Perspectives

For the period beginning October 1, 2016

CENTRAL BANKS PASS THE BATON

Central banks have done all they can for economic stimulus. Governments must now step in.

Central banks must hand policy leadership over to other policy makers (read politicians) to continue stimulus efforts via fiscal policy and longer-term structural reforms. This is obviously easier said than done, given the political tensions in many regions.

Political risks will be particularly elevated over the coming months with the U.S. presidential election (see page 4). In addition, moving into 2017, many European countries will also be holding elections. This substantially delays the potential use of fiscal policy to support economic activity.

CIBC Asset Management

Asset Allocation Outlook as at October 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: Since early summer, we have adopted a more neutral stance between equity and fixed income. However, bonds are unlikely to rally much in the case of a "risk-off" equity correction and will likely provide a lower degree of portfolio diversification than in the past.

Equity: Even after a recent period of outperformance, emerging Asian equity markets remain attractively valued and our preferred global equity region.

Fixed Income: Canadian Government bond prices will remain close to unchanged, while corporate bonds will continue to outperform.

Currencies: The Canadian dollar will likely lose ground—not only against the U.S. dollar, but against other currencies in our trading universe.

Expected returns for the 12-month period beginning October 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%	0.3%	0.6%	0.5%	0.3%
Canada Bond	-1.5%	0.4%	2.5%	-1.5%	0.4%	2.5%
Canada Federal Government Bond	-2.4%	0.1%	3.5%	-2.4%	0.1%	3.5%
Canada Corporate Bond	0.9%	1.2%	-0.3%	0.9%	1.2%	-0.3%
Canada Real Return Bonds	-2.6%	-0.6%	1.8%	-2.6%	-0.6%	1.8%
Canada High-Yield Bond	4.8%	2.3%	-16.5%	4.8%	2.3%	-16.5%
International Government Bond	-11.5%	0.8%	9.7%	-4.4%	-0.7%	1.2%
Canada Equity	10.2%	3.4%	-19.8%	10.2%	3.4%	-19.8%
United States Equity	2.8%	3.9%	-7.6%	8.1%	1.9%	-15.0%
International Equity	5.6%	5.8%	-19.3%	11.7%	4.7%	-22.8%
Emerging Equity	10.9%	6.1%	-20.6%	13.5%	7.7%	-18.9%

Global Outlook

Policy Limits

Since the Great Recession, central banks in the developed world have fought very hard to keep the world economy afloat and to bring some inflation back into the system. For all these years, their implicit objective was to make sure they would be well-positioned for the next global economic downturn. Now that they have nearly deployed their full policy arsenal, the victory on deflation risks unfortunately still can't be declared.

To avoid being stuck in this very uncomfortable position, the most desperate central bankers have gone where no central bankers would have dared to go before them. After launching massive asset purchasing programs, eurozone and Japanese monetary authorities have adopted sub-zero interest rate policies, leading to an unprecedented flattening of global yield curves. While they were certainly aware that going this far was not without risk, they underestimated the negative side effects associated with such an unorthodox policy mix.

More than a year after we alerted our readers to the limits of central bankers' new policies, unanticipated side effects have become very apparent. While governments are breathing easier thanks to lower borrowing costs, the same thing cannot be said for other economic entities. Artificially low interest rates are hurting aging households and financial institutions are under intensifying pressure. Years of capital misallocation have resulted in a pronounced decline in productivity growth across the developed world. In turn, this is making it very hard for nonfinancial corporations to cope with rising compensation costs.

Our **"Policy Limits"** scenario has now reached a critical juncture. To avoid an aggravation of these multiple side effects, central banks now have no other option but to start handing over the policy leadership to other policy makers (read politicians) to continue the stimulus efforts via fiscal policy and longer-term structural reforms. This is something that is obviously easier said than done. The first to try modifying its policy stance without rattling markets was the Bank of Japan (BOJ), when it announced in September that it would now target 0% yield on its 10-year bond. This policy shift amounts to implicitly opening the door to some potential tapering of the BOJ's Government bond (JGB) purchases. Watching the BOJ from a close distance is the European Central Bank (ECB), which is facing the same dilemma. Despite all the efforts deployed, the deflation threat is still elevated in the eurozone. The sub-zero rate and QE policy combination is having intensifying undesired effects on the economy.

