CIBC Asset Management

TURNING UP THE PRESSURE

Market volatility returned with a vengeance over the last three months, with most asset classes providing low to negative returns. Although the big picture hasn't really changed, the high financial market valuation of many asset classes left little room for negative surprises. Trade frictions and the threat of higher wage inflation have investors on edge.

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ASSET ALLOCATION OUTLOOK

as at April 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: While equity market volatility will likely continue, the current correction is taking place outside of an economic recession. This increases the likelihood that the equity market uptrend will resume, albeit at a more moderate pace than last year. Equities still look slightly more attractive than bonds for the moment.

Equity: Emerging markets showed resilience during the recent high volatility–likely the result of stronger fundamentals; they should continue to offer the best prospects in the equity universe.

Fixed Income: Global bond yields should continue to edge higher over the coming year after a recent pause, as the process towards renormalization remains a key force behind the price action.

Currencies: Following a weak start in 2018, the Canadian dollar is expected to stay in a trading range. The loonie is caught between supportive oil prices and easing NAFTA risks on one hand and deteriorating trade and a prudent Bank of Canada (BoC), which will trail the pace of the U.S. Federal Reserve (Fed).

EXPECTED RETURNS

Expected returns for the 12-month period beginning April 1, 2018

	IN CANADIAN DOLLARS			IN LOCAL CURRENCY		
	Global Reflation	Policy Renormalization	Global Recession	Global Reflation	Policy Renormalization	Global Recession
Probabilities	**20.0%**	**65.0%**	**15.0%**	**20.0%**	**65.0%**	**15.0%**
Canada Money Market	1.7%	1.4%	0.8%	1.7%	1.4%	0.8%
Canadian Bond	-1.8%	0.5%	3.4%	-1.8%	0.5%	3.4%
Canadian Federal Govt. Bond	-1.9%	0.4%	5.3%	-1.9%	0.4%	5.3%
Canadian Corp. Bond	0.1%	1.3%	0.6%	0.1%	1.3%	0.6%
Canadian RRB	0.8%	-0.5%	3.0%	0.8%	-0.5%	3.0%
Canadian High Yield	5.3%	3.3%	-5.8%	5.3%	3.3%	-5.8%
International Govt. Bond	-8.2%	-3.4%	7.9%	-4.1%	-2.4%	5.1%
Canada Equity	13.7%	6.7%	-18.3%	13.7%	6.7%	-18.3%
United States Equity	6.3%	3.4%	-12.4%	11.0%	5.0%	-16.3%
International Equity	10.3%	7.2%	-19.4%	15.0%	8.1%	-19.0%
Emerging Equity	14.5%	9.2%	-26.6%	16.2%	9.5%	-23.9%

GLOBAL OUTLOOK

Policy Renormalization

After 2017 ended on a strong note, most global investors visualized 2018 with plenty of optimism, highly confident that smooth sailing lay ahead. Unfortunately, the first quarter of 2018 didn't quite pan out as widely expected. Three months into 2018, market volatility has returned with a vengeance, with most asset classes providing low to negative returns. At first glance, this might seem like an odd turn of events. After all, the big picture hasn't really changed. The global economy is expanding at a brisk pace, while inflation remains well-behaved in most parts of the world. Given the improving but still non-inflationary cyclical backdrop, many central banks are slowly taking a foot off the accelerator, but are in no rush to put on the brakes. On balance, the global monetary policy stance remains quite accommodative.

Then why has the risk environment suddenly deteriorated, with investors turning so jittery? In our view, the high financial market valuation of many asset classes left little room for negative surprises. However, a re-pricing of U.S. inflation expectations took place over the first quarter, with more and more market participants worrying about an overheating U.S. economy. Trade frictions also intensified, with announcements of the imposition of tariffs from the U.S. administration, which led to retaliatory gestures from its main trading partners. This, in turn, led to an important equity correction, a resurgence of equity volatility from historically low levels and a move higher in both short-term and long-term interest rates. In terms of magnitude, this bond market pullback is comparable to the "taper tantrum" episode experienced in the summer of 2013. This time, however, it is the threat of higher cost-push inflation that could potentially lead to higher interest rates that is the main source of concern. Very tight labour conditions have been translating into faster wage inflation. If significant enough, the build-up in cost-push pressures could force the Fed to deliver more aggressive rate hikes and put the U.S. economic expansion at risk. Higher wage inflation can also lead to lower profit margins and ultimately depress the revenue growth of S&P500 companies.

We raised this risk of faster-than-expected inflation in the last edition of Perspectives. Market participants will stay cool-headed only if they remain convinced that inflation is not a threat and central banks have plenty of time to renormalize monetary policies. However, the more the global economy surprises on the upside, the greater the risk that central banks will fall behind the curve. Unfortunately, recent financial market developments are validating the concerns we raised late last year: inflation could raise its ugly head faster than generally expected and spoil the party for global investors.

