NAVIGATING THE EXIT PLAN

Our baseline economic forecast continues to project a sluggish expansion over the next twelve months. We are gradually moving away from an environment characterized by extreme monetary policy accommodation, global fiscal retrenchment and balance sheet deleveraging, both at the consumer and banking industry level. We believe that a strategic bias in asset allocation strategies to overweight equities and underweight government bonds in balanced portfolios should provide excess returns.

Current Asset Allocation, as at July 1, 2013

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Underweight</th>
<th>Neutral</th>
<th>Overweight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity / Fixed Income</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Fixed Income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canadian Money Market</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canadian Government Bond</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canadian Corporate Bond</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>International Government Bond</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Canadian Equity</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>U.S. Equity</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>International Equity (Developed Markets)</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Currency (versus U.S. Dollar)</th>
<th>Underweight</th>
<th>Neutral</th>
<th>Overweight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canadian Dollar</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Euro</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Japanese Yen</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>British Pound</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Swiss Franc</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
<tr>
<td>Australian Dollar</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td></td>
<td></td>
<td>✓</td>
</tr>
</tbody>
</table>
**Highlights**

**Fixed Income Versus Equity:** The relative outperformance of equities will be supported, over time, by a reduction in the perceived risk of stocks as the global expansion continues to forge ahead.

**Equity:** As the Federal Reserve starts to prepare its quantitative easing exit strategy, the next phase in the equity market rally should be driven by improving earnings, as the economy is robust enough to grow with less quantitative easing support.

**Fixed Income:** We believe that a more balanced approach by the Federal Reserve, where it can either reduce or increase its bond purchases, should prevent any uncontrolled pull-back in interest rates.

**Currencies:** The Federal Reserve may no longer be the most dovish global central bank, which in turn should lessen the downward pressure on the U.S. dollar over the coming 12 months.

**Expected Returns**

We are maintaining the probability for our main Sluggish Expansion scenario at 70% for the next twelve-month period. We have reduced the probability of a Global Recession from 20% to 15% and increased the probability of a Growth Surprise to 15% from 10%.

<table>
<thead>
<tr>
<th>For the 12-month period beginning July 1, 2013</th>
<th>In Canadian Dollars</th>
<th>In Local Currency</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Growth Surprise</td>
<td>Sluggish Expansion</td>
</tr>
<tr>
<td>Probabilities</td>
<td>15.0%</td>
<td>70.0%</td>
</tr>
<tr>
<td>Canada Money Market</td>
<td>1.3%</td>
<td>1.0%</td>
</tr>
<tr>
<td>Canada Bond</td>
<td>-0.3%</td>
<td>3.2%</td>
</tr>
<tr>
<td>Canadian Federal Gov't Bond</td>
<td>-0.9%</td>
<td>2.3%</td>
</tr>
<tr>
<td>Canada Corporate Bond</td>
<td>1.6%</td>
<td>3.9%</td>
</tr>
<tr>
<td>Canada RRB</td>
<td>-2.6%</td>
<td>3.3%</td>
</tr>
<tr>
<td>Canada High Yield Bond</td>
<td>10.3%</td>
<td>9.8%</td>
</tr>
<tr>
<td>International Gov't Bond</td>
<td>-11.4%</td>
<td>-0.9%</td>
</tr>
<tr>
<td>Canada Equity</td>
<td>20.1%</td>
<td>11.8%</td>
</tr>
<tr>
<td>United States Equity</td>
<td>10.3%</td>
<td>12.1%</td>
</tr>
<tr>
<td>International Equity</td>
<td>14.1%</td>
<td>12.2%</td>
</tr>
<tr>
<td>Emerging Equity</td>
<td>25.7%</td>
<td>15.1%</td>
</tr>
</tbody>
</table>

*Source: CIBC Global Asset Management Inc.*

**Global Outlook**

Over the second quarter, additional signs have confirmed a slow but steady change in the economic regime that has been predominant for the last five years. As outlined in previous editions of Perspectives, we are gradually moving away from an environment characterized by extreme monetary policy accommodation, global fiscal retrenchment and balance sheet deleveraging, both at the consumer and banking industry level.

