CIBC Asset Management

PERSPECTIVES

For the 12-month period beginning July 1, 2019

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Doing whatever they can

The number of countries on the trade war's casualty list is growing quickly. For the first time in more than a decade we are projecting a pronounced global growth slowdown, with world real GDP growth falling below 3% over the next twelve months. While global investors were relieved to hear that central bankers are taking a dovish turn, market jitters have not completely disappeared.

Asset class highlights

Fixed Income vs. Equity: For a longer-term investment horizon, equities have a more attractive risk premium than bonds. But the path from the short term to the long term may be quite volatile. In this challenging environment, we are also turning to non-traditional asset classes like gold and emerging markets local-currency debt.

Equity: Canadian equity valuation is slightly less attractive than international equities, but Canada does not face the same structural slow growth. With low interest rates, U.S. equity valuation is expensive but not excessive.

Fixed Income: U.S. Treasury 10-year yields will most likely hover in a range of 2-2.50% over the next 12 months, with an increasing probability of yields below 2% if the global slowdown lingers.

Currencies: The Canadian dollar remains more fundamentally challenged than most developed market currencies.

Multi-asset outlook

Asset class	Current June 30, 2019	Most likely minimum of range for next 12 months	Most likely maximum of range for next 12 months
Canada 3-month T-Bills rate	1.75%	1.25%	1.75%
Canada 2-year government bond yield	1.48%	1.05%	1.60%
Canada 10-year government bond yield	1.47%	1.25%	1.85%
U.S. 10-year government bond yield	2.00%	1.75%	2.50%
Germany 10-year government bond yield	-0.32%	-0.50%	0.25%
Japan 10-year government bond yield	-0.16%	-0.25%	0.30%
Canada 10-year real-return government bond yield	0.32%	0.15%	0.35%
Canada investment grade corporate spreads	1.10%	0.95%	1.45%
U.S. high yield corporate spreads	4.14%	3.75%	4.75%
Emerging market sovereign (USD dominated) bond spreads	365	290	500
S&P/TSX price index	16,382	15,900	17,300
S&P 500 price index	2,942	2,750	3,025
Euro Stoxx 50 price index	3,474	3,250	3,590
Japan Topix price index	1,551	1,460	1,600
MSCI Emerging Markets	58,072	56,300	61,600
U.S. Dollar/Canadian Dollar	1.3068	1.25	1.43
Euro/U.S. Dollar	1.1388	1.10	1.24
U.S. Dollar/Japanese Yen	107.74	100.0	115.0
U.S. Dollar/Offshore Chinese Yuan	6.87	6.50	7.30
Gold	1,412	1,350	1,500
Oil price, WTI (West Texas Intermediate)	58.20	50	60

Asset class outlook

Global overview

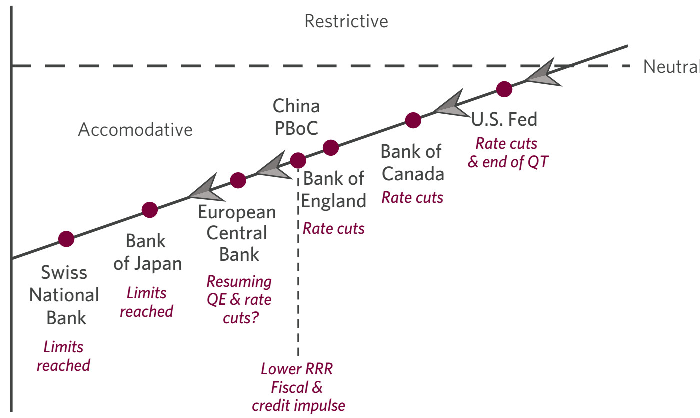
From "Whatever it takes" to "Whatever they can"
Monetary authorities across the globe are expressing concern about the impact of the trade war on the world economy—signaling in unison their intentions to provide more policy relief if conditions justify it. Global policy-makers are right to be concerned. The number of countries on the trade war's casualty list is growing quickly. For the first time in more than a decade we are projecting a pronounced global growth slowdown, with world real GDP growth falling below 3% over the next twelve months. While global investors were relieved to hear that central bankers are taking a dovish turn, market jitters have not completely disappeared. This hardly comes as a surprise. With already ultra-low interest rates and already massive central bank balance sheets, how can we be sure that a global economic downturn can be avoided?