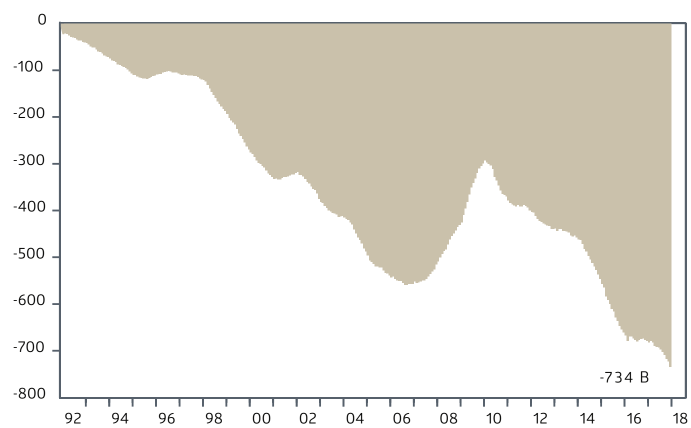
In our *Policy Renormalization* scenario (our main scenario), we expect global economic growth will average 3.7%. Inflation should remain below most major central banks' inflation mandates, but with a clear direction towards their respective targets. This should motivate policymakers to continue to gradually remove monetary accommodation and begin more synchronized quantitative tightening, as the European Central Bank (ECB) and eventually the Bank of Japan (BOJ), decide to follow the Fed. Solid growth should continue to support earnings growth, but ongoing anticipation of liquidity withdrawal should sustain a higher financial volatility environment, as we suggested in our last edition.

Trade war or skirmish?

In the February edition of the Economic Report of the President, the U.S. administration elaborated on its views towards trade: "In the coming year, we will also seek to negotiate new, better trade deals, and we will hold accountable any country that engages in unfair trade practices through tough and focused action."

The administration's position on trade has no doubt been motivated by a large and growing ex-oil trade deficit near $734 billion.

U.S. EX-OIL TRADE DEFICIT HITS RECORD PROPORTIONS
U.S. non-oil trade balance in billions USD (12-month cumulative)



Source: CIBC Asset Management Inc.

During the first quarter, the Trump administration launched a number of trade disputes by imposing tariffs on numerous products aimed at various trading partners. The market is now trying to assess the extent to which the administration is serious and how far it will go in its quest to improve its trade position. This will no doubt lead to trade negotiations but, at the time of this writing, it is too early to determine the ultimate implications. We can only speculate that if the conflicts escalate and persist, they could be detrimental to consumer and business sentiments and could negatively impact economic activity. The imposition of tariffs could also impact consumer prices and force central banks to adjust their monetary policies. Finally, the uncertainty created by newspaper headlines and tweets has, at the very least, unnerved financial markets and created volatility. Unfortunately, we believe that the trade dispute headlines may be with us for another quarter or two—timing that could benefit the Trump administration's posturing ahead of the November mid-term elections.

What is more troubling is the U.S. administration's narrow view on trade. First, by focusing on increasing exports and decreasing imports, the administration assumes that exports are good and imports are bad. However, if a country can buy goods from abroad at a cheaper price than they can manufacture them at home, imports provide a benefit to the country. Too much of a narrow focus on the trade balance is unproductive. Also, ironically, while the administration is trying to reduce the U.S. trade deficit through its trade policies, its other policies (such as the implementation of tax cuts and infrastructure investments) are likely to lead to larger trade deficits. Excess U.S. demand, at a time when the economy is running close to full capacity, will produce the need to import a number of goods and services and will likely lead to a deterioration of the trade balance.

FIXED INCOME VERSUS EQUITY

Markets in Transition

Equity investors will remember 2017 as one of the strongest years on record for volatility-adjusted returns. This outcome was made possible by a confluence of factors. First, economic growth was very robust and led to strong earnings growth. In addition, not only was growth robust, it was globally synchronized, challenging the view that the post-crisis global economy remains fragile. In fact, we believe the global economy has achieved escape velocity. Second, inflation pressures remained subdued. While structural forces restrained inflation, cyclical forces had little impact on inflation. Third, central banks very cautiously signaled that they would gradually remove excess accommodation and so continued to suppress bond yields.

