack in the labour market. In other words, the U.S. is expected to continue to move along in the late phase of its economic cycle. The issue is whether markets are already pricing this in. One concern is that our forecasts are below consensus, leaving open the possibility that the market's expectations will be downgraded. The second concern is that, although earnings are improving, most of the recent equity gains came from higher P/E ratios, not from higher earnings.

As conditions continue to gradually normalize in the United States, the U.S. Federal Reserve (Fed) has seized the opportunity to hike the fed funds rate for the third time in a decade. The resulting rate and curve dynamics are expected to lead to a better-functioning transmission mechanism[1] for the financial sector. However, fiscal initiatives are necessary to push the private sector meaningfully forward, and early stumbles by the Trump administration call into question the size and scope of any such plans. All eyes will remain on legislative developments in the U.S., as those results will be closely scrutinized by other economies facing similar handoffs. In Europe, the economy continues to outperform modest expectations. The European Central Bank (ECB) has started to shift its communications as it prepares itself (and financial markets) for the end of European quantitative easing. Fiscal consolidation at the eurozone level remains in the crosshairs of policymakers. But concrete plans are unlikely to emerge until the market gets through both the French and German elections without major negative surprises.

This policy transition (i.e. from monetary stimulus to fiscal stimulus) is happening slowly and political obstacles are producing elevated levels of uncertainty. Interest rates and yield curves should face gradual but continued upward pressure. In this context, and with a continuation of the economic expansion, equities should remain more attractive than bonds. That being said, at current levels equities are already pricing in an improving economic outlook and are at risk for disappointment.

[1]The monetary policy transmission mechanism is the process by which asset prices and general economic conditions are affected as a result of monetary policy decisions.

US Fed policy target rate vs. commerical bank lending (%, 6m / 6m)



Equity Market Outlook

Is rising corporate leverage a concern?

In an ongoing environment of historically low interest rates, corporate executives have taken the opportunity to finance more of their balance sheets with debt. This raises concerns that the corporate sector would be at risk if interest rates were to rise. This trend is not a concern in itself, unless companies have taken on more debt than they can support. On the contrary, balance sheet leveraging has been a very effective tool to enhance return on equity (ROE). Fortunately, the decrease in debt servicing costs and good overall profitability mean those companies still have healthy balance sheets. However, this cycle of leveraging will someday reverse. When it does, the tailwinds to profitability will become headwinds. As interest rates renormalize, one of two things will happen. Companies will maintain their debt at current levels, debt servicing will rise and profits will decline. Alternatively, leverage will return to more normal levels, producing a drag on ROE.

Looking at capital structures by sectors and regions, the increase in leverage has been more pronounced for non-financial companies in the U.S. and Canada. In EAFE countries, there has been little increase in leverage in recent years. In the financial sector globally, significant deleveraging has taken place. The main reason for companies to raise debt was to decrease the cost of capital. Higher leverage becomes a bad thing only when you can no longer afford to pay your debt and the interest coverage ratio is a widely used measure of corporate health. While more debt has led to lower coverage, the ratios remain good overall. Emerging markets (EM) are a special case. Here, the trend of corporate leveraging has been in place since the late 90s and started from a point of very low leverage. Twenty years ago, EM companies financed roughly 55% of their balance sheets with shareholder equity, compared to 29% for the U.S. Today, equity represents 37% of EM balance sheets, compared to 32% for the U.S.

Canada has benefited from the rebound in oil prices that has started to restore profitability in the energy sector. The steeper yield curve and global re-rating of financial companies have also contributed to the good Canadian equity market performance, with its heavy weighting in banks. Canadian equities are slightly overvalued in absolute terms, but slightly more attractive when compared to other markets. Earnings in the commodity sectors will benefit from easy comparisons, as they are at a cyclical trough. That alone would contribute to strong earnings growth for the aggregate market, but this type of growth is not sustainable. While we are still constructive on Canadian equities, the risk/reward proposition is no longer as compelling.

