CIBC Asset Management

PERSPECTIVES

For the 12-month period beginning January 1, 2020

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New growth needs new tools

Although the global economy clearly slowed in 2019, investors remained optimistic and propelled equity markets to all-time highs. We don't expect a blockbuster growth year in 2020, but central banks will likely set the stage to allow governments to provide fiscal help and stimulate growth.

Asset class highlights

Equity: A stabilizing economic cycle could trigger a rotation away from U.S. equities in favour of more cyclical markets such as emerging market equities.

Fixed Income: Disappointing economic growth and the low risk of inflationary pressure from the energy sector should keep a lid on bond yields.

Currencies: We believe it's too soon to call for a widespread U.S. dollar trend reversal, but the greenback will be under increased pressure in 2020.

China: The de-escalation in the trade dispute, along with a phase-one trade deal, will provide some relief for Chinese growth starting in Q2 2020.

Multi-asset outlook

Asset class	Current December 31, 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%	2.00%
Canada 2-year government bond yield	1.69%	1.15%	1.95%
Canada 10-year government bond yield	1.70%	1.15%	2.10%
U.S. 10-year government bond yield	1.92%	1.35%	2.30%
Germany 10-year government bond yield	-0.19%	-0.50%	0.20%
Japan 10-year government bond yield	-0.03%	-0.25%	0.30%
Canada 10-year real-return government bond yield	0.37%	0.05%	0.60%
Canada investment grade corporate spreads	1.14%	0.95%	1.55%
U.S. high yield corporate spreads	3.58%	3.30%	4.90%
Emerging market sovereign (USD denominated) bond spreads	277	250	500
S&P/TSX price index	17,063	16,300	18,100
S&P 500 price index	3,231	2,975	3,350
Euro Stoxx 50 price index	3,745	3,500	3,900
Japan Topix price index	1,721	1,625	1,825
MSCI Emerging Markets	61,467	59,000	66,500
U.S. Dollar/Canadian Dollar	1.2990	1.29	1.36
Euro/U.S. Dollar	1.1213	1.07	1.18
U.S. Dollar/Japanese Yen	108.61	100.0	112.0
U.S. Dollar/Offshore Chinese Yuan	6.96	6.65	7.20
Gold	1,517	1,370	1,600
Oil price, WTI (West Texas Intermediate)	61.06	50	60

Asset class outlook

Global overview

A new policy regime ahead

The most striking feature of 2019 was that global investors stayed in an optimistic mood all year—despite the fact that the global economy clearly shifted into lower gear. By year end, global equity markets were trading at all-time highs, while credit spreads and market volatility were hitting all-time lows. True, market participants had good reason to feel more upbeat in late 2019. Trade tensions between the United States and China finally appeared to be abating with the announcement in December that a trade deal had been reached. In addition, global central bankers have not been gun shy, deploying more stimulus to keep the global economy in expansion mode.

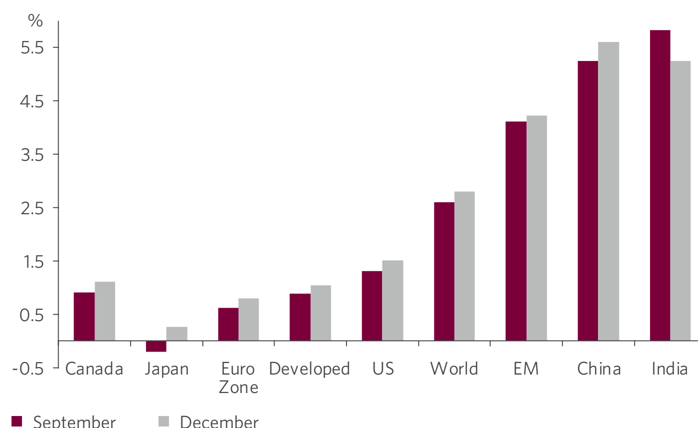
Looking forward to 2020, we have to throw some shades of grey into the outlook. Our world real GDP forecast calls for a global growth slowdown, with global growth averaging +2.8% over the forecast horizon. Given these lower growth expectations, 2020 won't necessarily resemble 2019, with its unusually low volatility in risky markets. On the bright side, it's true that progress has been made on the trade front, with the U.S. and China agreeing on a phase-one trade deal. Having said that, it is important to recognize that this doesn't imply that the trade shock is gone. The U.S. will halve its 15% tariffs on about $120 billion in Chinese goods, still leaving roughly $250 billion taxed at 25%. In short, even with this phase-one deal, the hit from U.S. tariffs on China remains quite substantial. It's also worth noting that while China agreed to substantially increase its imports from the U.S., it didn't agree to specific tariff reductions on U.S. imports.