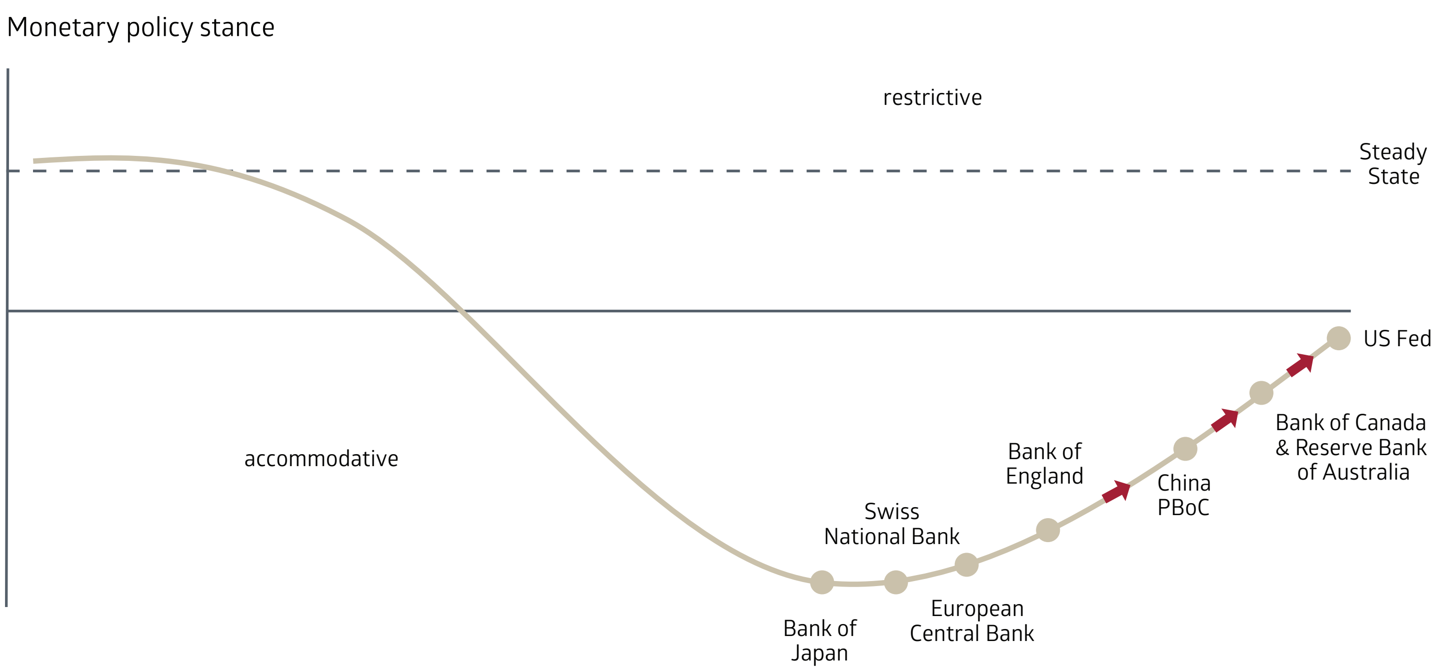
The Goldilocks phase[1] of 2017 is unlikely to remain in place going forward. In 2018/2019, we are more likely to experience a phase where robust growth meets late-cycle monetary policy removal to sustain an increasingly volatile bull market. Growth may have slowed from a very high level, but it remains robust and is expected to remain above potential. However, the biggest change in the outlook relates to inflation and the impact it will have on interest rates and valuations. As the economy and the labour market continue to grow and use all excess capacity, inflation should continue to build, starting with wage pressure. While central banks may tolerate more inflation, they are committed to gradually removing the very easy monetary policies they put in place after the financial crisis almost ten years ago.

The most recent highly volatile period is best characterized as a turbulent transition between these two phases. It remains to be seen how long it will last, but historical precedents point toward more turbulence before the dust settles and investors adjust to the new regime. In comparison, the previous equity corrections of 2011 and 2015 lasted six and nine months respectively.

An important point to consider is that the current equity correction is taking place outside of an economic recession. Historically, there is a significant difference between a mid-cycle correction and a recession bear market. The former may remain short lived and shallow, while all recession bear markets are deeper and last much longer.

Bond yields continue to face the offsetting forces of strong economies and normalization of monetary policy against structurally weak inflation. But the U.S. is diverging from other core markets in an important regard, as U.S. short

2018: FROM U.S. TO GLOBAL POLICY RENORMALIZATION



Source: CIBC Asset Management Inc.

rates continue to move higher while the eurozone and Japan continue to engage in quantitative easing. The shrinking of the Fed balance sheet is underway and the effects of this shift are starting to be felt in global funding markets. The added effects of stimulus, while at full employment, and trade tarrifs further serve to put upward pressure on bond yields, at least in the U.S.

Although we have an environment where corporate bond defaults are at cyclical lows, investment-grade credit spreads are starting to widen against Treasuries. For now, these effects can be attributed mainly to technical factors and do not seem to be a harbinger of risky times ahead—but given a general pickup in the risk environment, they are worth monitoring. Emerging market CDS spreads are also starting to widen from low levels, confirming the general observation that the risk environment has normalized.

EQUITY MARKET OUTLOOK

United States

Despite the 10% correction in the S&P 500 earlier this year, U.S. equities still trade at elevated valuation levels. To some extent this rich valuation can be attributed to an economic environment that was very supportive for equities. In fact, we estimate that roughly two-thirds of the increase in P/E ratios since 2009 can be explained by improving growth and structurally lower interest rates. This is odd, because better growth would normally be consistent with higher interest rates. However, the last ten years were anything but normal.

This leaves a third of the increase in P/E not explained by our model. In other words, the market has overshot its fair value. At the peak in late January, the market was 20% overvalued, according to our valuation model. In the aftermath of the correction, valuation has improved but is still 10% overvalued. Furthermore, fair value is a moving target and its trend is expected to be downward as interest rates normalize. The bottom line is valuation will remain a headwind for U.S. equities for years to come.

