Perspectives

For the period beginning October 1, 2015

CENTRAL BANKS NEARING LIMITS?

Central banks can only stretch policy so far in order to ignite growth—and many are nearing those limits. Several interest rates are already at zero and some central banks are also likely approaching their boundaries for non-conventional policy. Despite their best efforts, global growth remains relatively low by historical standards.

Central bankers also face the problem that it is difficult to raise interest rates without derailing any existing momentum. Uncertainty is a negative—the U.S. Federal Reserve (Fed) introduced higher volatility to financial markets by postponing a first rate hike and keeping the market on edge. However, if monetary policy keeps rates close to zero, what tools are left to prevent the next economic slowdown? We explore what these constraints likely mean for markets going forward.

CIBC Asset Management

Current Asset Allocation as at October 1, 2015

Asset Class	Underweight		Neutral	Overweight	
	Significant	Moderate		Moderate	Significant
Equity Relative to Fixed Income				✓	
Fixed Income					
Canadian Money Market	✓				
Canadian Government Bond		✓			
Canadian Corporate Bond				✓	
International Government Bond		✓			
Equity					
Canadian Equity			✓		
U.S. Equity			✓		
International Equity (Developed Markets)					✓
Emerging Markets					✓

Currency (versus U.S. Dollar)	Underweight		Neutral	Overweight	
	Significant	Moderate		Moderate	Significant
Canadian Dollar		✓			
Euro	✓				
Japanese Yen			✓		
British Pound		✓			
Swiss Franc		✓			
Australian Dollar			✓		
Emerging Markets				✓	

Highlights

Fixed Income Versus Equity: We maintain an overweight in equity, favouring a stabilization following the third-quarter equity correction, but the risk of a global economic slowdown remains.

Equity: While equity valuation has improved since the beginning of the summer, expected returns are not materially higher due to lower expected earnings growth.

Fixed Income: The Canadian bond market should do marginally better than its U.S. counterpart while well-selected, quality corporate issuers should outperform government bonds.

Currencies: The Canadian dollar could be heading deeper into undervalued territory, as it did in the 1990s.

Expected returns for the 12-month period beginning October 1, 2015	In Canadian Dollars			In Local Currency		
	Global Renormalization	Sluggish Expansion	Global Slowdown	Global Renormalization	Sluggish Expansion	Global Slowdown
Probabilities	15.0%	50.0%	35.0%	15.0%	50.0%	35.0%
Canada Money Market	0.8%	0.5%	0.3%	0.8%	0.5%	0.3%
Canada Bond	-1.5%	1.5%	4.9%	-1.5%	1.5%	4.9%
Canada Federal Government Bond	-3.2%	0.2%	4.3%	-3.2%	0.2%	4.3%
Canada Corporate Bond	1.4%	2.9%	3.7%	1.4%	2.9%	3.7%
Canada RRB	0.5%	3.5%	11.2%	0.5%	3.5%	11.2%
Canada High-Yield Bond	14.2%	9.9%	1.7%	14.2%	9.9%	1.7%
International Government Bond	-15.3%	-1.3%	9.6%	-7.3%	-0.8%	3.9%
Canada Equity	12.0%	6.0%	-16.3%	12.0%	6.0%	-16.3%
United States Equity	-0.4%	4.9%	-10.4%	10.8%	4.6%	-14.2%
International Equity	4.7%	6.1%	-11.1%	12.4%	7.1%	-14.9%
Emerging Equity	16.2%	5.7%	-18.1%	17.5%	7.0%	-17.1%

Source: CIBC Asset Management Inc.

Global Outlook

Oil price declines and accommodative monetary policies across the U.S., Europe, Japan and China have failed to materially boost economic activity, disappointing the consensus. Our own global economic outlook remains below consensus, with global growth projected to reach approximately 3.1%. Inflation will also remain well below the major central banks' official targets over the forecast horizon, as lower commodity prices and general weakness in global demand persist.

In the U.S., the economy remains resilient, boosted by continued improvement in the labour market, which in turn strengthens the housing sector. The investment sector has been disappointing, as firms have chosen to buy back shares rather than generating future growth by increasing their investment spending. The U.S. domestic resilience, however, may sow the seeds of future weakness. U.S. economic outperformance is pushing the U.S. currency higher against many other currencies. Combined with slowing emerging market economies, this may eventually slow the U.S. economy enough to delay the Fed's plans to raise interest rates this year.