What is comforting is that the efforts being deployed now are truly global. Not too long ago, the most important central bank in the developed world—the U.S. Federal Reserve (Fed)—was still in tightening mode. By shifting policy into easy territory, the Fed will be providing much needed liquidity relief across the globe.

The most important lesson of the last decade has clearly been never to underestimate the ingenuity of policy-makers. When conditions required it, they did not hesitate and took action. In most cases, this led to the adoption of very unorthodox policies (i.e. sub-zero policy rates and asset purchasing programs). Looking forward, we could again be surprised by how far they are ready to go. If conditions justify it, it is not impossible that policy rates will be moved deeper into negative territory and that many central banks will adopt or resume Quantitative Easing (QE).

Having said this, it has become quite clear that, over time, unorthodox policies come with significant negative side effects. This is very apparent when looking at interest rates across the maturity spectrum. For the first time ever, the global yield curve is inverted in the context of ultra-low policy rates and increasingly adverse economic conditions. This spells trouble for the financial sector. The longer this situation prevails, the more intense the pressure will become for global banks. From this angle, delivering more QE and/or lowering policy rates further probably isn't the right prescription to get the world economy back on its feet. In this environment, navigation conditions will likely remain difficult for global investors over the forecast horizon.

Monetary policy stance



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

Global strategy

Equities vs. bonds: A conflicting view of global growth?
The growth recovery that's been tentatively taking shape is fading. On top of that, it's more and more difficult to predict the outcome of the trade war. Breakeven inflation expectations have declined below 1.7%, meaning the market is expecting that the Fed will fail to reach its inflation target over the next 10 years. With these concerns, it's no surprise that the 10-year nominal yield for U.S. government bonds has continued to decline. With as little as 2% nominal and 0.3% real yield, U.S. bonds still rank as the highest yielding developed-market government bonds. Globally, there are now over 13 trillion dollars worth of bonds with a negative nominal yield—the bond market is clearly pricing in an easing cycle from the Fed and other central banks. Unless they deliver more than expected, there is little downside left for bond yields. A more pronounced slowdown, or an outright recession, would be required to force central bankers into more easing (i.e. more than is already priced in). On the other hand, if growth stabilizes, bonds could face a tough year.

Meanwhile, equities continue to rally, with some markets coming into close range of their all-time highs and creating a more benign picture of the global outlook. U.S. corporate earnings are slowing, but have so far been relatively resilient, and investors seem comfortable with the relatively high P/E[1] ratios. Falling interest rates are positive for equity valuations—as long as growth does not falter. The bottom line is the equity market is betting that central banks will be successful in keeping the growth engine running. That may yet happen, but even if it does, it looks like this scenario has already been priced in by the market. On the other hand, if growth does not respond so kindly to central bank easing, equities could face a tough year.

[1]Price/earnings

For a longer-term investment horizon, equities have a more attractive risk premium than bonds. But the path from the short term to the long term may turn out to be quite volatile. Equities, the default asset class for capital appreciation, are facing cyclical pressures and bonds, the typical defensive asset class, are expensive and already pricing in a weak cyclical outlook. From a tactical standpoint, this is certainly a challenging environment for portfolio construction. As a result, we are turning to non-traditional asset classes like gold and emerging markets (EM) local-currency debt.

Emerging countries have higher interest rates than the U.S., so provide more return that comes from income. They also have higher real interest rates, giving central banks room to cut rates to support their economies. With the Fed expected to ease, we do not expect a repeat of 2018, when Fed tightening triggered a sharp rise in the U.S. dollar and bond yields, and led to a significant underperformance for emerging markets. On the risk spectrum, EM local currency debt stands between equities and bonds—not quite as safe as G10 bonds, but less volatile than equities. The undervaluation of EM currencies adds to the attractiveness of the asset class.

