Perspectives

For the period beginning January 1, 2017

PLOTTING A COURSE FOR AN UNCERTAIN YEAR AHEAD

The global economic expansion is expected to continue in 2017, but growth is unlikely to accelerate. Uncertainty around our forecast is unusually large this quarter, given many policy unknowns as we enter 2017.

Since the U.S. election of Donald Trump last November, the prospect of fiscal stimulus amid accommodative monetary conditions in the U.S. has dramatically changed global financial dynamics. Other aspects of a new Trump administration, such as trade protectionism and the potential imposition of tariffs on trading partners, have so far been treated with benign neglect by financial markets. This may come to haunt investors in the first 100 days of the new administration.

CIBC Asset Management

Asset Allocation Outlook as at January 1, 2017

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: A neutral to cautiously positive stance on equities is warranted. Bonds should underperform, as monetary policy and bond yields continue to normalize.

Equity: Emerging Asian equity markets remain attractively valued, especially following the post-U.S. election sell-off. This is our preferred global equity region.

Fixed Income: Current conditions are moderately bearish for bond prices, marginally favourable to Canadian bonds versus U.S. and still supportive of an outperformance of corporates relative to sovereigns.

Currencies: The projected widening in Canadian versus U.S. monetary policy differentials will keep the U.S. dollar well supported against the Canadian dollar.

NEW! **Long-Term Capital Market Asset Allocation Forecast**: A new assessment of 10-year expected returns for major financial market asset classes—please see page 10.

Expected Returns

Expected returns for the 12-month period beginning January 1, 2017	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%
Canadian Bond	1.0%	2.8%	5.8%	1.0%	2.8%	5.8%
Canadian Federal Govt. Bond	-0.6%	1.6%	6.3%	-0.6%	1.6%	6.3%
Canadian Corp. Bond	3.0%	3.9%	1.5%	3.0%	3.9%	1.5%
Canadian RRB	2.0%	2.2%	7.8%	2.0%	2.2%	7.8%
Canadian High Yield	6.0%	2.8%	-8.5%	6.0%	2.8%	-8.5%
International Govt. Bond	-8.3%	2.0%	17.5%	-3.7%	-0.7%	5.6%
Canada Equity	18.2%	8.6%	-14.8%	18.2%	8.6%	-14.8%
United States Equity	8.8%	5.8%	-10.7%	16.8%	5.1%	-16.2%
International Equity	15.8%	9.0%	-7.8%	18.4%	7.1%	-14.6%
Emerging Equity	12.6%	8.8%	-15.6%	18.5%	10.9%	-14.5%

Global Outlook

"Uncertainty prevails everywhere"

Mario Draghi, President, European Central Bank

Policy Limits

The theme of our last edition of *Perspectives* reflected our anticipation that monetary policy would need to "pass the baton" to looser fiscal policy to keep the global economic expansion on track. This was a pressing issue in light of the fact that the monetary policies of the world's main central banks had reached their limits. Interest rates were in negative territory and asset purchase programs (also known as Quantitative Easing) were depleting the stock of government debt available for purchase. There were signs that these policies were reaching their limits, as negative feedback loops in the financial sector, insurance companies and pension plans were becoming apparent.

Over the last few months, this transition has evolved faster than we were expecting. The most significant event was in the U.S., with the surprise election of Mr. Trump and a Republican majority in Congress. Republicans based their election campaign platform on tax reform and infrastructure spending in a bid to "make America great again". Unfortunately for market participants, many details are still missing with regards to Trump's proposed fiscal policy shift.

Still, the prospect of fiscal stimulus amid accommodative monetary conditions in the U.S. has dramatically changed the financial dynamics. Bond yields have risen, along with inflation expectations, while rising stocks prices are anticipating only a positive impact from the expected policy boost. Other aspects of a new Trump administration, such as trade protectionism and the potential imposition of tariffs on trading partners, have so far been treated with benign neglect by financial markets. This may come to haunt them in the first 100 days of the new administration. For example, renewed strength in the mighty U.S. dollar is likely to negatively impact manufacturing employment prospects, the very base of Trump's election supporters. Continued strength in the greenback makes it more likely that the new administration will make good on implementing trade restrictions. This development is the one that is most likely to unnerve financial markets and trigger retaliation from trading partners impacted by the new measures.

The Federal Reserve (Fed) also remarked that fiscal spending, when the U.S. economy is at full employment, will likely trigger a faster tightening of monetary policy, given the rising wage inflation risk. The Fed already delivered two hikes this past December—one official hike via the fed funds rate increase and another hike in the form of an increase in the number of "dots" published in the so-called dot plots*.

*Dot plots represent the consensus outlook of the FOMC Committee for the number of hikes expected for next year.