Our bigger concern is that monetary authorities don't have the policy leeway they had in previous periods of global growth deceleration to cushion the landing. The problem is not just that interest rates are already ultra-low, it's also that the unorthodox policies (i.e. QE and sub-zero policy rates) delivered in recent years came with negative side effects. This is why we think that one of the key features of 2020 will likely be an acceleration in the transition to a new regime by policy-makers. In this new policy regime, central banks will set the stage to facilitate some loosening of their governments' fiscal stance. To achieve this objective, they will anchor policy rates near zero, while aiming for steeper yield curves and maintaining asset purchasing programs to meet the governments' growing borrowing requirements (i.e. debt monetization).

In the developed world, very few central banks are in the same position as the U.S. Federal Reserve (Fed) and the Bank of Canada (BoC), where room still exists to further cut policy rates. However, they are also fast approaching the zero bound.

The shift from the current policy regime to an MMT (Modern Monetary Theory)-style regime concerns all central banks. Such a shift is obviously easier said than done, as it comes with major risks. These tools have the power to do appreciable good, but they can also cause real harm if not used responsibly. The governance and decision rights need to be carefully engineered. For global investors, navigating this regime change will prove challenging, making it less likely that financial market volatility will remain historically low throughout 2020.

Global growth projections: December vs. September CAM forecast



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

Global strategy

Hindsight 2020

Understanding where you come from helps you know where you are going. This is especially true for financial markets, where the starting point (basically, the price you pay) is critical for future returns. We can look back at 2019 and see a surprising picture—a global economy dangerously slowing, triggering a major rally in bond yields and an inversion of the yield curve. However, despite this bleak outlook, the equity market managed to make new all-time highs. It may look somewhat inconsistent, but these market moves can be explained by a textbook sequence for the market cycle: 1. the economy slows (mid to late 2018); 2. the equity market corrects while the bond market rallies on expectations of central bank policy easing (late 2018); 3. central banks ease and the equity market rallies on expectations the easing will pave the way to better growth prospects (early 2019 and after). That being said, no two cycles are identical—this one was characterized by an escalation of the U.S.-China trade war and the fact that monetary policy is less effective than in the past.

Looking ahead to 2020, we see three potential developments that will be critical for financial market returns: 1. the economic cycle has stabilized; 2. for the most part, markets have already priced in this nascent recovery; 3. secular headwinds will limit the potential strength of the recovery.

Economic indicators are showing signs of an improving outlook. Growth remains quite weak at this point, but forward-looking indicators have turned up. The economy is at full employment and the consumer remains in good shape. As such, the contraction in the manufacturing sector should have limited spillover to the service sector and the global economy should avoid a recession. Furthermore, monetary and fiscal policies will remain accommodative and support growth.

The political uncertainty has recently abated. First, the U.K. came to an agreement (yet to be signed) with the European Union about their divorce. Following general elections, Boris Johnson, the incumbent Prime Minister, won a significant majority. This should lead to a market-friendly outcome for the remaining negotiations. Second, the U.S. and China have signed a phase-one trade deal. While there are outstanding issues still unresolved, both the U.S. and China have incentives to put their differences aside for the foreseeable future.

Other things being equal, a stabilization of the economic cycle should be positive for the equity market, although it seems this cycle has already been priced in. With increases in the P/E ratio driving most of 2019's strong returns, our analysis shows there is little upside left to the equity market. This statement might be a bit too general—while the main equity indices performed quite well, other segments of the market did not fare as well. Technology, consumer and rate-sensitive equities were very strong but small caps and highly cyclical sectors lagged and could still benefit if the cycle improves. We can also point to commodity prices and cyclical currencies as examples of markets that have not moved up decisively.

