Perspectives

For the period beginning October 1, 2017

INFLATION OUTLOOK CALLS THE SHOTS

The distinction between a gradual normalization of monetary policy and a more abrupt tightening is critical to the market outlook. For bonds, both scenarios should lead to higher yields. For equities, the distinction could mean the difference between positive and negative returns. Ultimately, inflation pressure, or its absence, will dictate how quickly central banks must remove accommodation.

CIBC Asset Management

Asset Allocation Outlook as at October 1, 2017

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

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

Highlights

Fixed Income vs. Equity: If inflation remains under control, bond yields will rise gradually, risk appetite will remain high and equities will be further supported by robust earnings.

Equity: Cheap equity valuation represents a potentially lucrative opportunity in emerging markets (EM), especially since EM currencies are attractive as well.

Fixed Income: U.S. and Canadian bond yields are likely to edge higher—but the upside remains limited in the context of subdued and well-anchored inflation expectations.

Currencies: The Canadian dollar is facing an uncertain outlook given the NAFTA negotiations and recent hikes from the Bank of Canada (BoC).

Expected Returns

Expected returns for the period beginning October 1, 2017	In Canadian Dollars			In Local Currency		
	Global Reflation	Policy Renormalization	Global Recession	Global Reflation	Policy Renormalization	Global Recession
Probabilities	15.0%	65.0%	20.0%	15.0%	65.0%	20.0%
Canada Money Market	1.5%	1.1%	0.8%	1.5%	1.1%	0.8%
Canadian Bond	-0.4%	1.6%	4.8%	-0.4%	1.6%	4.8%
Canadian Federal Govt. Bond	-0.7%	1.4%	5.8%	-0.7%	1.4%	5.8%
Canadian Corp. Bond	1.3%	2.2%	1.8%	1.3%	2.2%	1.8%
Canadian RRB	1.8%	-2.5%	4.4%	1.8%	-2.5%	4.4%
Canadian High Yield	4.5%	3.3%	-5.8%	4.5%	3.3%	-5.8%
International Govt. Bond	-5.6%	0.5%	8.1%	-3.8%	-1.0%	5.3%
Canada Equity	15.4%	4.9%	-20.2%	15.4%	4.9%	-20.2%
United States Equity	10.7%	4.4%	-13.8%	11.6%	2.0%	-17.1%
International Equity	14.4%	6.3%	-17.5%	16.5%	5.8%	-17.5%
Emerging Equity	17.2%	10.8%	-22.1%	18.6%	9.0%	-18.4%

Global Outlook

Policy Renormalization

After carefully preparing the financial markets, the U.S. Federal Reserve (Fed) officially announced its plan to shrink its balance sheet—almost ten years after the onset of the global financial crisis. This marks another step into uncharted territory for unconventional monetary policy. That being said, while the Fed's balance sheet will start shrinking, it is not expected to return to pre-crisis levels—this will leave liquidity conditions relatively loose. In Europe, we expect the ECB to keep purchasing assets through the end of 2018. However, this will occur at a reduced pace given approaching policy limitations due to a shrinking pool of available securities to purchase. In addition, the Bank of Japan recently reaffirmed its existing policy stance of Quantitative Easing with yield-curve control. Some central banks have recently expressed the desire to embark on a policy renormalization process (here the Bank of Canada comes to mind!). But overall, the global turn in policy is expected to remain very gradual and, as the expression goes, data dependent. Our forecast assumes that global monetary policy and liquidity conditions should remain favourable throughout the forecast horizon. Some changing of the guard at the Federal Reserve may bring some policy uncertainty early next year. However, we suspect it would be difficult for a new Chairperson to completely change the course that is now well underway on the path to renormalization.

Our forecast for the global economy has not changed materially from our last publication—data over the past three months has come in more or less in line with our expectations. Specifically, the global economy should continue to grow at a moderate pace and above potential. Inflation should gradually bottom from below central banks' targets as excess capacity, particularly in the labour market, continues to be removed. With inflation still far from target and monetary conditions remaining loose, the risk of a precipitated end to the economic cycle is diminishing. This is despite the age of this economic recovery, soon to be the longest in history. The U.S. may be running at full capacity, but structural forces seem to be keeping inflation pressures moderate. Meanwhile, growth in Europe is gaining momentum although a negative output gap should continue to exist for at least a couple of years. This should encourage the ECB to maintain patience with regard to its accommodation. China should continue to support global growth. Fears of a financial or economic crisis are diminishing as the central government makes progress on structural reforms and economic rebalancing.