Of course, if the rest of the world economy remains solidly in expansion mode, it will be much easier for the BOJ and ECB to readjust policies without causing havoc in global financial markets. Unfortunately, we believe that a global growth slowdown is likely what lies ahead. On the bright side, as explained in the China section, the Chinese economy is expected to do relatively better (6.3% 12-month average vs 6.1% previously), thanks to a massive fiscal injection. On the downside, our U.S. growth projections are being revised lower, from 1.6% to 1.2%. This leaves our global growth forecast unchanged at around 3.0% for the next twelve months—our lowest global growth projection since the Great Recession.

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 since economic activity remains relatively modest. This more negative scenario could be triggered by the European banking problems. The aggressive ECB policy of negative interest rates and a flat yield curve has weakened the financial sector in Europe, which is now experiencing profitability issues and growing non-performing loans. Banks are focused on reducing risk on their balance sheets and raising capital, short-circuiting efforts by the ECB to encourage them to lend and grow the economy. This could lead to lower-than-expected economic activity in the eurozone, exacerbating the uncertainty as Brexit negotiations and political uncertainty are about to begin. Also, already coping with a profit recession, U.S. nonfinancial corporations would be even harder hit moving into the next twelve months—owing to 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 potential economic downturn.

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, continued fiscal stimulus and infrastructure spending in China could provide enough stimulus to push economic activity higher than in our base case scenario.

This 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.

The risks to our main scenario are to the downside. The main risk is for the projected global slowdown to turn into a full-blown recession. We are still putting 20% probability on this more adverse outcome. Political risks will be particularly elevated over the coming months with the U.S. presidential election. In addition, moving into 2017, many European countries will also be holding elections. This substantially delays the potential use of fiscal policy to support economic activity.

U.S. ELECTION

Policy continuity or structural shift?

The two candidates for U.S. President, Hillary Clinton and Donald Trump, offer fairly contrasting policy views on a number of topics. This comes at a time when the electorate has expressed frustration following years of disappointing economic activity and sluggish wage growth.

While Democratic candidate Clinton offers continuity relative to the current administration, the Republican candidate is promising radical change, not least because he wants to please a disgruntled electorate. While Clinton remains favoured to win, according to most polls, a Trump victory is far from unrealistic at this point in the campaign.

While both candidates emphasize the need for fiscal stimulus, this is the only area of policy common to the candidates. Ultimately, Congressional election results will determine how much either candidate is able to implement their policies. A divided government remains the most likely outcome, which will mean continued policy gridlock. The proposed policies that separate the candidates' platforms are numerous, including:

Trade: Clinton remains supportive of existing trade relations but will likely reject the Trans-Pacific Partnership. Trump has expressed a strong protectionist stance and suggested the introduction of tariffs and duties, particularly on China. He has also threatened to label China as a currency manipulator.

Tax: Clinton wants to raise taxes on the wealthy, including estate taxes and limiting exemptions. Trump wants to cut the top rate on personal tax and repeal the estate tax while cutting corporate taxes.

Federal Reserve: Clinton is supportive of the U.S. Federal Reserve (Fed) and its independence. Trump has been very critical of the Fed and supports subjecting it to an audit.

Foreign Policy: Clinton would continue to support NATO and cooperation with China. Trump has expressed more protectionist and isolationist tendencies and has been critical of China and NATO.

The economic impact of the election will likely be felt through the fiscal spending that both candidates are planning. The uncertainty that the election brings might show in subdued investments and consumption over the coming months while we wait for more clarity on policy. Market volatility should therefore rise around the election and, at the margin, interest rates could rise as the market anticipates the stimulative impact of fiscal spending.