However, the U.S. equity market will continue to be supported by cyclical factors. While the Fed is prudently hiking interest rates, monetary policy will probably still be accommodative until mid-2019. The Trump administration also pursues a very loose fiscal policy: tax cuts for corporations and investment incentives (accelerated depreciation of fixed asset investments) were passed in December 2017, and an increase in government spending was enacted in the Bipartisan Budget Act of 2018. This will continue to support growth and benefit companies via higher revenues and earnings.

International Equities

The performance of international equities was disappointing in Q1. The eurozone, the UK and Japan all underperformed the S&P 500, in their respective local currencies. The interesting point is that the equity market performances in USD were comparable to the S&P 500's performance, at least for the eurozone and Japan (less so for the UK). International equities have suffered from the strength of their currencies.

Going forward, the valuation argument in favour of international equities versus the U.S. is intact. P/E ratios in EAFE equities are high, but less demanding than for the U.S. Dividends yields are also higher.

In recent years, Europe's economic cycle was less advanced than the U.S., leaving some room for profit margins and profitability to catch up. This argument is weaker now—companies in many European countries have restored their profitability and margins, and now appear to also be in the late expansion phase of their economic cycle. This view is also supported by the fact that the eurozone output gap will be closed at the end of 2018 (based on OECD forecasts). Peripheral countries like Spain and Italy still have room for earnings to catch-up, but the overall regional impact is relatively small. This will translate into earnings growth that will gradually decelerate from the current elevated levels.

While growth has improved, inflation remains below target and still well out of reach. As such, the ultra-easy monetary policy will be extended, and financial conditions will remain accommodative. The strong currency moves in the EUR, GBP and JPY are also deflationary, supporting the current loose monetary policy.

The political environment is getting muddy in the EAFE space: Brexit negotiations, the weak German coalition government, the uncertainty related to the coalition that will govern Italy, the sinking approval ratings of Japan's Abe … all of those risk factors can ultimately result in lower investment, lower consumer confidence, and increased trade barriers. The expected impact on earnings of these increased political risks is likely to be minimal, but could prevent P/E ratios from rising further.

Canada

The valuation of Canadian equities improved by 6% during the first quarter of 2018, more than in other regions. In particular, energy companies have de-rated by almost 9%, despite improving earnings and the rise in the price of Western Canada Select oil. Financials also showed the same combination of decent earnings growth and P/E de-rating. This makes relative valuation now more attractive.

In terms of earnings, we expect a strong deceleration of growth, as the past 12 months earnings were boosted by temporary factors. Commodity sectors enjoyed exceptional earnings growth (40% for materials, 90% for energy) due to a base effect and higher commodity prices, and were a big contributor to the S&P TSX's 23% earnings growth. This will slowly abate as net profit margins and ROE are now back to their long-term averages. Consensus now expects a much lower 13% for earnings growth over the next 12 months in commodity sectors. Earnings growth in the energy sector will be supported by currently elevated oil prices. Moreover, the large spread between the WCS and WTI during Q1 has already narrowed significantly, and should gradually return to a range of $10-15 per barrel, as Canadian companies ramp up their "crude-by-rail" exports.

Banks also posted strong earnings growth last year, as the economy surprised to the upside. The BoC's interest rate hikes led to a steepening of the yield curve and increased net interest margins. This is expected to continue in 2018 and 2019. We expect GDP growth to slow to a level close to potential over the next four quarters. This means that bank revenues will not get the strong boost they got from growth last year. However, the deceleration in earnings growth will not be a surprise, as it is widely expected by the consensus. Bank earnings continue to be supported by a benign credit outlook, earnings leverage to rising rates that increases over time and reasonable valuation.

Canada faces important long-term headwinds in the coming years: NAFTA renegotiation, the renormalization of monetary policy in the context of elevated debt levels, and a growing lack of competitiveness versus the U.S. in non-energy sectors. But the current environment is still supportive for equities, and will likely remain positive in the near future. The correction that occurred in Q1, led by a strong compression in multiples, makes the prospects for Canadian equities more attractive.

Emerging Economies

Emerging markets (EM) remain the most attractive equity region in the current environment. Economic growth will continue to be relatively stable for the next 12 months.

China's GDP growth will come mainly from strong domestic consumption and investment. Net exports are not expected to materially contribute to growth, with a risk that their contribution to growth could turn negative if the potential trade war with the U.S. intensifies. The profit recovery since 2016 was made possible by PPI inflation that moved out of deflationary territory. It is now slowing, but we expect it to stay relatively robust, above zero. This is crucial, as it provides a tailwind to companies' revenues and earnings, and also gives some relief to banks when it comes to their non-performing loans.

Chinese banks' nonperforming loan cycle is trending lower, thanks to good growth since 2016. As a result, markets participants' fears of a banking crisis in China have greatly diminished. The improving confidence in the country is also supported by various measures of capital control liberalization.

Apart from Asia, commodity-producing countries like Russia and Brazil currently benefit from oil prices that remain close to the top of their $45-65/barrel range.