In Europe, the economy is showing signs of improvement. Earnings and sales have rebounded and are now growing strongly. While the U.S. is in the late phase of its economic and earnings cycle, Europe is still recovering from years of weak growth. Net profit margins are low and do not immediately face the headwinds of higher debt servicing costs and higher inflation in employees' compensation. Valuation is also more attractive than in other regions, reflecting the economic and political challenges that lie ahead in Europe. Obviously, European equities would be at risk if another political crisis emerges, but they currently offer good potential for catch-up growth at a reasonable price.

Commodity Insight

Since OPEC's announcement in November to curtail production, oil market participants have been scrutinizing data points as they try to determine the future direction of pricing. Recent crude market commentary has focused on U.S. production and inventory levels in assessing the health of the global crude markets. This is largely due to the lack of timely data outside the U.S. and the markets' short-term focus. However, when assessing a global market, it is essential to consider both domestic and international trends and signals.

The announced curtailment of production by OPEC and some non-OPEC members resulted in an increase in the price of both U.S. domestic and international crude prices. In response, U.S. exploration and production companies (E&Ps) with exposure to low-cost shale oil increased their budgets, putting rigs back and started to grow production. This caused some to question the effectiveness of the new OPEC policy. However, globally, investment continues to decline. Oilfield services company Schlumberger recently commented at an industry conference that investment targeting 50 million barrels of the global production base has declined by 50% since 2014 and has yet to recover. As a result, depletion rates in major basins, including the Gulf of Mexico and North Sea, are accelerating—something that is more difficult to monitor and largely overlooked by the markets. Without significant investment, depletion will lead to eventual production declines.

In assessing U.S. data it is essential to look at the seasonality of refining maintenance, which typically peaks in late March as refiners begin production of summer-grade gasolines. This has a large impact on crude demand of 1 to 2 million barrels per day and can lead to seasonal builds in crude. This year has seen similar builds; however, as we move forward in the coming months, inventory data should tighten in the U.S., reflecting the increased utilization of refining assets.

Other global signposts are signalling a tighter market. OPEC production cuts should disproportionally impact heavy crude grades, as they have lower relative value and are typically the first barrels to see production cuts. Price signals in the market are indicating tightness in these heavier grades, with Brent Dubai spreads narrowing. Furthermore, time spreads are narrowing globally, which is indicative of tighter physical markets and a signal and disincentive to add to storage.

Overall, the oil markets are complex and extend beyond national borders. As such, it is important to look beyond the U.S. in accessing supply and demand. At this point, global physical markets are showing the first signs of tightness as OPEC and its non-OPEC partners pull barrels out of the market.

Fixed Income Outlook

How long will global bond markets remain well-behaved?

Global bond markets were suspiciously well-behaved in the first quarter of 2017, despite the most pronounced inflation reacceleration phase in more than six years. This good behaviour is largely explained by the fact that the recent reacceleration in global inflation has essentially been energy-led and is generally expected to be short-lived.

While some deceleration in headline inflation likely lies ahead, there are other forces at work which are expected to exert upward pressure on sovereign bond yields later in 2017. For one, the ECB is expected to signal its intentions to slow the speed at which it is buying eurozone sovereign bonds. If this happens, a major source of support for both eurozone sovereign bonds and bond markets worldwide would be lost. Since 2015, the ECB has bought eurozone sovereign bonds at a very fast clip, producing a powerful rally in those bonds and capping debt financing costs for governments across the eurozone. The prospect of ECB tapering could change all of this. We see two important potential implications. First, this would very likely de-anchor bond yields globally, translating into upward pressure at both ends of the yield curve. Second, the ECB's asset-purchase program has underpinned bond yields in the single currency bloc. The program held down borrowing costs and shielded vulnerable members from shocks such as last year's British vote to leave the European Union. If the ECB lightens up on its sovereign debt purchases, eurozone sovereign spreads will be susceptible to significant upward pressure, potentially reigniting fears of a debt crisis.

