Perspectives

For the period beginning July 1, 2016

BREXIT AND BEYOND

The political and economic implications of the U.K. exit from the European Union are difficult to assess at this early stage. What we do know—there are more uncertainties and risks today than if the *Remain* vote had won.

Increased uncertainty and market volatility are the last things the fragile global economy needs when the cyclical outlook is not improving. Slower global growth seems inevitable for many reasons including: the need to slow credit growth in China, increasing pressure on the profitability of European banks and a profit recession in the U.S.

CIBC Asset Management

Asset Allocation Outlook as at July 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: We are adopting a more neutral stance between equity and fixed income for the time being to reflect the various global economic and political uncertainties.

Equity: Declining profit margins in developed nations combined with currency issues that impact global competitiveness are clouding the outlook for equities.

Fixed Income: Bonds are likely to remain well supported. Corporate bonds are expected to outperform due to their higher running yield as the global search for yield continues.

Currencies: The Canadian dollar is expected to start losing steam and give up some of its recent gains against the U.S. dollar.

Expected returns for the 12-month period beginning July 1, 2016	In Canadian Dollars			In Local Currency		
	U.S. Renormalization	Policy Limits	Global Recession	U.S. Renormalization	Policy Limits	Global Recession
Probabilities	15.0%	65.0%	20.0%	15.0%	65.0%	20.0%
Canada Money Market	0.6%	0.5%	0.2%	0.6%	0.5%	0.2%
Canada Bond	-1.0%	1.4%	2.8%	-1.0%	1.4%	2.8%
Canada Federal Government Bond	-2.3%	0.4%	3.2%	-2.3%	0.4%	3.2%
Canada Corporate Bond	1.7%	2.4%	1.3%	1.7%	2.4%	1.3%
Canada Real Return Bonds	-1.7%	2.5%	9.3%	-1.7%	2.5%	9.3%
Canada High-Yield Bond	9.0%	4.0%	-8.3%	9.0%	4.0%	-8.3%
International Government Bond	-9.7%	2.3%	12.4%	-4.0%	-0.5%	0.7%
Canada Equity	10.7%	1.0%	-19.3%	10.7%	1.0%	-19.3%
United States Equity	2.9%	1.4%	-6.6%	6.9%	-1.7%	-16.4%
International Equity	6.2%	1.8%	-17.8%	10.9%	0.8%	-23.5%
Emerging Equity	15.8%	4.1%	-13.6%	16.0%	6.3%	-16.5%

Source: CIBC Asset Management Inc.

Global Outlook

Policy Limits

For the last five years, our main global economic scenario was a "sluggish global economic expansion". In that scenario, the world economy continued to grow at an unusually slow pace, despite the colossal efforts deployed by global monetary authorities. Unfortunately, we have now reached the point in the global cycle where this description no longer fits.

The scenario that now best describes the forces shaping the global economic landscape is what we are calling ***Policy Limits***. We are giving this scenario a 65% probability. The harsh reality is that major central banks, as a whole, have very little leeway left in terms of additional policy easing without generating negative side effects. In most countries, interest rates are already ultra-low across the maturity spectrum. After more than six years of economic expansion, global deflationary headwinds are still persistently present. Much to the regret of global policymakers, inflation never staged the wished-for comeback. This leaves policymakers in a bind in the advent of an eventual slowdown in global growth and, unfortunately, a global growth slowdown is most likely what lies ahead.

For the next twelve months (June 2016 to June 2017), our global growth forecast now stands at 3.0%—our lowest global growth projection since the great recession of 2008. Slower global growth seems inevitable for many reasons. For one thing, Chinese monetary authorities have little choice but to slow credit growth further to avoid having debt spiral out of control. But closing the liquidity tap is not without consequences for the Chinese economy: it produces a direct hit on domestic growth. In turn, weakening demand from China will continue to hurt its trading partners in the rest of Asia.

In addition, the outlook for the eurozone economy is also darkening. In Europe, unwanted side effects of European Central Bank (ECB) sub-zero interest rate policy are becoming increasingly apparent. Across the eurozone, the pressure on banks' profitability is intensifying as yields continue to decline and yield curves flatten. Traditionally, this area was an important source of profit for the banking industry. The ECB is crossing its fingers that its new TLTRO II lending scheme (effective this past June) will help to alleviate the pressure. However, it is not at all clear that this will do the trick.