Global equities

Canada

With the U.S. market the biggest export destination for Canadian companies, a slowdown in the U.S. typically means even more weakness for Canada. However, in the case of the current trade war, it seems that Canada has managed to stay outside the line of fire and has avoided being a direct casualty. Economic data has been better than expected by the consensus, as shown by the Citigroup Economic Surprise index. Valuation is not a significant headwind, as it is in the U.S. Compared to international equities, valuation is slightly less attractive, but Canada does not face the same structural slow growth.

United States

The U.S. Federal Reserve has more leeway than other countries to support its economy, and, in that way, can indirectly support the equity market. However, it also faces a relatively more robust economy and, because of this, there is no need to act aggressively. The S&P 500 is up 19% year-to-date, mostly because P/E ratios have been lifted by falling interest rates. With low interest rates, U.S. equity valuation is expensive but not excessive. Although there are downside risks to our forecasts, our main scenario of a not-so-soft landing, i.e. a slowdown without an official recession, could mean the Fed will disappoint the market by cutting rates less than expected. After all, financial conditions have already improved, doing part of the Fed's job. In that scenario, valuation will turn from expensive to excessive.

EAFE

European equities have followed in the footsteps of their American counterparts, with close to a 20% return this year. Like the U.S., the market was pushed higher by expectations of central bank dovishness and falling interest rates. While we argue the Fed has policy tools available (but may not need to use them), we would also argue the European Central Bank (ECB) will need to ease but will not be able to deliver as much as investors expect. The ECB has made considerable efforts to reassure the market that it still has policy options. However, the main question is not whether they can come up with something creative, but rather if it will have any lasting impact. The other issue is that while earnings in the U.S. were slowing from a high level, European companies saw their earnings growth dip into negative territory. Paying a higher price for lower earnings is not a great proposition.

Emerging Markets

The attractiveness of emerging markets is structural. With higher potential growth, lower valuation and undervalued currencies, emerging equities have, by far, the highest long-term expected return of all the asset classes we cover. The trade war does not alter that equation. First, the direct impacts of tariffs on growth are expected to be transitory and moderate. In other words, it will have barely any impact on potential growth. Second, the main impact of the trade war is on sentiment, and that impact is more cyclical than structural. Third, if anything, valuation has become somewhat more attractive since the start of the trade war. However, when looking at a more tactical horizon, there is clearly a risk to emerging markets. When considering the recent underperformance of EM equities, we see the the trade war impact. Countries like China, Korea and Mexico, which are directly affected, have underperformed. Other countries that are not directly affected, like India, Russia and Brazil, have actually done very well. The short-to-medium term downside risks for EM have to be balanced against the upside risk. A resolution, or at least the hope of one, could be a very positive catalyst for EM. The bottom line is we are cautious over the short term but remain constructive over the long term.

Global bonds

Repricing continues

Developed market bond yields have continued to move lower, with U.S. Treasuries and Bund yields reaching 2.00% and -0.33%, respectively, at the end of the quarter. Uncertainties related to the U.S./China trade war, shifting monetary stance at central banks, weakening economic data worldwide and subdued inflationary pressure all converged to increase demand for safe-haven bonds.

In normal times, U.S. Treasury yields would stabilize around current levels. The latest trade war truce between the U.S.

and Chinese administrations would help global consumer and business confidence improve. The impact of more dovish developed market (DM) central banks and reflationary efforts in China over the last six months would normally lead to improved global economic data over the next few quarters. Finally, with the mood already very depressed, the bar is currently set very low and incoming global data could easily surpass expectations. This view has already flowed into the equity and the credit markets, but is not yet reflected in the sovereign bond market. As a result, the improved financial conditions could support growth going forward and DM bond yields could soon resume their upward trajectory.

