Perspectives

For the period beginning January 1, 2016

U.S. Breaks Away

The U.S. is diverging from the rest of the world in several important ways. U.S. interest rates have started to rise, leaving the U.S. Federal Reserve as the only developed-nation central bank with a tightening bias. Driven by U.S. consumer strength, the Fed assumes that the U.S. economy will be able to cope with the strong appreciation of the greenback, but we are not as upbeat about U.S. prospects. From both a valuation and monetary policy standpoint, other parts of the world offer better opportunities at this juncture.

In any case, the tailwind behind financial markets previously provided by universally accommodative monetary policies could be fading. This will likely result in flatter and more volatile global financial market returns over the next 12 months.

CIBC Asset Management

Current Asset Allocation as at January 1, 2016

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 Versus Equity: Global economic activity points towards sluggish, but positive, earnings growth. We forecast mid-single digit returns for equity markets over the coming year—with equities more attractive than fixed income.

Equity: Increasing uncertainty around monetary policy and continued downside risk in emerging markets indicates that equity outperformance is likely to come with higher volatility. Our overweight in international and emerging markets moves to **moderate** from **significant**.

Fixed Income: With near-zero policy rates in Canada and the U.S., and little further downside in long-term yields, expected returns on fixed income assets should remain in the low single digits.

Currencies: The uncertainty surrounding the currency regime change in China will likely be the dominant theme in the currency market, along with continued volatility in commodity markets.

Expected returns for the 12-month period beginning January 1, 2016	In Canadian Dollars			In Local Currency		
	Global Renormalization	Sluggish Expansion	Policy Limits	Global Renormalization	Sluggish Expansion	Policy Limits
Probabilities	20.0%	50.0%	30.0%	20.0%	50.0%	30.0%
Canada Money Market	0.8%	0.5%	0.2%	0.8%	0.5%	0.3%
Canada Bond	-1.6%	0.9%	3.6%	-1.6%	0.9%	3.6%
Canada Federal Government Bond	-2.8%	0.0%	3.5%	-2.8%	0.0%	3.5%
Canada Corporate Bond	1.5%	2.2%	2.2%	1.5%	2.2%	2.2%
Canada Real Return Bonds	0.9%	-0.7%	11.3%	0.9%	-0.7%	11.3%
Canada High-Yield Bond	14.7%	7.9%	-1.9%	14.7%	7.9%	-1.9%
International Government Bond	-10.7%	3.2%	17.3%	-1.3%	0.5%	4.2%
Canada Equity	11.4%	5.3%	-16.9%	11.4%	5.3%	-16.9%
United States Equity	-2.7%	4.5%	-10.2%	8.2%	2.6%	-16.8%
International Equity	3.5%	8.8%	-4.2%	12.6%	6.8%	-14.8%
Emerging Equity	14.2%	5.2%	-15.0%	17.4%	6.6%	-17.2%

Source: CIBC Asset Management Inc.

Global Outlook

A **sluggish global economic expansion** remains our central scenario, with a below-consensus global growth expectation around 3.1%. The continuing recovery in developed markets will continue to offset a slowdown in some emerging economies, particularly China and Brazil. The U.S. consumer should remain the strongest segment of the global economy, while the manufacturing and industrial segments of the Chinese economy will continue their necessary deleveraging. The uncertainty resides in the degree to which the manufacturing weakness can spill over to the service side of the global economy and produce a weaker outcome. We account for some of this spillover risk in our below-consensus global growth view as well as our benign outlook for the U.S. Federal Reserve (Fed) renormalization. A small positive is that, for the first time in quite a while, fiscal policies should support global growth—this represents an interesting change in the policy mix. Fiscal policies will ease across the major economic areas. The fiscal expansion in the U.S. and Japan could be in the neighbourhood of 0.2%. A larger 0.3-0.4% fiscal boost in the euro area is also possible, while China's fiscal initiatives could also support growth, according to various estimates. While not extravagant, this additional stimulus should help at a time when monetary policy may become less effective.

On the inflation front, the negative impact of the oil price drop should dissipate from headline inflation numbers as the decline will likely moderate over the coming months. Core inflation should increase as the global economy's sluggish expansion continues to remove excess capacity. In particular, wage growth should continue to improve modestly in the U.S. and Japan, supporting long-term inflationary pressures from a low base. Meanwhile, high unemployment in Europe should keep wage pressure dormant for a while longer. Global inflation is expected to pose no obstacle to continued easy monetary policy over the next 12 months in most regions, with the possible exception of the U.S. We are maintaining our 50% probability that a sluggish economic expansion will continue over the coming 12 months.

