CIBC Asset Management

PERSPECTIVES

For the 12-month period beginning April 1, 2019

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In a wait-and-see mode

Risk assets fell off a cliff late last year, only to stage their strongest comeback in more than a decade over the first quarter. The economic slowdown and market turmoil of 2018 were triggered by monetary policy normalization and concerns around trade wars and geopolitics. While these headwinds are dissipating, they haven't completely disappeared.

Asset class highlights

Fixed Income vs. Equity: Our strategy favours a small tilt toward equities; however, with their downside risk and the scarcity of attractive defensive assets to balance portfolios, our approach is conservative.

Equity: While equity markets may struggle in the short term to find a catalyst, we should see positive but unspectacular returns in 2019.

Fixed Income: Global economic data is unlikely to consistently surpass expectations—this could cap the upside for yields at 2.60% (U.S.) and 1.85% (Canada) for 10-year sovereign bonds.

Currencies: The Canadian dollar remains more fundamentally challenged than most developed market currencies.

Multi-asset outlook

Asset class	Tactical view[1]	Change in tactical view[1]	Long-term return[2]	Long-term volatility[3]
FIXED INCOME Canada 2 Year	NEUTRAL	No change	1.9%	1.0%
FIXED INCOME Canada 10 Year	MODERATELY BEARISH	No change	1.4%	5.7%
FIXED INCOME U.S. 2 Year	NEUTRAL	No change	1.9%	9.3%
FIXED INCOME U.S. 10 Year	MODERATELY BEARISH	No change	1.7%	12.7%
FIXED INCOME International Bonds	SIGNIFICANTLY BEARISH	Downgrade	1.7%	9.0%
FIXED INCOME CREDIT Canada Investment Grade	NEUTRAL	Downgrade	3.0%	3.8%
FIXED INCOME CREDIT U.S. Investment Grade	NEUTRAL	Downgrade	2.8%	9.1%
FIXED INCOME CREDIT U.S. High Yield	MODERATELY BULLISH	No change	4.5%	7.2%
FIXED INCOME Emerging Sovereign[4]	MODERATELY BULLISH	No change	8.0%	8.8%
EQUITY Canada	NEUTRAL	No change	4.7%	10.3%
EQUITY U.S.	MODERATELY BEARISH	Upgrade	2.9%	9.7%
EQUITY EAFE	NEUTRAL	Downgrade	5.7%	11.2%
EQUITY Emerging Markets	MODERATELY BULLISH	Downgrade	12.2%	12.8%
CURRENCY U.S. Dollar[5]	NEUTRAL	No change	-0.6%	9.2%
CURRENCY Euro[5]	MODERATELY BEARISH	No change	0.6%	7.9%
CURRENCY Japanese Yen[5]	MODERATELY BULLISH	Upgrade	1.3%	12.4%
CURRENCY Great Britain Pound[5]	NEUTRAL	Upgrade	0.9%	8.6%
CURRENCY Swiss Franc[5]	NEUTRAL	Upgrade	-1.0%	10.0%
CURRENCY Chinese Yuan[5]	NEUTRAL	No change	3.0%	8.6%

This chart represents general views and may not reflect the strategy of specific portfolios.

[1] For the next 6-12 months, any change in view reflects a change from the previous quarter's outlook

[2] Projected average annual return – next 10 years, in CAD

[3] Historical annual volatility, in CAD

[4] Emerging sovereign bonds denominated in local currency

[5] All currencies evaluated against the Canadian dollar (CAD)

Asset class outlook

Global overview

The global economy: In a wait-and-see mode
The economic slowdown and market turmoil in 2018 were triggered by monetary policy normalization and concerns around trade wars and geopolitics. While dissipating, these headwinds haven't completely disappeared. Although the economic cycle has disappointed in recent months, there are signs the worst may be behind us. That said, it's difficult to identify the potential catalysts for sustainable stronger growth.