Unfortunately, we might not be in normal times. The end of more than ten years of global monetary expansion and an atypical global political environment are blurring the picture—a more dire "alternative" scenario still can't be discarded. In fact, several important signposts are not yet signaling a recovery. Global leading indicators continue to deteriorate, global trade volume remains in free fall and business surveys offer little to cheer about. Meanwhile, inverted yield curves in the U.S. and Europe are already signaling the high likelihood of a global recession. Moreover, with feeble and constrained credit and fiscal impulses in all regions (especially in Europe), it will be difficult for the global economic landscape to materially improve. These dynamics are usually associated with downward pressure on bond yields.

If our base case scenario unfolds, U.S. Treasury 10-year yields will most likely hover in a range of 2-2.50% over the next 12 months. That said, we need to stress the increasing probability that U.S. Treasury yields will plunge below 2.00% in more permanent fashion if the global slowdown lingers.

In Canada, our base case scenario is for 10-year sovereign bond yields to trade between 1.30% and 1.90% over a twelve-month horizon. Household and housing imbalances, and especially worrisome nonfinancial corporation debt levels, are major sources of concern. These structural soft spots leave the Canadian economy in a vulnerable position in the current external economic slowdown. If our below-consensus Canadian real GDP forecast materializes (highlighted on page 6), the BoC will need to cut interest rates more than is currently priced in, leading to still lower bond yields.

Currencies

U.S. Dollar

With the Federal Reserve the only major central bank in tightening mode, the U.S. dollar was well supported over the last three years. As a result, the greenback is now trading deep in overvalued territory on a trade-weighted basis. Over the last 40 years, the U.S. dollar has only been as expensive as it is now on two occasions—in the mid-1980s and in the first half of the 2000s. In both cases, a multi-year U.S. dollar bear market followed.

These two U.S. dollar bear markets didn't happen because the Fed turned more dovish than other central banks. They materialized because of fundamental misalignments. In effect, for a long-lasting USD trend reversal to occur, the overvaluation of the greenback has to hurt so much that it translates into a pronounced widening of the U.S. current account deficit. At this moment, the problem is that the U.S. current account deficit is not wide enough to produce sustained USD weakness. For other currencies to decisively move higher against the U.S. dollar, monetary authorities in the rest of the developed world have to take a more hawkish turn. This is not likely to happen anytime soon. In the meantime, currency market volatility should remain elevated.

Canadian Dollar

In early summer, the Canadian dollar managed to recoup some of the ground lost to the U.S. dollar in late 2018. The loonie's revival was essentially a result of a brutal shift in relative market expectations about monetary policies on both sides of the border. In the United States, rising odds of a substantial U.S. economic slowdown shifted market expectations to price in multiple rate cuts by the Federal Reserve before year end. In turn, this downshift in Fed expectations, relative to market expectations about monetary policy elsewhere, allowed for a broad-based weakening of the U.S. dollar. The Canadian dollar participated, moving from approximately 0.74 U.S. cents in late May to more than 0.76. Is this the start of a Canadian dollar bull market? Not in our opinion. The price of oil is more likely to weaken than to strengthen over the forecast horizon and it probably won't take long for the BoC to follow the Fed's lead and ease its policy stance. What's more, markets have likely gone overboard by pricing in too many Fed rate cuts before year end. Last but not least, the Canadian dollar remains one of the most fundamentally-challenged currencies in our trading universe.

Euro

For nearly half a year the euro has been very stable against the U.S. dollar, fluctuating in a tight trading range. However we don't believe this is an indication of things to come. With an intensifying economic downturn and declining long-term inflation expectations, the ECB will do all it can to jumpstart the moribund eurozone economy. However, as we emphasized in past editions of Perspectives, the ECB is running out of policy options. If the ECB decides to cut rates deeper into negative territory and/or to resume QE, it will be with the implicit objective of weakening the euro. Just how successful this will be remains to be seen, but we would argue that the balance of risk is tipping to the side of further euro weakness.