Fixed Income Versus Equity

Less Central Bank Support = Flatter Returns?

It was an unusually active and divergent year for central bank policy-making in 2015. The tone was set at the start of the year with the introduction of negative rates and quantitative easing by the ECB, helping to push European equities to new highs and European interest rates even further into negative territory. In the U.S., the year finished with the Fed officially ending its own zero-interest-rate policy. Facing these divergent policies as well as declining commodity prices, equity markets experienced increased volatility in the fourth quarter and produced uninspiring returns. Looking forward, we see the Fed embarking on a renormalization of monetary policy, and other central banks arguably approaching unconventional monetary policy limits. The tailwind behind financial markets

Alternative Scenarios

Policy Limits

In this scenario, we evaluate the risks and impact of central banks reaching the limits of unconventional monetary policies. Our concern in this scenario is that some central banks—first and foremost the Bank of Japan (BOJ), the Swiss National Bank (SNB) and, to a lesser extent, the European Central Bank (ECB)—may reach institutional and/or political boundaries. These could limit the use of unconventional policies like asset purchase programs, which have been instrumental in supporting the economic recovery and asset markets. A growing body of research shows that there are limits to the use of unconventional policies and that these limits could be approaching. The BOJ could see its ability to buy Japanese Government bonds diminish rapidly over the coming one to two years. The SNB foreign currency intervention already represents a sizable portion of its GDP, running the risk of large fiscal deficits. The ECB could reach the limits of acceptable negative interest rates, estimated to be around -0.75%. Large negative interest rates could motivate investors to pull money out of the financial system, creating a liquidity run on the banking system and a loss of monetary policy effectiveness.

At the heart of this scenario is the inability of central banks to address an economic relapse—no additional tools would be available to stimulate growth. The sudden loss of effectiveness of these unconventional policies may create financial market volatility as investors disengage from markets due to declining central bank credibility. Our new "**policy limits**" scenario has an estimated probability of 30% to reflect this growing risk.

Global Renormalization

A more positive scenario could come from stronger-than-expected benefits related to energy price declines and a stronger-than-expected U.S. recovery. This could lead to more robust global consumer spending, as consumers could spend most of the savings from lower energy costs instead of reducing their debt or saving more. A stronger U.S. recovery would also help a global recovery through stronger export growth. In addition, the end of deleveraging by European banks could foster better lending activity and increased consumption in the eurozone and lead to a stronger-than-expected global economic recovery. A gradual improvement in European lending is slowly surfacing. This scenario would bring renormalization of monetary policies sooner than expected. Higher interest rates would not impede higher equity markets as earnings would provide a positive surprise, supporting equity market valuation. We estimate the probability of this positive **global renormalization** scenario at 20%.

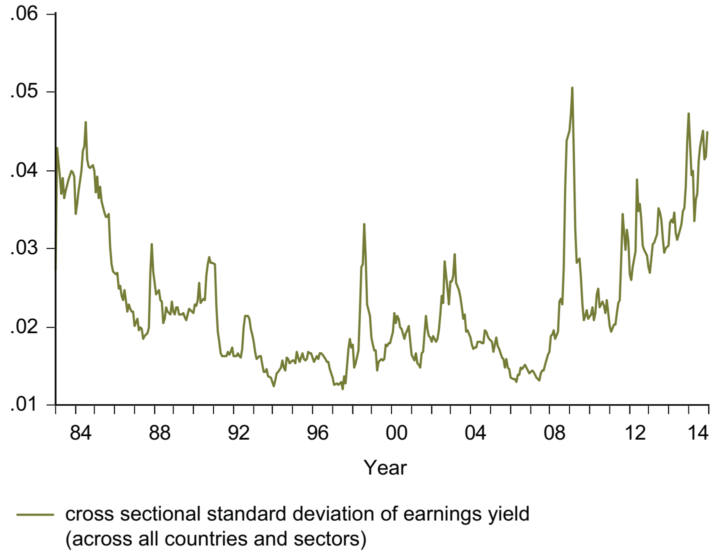
previously provided by universally accomodative monetary policies could be fading, resulting in flatter and more volatile financial market returns.