On the positive side, although it has not yet been resolved, the U.S.-China trade war negotiations have at least halted the escalation of punitive actions. The service sectors of the major economies remain healthy, with high employment and decent wage growth. Early signs of green shoots are showing up in economic surprise indices as well as our proprietary leading indicators. Monetary conditions remain accommodative.

We believe the global economy will likely remain in expansion mode over the next year, thanks to the policy relief efforts of central banks earlier this year. This should be supportive for risk assets. However, the amount of policy relief that central banks can provide from now on is probably more limited than generally perceived, implying still difficult navigation conditions for global investors. This will be a key issue when the global economy faces its next recession, which will eventually come. Until then, markets will look for evidence that the current slowdown is abating.

Central bank actions
Global central banks are increasingly debating whether keeping policy rates ultra-low over an extended period of time may be detrimental to the global banking system and the world economy. For this reason, they will be patient before spending the ammunition they have left.

The U.S. Federal Reserve (Fed) has led the way in terms of putting its policy path on hold and the People's Bank of China (PBOC) and European Central Bank (ECB) are following. However, the Fed is unlikely to do much more. It'll stop shrinking its balance sheet in September but has no immediate plan to start expanding it. U.S. monetary authorities have more ammunition, but the still-sound U.S. economy doesn't justify more Fed policy relief.

Chinese monetary authorities don't want to repeat the policy mistake of 2016, when too much liquidity entered the economy. The prevailing PBOC financial stability concerns imply that Chinese policy relief won't be anywhere near 2016 levels.

The ECB will do its best to cushion the economic downturn already underway in the eurozone; however, it's clearly running out of policy options.

Asset class strategy
Positive developments in the global economy, although still modest, would normally argue for a more constructive portfolio strategy, i.e. favour equities over bonds. We may end 2019 by looking back and seeing a generally decent year for the economy and for markets. However, there is not yet enough evidence to declare that the soft patch is over or to rule out a deeper contraction, and geopolitical frictions may resurface at any time. Meanwhile, risk assets have already reacted very strongly to the improving environment and will need new catalysts to move higher. Although this has been a strong rebound, equity valuation is fair, on average, with some countries showing attractive value. A stabilization in economic activity should be supportive of earnings growth. While the equity market may struggle in the short term to find a catalyst, we should see positive but unspectacular returns in 2019.

After finishing 2018 on a strong note, the bond market has continued to do well this year, pushing bond yields even lower. In particular, German yields have entered negative territory for the first time since 2016. Yield-seeking investors will have to find comfort in carry trades yet again. Carry does not come without risk however, especially in an environment of low government interest rates. In order to find sufficient yield, investors have to fall back on emerging market bonds and currencies, as well as the lowest tranche of corporate credit. The central banks' pause should maintain the anchor in long-term interest rates and limit the upside for the U.S. dollar, providing support for these strategies.

In anticipation of more evidence of stabilization in economic activity, we favour a strategy with a small tilt toward equities and carry trades like emerging market (EM) bonds. However, given the downside risk of equities, and the scarcity of attractive defensive assets to balance portfolios, we prefer to maintain a conservative strategy, at least for the moment.

Global equities

Canada: Losing its lustre
Earnings growth has rolled over in Canada, led by commodity sectors. This is unlikely to reverse: energy will remain challenged as the U.S., Canada's main export partner, is expected to turn into a net exporter of crude oil in 2020. The last time energy prices tanked, in 2015, the economy got a boost from the robust housing sector and fiscal stimulus. This time, housing won't provide any economic relief, as real estate markets are rolling over in Vancouver and Toronto. Without leading to a systemic crisis, the slowdown in real estate will limit credit growth and banks' earnings growth.

Canada is slightly overvalued, roughly in line with the average developed market—valuation is not the main differentiating factor at this point. Canadian equities have had a good run of outperformance lately, but the outlook is darkening. Consensus is too optimistic on growth and will likely be disappointed: Canadian earnings are expected to grow by 7.4% next year and market returns are unlikely to be boosted by P/E expansion.