Outside the U.S., Europe is showing signs of life, with domestic demand improving. But growth remains relatively low by historical standards. Then there is China, which we could call the "elephant in the room." China's persistent slowdown looks more and more structural and is increasingly showing signs of impacting its neighbors. Investment, as a share of GDP, and credit growth are still too high and need to slow further. This would ease the imbalance between investments and consumption in China's economy. Supportive monetary and fiscal policy will still be required to prevent the economic rebalancing from becoming disorderly. Given the size of the existing economic imbalance, policy measures are more likely to temper the slowdown than reverse it. This expected slowdown is embedded in our growth forecast for 2016. Uncertainty also remains in the degree of transmission of China's economic weakness to the rest of Asia and, in turn, the impact on the developed world. The channels of transmission can also be indirect, in the form of commodity price weakness inflicting distress on highly-leveraged small economies or large corporations, triggering more financial deleveraging.

We have therefore raised our risk assessment this quarter by increasing the probability of our ***growth slowdown*** scenario to 35% and reducing the probability of our main ***sluggish expansion*** scenario to 50%. We have been monitoring global debt since the start of the financial crisis, more than seven years ago. Despite efforts by policy makers to spur economic activity and stabilize debt levels, developed economies have seen total debt (including government and private sector) rise from 229% to 265% of GDP since 2007. In emerging economies, the same ratio went from 117% to 167% of GDP for that period*. Central banks have already used many of the tools in their monetary policy arsenal and interest rates remain at zero for most of the major central banks. It could be argued that some central banks are approaching their policy limits. For example, the Bank of Japan is already the biggest holder of Japanese bonds (JGB), representing close to 30% of all issues outstanding. Any increase in JGB purchases would likely reach a limit, as there would not be enough sellers of these bonds. The Swiss National Bank's foreign exchange reserve represents around 80% of the size of the economy as a result of its foreign exchange intervention to limit its currency's appreciation. We also wonder how effective additional quantitative easing (QE) would be in the U.S. if it became necessary during the next economic downturn. With debt levels so high, central bankers face the problem that it is difficult to raise interest rates without derailing growth. On the other hand, if monetary policy keeps rates close to zero, what tools will be available to prevent the next economic slowdown?

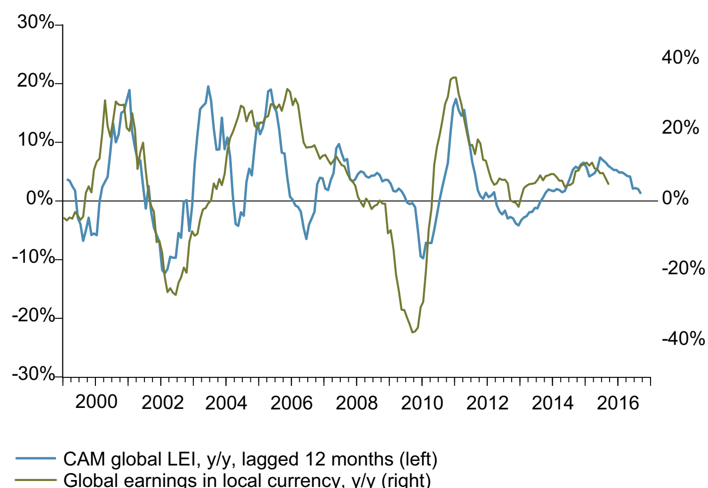
The ***global renormalization*** scenario remains a distant third probability (15%) for the moment, given the remaining headwinds for the global economy. While central banks would like to renormalize monetary policy, the demographic and debt headwinds remain too powerful to attribute a higher probability to this scenario at this time.

Fixed Income Versus Equity

Equity Valuation Has Improved, But Earnings Are Slowing

The late summer correction in the equity market had at least one positive consequence—stock market valuation has improved. Our cyclically-adjusted P/E ratio shows the eurozone trading at 12.8, down from 15 before the correction. U.S. equities now trade at 16.5, compared to 17.9 previously. This is certainly an improvement from the high valuation we warned about in our last quarterly forecast. However, we don't believe it is enough to produce undervalued equities, especially in the U.S. market.

Global Earnings and the Economic Cycle



Source: Datastream, CAM

*Bank for international settlements.

Meanwhile, earnings growth is slowing and, if our proprietary global leading economic indicator is any guide, earnings may remain weak over the coming months. This will stem from China's economic slowdown and its negative impact on commodity prices that continue to flow through to corporate earnings. The resource sectors (energy and materials) have seen their earnings decline since 2011, even as other sectors maintained a steady pace of growth. The weakness is now spreading to those sectors. While the lull could be temporary, earnings growth will likely continue to slow unless the global economy picks up.