With near-zero policy rates in Canada and the U.S. and little further downside in long-term yields (see fixed income section), expected returns on fixed income assets should remain in the low single digits. Meanwhile, a cross section of valuation ratios towards year-end 2015 indicates global equities are trading around fair valuation. However, this represents an average, and masks a wide distribution around this average valuation. For example, equity markets and sectors experiencing strong and stable earnings growth come at a hefty valuation premium. In contrast, markets and sectors with poor earnings momentum are very cheap, leaving investors with very difficult choices. With less central bank policy support, equities are unlikely to gain from expanding valuations, leaving earnings as the only growth engine for equity market returns. Given that our forecasts for global economic activity point towards sluggish, but positive, earnings growth, we forecast mid-single digit returns for equity markets over the coming year—with equities mildly more attractive than fixed income. However, with increasing uncertainty around monetary policy and continued downside risk in emerging markets, equity outperformance is likely to come with higher volatility.

Global Equity Valuation

Source: CIBC Asset Management

Global Equity Valuation Dispersion



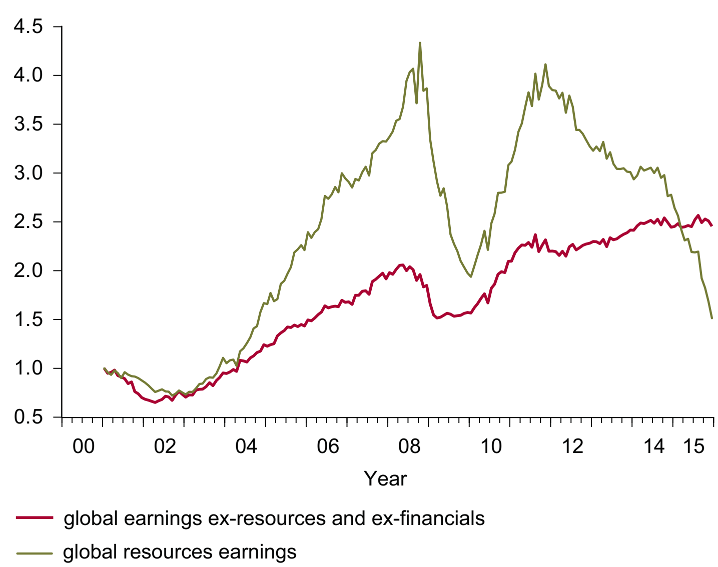
Source: CIBC Asset Management

Equity Market Outlook

Not Yet Time To Be A Contrarian

The commodity boom-bust cycle continues to wreak havoc on global markets. The wide valuation dispersion in equities is in large part due to resource versus non-resource sectors. The resource sectors (energy, materials, minerals, etc.) are cheap, with depressed earnings; non-resource sectors, particularly the consumer sectors, are expensive, with peaking earnings. With commodity prices still falling, it will be difficult to pinpoint the exact bottom between these main sectors. Given our central scenario of sluggish growth, valuation dispersion might get wider before we see the gap between these sectors reversing. But at some point these market dislocations will trigger a response that could mark the beginning of a period of strong performance from the beaten-down sectors. Given our view that commodity prices could reach lower levels before recovering, we remain neutral on the Canadian equity market for the moment.

Global Earnings



Source: CIBC Asset Management

Emerging market(EM) equities have faced headwinds from slower growth in China, weak commodity prices and expectations of rising U.S. rates. The resulting underperformance leaves them with very attractive valuations. Based on our long-term return forecasts, emerging markets represent one of the most attractive asset classes. As their currencies depreciate, EM companies grow more competitive and earnings should improve. Meanwhile, EM real rates have declined just as they start to rise in the developed world. Relative to other regions, emerging countries have seen a significant improvement in their monetary conditions. At this point, we need the growth outlook to stabilize, especially in China, to see an improvement in the relative performance of EM equities. But patient investors following a valuation discipline should be rewarded over the medium-to-long term and should remain overweight.