Fixed Income Versus Equity

The impact of policy limits on a balanced portfolio

Earlier this year, strong equity returns were supported by improving economic numbers. However, recent U.S. data, as well as global PMI surveys, have been weak. Although equities are not overbought, a number of technical and sentiment indicators are turning negative and potentially point to a peak in market momentum. Fundamentally, there are a number of warning flags for the U.S. economic cycle. Not only is the cyclical outlook uncertain, but potential growth is also being revised downward. With corporate profit margins under pressure, this is a worry. Investors are hoping the Fed will save the day (one more time) by implementing a very slow normalization of its monetary policy. This would keep bond yields well anchored and further lift the price of risky assets. This is a risky proposition when valuation in many equity markets is high.

This risk is even greater in the context of changing correlations between equities and bonds. Since the end of the Great Financial Crisis, all stars have been aligned for investors in balanced funds. We have witnessed strong returns and low volatilities in both equities and bonds, and a strongly negative correlation between equities and bonds. The result has been very good performance for a balanced portfolio composed of 50% U.S. equities and 50% U.S. bonds[1]. The risk-adjusted performance of such a portfolio[2] has been better only 3% of the time in the last 140 years. This is an historical anomaly that is unlikely to persist.

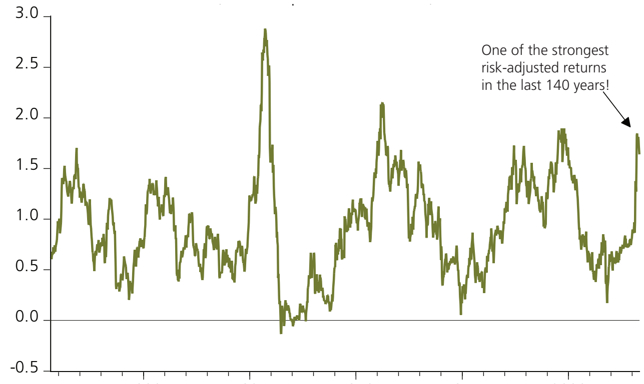
Over short-term periods (i.e. a few months), the change in interest rates is the main driver of bond returns. Markets will typically look at falling bond yields as a loosening of monetary conditions that should be followed by better growth. In this context, positive bond returns (from lower yields) are associated with positive equity returns (from expectations of better growth). However, in a deflationary economic environment, disappointing growth will push bond yields lower (positive bond return) but also stokes fears of deflation that will drive equity prices lower. Therefore the correlation between equities and bonds turns negative.

This negative correlation is unlikely to provide much protection if equites correct. With a significant number of global bonds now with negative yields, central banks have reached a point where their policies are, at the margin, much less effective. Bonds are unlikely to rally much in the case of a "risk-off" equity correction and will likely provide a lower degree of portfolio diversification. There are some specific segments of the bond market where investors can still find attractive yields—long-term Canadian and U.S. bonds, corporate and high yield bonds or emerging market sovereign bonds. The caveat is that these bonds are riskier than core government bonds. The bottom line is safe assets are not as safe as they used to be, given the distortion effect of indiscriminate bond buying by major central banks. Their actions have pushed bond yields to unprecedented low levels, making bonds a tough choice for the typical investor.

Correlation measures how the returns of two assets follow each other. From the point of view of portfolio diversification, negative correlation is desirable because it means when one asset does not perform well, the other one tends to perform better and stabilize the portfolio performance. Equities and bonds typically have a low and positive correlation, but since the early 2000s this correlation has been strongly negative, leading to a significant diversification benefit.