Under those conditions, it would be difficult for North American bond markets to stay well-behaved—particularly in the context of a Fed determined to further renormalize its monetary policy stance. Bond yields in the United States and Canada are expected to head higher over the forecast horizon. Having said this, the rise in bond yields should be limited. Our twelve-month forecast calls for U.S. and Canadian 10-year sovereign bond yields to hit 2.85% and 1.75% respectively by the beginning of 2018.

Currency Markets

U.S. Dollar

In contrast with prevailing consensus expectations, the broad U.S. dollar experienced a difficult start to 2017. The monetary policy divergence theme and expectations of a "huge" Trump fiscal stimulus gradually faded during the first quarter. In recent editions of Perspectives, we also pointed out that the degree of U.S. dollar overvaluation would also be a challenge for further broad gains for the greenback.

Looking forward, we continue to expect limited and selective U.S. dollar strength over the coming year. Besides U.S. dollar overvaluation, monetary policy divergence between the U.S. and many G10 economies will not be as supportive. The global economic expansion is broadening and a number of countries will start reversing course on their own aggressive monetary policies, starting with Europe. In addition, as we discuss in our U.S. economic assessment, we remain below consensus regarding the timing and the impact of the expected fiscal stimulus and infrastructure projects. The recent failure to reach a compromise on health care reform may be a good barometer of the challenge for agreement on tax reform and infrastructure plans. We remain skeptical that the final stimulus plan can be agreed to, let alone implemented, in 2017. This will likely be a disappointment for the currency market and should keep the Fed on a gradual policy renormalization path. Under this most likely scenario, the broad U.S. dollar will likely remain in a wide trading range.

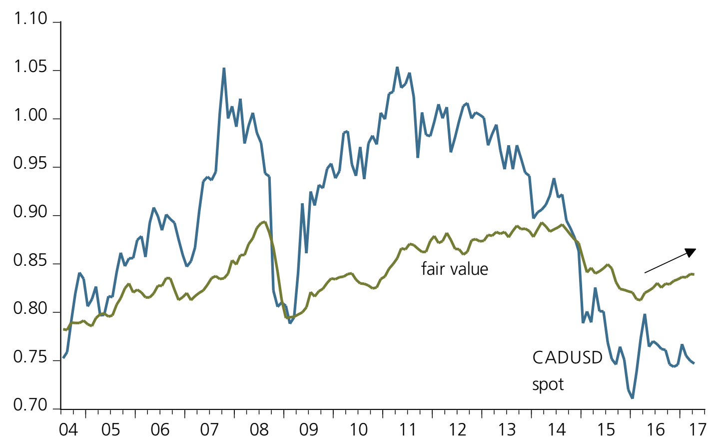
Canadian Dollar

We recently argued that the prospect of oil prices in a trading range in 2017 likely implied a greater role for relative Canadian-U.S. cyclical forces in determining the CADUSD bilateral exchange rate. That is precisely what happened in the first quarter. The recent weakening of the Canadian dollar against the greenback is largely explained by the downshift in relative Bank of Canada (BoC)-Fed expectations. The question now is whether there is any downside left for CADUSD? We are tempted to answer in the affirmative.

Thanks to recent better-than-expected economic numbers, market expectations about the BoC haven't changed much (i.e. no easing priced in). Economic numbers have been surprising on the strong side. However, we have a strong conviction that this energy-led Canadian cyclical recovery will prove to be short-lived. For one thing, at current production and oil price levels, the Canadian energy sector remains under pressure. For another, oil prices found renewed support when OPEC countries struck a deal to cut production in late 2016. Let's not forget that this agreement ends in July. Doubts about a possible deal extension will likely soon resurface, potentially capping the upside for oil prices.