Elsewhere in the world, fiscal stimulus has also gradually appeared on government agendas. The European Commission recently wrote a note titled "Towards a positive fiscal stance for the euro area". In it, recommendations were made to European governments to support, where possible, economic activity via a loosening of fiscal stance. However, Europe has limited scope to expand fiscal spending. Germany may be the exception, as it benefits from a budget surplus and may use some of it ahead of its fall election. However, this is not expected to be a game changer for eurozone growth as a whole, given the remaining demographic and debt headwinds. In short, Europe shows no sign of interest in a revival of Keynesian economics. Britain's economic growth risks are tilted to the downside as well, given the uncertainty faced by economic agents, consumers and businesses once Brexit negotiations start in earnest (first quarter of 2017). This is likely to keep the European Central Bank (ECB) pursuing its Asset Purchase Program at least until year-end 2017. It may even prolong purchases into 2018, perhaps at a slower pace, to insure against sharp spikes in peripheral yields. Fiscal room is also limited in Japan, given the high debt level, while China can use some fiscal levers. However, given the large fiscal stimulus of the past year, the growth impact will only be enough to maintain government growth targets but not to exceed them.

As a whole, our main scenario of **"Policy Limits"** remains valid, given little monetary and fiscal room to maneuver at the global level. While the economic expansion is expected to continue in 2017, growth is not expected to accelerate. Uncertainty around this forecast is unusually large, given the many policy unknowns as we enter 2017.

Alternative Scenarios

Global Recession

Under this scenario, the world economy slows more than projected in the baseline scenario (*Policy Limits*), making it difficult to avoid a global recession as economic activity remains relatively modest. This more-negative scenario could be triggered by a number of potential events: trade frictions as the new American administration takes over, European uncertainty related to the start of Brexit negotiations and/or problems related to the Italian banking recapitalization efforts and/or extreme political parties winning the French or German elections. Any one of these developments 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 12 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 renormalization policy and start planning steps to cushion the potential economic downturn.

U.S. Renormalization

Since the surprise election of Trump and the Republican majority, financial markets have behaved as if a ***"U.S. Renormalization"*** scenario was taking place. With expectations of large fiscal stimulus that would generate above-consensus growth in the U.S., equity markets have outperformed and fixed income markets have anticipated stronger inflation and rising bond yields. Whether this leads to more robust global economic activity is questionable, given the protectionist rhetoric of President Trump.

Continued fiscal stimulus and higher-than-expected infrastructure spending in China could provide enough stimulus to push global 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. Furthermore, given that market action has already priced-in part of this outcome, there is little to gain, for the moment, in positioning portfolios along the lines of this scenario. The risks are for a move towards the other two scenario outcomes (*Policy Limits or Global Recession*) as we begin the year.

Fixed Income Versus Equity

Known political unknowns

The last quarter of the year was marked by many political events. First and foremost, the election of Donald Trump as President of the United States took the world by surprise. The markets' reaction to this unlikely event was also a surprise. On the night of the election, markets initially reacted with panic, as expected. Gold and bonds rallied, while equities saw sharp declines. However, these moves quickly reversed and paved the way for a sharp correction in gold and bonds, and a rally in U.S. equities. A less significant, yet still important, political event was the Italian referendum on constitutional reforms in December. Italians rejected the proposed reforms, leading to the resignation of the Prime Minister. Although less significant than Brexit, it is another event in Europe that highlights popular discontent following years of economic stagnation.

From an investment point of view, the main outcome of these events is increased uncertainty around policy outlook. We know what Trump discussed during the election, but doubts remain about what he will actually do. And we know even less about what he will be able to get passed through Congress. One thing is certain—Trump will need to moderate his policies. Congress is not only unlikely to allow these measures to pass in their existing (proposed) form, but his advisors, as well as lobbyists, may push him in a more pragmatic direction. It is an understatement to acknowledge that Donald Trump is unpredictable. But it will take time before his policy agenda starts to take shape. It will take even more time before the policies are implemented and have an actual impact on the economy.

Any attempt to assess how Trump's policies will affect financial markets is pure speculation, at least at this point. Generally speaking, we can expect his policies to take aim at creating jobs and favouring stronger growth. The adverse side effect could be upward pressure on inflation. The implications for the bond market should be higher yields, and this is what markets have been rapidly pricing in.

The impact on equities is less obvious. Given stronger economic growth, investors might be willing to pay a higher price for equities. That said, inflation typically leads to lower P/E ratios. In order to assess the net impact of stronger growth and higher inflation, we used a regression model. With this model, we can measure the marginal impact of each variable on the P/E ratio. As shown in the table (next page), inflation and inflation uncertainty are the most significant drivers of P/E ratios. A tight labour market that generates higher wage growth and higher import prices from trade tariffs would be bad news for equities. However, if fiscal policy succeeds in boosting growth, some of the negative impact could be offset. The caveat is that it would not be sufficient to only deliver faster economic growth. Investors are willing to pay a higher price for equities not just if the economy is stronger, but only if companies are more profitable. In fact, a moderate increase in inflation would require a large improvement in profitability in order to maintain the P/E at the same level.