[2]Japanese Government Bond

Japanese Yen

Judging by the tone used in its last Statement on Monetary Policy, the Bank of Japan (BOJ) is increasingly concerned about Japan's growth prospects. Just like the Fed, the BOJ has signaled that it is ready to make policy adjustments as appropriate. However, with 10-year JGB[2] yields trading well below the lower band of the Yield Curve Control (YCC) target band, the BOJ is running short of options to combat threats to growth. This is important because relative U.S.-Japan liquidity conditions have played a key role in the determination of the USDJPY exchange rate since 2016. The tables now appear to be turning, with the BOJ drastically slowing the expansion of its monetary base just as the Fed is putting an end to its Quantitative Tightening (QT) policy. In short, developments on the liquidity front should continue to be more supportive for the Japanese yen.

Commodities

OPEC speaks

There were several interesting developments at the June OPEC meeting. With existing oil production cuts set to expire, market watchers had been expecting an extension to the end of the year. Instead, OPEC+[3] delivered the news that cuts would remain in place until March 2020. While this was a positive for oil prices, after rallying in the weeks leading up to the meeting, oil had little reaction to the actual announcement. Of course, demand remains a concern, with trade wars dampening the already sluggish global growth forecast. The G20 meeting seemed to bring the U.S. and China closer to a resolution. However, the "now you see it, now you don't" rhetoric from the White House frequently clouds the picture and leaves many wondering whether true progress is occurring.

From a supply standpoint, global political developments are playing a major role. Venezuelan supply continues to decline as the country remains chaotic with no obvious political solution in sight. In Iran, the destruction of a U.S. surveillance drone in June followed by heated exchanges between the countries served to heighten tensions to the boiling point. U.S. allies continue to avoid the purchase of Iranian oil, virtually removing that source from the supply equation.

Several comments from the Saudi oil minister piqued our interest over the past several weeks. For the first time, the minister specified targeted oil inventory levels, mentioning levels that predominated from the years 2010 to 2014. These are lower levels than we've seen over the past five years, and we estimate that two years of extended production cuts would be necessary to reach those levels. The minister also commented on U.S. shale production, a major factor that has boosted global supply. The comment appeared to discount the longevity of the shale supply, mentioning that while the shale basins are growing, that supply will eventually plateau and decline. We believe this may indicate a strong propensity for Saudi Arabia to "wait out" U.S. shale producers. To that end, OPEC could extend cuts for some time with the intention of retaking market share once shale is depleted. Our analysis focuses more on the fact that U.S. shale producers have been resilient and innovative, with the potential to develop technology to extend the life of existing basins. While this game of chicken could continue indefinitely, in the short term we expect to see WTI oil prices move in the $50-60/bbl range.

Regional economic views

Canada

BoC to follow in the Fed's footsteps

- The Bank of Canada will deliver two rate cuts over our 12-month forecast horizon, following in the Fed's footsteps.
- We are working with a below-consensus forecast of +1.0% average real GDP growth over the next four quarters.

Canadians are experiencing a two-speed economy as we move further into 2019. On one hand, service-providing sectors are growing at an accelerating pace. On the other hand, goods-producing sectors are experiencing a severe downturn. With services accounting for nearly three-quarters of the overall economy, it's tempting to conclude there's not much to worry about. However, there is a non-negligible risk that the goods-producing sectors' downturn will be too deep to avoid spillover to service-providing sectors.

A year ago, we projected that Canada's two growth engines—the energy and construction sectors—would likely stall moving into 2019. While our projections materialized, we have been somewhat surprised by the severity of the hit. The biggest concern obviously relates to the unfolding slowdown in Canadian housing activity. The contraction in construction activity is now as deep as the one experienced a decade ago. Back then, the hit on Canadian real estate, along with heightened global financial turmoil, sent the Bank of Canada into panic mode and it hastily delivered multiple rate cuts. This time around, Governor Poloz and his team will likely try to stay cool-headed and refrain from shifting from tightening to easing mode—unless the still-concentrated slowdown spreads to the rest of the economy. We are not there yet, but the downturn is broadening. In early 2019, the drag from energy and construction was partly offset by the continued expansion in Canadian manufacturing. However, leading indicators are now signaling a contraction in Canadian manufacturing activity.