Finally, the U.S. economy is on less solid footing than most pundits believe. The U.S. economy is experiencing a profit recession and, with profit margins under pressure, U.S. corporations have been hesitant to invest. The U.S. Federal Reserve (Fed) policy actions are not helping. The more the Fed talks about additional monetary policy tightening, the stronger the U.S. dollar becomes and the greater the hit on corporate profitability.

Shifting the highest probability to the ***Policy Limits*** scenario has implications for strategy. Under such adverse global conditions, our representative asset mix is now neutral in equities and neutral in bonds.

The risks to our main scenario are further to the downside. The biggest risk is that the projected global slowdown turns into a full-blown recession. We are putting 20% probability on this more adverse outcome.

Alternative Scenarios

Global Recession

Under this scenario, the world economy slows more than projected in the baseline scenario, making it difficult to avoid a global recession. This unfortunate turn of events would take place because of a downshift into lower gear by the world's two growth engines: the United States and China. Already coping with a profit recession, U.S. nonfinancial corporations would be even harder hit moving into the next twelve months—mainly owing to the unprecedented strength of the U.S. dollar and weaker growth abroad. The hit on profitability would be severe enough to force corporate America to lay off workers and cap wage increases: the perfect recipe to produce a retrenchement in consumer spending. Under such conditions, the Fed would be forced to rapidly abandon its plans to tighten policy and start planning steps to cushion the downturn and limit U.S. dollar appreciation.

If the world economy slowed too much, global debt dynamics would likely become a bigger burden to support. Given the global debt overhang, global growth is necessary. This is particularly problematic in the context of an aging world population, which acts as a structural drag on global growth.

Country-wise, it is in China that rapid debt accumulation is most worrisome. In this scenario, Chinese credit and investment growth slows more than projected in the baseline scenario, despite the efforts deployed by monetary authorities in China. In turn, the weakness in credit and investment spills over to the Chinese consumer and to the rest of Asia.

U.S. 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 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. Even now, a gradual improvement in European lending is slowly surfacing.

This scenario would bring continued renormalization of U.S. 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 have limited this renormalization to the U.S. economy only. Recent signs of weakness in the Japanese and European economies and ample slack in their labour markets are unlikely to trigger a renormalization of monetary policy outside the U.S. At the same time, we have reduced the probability of this positive U.S. renormalization scenario to 15%.

Fixed Income Versus Equity

Navigating turbulent waters

After a volatile first quarter, markets calmed down and moved into a wait-and-see mode. The vote on Brexit, the U.S. presidential election and the Fed policy decisions were top-of-mind for investors. That was until June 23, the day of the U.K. referendum. On that day, the U.K. voted to leave the European Union. This outcome was a shock, and markets reacted accordingly with a correction in risky markets (equities, commodities and high-yield bonds were lower), a rally in safe assets (government bonds, gold, the U.S. dollar and the yen were up strongly) and a general increase in volatility. However, what's most important for investors is not the immediate or short-term market reactions to this unforeseen turn of events, but its longer-term implications in the context of the underlying global economic outlook.

The political implications of the U.K. leaving the European Union are difficult to assess, as the process will be subject to long and complicated negotiations. One thing we know for certain however, and this is one of the most important implications for financial markets—there are more uncertainties and risks today than if the *Remain* vote had won. Increased uncertainty and market volatility are the last things the global economy needs. The global economy remains fragile and the cyclical outlook is not improving. Faced with profit margins under pressure and lackluster sales growth, and now political instability in Europe, corporate leaders are likely to think twice before hiring or investing. Earnings growth will likely remain subpar.

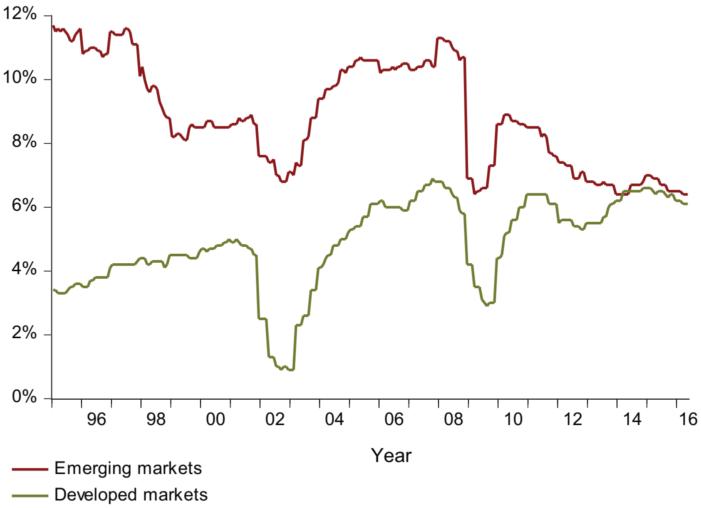
A more uncertain environment means equity investors should rationally demand a higher risk premium, which should lead to lower equity prices. Another way to look at it is through the risk/return tradeoff. With higher volatility, higher returns are also required to compensate for the additional risk. The problem is equities have little buffer from their valuations. The market P/E ratios are not expensive by historical standards, but not cheap either, and some countries and sectors (e.g. the U.S. and consumer sectors) are quite expensive. An environment of slow earnings growth, high P/Es and high volatility is not an attractive proposition.