Without a doubt, the most significant event of the last quarter was the announcement by Federal Reserve (the Fed) Chairman Ben Bernanke that, if the Fed’s forecasts prove accurate, the Federal Reserve would start reducing the pace of its massive asset purchase program by the fall of 2013. Since the last quantitative easing program (QE3) was introduced based on the assessment that the U.S. economy was facing an “extraordinary time which required extraordinary measures”, the fact that the Fed judges it appropriate to slowly end the program sends a signal that the economy no longer requires extraordinary measures. The financial market impact was almost instantaneous and wide sweeping. Interest rates rose
and yield curves steepened dramatically while the U.S. dollar rallied. Commodities, particularly gold, sold off and volatility rose, reversing well-established trends. Our sense is that, while these initial movements will be partly reversed in the short-term, they herald a sign of trends to come.

The second most important change, in our view, is the aggressiveness with which Chinese authorities seem to be tackling excessive lending practices in the banking system. Despite weakening economic indicators, the new administration has demonstrated resolve in reducing excessive lending practices that have existed since the beginning of the financial crisis. While painful in the short-term, we view this change of approach as encouraging, as it signals determination of China’s new leaders to foster lower but more sustainable growth in the medium-term. Our sense is that Chinese financial markets have been discounting a large portion of the risks associated with this transition, as Chinese equity markets are now trading at a significant discount to other major markets. Since the duration of this transition remains difficult to gauge, it may continue to result in volatility in the equity market and exert downward pressure on industrial commodity prices - another characteristic of the new regime.

Japanese law makers are also attempting to escape a two decade long deflationary trend by implementing important changes in all policy areas - massive monetary loosening, flexible fiscal policy and ground-breaking structural labour and corporate tax reforms. A victory in the July 21st upper house election would give the ruling Liberal Democratic Party (LDP) party an extremely rare three-year window to push these long-term reforms without facing a national election and increases the likelihood of sweeping reforms. Based on recent election polls and the recent assembly election in Tokyo, there is a high probability of an LDP win and continued structural changes. This scenario would continue to support the recent trends in Japanese assets - a continued rise in Japanese equity prices and weakness in the yen.

In Europe, the euro crisis remains under control and the economy continues to muddle through thanks to the umbrella provided by the European Central Bank (ECB) and its Outright Monetary Transactions (OMT) program. The banking sector is continuing its deleveraging whereby loan growth continues to weaken, balance sheets are being aligned with regulatory requirements and loan demand remains poor. Some progress has also been made in fiscal deficit reduction and current account balances have improved, highlighting increased competitiveness in the euro zone trade sector. We are less optimistic, however, regarding the pace of structural reforms as weak economic activity and high unemployment translate into "austerity fatigue" from the electorate. Europe will remain on our risk radar as long as economic activity remains below growth potential since progress on deleveraging will be difficult to achieve under those conditions. However, European asset prices remain depressed and further improvements could lead to positive surprises.

For emerging markets (EM), a faster-than-expected reduction in the Federal Reserve’s asset purchase program could pose challenges to the short-term performance of this asset class. Declines in global interest rates and the search for yield have benefited the EM asset class, which has seen large capital inflows. A change in the course of U.S. interest rates has already reversed part of these investment flows, pushing EM yields higher and equity markets lower. Higher than normal public fiscal and current account deficits will make this rising yield environment more difficult for some emerging countries (such as India and Brazil) in the short-term. But longer-term, high savings rates, low public debt and tame inflation should help the asset class weather the storm given its attractive valuation.

Despite lower estimates for China’s economic growth, higher U.S. and Japanese growth, along with a stabilizing Europe, should ensure that global GDP growth remains slightly higher than its long-term trend of 3.5% over the next year. At the same time, as Chinese investment slows, global growth will likely be less energy and commodity intensive, leaving global inflation relatively well-behaved.