[3]The Organization of Petroleum Exporting Countries (OPEC), Azerbaijan, Kingdom of Bahrain, Brunei Darussalam, Kazakhstan, Malaysia, Mexico, Sultanate of Oman, the Russian Federation, Republic of Sudan, Republic of South Sudan.

This downturn in activity is happening at the worst time possible. Canadian non-financial corporations (NFCs) are loaded with debt. In recent years they borrowed heavily from Canadian banks while also issuing lots of bonds. This took their overall debt load to 114% of Canadian GDP. As a result, they are now more vulnerable than ever to adverse economic conditions. In our opinion, the hit on NFC revenues will likely be too big to avoid spillover to the rest of the economy. We are working with a below-consensus forecast of +1.0% average real GDP growth over the next four quarters. Under these conditions, the BoC will have to follow in the Fed's footsteps and deliver two rate cuts over the forecast horizon.

United States

More Fed relief coming

- The U.S. economy is heading for a not-so-soft landing and below-target inflation, justifying more Fed policy relief.
- U.S. real GDP growth is projected to average +1.5% over the forecast horizon.

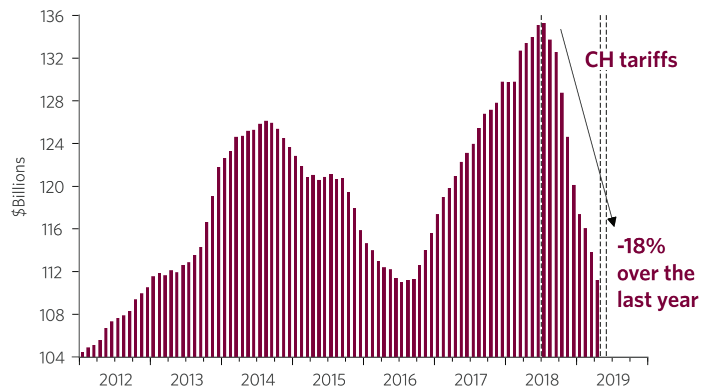
The Federal Reserve delivered its last rate hike only six months ago on expectations of a continued U.S. economic expansion. Six months later, the U.S. yield curve (i.e. differential between 10-year Treasury yield and 3-month T-Bill rate) inverted, implying rising odds of a 2020 U.S. recession. Should this signal be taken seriously? Market participants seem to think so, as they now expect the Fed to deliver rate cuts in the second half of the year. U.S. monetary authorities also seem to be taking the yield curve inversion seriously, acknowledging increased uncertainty about the U.S. economic outlook and standing ready to ease policy when appropriate.

For the U.S. economic outlook, many forecasters believe a mild slowdown is the only likely scenario. The U.S. economy remains healthy and the trade shock owing to China's retaliation pales in comparison with the trade shock imposed on China. Could the U.S. be heading for a hard rather than a soft landing? The risk of a deeper downturn is more apparent when focusing on U.S. nonfinancial corporations (NFCs). In the U.S., nonfinancial GDP accounts for nearly half the economy. Last year, it was America's growth engine, with NFC real GDP growing at nearly +5%. Since then, NFC real GDP growth has significantly decelerated to +3.1% in Q1 of this year.

This deceleration should be a cause for concern. In the last two U.S. recessions, the contraction in activity was much deeper for nonfinancial corporations than for the rest of the economy. During the 2001 recession—which qualifies as a mild recession—overall real GDP growth stayed positive (+0.6% on average), but NFC real GDP growth turned negative (-2.0% on average). In 2001, nonfinancial corporations did not lay off a lot of workers to cope with the shock. Instead, hours worked were considerably reduced via shorter workweeks. The end result was the same: the hit on nonfinancial corporations spilled over to consumers and caused a broad-based recession. The same thing could very well happen this time around, with a potentially bigger-than-generally-expected trade hit on U.S. nonfinancial corporations. In this context, the U.S. economy is likely heading for a not-so-soft landing that will take place in the context of below-target inflation and justify more Fed policy relief. U.S. real GDP growth is projected to average +1.5% over the forecast horizon.