If we are right and the Canadian economy disappoints in the second half of 2017, the BoC will stick to its easy policy stance. Meanwhile, the Fed will most likely keep monetary policy on the path to renormalization. This projected widening in BoC-Fed monetary policy differentials will keep the U.S. dollar well-supported against the Canadian dollar. Our expectation is a drop to 0.73 over the next twelve months for the CAD/USD bilateral rate.

Canadian vs. US dollar (CADUSD) & CAM fair value



Euro

Over the last two years, the ECB has deliberately pushed monetary policy to the limit by cutting the refinancing rate deep into negative territory and launching a massive asset-purchase program. Thanks to these colossal efforts, the euro remained well-behaved on a trade-weighted basis, while losing some ground against the U.S. dollar. This was enough to allow for an export-led recovery in the eurozone economy. Indeed, exports have been the eurozone's main growth engine in recent years, contributing significantly more than consumer spending to overall growth. As a result, the eurozone's trade surplus with the rest of the world is at a record high. However, the favourable dynamics now at work could soon be about to change.

The euro's good behaviour is highly influenced by the ECB's policy stance. Until now, the ECB has been aggressively easing while the Fed has remained in renormalization mode. With the ECB now getting ready to signal its intentions to start its own renormalization via faster tapering, a shift in relative EU-U.S. monetary policy market expectations is expected. This should be enough to trigger an appreciation of the euro against the U.S. dollar. The risk is for too strong an appreciation, which could eventually put the export-led recovery in jeopardy. Embarking on the policy renormalization road promises to be quite challenging for European monetary authorities.

Emerging Markets

Because of the diversity and breadth in the emerging market currency universe, we continue to see a number of opportunities in the coming year. Our proprietary valuation and interest rate differential indicators show that a number of emerging market currencies offer a combination of attractive valuation and high real interest rates. A number of these currencies have already performed very well over the last twelve months. But the fundamentals of a number have also improved, with sustainable current account balances and credible inflation policies making additional currency gains likely.

That being said, this outlook is not risk free. For example, China's rebalancing remains a difficult balancing act. China is aiming to maintain growth targets in the short term, even as debt levels continue to grow at an unsustainable pace in the long term. Policy miscalibration could trigger fears of financial instability for China and its close trading partners. South Korea is holding Presidential elections following the recent impeachment by the Constitutional Court, at a time when North Korea seems to be less stable than ever. Finally, while the Trump administration has been somewhat quiet regarding its trade objectives, free and fair trade remains on the U.S. political agenda. That objective may create more stress for a number of emerging countries boasting large trade surpluses with the U.S., such as China, Korea and Mexico. Nevertheless, we believe that a select number of currencies will provide attractive returns for the coming year including the Indian rupee, Russian ruble and the Mexican peso, to name a few.

Regional Outlook
Canada

Fully recovered from the oil shock?

Canada has been particularly hard hit by the global oil shock over the last two years. Moving into 2017, many forecasters predict better days ahead for Canadian oil producers and, as a result, for the Canadian economy. The consensus of private sector forecasters calls for 2.3% average real GDP growth between 2017Q2 and 2018Q1. Is the worst really in the past for Canada? Our below-consensus projection of 1.9% growth demonstrates that we are not as upbeat as most.

Much of the recent enthusiasm seems to stem from the fact that there is finally some evidence of a recovery in the Canadian energy sector. While employment in the energy sector is still in contraction (-6.1% y/y), activity in the Canadian oil sector has seen a strong recovery (from -5% in late 2015 to +5.3% late last year), providing a +0.5% boost to overall real GDP growth. Excluding the energy sector, Canadian real GDP growth is only running at 1.8% on an annualized basis.

Unfortunately, the recovery in the Canadian energy sector will likely be short-lived. From this point on, there is very limited upside for Canadian oil production and oil prices. As a result, growth in Canadian oil revenues will likely start decelerating, potentially heading back into negative territory. Overall, the outlook is not particularly rosy for Canadian oil producers. With oil prices projected to stay in consolidation mode—ranging between $45 and $55—the profit margins of Canadian oil producers will likely remain under pressure.