Despite this benign outlook, the global economy is not completely immune from risks. Complacency seems to persist, if one interprets the historically low volatility and high valuation across many asset classes. The U.S. inflation puzzle remains a dominant theme, as wage growth in the U.S. remains tame despite what seems to be a labour market

Alternative Scenarios

Global Recession

We suspect that the key recession risk is more likely to emerge from the U.S., which is the most advanced in its business cycle. We are watching financial stability risks that could emerge from the corporate leverage build-up as interest coverage ratios fall with rising interest rates. Stronger wage increases would support the rise in inflation but could put downward pressure on corporate profitability. Policy risks, both monetary and fiscal, are also prominent in the U.S. The pace of interest rate hikes and/or the shrinking of the Fed balance sheet could be more damaging than expected, causing a meaningful tightening in financial conditions. Failure to pass health care legislation would reduce the fiscal flexibility to pass meaningful tax cuts that would be stimulative to the U.S. economy. Global trade tensions could also be back on the agenda, which could be disruptive to business and consumer confidence and exacerbate a potential downturn. Finally, the recent chorus of central banks voicing their intentions to renormalize monetary policy could turn into a policy mistake that miscalibrates the sensitivity of the global economy to rising interest rates.

Global Reflation

In our *Policy Renormalization* central scenario, the global economy is not expected to grow fast enough to result in a substantial rise in inflationary pressures. In this alternative scenario, the buildup in inflationary pressure is strong enough to convince more central bankers to "lift a foot off the accelerator". For central banks already in tightening mode (such as the U.S. Federal Reserve and the Bank of Canada), this implies more aggressive policy tightening over the forecast horizon. For central bankers like the European Central Bank (ECB) and the Bank of Japan, this implies reducing asset purchases at a faster pace. Stronger earnings growth would provide an offset to higher interest rates, supporting equity market valuation and providing stronger-than-expected returns. Furthermore, constructive political developments in Europe could lead to improved business and consumer sentiment and stronger economic activity than in our central scenario.

with little remaining slack. A surprise on this front, when the Phillips curve reasserts itself, could upset the current calm in financial markets, as tight labour markets finally lead to rising wage inflation. Higher-than-expected U.S. bond yields could upset this calm and lead to the unwinding of risky assets. Elsewhere, we will be monitoring the next election in Italy early in 2018, which could also serve as a market disruptor given the debt challenge of this European economy. Here at home, NAFTA negotiations should also be carefully monitored. A special segment has been dedicated to this topic in this edition of *Perspectives*.

Fixed Income Versus Equity

The inflation outlook is critical

The global economic expansion continues—growth is expected to remain above potential while momentum should slow. Monetary conditions will remain loose, even as central banks slowly remove extraordinary policies. However, at the margin, this means less stimulus. The U.S. is running at full capacity, while growth in Europe is gaining momentum, with a negative output gap that should continue for at least a couple of years. In China, fears of a financial or economic crisis are diminishing as the central government makes progress on structural reforms and economic rebalancing.

In an environment where the growth outlook is benign and mostly supportive of risky assets, the outlook for inflation will take center stage. If the cyclical outlook is working in favour of rising inflation pressure, structural forces are keeping these pressures at bay, at least for the moment. The tug of war between structural and cyclical forces is a key source of uncertainty for financial markets.

Inflation pressure, or its absence, will dictate how quickly central banks must remove accommodation. The distinction between a slow and gradual normalization of monetary policy and a more abrupt tightening is critical for the market outlook. For bonds, both should lead to higher yields. For equities, the distinction could mean the difference between positive and negative returns.

In a scenario where inflation remains under control, central banks will not surprise markets and bond yields will rise gradually. With a continued stable economic outlook, risk appetite will remain high and equities will be further supported by robust earnings. Valuation will not be the main concern.

However, in a different scenario, inflation could surprise to the upside. In the U.S., the unemployment rate is at or below the level that signals full employment. Additional employment gains from here could create bottlenecks and wage pressure. If this process takes place more quickly than expected, central banks would have no choice but to react by tightening more aggressively. The repricing of investors' expectations would have serious repercussions for most financial assets. Bond yields would spike and the resulting U.S. dollar rally would hit emerging markets and commodities. High equity valuations would become hard to justify and a correction would follow.

These two scenarios stand in opposition—Goldilocks vs. Armageddon. The reality will most likely fall somewhere in between, while market expectations may shift back and forth from one scenario to the other. For the moment, inflation remains benign and we are leaning towards the Goldilocks scenario.

Equities have been rising without interruption since early 2016 and, year-to-date, are up double digits. This creates some concerns about "overbought" markets. Outside of inflation, there are a number of other issues creating uncertainty: North Korea, U.S. tax reforms, Italian banks… to name a few.