U.S. exporters already hit hard

U.S. exports to China - cumulated 12 months



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

Europe

Will ECB resume QE?

- The ECB argues that it still has plenty of policy leeway. We disagree.
- The eurozone economy will remain mired in the mud because the ECB is running out of policy options to jumpstart its weakening economy.
- Our forecast calls for below-consensus average real GDP growth in the eurozone (+0.7%), with an elevated risk of slipping back into recession.

As we feared, the eurozone economy has clearly downshifted into lower gear. What was initially considered by most forecasters to be a soft patch has turned into a longer lasting and more broadly based economic slump. ECB officials are still wearing rose-tinted glasses and betting on a continued eurozone economic expansion. However, they have also made it clear that they are ready to act with all instruments, as appropriate, unless the euro area economic situation improves. Draghi and his colleagues argue that the Asset Purchasing Program still has considerable room and further cuts in policy interest rates remain part of the ECB's toolbox.

We have argued for some time that the ECB is running out of policy options. If it wishes, the ECB could push rates deeper into negative territory and resume QE. However, these additional policy moves could do more harm than good.

With the German economy in the doldrums, German fiscal surpluses will likely turn into fiscal deficits. If Germany issues more bunds, the ECB could be in a position to buy more without exceeding the already-reached self-imposed limit (i.e. 33% of the outstanding amount of bunds), and this opens the door to buy government bonds across the eurozone. This option could also provide much needed relief to Italy, as the ECB could buy enough Italian government bonds to match the Italian government's growing borrowing requirements. However, more ECB bond buying would also mean more downward pressure on already very depressed eurozone bond yields and flat-to-inverted yield curves.

Negative short rates and flat/inverted yield curves are very problematic for eurozone banks, as they translate into narrowing interest margins. According to Draghi, the impact of ECB policy on bank profitability has so far been broadly neutral, with the hit on net interest margins offset by improving economic conditions. However, in light of the powerful rally at the long end of the maturity spectrum and the deteriorating economic landscape, it's clear that the eurozone banking system is under intensifying pressure. From this angle, it's not at all clear that taking policy rates deeper into negative territory and/or buying more government bonds is the right prescription.

The bottom line is that the eurozone economy will remain mired in the mud because the ECB is running out of policy options to jumpstart its weakening economy. Our forecast calls for below-consensus average real GDP growth in the eurozone (+0.7%), with an elevated risk of slipping back into recession.

China

Trade war shock requires additional policy support

- Chinese real GDP is forecast to grow below 6% over the next four quarters, the lowest rate of growth in over three decades.
- The growth slowdown is the result of additional tariffs on Chinese exports to the U.S., in combination with a slowing global backdrop. This opens the door for the introduction of additional policy stimulus in China in H2 2019.
- Inflation is expected to stay well-behaved (below the 3% target), providing policy space to Chinese monetary authorities.

The growth outlook for GDP over the next four quarters is 5.7%, due to an anticipated major growth disappointment in H2 2019. Real GDP growth will undershoot the central government's target range, in large part due to the increased pressure coming from the trade war with the U.S. The introduction of new tariffs in the latter part of Q2 2019 created a new shock to the Chinese economy. This will weigh on manufacturing activity and generate a negative secondary impact on other sectors of the economy, including consumer spending.

So far this year there have been clear signs that tariffs imposed in September 2018 have led to slower growth. This includes deteriorating trade activity, particularly with the U.S. Historically, this type of export contraction between China and the U.S. is generally observed in periods of significant growth slowdown. Consequently, we are observing rather weak industrial production activity, and slower growth in manufacturing-related fixed asset investment. With additional tariffs imposed in June 2019, the Chinese economy is again facing a growth shock that is likely to be somewhat more damaging than the impact of the first round of tariffs. Our growth scenario does not foresee a reversal of the tariffs in 2019, but further escalation is not expected either. Instead, we are likely to see a spirit of cooperation from both the U.S. and China as they try to move closer to a mutually acceptable deal. This being said, we can't rule out the alternative scenario of an agreement where currently imposed tariffs are removed or a scenario where further escalation takes place. This leaves room for significant upside and downside risk for growth over the next year.