For more details about our alternative scenarios, their implications on financial markets and the main signposts to monitor, please see the last two pages of Perspectives
FIXED INCOME VERSUS EQUITY

Bond prices had a meaningful retracement during the second quarter, with yields making new highs for the year in both Canada and the U.S. Economic data, while not stellar, continued to point to a continuing expansion. As discussed in previous editions of Perspectives, the starting level of government bond yields is so low that an orderly rise in yields is not expected to derail the equity uptrend. When bond yields move below fair value they will provide more competition for equity yields. For now, bond yields remain “rationally overvalued”, a phrase we coined to describe the need for exceptionally low rates due to the fragility of the economic expansion; our expectation is for bond yields to move only gradually higher. This will not act as major headwind for higher equity markets.

The argument in favour of equities relative to bonds is supported by the relatively large equity risk premium versus the low risk premium offered by government bonds. Our overweight position in equities is based on the premise that this relative risk premium will close, both from a rise in bond yields and a rise in equity prices. The relative outperformance of stocks will be supported, over time, by a reduction in the perceived risk of stocks as the global expansion continues to forge ahead. This will reduce the perceived need for investors to hold safe assets such as government bonds. Our view is also supported by our measure of the equity risk premium, which is still attractive by historical measures.

<table>
<thead>
<tr>
<th>Equity Risk Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Time Period</strong></td>
</tr>
<tr>
<td>Historical</td>
</tr>
<tr>
<td>From January 1875 to March 2013</td>
</tr>
<tr>
<td></td>
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<tr>
<td></td>
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<td></td>
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<tr>
<td></td>
</tr>
<tr>
<td>CGAM Forecasts</td>
</tr>
<tr>
<td>From July 1, 2013 to July 1, 2014</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
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<tr>
<td></td>
</tr>
</tbody>
</table>

Source: Thomson Reuters Datastream, CIBC Global Asset Management Inc.

Our debt versus equity strategy is not predicated on strong economic activity supporting above-average earnings growth but on a normalization of global growth activity, particularly in the U.S. and perhaps Europe. These conditions could lead to an ongoing normalization of the wide spread in the existing risk premium; most importantly, economic activity will need to continue to improve and, in particular, employment and income must continue to normalize. In such a scenario, the rotation away from government bonds and into equities will continue over the forecast horizon, rewarding investors who position themselves ahead of this trend.

EQUITY MARKET OUTLOOK: FUNDAMENTALS DRIVING RETURNS

- Earnings growth will be the driver of equity market returns going forward.

- Our global earnings growth estimate is 10.5% year-over-year. Canadian earnings will lag, growing 7.0% year-over-year due in part to weak commodity sectors.
(Japanese equities, emerging market equities) have been affected by this volatility to a greater extent than other asset classes.

Eventually, the Fed will gradually normalize its monetary policy, although the timing will be data-dependent and only occur if the economy is strong enough to withstand it. Initially, the Fed will reduce the pace of quantitative easing and the signal sent to the market about the economic outlook should be positive for equities. Other central banks (notably the European Central Bank and Bank of Japan (BOJ) remain in full easing mode. As a result, the investment environment for the next 12 months should reflect both a pick-up in growth and very accommodative monetary conditions. While there will be times when concerns about growth and monetary policy will resurface and cause renewed market turmoil, the general trend in equities should remain positive, though weaker than before, with returns driven by earnings growth. While valuation is neutral at this point and not expected to contribute much to equity appreciation, the environment is susceptible to overreaction.

Emerging markets (EM) have underperformed developed markets since late 2010 owing partially to their relative deceleration in economic growth. At this juncture, monetary conditions will likely begin to tighten in these regions. Previously, facing a slowdown in global growth, many emerging central banks set their monetary policy looser than justified by their own economic conditions. As the Fed prepares for a normalization of its policy, these central banks will be able to normalize their policies as well. This move could provide support for emerging market currencies which are currently under pressure. Although the case for EM over the long-term is still valid, outperformance may not materialize in the near future even though these markets remain undervalued. Relative to the developed world, EM trades at the biggest discount since 2005, based on our valuation models. Over the long-term, expected equity returns are much higher for emerging markets compared to the developed world. Recently, emerging markets earnings have been lackluster. Most of the weakness can be attributed to Brazil and Russia, and more specifically to the energy and materials sectors, which we expect to remain weak. Earnings in Asia have remained resilient, and have been among the strongest globally. This should remain an area of high growth, with double digit earnings growth expected.