The dilemma for investors remains the same: with bond yields even lower than they were three months ago, and unattractive equity markets, where do you invest your money? From a relative point of view, the outlook for equities may be bleak over a short or intermediate horizon, but over the long term, valuation still favours equities over bonds. The road to the long term could get bumpy and some investors might consider alternatives to traditional asset classes. In a world of ultra-accomodative monetary policies and competitive currency depreciation, gold might be the ultimate winner. Low rates and a lack of alternatives can also make real estate an attractive option. The bottom line is we live in a new investment era and we need to look beyond traditional equities and bonds to find attractive opportunities. As a result, we are adopting a more neutral stance between equity and fixed income for the time being to reflect the various uncertainties. The search for yield continues.

Equity Market Outlook

The fact that profit margins in the U.S. are at historical peaks has been well documented by many market commentators, including us. What has attracted less attention is the flip side of rising margins in the U.S.: falling margins in emerging markets. While U.S. margins have been rising since the early '80s, the trend sharply accelerated in the mid '90s. The signing of NAFTA in 1994 and the admission of China to the World Trade Organization in 2001 are just two examples of events that accelerated the trend toward globalization. By relocating production to emerging markets, companies from developed countries benefited from a lower cost of production and thus an increase in their margins. However, this pushed up the cost of production in emerging markets, to the detriment of local companies. Therefore, globalization has led to a convergence in profit margins. Today, margins in the developed world are at peak levels and have started to decline. Meanwhile in emerging markets, margins have never been so low and have stabilized.

Corporate Profit Margins
(all sectors excluding financials and commodities)



Source: Datastream, CIBC Asset Management calculations

The outlook for international equities was already deteriorating before the U.K. vote. An important factor behind Brexit is currency and specifically the yen and the euro. The impact of currencies on equity performance is twofold. First, there is a direct impact on earnings through translation effects. Companies operating outside of their home market will book profits from foreign operations at the current exchange rate. If the home currency appreciates, those foreign earnings are worth less when translated back to home currency. The second impact is less immediate, but more durable. When its currency appreciates, a country becomes less competitive in foreign markets and loses market share. These arguments work in reverse when a currency depreciates.

Japanese Equities and the Yen

Source: Datastream

Between 2008 and 2015, the euro depreciated from roughly 1.60 against the U.S. dollar to 1.05. From 2012 to 2015, the yen depreciated from 75 to 125 (although on a trade-weighted basis the moves were smaller). This provided significant help to exporters, especially in Japan and Germany. However, the currencies stopped depreciating last year when the Fed moved to a more cautious stance. This is bad news for both Europe and Japan.

Commodity Insight

A golden moment?

In July 2012, Mario Draghi, the head of the ECB, gave a speech in which he addressed the question of how to get out of the crisis that was gripping the E.U. and leading investors to question the viability of the euro currency. He pointed out that it was first essential to repair the "financial fragmentation" that was occurring within the boundary of the common currency. To that end, he promised the ECB would do "whatever it takes" to ensure the viability of the common currency.

Four years later, the citizens of the United Kingdom have voted to become the first nation to exit the European Union. With this historic vote, they have again thrown the viability of the trade union and the common currency into question.

The ensuing political and economic uncertainty that the vote has created will ensure renewed interest in gold and other safe haven assets. As a result of the U.K. vote, market participants have reduced the probability assigned to future interest rate hikes and taken 10-year bond yields in Germany negative, all supportive of gold bullion. Moreover, in June, Janet Yellen, the head of the Fed, highlighted that interest rates would likely be lower for longer as global growth continues to be lower than expected.

