

PULLING THE PLUG ON GLOBAL LIQUIDITY

While it took much longer than in past business cycles, we have finally reached the point where excess liquidity is being drained from the global financial system. This is a turning point, with the Fed shrinking its balance sheet, the ECB about to stop buying assets and the BOJ in tapering mode. While the policyinduced global economic slowdown is likely to be relatively mild, global financial markets may have trouble coping as central banks turn off the global liquidity tap.

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ASSET ALLOCATION OUTLOOK

as at July 1, 2018

ASSET CLASS		 WEIGHT MODERATE	NEUTRAL	VEIGHT 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)	UNDER SIGNIFICANT	 NEUTRAL	OVERWEIGHT MODERATE SIGNIFICAN	
Canadian Dollar				
Euro				
Japanese Yen				
British Pound				
Swiss Franc				
Australian Dollar				
Emerging Markets				

HIGHLIGHTS AND KEY THEMES

Fixed Income vs. Equity: Equity returns should remain positive but are increasingly at risk. Bond yields are still below fair value and should continue to gradually move up as bond prices decline.

Equity: The U.S. continues to face headwinds from both valuation and shrinking profit margins—these will likely limit returns for the foreseeable future. Valuation arguments still favour emerging markets versus other global regions.

Fixed Income: Global bond yields should grind higher. Although the global growth outlook has become more uncertain, the steadfast desire to renormalize monetary policy remains intact.

Currencies: Canada is vulnerable to tightening U.S. credit conditions and any U.S. policies aimed at widening Canada's overall trade deficit. For these and other fundamental reasons, we believe it is too early to call a bottoming for the Canadian dollar.

	GDP OUTLOOK		INFLATION OUTLOOK			
	Direction	vs. Consensus	Direction	vs. Consensus	KEYTHEMES	IMPORTANCE
U.S.		••••		<i>A</i> .	Fed to stay on policy renormalization path	
Canada		*	••••	••••	BoC walking a tightrope	
Europe	w	w		w	ECB taking away the punch bowl	
China	**	w		••••	Time for policy insurance as trade war undermines growth	-111
Japan	**	**		••••	BoJ to tweak its Yield Curve Control (YCC) policy	
World	w	w		••••	Policy-induced global growth slowdown	

EXPECTED RETURNS

Expected returns for the one-year period beginning July 1, 2018

	IN CANADIAN DOLLARS			IN LOCAL CURRENCY			
	Global Reflation	Policy Renormalization	Global Recession	Global Reflation	Policy Renormalization	Global Recession	
Probabilities	20.0%	50.0%	30.0%	20.0%	50.0%	30.0%	
Canada Money Market	1.8%	1.5%	0.9%	1.8%	1.5%	0.9%	
Canadian Bond	-0.4%	0.8%	3.6%	-0.4%	0.8%	3.6%	
Canadian Federal Govt. Bond	-0.3%	1.1%	5.7%	-0.3%	1.1%	5.7%	
Canadian Corp. Bond	1.5%	1.3%	1.0%	1.5%	1.3%	1.0%	
Canadian RRB	-0.6%	-0.8%	-0.9%	-0.6%	-0.8%	-0.9%	
Canadian High Yield	6.3%	5.0%	-6.8%	6.3%	5.0%	-6.8%	
International Govt. Bond	-6.5%	-2.2%	11.2%	-3.3%	-2.1%	5.8%	
Canada Equity	14.3%	6.4%	-17.7%	14.3%	6.4%	-17.7%	
United States Equity	4.1%	0.2%	-13.0%	10.9%	3.8%	-16.4%	
International Equity	12.3%	7.7%	-17.2%	14.0%	5.8%	-20.0%	
Emerging Equity	16.6%	8.3%	-24.7%	15.6%	8.2%	-24.5%	

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GLOBAL OUTLOOK

Receding global liquidity tide

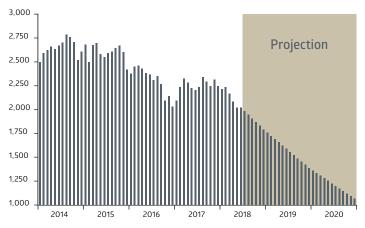
Over the last decade, central banks have injected a massive dose of liquidity into the global financial system. This was accomplished by lowering rates (conventional method) and with massive Quantitative Easing (QE) programs (nonconventional method). Taken jointly, the actions of the U.S. Federal Reserve (Fed), Bank of Japan (BOJ) and European Central Bank (ECB) gave rise to a massive global credit expansion and provided very strong support to the global economy.