Given the secular headwinds, 2020 is not expected to be a blockbuster year for growth. As we explain in the 2020 edition of our "*Long Term Capital Market Returns*" publication, we expect a gradual deceleration of potential GDP growth across economies, reflecting increasing headwinds and receding tailwinds. Changing demographics will be a lingering headwind, productivity growth is not expected to pick up materially to provide an offset, and central bank attempts to raise interest rates will be gradual, at best.

Global equities

An exceptional decade for the U.S.

The U.S. equity market had a remarkable decade. The annualized 10-year total return of the S&P 500 from March 2009 (the trough, post financial crisis) to March 2019 was 16%. It has only been stronger 10% of the time in the last 148 years. Not only did the U.S. do well compared to its history, it also outperformed other global equity markets quite significantly. Looking at a breakdown of the U.S. returns, we find that U.S. companies actually performed in line with other markets, when considering sales growth and dividend yield. However U.S. equities clearly distinguished themselves with increases in profit margins and P/E ratios, as well as share buybacks. More than half of the total return came from these three sources, which explains most of the outperformance relative to other markets.

We think these were one-time tailwinds for returns that are unlikely to be repeated. In order to remain a tailwind, profit margins and P/E ratios would need to increase year after year, which they can't do indefinitely. They fluctuate around a mean and will tend to revert back to the mean over time. As such, when the starting point is high, margins and P/Es are likely to go down, not up. We can certainly argue that technology firms are a bigger weight of the market today, and because they have higher margins and P/Es, the market should now exhibit higher profit margins and trade at a higher P/E. But unless techhnology companies continue to take an increasingly bigger share of the equity market, margins and P/Es will not continue to provide a tailwind. Furthermore, after a decade of near-zero interest rates, corporate debt has increased significantly, in part to finance buybacks. With a more leveraged balance sheet and rates that should gradually trend upward, we are not likely to see as big a contribution from buybacks.

Finally, a stabilization of the economic cycle should trigger a rotation away from U.S. equities, a low beta equity market, in favour of more cyclical markets. The S&P 500 has been resilient throughout the slowdown and has quickly moved to price in a potential turn in the cycle, despite very narrow breadth behind the index. One region that should benefit is emerging markets (EM). Structural factors like valuation and potential growth have argued, and will continue to argue, for the outperformance of emerging markets. What was missing for EM in 2018 and 2019 was a more constructive cyclical outlook. Our central scenario that calls for a stabilization in the economic cycle, should be favourable for emerging markets.

In order to continue, the global equity rally will require an environment of good, but not too good, growth with no inflation pressure and stable bond yields. The market will be vulnerable to any disappointment or unexpected policy shock—for example, a resumption of the trade war. Given this environment will likely unfold with a few bumps in the road, the equity market will remain in a volatile trading range.

Global bonds

Crosscurrents on the horizon

Developed market (DM) bond yields moved higher during the fourth quarter, with U.S. Treasury yields increasing from 1.66% to 1.92% and German Bund yields from -0.57% to -0.18%. The main "culprit" was reduced global uncertainties, dissipating from the elevated levels seen in Q3. U.S./China trade-related news flows have taken a more conciliatory tack and worldwide economic data releases have been more encouraging.

As a result, demand for safe-haven bonds decreased and demand for riskier emerging market (EM) bonds increased, allowing for a tightening in EM-US spreads.

Looking forward, DM bond yields are unlikely to move much higher. As our economic forecasts elaborated on in earlier sections, disappointing economic growth (compared to consensus) should keep a lid on bond yields. In addition, the risks of inflationary pressure coming from the energy sector are tilted to the downside. According to our research team, global oil oversupply will not only come from the U.S. but from members of OPEC going forward.

That said, in the latter part of our forecast horizon, several factors could again start to push DM bond yields higher. Reflationary efforts by most DM central banks and the Peoples' Bank of China (PBOC), and synchronous rate cuts by most EM central banks, could stabilize global growth and may bring positive surprises. These monetary policy easing measures will be reinforced by the positive impact of the current trade war truce, especially if prolonged.