With the yields on government bonds making new lows globally, gold will continue to garner more investment attention, as investors question central bank policy and its effectiveness in ensuring global growth in an increasingly indebted economy. As a means of exchange, it is the one "currency" that has historically grown its supply less than 2% per annum. In contrast, central banks can print fiat currencies in unlimited quantities—as such, gold can be thought of as the ultimate insurance against destruction of fiat currencies.

With renewed concerns over stalling global growth and the potential for additional monetary stimulus, the use of gold as insurance is becoming increasingly relevant for investors looking to protect their wealth.

Fixed Income Outlook

Overvalued but well supported

- **U.S. 10-year sovereign bond yields are projected to average 1.65% over the next 12 months. Canadian 10-year yields will likely average 1.15% over the same period.**

Global bond markets continued to do well over the second quarter, in line with our expectations. Looking forward, bonds are likely to remain well supported. For one thing, the evidence is mounting that the U.S. economy is downshifting into lower gear. Earlier in the year, the Fed was pushed to the sidelines owing to growth disappointments abroad. The concerns now also relate to domestic economic conditions. Market expectations about further policy tightening have already been significantly lowered. However, we believe that the economic slowdown already underway will force the Fed to postpone its renormalization process beyond the next 12 months (our forecast horizon). In light of these developments, the U.S. 10-year bond yield is projected to average 1.65% over the forecast horizon.

Since the beginning of the year, Canadian bonds have not performed as well as U.S. bonds, resulting in a widening of Canadian-U.S. 10-year sovereign spreads. This has mainly reflected relative developments on the cyclical front. In sharp contrast to the U.S., the Canadian economy has surprised with its strength over the first half of the year. However, in our opinion, this is unlikely to last very long. Canada is a small, open economy and certainly not immune to developments in the rest of the world—particularly to what happens south of the border. Our forecast calls for the Canadian 10-year bond yield at 1.15% by the middle of 2017.

Mimicking equity market participants, corporate bond holders were apparently unshaken by the ongoing squeeze on corporate profitability over the last three quarters. Since the year started, both investment-grade and high-yield corporate bonds have delivered strong performance on expectations of a profit recovery in the second half of the year. This is where the risk lies. We believe that corporate profit margins will likely remain under pressure for the remainder of 2016. However, spreads of investment-grade credits should remain around their current level while corporate bonds are expected to outperform due to their higher running yield.

Currency Markets

U.S. Dollar

Over the last year, fluctuations in the U.S. dollar have been heavily influenced by market expectations about U.S. monetary policy. The year started with a radical shift in expectations—from market participants thinking that the Fed's tightening cycle was just beginning, to thinking that the Fed would instead move to the sidelines for an extended period. This was enough to push the greenback lower against most other currencies. Since then, market participants have had trouble figuring out what the Fed will do next, resulting in increased U.S. dollar volatility.

Looking through this short-term volatility, one thing stands out: with the exception of the yen, the U.S. dollar remains strong against the currencies of most of its trading partners and this is hurting U.S. corporate profitability. U.S. corporate profits have been declining for three consecutive quarters—a profit recession. Under these conditions, it is very hard for the Fed to commit to further policy tightening. The more the Fed raises rates, the more ground the U.S. dollar gains and the bigger the negative impact on U.S. corporate profits.

Under these conditions, heightened U.S. dollar volatility is most likely here to stay. For currencies with safe-haven features like the Swiss franc and the Japanese yen, the U.S. dollar's cyclical peak has probably already been reached. The outlook is not as clear for other currencies. Global and domestic developments will play a key part in determining the fate of most cyclical and emerging currencies against the greenback.

Canadian Dollar

The Canadian dollar had been in a bear market that lasted more than three years and produced a cumulative decline of more than 30%. However, in 2016 the Canadian dollar recouped nearly a third of that lost ground in a little more than a quarter. This recovery was, of course, driven mostly by the convincing bounceback in oil prices, an improving Canadian cyclical backdrop and a sidelined Fed. Is a long-term trend reversal in the making or are we just witnessing a countertrend and short-lived Canadian dollar rally?