While valuation has improved since the beginning of the summer, expected returns are not materially higher due to lower expected earnings growth. Investors are paying a lower price for equities, but are getting lower earnings growth in return. Furthermore, the divergence of valuation across equity markets continues to widen. Some equity markets (e.g. Turkey) and sectors (e.g. basic resources) are very cheap. But these tend to be countries or sectors with structural economic issues such as large current account deficits and overcapacity. The countries and sectors with robust fundamentals tend to be richly valued (e.g. the U.S. or consumer staples).

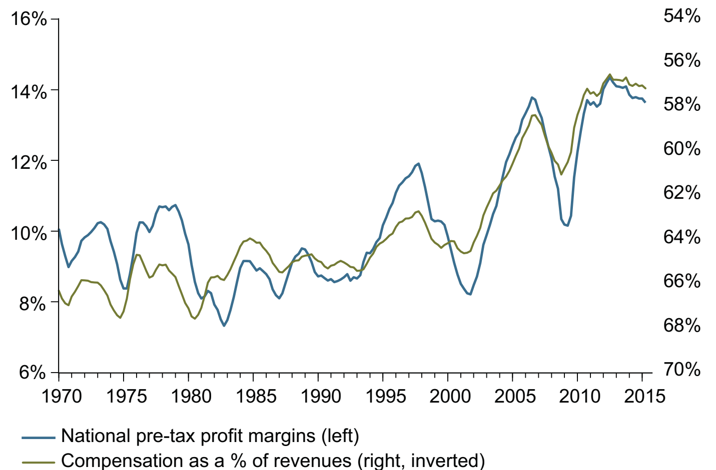
The investment outlook is further complicated by the Fed outlook. The Fed has introduced higher volatility to financial markets by postponing a first rate hike and keeping the market on edge. This complex environment leaves investors with relatively difficult choices. On one hand, equity markets offer higher expected returns that will be accompanied by a fair degree of volatility. On the other hand, safer assets, such as sovereign fixed income, offer a more stable return. However, this expected return will have difficulty maintaining purchasing power over time. We maintain an overweight in equity, favouring a stabilization following the third-quarter equity correction, but the risk of a global economic slowdown remains. Our conviction in the ability of central banks to continue to stimulate economic activity with non-conventional policies is also diminishing.

Equity Market Outlook

The Impact of ZIRP on Equities

The last quarter was not kind to equity investors, as they experienced the first 10%+ equity market correction in close to four years. There may be a number of reasons behind this correction but we think the peak in profit margins was one of them. The Fed has been pursuing an extraordinarily loose policy to fuel a recovery in the labour market. Such an improvement in employment eventually reduces the supply of available workers and leads to a rise in the cost of labour. The steady erosion of compensation (as a % of corporate revenues) since the early 80s had been driving profit margins ever higher. The chart on the right shows that this trend is reversing and starting to eat into profit margins. Second, the falling cost of interest has been another significant factor behind improving margins, and this is also likely coming to an end. Finally, the divergence between the Fed and other central banks has led to a sharp appreciation of the U.S. dollar, making U.S. companies less competitive. All those developments point to a peak in U.S. profit margins. The impact of the Fed's policy is also apparent on valuation. With looser monetary conditions, the U.S. economy has been able to recover faster than the rest of the world. The outperformance of the U.S. stock market now leaves U.S. companies more richly valued. The bottom line is that U.S. equities face headwinds that should inhibit performance, both in absolute terms and relative to the rest of the world.