In addition, 2020 could mark the start of global bond yields de-anchoring[1]. European Union policy-makers are running out of policy options in the face of lacklustre economic growth. They must change their monetary policy regime and target zero policy rates and steeper yield curves to alleviate pressure on the financial sector. If this succeeds, it will allow some eurozone member countries to loosen their fiscal policy stance, thus increasing the aggregate bond supply. If it materializes, the de-anchoring of bond yields could have important spillover effects on other DM bond markets, especially in the context of a significant increase in the supply of U.S. Treasuries (due to the widening U.S. fiscal deficit).

Considering all the different crosscurrents, and as a base case scenario, we believe the U.S. Treasury 10-year yield should hover in a range of 1.35%-2.30% over the forecast horizon. In Canada, 10-year sovereign bond yields should trade between 1.15% and 2.10% over the twelve-month horizon.

Currencies

The Fed switch to easing mode was not enough to produce a broad-based weakening of the U.S. dollar in 2019. While it's too soon to call for the start of a widespread U.S. dollar trend reversal, the greenback will be under intensifying pressure in 2020.

U.S. Dollar

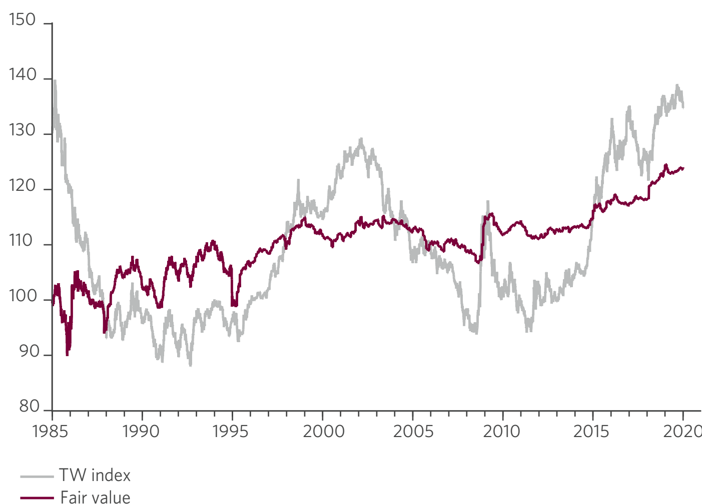
With the Fed switching to easing mode, the cyclical forces supporting the U.S. dollar over recent years are now quickly fading. Moving into 2020, market participants expect that the Fed will remain on the sidelines. However, the Fed will probably need to ease policy further via rate cuts and some further expansion of its balance sheet.

[1] If there are no safer bonds available, a bond may trade with a lower yield than its risk would normally warrant. Demand for the bond is elevated and its yield becomes "anchored" due to the lack of alternatives.

The need for some additional Fed policy easing is not only due to the projected U.S. economic growth slowdown. The Fed's other concern is that the already-wide U.S. federal deficit is about to get even wider. This is problematic because the U.S. yield curve is too flat to persuade foreigners to buy the rapidly-rising excess supply of Treasuries. The Fed must figure out a way to get enough steepening of the U.S. yield curve to eliminate the Treasury glut. If it succeeds, we should expect U.S. dollar weakness. While it's too soon to call for the start of a widespread U.S. dollar trend reversal, the greenback will be under intensifying pressure in 2020.

A U.S. dollar trend reversal in 2020?

CAM U.S. dollar trade-weighted index and fair value estimate



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

Canadian Dollar

The Canadian dollar proved remarkably resilient in 2019, ranking as the top-performing G-10 currency, with a +3.6% appreciation against the U.S. dollar. As mentioned in past editions of *Perspectives*, we see two reasons for this: very well-behaved oil prices and a dovish turn by the Fed in the context of a sidelined Bank of Canada. In retrospect, the Bank of Canada's decision not to follow the Fed's lead made a lot of sense. The Canadian economy remained on solid footing throughout the year. Looking forward however, the strength of the Canadian dollar will likely do too much damage to Canada's external sector. This will eventually force the BoC to follow in the Fed's footsteps and cut its policy rate.

Canadian goods-producing industries have started to act as a big drag on Canadian real GDP growth. That will be more than enough to convince market participants that the Bank of Canada is about to take a dovish turn, translating into Canadian dollar weakness.