In recent years, the Fed has started to reduce the excess reserves it holds and shrink the U.S. monetary base. For some time, this was more than offset by the expansion of monetary bases in Japan and the eurozone, via expanding QE policies. The global economic expansion remained well supported by highly accommodative global credit conditions. The story will likely be different as we move into 2019. The ECB has officially announced that it will stop buying assets in early 2019—a non-trivial shift in policy. In addition, the BOJ, in effect, switched to tapering mode when it implemented its Yield Curve Control (YCC) policy in late 2016. It has reduced its Japanese government bond (JGB) purchases by 40%, from a yearly rate of nearly ¥80 trillion a year-and-a-half ago to ¥32 trillion recently.

More importantly, along with policy rate renormalization, the Fed is planning to increase the pace that it reduces its excess bank reserves, draining much more U.S. dollar liquidity out of the global financial system. This Fed-led U.S. dollar global liquidity squeeze is just beginning. With excess reserves still close to \$2 trillion, the Fed is targeting a reduction somewhere between \$400 billion to \$1 trillion. If the Fed follows its plan, this would mean a drain of liquidity from the global financial system for at least another two years.

FED SHRINKING OF THE MONETARY BASE

Excess reserves held at the Fed



Source: Thomson Reuters Datastream, Federal Reserve, CIBC Asset Management Inc.

In our base case scenario, the global credit impulse¹ will be turning negative as we move into next year. Just as an expanding global monetary base led to an expansion of onshore and offshore global credit, a contraction in the global monetary base should lead to a slowdown in global credit and global economic activity in 2019. Our forecast calls for global GDP growth to decelerate from 3.9% currently to 3.6% by the middle of 2019.

Fiscal policy is unlikely to come to the rescue. With the exception of the United States, the global fiscal impulse is fading just as fast as the global credit impulse. Rising debt servicing costs are leaving governments with much less fiscal leeway.

More shades of grey must be added to the global outlook when considering developments in China. The Chinese credit impulse that allowed for a convincing growth reacceleration between 2016 and 2017 has now turned negative, signaling that China is also likely heading for a growth slowdown. Luckily, with inflation still well-behaved, Chinese monetary authorities have the necessary leeway to adopt a more accommodative policy stance to cushion the downturn.

The global economic outlook also looks more uncertain in light of mounting tensions on the trade front between the U.S. and many of its trading partners (most of them allies!). Considering the big picture, financial markets are weighing the probability that this dispute will trigger a reversal of globalization.

The bottom line is that while it took much longer than in past business cycles, we have finally reached the point where excess liquidity is being drained from the global financial system. This is a turning point, with the Fed shrinking its balance sheet at an accelerating pace, the ECB about to stop buying assets and the BOJ in tapering mode. While the policy-induced global economic slowdown is projected to be relatively mild, global financial markets may have trouble coping with central banks turning off the global liquidity tap. After years of easy money and an environment of abundant liquidity, global investors have developed a strong dependency on central bank liquidity injections. Going cold turkey would be too difficult and central banks must gauge the appropriate pace to turn off the tap.

TRADE WAR VIEWS

Trade front tensions between the U.S. and many of its trading partners have intensified in recent months. Considering the big picture, financial markets are weighing the probability that the dispute will trigger a reversal of globalization. Let's remember that an important factor that has determined prices in recent decades has been a deflationary labour supply shock. The addition of billions of workers from low-wage countries to the global labour pool has pushed down wages, prices and interest rates from the early 1980s onward. An all-out trade war that reverses globalization would set off an inflationary supply shock that would lower growth, bring higher inflation and negatively impact the pricing of most financial assets.

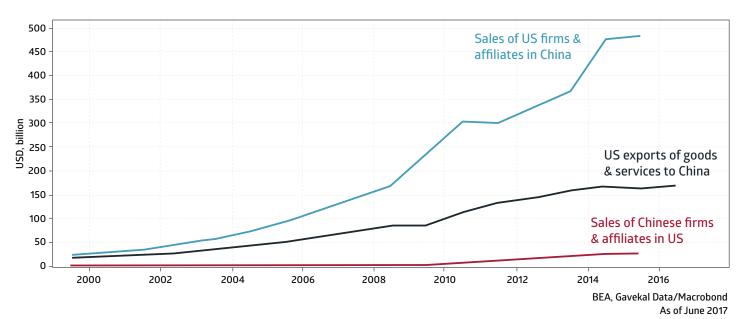
Bond yields would rise, equity market multiples would decline and real estate prices would collapse. What probability do we assign to this kind of risk scenario? Our best guesstimate with what we currently know (at the time of this writing) is low, but not zero, over the next 1-2 years.