Unless a trade agreement can be reached in Q3, the Chinese economy will likely need additional policy support. This is likely to come in the form of currency depreciation, additional liquidity support to the banking system, and further fiscal policy stimulus. However, like the most recent policy support in Q1 2019, the package will be measured and targeted. In this environment, any future policy support will provide a limited boost to the overall credit impulse, just enough to stop the deceleration but unlikely to promote significant growth reacceleration in China. Against this lacklustre economic backdrop, inflation is expected to stay well-behaved and well below the 3% target, providing policy space for Chinese monetary authorities.

Alternative scenarios

Global Reflation Scenario

The buildup in inflationary pressure becomes strong enough to convince more central bankers to "lift a foot off the accelerator". For central banks already in tightening mode, this implies more aggressive policy tightening over the forecast horizon. Stronger earnings growth would provide an offset to higher interest rates, supporting equity market valuation and providing stronger-than-expected equity returns but weaker fixed income. Continued Chinese easing efforts and constructive political developments in Italy could lead to improved business and consumer sentiment and stronger economic activity than in our central scenario.

Global Recession Scenario

We suspect that the key recession risk is more likely to emerge from Asia and/or Europe. Both regions are currently coping with a cyclical growth slowdown. Given the relief efforts deployed by policy-makers, economic growth will most likely stabilize over the forecast horizon. However, there is significant risk that the policy stimulus provided won't be sufficient to avoid a more pronounced economic downturn with spillover effects to the rest of the world. This could produce a meaningful tightening in global financial conditions and possibly spill over to weaker emerging economies, creating more contagion and risks to financial stability.

Scenario	Less Favourable	More Favourable
Global Reflation	International bonds Canadian bonds Long-dated U.S. Treasuries	Emerging Asia equities European equities Commodities
Global Recession	Global equities High Yield bonds Emerging market currencies	Gold U.S. Treasuries Japanese yen

Economic forecasts (next 12 months)

Region	Current GDP[4]	GDP - Consensus	GDP - CAM View	Current Inflation[5]	Inflation - Consensus	Inflation - CAM View	Policy Rate - CAM View
Canada	1.3%	1.8%[6]	1.0%	2.4%	2.0%	2.1%	-50 bps
United States	3.2%	2.0%	1.5%	1.8%	2.1%	2.2%	-75 bps
Eurozone	1.2%	1.3%	0.7%	1.2%	1.3%	1.1%	-10 bps + QE
China	6.4%	6.2%	5.7%	2.7%	2.5%	2.4%	Fiscal + monetary stimulus
Japan	0.9%	0.6%	0.5%	0.8%	0.8%	0.5%	-
World	3.2%	-	2.9%	-	-	-	-

[4]Real GDP Growth (y/y %)
[5]Year/year %
[6]Implied (converted from a Q/Q basis)

Data as of July 8, 2019
Source: Datastream, Bloomberg, CIBC Asset Management Calculations

Long-term capital market returns (10 year)

A key input in our investment process is projected average returns for major financial market asset classes for the next 10 years, based on our internal macroeconomic research.

While counterintuitive in the current environment, higher policy rates will be needed over the next 10 years to create the capacity to cope with any economic slowdown. Higher rates could also prevent a build-up of financial imbalances associated with too-low for too-long interest rates. Along with slowing potential economic growth, higher policy rates will be a lingering global headwind, particularly where indebtedness is elevated.

From a relative perspective, emerging economies are experiencing better long-run macro prospects (higher trend economic growth, smaller debt), have more policy leeway to boost growth if needed (smaller fiscal deficits, higher policy rates), and have become much less risky (higher reliance on domestic services, better institutions, structural reforms).

As a result, emerging market asset classes are more attractive from a long-run perspective. While developed market asset classes will be challenged to exceed 5% average annual returns over the next 10 years, we project that emerging market government bonds and equities will deliver average returns of 8% and 12%, respectively.

For full details, please request a copy of *"2019 Long-Term Capital Market Returns"*.