U.S. Margins and Compensation



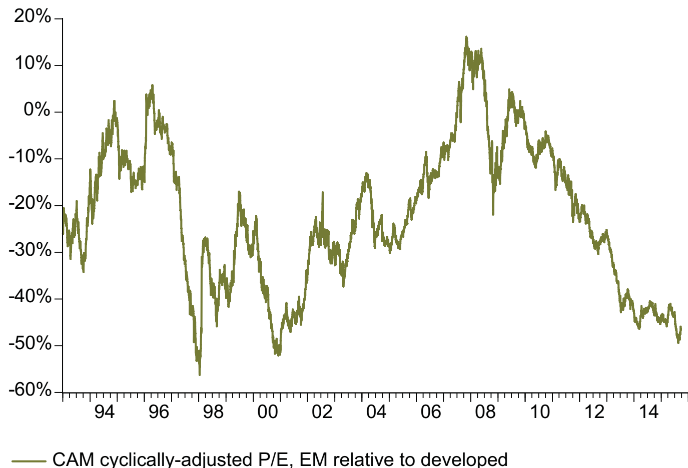
Source: Datastream, CAM calculations

The landscape in emerging markets has changed significantly since the Fed embarked on its zero-interest rate policy (ZIRP). China is not growing as fast as before, the commodity bull market has turned into a bust and the macroeconomic stability of many countries has deteriorated. Basically, the trends that were behind the outperformance of emerging market (EM) equities between 1999 and 2010 have reverted. Where does that leave EM? Quite undervalued. Emerging markets trade at 8.1 times our measure of cyclically-adjusted earnings, compared to 15.1 for the developed world. We believe valuation is one of the strongest contributing factors to equity return over the medium term. The challenge in our allocation strategy resides in the short-to-intermediate cyclical outlook for some of the emerging markets, as some of the valuation discount is justified by a difficult cyclical outlook. Some of these cyclical challenges are caused by China's investment overcapacity. This has led to depressed commodity prices and balance sheet deleveraging and created an economic slowdown and slower earnings growth. It is difficult to gauge how far along we are in this cyclical process. But judging from depressed valuations, it seems we are fairly far advanced.

Europe and Canada land somewhere between the U.S. and emerging markets on our valuation spectrum—not as expensive as the U.S. market but not as attractive as emerging markets. European equities continue to be supported by accommodative monetary policy from the ECB (European

Central Bank), lower oil prices and, until recently, a weakening euro, which should support earnings. Canada remains challenged by weak commodity prices and a weak domestic economy, which should cap its relative equity performance.

Equity Valuation: Emerging vs. Developed



Source: Datastream, CAM calculations

Fixed Income Outlook

The Challenging Road to Normalization

- **We maintain our view that bond yields will be forced a little bit higher over the next 12 months. This will occur through a certain level of policy renormalization by the Fed and the enhanced premium that heightened market volatility normally requires.**
- **However, we are revising our yield forecasts marginally lower to reflect the increasing probability that a Fed normalization could be delayed. Our 12-month target for U.S. 10-year Treasuries stands at 2.50% and the Canadian equivalent at 1.70%.**

The last few months have provided growing evidence that the Fed is making progress towards renormalization. As the Fed checks off the necessary conditions to move ahead with its first rate hike in nearly 10 years, external headwinds remain and some are slowly intensifying.

Among the arguments that justify higher yields is the health of the U.S. economy. Domestically, sufficient improvements have been made in the housing sector and labour market to allow for a lift away from ZIRP, while still remaining very accommodative.

Another element is the decline in foreign reserves of global central banks, which are largely held in fixed income. China's adoption of a more floating currency regime will lead to less foreign exchange intervention. The result will be less accumulation of U.S. dollars by China, leading to a diminishing appetite for U.S. Treasury bond purchases from global central banks. A prolonged period of low oil prices should result in less petrodollar* recycling. At the margin, these factors will exert upward pressure on U.S. bond yields.

Moving against these forces is the drag on growth from high levels of debt and global deflationary pressures. The strong appreciation of the U.S. dollar against most currencies over the past year and recent developments in China have exacerbated these factors. As a result, there is a growing risk that the U.S. renormalization could be derailed or at least postponed.

In the context of persistent weakness in energy and commodity prices, we believe the Canadian bond market should do marginally better than its U.S. counterpart. Agencies and corporate securities should continue to face a challenging environment. However, their recent deterioration relative to government equivalents, along with the need for investors to find additional yield, should contribute to the outperformance of well-selected, quality issuers.

*U.S. dollars earned through exports of petroleum

Currency Markets

U.S. Dollar

The U.S. dollar has been appreciating because U.S. monetary authorities are preparing to launch a tightening campaign. The timing of the first rate hike is still uncertain, but the Fed's next move is generally not questioned—U.S. policy rates are widely expected to head higher. This means as long as U.S. economic data stays relatively strong, the U.S. dollar uptrend will remain in place. At this juncture, the economic data doesn't provide enough reason for market participants to challenge the Fed. However, the group of economic reports released in the fourth quarter will be important—the U.S. economy has to continue to follow the Fed's script.