If we are right and the Canadian economy starts to disappoint again in the second half of 2017, the BoC will be inclined to keep monetary policy in easy territory. It will also re-emphasize that Canada will be stuck in a low-growth environment for much longer than generally expected (i.e. "lower for longer"). This will implicitly signal that there is no BoC policy renormalization in sight.

United States

- **U.S. real GDP growth is projected to average +1.9%, a less optimistic view than consensus (+2.3%).**
- **The Fed wants to continue its policy renormalization, but the process could be challenging, elevating the risks of a policy mistake.**

Nearly eight years after the Great Recession, the Fed can finally breathe a little easier. Thanks to the colossal efforts it has deployed over a number of years, the U.S. labour market is in its best shape in over a decade. This is certainly good news and provides enough justification for the Fed to shift to the second phase of its tightening campaign—one where it could deliver rate hikes at a faster pace. However, this second phase should prove to be a critical one with much higher risk of a policy mistake. Why worry? Aren't continued employment growth and accelerating wage inflation very positive economic developments? Not for all economic agents.

While the Fed is getting what it wanted—a rise in the share of employee compensation to GDP—these developments are typically associated with harder times for U.S. nonfinancial corporations. More often than not, when compensation costs per employee rise faster than top-line corporate revenue growth (as they are doing right now), profitability takes a severe hit. The only way to compensate for such a hit on profits would be via much stronger productivity growth. Unfortunately, U.S. productivity growth has been, and remains, atypically low. Rapidly rising compensation costs are not the only reason U.S. corporate profit margins are under pressure. The broad-based strength of the U.S. dollar is certainly not helping either.

Over the forecast horizon, U.S. real GDP growth is projected to average +1.9%. This below-consensus forecast is essentially explained by the continued drag from net exports, soft non-residential investment and weakening consumer fundamentals. However, this growth profile is strong enough to eliminate the excess supply conditions now prevailing and allow core CPI inflation to move closer to the Fed's implicit target, thanks to intensifying cost-push pressures.

If this forecast materializes, the Fed will have to renormalize at a faster pace. Needless to say, the challenge for the Fed will be to figure out the right dosage of tightening to deliver. Accounting for all economic agents (households, government and corporations), the U.S. debt load is at record levels, amounting to roughly 300% of GDP. In other words, the U.S. economy is now more vulnerable than ever to rising borrowing costs. Because of this unique feature, the Fed will have a difficult balancing act between renormalizing monetary policy and keeping an eye on the unusually high economic debt load.

Europe

Time for the ECB to take its foot off the accelerator

Since the eurozone debt crisis in 2012, the ECB has conducted monetary policy with two distinct objectives. The first was to bring inflation back in line with the ECB's implicit target. The second has been to preserve the integrity of the eurozone by providing support to weak peripheral countries. So far, the unorthodox policy combination delivered by the ECB nearly two years ago (sub-zero policy rates and quantitative easing) has helped to achieve both objectives with limited tension between them. The threat of deflation and economic weakness justified the ECB's ultra-lax policy stance, which in turn supported vulnerable sovereign peripheral economies such as Italy and Portugal.

Now that economic prospects for the eurozone are improving and deflation is no longer an immediate threat, the ECB has to start contemplating some form of policy renormalization. This task promises to be quite challenging. Debt overhangs will persist even as the economy recovers and inflation resurfaces. In weaker countries, low borrowing costs are still required to keep debt dynamics under control, as economic activity remains weak.