Typically, we formulate our main economic scenarios and then assess the implications for financial markets. However, the 2017 economic outlook is more dependent than usual on the performance of the bond market and the U.S. dollar. These unusual conditions make it especially difficult to develop investment strategies. One consequence is that it should accentuate trends—markets may overreact on the upside and the downside—as investors will be unsure how to interpret new information.

The global economy has good momentum. Monetary conditions (i.e. interest rates and currencies) and fiscal stimulus always take some time before their impact is felt on the real economy. As such, the current economic momentum is the result of monetary conditions that loosened in the U.S. earlier in 2016, as well as previous stimulus measures implemented in China. Those effects should carry over into the first and second quarter of 2017. After that, the recent rise in interest rates and the appreciation in the U.S. dollar will start to bite, while the expected U.S. fiscal stimulus will not yet be deployed. For now, a neutral to cautiously positive stance on equities is warranted. Bonds should underperform, as monetary policy and bond yields continue to normalize.

What Determines P/E Ratios?

For a 1% Increase in:	The Marginal Change in P/E is:
Volatility of inflation	-9.9%
Inflation	-9.1%
Return on equity (ROE)	4.5%
Real interest rate	-1.6%
Real GDP growth	0.1%

Based on a multiple regression of the S&P 500 P/E ratio against these 5 variables
Source: CIBC Asset Management

Equity Market Outlook

More on U.S. vs. Emerging Equities

The attractiveness of emerging markets relative to U.S. equities has been at the core of our equity strategy for some time. In the context of the outcome from the U.S. election, we take another look.

Our arguments against U.S. equities have relied on the following: 1) U.S. equity valuation is high, both compared to its own history and compared to other markets; and 2) profit margins are historically high, at a time when the labour market is tight and wages are picking up. Are these arguments still valid? Profit margins were high because both the cost of labour (as a % of GDP) and interest rates were historically low. These conditions were beneficial for companies, but are unlikely to persist. In fact, margins have already started to decline as wages have picked up.

The impact of Trump's fiscal policy on valuation will depend on its impact on growth versus how much inflation it generates. Let's assume U.S. CPI, which now stands at 1.6%, rises to the 2% targeted by the Fed. This is a conservative assumption, since the Fed has indicated they would tolerate an overshoot for inflation. Also assume inflation volatility, now at 2.2%, returns to its historical average of 3.4%. In this scenario, a minimum increase of 2% in Return on Equity (ROE) would be required to keep the P/E ratio stable (based on the sensitivities shown in the previous section). That would raise ROE from 15.2% currently (which, coincidently, is in line with the historical average) to 17.2%. This is not impossible, but it would be a significant increase. To put this in perspective, ROE has historically peaked around 18%. Only during the boom years of the late 90s has it been higher. A higher ROE would most likely not come from higher profit margins—higher leverage or higher asset turnover would be needed to raise ROE. The bottom line is the policies favoured by Donald Trump are likely to be more positive for Main Street than for Wall Street.

If U.S. equities have performed well in the aftermath of the elections, investors have not been as kind to emerging markets. Both equities and currencies in emerging countries have underperformed, leading to even more attractive valuations. The main question is: why are emerging markets cheaper? We look at a number of factors that could explain this gap.

The valuation of emerging markets (EM), relative to the U.S., and more generally to all developed markets (DM), has loosely followed the relative economic growth of the two regions. In recent years, while growth in EM has remained higher than in DM, the difference between the two has narrowed. This relative slowdown in EM economic growth has also spilled over to weaker profitability. Return on equity in EM has declined and is now close to the level of the developed world. If we break down ROE, we see that profit margins have declined while corporate leverage has increased, not the most desirable combination. However, we also note that the interest coverage ratio, a measure of how much cash companies generate to pay debt, has remained healthy. Most of the increase in leverage has come from China. Other emerging countries continue to show less leverage than in the developed world. In China, the increase in leverage has come from industrial and basic materials companies. These are the old economy sectors struggling with over-capacity. Furthermore, our measure of economic vulnerability shows that the economic health of EM improved until late 2015. Since 2015, the improvement has stalled, but only a few countries have actually deteriorated. Russia and Brazil have felt the pain from weak commodity prices. While there are a few pockets of concern (i.e. the old economy in China and commodity producers), the overall corporate and economic health of emerging markets has improved since the Great Financial Crisis and, more recently, has remained stable. As such, we believe the large valuation discount in emerging markets is not justified—in other words, emerging markets are currently undervalued.