After a strong rally, induced by hopes of aggressive monetary easing and structural reforms, the Japanese equity market has pulled back, an expected development given the magnitude of the previous rally. The Bank of Japan has already laid out its policy plans and should not be expected to make any significant announcements in the near future. While it is too early for the BOJ to do more, it is too late for it to turn back. The government faces an election in July so it is understandable that they do not want to “rock the boat” before that event. Ultimately, Japanese earnings stand to benefit from a weak yen and a positive global economic cycle.

There are signs that the European economy is improving and we believe the euro zone recession should come to an end in the last quarter of 2013. European manufacturing activity bottomed in August 2012 and is signaling a pick-up in economic activity, with Germany expected to lead the euro area recovery. Valuation in many markets is still distorted by a depressed level of earnings and will gradually normalize as earnings recover. Earnings in EAFE (Europe, Asia, Far East) should grow faster than the rest of the world. With Europe still in recession and not expected to post positive growth until 2014, strong earnings growth will come as much from a depressed starting base as from economic growth.

We expect U.S. earnings to grow at 9.9% this year, with most of the gains coming from sales growth. U.S. companies are in good financial health and, although margins are at a cyclical peak, we do not expect them to revert to the mean in the near term. The U.S. is the main global growth engine, with acceleration in economic activity and a job market that is far from full employment. As the Fed is now explicitly targeting the unemployment rate, initial success in job creation should have positive implications for top-line growth yet create little pressure on wages. U.S. equities are trading below our estimated fair value but above the long-term average. In our view, U.S. equities have little room for a valuation re-rating from current levels.

After lagging for almost two years, the Canadian market underperformance may finally be in its late stage. Even with a flattening housing market, Canadian banks should continue to do well but will lag international banks. Although commodity prices are expected to remain weak, the sector has underperformed to a point where valuation has become attractive. With little growth coming from the energy and materials sectors, Canadian earnings will grow at an estimated 7%. In the second half of 2011, global equities began a sharp
bull market that pushed valuation from significantly undervalued to fair value. The Canadian market was one of the biggest underperformers during that period and, as a result, Canadian equities are still undervalued and one of the most attractive globally. We expect some of that discount to correct itself over the next 12 months.

We expect global earnings to grow at 10.5% year-over-year. Global earnings momentum in the financial sector is strong and expected to continue as earnings are still recovering from the crisis. A steepening yield curve will support net interest margins, while the pick up in economic activity and a buoyant housing market will fuel credit growth. Furthermore, return on equity (ROE) has declined due to bank deleveraging. While deleveraging may have run its course in the U.S., banks are unlikely to increase leverage to pre-crisis levels. With declining margins and lower leverage, ROE will be structurally lower over the next few years. European banks earnings are still very depressed and not yet improving.

The generally positive picture on global earnings is offset by pronounced weakness in the energy and materials sectors. Earnings in those sectors are highly correlated with commodity prices. Given our outlook for prolonged weak commodity prices, we do not see much earnings improvement for these sectors.

Earnings in sectors other than financials or commodities have been more stable. The two biggest contributors to global earnings in the current cycle have been U.S. technology and emerging Asia, together accounting for 80% of the marginal dollar of earnings since 2008.

**Fixed Income Outlook: Improving Return Prospects**

- **With the recent increase in yields and a more balanced approach by the Fed, the upward pressure on rates over the next 12 months has diminished. Our forecast over that period stands at 2.70% for the U.S. 10-year Treasury yield and 2.55% for the Canadian equivalent.**
- **Range-bound movements in yields should translate into improved, yet modest, returns for bondholders.**

Over the last two months, the possibility of a future reduction in bond purchases by the Federal Reserve has had a significant impact on bond yields around the world. While the U.S. 10-year Treasury yield experienced a 70 basis point (bp) increase in less than six weeks, bond markets in Mexico and Brazil, for example, more than doubled that increase over the same period. This was a good reminder that the Fed’s actions generally exert an influence that goes far beyond its domestic economy. The speed at which the movement occurred was also a good indicator of the uncertainty surrounding the exit strategy.