Beneath all these issues is a broadly stable economic outlook. Earnings growth has been the dominant driver of returns this year—a significant improvement from last year's P/E driven rally. Valuation is high and volatility is low. But both cannot stay at these levels forever. The bull market may not be over, but further gains will depend on an increasingly delicate balancing act.

Equity Market Outlook

Not your father's emerging markets

Back in the good old days (prior to the Great Financial Crisis), emerging markets (EM) were the destination of choice for investors looking for strong growth. Their economies were more volatile and cyclical, but EM countries were also growing faster than developed countries. Investors were rewarded for the cyclical risks by higher returns.

Fast forward to recent years. Emerging market growth has slowed more than developed world growth, leaving EM with less excess growth than before. Corporate profitability remains higher but the gap with developed markets has also narrowed. As a result, EM equity markets have underperformed. While equities in developed countries, especially in the U.S., have seen a sizable increase in valuation, EM valuation has not moved much.

Intuitively, economic underperformance should have led to equity underperformance and a higher risk premium—as it did. But this reasoning misses some other key facts.

The rate of growth of emerging countries may have slowed, but the volatility of growth has also declined. Most EM economies are showing improving fundamentals in terms of external debt, current account balance and credit rating. EM economies are less cyclical and more resilient than in the past.

Furthermore, the composition of the EM index has changed drastically. The weight of sectors operating in primary and secondary economic sectors (i.e. natural resources and manufacturing) has fallen, while sectors from the tertiary economy (i.e. services) have increased significantly, reflecting EM's economic transformation. Bigger and more mature countries such as South Korea now represent a significant share of the index (in fact, South Korea is considered emerging by MSCI but developed by FTSE). China, now the biggest weight in MSCI Emerging, is actively transforming into a higher value-added economy.

Globalization has led to a convergence in economic cycles, profit margins and volatility—yet equity valuation has actually diverged. While slower growth may justify a lower valuation, stronger fundamentals should actually lead to a lower risk premium. It seems equity markets have been focused on the former while ignoring the latter. Incidentally, this is at odds with the bond market, where credit default swap (CDS) spreads have narrowed. Cheap equity valuation represents a potentially lucrative opportunity, especially since EM currencies are attractive as well.

Europe

EAFE companies have benefited from the positive macroeconomic environment in 2017. GDP growth numbers are not impressive but still above potential, and the output gap is slowly closing. There are no inflation pressures, nor any short-term threat of a return of deflation.

This translates into positive revenue growth that is still lower than in other regions. Earnings are growing at a double-digit pace thanks to improving margins. Commodity sectors are restoring their profitability, and contributing significantly to earnings growth. Based on our outlook for stable oil prices, this tailwind will diminish next year, but still contribute positively to earnings.

In Japan and in the eurozone, monetary accommodation is here to stay, giving companies in those regions an edge over their U.S. peers that face increased borrowing costs. Credit conditions are improving in the eurozone, providing a relief to banks. The Italian banking system is a potential source of market stress and is not "out of the woods". However, it is moving in the right direction with the first steps of a recapitalization program and the disposal of toxic assets. Political uncertainty has also decreased following the French and German elections.

The euro's rapid appreciation in Q3 weighed on equity market performance. Initially, both equities and the currency reacted positively to stronger economic figures, but the strength of the currency started to affect competitiveness and the translation of foreign profits. The euro has now begun a consolidation phase, giving eurozone equities the room to catch up and outperform global markets.

Apart from Japan, valuation is not overly expensive compared to other developed markets, especially the U.S. We expect international equities to resume their outperformance, supported by valuation and cyclical conditions.

Canada

Canada's economy has surprised on the upside in the past 12 months, giving the BoC room to raise rates by a cumulative 50 bps. As a result, the Canadian dollar was particularly strong versus its U.S. counterpart in the third quarter. This will affect competitiveness and the repatriation of foreign earnings.

The energy sector was the biggest contributor in terms of earnings growth last year, as profitability was restored. Earnings have more than doubled in the last 12 months and net profit margins are now back to their long-term average. Apart from energy, earnings growth is also good in other cyclical sectors: materials, financials and industrials. It has been more disappointing in consumer-related sectors.

For next year, the consensus is expecting the TSX Composite to maintain the same pace of earnings growth as last year, around 14%. Our view is more prudent, as we believe the tailwind from the energy sector will not be repeated.

Almost all developed equity markets look overvalued on a P/E basis. Valuation of the TSX Composite stands in the middle of the range for developed markets, between the least overvalued region, the eurozone, and the most expensive market, the U.S.

Canadian equities have strongly underperformed year-to-date. Over the short term, there is ample room to catch up to other markets. The catalyst could be a stabilization in the Canadian dollar and the price of oil. However, the excess optimism evident in consensus earnings, and the low probability that recent economic strength will be repeated, make Canadian equities less attractive over a longer time frame.