Euro

Since 2015, the European Central Bank (ECB) has been fighting hard to keep the euro undervalued and fuel Europe's export-led economic expansion by cutting rates aggressively

and massively expanding its balance sheet. At first glance, it's tempting to conclude that these forces are still at work. However, the reality is that the ECB has reached its policy limits. The recent implementation of a two-tiered system for excess reserves implies that it's putting an end to its sub-zero policy rate experiment by allowing the effective policy rate to move back closer to zero.

Relative ECB-Fed policy rates are widening and the Fed is expanding its balance sheet at a faster pace than the ECB. In other words, the cyclical forces exerting downward pressure on the euro against the U.S. dollar are dissipating. This means that the fate of the euro will increasingly be determined by developments on the trade front.

Japanese Yen
At first glance, the fact that the Japanese yen finished the year pretty much where it started (around 109 against the U.S. dollar) may seem like a trivial development. The reality, however, is that it's a very important development. Looking back at 2019, Japanese monetary authorities must be breathing easier. With the Japanese economy flirting with recession, the last thing that Japan needed was a pronounced strengthening of the Japanese yen and, luckily, that did not happen. But how did Japanese policy-makers succeed in lowering the volatility of the Japanese yen so much? While lower volatility is not unique to the Japanese yen, we suspect that the implementation of a Yield Curve Control (YCC) policy in late 2016 probably contributed to the sharp decline in the yen's volatility.

Looking forward, the BOJ's policy stance is not likely to change much. It will continue to buy enough JGBs to roughly match the fast-rising borrowing needs of the government, while keeping short rates close to zero and targeting 0% for 10-year JGB yields. This should help keep the yen in a tight trading range between 100 and 112.

Commodities

The killing of Iran general Soleimani by the U.S. in January seemed tailor-made to raise investor concerns about Middle East oil disruptions. True to form, oil prices jumped on initial news reports, but quickly retreated when Iranian retaliation seemed muted and resulted in no loss of American life. We might argue that this was a relatively mild Iranian retaliation (especially when compared to other possible outcomes). However, the fleeting jump in oil prices was quite different from the market reaction we've sometimes witnessed when destabilizing incidents occurred in or around oil-producing nations.

The lack of investor response to heightened Middle East conflict may highlight the new U.S. strength as the world's number one oil exporter. Increased U.S. shale oil production has markedly changed global oil dynamics and America is in a much less vulnerable position where oil supply disruptions are concerned. As the world's number one oil consumer, the U.S. is now more self sustaining thanks to the technology push that made shale production a reality.

As more countries industrialize, energy demands increase and global oil demand is still growing on an absolute basis. The rate of global growth will eventually slow, but we can't forget that oil is also a key input in plastics production—an end use that can't be replaced by solar or wind alternatives. Electric cars will eventually reduce gasoline demand, but it will likely be some time before they are widely adopted. Not only are they relatively expensive, but the compulsory charging stations are not everywhere and electric car batteries can currently only run between 100 and 250 miles before they need a recharge. These are some of the issues we're considering in our forecasts of long-term energy demand. For the shorter term, considering global crosscurrents and the current supply situation, we are maintaining our forecast range of $50-60 USD for WTI* oil for the next year.

*West Texas Intermediate

Regional economic views

Canada

How long will the BoC stay on the sidelines?

- Real Canadian GDP growth is projected to decelerate from +1.6% currently, to +1.1% over the forecast horizon.
- With an increasingly hostile global environment, the Bank of Canada will need to take a more dovish turn in 2020.

The Canadian economy has remained surprisingly resilient in 2019, but growing global trade headwinds are now hitting its shores. Canadian manufacturing and trade sectors have taken a hit, just like the rest of the world, and Canadian goods-producing industries have started to act as a big drag on Canadian real GDP growth. The question is whether negative spillover to service-providing industries will become apparent over the coming quarters—we think they will. In a nutshell, the ongoing profit squeeze for Canadian non-financial corporations (NFCs) is expected to lead to a slowdown in job creation and, as a result, a smaller contribution to growth from consumer spending.