In many respects, the U.S. equity market faces a different set of circumstances than EM. U.S. stocks are among the most overvalued. From a cyclical perspective, U.S. companies must cope with a strengthening U.S. dollar and a Federal Reserve that is expected to raise interest rates, pushing financing costs higher. We continue to expect the U.S. market will offer the least attractive prospects over the coming year, and it remains our least-favoured market. Meanwhile, international equity markets fall between the previous two groups. On one hand, they are neither cheap nor expensive, but they continue to benefit from a very accomodative monetary policy stance. They are also seeing profit growth improve at the margin, which leaves them overweight in our regional strategy.

Commodity Insight

The past few years have seen some of the biggest changes to the crude oil market in history. Arguably, the biggest change was the introduction of technology that permitted the economic development of North American shale oil. The application of horizontal drilling and fracture stimulation reversed a multi-decade trend of declining North American oil production. By doing so, it created challenges to the one industry that is the buyer of crude—the refiners. The recent introduction of legislation by the U.S. Congress to eliminate the U.S. crude export ban can find its roots in this newfound supply.

Crude oil comes in many forms and is graded by industry participants based on the crude slates characteristics, sweet to sour and light to heavy. The distinction of the type of crude is critical for the refining industry, where plants and equipment are designed to process a specific crude slate or grade. The Nelson Index ranks refineries on their ability to handle complex crudes like the heavy sour crudes produced by the Canadian oil sands. The higher the ranking, the more sophisticated the refinery and the better the ability to handle low-quality crudes.

During the early 2000s, large investments were made by the North American industry to increase refiners' ability to handle heavy sour crudes. These poor-quality crudes were expected to be the most abundant in North America, given the growth of Canadian oil sands production.

The investments were completed just as production of light sweet crude from shale started to accelerate. As such, a dislocation between the crude quality available in the domestic market and refinery capability to process it started to form. The industry had developed refineries that could not process the fast-growing, light sweet production. Without the ability to export the new shale oil production, inventories would grow. This was becoming a large concern to market participants, given the growing inventory of light sweet crudes at Cushing, Oklahoma, the home of the WTI (West Texas Intermediate) benchmark. The sweet crude inventories have been building, even as the U.S. continues to import heavy crudes to process in the highly-complex, domestic refining system.

Without the ability to export crude from the U.S., light sweet inventories would continue to build until storage capacity was exceeded. This would sometimes result in domestic discounts to global prices for the same quality crude, disadvantaging the domestic producers of this commodity.

The removal of the crude export ban will alleviate artificial pricing distortions and the bottleneck in the U.S. system. In fact, producers such as ConocoPhillips and Enterprise Products were preparing the first tankers of American crude for export at the turn of the year—marking the start of a new era. U.S. oil producers can now look forward to unhindered access to the global markets and a price that is determined by free markets.

Fixed Income Outlook

Growing Divergence

- **In light of the contrasting outlook between the U.S. and Canadian economies, we are now penciling in a 12-month target of 2.50% for U.S. 10-year Treasuries and 1.50% for the Canadian equivalent.**
- **We expect the U.S. Federal Reserve will remain the only central bank in developed countries with a tightening bias. This will contribute to the challenge for the U.S. to renormalize monetary policy.**

Over the past year, our more constructive view on fixed income versus market consensus proved to be justified. The U.S. renormalization process was delayed by developments abroad, while ongoing weakness in oil prices continued to be a drag on the Canadian economy. The U.S. Federal Reserve has now officially marked the beginning of its journey towards normal monetary policy by implementing its first rate hike in more than nine years. Should we expect this to be the beginning of a prolonged bear market for bonds?

Our assessment of the world economy over the next 12 months suggests only marginally higher yields in the U.S. and virtually unchanged yields in Canada. In Canada, we see persistent domestic weakness and a slower normalization process than is currently priced in by market consensus, despite ongoing improvements south of the border. Here are some of the factors contributing to our view:

The quantitative easing of both the BOJ and the ECB should, at minimum, provide a ceiling to rising yields in these economies. These two major central banks are well advanced in the use of non-conventional monetary policies. However, the Bank of China is far from the zero-interest-rate boundary and has more leeway to ease monetary policy and keep interest rates low. China's actions should also create a ripple effect for other Asian countries as they try to remain competitive vis-à-vis the region's powerhouse.

Lower energy and commodity prices should also contribute to keeping yield increases in check. While the impact will be obvious in Canada, it could also indirectly force the Fed to be patient to avoid triggering a crisis led by commodity-driven emerging countries.