Commodity Insight

In 2016, commodity markets entered the year with an accelerating deflationary backdrop, as global demand growth was looking increasingly challenged. However, as we exited the year, markets had moved in the opposite direction, with reflationary expectations increasing post the election of Donald Trump. Crude oil markets received additional support from a dramatic reversal in direction of OPEC's strategy. In November, OPEC, led by Saudi Arabia, indicated that it would shift its policy from one of growing market share to one of supply management, in order to bring about a quicker rebalancing of the global oil markets. In addition, several non-OPEC members also indicated support for production cuts starting in the new year. Russian support in particular was seen as key to achieving the cuts proposed by the non-OPEC members. It is now expected that crude oil markets will move to a deficit towards the end of 2017. U.S. producers are likely to be the biggest beneficiary of the expected increase in oil prices as they move to increase the pace of production from the relatively fast-cycle shale basins. Market participants will be watching OPEC members' compliance with the new production quotas, along with the pace of U.S. production growth to determine the future direction of oil prices. 2017 promises to be another interesting and volatile year for the commodity markets.

Fixed Income Outlook

Navigating a policy transition

- **In light of recent developments on the policy front, we are now working with a 12-month target of 3.00% for U.S. 10-year Treasuries and 2.00% for the Canadian equivalent.**

Although bond yields reached new cyclical lows last summer, the final months of 2016 resembled the famous "taper tantrum" of 2013. The year-end pullback in the Canadian bond market was triggered by shifting market expectations about the inflationary nature of potential policy changes from a new U.S. administration.

Moving into the new year, the pullback in bond markets is expected to continue, but the upside for bond yields (downside for bond prices) should be limited. U.S. and Canadian 10-year sovereign bond yields are projected to peak around 3.00% and 2.00% respectively in 2017. This forecast is somewhat below consensus.

There are multiple forces pushing yields higher in 2017. First, the U.S. Federal Reserve is expected to stay in renormalization mode and gradually and prudently hike interest rates. While this is, for the most part, already priced into the bond markets, it should provide a floor for bond yields. Second, other major central banks, such as the Bank of Japan (BOJ) and the ECB, will likely experiment further with the "QE with yield curve control" policies already implemented. The implicit objective here is to gradually re-steepen yield curves in an orderly fashion, as conditions allow. The efforts deployed to control the shift in term structures in Japan and the eurozone should indirectly limit the size and speed at which yields can rise in North American markets. Finally, our forecast accounts for the inflation risk associated with potential developments on the fiscal and trade fronts in the United States. The policy changes envisaged have the potential to significantly alter the U.S. inflation backdrop. As a result, the inflation premium embodied in bond yields is likely to rise. Altogether, we see these factors as moderately bearish for bond prices, marginally favourable to Canadian bonds vs. U.S. and still supportive of an outperformance of corporates relative to sovereigns.

The risk to this baseline scenario is for a pullback in bond markets that turns too violent. If this happens, the damage on the economic front could be serious enough to force U.S. monetary authorities to move to the sidelines.

Currency Markets

U.S. Dollar

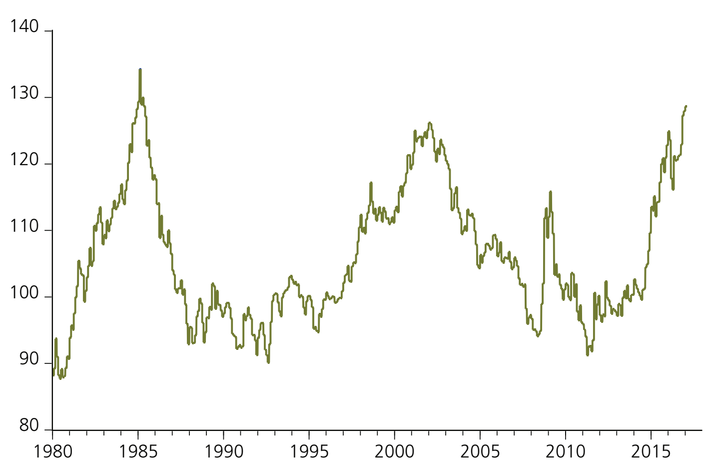
Looking back on 2016, the U.S. dollar remained strong on the back of widening monetary policy divergence between the Fed and other central banks. As the Fed continues its policy renormalization, nearly all other central bankers are either keeping their monetary policy stance ultra-easy or easing policy further. Not surprisingly, against this backdrop, the U.S. dollar uptrend has not been seriously challenged.

Looking at 2017, the U.S. dollar outlook is not as clear. For one thing, it is not evident that the U.S. economy will be able to cope much longer with U.S. dollar strength. This is a direct hit on U.S. global competitiveness. The side-effects are already very apparent. The U.S. ex-energy trade deficit has been widening throughout 2016 and will most likely reach record highs in 2017. This could prove challenging for corporate America. Just as the U.S. profit recession appeared to be drawing to a close, U.S. nonfinancial corporations now have to cope with the U.S. dollar's continued ascension, implying another drop in profits from abroad and further declines in exports.