United States: A high price for quality and defensiveness
Profit margins in the U.S. are high, but not under immediate threat. Wage inflation is slowly increasing, but not accelerating, and is partly offset by higher productivity, resulting in a small impact on unit labour costs. The Fed's pivot means that interest costs are capped for the moment. The tax cuts had a one-time boost to earnings growth but, as expected, this impact has faded. Going forward, earnings growth will have to rely mostly on revenue growth.

U.S. equities show stronger earnings growth and are less volatile than most other regions. As such, they could be considered somewhat of a more defensive market than international and emerging equity markets. This characteristic will typically make the U.S. outperform during periods of market turmoil. However, quality and defensiveness come at a price. The U.S. is the most expensive equity market, although there are better reasons to justify higher P/E ratios than in other regions. That being said, our fair value for U.S. equities suggests a P/E just below 21 (based on cyclically-adjusted earnings) while the market is trading above 24. This fair value is expected to drift lower as potential growth slows and interest rates move back to neutral. The bottom line is the U.S. may outperform from time to time, but valuation should remain a headwind.

U.S. fair value model

Fair value model based on potential GDP, inflation, R* and volatility of inflation
Source: CIBC Asset Management Inc.

EAFE: Central bank limit = limited recovery
International equity markets have been hit particularly hard by the economic slowdown. The consensus expects earnings growth will bottom and improve in the next year, but our economic forecasts point to further weakness ahead. In the eurozone, the ECB has limited leeway to stimulate the economy. Fiscal stimulus will provide some breathing room in France, Italy and Spain, but this will not be a game changer. Brexit uncertainty will keep weighing on U.K. business confidence and investment decisions. Japan's growth has stalled and the Bank of Japan's (BoJ) options are limited at this point. The government will likely delay the planned VAT increase because of weak economic conditions.

Valuation is slightly positive in relative terms, but this won't be enough for markets to outperform, given the weak cyclical conditions. European markets are close to fair value—a positive in relative terms, as developed markets are slightly overvalued on average. Dividend yields in Europe are attractive, at 3.7% on average.

Emerging Markets: Ready to rebound?
The global economic slowdown of 2018, led by China, has been painful for EM earnings. Year-over-year earnings growth has turned negative in EM Asia, after running at 26% one year ago. This is partly explained by a 7% contraction in net profit margins. Rising U.S. interest rates, a strong U.S. dollar, rising commodity prices and the trade war have proven too much for China and neighbouring countries. China has started to provide some prudent monetary and fiscal stimulus. While a repeat of the strong growth reacceleration of 2016 is not in the cards, it should still help to stabilize growth. Given the sharp correction in equity prices, there is room for a tactical rebound.

Although dominated by Asia, the emerging world is not only confined to this region. Eastern Europe and Latin America have held up better in terms of margins, earnings growth and equity prices. There are also some important valuation disparities among emerging markets. While some countries are expensive, the majority remain attractively valued.

Global bonds

Significant Repricing Underway
Developed market bond yields remained relatively stable for the first two months of the year, but hinged decidedly lower in March. Several developments converged to increase demand for safe-haven bonds, bringing U.S. Treasuries and Bund yields to 2.40% and -0.07%, respectively, at the end of the quarter.

Primarily, the Fed turned decidedly more dovish during the March FOMC[6] meeting, announcing a pause for balance sheet normalization policy. Chairman Jerome Powell pointed out that financial conditions had tightened considerably over the fourth quarter of 2018 and remained less supportive of growth than during most of 2018. This U-turn in rhetoric left investors wondering whether the path towards normalization had ended for good and earlier than expected. In a similar fashion, the ECB's president Mario Draghi, later in March, stated that risks were now tilted to the downside. He also suggested that some adjustments to policy settings might be necessary to protect the banks from the impact of negative interest rates.