From a valuation angle, EM is still the only region where P/E ratios are below their long-term average—contrary to developed markets, which will face headwinds from high valuation.

Emerging markets proved to be resilient during the recent high volatility in February and March, and generally continued to outperform their developed market peers. This region will continue to offer the best prospects in the equity universe, thanks to their above-average expected earnings growth and more attractive valuation.

COMMODITY INSIGHT

Canada exports over 3 million barrels/day (MB/D) of oil to the U.S. via pipelines such as Enbridge's Mainline and TransCanada's Keystone. These pipelines connect to major U.S. markets in the U.S. Midwest and U.S. Gulf Coast. U.S. refineries have been demanding Canadian heavy oil as a replacement for dwindling supplies from Mexico, Venezuela, and to some extent from OPEC, which has continued to hold its production cuts to-date.

Canadian oil production is skewed toward heavy barrels, with major projects such as Suncor's Fort Hills expected to achieve peak capacity this year. Canadian heavy oil production continues to increase, even with limited pipeline capacity available to move it to its end market. This situation has depressed heavy oil prices and is reflected in the large discount of WCS (Western Canadian Select) prices relative to WTI (West Texas Intermediate). This differential expanded to $25-$30/bbl earlier this year versus long-term historical levels of $15/bbl.

While the differential will likely continue to be volatile, it is wide enough to cover the cost of rail transport–this is where "crude-by-rail" enters the picture. With no near-term pipeline additions, producers will likely seek rail agreements to move their product to the U.S. market or continue to face depressed WCS pricing. Ultimately, we believe the industry will strike a rail deal this year, which will result in a narrowing of the heavy oil differential into the high teens range.

In the long term, we expect differentials to narrow further, once available pipeline capacity comes online. However, the next pipeline addition (Enbridge's Line 3 Reversal project) won't take place until late 2019. After that, we estimate TransCanada's Keystone XL and Kinder Morgan's Trans Mountain Expansion will come online post 2020. Collectively, these three projects will add approximately 1.8 MB/D of additional transportation capacity. Until then (and pending no pipeline delays), oil producers are likely to increasingly utilize crude by rail.

From an investment standpoint, companies with firm pipeline solutions and/or the ability to hedge the widening differentials through their refineries can benefit in this environment. In addition, Canadian rail companies will ultimately be able to reap benefits by moving crude along their rail networks.

FIXED INCOME OUTLOOK

Interest Rate Normalization Continues

Global bond yields increased for most of the first quarter, but stabilized later in March. U.S. bond yields finished the quarter at 2.74%, up from 2.40% at the beginning of the year. Shrinking output gaps, stronger-than-expected fiscal stimulus and buoyant energy prices fueled inflationary expectations. In turn, this resulted in higher breakeven inflation, which helped push nominal yields higher.

Meanwhile, global central bankers continued to move away from their easy monetary stance. In March, the new Fed chairman, Jerome Powell, announced the first rate hike of his tenure and signaled that the interest rate path established by his predecessor would be maintained. In Europe, the ECB kept policy unchanged, but implicitly re-affirmed that previously announced asset purchase reductions would remain effective until September. In a similar fashion, the Bank of England maintained its policy rate at 0.50%. However, rising domestic consumer prices led to an increased likelihood of a rate hike in May, despite continued uncertainty surrounding Brexit. Finally, despite a recently inactive BOJ, speculation continued to swirl around the timing of a potential adjustment to its yield curve control policy. The BOJ faces the imminent limit of its ability to continue bond purchases.

Global bond yields should continue to edge higher over the coming year after a recent pause. The process towards further renormalization will remain a key force behind the bond market's price action, representing a headwind for sovereign bondholders. Quantitative tightening in the U.S. and dwindling asset purchases in Europe will result in an important reduction in demand for sovereign bonds, which are already expensive from a quantitative perspective. Low real rates (by historical standards) in developed markets have become hard to justify, especially considering the positive global growth backdrop. As such, an upward readjustment in global yields is in order.

In our base case scenario, and given a twelve-month time horizon, 10-year sovereign bond yields should reach 3.25% and 2.50%, in the U.S. and Canada respectively. However, a number of risks could challenge this scenario. For example, intensifying protectionist policies adopted by the U.S. and/or China could slow global trade, or recent revelations of data breaches in the tech sector could lead to increased regulation and slower growth. On the other hand, excessively easy monetary policy, for far too long already, could lead to higher-than-expected inflation that will push bond yields well above recent levels. This economic uncertainty is likely to underpin increased volatility over the coming months.

CURRENCY MARKETS

U.S. Dollar

Against all odds, the U.S. dollar held its ground over the first quarter of 2018. In late March, it traded at roughly the same levels as it traded in early January (on a trade-weighted basis). There was no broad-based directional move—the greenback appreciated against cyclical currencies like the Canadian dollar and Australian dollar, but lost ground against the yen and most euro-block currencies.