In the past, foreign exchange developments played very little 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 decisions on the U.S. dollar. The current situation could be different. On a real-effective basis, the U.S. dollar is the strongest it has been in over two decades and the all-time highs of 1985 are well within reach.

US Dollar: Revisiting the 1985 All-Time Highs?

Effective US dollar Index (CAM)



Sources: Thomson Reuters Datastream, CIBC Asset Management Inc.

Canadian Dollar

In 2016, fluctuations in the Canadian dollar were again heavily influenced by developments in the oil market—this will likely continue in 2017. From this perspective, it's tempting to conclude that prospects for range-trading in oil prices over the next year should allow for some stabilization in the value of the Canadian dollar against the U.S. Unfortunately, this may not necessarily be the case. Fluctuations in the Canadian dollar exchange rate are not solely driven by swings in oil prices. The relative Canadian-U.S. cyclical backdrop and its implications for monetary policy setting by the Bank of Canada (BoC) and Fed are just as important—especially when there is very little price action in the oil market.

If we are right and the Canadian economy disappoints again in 2017, the BoC will be inclined to ease policy further. Meanwhile, the Fed will most likely keep its monetary policy on the path to renormalization. This projected widening in BoC-Fed monetary policy differentials will keep the U.S. dollar well-supported against the Canadian dollar.

Japanese Yen

In late 2016, fluctuations in the USDJPY exchange rate were essentially driven by swings in the U.S.-Japanese 10-year sovereign bond yield spreads. Since the BOJ introduced "QQE with Yield Curve Control" on September 21, JGB 10-year yields have remained extremely well-behaved. Meanwhile, all other bond markets in the developed world experienced a brutal pullback. The end result: a sharp widening in U.S. bond yield spreads with Japan. The widening of US-JP 10-year spreads from +169 basis points (bps) to +233 bps entirely explains the substantial appreciation of the U.S. dollar against the Japanese yen. The Bank of Japan is probably satisfied with what its comprehensive monetary policy framework reassessment has achieved so far on the currency front.

What remains to be seen, however, is whether the Japanese yen will continue to be solely driven by yield spreads moving into 2017. The yen has been steadily declining because investors haven't, so far, sought refuge in safe haven assets. Thanks to a wide current account surplus, the yen is fundamentally well-supported and has not lost its safe haven properties. With many political events still to come in 2017 (elections in France, Germany and the start of Brexit negotiations) the safe haven nature of the yen may push the yen to higher levels during the year.

Euro

Despite all the easing efforts deployed by the ECB, the euro has been range-trading for nearly two years. Since the beginning of 2016, the euro's value against the U.S. dollar has been stuck between 1.10 and 1.14—a relatively tight trading range by historical standards.

This has been happening because opposing forces have been at work, offsetting each other over this period. On one hand, the euro's fundamentals have improved considerably with the widening of the eurozone's current account surplus. The eurozone's trade surplus with the rest of the world has widened sharply, from near zero in early 2012 to 280 billion EUR currently—a record high (+2.6% of GDP). On the other hand, the ECB has remained in easing mode, in sharp contrast to the Fed, which has been tightening its policy stance.

During 2017, the scale could very well tip to the downside, owing to a narrowing of the eurozone's current account surplus. As we point out in the European economic section, going forward, EU exports are not likely to be the growth engine they used to be. If the eurozone's domestic economy holds up, the trade balance will deteriorate. Under such conditions, the EURUSD bilateral exchange rate will likely lose more ground against the USD over the coming twelve months.

Regional Outlook
Canada

- **Over the next 12 months, real GDP growth will likely further disappoint, ending up closer to +1.2% than the +1.8% widely expected for 2017.**

For the last two years, the BoC and consensus have been overly optimistic about growth prospects in Canada and the United States. Looking ahead to 2017, the BoC is still wearing the same old rosy glasses, projecting 2.0% real GDP growth for the Canadian economy.