Looking ahead, we maintain our view that the need to prepare for an eventual unwinding of QE, along with a marginal improvement in global growth, should continue to gradually exert upward pressure on yields. However, in light of the recent market reaction, yields now have little room to move up further without risking an adverse impact on growth and employment. Furthermore, we believe that a more balanced approach by the Fed, where it can either reduce or increase its bond purchases, should also prevent any uncontrolled pull-back in interest rates.

This range-bound type of market should be more positive for agencies and sovereign securities as they will avoid the negative impact from a large rate increase. This environment will also represent an additional element of support for corporate bonds that will continue to benefit from improving growth and investors’ need for extra yield. Overall, return prospects for fixed income securities over the forecast period have improved.

Our 12-month forecast stands at 2.70% for the U.S. 10-year Treasury yield and 2.55% for the corresponding Canadian interest rate.
CURRENCY MARKETS

U.S. DOLLAR

At its June meeting, the Federal Reserve expressed greater confidence about the state of the U.S. expansion and elaborated on its strategy to end its asset purchase program. The intention to gradually remove these extreme monetary policy stimulus measures triggered a re-normalization in the interest rate market, pushing U.S. nominal yields over 2.6% and moving real yields from negative to positive. As interest rates are an important currency performance factor, this provided support to the U.S. dollar against a broad range of currencies, particularly commodity currencies such as the Australian and Canadian dollar and emerging market currencies. This further illustrates the changing economic regime we have described in previous editions of Perspectives. At the margin, the Federal Reserve may no longer be the most dovish global central bank, which in turn should lessen the downward pressure on the dollar over the coming 12 months. The U.S. maintains a large current account deficit and fiscal deficit which will limit the scope of its appreciation relative to currencies that demonstrate even poorer fundamentals such as the Japanese yen, the British pound and a number of emerging currencies that combine larger current account deficits, fiscal deficits and/or easier monetary policies. While these developments should end the broad U.S. trade-weighted-dollar index depreciation, U.S. dollar appreciation will likely be confined to low yielding, high current account deficit countries.

CANADIAN DOLLAR

The Canadian dollar weakened further during the quarter. External factors were the cause of the depreciation, as disappointing growth in China put downward pressure on commodity prices. Continued uncertainty around the economic transition in China will likely continue to put pressure on the Canadian dollar as Canada’s terms of trade deteriorate. With domestic economic activity likely to remain subdued due to the high debt level of Canadian consumers, the Bank of Canada (BoC) will likely continue its accommodative monetary policy. The decline in the Canadian dollar has corrected some of its overvaluation but the currency is still trading at a premium to its long-term fundamentals. On the positive side, the Canadian economy is sensitive to the U.S. economic cycle and, on that front, we see a gradual improvement over the course of the next 12 months. This should lend some support to the exchange rate, which is forecast to remain close to the recent lows of 1.05 USDCAD.

JAPANESE YEN

Japanese officials have so far maintained their objectives of bold policy action with aggressive Bank of Japan quantitative easing and flexible fiscal stimulus. Even so, yen depreciation paused in the second quarter as skepticism over the determination of Japanese policy makers grew. We believe that yen weakness will reassert itself in the second half of the year. One of the triggers could be the July upper house election which could produce an LDP victory. This win would give the LDP a full majority and, in
turn, give Prime Minister Abe full power for the next three years to implement structural reforms. Changes in the corporate tax structure combined with a relaxation of labour laws would enhance long-term growth potential and help to lower deflationary pressures. These initiatives, combined with an ongoing trade deficit and a dovish central bank, would continue to weaken the yen relative to most other currencies.

**EURO**

The currency has remained in a narrow trading range of 1.28-1.35 EUR for the better part of the last nine months. The euro remains supported by a positive and growing current account surplus as restructuring in peripheral economies is providing signs of improved competitiveness. Years of labour reform and subdued domestic demand has improved the competitiveness of the export sector in peripheral countries, such as Spain, with improved exports relative to import growth. On the other hand, continued sluggish economic activity, as a result of high unemployment and fiscal austerity, is forcing the European Central Bank to remain accommodative to support ongoing economic restructuring throughout Europe. This will likely leave the euro within its recent trading band. A continued gradual European recovery could push the euro towards the high end of the range in the second half of our forecast.