The U.S. dollar's shift into consolidation mode is a result of two major opposing forces. On one hand, the Fed's policy rate renormalization process is well underway, with the Fed steadily delivering rate hikes while shrinking its balance sheet at an accelerating pace. To a large extent, market participants have already priced-in these events and they are providing less support to the U.S. dollar than they did previously. To provide more support, a stronger buildup in inflationary pressures would be required, forcing the Fed to tighten policy more aggressively.

On the other hand, other central bankers are expected to eventually follow the Fed's lead and also embark on tightening campaigns. At this juncture, however, monetary authorities outside of the U.S. are still staying comfortably on the sidelines. With no imminent inflation risk, time is still very much on their side. For other currencies to decisively move higher against the U.S. dollar, monetary authorities in the rest of the developed world would need to clearly signal the launch of tightening campaigns. In the meantime, the U.S. dollar is likely to remain in consolidation mode, fluctuating within a wide trading range. In other words, investors will likely experience a significant increase in volatility in foreign exchange markets.

Canadian Dollar

The Canadian dollar started the year on a weak note, depreciating by more than 3% against the U.S. dollar. Looking forward, we still think that the forces at work won't be particularly supportive for the Canadian dollar. For one thing, Canadian monetary authorities are not expected to tighten monetary policy as much as the Fed, owing to financial stability concerns. For another, we see limited upside for oil prices following recent price increases and the ability of the U.S. to increase production. Last but not least, NAFTA negotiations may continue to inject a degree of uncertainty, and thus volatility, which will make reading the Canadian tea leaves relatively difficult.

Euro

The year started with very high hopes for the euro, with a majority of forecasters predicting an easy ascension to 1.30 against the U.S. dollar before yearend. After gaining solid ground in January, however, the euro has apparently hit a wall at around 1.24. This is no coincidence. While the eurozone economy has clearly been improving, there is still very little evidence of a significant build-up in inflationary pressures. As a result, the ECB has very little incentive to precipitate the launch of a tightening campaign and will likely stick to its sub-zero rate policy for a while longer. This will leave Europe's large current account surplus as its main positive support. As a consequence, from this point on, the euro's upside seems confined to a trading range.

Japanese Yen

The Japanese yen was the top-performing currency of the developed world over the first quarter of 2018. It appreciated by more than 6% against the U.S. dollar and by more than 4% on a trade-weighted basis. In our opinion, this provides clear confirmation that the BOJ's "QQE with yield curve control" policy is no longer doing what it was initially designed to do—limiting the Japanese yen's upside. Why is this happening? 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 is that the yield curve control policy could be difficult to sustain in the long term. With no change in the current policy settings, the BOJ could hold more than 60% of the JGB market by the end of 2018. In short, policy changes will also be taking place in Japan, translating into increased volatility in the Japanese exchange rate.