Even under such difficult navigating conditions, the ECB has no other option but to steer monetary policy by signaling to the world that more tapering lies ahead. The asset-purchase program launched by the ECB in early 2015 was poorly designed to begin with, qualifying as over-kill. New sovereign debt issuance coming to the market in 2017 only amounts to €171 billion, but the ECB is still buying more than €700 billion. In other words, the available supply of EU sovereign bonds is shrinking at a very fast clip. With no tapering, the ECB will run out of German bunds to buy next year. Scarcity is already a major problem, creating important dislocations in the German bund market.

How will markets react to the prospect of increased ECB policy renormalization? Lessons can be learned from the U.S. taper tantrum episode of 2013. While the Fed only started to reduce its asset purchases in December 2013, a brutal market adjustment took place eight months earlier when the Fed subtly signaled its intentions to eventually taper. It did this by stating that the Committee was prepared not just to increase, but also to reduce, the pace of its asset purchases. This subtle change in phrasing sufficed to trigger a major pullback in the U.S. Treasury bond market (+150 bps).

With real GDP growth projected at 1.4% and inflation at 1.5%, economic conditions in the eurozone justify the beginning of some ECB policy renormalization over our forecast horizon.

China

Focusing on more currency stability in 2017

- **Our estimate for GDP growth is 6.3% by Q1 2018. This suggests that growth momentum is peaking in H1 2017 and will slow in the coming quarters.**
- **The renminbi (RMB) will likely experience less volatility in 2017 as compared to 2016. This is largely due to increased capital controls, which are already proving very effective in limiting capital outflows.**

Chinese lawmakers held their fifth session of the 12th National People`s Congress in March 2017, where the country`s leadership set its main policy objectives for the calendar year. The GDP growth target is set for 6.5% in 2017, a change from the range of 6.5% to 7% in 2016. The fiscal deficit target is set at 3% of GDP, below the 3.8% deficit registered last year. We expect economic activity to record growth close to the desired target in 2017; however, a slowdown is expected late in the year. This is due to a significant unwinding of policy stimulus in 2017, particularly in government expenditures. The removal of tax incentives, along with the tightening of macro prudential measures imposed to limit growth in the residential property market, will also weigh on economic growth in H2 2017.

The inflation target remains unchanged at 3%. So far this year, inflation has remained well managed, despite the sharp rise in producer prices due to higher commodity prices. Despite CPI appreciation that was well below target on average, we see inflation dynamics as a key factor that could put the growth target at risk. As long as inflation is contained, the Chinese central bank (People's Bank of China or PBoC) will have the flexibility to maintain a relatively neutral policy rate environment, thereby promoting economic activity. However, if inflationary pressures start to rise, the PBoC will have a harder time managing the balance between growth and inflation.

The RMB will likely experience less volatility in 2017 as compared to 2016. This is largely due to the increased capital controls, which are already proving very effective in limiting capital outflows, particularly those driven by M&A activity. Given the significant change in expectation in net direct investment going forward, we expect interest rate differentials to be the driving factor for the RMB over the next 12 months.

Signposts

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

Canadian Signposts

- Housing activity and property prices
- Employment growth
- Retail Sales (monitoring impact of fiscal policy)
- Oil impact on trade balance (energy vs. non-energy)

U.S. Signposts

- Fiscal policy announcements (tax cuts, tariffs, currency manipulator etc.)
- Corporate profitability
- Effective U.S. dollar
- Wage growth (best measure is Employment Cost Index)
- Core PCE inflationary pressures (a favoured Fed measure)
- Domestic oil production increase (following OPEC agreement)
- New orders versus inventories
- Capital Goods orders (monitor investment growth)

Chinese Signposts

- Housing sales, prices and housing starts
- GDP growth mix (industrial production vs. retail sales vs. services)
- Lending to households and businesses
- Fiscal and monetary policy initiatives

Other Market Signposts

- Post-TLTRO II European bank lending
- French elections
- Brexit negotiations
- OPEC production cut agreement/extension
- Global Purchasing Managers' Indices
- Eurozone banks' relative performance
- UK commercial real estate activity