**REGIONAL OUTLOOK**

**CANADA: RISKS REMAIN**

- **Our forecast for Canadian real GDP growth has been revised higher. We are forecasting 12-month average growth of +2.1%, a below-consensus view.**

- **We do not believe that the Bank of Canada will tighten policy over the forecast horizon.**

At first glance the outlook for the Canadian economy looks relatively bright, with the economy underpinned by a foundation of low inflation, modest fiscal consolidation and relatively strong labour market conditions. Against this backdrop, the consensus view seems to be that the Canadian economy will be shifting into higher gear over the coming year. While we do expect some growth reacceleration, our growth forecast is not as upbeat. Our main concern is that, while Canada still looks healthy, the country’s economy may be vulnerable. Significant exposure to energy prices and the possibility of a deeper downturn in housing activity provide reasons for caution.

With energy goods accounting for approximately 20% of Canadian exports and energy production about 10% of domestic output, the Canadian economy is very sensitive to fluctuations in global energy demand and energy prices. Our concern is that the U.S. energy policy established several years ago is now radically changing the energy picture in the United States and, consequently, in the rest of the world. In light of this development, the potential upside for oil prices looks very limited, darkening the outlook for the Canadian energy sector.

As the U.S. housing downturn painfully illustrated, a pronounced decline in property prices can have serious knock-on effects on economic activity, through a decline in residential investment and a negative wealth effect on consumption. Both effects can seriously damage the banking sector. However, as long as employment growth remains relatively strong and broad-based across economic sectors, the odds of a deep contraction in housing activity remain low. The rebalancing in the Canadian real estate market is more likely to be similar to the one that took place in Canada in the 1990s, a multi-year flattening in property prices. Nevertheless, the situation needs to be closely monitored.

Given our view that growth will be softer than what the Bank of Canada is currently projecting and our call for well-behaved inflation, we do not believe that the Bank of Canada will tighten policy over the forecast horizon. Instead, if the downside risks to growth that we have highlighted show signs of crystallizing, the BoC would likely remove its tightening bias.
**UNITED STATES: OVER THE FISCAL CONSOLIDATION HUMP**

- The U.S. economy is in the best shape in years, leading Fed officials to contemplate their quantitative easing exit strategy.
- Extremely well-behaved inflation implies that the Fed will be patient before starting to raise interest rates.
- The Fed is currently contemplating a much more subtle policy change - a slowdown in the pace of its asset purchases. This will likely take place in the fall of 2013.

The U.S. economy is in the best shape in years. This is great news, but it is making markets nervous that the Fed officials will soon start to tighten policy in response. This shift in the Fed’s expectations has recently translated into a pullback in bond markets in the developed world and an even more violent selloff in emerging bond markets. Mortgage and credit spreads have widened in sympathy and defensive stocks with bond-like characteristics have sold off sharply.

Have markets reached a stage where good news is perceived as bad news because of its negative policy implications? We doubt it. From a policy perspective, well-behaved inflation is just as important for the economy’s revival as an improvement in employment. With core inflation standing at its lowest level in its fifty-year history, U.S. monetary authorities will be very patient before starting to raise interest rates.

The Fed is also likely considering the fact that the U.S. economy is still stuck with excess capacity. Since the recovery in employment started more than three years ago, 6.3 million new jobs have been added to the workforce. This is encouraging, but still isn’t sufficient to compensate for the 8.7 million jobs lost during the recession. The unemployment rate has declined more quickly than generally expected, but this is due to a further decline in labour force participation, not to stronger-than-expected growth in employment.

In short, the Federal Reserve is still a long way from contemplating an actual tightening in policy. In our opinion, the Fed is currently contemplating a more subtle policy change - a slowdown in the pace of its asset purchases. This will likely take place towards the fall of 2013. Of course, the exact timing of this policy shift will mostly depend on the speed of improvement in labour market conditions and on inflation.

**EUROPEAN OUTLOOK: ROAD TO RECOVERY**

- After six long and painful quarters of economic contraction, Europe is finally ready for a recovery. The recovery will be led by Germany and fueled by external demand, unfolding in early 2014.
- Europe needs economic growth to stabilize debt - and the sooner the better.