Another consideration in assessing the direction of bond yields in the next year is the implicit tightening that has already occurred through the rise of corporate yield premiums over government securities. Corporations at the lower end of the credit quality spectrum have seen their financing conditions deteriorate substantially. Further action by the Fed could be a tipping point unless improvements are made on the business side.

Under these circumstances, we believe that fixed income securities, whether governments, agencies or higher-quality corporates should provide a decent level of return and protection through this challenging period.

Currency Markets

U.S. Dollar

The U.S. dollar remained strong in 2015 on the back of widening monetary policy divergence between the Fed and other central banks. As the Fed prepared to hike rates, almost all other central bankers either maintained ultra-easy monetary policy or deployed efforts to further ease policy. Against this backdrop, the U.S. dollar uptrend was not seriously challenged.

Looking forward to 2016, the U.S. dollar outlook will be more complicated. While the Fed has delivered its first rate hike, it is not clear whether the U.S. economy can cope with the ongoing U.S. dollar strength. The side effects are already apparent. The U.S. ex-energy trade deficit recently reached record highs and will likely widen further. As a consequence, activity in U.S. goods-producing industries has slowed substantially and the risk of spill-over effects to service-providing industries has been rising. In the past, foreign exchange developments played a negligible role in setting the Fed's monetary policy stance. When domestic conditions justified hiking interest rates, the Fed did not shy away because of the potential impact of its policy decision on the U.S. dollar. However, the current situation could be different. While some of the economic effects of U.S dollar strength may be transient and prone to fade, the greenback's strength is likely to be more moderate and more selective in 2016 than the broad advance witnessed in 2015. This is particularly true in an environment where even China will be less inclined to let its currency appreciate, particularly against the greenback.

Canadian Dollar

In December, Bank of Canada (BoC) governor Poloz delivered a speech in which he felt obliged to elaborate on the policy options left in the BoC's toolbox. He concluded that, hopefully, the BoC will not need them. In reality, he won't have to take additional steps if Canadian dollar weakness sufficiently cushions the economic downturn. Unfortunately, so far this has not been the case. Contrary to the BoC's expectations, the oil shock isn't fading but deepening instead. In our opinion, this dire economic reality points to further Canadian dollar weakness over the shorter term. The Canadian dollar will likely sink below $0.70 US owing to the oil-driven terms of trade shock and widening Canadian-U.S. monetary policy differentials.

For the longer term, it is too early to envisage a consolidation for the USDCAD bilateral exchange rate. The cyclical downtrend initiated two years ago should remain because of developments on the oil front as well as deteriorating domestic economic conditions in Canada.

Euro

Interest rates differentials and, more broadly, monetary policy divergence, were the main drivers of the euro/U.S. dollar exchange rate in 2015 and led to a sharp euro correction. While consensus seems to expect more of the same for 2016, we hold a more balanced outlook. First, now that the euro deposit facility rate has dropped to -0.30%, the potential for further rate cuts appears more constrained. Second, the EURUSD bilateral exchange rate is already undervalued and a move deeper into that territory could be more limited.

Based on our valuation metrics, the euro is already undervalued by roughly -16% against the U.S. dollar. In addition, our fair value estimate has been trending higher owing to relative prices and relative terms of trade.

In the early 2000s, the euro became undervalued by -30% against the greenback. However, a move that deep into undervalued territory is currently not as well supported. In the early 2000s, the eurozone's current account deficit was reaching record proportions, amounting to -2.7% of GDP. The opposite is now taking place, as the eurozone enjoys a wide current account surplus that recently reached record highs (+2.9% of GDP).

Japanese Yen

At first, the Bank of Japan's (BOJ) Quantitative & Qualitative Easing policy (QQE) was a very successful operation. It capped borrowing costs, triggered yen weakness and ignited the Japanese equity market. Unfortunately, three years later, QQE objectives remain out of reach and the limits of the BOJ's QQE policy are within sight.

Indeed, inflation remains a long way from the BOJ's 2% objective, and the yen's deep undervaluation has failed to boost Japanese exports. Despite the yen's freefall, Japan's non-energy trade surplus is not widening. This is essentially owing to weakness in Chinese demand. It's not just that Japanese exports to China aren't picking up—even worse, growth in Japanese exports to China is now in negative territory.