While the speed and magnitude of the Canadian dollar's bounceback did take us by surprise, we continue to believe that this rally is not fundamentally supported. For one thing, global imbalances in the oil market remain wide, raising questions about the sustainability of the recent strength in oil prices. Renewed weakness in oil prices will surely weigh heavily on the Canadian currency. For another, the Canadian economy is weaker than first meets the eye. First-quarter economic numbers simply looked better because of the base effect—that is, the comparison is made with already-depressed levels of economic activity from one year ago. However, the loonie is expected to start losing steam again and the slowdown should be deep enough to convince the Bank of Canada (BoC) to reiterate the need for an ultra-dovish monetary policy stance. Looking forward, the Canadian dollar's downtrend against the U.S. dollar will remain in place, with the 12-month target at 0.75.

Euro

Under more normal conditions, the euro would largely benefit from increased market uncertainty regarding the next Fed policy move. However, current financial conditions are anything but normal. Uncertainty regarding Brexit has quickly turned into wider and deeper market concern about the sustainability of the ECB's policy mix and the drastic implications for eurozone financial corporations.

For more than a year, the end result has been a lack of conviction from investors and a euro that has traded sideways within a wide range. In other words, we have witnessed a sharp increase in volatility in the EURUSD bilateral exchange rate. For the time being, it is very hard to see what could turn things around for the euro. In fact, we believe that the balance of risk is tipping to the downside. For one thing, it is too early for the Fed to start talking about anything but policy tightening prospects. What's more, it is unclear whether moving rates further into negative territory in the eurozone truly qualifies as policy accommodation given the negative impact on the financial sector. Our 12-month forecast for the EURUSD bilateral rate stands at 1.06.

Japanese Yen

For the first time since 2012, the strength in the yen has fundamental support. While foreign domestic investment (FDI) outflows continue to be very strong (-¥16 trillion), they are now more than compensated by current account inflows (+¥18 trillion). This is owing to a combination of factors. First, the drop in energy prices has allowed for a sharp narrowing of Japan's energy deficit. Second, with Japan falling back into recession, Japanese imports have collapsed. Finally, the sharp increase in FDI and portfolio outflows observed over recent years is slowly translating into a widening income surplus.

However, there is a lot more to this story. Financial corporations in Japan have radically changed their behaviour in the belief that the Bank of Japan's Quantitative Easing (BOJ QQE) would jumpstart Japan's moribund economy while bringing inflation back from the dead. Indeed, banks and pension plans have been reducing their holdings of Japanese government bonds (JGBs) to buy domestic and foreign equities en masse. They must now be bitterly regretting that decision. Not only is deflation staging a comeback in Japan, but domestic and foreign equity holdings are generating heavy losses. To limit the damage, hedging ratios are being increased, exerting strong upward pressure on the Japanese currency. With the BOJ hitting its policy limits in the context of improving yen fundamentals, the yen is expected to appreciate further. Our twelve-month target stands at 98.

Regional Outlook
Canada

- **Real GDP growth will likely further disappoint over the next twelve months, ending closer to +1.3% than the +1.8% that is widely expected.**
- **The Bank of Canada will likely be forced to cut rates further over the forecast time horizon and start debating the eventual need for unorthodox monetary policy instruments.**

When BoC governor Poloz took office in the summer of 2013, he immediately acknowledged that elevated household debt loads were an important financial risk in Canada. He also underlined the urgent need to bring that household debt under control. Three years later, the household debt load in Canada is reaching record levels, representing a staggering 165% of disposable income. Not surprisingly, the BoC still puts this elevated indebtedness as a top vulnerability. Canada now ranks fifth in terms of biggest household debt loads in the developed world.

It might be tempting to conclude that elevated debt is less of a concern than officially stated. Canadian households have been taking on a lot more debt for many years and, so far, nothing dire has happened. While this is true, it says nothing about what lies ahead.

Over the last decade, Canadian households have managed to substantially increase their debt load without complications. This is largely because borrowing costs have declined significantly and the Canadian economy has remained in expansion mode. But elevated debt becomes a serious problem when the economy stops growing fast enough to keep debt on a sustainable growth path. In other words, the Canadian household debt problem becomes apparent in the context of an economic slowdown and this is precisely what is happening.

The Canadian economy downshifted into lower gear last year owing to the oil shock. Real GDP growth is now running at a yearly rate of +1.1%. So far, the slowdown has been mainly concentrated in the goods-producing sectors. However, there is more and more evidence pointing to negative spillover effects in the rest of the economy.