REGIONAL OUTLOOK

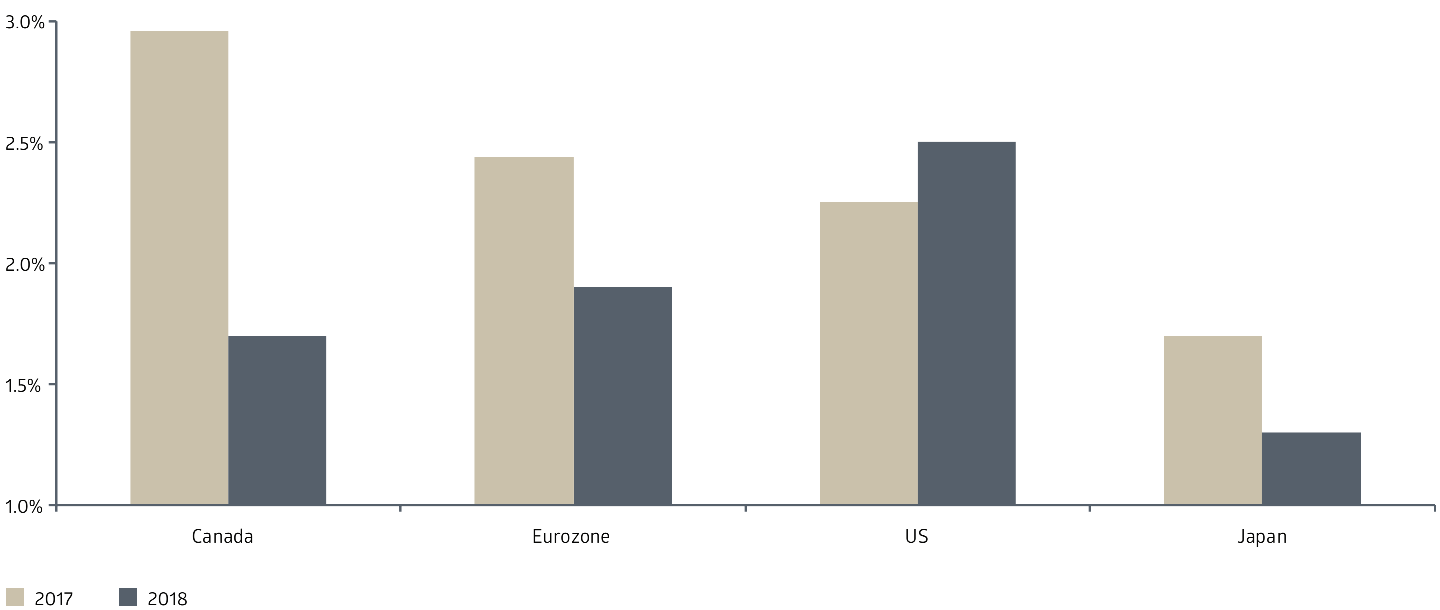
Canada

- There will likely be no medal-winning performance for the Canadian economy in 2018, as growth is expected to decelerate to 1.7% over the next four quarters.
- Core inflation is expected to hit the BoC's target, as conditions of excess supply shift to excess demand—compelling the Bank of Canada to further tighten its policy stance.

Governor Poloz took office five years ago, with a high conviction that the Canadian economy would be getting a significant boost from foreign demand, producing a solid recovery in Canadian non-oil export sectors. As it turns out, the global economic backdrop did significantly improve, but the recovery in Canadian non-energy exports turned out to be a big disappointment. Canada's non-energy trade deficit with the rest of the world is now back at record levels, amounting to -$80 billion (CAD).

Looking ahead, it's tempting to conclude that the undervaluation of the Canadian dollar will allow Canada to restore its competitiveness, as has often occurred in the past. This time around, however, there are a few caveats to consider. First, while the Canadian dollar does qualify as undervalued, it is not particularly cheap. Many other currencies are more undervalued than the Canadian dollar when compared to the U.S. dollar. Second, issues around competitiveness are numerous and becoming more and more problematic. In many sectors, the non-energy trade deficit has continued to widen and Canadian exporters have continued to lose U.S. market share. In the oil sector, despite higher oil prices, investment intentions for 2018 are more

AVERAGE REAL GDP GROWTH: 2017 VS. 2018 PROJECTIONS



Source: Bloomberg & CIBC Asset Management Inc.

than 10% below last year, the fourth consecutive annual decline. Last but not least, the prospect for a deep reform of U.S. trade policy is certainly not good news for Canadian exporters.

The hit on Canadian competitiveness was not very apparent last year as it was more than offset by powerful but transitory growth tailwinds—the boost from strong consumer credit, the lagged effects of the 2016 fiscal stimulus, and the strong recovery in the Canadian oil sector. These three growth tailwinds had already started to recede in the second half of last year, translating to growth disappointment.

There will likely be no medal-winning performance for the Canadian economy in 2018, as growth is expected to decelerate to 1.7% over the next four quarters. This growth deceleration will essentially be due to receding tailwinds, but also to Canada's inability to benefit, as it did previously, from very favourable global economic conditions.

Core inflation is expected to hit the BoC's target, as conditions of excess supply shift to excess demand—compelling the BoC to further tighten its policy stance. The BoC will likely deliver two additional rate hikes over the forecast horizon.

United States

- The U.S. economy is about to get a significant boost from fiscal policy and, potentially, from trade policy changes. However, this will be partially offset by the Fed's continued efforts to tighten U.S. credit conditions.
- Under these conditions, the U.S. economy will remain in expansion mode, growing at a projected average rate of +2.5% over the next four quarters.

A year ago, we argued that the U.S. non-oil trade deficit would very likely reach record proportions in 2018. This would be a result of past U.S. dollar strength and a boost to private and public domestic demand (and consequently to imports) coming from fiscal policy. A little more than a year later, the U.S. non-oil trade deficit has, as expected, reached record proportions. The bilateral deficits with China, the eurozone and Switzerland are all at record highs. This provides enough justification for the Trump administration to launch a major reform of U.S. trade policy, with a clear objective to remove barriers to trade imposed by other nations that are judged to be unfair. From this angle, recent tariff announcements on aluminum, steel and numerous products from China are trade negotiation tactics aimed at reducing America's $566 billion annual trade deficit with the rest of the world. Other economies such as the eurozone, Japan and South Korea are also likely to eventually be targeted for trade as well as for political gain.

While the potential impact of U.S. retaliation measures on the trade front is not as clearly negative for the U.S. economy as it is for the rest of the world, the potential impact on U.S. inflation is clear. Adjustments to unfair tariffs and non-tariff trade barriers would push U.S. headline CPI inflation significantly higher. This would be happening at the worst possible time—that is, just as the U.S. economy is at risk of overheating.

Developments on the U.S. fiscal and trade policy fronts are obviously complicating the economic outlook for the Fed. The best-case scenario for U.S. monetary authorities is a gradual and controlled rise in headline and core inflation, eventually hitting the 2% targeted level. If this forecast materializes, officials at the Fed will have enough time to gradually hike interest rates and shrink its balance sheet. The worst-case scenario for the Fed would be for a much faster-than-expected acceleration in inflation fueled by an ultra-lax fiscal policy stance and U.S. retaliative trade measures.