After six long and painful quarters of economic contraction, Europe is finally ready to embark on the road to recovery. Real GDP growth is expected to average +0.8% between the third quarter of 2013 and the second quarter of 2014. While the recovery should only start to become apparent early next year, it will begin to be priced in by market participants over the second half of this year. With pessimism still running deep and sentiment depressed, the market impact of this shift in expectations could be substantial.

The euro area recovery will be led by Germany – Europe’s growth engine. Throughout the recession, domestic demand in Germany has remained resilient owing to sound fundamentals. Moving into 2014, German domestic demand is projected to strengthen considerably, providing a boost to exports in the rest of the euro zone.

It is general consensus that the recovery in European economic activity will initially come from stronger external demand. Less recognized by the market is the fact that trade has been improving at a faster rate than generally expected. Europe’s trade surplus with the rest of the world has never been as wide. Judging by the sharp widening of its bilateral trade surplus with the United States, Europe is well positioned to benefit from the projected acceleration in U.S. economic growth.
Odds of a successful recovery in economic activity have also improved as a result of Europe’s new fiscal realism. Not only will the pace of fiscal austerity be slowing, the Troika (European Central Bank, European Commission, International Monetary Fund) is now targeting cyclically-adjusted deficits. If growth turns out to be weaker than expected, a country will not be asked to implement austerity to ensure that initial targets are met. We could not have made this statement a year ago.

It is also important to recognize that the growth slowdown in Europe has been amplified by a prolonged drawdown in inventories (i.e. four consecutive quarters of contraction). Moving into next year, inventory rebuilding will be an additional source of growth across Europe.

The path taken by the European economy over the forecast horizon is of critical importance. This is because the overall level of European sovereign debt has increased as public debt (general government) is quickly approaching 100% of GDP. Europe needs economic growth for stabilization and the sooner the better. An economic recovery that fails to materialize would test market confidence in austerity, reform and integration, highlighting Europe’s fiscal vulnerability.
CHINA: ENGINEERED SLOWDOWN

- A top national priority over the last several quarters has been reigning in credit growth in high risk sectors of the economy.
- China’s recent slowdown in economic activity represents a mix of weakening activity in cyclical sectors and successful policy implementation that rebalances its economy towards more sustainable growth.
- Monetary policy makers will likely be forced to shift into easing mode in the second half of the year as cyclical conditions may be slow to improve.

The Chinese economy, specifically key economic indicators in both the domestic and export sectors, has been weaker than many expected at the beginning of 2013. As a result, consensus GDP growth expectations have been revised down, with the economy now expected to grow at a pace between 7.6% and 7.8% in 2013. Part of the recent slowing in activity is a result of actions taken to achieve more sustainable growth for the Chinese economy. This transition is expected to result in a rebalancing of growth away from investment spending, particularly public infrastructure spending, and increase the importance of consumption and private sector investments in value-added activities. Data suggests that this trend is underway.

Engineering a healthier Chinese economy has become a national priority. Three areas of the economy continue to attract negative attention: the residential real-estate sector, unhealthy financing of local government investment vehicles, and the expansion of wealth management products. As a result, the government has resorted to increased regulation as it tries to clamp down on unproductive, high risk activities. Consequently, this has meant tighter credit conditions, a key factor in partially explaining the slowdown seen in the first half of 2013. Steps taken by the central government to reduce the expansion of credit flowing into higher risk areas of the economy are difficult to evaluate but the increase in targeted regulations are showing signs of progress. Consequently, the fight to reduce the risk of a speculative bubble in real estate or a crisis in local government financing implies that credit conditions are tightening and therefore lowering growth prospects.

Until now, the government has been willing to sacrifice growth in order to implement structural economic changes. In addition, the central bank has focused on keeping inflationary pressures at bay. Both of these trends bode well for longer-term sustainable growth and should be recognized by financial markets over time.