In fact, consumer fundamentals have recently weakened. In terms of job creation, we continue to see a gradual decline in yearly growth numbers (now standing at only +0.6% y/y). In addition, the latest average hourly wage numbers showed a big drop in yearly wage inflation (from nearly 3.0% to 1.9%). If these trends persist, more difficult times lie ahead for highly-leveraged Canadian households.

In light of these developments, it is surprising to see that the BoC is still betting on resilient Canadian consumers to keep the Canadian economy alive and kicking. With weaker fundamentals and a wide and widening household debt overhang, this forecast seems increasingly at risk. Over the next twelve months, real GDP growth will likely further disappoint, ending closer to +1.3% than the +1.8% that is widely expected.

For borrowing costs, there is very little leeway left to lower them further. However, the BoC will likely be forced to cut rates as much as possible over the forecast horizon. They may also start debating the possible need for unorthodox monetary policy instruments.

United States

- **U.S. economic growth is projected to slow significantly, owing to the drag from net exports, a deeper downturn in non-residential investment and weakening consumer fundamentals.**
- **U.S. real GDP growth is projected to slow from +2.0% currently to +1.6% in the next 12 months.**
- **Under these conditions, the Fed will be forced to move to the sidelines for the foreseeable future.**

While the U.S. economy is still doing relatively well as a whole, U.S. non-financial corporations are not as lucky. They now have to deal with rising production costs in the context of slowing revenue growth. The end result: a severe squeeze on profitability. U.S. corporate profits have been declining for three consecutive quarters—this qualifies as a profit recession.

We are concerned because, with the exception of a period in 1985, all profit recessions have turned into full-blown economic recessions. How will this unfold this time and will it resemble the 1985 period? In 1985, the economy slowed significantly, but a recession was avoided owing to pronounced U.S. dollar weakness, monetary policy easing, heavy government spending and strong household credit growth. Needless to say, that set of conditions is very different from those that currently prevail.

Another concern is that the current U.S. profit recession is broadly based across sectors. Of course, oil-sensitive sectors have been very hard hit. But profits generated from the rest of the world have also been contracting heavily, owing to U.S. dollar strength and sluggish growth abroad. Looking forward, a quick profit recovery is hard to envisage. At this point in the expansion phase, U.S. corporations have to deal with rapidly rising compensation costs in a low productivity environment. The risk is that the hit on profits will eventually translate into slower growth in labour compensation—potentially hitting employment and wages directly.

That would come at a bad time. The U.S. consumer is already dealing with quickly rising prices for many core non-discretionary items such as insurance costs, rents and medical care. What's more, if oil prices stabilize at current levels, the U.S. energy relief for consumers quickly turns into an energy squeeze.

In short, some further deterioration of consumer fundamentals likely lies ahead. If that is the case, the Fed will again have overestimated the strength of the U.S. economy and will be forced to move to the sidelines for the foreseeable future. U.S. real GDP growth is projected to slow from +2.0% currently to +1.6% in the next 12 months.

Europe

- **The eurozone economy is showing signs of fatigue. We expect real GDP growth to moderate to +0.9% over the forecast period. This is below the consensus forecast and insufficient to eliminate the risk of deflation.**
- **Unfortunately, the ECB is running out of ammunition. With eurozone banks under intense pressure, the side effects of the ECB's current policy mix (QE and sub-zero rates) are becoming very apparent.**

While the economic situation in Europe has not been getting as much media attention as the U.S. lately, there are more and more reasons for concern. For one thing, Britain's decision to repudiate 40 years of European Union membership is introducing unprecedented policy uncertainty. What's more, the ECB's experiment with negative interest rates is not working out as planned. The European currency has not really lost any significant ground, implying that deflationary pressures have not been abating. Second, the eurozone economy is already showing signs of fatigue, despite the efforts deployed by the ECB. In most eurozone countries, leading indicators are flashing red.

Even more worrisome are the increasingly apparent side effects of the ECB sub-zero policy. Across the eurozone, the pressure on banks is intensifying. The ECB is crossing its fingers that the TLTRO II lending scheme will help to alleviate the pressure. However, it is not at all clear that it will do the trick.

To jumpstart its moribund economy and bring inflation back to the system, the ECB has gone a long way in terms of unorthodox monetary policy easing. It launched a massive asset purchase program (QE) more than a year ago. If the current pace of purchases is maintained, the ECB will hold 5.2 trillion euros worth of assets on its balance sheet by 2018 (close to 50% of GDP). To top it all off, the ECB has lowered its deposit facility lending rate as much as possible into negative territory. In our opinion, this policy combination is the equivalent of trying to put out a fire with gasoline.