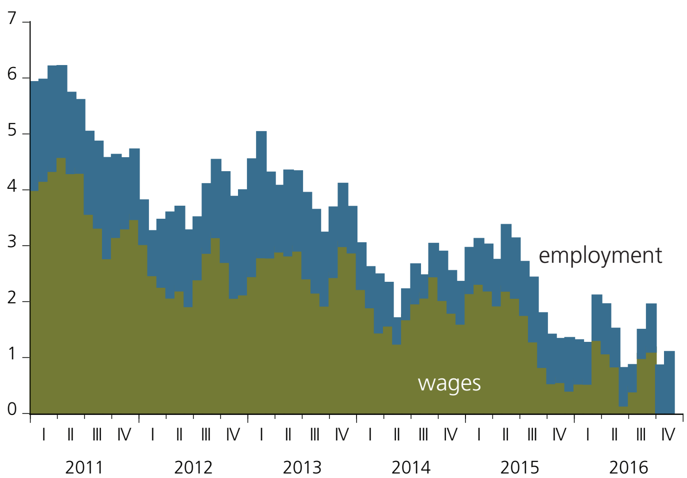
For this forecast to materialize, two important developments need to occur. **First**, the Canadian consumer has to remain the economy's growth engine, contributing as much to GDP growth as it did in 2016. This is easier said than done, as consumer fundamentals have deteriorated over the last year. Employment and wage growth have both slowed substantially and the debt load of Canadian households has reached record highs. The national ratio of debt to disposable income is fast approaching 170%, implying heightened vulnerability to rising borrowing costs.

Second, the long-awaited recovery in exports has to finally take place and, so far, there is no indication that this is happening. In late 2015, the BoC projected that real exports would add +1.7% to real GDP growth in 2016. Real exports have instead acted as a drag on growth—a huge disappointment. How can this be happening? Normally, with improving U.S. domestic conditions and an undervalued Canadian dollar against the greenback, it doesn't take long for Canadian exports to the U.S. to grow at a faster pace. This is not happening, in part, because the U.S. economy is not as strong as the BoC projects. That being said, the main reason why Canadian exports are not recovering relates to relative competitiveness. The depreciation of the Canadian dollar pales in comparison to the plunge experienced by the currencies of most other countries that export to the U.S. The end result is that Canada is losing its U.S. export market share to the rest of the world.

Our forecast projects 1.2% average Canadian real GDP growth in 2017. If we are correct in our assumptions and the Canadian economy disappoints again, the BoC will be inclined to further ease monetary policy. Unfortunately, with the policy rate near zero, there is very little left in the "normal" policy toolbox. One option available is to use forward guidance and strongly and repeatedly re-emphasize that Canada will be stuck in a low growth environment for much longer than generally expected (the lower-for-longer mantra). This would implicitly signal that there is no BoC policy renormalization in sight.

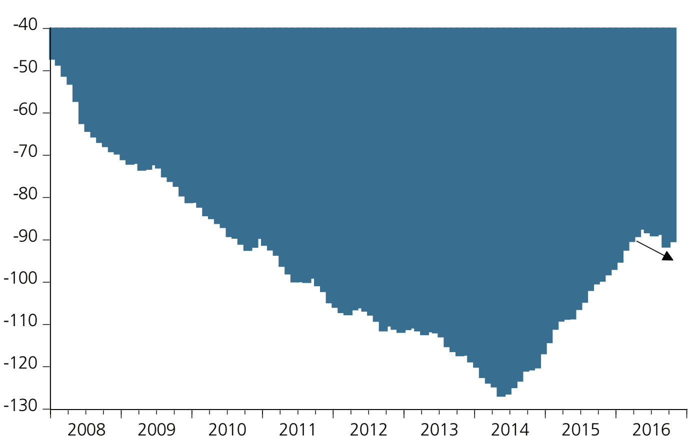
Weakening Consumer Fundamentals

CN household income growth (y/y%): employment & wages



Widening Canada Ex-Oil Trade Deficit?

Ex-Oil Canadian Trade Balance (CDN Billions)



Sources: Thomson Reuters Datastream, CIBC Asset Management Inc.

United States

- **In 2017, we project U.S. real GDP growth will average +1.6%. This below-consensus forecast is based on our expectation of continued drag from net exports, a deeper downturn in non-residential investment and weakening consumer fundamentals.**

As 2016 finishes on a positive note, consensus remains relatively upbeat about U.S. economic prospects moving into the new year. Most private-sector economic forecasters expect U.S. real GDP growth to exceed 2.0% on average in 2017—a forecast very similar to the projection for 2016 at the end of 2015. Will the U.S. economy disappoint for a fifth year in a row? Odds of another growth disappointment are higher than generally estimated for two reasons.

First, relatively better U.S. growth prospects (as compared to the rest of the developed world) imply that the Fed will stick to its policy renormalization plans. In turn, this means that the overvalued U.S. dollar will stay strong moving into 2017. U.S. dollar strength will likely suffice to kill all hopes of a recovery in U.S. exports, leading to a widening of U.S. trade imbalances. The already-wide U.S. non-oil trade deficit will likely reach record proportions in 2017. This will create a challenging environment for corporate America. Just as the U.S. profit recession appeared to be drawing to a close, U.S. nonfinancial corporations will have to cope with another drop in profits from abroad and lower export revenues. This will be taking place in the context of rising compensation costs, intensifying the squeeze on U.S. corporate profitability. Under such conditions, non-residential investment spending growth could continue to disappoint.