The inversion of the 3-month/10-year yield curve in the U.S. was another important catalyst during the quarter. Historically, this phenomenon has often been associated with an ensuing recession over the next 18 months or so. In reaction, investors precipitately re-assessed their monetary policy projections, pushing market expectations lower—towards at least one rate cut by the Fed in the next 12 months. However, we have to point out that these yield-curve signals are far from being foolproof, and have often provided false recession signals.

From our perspective, the market has become too dovish with respect to the Fed's monetary policy. Although the risk of a global recession has increased, the U.S. economic outlook remains decent and inflation should remain anchored around current levels. We forecast U.S. real GDP growth will average 2.1% YoY[7] growth over the next 12 months, slightly below consensus. As such, "no change" in policy rates is more probable than a cut during this period.

Going forward, credit and fiscal impulses should remain constrained in all regions of the globe. This makes it unlikely that global economic data will consistently surpass expectations. Consequently, this could cap the upside to developed market bond yields and leads us to revise our global bond yield forecasts to the downside. As a base case scenario, 10-year sovereign bond yields should reach 2.60% and 1.85%, in the U.S. and Canada respectively, over a twelve-month horizon.

Currencies

U.S. Dollar
Following the U.S. Federal Reserve's flip flop from a hawkish to a dovish policy stance over the first quarter of the year, the U.S. dollar gave up a good chunk of the ground it gained late last year. However, the hit was not too severe and the U.S. dollar remains deep in overvalued territory on a trade-weighted basis (+7.5%).

The US dollar's downside remains limited because of relative cyclical conditions. True, market expectations about Fed policy have taken a definite dovish turn. However, this has happened in the context of sharply deteriorating growth prospects in the rest of the world, impacting market expectations about monetary policy outside the U.S. It is not the U.S. economy that has global investors increasingly worried—core concerns relate to the material growth slowdown taking place in Europe and Asia.

For other currencies to decisively move higher against the U.S. dollar, monetary authorities in the rest of the developed world must clearly signal the launch of tightening campaigns. This is not likely to happen anytime soon.

Canadian Dollar
The Canadian dollar participated only modestly in the relief rally in global risk assets in the first quarter of 2019. The appreciation of the Canadian dollar (+1.75%) was particularly disappointing when evaluated in light of the more convincing recovery in oil prices (nearly +30% from cyclical lows).

Looking forward, it is hard to find reasons to be upbeat about the Canadian dollar's prospects. While it qualifies as an undervalued currency, its fair value has been trending lower owing to negative developments on the productivity front and deteriorating Canadian terms of trade. Canada's currency valuation gap is shrinking fast and, in addition, we see limited upside for energy prices from current levels.

Finally, Canada is saddled with a wide and widening fundamental deficit (i.e. both current account and foreign direct investment deficits). The Canadian dollar remains more fundamentally challenged than most developed market currencies.

Euro
In early 2018, the consensus view was that the eurozone would continue to do well and the ECB would renormalize policy. Consequently, the euro was expected to substantially appreciate against the U.S. dollar. Instead, the eurozone economy unexpectedly downshifted into lower gear and the euro depreciated substantially. For 2019, consensus expectations are for a growth recovery in the eurozone and a strengthening of the EURUSD exchange rate. Will this instead turn out to be a replay of 2018? As explained in the European economic section (pg. 7), we put high odds on a more negative turn of events for the eurozone economy, implying further EURUSD weakness over the forecast horizon.

Japanese Yen
Since the Bank of Japan introduced its Yield Curve Control (YCC) policy three years ago (late 2016), the USDJPY bilateral exchange rate has fluctuated in a tight trading range between 105 and 115. Will we witness a Japanese yen breakout over the next 12 months? A breakout above 115 seems very unlikely given that the Bank of Japan is shifting into tapering mode just as the Federal Reserve is putting an end to its Quantitative Tightening (QT) policy. The Bank of Japan's bond purchases have slowed drastically, from a peak of 80 trillion JPY per year in 2016 to 18 trillion JPY per year now. This is important

[6] Federal Open Market Committee
[7] year-over-year

because relative U.S.-Japan liquidity conditions have played a key role in determining the USDJPY exchange rate since 2016. Developments on the liquidity front imply less support for the Japanese yen and the path of least resistance should be lower. Given the yen's safe-haven properties and the current risk-off environment, odds of a breakout on the downside for the USDJPY bilateral rate are significantly more likely moving further into 2019.