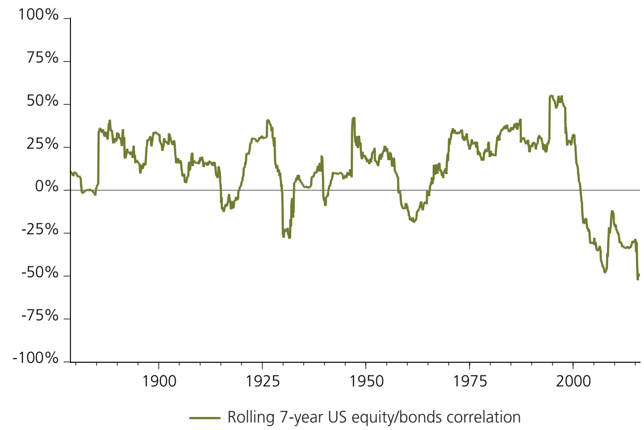
[1]U.S. market is used in this analysis because of the availablility of very long-term data
[2]Balanced portfolio performance from 2009-2016

U.S. Balanced Portfolio
(50/50 equities and bonds)



(*) The risk adjusted return is the total return divided by volatility; we use a 7-year period to match the time elapsed since the end of the financial crisis

U.S. Equity vs. Bonds Correlation



Equity Market Outlook

Valuation opportunities

Despite the surprising outcome of the UK vote on Brexit, global equities performed well in the most recent quarter. Emerging markets outperformed, with China notably leading the way, and Europe rebounded as well. A sector rotation has been taking place, as the defensive and rate-sensitive sectors underperformed and cyclical sectors took the lead. The rate-sensitive sectors (e.g. real estate, utilities, infrastructure) have been well supported in recent years by ultra-low interest rates. However, further outperformance will depend on continued loose liquidity conditions. This recent occurrence is just a warning sign that when the search for yield truly unwinds, the underperformance of sectors that have benefited from it could be dramatic.

One of the key factors in our investment process is the assessment of valuation, both across asset classes and within asset classes. Valuation strategies are more rewarding when the difference between expensive markets and cheap markets is higher. A measure we track for equities is the average difference, based on P/E ratios, between expensive and cheap markets across all countries and sectors. The higher this spread, the more opportunities there are for a value strategy. As of the end of September, this measure was considerably higher than normal. Delving more deeply into it, the average valuation spread between countries is higher than it is across sectors. In other words, while it is always advisable to pay attention to valuation, it is especially important now. Equity valuation may be very high in some markets, but other countries still offer attractive bargains and investors would likely be rewarded to hold them over the long term.

The most important difference in valuation is between developed markets and emerging markets. Within developed markets, the U.S. and Japan look especially unattractive. Valuation in Europe is relatively good, but it reflects the structural headwinds facing the region. One thing these three regions share is monetary policies that have been pushed to the limit. Japan is on the front line and demonstrates just how ineffective, and even counter-productive, these policies have become. Indeed, the profitability of the European and Japanese banking sectors has been under pressure as a result, making banks less prone to lend.

Emerging markets, on the other hand, show attractive valuation. China's growth may have structurally declined, but that is more than reflected in its valuation. In the case of Chinese equities, we would argue they are unduly cheap and, in fact, reflect a deep concern about the country. When prices get so cheap, markets can rise quickly with some good news as the catalyst. The news doesn't need to be that positive, but only needs to demonstrate that, ultimately, things are not quite as bad as believed. This is what has been happening to China, and in general to the greater emerging Asia region. Growth in Asia has stabilized, and equity markets have done very well. Yet even after this recent period of outperformance, they remain attractively valued.

Commodity Insight

OPEC policy change

In the last two years, the oil market has witnessed some of the most dramatic price swings in its history. In November 2014, OPEC shocked the market when they decided to back away from their historical role as the swing producer. This decision was taken to reduce the growth of U.S. shale production which had been increasing at the annual rate of 1 million barrels per day. The market and OPEC had expected a rapid reduction in U.S. supply and, as a result, a firming of oil prices above $80 per barrel.

Two years later, OPEC is reassessing its position. U.S. supply has responded, although later than expected, and is now 1 million barrels per day lower than its peak output. In addition, the sanctioning of new projects globally has also slowed dramatically. However, the U.S. industry, and now slowly the global industry, is becoming more efficient at producing oil, reducing the cost of extraction. What OPEC failed to assess was the continued improvement in the application of drilling and completion technologies and the impact that it would have on the global cost of oil production.