The **second** reason why we think U.S. growth may disappoint relates to rising borrowing costs. With the prospect of higher inflation and elevated fiscal stimulus, market interest rates moved higher in late 2016. This pullback in bond markets is unlikely to be followed by a market rally that would bring yields back to their cyclical lows. In short, borrowing costs are rising in a more permanent way. This could be problematic, as the overall U.S. debt overhang has never been so big: $45 trillion split between households, nonfinancial corporate and governments. <u>If sustained</u>, the recent rise in borrowing costs has the potential to do some damage to the economy in general and to the real estate sector in particular.

In light of the expected U.S. dollar appreciation and continued rise in borrowing costs, we are working with a below consensus forecast for U.S. real GDP growth of +1.6% (average) for 2017. U.S. headline CPI inflation is expected to accelerate to +2.6%.

Europe

Last December, the ECB made important changes to its monetary policy framework. While it will be buying European Union (EU) sovereign bonds at a slower pace (from 80 B to 60 B per month), other adjustments to the ECB's program established a firmer foundation for Quantitative Easing (QE) going forward. While appearing to taper its asset purchases, the ECB has actually delivered the prospect of QE ad infinitum. Why is this necessary? It is simply because the ECB's battle against deflation is far from over.

If all goes according to plan and the eurozone economy doesn't hit any speed bumps, the slack in the eurozone labour market should be eliminated in 2017. In turn, this should put an end to the continued deceleration in wage inflation observed all across the eurozone, fuelling hopes that the ECB may one day declare victory on deflation risk. While this hoped-for scenario may very well materialize next year, there are a few important potential roadblocks to consider.

The most important roadblock relates to external trade. Strong exports were the main reason why the eurozone finally shifted to recovery mode a few years ago. The eurozone's trade surplus with the rest of the world widened sharply, from near zero in early 2012 to 280 billion EUR currently—a record high (+2.6% of GDP). Going forward, EU exports are not likely to be the growth engine they used to be. This means that growth in the eurozone could possibly disappoint. We are working with a below-consensus real GDP growth projection of +1.0% (average) for 2017.

While growth disappointments may not be a big worry for those eurozone economies that are doing well, like Germany, they are problematic for the eurozone's weaker links, like Italy. At this juncture, Italy's fragile economy just wouldn't be able to cope with an external trade shock.

In short, the ECB is walking a tightrope. Its battle against deflation is not over, implying that it will have to stick to its unorthodox policy combination (i.e. massive asset purchases and sub-zero policy rates) throughout 2017. At the same time, it will need to manage, as much as possible, the side-effects of the policies it implements. The task at hand promises to be a challenging one.

China

Unwinding of policy stimulus in 2017

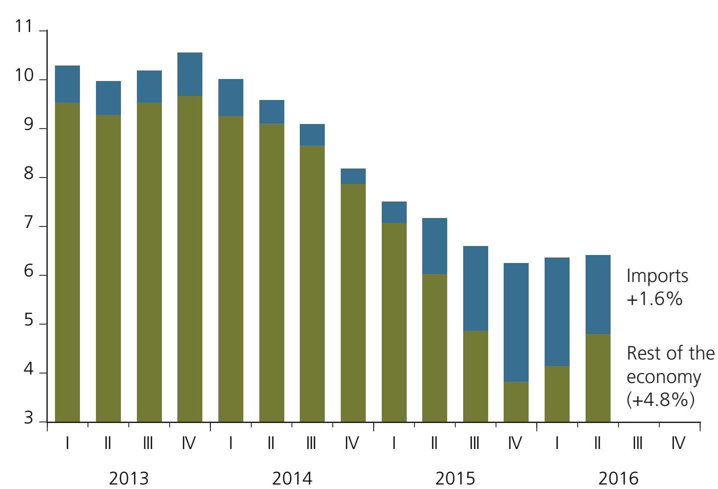
- **Our estimate for Chinese GDP growth is 6.2% by Q4 2017. This suggests that growth momentum has peaked and will slow in the coming quarters.**
- **Chinese exports continue to gain global market share. This dynamic, in combination with a weakening currency, is an important hurdle for the relations between the U.S. and China.**

In 2015 and 2016, Chinese policy-makers supported economic growth with a significant amount of policy stimulus. Stimulus came initially from the expansion of fiscal and monetary policy and through currency depreciation. The result was a boost to growth and a recovery in private sector activity. However, in 2017 we will see an important unwinding of policy stimulus. Monetary policy has shifted to neutral gear as inflation firms and is expected to remain firm throughout 2017. In addition, fiscal policy expansion is likely to be on the sidelines in the first half of 2017, as the government assesses the sustainability of the current growth of the economy. We expect little fiscal policy support in the first half of 2017. Our estimate for GDP is 6.4% average growth and 6.2% year-over-year by Q4 2017. Consumer price inflation is expected to advance by an average 2.3% in 2017.