Very few tariffs have actually been imposed so far. Estimates on the impact of announced tariffs against China from various research firms are relatively modest. For example, Goldman Sachs estimates that the impact on U.S. inflation of the \$50bn in tariffs already announced and the potential addition of tariffs on \$200bn in imports from China would be an increase in U.S. core PCE² inflation of around 15 basis points³. They also expect that the growth impact from these measures would be of a similarly modest size, potentially reducing the level of U.S. GDP by 1-2 basis points after two years. However, trade war headlines and rhetoric, combined with retaliatory initiatives, make it difficult to evaluate the ultimate impact on consumer and business confidence. This might lead to an underestimate of the final economic impact. More importantly, there does not have to be a material economic problem to cause volatility in the financial markets. Recent trade positioning from the U.S. administration has revealed some different behaviour, a new mindset that is more philosophical about trade and the need to change trade relations with their partners. The focus is on bilateral trade rather than multilateral trade, which creates a risk that the global supply chain and its productivity advantages will be dismantled. Tariffs imposed by the U.S. administration are also contravening the World Trade Organization (WTO) rules and weakening international trade relationships.

That being said, there are a number of factors that will limit a large trade dispute escalation, particularly with China. Based on research from the Peterson Institute, an important share of U.S. imports from China in high technology sectors originate from Chinese-based affiliates of multinational firms, not Chinese domestic firms. Furthermore, the products on the U.S. administration's tariff hit list are largely inputs used in American production, even when looking beyond the formal affiliates of U.S. companies. This means that the proposed Trump tariffs would decrease American competitiveness yet again, according to the Peterson Institute. In addition, the political costs for the U.S. will grow as the conflict escalates ahead of mid-term elections this November. Additional U.S. tariffs, beyond those proposed on the first \$50 billion in imports, would be met with additional tariffs by China on U.S. exports. These could touch sensitive areas for U.S. consumers and states that are Republican Party supporters. Rising goods prices or potential job losses would be detrimental for electoral votes. Another limiting factor to the trade dispute escalation relates to the U.S. Congress. Congress has the constitutional power to impose tariffs but has historically delegated, by law, power to the U.S. President to impose tariffs in specific circumstances (such as "national security" reasons). If the Trump administration pursues a more aggressive approach to trade and abuses the power to impose tariffs, Congress could eventually intervene. At a minimum, Congress could remind the President of its ability to remove the Presidential power to manage trade.

Trade is also an electoral objective for the current U.S. administration (they are not looking to abolish trade) and is well covered in the latest Economic Report of President. In the short term, we can expect some intensification of trade tensions with the U.S. major trading partners. The latest of these could curb Chinese direct investment in U.S. companies and impose export restrictions that block China's access to American technology. China has a number of retaliatory options, in addition to imposing tariffs on U.S. exports to China. American companies operating in China have grown over the years and could be subject to more "red tape" that would slow their growth and impact share prices.

FLOW OF GOODS BETWEEN U.S. AND CHINA



Ultimately, aside from negotiation tactics, all parties understand that intensifying trade frictions will not be positive for growth, inflation or votes! The financial markets have other items to consider such as tight labour markets, wage pressures and major central banks' renormalization. These areas should attract more market attention over the coming months.

REGIONAL OUTLOOK

Canada

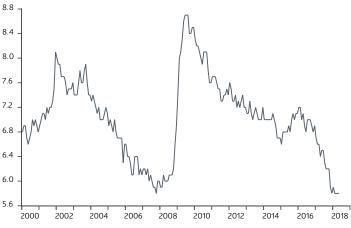
BoC walking a tightrope

- We forecast +1.7% average real GDP growth for the Canadian economy over the next 12 months.
- Mounting trade tensions and cooling Canadian housing activity mean the Bank of Canada (BoC) won't be following in the Fed's policy-tightening footsteps. The BoC will be hiking, but trailing in its delivery pace.

A very difficult balancing act has developed for Canadian monetary authorities. The Canadian economy seems to be firing on all cylinders, with an unemployment rate that stands at its lowest level in more than a decade. With very tight labour market conditions, cost-push inflationary pressures have been intensifying, with wage inflation sharply accelerating (i.e. now running at +3.9%, its fastest pace in nine years). Under normal conditions, Governor Poloz and his staff wouldn't think twice and would already be renormalizing policy rates at a pace similar to the Fed.

TIGHT CANADIAN LABOUR MARKET

Canadian unemployment rate



Source: CIBC Asset Management Inc.

However, the current environment doesn't exactly qualify as "normal"—far from it. Instead of abating, trade tensions between Canada and the United States, as well as between the U.S. and the rest of the world, have been intensifying. Because of this, the Bank of Canada has to incorporate the effects of recently announced trade tariffs in its projections,

along with retaliatory measures, both from Canada and globally. This promises to be a very difficult task.