Commodities

Are higher oil prices sustainable?
Oil prices rose dramatically in the first quarter, as a combination of fundamental and market psychology factors supported higher energy prices. OPEC cuts came into effect in January, limiting production growth and resulting in fewer oil barrels exported into the global market. The next scheduled OPEC meeting in April has been pushed to June, implying that the cuts will remain in place until then and allow the market more time to rebalance itself. In addition, U.S. warnings to nations that purchase oil from Iran have turned more hawkish and U.S. waivers that allow some countries to continue to buy Iranian oil will expire at the end of April. In fact, some of those countries have already curbed their Iranian oil imports and, as a result, Iran has lowered its oil production. Adding to supply concerns, the Venezuela situation has worsened, with production now less than 1 million bpd (compare this to 2010 production of 3.1 million bpd). The reestablishment of a risk-on market psychology also supported higher commodity prices—and some resolution of U.S.-China trade disputes would go a long way to extending this mind set. The fact that U.S. oil producers have not ramped up output in the face of higher oil prices is another positive on the supply side.

In Canada, the Alberta government's unprecedented mandate to oil companies to cut production had the desired effect—the price differential between WCS oil and WTI has improved dramatically. At its peak this spread was $45-$50 per barrel, as of this writing it stands around $10.

How are we evaluating the direction of oil prices from here? We'll continue to monitor OPEC actions, especially as the June meeting approaches. Although OPEC doesn't want the existing cuts to extend indefinitely, they are hoping to establish a better balance between supply and demand so that prices don't tumble when supply is re-established. Obviously, there are a lot of moving parts to this story, as some of the variables we've mentioned can reverse themselves fairly quickly. In particular, U.S. shale producers can ramp up production within a few months. However, because the active rig count is reported weekly, energy investors follow this statistic closely and use it as an early gauge of increased production. Oil prices can reflect this before production volumes actually rise.

Regional economic views

Canada

Intensifying Global Headwinds

- The Bank of Canada will stay on the sidelines as a result of intensifying global headwinds.
- We are working with a below-consensus forecast of +1.1% average real GDP growth over the next four quarters.

For the next year, the consensus view calls for a soft patch for the Canadian economy early in the year, followed by a speedy recovery moving into 2020. In the context of an improving cyclical backdrop, the Bank of Canada is expected to shift back into tightening mode later this year—we have a different opinion. We fear that major headwinds will be blowing harder and harder on Canada's economic landscape, limiting the potential for a growth reacceleration later this year and keeping the Bank of Canada sidelined.

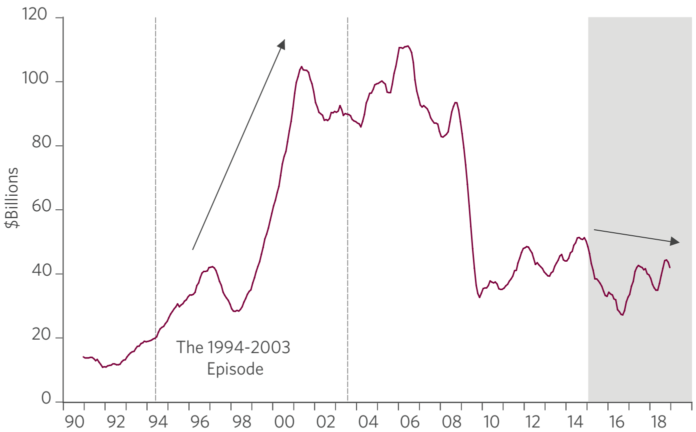
As we suspected late last year, Canada's two growth engines—the energy and construction sectors—are now choking. Between 2017 and 2018, these two sectors provided a substantial boost to GDP growth, but unfortunately the boost has increasingly turned into a drag.

