



Review & Strategy

CIBC Private Investment Counsel

Global rebalancing enters final stage

Probable scenario: U.S. economy weakens and growth slows in the rest of the world*

The world appears to be moving into the last stage of the global rebalancing theme that we have been monitoring for some time now. In this stage the dominance of the U.S. begins to fade and faster-growing countries, such as China, play a more influential role in the global economy.

In the short term, however, the slowdown in the U.S. is likely to be accompanied by slowing growth in other regions of the world. We are already seeing some signs of this. In Europe, a rapidly rising euro is dampening consumer and business confidence. Consumer demand in Japan is lacklustre, while a rising currency and higher interest rates are curtailing growth in China.

Injections of liquidity

Global policy makers are continuing to work hard to contain the effects of the U.S.-born credit crunch. The U.S. Federal Reserve Board, the Bank of Canada, and the Bank of England, among others, have lowered rates and endeavoured to provide more liquidity to the system.

Tens of billions of dollars in short-term loans have gone to banks to assist the interbank lending market. The full effects of the housing-market slowdown have yet to be felt in the wider economy of the U.S.

At the same time, global inflation is on the rise, to 5% in Asia ex-Japan and 6% in China, providing an additional challenge for the central banks.

Continued growth in Canada

Tight credit conditions, an intensifying manufacturing slowdown, and easing of

short-term inflation pressures have encouraged the Bank of Canada (BoC) to keep interest rates low.

On January 22, the BoC lowered its overnight rate by a quarter point (0.25%), bringing it to 4%, following a one-day decline of more than 600 points in the S&P/TSX Composite Index and an unexpected 75-point reduction in the U.S. Federal Funds rate.

Those low rates are adding fuel to Canada's already hot service sector, resulting in an exceptional economic expansion. Given the importance of the service sector to the overall Canadian economy and the strength of the employment market, we do not expect economic growth to cool significantly over the near term.

Although the core inflation rate, inflation without food and energy increases, could fall below 1.0% over the coming months, inflation concerns could resurface next year. The likely response from the BoC would be to resume monetary tightening and begin increasing interest rates.

Many investors may be concerned about the effect of the high Canadian dollar on the economy. As the chart on the following page shows, Canada is coping quite well with its strong currency with the exception of the manufacturing sector.

U.S. striving to avoid recession

Fears of an impending recession have increased substantially in the U.S., a direct result of the intensity of the credit

“The slowdown in the U.S. is likely to be accompanied by slowing growth in other regions of the world.”

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Global rebalancing

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squeeze. However, we believe that the odds of a severe contraction in the U.S. economy have dropped, owing to greatly eased monetary conditions.

The U.S. Federal Reserve Board has cut the Fed Funds rate since September 2007, dropping it by a total of 2.25 percentage points by the end of January 2008.

With weaker home prices and lower mortgage interest rates, housing affordability should improve in the first half of 2008, which in turn should provide support for consumer spending. In addition, one benefit of a weaker U.S. dollar is that net exports should increase, providing a boost to the U.S. economy. Similarly, low inventory levels could translate into increased demand for industrial production.

Europe's balancing act

The European Central Bank (ECB) has kept interest rates constant since June 2007. The ECB faces the difficult task of balancing the needs of European Union members that find its current policy adequate against the needs of those that find it too restrictive.

At the same time, the current European inflation of 3.2% remains above the ECB target of 2%, and we expect the central bank to keep its tightening bias. With unemployment levels at historical lows, consumer spending is likely to hold steady.

Positive rates possible in Japan

With inflation returning to Japan, the Bank of Japan may need to end its zero-interest-rate policy of the past decade.

Leading indicators are signaling a slowdown in economic activity. Higher prices for oil and raw materials are cutting into profit margins, consumer

sentiment is down, and consumer prices are up.

The downside risks to the Japanese economy are likely to be concentrated in the early part of 2008. In addition, we believe that equity markets have already priced in the slowdown in growth.

Rising currency in China

Until now, China has kept its currency undervalued in order to support its export sector, a key contributor to the Chinese economy. As a result, it is now vulnerable to a global slowdown.

With inflation running at more than 6%, the Bank of China faces a difficult task. Raising interest rates would help rein in inflation but could also impair the purchasing power of Chinese consumers at a time when domestic demand is most needed to offset weakening exports.

Risks to the probable scenario

There are two potential risks that could have an impact on our projections:

- **Deflation.** If the U.S. Federal Reserve Board cannot successfully alleviate the financial tensions created by the sub-prime market fallout, the resulting deflation and weak U.S. demand could drag down the economies of the rest of the world. Commodity prices could reverse, seriously challenging the bull market in emerging market equities.

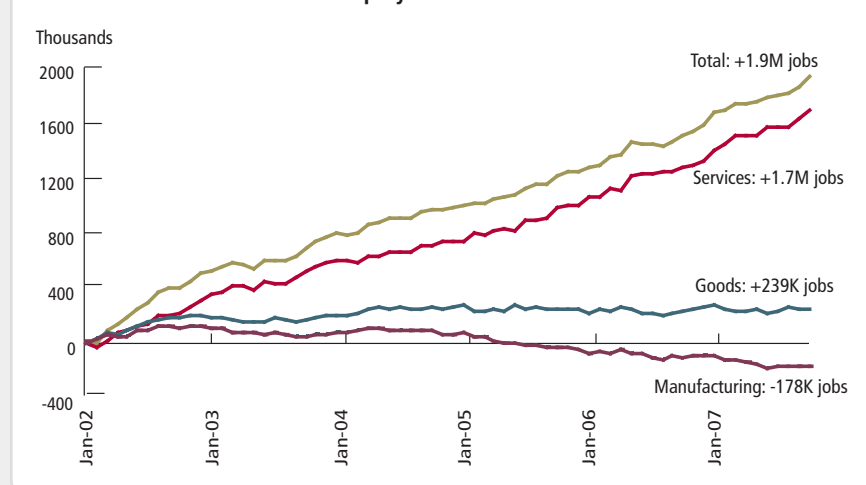
- **Growth surprise.** Under this scenario, a quicker-than-expected resolution of the credit crunch would be extremely stimulative. The result would be stronger-than-expected economic growth and potential inflationary pressures.

* *Twelve-month forecast to December 31, 2008. This article and the information within, in part using information from Datastream, were prepared by the Global Asset Allocation team at CIBC Global Asset Management Inc., a member of the CIBC Group of Companies.* ■

Canada coping nicely with a strong currency

The Canadian economy continues to generate jobs, in spite of ongoing strength in the Canadian dollar. Only the manufacturing sector has not contributed to net employment creation over the past five years.

Canadian employment creation since 2002



Source: Datastream

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