Further complicating things, the Bank of Canada has to also figure out how new Canadian lending guidelines are affecting the housing market and mortgage renewals. At the current juncture, it is too early to draw any conclusions that would justify a slow pace for rate hike delivery. However, there is clear evidence of a slowdown in Canadian housing activity. According to the National Association of Realtors, home sales are in decline and home inventories are rising, putting downward pressure on property prices. Under these conditions, Governor Poloz has to be extremely prudent with policy rate renormalization. The last thing he wants is a policyled hard landing in the Canadian housing market. To avoid this, he has no choice but to wait for signs of stabilizing activity in the Canadian housing market. Better to be safe than sorry.

The bottom line is that, given mounting trade tensions and the cooldown in Canadian housing activity, the Bank of Canada won't be following in the Fed's footsteps in terms of policy tightening. It will be hiking, but trailing in its delivery pace.

United States

- The U.S economy is moving into the late stages of the business cycle, characterized by rising wage inflation, higher interest rates, and slowing economic growth—a challenging environment for corporate profits.
- We expect GDP growth to average 2.5% over the next four quarters, slightly below consensus. After reaching a peak in the second half of this year, economic growth will decelerate, owing to fading fiscal stimulus and higher interest rates.

After five years in expansion mode, it is becoming clear that the U.S. economy is increasingly at risk of overheating. The unemployment rate is near all-time lows, job openings exceed the pool of unemployed workers and a record-high proportion of small and medium enterprises report a lack of qualified candidates—labour market conditions are as tight as they get. Looking forward, this scarcity of workers will likely increase. The U.S. economic expansion is well supported, thanks to a significant boost from fiscal policy, still-accommodative monetary policy and solid fundamentals.

In this environment, wage inflation is likely to materially increase. This is a typical late cycle feature. When it happens, the Fed is generally caught off guard and forced to tighten its policy stance more aggressively, jeopardizing the economic expansion. However, the Fed can prevent this from happening by moving gradually and steadily towards a neutral monetary policy stance. For this reason, we expect U.S. monetary officials to deliver one hike per quarter, more than what is actually priced in by the markets. By following this gradual tightening path, the Fed will hopefully cushion the negative impact of higher interest rates and minimize the risk of a hard economic landing.

The late stages of a business cycle mean more challenging times ahead, and not only for the Fed. Corporate profitability will increasingly be squeezed via slowing growth and rising costs, another late cycle feature. The risk of profit disappointment is increasing, and could potentially be exacerbated by an intensifying trade war. This matters, because too big a hit on profits would inevitably have a negative impact on employment, household income and consumer spending and, in turn, on the overall growth outlook.

Europe

ECB taking away the punch bowl

- The end of QE in early 2019 is no minor development, as ECB officials are well aware. This means the ECB will stick to its sub-zero policy rate until the impact of ending QE is fully assessed.
- · We project the eurozone economy will experience a significant growth slowdown by the middle of 2019, with real GDP growth decelerating from +2.5% (currently) to +1.5%.

As widely expected, the ECB announced that it will put an end to QE in early 2019 and further reduce the amount of securities purchased between now and year end. At first glance, it's tempting to conclude that this does not represent a material change in its policy stance and will not threaten the eurozone's economic expansion. After all, the ECB also made it clear that policy rates would be kept unchanged well into next year. The reality is that the end of QE is no minor development, as ECB officials are well aware.

When the ECB launched its asset purchase program, the objective was to jumpstart the moribund eurozone economy by flooding the banking system with cash via excess deposits/ reserves. This would exert downward pressure on market interest rates and hopefully allow commercial banks to start lending again. Judging by the eurozone's cyclical revival, it seems that QE did exactly what it was designed to do. By late 2016, the eurozone economy had clearly shifted into higher gear and has been growing at a strong clip for nearly two years.

Upon closer examination, the success of the ECB's QE program can't really be attributed to its impact on bank credit. In aggregate, the recovery in bank lending has been modest and essentially concentrated in Germany and France. If that is the case, what explains the eurozone's cyclical revival?

We believe that the ECB's QE was badly designed from the start. From day one, the heavy buying of government debt securities by the ECB has widely exceeded the new borrowing requirements of eurozone central governments. With no government bonds to buy, eurozone investors were forced to seek returns elsewhere. To meet this artificially boosted demand, non-government bond issuance in the eurozone exploded. This was not a trivial development, as it translated into a massive credit injection, essentially explaining the eurozone's economic lift-off.

Moving into next year, the ECB will no longer be a heavy buyer of eurozone government bonds. This will likely restore liquidity conditions and reduce market dislocations, making way for the return of traditional buyers into the government bond market. This also means that there will be much less demand for non-government debt securities. In short, the shock to the eurozone bond market (government and non-government) could be potentially violent. Under these conditions, the ECB has no other choice but to stay on the sidelines until the impact of ending QE is fully assessed.

This also means that the eurozone economy won't be getting as much of a credit impulse. For these reasons, we project a significant growth slowdown, with real GDP growth decelerating to +1.5% by the middle of 2019.