As we look ahead into the second half of the year, with little inflation risk and weakening cyclical conditions, we may be approaching a shift in attitude at the central bank. Eventually, tight credit conditions resulting from regulatory changes will need to be offset with a lower cost of capital. With China currently showing one of the highest real interest rates among emerging market nations, the second half of the year may be marked by the People’s Bank of China moving rates lower. That said, rising property prices will remain a concern for policy makers and limit the scope of rate cuts.
ALTERNATIVE SCENARIOS

We estimate the likelihood of our base case Sluggish Expansion scenario at 70%. There is, however, a possibility that this scenario will not take place as expected if the global economy takes a turn for the better (Growth Surprise) or for the worse (Global Recession).

GROWTH SURPRISE:

We put a 15% probability on the Growth Surprise scenario. At this point in the global economic recovery, the only world region that has surprised positively is the United States. Economic activity has remained depressed in Europe while growth has continued to disappoint in the emerging world.

- In this scenario, the next positive growth surprise would likely come from Europe. Benefiting from stronger external demand from the United States, less fiscal austerity and a continued improvement in the deleveraging of the banking system, the long awaited recovery in European economic activity takes place more rapidly than generally expected.

- Stronger demand from Europe would greatly facilitate the growth reacceleration in China, smoothing the transition of the world’s growth engine to its new economic regime.

- As the world economy shifts into higher gear, bond yields move higher across all maturities in anticipation of earlier tightening in monetary policy. The bond market would deliver disappointing returns.

- Stock markets would be caught between reacting to better corporate profits – which is a positive for equity valuation – and higher interest rates – which is a negative. However, since central bank tightening would most likely be restrained, in the Growth Surprise scenario we expect equity markets to outperform bond markets by the widest margin. Cyclical sectors would likely take equity market leadership relative to interest-sensitive sectors in this scenario.

- While the Federal Reserve is expected to lead the global monetary policy tightening campaign, other central banks would follow suit, considerably limiting the U.S. dollar’s upside.

GLOBAL RECESSION:

We are forecasting the probability of a Global Recession at 15% over the next twelve months. If this more negative scenario unfolds, we would expect the following:

- Some growth disappointment in the United States owing to the rapid tightening in monetary conditions experienced over recent months. In this scenario, the recent surge in mortgage rates and the fast appreciation of the U.S. dollar prove to be too much for the U.S. economy to handle.

- As the U.S. economy stalls, European and Japanese growth prospects start deteriorating again, reigniting fiscal tensions in Europe and Japan. Combined with a weaker Chinese economic outlook following more aggressive reforms than expected, the end result would likely be another global confidence crisis. Government austerity plans would again be delayed.

- In a climate of heightened uncertainty, corporations would refrain from hiring. The longer the situation persists, the greater the odds that corporations would start laying off workers. In this scenario, a contraction in consumer spending would likely take place, pulling GDP growth into negative territory.

- With policy rates already close to zero, central banks would continue to rely on unorthodox policy measures to exert downward pressure on the long-end of the yield curve, triggering a powerful rally in global bond markets.

- Under such conditions, global equity markets would be expected to experience a deep correction. The contraction in global activity would also lead to a pronounced decline in commodity prices.

- The deepening crisis of confidence would fuel further flight to safety, benefiting the U.S. dollar. Commodity-related, cyclical and emerging currencies would be the hardest hit while the yen would no longer be considered a safe haven in light of the newly adopted monetary policy of the Bank of Japan.
SIGNPOSTS

Economic indicators that will help us determine if our Sluggish Expansion scenario is occurring as expected:

**Canadian Signposts**
- Employment growth & composition
- Trade balance
- West Canada Select oil price
- Housing activity and property prices
- Foreign appetite for Canadian Sovereign bonds

**U.S. Signposts**
- Change in the labour participation rate
- Core inflationary pressures
- Bank lending activity
- Employment growth and its composition
- Domestic oil consumption and production
- Recovery in housing activity and house prices

**Chinese Signposts**
- GDP growth mix (investment versus retail sales)
- Lending to households & businesses
- Speed of currency appreciation (FX policy)
- Relative equity performance
- Gap between lending and deposit rates

**Other Market Signposts**
- Changing behaviour of Japanese investors
- The return of Japanese inflation
- European bank lending surveys
- European Purchasing Managers Indices
- Foreign appetite for U.S. Treasuries
- European bank recapitalization details
- Improving European job creation
- German September election results

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