This is problematic for Japanese authorities because a sizable increase in net exports is required to more than offset the hit from the tax hike on domestic demand and avoid a recession. In short, Japan's fiscal and monetary credibility are now on the line. Japan has the heaviest government debt load of the developed world (246% of GDP). China's currency regime change (see below) also decreases the likelihood of further yen depreciation.

Chinese Renminbi

A milestone in international currency markets was reached in Q4 of 2015 when the renminbi (RMB), or yuan, was voted for inclusion in the IMF's Special Drawing Rights (SDR) currency basket (effective October 2016). This provides sufficient time for central banks and financial markets to adjust to this change. The yuan will receive a 10.92% weighting in the basket, the third largest weight. The inclusion of the Chinese yuan makes it the fifth currency to form part of the IMF's SDR basket since inception. It joins a privileged group, which should lead to growing demand for RMB-denominated assets by foreign central banks, sovereign wealth funds and institutional investors.

In addition, Chinese officials have indicated that the RMB is entering a new currency regime. A shift is now underway in the method of assessing RMB exchange rate movements—moving away from a bilateral focus on the RMB/USD cross to a multilateral focus on a basket of currencies. This is being promoted as a better way to capture changes in competitiveness, and will provide a more comprehensive way to assess market conditions for the currency. With these changes, we expect increased volatility for the USD/RMB cross rate, which will be increasingly market driven. In this period of policy rate divergence between China and the U.S., we expect the U.S. dollar to strengthen moderately against the RMB in the first half of 2016.

At this early stage, China's policy intentions remain unclear. How much will it be willing to let the currency float and potentially depreciate, how much capital outflow could it generate and how much will it be willing to deplete its foreign exchange reserves to prevent depreciation?

Regional Outlook
Canada

- **2015 was not a good year for Canadian growth and 2016 is unlikely to be much better.**
- **Real GDP growth is likely to disappoint again in 2016, ending closer to +1.5% than the +2.0% that is widely expected.**
- **The Bank of Canada will likely be forced to cut rates further and start a debate about the eventual need for unorthodox monetary policy instruments.**

2015 won't go down as a very good year for Canadian economic growth. Severely hit by the oil shock, Canada's growth downshifted all year from a respectable +2.5% in late 2014 to a complete halt in September 2015. This is the lowest real GDP yearly growth rate in nearly six years. Despite this setback, most forecasters—including Bank of Canada staff—remain upbeat about 2016. They are calling for a solid reacceleration in growth throughout the year, taking forecasts all the way back to +2.0% by late 2016. We dare to be different, calling for more modest growth (+1.5%).

In our U.S. analysis, we concluded that the main risk in 2016 is the apparent slowdown in U.S. goods-producing industries that could be big enough to spill over to the service-providing industries. Unfortunately, exactly the same developments are taking place in Canada, with one important nuance—the overall slowdown in Canadian economic activity is much more pronounced. As in the U.S., the slowdown is mostly concentrated in goods-producing industries. Of course, the oil shock is largely to blame (-7.0% yearly contraction in the energy sector), but there is a lot more to the story. Canadian manufacturing is now also in contraction (-0.86% vs. +3.0% just a year ago). In addition, construction activity is declining at a -3.0% yearly rate. In short, 26% of the economy virtually qualifies as being "in recession" (i.e. in contraction for six months or more).

At this juncture, what is really concerning is that spillover effects to the service-providing sector are clearly becoming apparent. Indeed, growth in Canadian service-providing industries has substantially slowed over the last year—from +2.4% a year ago to +1.4% last September.

The bottom line is that the Canadian economy has already slowed to levels that are very much in line with our below-consensus forecast. The risk is for continued weakness in 2016, forcing the BoC to cut rates further and start a debate about the eventual need for unorthodox monetary policy instruments—negative policy rates and quantitative easing (QE). The BoC has already started to prudently prepare for this eventuality. In early December, Governor Poloz delivered a speech on the tools left in the BoC toolbox, concluding that he hopes it won't be necessary to use them. He is probably right, but it seems odd that he feels the need to review the Bank's policy-easing options at this juncture. One explanation is that the Governor and his staff are slowly realizing that the Canadian dollar weakness experienced so far has not cushioned the economic downturn as expected. This implies that further Canadian dollar weakness may be required to finally get the long-awaited boost from non-energy exports.