China

Time for policy insurance as trade war undermines growth

- Our forecast calls for a slowdown in Chinese real GDP growth-from +6.8% currently to +6.1% by Q2 2019. Adding to the uncertainty over growth is the U.S.-China trade dispute and imposition of tariffs.
- We expect CPI inflation to remain well-behaved, averaging +2.5% over the next 12-months. This will allow the PBoC to adopt an increasingly accommodative policy stance that will support growth.

The Chinese economy has reported solid growth over the past year, running above the 6.5% minimum growth level targeted by policymakers. However, the growth outlook for the year ahead promises to be much more challenging. Our forecast calls for a slowdown in Chinese real GDP growth from +6.8% currently to +6.1% by Q2 2019. Our expectation for a growth slowdown is supported by factors that include the full unwinding of past monetary and fiscal policy stimulus in addition to the drag currently observed from the Chinese credit impulse. Adding to the headwinds on growth is the uncertainty generated by the intensifying U.S. trade war with China. The risk is for a build-up in trade disputes that will lead to more trade sanctions on both sides, damaging the constructive sentiment that policymakers have gradually developed over the past few years.

Given the uncertainties surrounding growth, the People's Bank of China (PBoC) will likely adopt an increasingly more supportive policy stance over the next 12 months. A more dovish policy tilt is already apparent following the announcement of a reduction in the central bank's reserve requirement ratio (RRR), which helps to improve liquidity conditions in the banking system. Additional liquidity is likely to be injected later this year.

We expect CPI inflation to remain well-behaved, averaging +2.5% over the next 12 months. This will allow the PBoC to adopt an increasingly accommodative policy stance to support growth. We may even see an easing in the cost of borrowing later this year through a reduction in the central bank's policy rates.

The intensifying U.S.-China trade disputes are creating uncertainty for Chinese exporters. However, the imposition of tariffs on Chinese products has important repercussions beyond Chinese borders. Close to 30% of the value-added on Chinese exports to the U.S. comes from outside China. Non-domestic value-added for electronic product exports is estimated at approximately 50%. This implies that the consequences of the trade war will affect other Asian countries that are involved in the production supply chain. Some of the countries at risk include Taiwan, Malaysia, South Korea, Thailand, Philippines, and Singapore. In short, the U.S.-China trade war is not just a headwind for China but for the whole Asian manufacturing hub.

MULTI-ASSET STRATEGY OUTLOOK

Late cycle expansion = rising risks

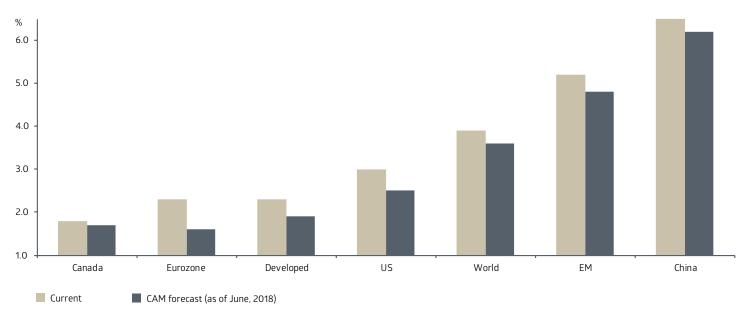
A slowdown in the economy had to be expected after a long stretch of robust growth. Is the current slowdown a typical mid-cyclical fluctuation, or will it turn out to be a deeper slump resulting from too much monetary policy tightening and rising imbalances? At the time of writing, it is still too early to declare the soft patch over. There are signs the U.S. economy is doing just fine, but questions remain for the rest of the world.

We expect the global expansion to continue at a slower pace than 2017. However, growth will remain above potential, continuing to remove excess capacity and building some inflationary pressures, mainly in the U.S. While the global monetary policy stance remains accommodative, central banks have already generated a significant amount of tightening when we consider the removal of QE. The combination of rising policy rates and quantitative tightening will continue to drain central bank excess liquidity. Although central banks are determined to normalize monetary policy at a gradual pace, it will be a delicate balancing act to prevent the buildup of excessive inflationary pressures and engineer a soft landing.

There is little precedent to guide central bankers and investors through the process of removing quantitative easing. This makes it difficult to gauge how much tightening has already occurred, and how much more is yet to come. At what point will it break the economic cycle? Capital markets are likely to remain volatile as investors constantly adjust to incoming information.

Recent weak and volatile equity performance was consistent with a typical economic slowdown. However, bond yields have acted quite differently. The typical behaviour during a slowdown is for bonds to rally, as the market expects the central bank will need to ease in order to support the economy. Recently, the bond market was not concerned as much with growth as it was with inflation. Throughout 2017 and early 2018, growth was remarkably stable and broadbased, but the inflation outlook grew increasingly uncertain. Now, it seems the inflation outlook is more certain while risks are rising with respect to growth.