In the past, foreign exchange developments played very little part in determining 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 is different. The U.S. dollar has gained substantial ground in recent years. Since 2012, it has appreciated nearly 30% on a trade-weighted basis. It is now overvalued by more than 8% against the currencies of its main trading partners—a rare situation. This is definitely complicating the situation for U.S. monetary authorities, forcing the Fed to put more weight on foreign exchange developments in its policy decisions.

Canadian Dollar

We believe it is too early to imagine a consolidation for the USD/CAD exchange rate. Over the short to medium term, the cyclical downtrend initiated two years ago should remain in place. This is due to developments on the oil front as well as deteriorating domestic economic conditions.

On the oil price front, further weakness is expected. The decline in West Texas Intermediate oil (WTI) has been primarily driven by supply-related fundamental factors. Wide oversupply conditions will continue to prevail into 2016. We also believe there is still too much optimism about the Canadian economic outlook. Over the next twelve months (2015Q4 to 2016Q3), real GDP will likely disappoint, ending closer to +1.4% than the widely expected +1.8%. With an already low policy rate, the Bank of Canada (BoC) is running out of ammunition. Any additional easing in monetary conditions will have to come from additional currency weakness.

The bottom line is that the Canadian dollar is being hit by a double whammy. It faces a resuming downtrend in oil prices and a downshift in BoC monetary policy expectations led by weaker-than-expected jobs and GDP growth. If our assessment is correct, the Canadian dollar will be heading deeper into undervalued territory, as it did in the 1990s.

Euro

As global financial markets shifted to "risk-off" mode in late August/early September, the euro began to regain some of the ground it lost after the ECB launched its asset purchase program earlier this year. This recent turn of events is problematic for the ECB, which was just starting to regain confidence about inflation's return in the eurozone. The problem is that the ECB's forecast for higher inflation was based on the assumption that the euro would remain weak. Unfortunately, on an import-weighted basis, the euro has already regained nearly all of the ground lost in anticipation of the launch of the ECB's QE program. The ECB urgently needs to act to avoid having the eurozone economy fall into a deflation trap. Owing to widening monetary policy differentials, we expect further weakness in the euro against the U.S. dollar.

Japanese Yen

When we turned bearish on the Japanese yen three years ago, we argued that there was a necessary condition for the success of Bank of Japan's QE program, which aimed to weaken the yen. China had to abstain from retaliating by lowering the value of its currency. Now that China is allowing greater foreign exchange volatility, this condition no longer exists.

In 2013, our conviction about upcoming Japanese yen weakness increased considerably because Japan's foreign direct investment and current account balances were moving deep into negative territory. Between 2012 and 2014, these fundamental capital outflows kept increasing, implying that downward structural pressures on the yen were intensifying. This year, Japan's fundamental deficit has narrowed significantly. It is no longer obvious that fundamental outflows are large enough to keep the yen on its downtrend against the U.S. dollar.

Owing to Japan's narrowing fundamental deficit and China's regime shift, it will be very difficult for the yen to depreciate further.

Chinese Renminbi

Discussions over whether the renminbi (RMB) will enter the IMF's Special Drawing Rights (SDR) basket have been ubiquitous. Inclusion of the RMB in the IMF SDR basket would significantly impact the internationalization of the RMB and its value. Inclusion implies a redistribution of central bank reserves, where the world increases its holdings of RMB and decreases its holding of other reserve currencies. The scale of such a change is quite meaningful under current IMF SDR basket-weighting methodology, which uses a country's export value and reserves held in other countries to measure weights.

Under the current methodology, the IMF has suggested that the RMB could ultimately represent between 14% and 16% of the basket.

Given China's closed capital account, it would take time for such a scenario to evolve. However, our analysis (table below) considers the possibility that central banks could increase RMB to various weights (with the most likely being 4% over a one-to-two year period) in their foreign exchange reserve holdings and proportionately reduce all other currency positions.

The table provides details for four scenarios. If RMB holdings increase to 4%, we would see an increase in demand for RMB of approximately $450B USD over the transition period. This value is comparable to over 2x China's 2014 current account balance or 4.6% of GDP.