Today, the U.S. industry is expected to grow production at just over $50 per barrel, a price which, two years ago, would have been considered uneconomic. The rapid improvement of production techniques and their application to the Texas Permian basin is changing the global cost curve. Offshore production is witnessing the same cost reduction, as inflationary pressures in the industry abate. Longer term, the market still anticipates that oil prices of $65-$70 will be required to incentivize enough production to meet global demand. However, in the short term, OPEC now believes it will once again be required to constrain production to help balance the market. The recent meeting in Algiers represents a dramatic reversal in OPECs stance and, as a result, the markets' assessment of future oil prices.

Fixed Income Outlook

- **Our 12-month forecast for the U.S. 10-year sovereign bond yield stands at 1.65%. We see the Canadian equivalent likely averaging 1.0% over the same period.**

In the third quarter, global bond yields rose from post-Brexit lows. For the U.S. bond market, this meant unwinding some of the relative outperformance experienced earlier in the year owing to its safe-haven status. In line with our projections made earlier this year, the Canadian bond market finally started to outperform U.S. bonds. This resulted in a gradual narrowing of the yield differential between Canada and the United States.

The pullback in global bond markets can also be explained by shifting expectations about central banks' objectives. Most central bankers now recognize that the colossal efforts deployed on the monetary policy front have produced too much yield-curve flattening. The first central bank to explicitly recognize this was the Bank of Japan, which now officially targets a steeper yield curve to alleviate the pressure on the financial sector. While, going forward, we believe that central banks will continue to try to limit any excessive flattening of the yield curves, it is not at all clear that they will be successful. Indeed, with a deteriorating global growth outlook, cyclical forces will be working in the opposite direction, preventing any significant rise in global bond yields. Against this backdrop, our forecast calls for the U.S. 10-year bond yield to average 1.65% over the next 12-month period. Still structurally adjusting to the oil shock, prospects for the Canadian economy are particularly dim. This implies that the Canadian 10-year bond yield will likely stay close to 1.0% over the forecast horizon.

We should remain in a very low-yield environment for sovereign bonds and ongoing purchases of corporate securities by various central banks (BOJ, ECB, BOE) will likely continue. Consequently, our forecast remains for spreads of both investment-grade and high-yield credits to narrow and to outperform vis-à-vis government securities.

Currency Markets

U.S. Dollar

The US dollar remained broadly in consolidation mode over the third quarter, gaining ground against cyclical currencies like the Mexican peso and Canadian dollar. However, it depreciated significantly against the Japanese yen and remained "well behaved" against most euro block currencies. The overall market action perfectly reflects the state of confusion prevailing in currency markets. There are many good reasons why investors feel so confused. For one thing, the Fed has been extremely gun-shy, letting a full year go by between its first and (still-to-come) second policy rate hike. For another, Japanese and eurozone monetary authorities have been forced to readjust their policy stance by making very unorthodox policy changes. Investors are having trouble figuring out the longer-term market implications of all of these developments.

In our view, the ultimate longer-term implication of central bankers reaching policy limits is a heightened risk of deflation. As Japanese monetary authorities have painfully learned over the last three decades, sustained deflation leads to currency appreciation for countries experiencing high real interest rates.

Canadian Dollar

Over the first half of the year, the Canadian dollar staged quite a comeback, outperforming nearly all the currencies in our trading universe with the exception of only three other oil-sensitive currencies: the Russian ruble, the Brazilian real and the Colombian peso. The opposite now seems to be happening. Since mid-June, the Canadian dollar has been weakening on a widespread basis.

To some extent, the loonie's potential downside relates to the oil risk. Global imbalances in the oil market remain wide, raising questions about the sustainability of the recent strengthening in oil prices. Canada's vulnerability to negative developments in the oil market remains elevated. This means that, in the context of renewed oil price weakness, the price decline is likely to be more pronounced for Canadian oil prices (Canada Western Select). In other words, the Canadian economy could experience renewed weakness through the deterioration of the oil trade balance.