GLOBAL GROWTH PROJECTIONS—NEXT 12 MONTHS



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

In addition to the impact on bond yields, this dynamic has also pushed the U.S. dollar higher. While emerging markets (EM) had remained resilient, the combination of rising U.S. yields and rising U.S. dollar was the straw that broke the camel's back. Furthermore, the unfolding trade war between the U.S. and the rest of the world brought unneeded worry to emerging markets. When equities in the U.S. and Europe rebounded in April, emerging markets equities traded sideways. EM bonds and currencies were hit quite hard.

Is this a sign of stress in EM? Emerging markets are cyclical high-beta assets, and underperformance in the context of a global growth slowdown is justifiable, particularly when emerging market assets had such a strong run in 2017. Over the past six months, a few countries (i.e. Turkey, Brazil, Argentina) drew attention for the wrong reasons.

So far, the correction in global equities has not been severe when compared to historical precedents, but equities are rightfully readjusting to this late cycle regime. Lower valuations are consistent with our view that rising inflationary pressures and interest rates will serve as headwinds to equities. Analysts still forecast double-digit earnings growth, consistent with the view that the global expansion will continue. Equity returns should remain positive yet increasingly at risk. Meanwhile, bond yields are still below fair value and should continue to gradually rise.

EQUITY MARKET OUTLOOK

United States

Earnings growth is currently very strong in the U.S. This is being fueled by strong economic growth, which we believe will surprise on the upside in the next two quarters before reversing course. Wage inflation and interest rates are starting to have a negative impact on profit margins, but the effect is currently more than offset by the one-time boost coming from tax cuts. The tax-cut effect will continue to be seen in year-over-year earnings figures for the next two quarters. Margins should then resume their downward trend due to the rising costs of labour and debt financing.

The U.S. market (as measured by the S&P 500) is still the most overvalued developed equity market, even if its cyclicallyadjusted P/E ratio has decreased by 6% since its end-of-January peak. We expect the ongoing multiple contraction will continue over the next four quarters. This means that strong earnings growth won't translate one-for-one into strong market returns.

The U.S. continues to face headwinds from valuation and margins—these will limit returns over the next year and for the foreseeable future.

International Equities

Economic growth is decelerating, and should not rebound as vigorously as in the U.S. But it is still expected to stay above potential, continuing to eat away at output gaps. Inflation is still very contained, so central banks can afford to take their time renormalizing monetary policies. This has been the recent message from the European Central Bank. This ongoing easing creates an environment where earnings can continue to grow nicely, albeit at a slower pace than last year, without facing headwinds from the labour and interest rate costs present in the U.S.

On average, P/E ratios in EAFE countries are slightly above our long-term targets, but remain more attractive than the U.S. However, this average masks some disparities between countries. In Europe, the UK, Sweden, Spain and France offer the best value. In Asia, the most attractive markets are Australia, Singapore and Hong Kong. Dividend yields are also attractive at 3.1%, and should contribute substantially to total returns.

EAFE equity markets tend to outperform when the U.S. dollar is gradually appreciating against their own currency, particularly in Japan, the UK and the eurozone. As emerging markets tend to do the opposite, a positive outlook on both EAFE and emerging markets reduces the implicit U.S. dollar risk in the equity strategy.

Canada

Earnings growth is expected to decelerate as economic growth continues to slow, while the base effect from higher commodity prices fades. Margins have little room to increase from current levels in Canada, and sales alone are unlikely to generate over 15% earnings growth, as they did last year.

The S&P/TSX Composite Index currently trades slightly above our estimate of long-term fair value. This is still more attractive than the majority of developed markets, especially when compared to the U.S. Still, we expect that multiples won't continue to overshoot for the next four quarters. The index benefits from a relatively good dividend yield of 2.9%.

Canada's economic growth is decelerating, but is still expected to remain above potential. This is supporting earnings growth despite the headwind coming from increasing rates. High oil prices will continue to support energy companies' earnings. However, now that their profitability has been restored, they don't get the same boost to earnings from expanding margins that they got last year.

Banks' net interest margins have some room to keep expanding, as the interest they pay on deposits won't increase as much as the interest they charge on loans. But this is offset by a slowdown in credit growth, occurring in both consumer credit and mortgage credit.

Overall, the outlook for Canadian equity is mildly positive.

Emerging Markets

China's economic growth is expected to continue to slow gradually, along with credit growth. Given the desire by Chinese officials to promote stability, some form of easing directed at banks is expected (reserve requirement ratio cuts), which could help to offset the economic deceleration. In fact, at the time of this writing, Chinese officials have been verbally signaling this intention.

Apart from China, certain emerging countries have seen their currencies lose ground against the U.S. dollar, and are now tightening their monetary policies to support their currencies and fight inflationary pressures. The good news is that the number of countries forced to hike in order to offset currency weakness is limited.