Scenarios of Composition Change in FX Reserves by Central Banks

		Target % of Central Bank RMB holding			
		4%	8%	12%	16%
	Current Allocated Holdings %	Expected Change (USD, Billions)			
Total FX Holdings of RMB	>1%	457	915	1,372	1,829
USD	64.1%	(293)	(586)	(880)	(1,173)
Pound Sterling	3.9%	(18)	(36)	(54)	(71)
Japanese Yen	4.2%	(19)	(38)	(57)	(76)
Swiss Francs	0.3%	(1)	(3)	(4)	(5)
Canadian Dollars	1.9%	(9)	(17)	(26)	(34)
Australian Dollars	1.9%	(9)	(17)	(26)	(34)
Euros	20.7%	(95)	(190)	(284)	(379)
Other	3.1%	(14)	(28)	(42)	(56)

Source: IMF, CIBC Asset Management

If this move occurs, it would support China's currency, likely reduce financing costs for its sovereign debt and improve its growth outlook.

Commodity Insight

The CRB Commodity index declined by approximately 14% during the third quarter, as concerns over global and Chinese growth increased. Appreciation of the U.S. dollar relative to emerging market economy currencies accelerated and commodities, which are mainly priced in U.S. dollars, came under increased pressure.

Oil prices retreated from the highs seen in May and June, as the seasonally strong demand growth of the summer months came to an end. U.S. onshore producer commentary during second quarter conference calls also challenged sentiment, as some producers indicated their desire to bring rigs back to the market. However, more recent declines in oil prices have prompted renewed cuts to spending, leading to the first reported declines in U.S. production growth since the oil bear market began. The increase in long-dated project deferrals by global major oil companies will also impact future production growth from non-OPEC, non-shale supply. The International Energy Agency (IEA) now anticipates that non-OPEC supply will decline by 500k bbl/d in 2016.

With the decline in prices, demand has started to increase for refined product. This led the IEA to increase its demand growth expectations for crude oil to 1.7 m bbl/d year-over-year in 2015 and further demand growth of 1.4 m bbl/d in 2016. The combined impact of reduced non-OPEC supply and stronger demand is anticipated to increase the demand on OPEC by 1.6 m bbl/d in 2016, further tightening the market and potentially lifting prices.

Regional Outlook
Canada

- **There is still too much optimism about the Canadian economic outlook.**
- **Over the next twelve months (2015Q4 to 2016Q3), real GDP will likely disappoint, ending up closer to +1.4% than the widely expected +1.8%.**
- **With an already low policy rate, the BoC is running out of ammunition. Any additional easing will be conditional on deteriorating growth prospects.**

Since the year began, we have argued that there was too much optimism about Canadian economic growth prospects. Until recently, the BoC, and the majority of private sector forecasters, expected the downturn in the first half of the year to be followed by a speedy recovery in the second half of 2015. This would result from a stabilization in oil prices and Canadian dollar weakness. This optimism about Canada's economic outlook has faded radically and the BoC has significantly cut its growth projections for the second half of 2015, from 1.8% to 0.7%.

This change of heart can be readily explained by the fact that oil prices have not stabilized as expected. Owing to wide excess global supply conditions, oil prices have been making new cyclical lows, implying a deeper and longer-lasting terms of trade shock to the Canadian economy.

Lower oil prices are just part of the reason why increased uncertainty has coloured the Canadian outlook. The weak Canadian dollar has also not provided the widely-expected boost to Canadian non-oil exports. A year ago, Canadian monetary authorities had high hopes that the pronounced depreciation of the Canadian currency against the U.S. dollar would restore competitiveness. This would facilitate an increase in exports for the Canadian manufacturing sector to the United States. This is not happening and the reason is simple—the Canadian dollar is not the only currency that has depreciated against the U.S. dollar. When compared to other countries that also export to the U.S., Canada isn't any more competitive than it was when the Canadian dollar peaked against the U.S. dollar in late 2012.

While there now seems to be less optimism about the second half of 2015, the consensus view remains upbeat about next year. There seems to be general agreement that the recovery, initially expected for the second half of 2015, will be simply pushed forward. This is where the risk lies. The main reason that Canada is expected to shift into higher gear moving into 2016 is that Canadian forecasters, including the BoC, feel very upbeat about the U.S. economic outlook. In the July edition of the BoC's Monetary Policy Report, the BoC forecast that U.S. real GDP growth would accelerate to +2.8% in 2016. If this forecast materializes, the Canadian economy will get a very welcome and timely boost from stronger activity south of the border. The problem is that the Fed doesn't seem to be as upbeat about U.S. economic prospects. In September, the Fed released its latest assessment for the U.S. economy, forecasting that growth would more likely be around +2.3% next year, down from +2.5% in its previous assessment. This latest Fed forecast is closer to our own U.S. growth projections (+2.0%). If we are right, and U.S. economic growth doesn't accelerate, Canadian growth will very likely disappoint.