The oil risk is not the only potential drag on the Canadian dollar. As discussed in the Canadian economic section, the Canadian economy is showing clear signs of fatigue. In our view, the unfolding economic slowdown should be deep enough to convince the Bank of Canada(BoC) to reiterate the need for an ultra-dovish monetary policy stance. Under such conditions, the Canadian dollar will likely lose ground—not only against the USD, but also against other currencies in our trading universe. For the Canadian dollar/USD bilateral rate, a drop to 0.73 is likely over the next twelve months.

Japanese Yen

Last September, the BOJ decided to modify its monetary policy framework and introduced "QQE with yield curve control". This basically amounts to maintaining the policy rate at -0.10% and keeping the pace of JGB purchases at around ¥80 trillion/year. It also entails scrapping the 7-12 year average maturity target for bond buying and replacing it with a yield target on 10-yr JGBs around 0%. In our opinion, this is the Bank of Japan's way of admitting that it has reached its policy limits. By committing to a yield target of 0% on 10-year JGBs, it allows for the possibility of some tapering in terms of its JGB purchases.

This is happening at a bad time. Most Japanese leading indicators of economic activity are now flashing red, signaling rising odds that Japan is tipping back into recession. What's more, deflation is staging a comeback. Headline CPI inflation is already back in negative territory (-0.5% y/y), while core CPI inflation has sharply declined to +0.2%. We think that deflation is poised to intensify for two reasons. First, the strength of the yen on an import-weighted basis definitively points to intense deflation in import prices (now at -30%). Second, the profit margins of Japanese corporations are under severe pressure owing to the decline in producer prices (-3.7%) and the rise in unit labour costs (+3.3%) that reflect rising wages and declining productivity. With the BOJ hitting its policy limits in the context of improving yen fundamentals, the yen is expected to appreciate further.

Euro

Third-quarter market action looked a lot like the rest of the year for the EURUSD bilateral rate. The euro remained well-behaved against the U.S. dollar, oscillating all quarter long around 1.11. This prolonged consolidation phase for the euro largely reflects the fact that there has been no clear trend in real-rate differentials between the eurozone and the United States.

Deflation is definitely knocking at the ECB's door and at this juncture there is very little the ECB can do to stop it from spreading across the eurozone. For the fourth year in a row, the ECB is overwhelmingly upbeat, projecting that HICP* inflation will climb to +1.2% over the next year. For the fourth year in a row, the ECB's forecast won't be materializing. Our forecast calls for HICP inflation to dip into negative territory (-0.2%) with core HICP inflation slowing to +0.5%. This will continue to put pressure on commercial banks via a potential deterioration in their non-performing loans. The EURUSD bilateral exchange rate may develop a wider trading range. On one hand, this could be supported by higher real interest rates due to declining inflation, with limited scope to lower nominal rates. On the other hand, downside pressure could arise from the growing systemic risk from deteriorating bank balance sheets, particularly in Italy and Germany. The euro's calm trading range may be a thing of the past.

* Harmonised Index of Consumer Prices

Regional Outlook
Canada

- **Over the next twelve months, real GDP growth will likely further disappoint, ending closer to +1.1% than the +2.0% that is widely expected.**

Coping with a severe oil shock, the Canadian economy nearly tipped into recession last year. Luckily, things started looking up in early 2016. Oil prices stopped their descent and the Canadian economy started to look better, with growth reaccelerating from near zero a year ago to +1.5% last spring. Unfortunately, the Canadian economy is once again showing clear signs of fatigue. The widely expected and widely hoped-for 2016 Canadian economic recovery is not materializing.

The biggest disappointment relates to the continued weakening of Canadian consumer fundamentals. In terms of job creation, we are still seeing a gradual decline in yearly growth numbers (now standing at only +0.4% y/y). Meanwhile, developments on the wage front are not any more encouraging. Average hourly wage growth numbers have continued to decline, now showing a yearly contraction of -0.2%. If these trends persist, more difficult times lie ahead for highly-leveraged Canadian households.