The biggest concern obviously relates to the unfolding slowdown in Canadian housing activity. The contraction in construction activity is now as deep as the one experienced a decade ago. Back then, the hit on Canadian real estate, along with heightened global financial turmoil, sent the Bank of Canada into panic mode, hastily delivering multiple rate cuts. This time around, Governor Poloz and his team will likely stay cool-headed and refrain from shifting from a tightening to an easing mode. Let's not forget that the panic of 2009 led to the rapid accumulation of Canadian household debt, pushing the debt-to-GDP ratio to more than 100% from 80% ten years ago. We believe that it is too early for Canadian monetary authorities to shift back to easing mode. Their best option is to stay on the sidelines, keeping their fingers crossed that the soft landing in Canadian real estate won't turn into a hard landing.

Another major headwind concerns Canada's lacklustre trade activity. Over the last four years, conditions were ideal to produce a sharp improvement in the Canadian trade balance: a healthy global economy, the strongest U.S. domestic demand in over a decade and an undervalued Canadian dollar. Instead, Canada appears to have lost its competitive edge, stuck with a continued widening of its trade deficit with the rest of the world. Now that the global economic backdrop is deteriorating, Canadian external imbalances are expected to stay wide.

The bottom line is that the Bank of Canada will be staying on the sidelines as a result of intensifying global headwinds. We are working with a below-consensus forecast of +1.1% average real GDP growth over the next four quarters.

CAD weakness, but no trade gains
Canadian Trade Balance with the U.S. (Cumulated 12 months CAD)



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

United States

From Fed Relief Back to Policy Renormalization?

- With no build-up in cost-push inflationary pressures, it's too early for the Fed to be switching back into policy renormalization mode.
- The U.S. economy is expected to continue to do reasonably well, growing at +2.1%, on average, over the forecast horizon, with well-behaved inflation.

In our last forecast, we argued that the Fed had no other option but to shift from policy normalization to policy relief. That is exactly what happened—and even faster than we had projected. Over the first quarter the Fed made two important policy changes. First, it clearly signaled its intention to stay on the sidelines with regard to policy rates. Second, it officially announced that it will be putting an end to its QT policy. The Fed will no longer be shrinking its balance sheet as of September.

This heavy dose of Fed policy relief did exactly what was intended. Tensions in global financial markets quickly dissipated, allowing for a convincing rally in risk assets over the first three months of this year. U.S. financial conditions are back in "easy" territory and markets are expecting an even more dovish Fed (i.e. pricing in at least one rate cut). But could we be in for a surprising Fed shift back to policy normalization?

The reality is that the Fed can afford to be patient before resuming its tightening campaign. True, U.S. labour market conditions have rarely been as tight as they are right now. Case in point: the U.S. unemployment gap is the lowest it's been in more than 18 years. Also true, this is translating into accelerating wage inflation. Yearly growth in U.S. average hourly earnings is running at +3.3% in recent months, the highest growth rate in more than a decade.

That said, because of high productivity growth, U.S. non-financial corporations have, so far, had no trouble absorbing bigger increases in compensation costs. In terms of unit labour costs, there is very little cost-push pressure in the U.S. economy, justifying a prolonged Fed pause. In short, it's too early for the Fed to be switching back to policy renormalization mode.

Does this mean that there is more Fed policy relief around the corner? Unfortunately not, in our opinion. At this juncture, there is no economic justification for policy rate cuts. What's more, putting an end to its QT policy simply means that the deep contraction in the U.S. monetary base experienced in 2018 will turn into a very modest expansion—but not a big enough expansion to stop the decline in the monetary base to GDP ratio. In effect, the Fed will still be closing the liquidity tap, but at a much more gradual pace.