National accounts data show that operating profit growth has either slowed or turned negative across most industries. Rising and elevated wages, the consequence of tight labour markets, along with subdued foreign demand, will continue to weigh negatively on NFCs' profitability. In this environment, we expect Canadian companies will hire and invest at a slower pace, contributing to the projected growth deceleration.

Unfortunately, this will take place in the context of substantially rising household debt-servicing costs, reflecting the lag impact of past interest rate increases. As a share of

GDP, household debt-servicing costs now exceed the peaks observed during the last tightening campaign more than a decade ago. In short, Canadian households have no room to increase their pace of consumption growth—particularly in the context of decelerating job creation and a low savings rate.

We are working with a below-consensus forecast of +1.1% average real GDP growth over the next four quarters. Under these conditions, the BoC won't be able to stay on the sidelines for too long, eventually following the Fed's lead by easing its monetary policy stance via a policy rate cut.

United States

A 2020 growth slowdown

- In 2020, U.S. real GDP growth is projected to further decelerate, averaging +1.5% over the forecast horizon.
- The hit on profitability will be too big to avoid a negative spillover to U.S. households.

The U.S. economy slowed materially over the last year owing to two negative shocks on U.S. non-financial corporations. These were intensifying global trade headwinds and a severe squeeze on profitability from low pricing power, fast-rising compensation costs, U.S. dollar strength and slowing productivity growth. These two shocks largely explain why U.S. real GDP growth has decelerated from more than +3% in 2018 to +2.1% in late 2019. They are also the reasons why it is very hard to imagine a U.S. economic growth reacceleration in 2020.

The reality is that U.S. non-financial corporations are experiencing a multi-year squeeze on profit margins that started five years ago. Until now, the hit has been manageable because profit margins were declining from relatively elevated levels. To cushion the hit, U.S. non-financial corporations have been doing two things. First, they have been borrowing a lot more from banks and/or issuing a lot of corporate debt. As a result, their overall debt load has increased considerably and now accounts for nearly 150% of U.S. non-financial corporate GDP. This makes them particularly vulnerable to any tightening in credit conditions. Second, they have been under-investing, with spending on fixed investments slowing substantially. The contribution to real GDP growth from non-residential investment spending dropped from +0.9% in 2018 to less than +0.2% in 2019.

From this point on, any additional thinning of profit margins will be more difficult to cope with. Unfortunately, the squeeze on non-financial corporation profitability is projected to intensify further moving into 2020, owing to fast-rising unit labour costs and falling PPI inflation. To cope with this shock, non-financial corporations will have to cut back further on investment spending, while slowing the pace at which they are hiring workers. The now modest boost to the U.S. economy from capital spending will likely turn into a drag in 2020. Spillovers to households will likely start to become apparent, with slower employment growth and a smaller boost to GDP growth from consumer spending.

With deteriorating growth prospects, it didn't take long for the U.S. Fed to switch back to easing mode in late 2019. The Fed seems to be in no rush to ease policy further at this stage. However, we think that more policy accommodation will be needed over the forecast horizon in the form of additional rate cuts, some further expansion of its balance sheet and a new repo facility.

The bottom line is that the hit on profitability is now probably too big to avoid producing negative spillover to U.S. households. As a result, U.S. real GDP growth will likely further decelerate, averaging +1.5% over the forecast horizon.

Europe

U.S.-E.U. trade war in 2020?

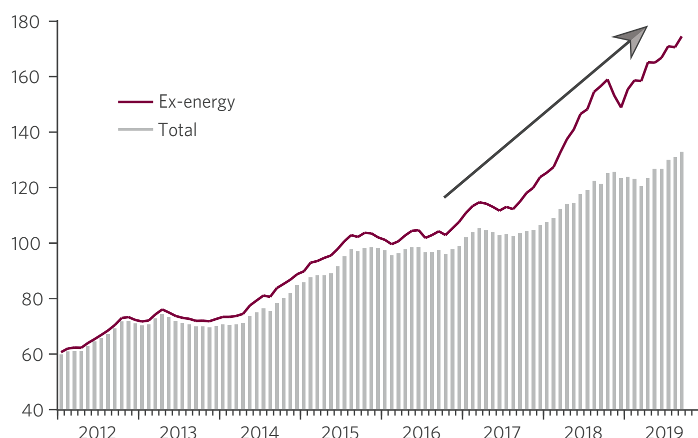
- Economic growth in the eurozone will likely continue to disappoint, with real GDP growth averaging +0.8% in 2020.
- U.S.-E.U. trade tensions are building and eurozone policy-makers are working on a new trade strategy to fight fire with fire.