Overall, we still believe there is still too much optimism about the Canadian economic outlook. Over the next twelve months (2015Q4 to 2016Q3), real GDP will likely disappoint, ending up closer to +1.4% than the widely expected +1.8%.

United States

- **The Fed remains too optimistic about U.S. economic growth prospects. Our forecast calls for 2.0% real GDP growth between 2015Q4 and 2016Q3, a forecast below the Fed's implicit objective.**

- **If our forecast materializes, it will be difficult for the Fed to hike interest rates. More likely, the Fed will hesitantly deliver only very modest rate increases.**

The Fed released its new economic projections in September, penciling in a little lower real GDP growth in 2016 (+2.3%) and a little less PCE core inflation (+1.7%). This is becoming a regular pattern with the Fed. Since 2012, the Fed has systematically revised down its growth projections for the U.S. economy as the forecast time horizon in question approached. For instance, its 2016 real GDP growth forecast stood at +2.75% a year ago, only to be revised lower to +2.5% last June. The forecast was lowered by another -0.2% in September.

To be fair, a big part of the reason why U.S. monetary authorities have systematically missed their growth objectives relates to continued economic weakness outside of the United States. The economic recovery in the rest of the world has been very sluggish, translating into anemic foreign demand for U.S. products. Meanwhile, U.S. imports have been growing in tandem with U.S. domestic demand. Under these conditions, it is no surprise that net exports continue to depress growth. The U.S. dollar keeps gaining ground against the currencies of most of its trading partners. As a result, U.S. exporters are losing competitiveness as export prices (USD) are rising faster than the prices of imports from other countries, where foreign currencies such as the euro have cheapened. Consequently, there is little hope for a quick turnaround on the U.S. trade front. Net exports will continue to depress U.S. growth, with a high probability that the drag will increase.

In addition, the U.S. housing recovery has been modest and, so far, very slow to improve. In our view, this is not about to change. Housing supply and demand conditions will continue to limit the recovery in residential investment spending.

Finally, underinvestment by U.S. non-financial corporations remains a dominant feature of the U.S. economic landscape. Since 2011, U.S. non-financial corporations have been restoring profitability by buying back shares and issuing corporate bonds—increasing lending to take advantage of the ultra-low interest rate environment. The net impact of this reshuffling on the liability side of the balance sheet has been very sluggish investment spending. Unfortunately, these dynamics will likely remain in place in the U.S. over the next year.

Odds are that the Fed is once again overestimating the improvement in U.S. economic activity for the coming year. Our forecast calls for +2.0% average real GDP growth between the fourth quarter of 2015 and the third quarter of 2016, a forecast below the Fed's objective. If our forecast materializes, it will be difficult for the Fed to hike interest rates. More likely, the Fed will hesitantly deliver only very modest rate hikes.

Europe

ECB QE For Longer

- **Our forecast for +1.4% average eurozone real growth (2015Q4 to 2016Q3) is below consensus, owing to weakness in European investment spending.**
- **The ECB will again miss its inflation target in 2016 by a wide margin. Our 2016 inflation forecast stands at +0.9% vs. +1.6% from the ECB.**
- **The ECB will need to maintain its zero-interest rate policy and asset purchase program for longer than generally expected.**

At first glance, it's tempting to conclude that the eurozone economy is finally out of the woods, as the economy is performing better than the ECB expected a year ago. Thanks to a stronger recovery in domestic demand, eurozone real GDP growth is running at +1.85% (vs. ECB year-ago expectations of +1.4%). What's more, the economic recovery has been broad-based, with much stronger growth than expected in the smaller eurozone economies. Ireland is growing at +7.3%, Spain at +3.1% and Portugal at +1.5%. Even Greece is now in recovery mode. The ECB expects that real GDP growth will average +1.4% in 2015 and +1.8% in 2016 and 2017—a forecast very much in line with the private sector consensus. Our own forecast of 1.4% average real growth between 2015Q4 and 2016Q3 is below consensus, owing mainly to continued weakness in investment spending across the eurozone.

Despite the better-than-expected growth numbers, the European employment recovery still significantly trails the U.S. in terms of job creation. Employment growth is almost 1%, but the unemployment rate remains elevated at 10.9%, implying still-wide excess capacity in the European labour market. As we underscored a year ago, the problem for European monetary authorities is that it will take a lot of time before the labour market gets tight enough to generate inflationary wage pressures. As this is not likely to happen before 2019, the risk of deflation will remain the ECB's main preoccupation for the next three years.