United States

- **We believe that the Federal Reserve and most private-sector forecasters are underestimating the slowdown in the goods-producing sector as well as the potential contagion to the service-providing sector. We are working with a lower-than-consensus real GDP growth projection of +2.0%.**
- **Under these conditions, the Federal Reserve will have to stay vigilant and prudent. The next rate hikes will likely be delivered at a slower pace than generally expected.**

For the third year in a row, the U.S. economy is ending the year on a weaker note than the Federal Reserve predicted at the end of 2014. So far in 2015, real GDP has grown at a yearly rate of 2.1% versus year-ago Fed expectations of +2.8%. While slower-than-expected economic growth did not stop the Fed from hiking rates in December, it will certainly keep it on its toes in 2016.

The Fed went ahead and delivered its first rate hike in nearly 10 years on the assumption that the U.S. economy will be able to cope with the strong appreciation of the U.S. dollar. This also assumes that the damage already apparent in goods-producing industries will prove transitory, with no spillover effects on services-producing sectors. With these assumptions, the Fed remains upbeat, expecting a mild growth reacceleration next year to +2.4%.

Working with a lower-than-consensus real GDP growth projection (+2.0%), we believe that the Fed and most private-sector forecasters are underestimating the slowdown in the goods-producing sector as well as the potential contagion to the services sector. The contribution to GDP growth from the goods-producing sector has already dropped to its lowest level since the 2008 recession (from +1.58% a year ago to +0.26% in Q3 2015). What's more, this sharp growth deceleration has been widespread across most goods-producing sectors (i.e. mining, utilities, manufacturing, agriculture, wholesale trade). So far, this drag has been more than offset by solid growth in the services sector and the consensus view seems to be that this will remain a key feature next year.

Our assessment is that the risk of a spillover from the goods sector to the services sector is higher than generally perceived. For one thing, the goods-producing sector now accounts for a much larger share of overall U.S. GDP. For another, while past recessions in goods-producing industries have never lead to recessions in service industries, they have always translated into significantly slower activity in services. If U.S. goods-producing industries fall into recession, one cannot assume that growth in services would stay strong. This implies a drop in overall GDP growth closer to 2.0%. Needless to say, in such a scenario the Fed's tightening campaign would be slower than current market consensus.

At this juncture, there is little evidence to suggest that the slowdown in real economic activity in the goods-producing sector is turning into a recession. However, the risk remains elevated, implying that the Fed will stay prudent and vigilant. The next rate hikes will likely be delivered at a slower pace than generally expected.

Europe

Challenging Times for the ECB

- **Our forecast for average eurozone 2016 real GDP growth (+1.4%) remains below consensus, owing to sluggish net exports and structural weakness in investment spending.**
- **The risk of deflation will remain elevated, keeping the ECB in easing mode for several years.**
- **With very little room for additional rate cuts, the ECB will stick to its asset purchasing program for much longer than generally expected.**

For the European Central Bank (ECB), 2015 was likely a disappointment. Determined to eliminate deflationary pressures and jumpstart the moribund eurozone economy, European monetary authorities launched a very ambitious asset purchase program early in the year and moved its deposit facility rate to negative territory. The market response was initially very promising—European bond markets rallied, reaching historically low yields. This translated into lower borrowing costs and equity markets roared ahead while the euro weakened substantially.

Unfortunately, enthusiasm soon waned when market participants began to realize that the colossal efforts deployed by the ECB would not bring inflation back to the system. More unorthodox policy easing would be required. The problem is not that the eurozone economy hasn't benefited from ECB policy—it has. The eurozone economy is doing better than the ECB expected a year ago. Thanks to a stronger recovery in domestic demand, eurozone real GDP growth is running at +1.9%. This is much better than the ECB had penciled in for 2015 (+1.0%) when it presented its growth forecast in late December 2014.

The problem for ECB President Draghi and his colleagues is that inflation refuses to follow the ECB script. HICP (Harmonised Index of Consumer Prices) inflation in the eurozone is running at only +0.1%. That is well below the inflation levels projected by European monetary authorities one year ago. This is a concern because the longer that CPI flirts with this level of deflation, the harder it will be for the ECB to keep long-term inflation expectations well-anchored. The official projection is for inflation to accelerate to target by 2017. The reality, however, is that the ECB will likely once again miss its inflation target by a wide margin in 2016. Our 2016 forecast stands at +0.4% vs. +1.0% for the ECB. More importantly, wide excess capacity conditions are not projected to be eliminated before 2019. In other words, for the next three years, the risk of deflation will remain elevated, keeping the ECB in easing mode.