Europe

ECB Running Out of Policy Options

- The ECB is running out of policy options to jumpstart its weakening economy. Unfortunately, the new TLTRO III lending scheme will only partially cushion the hit on the ECB's balance sheet.
- Our forecast calls for below-consensus average real GDP growth in the eurozone (+0.7%), with an elevated risk of slipping back into recession.

In early 2018, the consensus view was that the eurozone would remain on solid footing, allowing the ECB to start renormalizing policy. Unfortunately, the eurozone economy refused to follow the script, surprising pundits with a material slowdown. For the 2019 outlook, private-sector forecasters are still wearing the same rosy glasses, betting on a solid growth recovery over the second half of the year. Could 2019 instead turn out to be a replay of 2018, with further growth disappointment? Running out of policy options to jumpstart its moribund economy, the ECB is hoping that the recently announced TLTRO III lending scheme will allow the eurozone recovery to materialize. If it doesn't, the ECB will face a very big challenge.

The growth slowdown now taking place is happening at the worst possible time —immediately after monetary authorities have ended their quantitative asset purchase program. As we highlighted in the last edition of Perspectives, this is not a trivial development. Since the start of Quantitative Easing (QE) in 2015, the ECB has expanded its monetary base by 124%—from 20% to 40% of GDP—providing a massive monetary impulse to the eurozone economy. With no monetary impulse in 2019, odds of a successful growth recovery are low.

If this is the case, why not resume QE? In our opinion, the probability that the ECB will resume net asset purchases in 2019 is minimal. The ECB would have to drop the "capital key" which determines the proportions it must buy of each country's bonds and/or it would have to raise the 33% limit on the proportion of each outstanding issue it is allowed to buy. In each case, this is easier said than done. Capital keys are revised every five years and determined by the size of GDP and population of each economy in the European Union. The capital keys for Italy and Germany were respectively revised lower and higher in early 2019—the opposite of what would be required to address the current problem. In addition, increasing the 33% limit on the outstanding amount of central bank holdings of government bonds would just translate into a bigger shortage of bunds. With the German government generating budgetary surpluses, it would not take long for the Bundesbank to run out of bunds to buy.

The bottom line is that the eurozone economy will remain mired in the mud because the ECB is running out of policy options to jumpstart its weakening economy. Our forecast calls for below-consensus average real GDP growth in the eurozone (+0.7%) with an elevated risk of slipping back into recession.

China

Sober Policy Environment Means Cooling Growth

- Our forecast calls for +6% real GDP growth over the forecast horizon with a dip below 6% in early 2020.
- The projected growth slowdown is a result of conservative monetary and fiscal policy projections that will result in little credit impulse.
- Against this relatively sluggish economic backdrop, inflation is expected to stay well-behaved at 1.8%, providing some policy leeway to Chinese monetary authorities.

The outlook for GDP growth in 2019 is 6%, lower than the 6.6% growth in 2018 and at the low end of the Chinese government's GDP target band of 6% to 6.5% for 2019. We continue to expect a challenging trade environment due to a significant growth slowdown in Europe and an unresolved trade dispute with the U.S. As we enter Q2 2019, the U.S. and China have yet to confirm an agreement and U.S. tariffs on Chinese goods remain in place. Given these external challenges, expectations for domestic growth ultimately rely on the domestic policy environment and whether or not it is promoting any growth acceleration.

In terms of fiscal and monetary policy impulses, we don't expect much—certainly no stimulus comparable to what was delivered in 2016. On the fiscal side, the 2019 fiscal budget is conservative and does not provide strong support for economic growth. The fiscal budget shows an increase in the budget deficit of 0.2pp* to 2.8% of GDP, mainly due to tax cuts. However, on the expenditure side, national government spending growth will decline to 6.5% from 8.7% one-year earlier. Consequently, there is a smaller contribution to growth from government spending. Even when we include local government special purpose bonds, an off-balance sheet item, this is a very small growth impulse. Unlike previous periods of slower growth, Chinese policy-makers are not opening the spending taps; instead, they are in some ways tightening their belts. Ultimately, this means that fiscal policy will not offset the drag from trade.