A year ago, most forecasters were feeling quite upbeat about economic growth prospects for the eurozone economy. But 2019 was a big disappointment, with real GDP growth considerably decelerating. For 2020, the consensus view is that economic growth in the eurozone will stabilize around +1% owing to strengthening foreign demand. We disagree. In our opinion, growth will likely disappoint again, forcing policy-makers to shift to a new MMT-style policy regime.

The only good news for the eurozone in 2019 was that the drag coming from slowing Chinese demand was more than offset by strong U.S. demand. Last year, E.U. exports to the U.S. provided a +0.2% boost to nominal GDP growth, more than offsetting the decline in growth contribution from exports to China. The result was a sharp widening of the eurozone's ex-energy trade surplus with the U.S. to an all-time high of +174 B or +1.5% of GDP.

The only bright spot

Eurozone trade balance with the U.S. (EUR B)



Source: Thomson Reuters Datastream, CIBC Asset Management Inc.

The trade imbalances between the U.S. and the eurozone are now bigger than ever—big enough to be on the U.S. Administration's radar screen. This is not the only imbalance between the two superpowers. Since 2015, the ECB has been fighting hard to keep the euro undervalued and to fuel Europe's export-led economic expansion by cutting rates aggressively and massively expanding its balance sheet. Thanks to the efforts deployed, the euro has been trading deep in undervalued territory against the U.S. dollar (-11.6% undervaluation). Bottom line: the U.S. administration has all the arguments it needs to justify the adoption of more retaliation measures against the eurozone in 2020, as it did with China in 2019.

Eurozone policy-makers are fully aware of this risk. They are also fully aware that the ECB has reached its policy limits. As a result, to avoid losing market share (i.e. boost from trade turning into a drag), a new trade weapon is being created—the ability to match U.S. tariffs with just-as-big E.U. tariffs. Meanwhile, the ECB will be changing its monetary policy regime by targeting zero policy rates and steeper yield curves to alleviate pressure on the financial sector. If it succeeds, it will allow some eurozone member countries to loosen their fiscal policy stance.

In short, any strengthening in foreign demand from Asia will likely be offset by weaker export growth to the United States. For this reason, eurozone growth will likely continue to disappoint, with average real GDP growth at +0.8% in 2020.

China

China's slowdown—not just about the trade war

- The de-escalation in the trade dispute, along with a phase-one trade deal, will provide some relief for Chinese growth starting in Q2 2020. As a result, we are raising our GDP growth forecast to an average 5.6% for 2020.
- China will continue to support growth, mainly through fiscal policy, while providing very little accommodation in monetary policy in the first half of the year.
- Rising consumer price inflation is expected to peak in Q1 2020 near 5% and is likely to slow below 3% in H2 2020.

In 2019, the Chinese economy recorded its weakest growth in over 3 decades. The slowdown is the result of several factors, including continued restraint in credit growth in non-traditional lending, a major deceleration in manufacturing activity, and a notable external demand shock. Moving into the new year, we are likely to get some stabilization in growth but don't anticipate a meaningful growth recovery. Supporting the view for growth stabilization is the recent de-escalation of the trade dispute between the U.S. and China, where a phase-one deal has been signed. As a result, we should see a bounce in trade activity between the U.S. and China in 2020, after a year of sharp declines in trade activity between the two nations. In addition, the reversal of some tariffs will provide relief for consumers and increased optimism among economic agents. That said, not all headwinds on external demand have been removed. The continued expected weakness in the euro area is a negative shock partially offsetting the positive developments from the U.S.-China trade war.