In light of these developments, it is very surprising to see that the BoC is still projecting that Canadian consumer resilience will keep the Canadian economy going. With weakening 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, averaging approximately +1.1%—well below the +2.0% that is widely expected.

Under these conditions, the BoC will have to stay very prudent. It is now becoming clearer and clearer for all developed world central banks that sub-zero interest policies are not without important side effects. This is not a road that Canadian monetary authorities will want to take, implying very limited leeway left for monetary policy. Besides cutting rates by another notch, the only option left for the BoC is to try to talk down the currency. This is no easy task when nearly all other central bankers are also either aiming for currency weakness or have no tolerance for further currency appreciation.

United States

- **U.S. real GDP growth is projected to average +1.4% between 2016Q4 and 2017Q3. This below-consensus forecast is essentially explained by the continued drag from net exports, a deeper downturn in non-residential investment and weakening consumer fundamentals.**

U.S. economic growth in the first half of the year was quite disappointing. The U.S. economy only managed to grow by +1.2% on a yearly basis—well below Fed and consensus expectations. Looking forward, however, most forecasters remain upbeat, betting on a soon-to-come economic rebound. The Fed is definitively in the recovery camp. Last September, it lowered its 2016 growth projections by only a notch, from +2.0% to +1.8%. In other words, the Fed is implicitly calling for a very convincing second half of the year economic recovery. Needless to say, this call has to materialize in order for the Fed to go ahead with its plan to hike interest rates in December. The next string of U.S. economic indicators has to confirm that the economy is shifting into higher gear.

The resilience of the U.S. consumer is convincing most forecasters, including the Fed, that the U.S. slowdown won't turn into a serious slump and a recovery phase is just around the corner. However, the harsh reality is that the rest of the U.S. economy is not doing that well. The strength of the U.S. dollar and sluggish growth abroad are making it very hard for U.S. exporters. Meanwhile, corporate America is still coping with a deepening and long-lasting profit recession. Under these conditions, it has no other option but to cut back on investment spending.

In addition, the U.S. consumer must not shift into lower gear. With still solid consumer fundamentals, why would they start spending less? We can see two potential reasons. First, while more jobs are being added to the U.S. workforce, the rate of increase in employment has been slowing—from more than 2% to 1.7%. Second, U.S. consumers have been losing confidence with regard to U.S. growth prospects. Where is this pessimism coming from? The 55-plus cohort is feeling less and less upbeat about its economic prospects and this is heavily weighing on the "overall" U.S. consumer confidence reading. This is not likely to change. The U.S. demographic shock isn't fading but intensifying, increasingly impacting household income growth and spending habits. The confidence gap between the 55-plus age cohort and younger cohorts has never been as wide.

All in all, some further deterioration of consumer fundamentals probably 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. U.S. real GDP growth is projected to remain sluggish from +1.2% currently to +1.4% on average between 2016Q4 and 2017Q3.

Europe

Monetary policy at the crossroads—a comprehensive reassessment needed

- **Eurozone growth is expected to stay lacklustre, running at an average yearly pace of +0.8% over the next twelve months.**
- **The ECB is losing its battle against deflation and running out of ammunition. A comprehensive monetary policy reassessment is urgently needed.**

Four years after the peak of the euro crisis, and despite bold monetary policy measures, economic growth in the eurozone remains lacklustre. Economic slack is substantial and inflation continues to be a serial disappointment. In short, the ECB has to recognize that it is losing its battle against deflation and that a comprehensive policy reassessment is urgently needed.

It is becoming increasingly clear that the marginal impact of unconventional monetary policy is turning negative. This is owing to its diminished effects on activity and prices, coupled with intensifying negative side-effects on the banking sector. What's more, the ECB won't be able to continue buying sovereign bonds at the current pace for much longer, unless it changes the guidelines that dictate the QE program.