At this juncture, however, more and more pundits are questioning the ECB's ability to further ease monetary policy. With the ECB's deposit facility rate now at -0.3%, the potential for further rate cuts seems very limited. Central banks have been able to set negative interest rates to some limited degree owing to the cost of storing physical cash and the administrative inconvenience for corporations and individual savers to hold physical cash. There is a significant amount of uncertainty about exactly where the limit to negative rates lies. However, the external research "consensus" seems to be that a deposit rate set at -0.5% to -0.75% may begin to produce significant transfers of reserve balances into physical cash. The ECB definitely doesn't want to face such a scenario.

The only option left is for the ECB to stick to asset purchases for longer than initially planned. This is precisely what the ECB plans to do, as announced at its last policy-setting meeting. While this will likely help keep borrowing costs low across the eurozone, it is much less obvious that this will suffice to further weaken the euro. All in all, 2016 is shaping up to be a more challenging year for the ECB than 2015.

China

- **The Chinese economy will likely experience further growth deceleration in 2016.**

- **Inflation will likely stabilize at levels well below the central bank target, which should require continued monetary and fiscal policy support from Chinese authorities.**

Uncertainty around the Chinese economy will dominate 2016. Indicators of economic activity point to divergences for growth expectations between major sectors. The service sector is leading the growth outlook while manufacturing and construction continue to show signs of soft growth.

The government is targeting minimum real GDP growth of 6.5% in 2016. To meet this target, the economy will need to see a continued rise in residential property sales to help lower high property inventories. Reduced housing inventories should eventually lead to a rebound in housing starts and help provide support to the overall economy. Given the strength in sales activity in the second half of 2015, we expect housing starts to improve in the first half of 2016. However, a rebound could take longer than expected due to elevated inventory levels.

Another key factor that could impact the growth objective is an improvement in demand for Chinese exports. Given our expectations for global growth (around +3.1%), 2016 will be another year of relatively slow growth, likely resulting in lacklustre export dynamics. This leaves fiscal spending as the main source of support for increased output in 2016. We expect the fiscal deficit to increase by 0.5%, to -2.8% of GDP.

Inflation dynamics should begin to change in 2016 as consumer price inflation stabilizes. This will be driven by reduced drag in energy prices, in combination with somewhat stronger food price appreciation. We expect total CPI to move towards 2% from the current rate of 1.5%, a level that remains historically low and below the 3% CPI target. Core inflation should remain relatively unchanged at 1.5%. The price contraction in producer prices is also expected to slow as the negative impact of energy prices begins to fade. This being said, the challenges from overcapacity remain and will continue to weigh on producer prices in 2016. The slowing growth and low inflation environment will support the continued accommodative monetary policy of the Chinese central bank. We expect the combination of further rate cuts and reductions in the reserve requirement ratio to support the economy in several ways. It will provide a lower cost of debt financing and give the financial system sufficient liquidity flexibility to accommodate continued lending.

Signposts

Economic indicators that will help us determine if our **sluggish expansion** scenario is occurring as expected:

Canadian Signposts

- Housing activity and property prices
- Employment growth
- Oil impact on trade balance (energy vs. non-energy)

U.S. Signposts

- Underemployment (decline in U6 measure) and wage growth (ECI)
- Manufacturing vs. non-manufacturing (relative strength or weakness)
- Core PCE inflationary pressures (pass-through from U.S. dollar strength and oil price decline)
- Domestic oil production decline
- New export orders (assess impact of strong U.S. dollar)
- Existing home sales and housing starts

Chinese Signposts

- Housing sales, prices and housing starts
- GDP growth mix
  (industrial production vs. retail sales vs. services)
- Lending to households and businesses
- Fiscal and monetary policy initiatives

Other Market Signposts

- Japanese labour market wage growth
- Bank of Japan monetary policy guidance
- European bank lending surveys
- European Purchasing Managers' Indices
- Monetary policies in Turkey and Brazil to control inflation
- Improving European job creation
- U.K. wage growth
- U.K. referendum on EU