China's growth continues to be impacted by the transition of both external and internal rebalancing. Internal rebalancing is taking place quickly, with consumption expenditures contributing twice as much to GDP as fixed investment growth. The progress of external rebalancing is not as clear. From a domestic point of view, goods exports as a percentage of GDP remain in surplus and there has been no narrowing of the ratio since 2009. Where we do see a change is in the balance of services as a percentage of GDP, which has recorded a steady expansion of its service deficit. This being said, Chinese exports relative to total world exports have continued to increase, suggesting that China increased its market share of world exports in 2016. From an external perspective, China's export market continues to grow and is not showing any rebalancing, particularly in trade of merchandise goods. The market share gain, in combination with a weakening currency relative to the USD, has been a point of focus for the newly-elected U.S. political administration. The more this persists, the greater the risk that relations between these two nations will sour. An important risk to Chinese growth in 2017 is the possibility that the U.S. will impose heavy import tariffs on Chinese goods, which would negatively impact Chinese exports and GDP growth.

How China Is Meeting Its Growth Target

Contributions to Nominal GDP Growth



Source: CIBC Asset Management Inc.

Long-Term Capital Market Returns

We have prepared a new assessment of 10-year expected returns for major financial market asset classes. This section details our major conclusions and a summary of the inputs to the analysis. For our complete views and forecasts, please request the full report.

Asset class returns

- The most attractive asset classes are emerging market equity and emerging market sovereign bonds, even accounting for the fact that they are riskier. This attractiveness is further increased when factoring in the expected long-term movements in currencies.
- Projected returns for North American high-yield bonds or major developed market equities are better than for fixed income. However, they are not expected to exceed the approximately +7% (long-term annualized return) figure still used by many pension plans and endowment funds in their financial planning.
- Investing in North American bonds is expected to provide low or no real returns on average over the next 10 years.

Inputs: GDP forecasts and valuation

- A well-anchored view of macroeconomic prospects is necessary for assessing returns of financial assets over the long term.
- Potential GDP growth prospects are weak for advanced economies, hovering in most cases within a 1-1.6% range for the next 10 years.
- Prospects are stronger in emerging economies—owing to ongoing "catch-up growth", as living standards gradually converge towards those of advanced economies—but are lacklustre relative to pre-crisis figures. Emerging markets have made progress in recent years in the transition away from a reliance on exports and commodities, paving the road for sustainable macroeconomic performance over the long run. This is occurring despite increased concerns of protectionism, which have contributed to lower cyclically-adjusted P/E ratios in emerging economies, thus making them more attractive.

Background

We consider four factors that will shape GDP growth over the next ten years. Stimulus policies by central banks and governments have no effect on these factors.

- **Weak productivity growth**, including diminishing effects of technological advances on production;
- **Increasing debt-servicing costs** (from rising interest rates) will restrain expenditures of households, corporations and governments;
- **Less favourable demographic prospects**;
- **Weak demand for capital**, owing to adverse impacts of other factors on GDP

Expected Returns of Major Asset Classes – Next 10-year averages

Asset Classes	Expected Next 10-Year Returns (%)	
	CAD	Local Currency
Fixed Income (total returns)		
Canadian Money Markets	1.3	
Canadian 10-y Government Bond	1.7	
Canadian Inflation	1.8	
Canadian Corporate Bonds	1.9	
U.S. Money Market	2.1	1.7
U.S. 10-y Treasury	2.8	2.4
U.S. Corporate Bonds	3.3	2.8
U.S. High Yield Bonds	5.7	5.2
JPM World Gov. Bonds (advanced economies)	2.2	1.4
JPM Emerging Government Bond	10.5	6.8
Equity		
Canada	4.0	4.0
U.S.	2.4	1.9
U.S. REITS	1.4	0.9
MSCI EAFE	6.9	5.9
MSCI Emerging Economies	13.1	10.4
MSCI World	4.6	3.8

Sources: CIBC Asset Management calculations; asset classes weights from JP Morgan and MSCI.

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
- Retail Sales (monitoring impact of fiscal policy)
- Oil impact on trade balance (energy vs. non-energy)

U.S. Signposts

- Fiscal policy announcements (tax cuts, tariffs, currency manipulator etc.)
- Corporate profitability
- Effective U.S. dollar
- Underemployment (decline in U6 measure) and wage growth (ECI)
- Manufacturing (impact of U.S. dollar strength)
- Core PCE inflationary pressures (pass-through from U.S. dollar strength and oil price decline)
- Domestic oil production increase (following OPEC agreement)
- 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
- Brexit negotiations
- Effective Japanese yen
- Global Purchasing Managers' Indices
- Eurozone banks relative performance
- UK commercial real estate activity
- French elections