A change of guidelines implies relaxing prevailing ECB rules with regard to sovereign bond purchases. The self-imposed one-third limit of the overall stock of each country's sovereign debt could be increased. The ECB could also allow for deviations from capital key rules and buy more sovereign bonds from eurozone countries that need more help (e.g. Italy) and buy less from eurozone economies that are doing fine (e.g. Germany). However, relaxing purchase rules would give the ECB a more dominant position in sovereign bond markets, amplifying pricing distortions and potentially encouraging a lack of fiscal discipline. Obviously, this is not an easy road to take. Because of elevated costs from the side-effects and decreasing marginal benefits for the economy, the ECB could also start to consider reducing the pace at which it is buying sovereign bonds. However, this could prove to be very tricky, potentially triggering financial market turmoil. All in all, there is no easy way out of this.

No matter what policy option is chosen next by the ECB, the fact remains that monetary policy has reached its limits at a time when the eurozone economy is increasingly in need of more policy stimulus. Eurozone growth is expected to stay lacklustre, running at an average yearly pace of +0.8% over the next twelve months, and deflation is still knocking hard at the ECB's door. With elections coming in many eurozone economies, fiscal policy can't be considered as a way to fix the moribund eurozone economy over the short term. From this angle, the situation in Italy remains a big concern. Short-term risks from Italy are still elevated—namely, the risks of a banking crisis and political woes following the constitution referendum in December.

China

Growth targets are being achieved in 2016

- **The Chinese economy is meeting 2016 growth targets, with GDP growing at 6.7% yoy in Q1 and Q2. Traction in the private sector makes the current recovery stronger than initially expected.**

- **The pace of credit growth is creating imbalances in the economy and adding risk to the financial system. Given the Chinese economy's financial structure, we are more worried about the implications for potential growth than the probability of a banking system crisis.**

The economy has recorded real GDP growth of 6.7% during two consecutive quarters so far in 2016, a rate above the 6.5% minimum target set by government for the current calendar year. What was initially a recovery driven by government spending is spreading into private sector activity. We are seeing improvement in manufacturing activity, residential real estate and solid performance in retail spending. Employment indicators have stopped deteriorating and the profit cycle for industry has turned positive. At the same time, an important rebalancing is still taking place. The economy has recorded growth in the service sector that is outpacing industry, an important development for a country which has an excessively large share of investment as a percentage of its GDP.

The current pace of growth, combined with a firming inflation environment, is forcing policy makers to put the brakes on additional easing of monetary policy. Producer price contractions have narrowed significantly and could even turn positive in the months ahead, after more than four years of deflation. In addition, the rise in price of residential property is causing concern for policy makers over the possibility that another housing bubble may be taking place. If there is any hope that China will achieve a more sustainable growth path over the next few years, any form of irrational exuberance must be avoided.

Not everything is fine in China. The previously-discussed risk around unsustainable credit growth remains a concern and is one area where rebalancing is moving too slowly. We continue to see credit growth outpacing nominal GDP growth after years of a fast-rising debt-to-GDP ratio. Our concern over the pace of credit growth is centered on the risks it has brought to the financial system and its capacity to expand credit going forward. In recent reports, the Bank of International Settlements (BIS) has also warned that China is one of three economies showing early warning signs of stress in the domestic banking system. They point to the nation's unusually large deviation from its longer-term trend in the credit-to-GDP ratio, and its rising level of debt, as signs that the stability of its financial system is being compromised. Given the Chinese economy's financial structure and its strong support from government, we are not so much worried about the probability of a banking system crisis as we are about the implication that these stresses have for potential growth. A major downturn in the banking sector's earnings cycle would be the trigger for below 6% growth in the Chinese economy.

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 orders versus inventories
- Capital Goods orders (monitor investment growth)

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

- Post-TLTRO II European bank lending
- Japanese supplementary budget
- Effective Japanese yen
- Global Purchasing Managers' Indices
- Eurozone banks relative performance
- UK commercial real estate activity
- Italian referendum