The Chinese consumer is an important part of the domestic demand outlook. Indicators of consumer appetite for spending, including retail sales and particularly car sales, have disappointed. This may, in part, be the result of decreased discretionary spending from a massive surge in food prices, which are up 19% year-over-year (y-o-y). In addition, the longer-term perspective for household spending is becoming more challenging, given the rise in leverage. Household borrowing has been very strong over the past few years, with credit for this segment of the economy growing at a strong double-digit pace. However, with the ratio of household debt to disposable income reaching 100%, it's becoming unlikely that the consumer can keep up the same strong pace of borrowing as in the recent past.

Policy-makers will continue to support growth through stimulus measures, primarily with fiscal spending. Unlike 2019, tax cuts are unlikely in the coming year, as disappointing tax revenues leave little leeway for such action. Instead, most of the stimulus will come in the form of increasing local government special bond issuance. Monetary policy will likely play a limited role in adding accommodation to the economy. This is the result of a desire to force additional deleveraging on the shadow banking sector and limit potential spillovers from this year's strong rise in inflation. We do expect to see the People's Bank of China (PBoC) continue to actively provide liquidity through cuts in the reserve requirement rate in 2020. On a positive note, inflationary pressures are expected to ease, with CPI growth declining to under 3% (y-o-y) by Q4 2020 from the current pace of 4.5% (y-o-y). This would provide some additional flexibility for a more proactive central bank if needed later in the year.

Alternative scenarios

Global Reflation (20% probability)

After a strong dose of monetary stimulus, the buildup in inflationary pressure becomes strong enough to convince central bankers to "lift a foot off the accelerator". This implies a resumption of 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.

Even if bond yields have backed up in recent months, global yields remain very low and inconsistent with a stronger-than-expected upturn in the economic cycle. Combined with rising inflation pressures, this would prove fatal for the bond market. The implications for the equity market are less straighforward. Rising rates would hit valuation but the improving growth outlook would support the market. Emerging equities have more to gain as they would not face the valuation headwind.

Global Recession (30% probability)

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.

In this scenario, cyclical and risky assets will face a significant correction. The equity market did well last year on the belief that lower interest rates were a reasonable justification for rising valuation, and expectations that earnings growth will remain resilient. These assumptions would be severely challenged in the context of a global recession. Given that much of the global bond market is already in negative yield territory, only a few countries would have room for declining bond yields and safe haven assets like gold would surge.

Scenario	Less Favourable	More Favourable
Global Reflation (20% probability)	International bonds Canadian bonds U.S. Treasuries	Emerging Asia equities Cyclical equity sectors Commodities
Global Recession (30% probability)	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	1.7%[6]	1.6%[6]	1.1%	2.2%	1.9%	1.6%	-25 bps
United States	2.1%	1.8%	1.5%	2.1%	2.1%	2.0%	-50 bps
Eurozone	1.2%	1.0%	0.8%	1.0%	1.3%	1.0%	-
China	6.0%	5.9%	5.6%	4.5%	3.1%	3.6%	-
Japan	1.7%	0.3%	0.3%	0.5%	0.8%	0.3%	-
World	3.1%	3.1%	2.8%	3.1%	3.0%	3.1%	-

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

Data as of December 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.

Slow-moving economic forces will shape the global economy and impact capital markets over the long-run. Changing demographics will be a lingering economic growth headwind, productivity growth is unlikely to improve enough to provide an offset, and gradual central bank attempts to raise interest rates will have negative effects on economic growth. Relative to advanced economies, the effects of those headwinds will be less perceptible in emerging economies, where trend economic growth is higher and indebtedness lower.

The key takeaway of the report is that asset classes from emerging economies are the most attractive over the long-run, owing to higher interest rates (bonds) or earnings growth (equity), more attractive valuations, and better long-run currency prospects. The last two factors make U.S. equity unattractive from a Canadian perspective—valuation is stretched compared to long-term fundamentals and we expect the U.S. dollar to depreciate over the long-run.

From a risk perspective, EM economies have become structurally more resilient to adverse economic conditions. This reflects smaller current account vulnerabilities and an increasing role for the consumer as a growth engine—a more stable source of growth. Low structural inflation and interest rates in developed economies will also keep downward pressures on EM asset classes relatively muted. As a result, EM assets in general appear to have become less risky than in prior cycles.

For full details, please request a copy of *"2020 Long-Term Capital Market Returns"*.

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