The valuation gap between emerging markets and the U.S. had started to shrink in Q1 when EM was outperforming, but this trend has reversed during Q2. The valuation discount of emerging markets compared to the U.S. is now at its widest since 2002. Valuation arguments still favour emerging markets versus other major global regions.

The relative performance of emerging vs. developed markets (DM) is well explained by two factors, both of which have recently favoured DM. EM usually outperforms when its growth differential with developed markets is increasing, and when the U.S. dollar is weak. Our economic forecasts indicate a reacceleration of growth in the first half of the forecast horizon in the U.S., coupled with a slowdown in China. So this will continue to act as a headwind for EM. The ongoing USD liquidity squeeze and dollar strength has also led to a period of underperformance. We do not expect much dollar appreciation from here, so the pressure on EM will likely diminish over the forecast horizon.

FIXED INCOME OUTLOOK

Crosscurrents driving global yields

Domestic forces in the U.S., such as an economy operating beyond full employment, large incoming government stimulus and higher oil prices have pushed up U.S. inflation expectations. However, several external factors are acting as potent crosscurrents. The rhetoric surrounding trade protectionism has become louder. In Europe, the Italian political scene took a non-bond market friendly turn following their election, while the trade situation has further deteriorated in Asia. Weakening Chinese cyclical data provided evidence of this, and prompted authorities to cut the required deposit reserve requirements for banks in June. Political turmoil and the spectre of tightening U.S. dollar liquidity have led to instability in several emerging market countries and prompted outflows from EM bonds. All these factors have gradually eroded global confidence and reduced global growth expectations, triggering safe haven bids for developed market bonds and keeping a lid on yields in Q2. While global bond markets sold off in the first half of the second quarter, they rallied decisively to finish the period.

The U.S. 10-year Treasury yield finished the quarter at 2.86% after reaching 3.12% in May.

Nonetheless, at its June meeting the Federal Reserve reaffirmed its intention to raise rates at a pace of one hike per quarter in 2018. Meanwhile, other DM central bankers have shown more restraint in their assessments. The recent soft patch in European economic data forced the ECB to signal a delay for its next rate hike, from the first half to the second half of 2019. Similarly, the Bank of England, still concerned about the developments surrounding Brexit negotiations, passed on the previously expected June rate hike, although three council members dissented.

Going forward, global bond yields should grind higher. Although the global growth outlook has become more uncertain, the steadfast desire to renormalize monetary policy remains intact. As the Fed balance sheet shrinks and the ECB terminates its bond buying program later this year, shrinking demand for sovereign bonds should push bond yields higher.

From both a qualitative and a quantitative perspective, DM bond yields are still expensive (i.e. yields are still too low). As a base case scenario, 10-year sovereign bond yields should reach 3.25% and 2.40%, in the U.S. and Canada respectively, over a twelvemonth horizon. The risk is that mounting global economic and geopolitical risks could serve to keep yields in check.

CURRENCY MARKETS

U.S. Dollar

The US dollar rallied in the second quarter, with a broadbased appreciation of more than 6% on a trade-weighted basis. It is now trading close to the cyclical highs reached in early 2017. From this point on, however, its upside should be limited, given its already-significant overvaluation—what's next for the greenback will depend on a number of things.

The U.S. dollar will likely stay well supported if cyclical divergences between the U.S. and the rest of the world continue. Tight labour market conditions and building costpush pressures leave the Fed no option but to stay on its policy renormalization path. The story is different in the rest of the developed world, where inflation remains dormant and inflation targets are still well out of reach. Under these circumstances, there is no need for a faster pace of policy renormalization outside of the U.S.

The U.S. dollar is also both a primary reserve asset for foreign central banks and, importantly, a preferred currency for global trade and international commerce. For both of these reasons, there is offshore demand for dollars as a store of value and a medium of exchange. The faster the Fed shrinks its balance sheet, the tighter the global U.S. dollar liquidity squeeze, which provides support for the greenback.

Given the forces at work, it is too early to call for a widespread depreciation of the U.S. dollar. Monetary authorities in the rest of the developed world would need to clearly signal the launch of tightening campaigns to push other major developed world currencies decisively higher against the U.S. dollar. In the meantime, the U.S. dollar will likely remain well supported.

Canadian Dollar

Recently, nothing seems to be going right for the Canadian dollar. It is not benefiting as it did previously from rising oil prices. The price of oil is up nearly +14% since the start of the year, but the Canadian dollar is down by more than 6% against the U.S. dollar. This is happening because the Canadian dollar has become less of an oil play. While it still benefits when oil prices rise, higher oil prices have a smaller negative impact on the U.S. dollar. The net impact is less sensitivity in the bilateral exchange rate.