The U.S. economy is about to get a significant boost from fiscal policy and, potentially, from changes to trade policy. However, this will be partially offset by the Fed's continued efforts to tighten U.S. credit conditions. Under these conditions, the U.S. economy will remain in expansion mode, growing at a projected +2.5% average rate over the next four quarters.

Europe

- The eurozone economic expansion is projected to continue in 2018, with real GDP growth averaging 1.9%. Unfortunately, this won't be enough yet to bring inflation back in line with the ECB's implicit target over the forecast horizon.
- For the ECB, this means sticking to a sub-zero policy rate throughout the year, while putting an end to its asset purchase program (QE).

The eurozone's unemployment rate is at its lowest level in nearly a decade and economic growth is running at its fastest pace since 2010. It's tempting to conclude that it's "mission accomplished" for the ECB and the time has come for a renormalization in policy rates—from negative to positive territory. However, ECB officials have not reached that conclusion for the simple reason that there still is too much slack in the eurozone economy. Above-potential economic growth will be required for a longer period to eventually bring inflation back in line with the ECB's implicit target. At this juncture, the most likely outcome is that eurozone inflation will stay below target for another two years.

Why so long? Labour market conditions in the eurozone have been improving and are likely to continue improving. The ECB's problem is that the improvement in labour market conditions varies tremendously between eurozone economies. The tightening in labour market conditions over the last year has been quite impressive for Portugal, the Netherlands, France and Germany. However, the story is quite different for Spain, Finland and Italy. As a whole, cost-push inflationary pressures are just not strong enough to push CPI inflation significantly higher—at least not yet. The good news is that wage inflation, as measured by labour compensation per employee, is running at its fastest pace in more than five years. However, the impact on unit labour cost inflation has been largely offset by higher productivity growth.

Policy-wise, this suggests that the ECB will likely stick to the exit plan it sketched out in late 2017. This implies it will keep policy rates unchanged throughout the year, but put an end to its asset purchase program in early 2019. What is the risk of experiencing an ECB-led taper tantrum episode like the one experienced in the U.S. in the summer of 2013? For the shorter-term, we put a low probability on such an adverse scenario, given the decline in government borrowing requirements as a result of ECB remittances to national governments. As we approach year end, however, the risk of a eurozone bond market pullback will rise considerably.

The eurozone economy is expected to grow by 1.9% on average over the next four quarters, but inflation is projected to stay below target, at 1.6%. The ECB will soon be announcing the end date for its asset purchase program—initiating a difficult balancing act which represents a potential risk in terms of financial and fiscal stability that will be important to monitor.

China

A New Era for Chinese Politics

- Our projection for real GDP is 6.2% by Q1 2019. This is below the official party target, but consistent with the priority of financial risk management, in conjunction with the rising cost of borrowing and greater impact of U.S. trade protectionism.
- The central bank is maintaining a soft tightening bias. This policy will remain in place as long as inflation permits.
- China has lifted its presidential two-term limit, giving President Xi Jinping the office of President for an indefinite period.

The highlight of the March 2018 National People's Congress was the (almost) unanimous support for lifting the two-term tenure limit for the office of President. The removal of this two-term limit allows President Xi Jinping to stay in office indefinitely. Not only does this make the current president the most powerful man in China since Mao Zedong, but it creates renewed uncertainty over the reality of a strong-man rule. China has stated that the changes were necessary to protect the authority of the Communist Party, however this is clearly debatable. It does mean that President Xi will be able to impose his political and economic objectives beyond the next five years. Only time will tell whether this results in increased political stability or the end of an era during which we observed the peaceful transition of power in Beijing.

The Chinese government has reiterated its economic objective of 6.5% growth for 2018. However, we believe the Chinese economy will likely experience some slowing of growth. Our projection for real GDP growth is 6.2% over the next four quarters. This is consistent with the government priorities of financial risk management and longer-term stability over growth. Despite strong momentum, the Chinese economy will encounter a number of important road blocks. These include higher market interest rates (which will increase the cost of capital), continued focus on deleveraging and the reduction of excess capacity. It is also likely to see a drop in the contribution to growth from net exports, particularly with the headwinds of U.S. protectionist trade policy.

The central bank has stated that it will continue to promote a neutral policy stance. However, in reality, the People's Bank of China is in a slow tightening cycle. We have seen the central bank take small steps to lift the reverse repo rate—at times in line with hikes from the U.S. Fed. The central bank will be able to maintain this slow approach as long as inflation remains comfortably below the 3% target. This stance is warranted to support traditional lending channels, even as policymakers tighten regulations and reign in the growth of credit in the non-traditional financial system. We expect to see consumer price inflation test the 3% target over the next 12 months, suggesting that monetary policy management will become more challenging for the central bank.

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
- Canadian oil price discount to U.S.

U.S. Signposts

- Wage growth
- Labour participation rate
- Trade negotiations
- Core PCE inflationary pressures
- Domestic oil production trend (following OPEC agreement)
- New orders versus inventories
- Capital goods orders (monitor investment growth)

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

Other Market Signposts

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

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