On the monetary side, the PBOC's current neutral monetary policy stance is also in line with a conservative policy framework. Despite slowing economic activity and lacklustre deposit growth at commercial banks, the central bank's policy rate has been practically unchanged over the past 12 months. This means that there has been no stimulus from the PBOC. The one area where the PBOC has become increasingly aggressive is a reduction in the reserve requirement rate (RRR); however, this is much more a liquidity management tool than a measure to boost credit. This has helped provide liquidity to commercial banks and alleviated liquidity stress due to the challenges associated with restrictive rules on the issuance of shadow banking credit—overall, promoting a healthier financial system.

We don't expect the overall credit impulse will be large enough to translate into a significant growth reacceleration in China. Our forecast calls for +6% real GDP growth over the forecast horizon, with a dip below 6% in early 2020. Against this relatively more sluggish economic backdrop, inflation is expected to stay well-behaved at just under 2%, providing some policy leeway to the Chinese monetary authorities.

* percentage points

Alternative scenarios

Our main scenario for the next 12 months is **Limited Policy Relief** and we see two primary alternative scenarios.

Global Reflation Scenario

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

Global Recession Scenario

We suspect that the key recession risk is more likely to emerge from Asia and/or Europe. Both regions are currently coping with a cyclical growth slowdown. Given the relief efforts deployed by policymakers earlier this year, economic growth will most likely stabilize over the forecast horizon. However, there is significant risk that the policy stimulus provided won't be sufficient to avoid a more pronounced economic downturn with spillover effects to the rest of the world. This could produce a meaningful tightening in global financial conditions and possibly spill over to weaker emerging economies, creating more contagion and risks to financial stability.

Scenario	Less Favourable	More Favourable
Global Reflation	International bonds Canadian bonds Long-dated U.S. Treasuries	Emerging Asia equities European equities Commodities
Global Recession	Global equities High Yield bonds Emerging market currencies	Gold U.S. Treasuries Japanese yen

Economic forecasts (next 12 months)

Region	Current GDP[7]	GDP - Consensus	GDP - CAM View	Current Inflation[8]	Inflation - Consensus	Inflation - CAM View	Policy Rate - CAM View
Canada	1.6	1.6[9]	1.1	1.5	1.8	1.6	No rate change
United States	3.0	2.3	2.1	1.5	2.1	1.9	No rate change
Eurozone	1.1	1.3	0.7	1.4	1.3	1.1	No rate change
China	6.2	6.2	6.0	1.5	2.1	1.8	No rate change
Japan	0.3	0.7	0.5	0.2	0.9	0.5	No rate change
World	3.3	-	3.1	-	-	-	-

[7]Real GDP Growth (y/y %)
[8]Year/year %
[9]Implied (converted from a Q/Q basis)

Data as of April 8, 2019
Source: Datastream, Bloomberg, CIBC Asset Management Calculations

Long-term capital market returns (10 year)

An important component of our investment process is the analysis and forecast of average returns for major financial market asset classes for the next 10 years. Some of our major conclusions are summarized below. For full details, please request a copy of the complete 10-year report.

- Background: Higher policy rates will be needed to cope with potential negative economic shocks and prevent a build-up of financial imbalances. Renormalization will be a larger headwind in developed economies (non-U.S.), where rates are much lower and indebtedness much higher. Renormalization, combined with declining trend economic growth, is expected to depress financial market returns over the long term. Monetary policy renormalization will continue and provide a headwind to growth.
- Low starting yields, higher interest rates and the fact that investors will not be compensated for taking duration risk, will make developed market government bonds less attractive. High-yield corporate bonds and emerging market bonds offer better prospects.
- Emerging markets offer the best equity outlook, thanks to stronger growth and better resilience to adverse shocks. Current undervaluation also makes Canadian equity more attractive, while overvaluation makes U.S. equity less attractive.