In addition, while the Bank of Canada appears to have recently taken a hawkish turn, it pales in comparison to the recent move by the U.S. Federal Reserve. In terms of policy tightening, the Bank of Canada won't be following in the Fed's footsteps—it will be hiking, but will trail in its delivery pace.

Last but not least, the Canadian dollar is a fundamentallychallenged currency. The stellar performance of the Canadian economy over the last decade has led to a build in external imbalances. Canada has been accumulating current account deficits for nearly a decade, just like in the late 1980s and early 1990s. As a result, Canada's U.S. dollar borrowing needs have increased considerably. The difference between the current situation and the previous one (22 years ago) is, when expressed as a percentage of GDP, the Canadian external debt load currently stands at a record high (35% of GDP). This means that Canada is now more vulnerable than ever to tightening U.S. credit conditions. The more the Fed hikes rates, the bigger the U.S. dollar squeeze and the higher Canada's external debt servicing costs. Just as important, this also means that any U.S. policies aimed at widening Canada's overall trade deficit (or, more specifically, at narrowing its trade surplus with the U.S.) would imply an even greater shortage of U.S. dollars in Canada. In this environment, it is too early to call a bottoming of the Canadian dollar.

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 year end. More than halfway into the year, the euro is trading around 1.16 against the U.S. dollar—pretty much where it traded in late 2017. What happened? 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. As a consequence, the euro's upside seems very limited.

Japanese Yen

As widely expected, the Bank of Japan kept its monetary policy stance unchanged at its policy-setting meeting in June. What's now very clear is that the BOJ's inflation target is well

out of reach. The BOJ has been working with a forecasting range of +1.2% to +1.3% for core CPI inflation (ex-fresh foods) for fiscal year 2018. With core CPI inflation (+0.3% y/y in April and decelerating) still running well below the BOJ's target levels, it will have no other option but to lower its projection over the coming months. The question is whether this will suffice to significantly weaken the Japanese yen. We doubt it.

What is also now very clear is that the BOJ has reached QE policy limits. With inflation well-below target, the BOJ is not buying more securities, but instead substantially slowing the pace at which it is buying them. Despite its official rhetoric, the BOJ is clearly in tapering mode and tapering at an accelerating pace. Yearly increases in excess reserves held at the BOJ have slowed from a peak of nearly ¥80 trillion in early 2017 to ¥32 trillion last May. In light of these developments, the Japanese yen should remain well supported.

COMMODITY INSIGHT

OPEC announced an oil production cut of 1.8 MB/D⁴ in late 2016, but over the last year and a half, production cuts had actually reached 150% of the targeted amount (in total, about 2.7 MB/D). This was partly due to lower oil export volumes from Venezuela, a consequence of that country's social and economic chaos. In addition, the lack of reinvestment in oil projects in other countries added to production declines and lowered overall export volumes.

At the most recent OPEC meeting, member nations announced a commitment to maintain 100% compliance with the 2016 production cut. However, compliance with original cuts will amount to a roughly 1 MB/D production increase beginning July 1, larger than many analysts had expected. Typical estimates were in the range of 600-700,000 barrels/day, as many OPEC nations do not possess adequate capacity to quickly ramp up production. We view the announcement as an overall positive, as it removes some uncertainty and keeps oil markets in balance. Ultimately, we believe oil prices will trade in a range of \$60 to \$70 going forward, allowing oil producers to move ahead with business plans and deliver competitive rates of return. More details are expected in December, when OPEC and non-OPEC nations will meet to further discuss quota and output levels, and review production levels.

Aside from OPEC, key global regions to watch include Iran, as the U.S. pressures European nations and others to purchase crude elsewhere. Geopolitical risk continues to be high in nations such as Libya and Nigeria, where rebel attacks can take production offline. Closer to home, the newly elected Mexican government will need to reinvest in the oil industry. Any reluctance to do so could lead to a continued decline in Mexican oil production. Finally, although U.S. oil production continues to grow, there are pipeline constraints that limit the volumes that can flow from both the West Texas Permian Basin and the Cushing, Oklahoma storage and trading hub. These constraints should be alleviated with new pipeline capacity by the second half of 2019.

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
- Excess reserves held at the Fed
- 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
- · Trade balance
- Electricity consumption
- GDP growth mix (industrial production vs. retail sales vs. services)
- Lending to households and businesses
- North Korea geopolitical tension

Other Market Signposts

- Excess reserves held at the ECB and at the Bank of Japan
- European inflation
- Brexit negotiations
- Italian government coalition
- Global Purchasing Managers' Indices
- U.K. commercial real estate activity

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¹Credit impulse is measured as the change in new credit issued as a percentage of the gross domestic product (GDP).

² Personal consumption expenditures.

³One basis point is equivalent to 0.01%.

⁴MB/D=million barrels/day.