The building pressure on eurozone banks is a direct result of the ECB's policy mix. Net interest income is the main source of revenue for eurozone banks. Net interest margins are essentially determined by the level of short-term interest rates, the yield curve and nominal GDP growth. Current conditions are extremely adverse. With ultra-low short rates, an extremely flat yield curve and very sluggish economic activity, it's no wonder eurozone banks are struggling.

At this juncture, the relevant question is whether there is a significant risk of a eurozone banking crisis. There is, in our view, but some countries are more at risk than others. For instance, banks in Greece and Italy have been and are still dealing with extremely adverse conditions. In both countries, property prices have been declining since 2008 (no recovery)—translating into a very negative wealth effect for households. What's more, nominal GDP growth has been significantly weaker than projected by the ECB. Dealing with "extremely adverse" conditions, Greek and Italian banks have not been able to reduce the non-performing loans on their books. They now represent 50% of GDP in Greece and 12% of GDP in Italy.

To relieve some of the pressures on eurozone banks, the ECB launched its TLTRO II lending scheme. Meanwhile, national rescue efforts have also been put in place. A bail-out fund for distressed Italian banks was launched in early April. What remains to be seen is whether these efforts will be enough to eliminate the risk of a banking crisis. As long as the ECB sticks to its QE asset purchasing program and sub-zero rate policy, the risk remains.

China

Growth versus credit expansion – the policy dilemma

- **The service sector of the economy has continued to lead the growth in economic activity. This supports progress in the transition to sustainable economic growth.**
- **The financial system has become an important concern, with severe and unsustainable imbalances in debt growth. Credit growth has been rising at a double-digit rate for several years, outpacing nominal GDP. This has pushed the debt-to-GDP ratio to worrisome levels.**

The Chinese economy achieved GDP growth of 6.7% y/y in Q1 2016, the slowest GDP growth since Q1 2009. That said, the current growth rate is above the minimum desired growth objective of 6.5% and in-line with government expectations. In the first half of 2016, the Chinese economy saw a recovery in activity in the urban residential real estate market. Improved sales growth was accompanied by growth in property starts, after two consecutive years of decline. Demand for industrial commodities has also picked up compared to one year ago.

The service sector of the economy has continued to lead the growth in economic activity. This supports progress in the transition to sustainable economic growth. The Chinese consumer has also been a key factor in achieving the nation's growth objectives. Retail sales are growing at a low double-digit rate, the urban workforce is expanding and household credit is rising at a double-digit pace.

Over the past decade, employment conditions have supported the government's growth objective; however, the environment is becoming more challenging. Recent employment surveys are showing a slowing of demand for labour by employers, a signal that the labour market outlook may be deteriorating. This is happening at a time when the government is initiating programs to cut overcapacity in the coal and steel industries, which will weigh on jobs in those industries.

Furthermore, the financial system has become an important concern, with severe and unsustainable imbalances in debt growth. Credit growth has been rising at a double-digit rate for several years, outpacing nominal GDP and pushing up the debt-to-GDP ratio to worrisome levels. Most concerning is the non-financial corporate debt. This continues to rise, driving up risks associated with debt servicing. China's corporate debt relative to GDP is among the highest in the world and a top risk for the medium-term health of private sector growth. This will likely play an important role in the near-term policy objectives of improving credit allocation and slowing credit growth. This suggests that we are likely to see limited monetary policy stimulus in the second half of 2016 so that an improved growth dynamic in credit expansion can be restored.

The overall outlook on the economy is mixed for the next 12 months. A recovery is taking place in important sectors of the economy and the government is providing additional help through fiscal stimulus. However, our concern over the health of the labour market could make this recovery short-lived. In addition, limited help by monetary policy, as it becomes more focused on managing a slowdown in credit growth, will be a hurdle for keeping the momentum going. Finally, a slowing global growth environment is likely to generate lower-than-expected growth in trade and likely contribute negatively to GDP over the next year.

Signposts

Economic indicators that will help us determine if our ***Policy Limits*** 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

- Government household and corporate income tax receipts
- Corporate profitability
- Effective U.S. dollar
- 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

- Target-2 balances with the ECB
- Japanese supplementary budget
- Effective Japanese yen
- Post-TLTRO II European bank lending
- Global Purchasing Managers' Indices
- Eurozone banks
- UK commercial real estate activity
- Italian referendum