To complicate things even further for ECB president Draghi and his colleagues, inflation has refused to follow the ECB script throughout 2015. HICP (Harmonised Index of Consumer Prices) inflation in the eurozone is running at only +0.2%—well below the inflation levels projected by European monetary authorities a year ago. The longer the HICP flirts with deflation, the harder it will be for the ECB to keep long-term inflation expectations well-anchored.

Under these conditions, the ECB has no option but to stick to the message that it is just a matter of time before inflation returns in the eurozone. The ECB projects inflation of +1.6% and +1.7% for 2016 and 2017, respectively. Unfortunately, this inflation forecast already seems out of reach.

Additionally, the ECB's inflation forecast does not account for the renewed weakness in energy prices as well as the euro's renewed strength. On an import-weighted basis, the euro has already regained all of the ground lost as a result of expectations of the launch of the ECB's QE program in late 2014. This means that import price deflation will soon be moving deeper into negative territory and exerting downward pressure on HICP inflation.

Given all the forces at work, the ECB will need to maintain its zero-interest rate policy and asset purchase program for much longer than generally expected.

China

Chinese Growth in Transition

- **The Chinese economy is expected to slow to less than +6.5% in 2016, led by the deceleration of growth in investment spending and industrial activity.**
- **We expect the central bank of China to continue its accommodative policies. This will promote economic activity and provide relief on debt servicing.**

China has experienced increased turbulence so far in the second half of 2015. This has had an important impact on global growth prospects and is a key factor in explaining global financial market dynamics. Two developments were of paramount importance: 1) the sharp decline in China's domestic equity market after an extraordinary advance since November 2014 and 2) an unexpected change in China's currency policy that resulted in a relatively sharp decline in the renminbi versus the greenback in August.

Worrisome signs are appearing in several areas of the Chinese economy. Slowing production activity and deflation are pressuring profitability in the manufacturing sector, which also remains mired with overcapacity. As a result, investment growth is likely to further decelerate in 2016, a situation that could persist for several years as the economy works out current imbalances. However, there are some bright spots. One area of progress is the property sector, where increasingly accommodative monetary policy and positive macroprudential measures have inspired a likely demand recovery in residential real estate. Sales activity of residential property has improved in the past few months and the economy is recording a stabilization or advance in home prices in a growing number of cities. That being said, development activity is still contracting as high levels of inventory weigh on new developments.

Overall, the Chinese economy is expected to slow to less than +6.5% in 2016, led by the deceleration of growth in investment spending and industrial activity. Deflating producer prices are having an important impact on consumer price dynamics, which have been well below target since 2012. The most recent reading in CPI of +2% y/y suggests that inflation is firming (and should continue to do so into 2016QI) as the impact of lower energy prices drops out of the annual price changes. However, there is little reason to believe the disinflationary environment has ended as we look further out.

Given the slowing growth environment and disinflation tendency in the economy, we expect the central bank of China to continue its accommodative policies. This should promote economic activity and provide relief on debt servicing. On a historical basis, real interest rates remain relatively high, suggesting that more needs to be done by the central bank to loosen financial conditions.

Discussions over whether the renminbi will enter the IMF's Special Drawing Rights (SDR) basket have been ubiquitous. If it occurs, this move would support China's currency, likely reduce financing costs for its sovereign debt and improve its growth outlook. We cover this topic in greater detail in the Currency section.

Signposts

Economic indicators that will help us determine if our **sluggish expansion** scenario is occurring as expected:

Canadian Signposts

- Investment growth (focus on energy impact)
- Employment and wage growth
- Oil impact on trade balance (energy vs. non-energy)
- Housing activity and property prices

U.S. Signposts

- Underemployment (decline in U6 measure) and wage growth (ECI)
- Core PCE inflationary pressures (pass-through from U.S. dollar strength and oil price decline)
- Domestic oil production decline
- New export orders (assess impact of strong U.S. dollar)
- Existing home sales and housing starts

Chinese Signposts

- Housing prices and housing starts
- GDP growth mix (industrial production vs. retail sales)
- Lending to households and businesses
- Fiscal and monetary policy initiatives

Other Market Signposts

- Japanese labour market wage growth
- Bank of Japan monetary policy guidance
- European bank lending surveys
- European Purchasing Managers' Indices
- Monetary policies in India, Turkey and Brazil to control inflation
- Improving European job creation
- U.K. employment and wage growth

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