Commodity Insight

Commodity prices appreciated in the third quarter, as economic growth in China and globally accelerated. In particular, policy measures in China are supporting demand while curtailing supply. The steel market is one beneficiary of these policy measures. In its drive to control pollution and curtail production in oversupplied industries, the government has implemented strict policies, including those to reduce the steel production from induction furnaces. As a result, steel production has shifted to blast furnaces, which in turn is driving additional demand for iron ore and metallurgical coal. This policy has resulted in a tightening of the Chinese steel market, and led to a decline in Chinese steel exports to the global markets. This has produced increasing profit margins for North American steel producers. Similar measures are also impacting the global aluminum and thermal coal markets. Furthermore, the Chinese government has ordered large-scale industrial curtailments from November 15 through March 2018 in order to reduce pollution and improve air quality during the coming winter months. As a result of these production curtailments, further tightness in steel, aluminum, coal and base metal markets could support pricing at levels above recent ranges.

Fixed Income Outlook

As expected, North American bond markets turned increasingly volatile over the third quarter. Bond yields started the quarter with a steep upward move, but quickly resumed the downward trajectory observed in the first half of the year. Yields finished the quarter by jolting to higher levels. Several factors contributed to this volatility: global inflation continued to disappoint even as the global cyclical economic backdrop continued to improve. In addition, Trump-related policy disappointments and geopolitical tensions in the Korean peninsula exerted downward pressure on global bond yields at different times during the quarter.

Central bankers in developed markets subtly communicated their desire to renormalize monetary policy. Leading the pack, the U.S. Federal Reserve laid out its plan for reduction of its balance sheet. This process will be a very gradual one and should progressively push U.S. bond yields higher over a span of several years.

Meanwhile, other major central banks continue to approach their policy limits. Due to program limitations, the ECB and the Bank of Japan (BOJ) will, at some point, be required to pare down quantitative easing. That should lead to a de-anchoring of global bond yields from the historically low levels currently observed. Reduced asset purchases will probably be announced by the ECB later this fall. In a similar fashion, the Bank of Japan might have to rethink its yield-curve-control policy in the short to medium term, as bond buying capacities are not infinite.

Considering the different forces at play, we expect U.S. and Canadian bond yields to edge higher over the forecast horizon. As we highlighted in earlier versions of *Perspectives*, the upside remains limited in the context of subdued and well-anchored inflation expectations. Our twelve-month forecast calls for U.S. and Canadian 10-year sovereign bond yields hitting 2.5% and 2.25%, respectively, by the third quarter of 2018.

Currency Markets

U.S. Dollar

At this point in 2017, the U.S. dollar has lost all the ground gained over the previous year (on a trade-weighted basis). This occurred because U.S. economic and price data was not strong enough for market participants to price in a more aggressive Federal Reserve. This was especially true in the context of upshifting policy expectations in the rest of the developed world. Many central bankers outside of the United States have either started renormalizing, or signaled their intentions to soon renormalize monetary policy. The end result was a broad-based depreciation of the greenback.

Looking forward, our forecast has not materially changed. We still expect limited and only selective U.S. dollar strength over the coming year. For this to happen, however, the Fed has to stay on a gradual renormalization path. U.S. growth and inflation numbers may start to disappoint owing to the Fed tightening delivered so far. In this case, U.S. monetary authorities will be forced to move to the sidelines or shift to a slower renormalization path, more closely aligned with current market expectations. In that context, recent U.S. dollar strength would give way to renewed weakness. On the other hand, if inflationary pressures become more apparent than currently expected, market expectations will have to rise to meet the Federal Reserve renormalization path depicted in its economic forecast. This would help to sustain further modest gains, as other central banks would embark on a similar renormalization process. This would continue the path of gradual policy convergence that began earlier this year.

Canadian Dollar

Over recent months, the Canadian dollar has gained substantial ground against the U.S. dollar. It has appreciated by more than 13%, from a cyclical low of 72 cents to a peak of 83 cents. Such a rapid ascension is highly unusual and will likely have important consequences for Canada's economic and inflation outlook.

The Canadian dollar's recent show of strength can essentially be linked to two developments—the Canadian economy's stronger-than-expected recovery and the Bank of Canada's decision to deliver two back-to-back policy rate hikes. Moving closer to year-end, many things must transpire for the Canadian dollar to stay above 80 cents. First, Canadian monetary authorities will have to further tighten policy. For this to happen, the Canadian economy has to stay red hot; this is not what we are expecting. The Canadian economy will likely shed momentum, owing in part to the negative impact of a strong dollar on Canada's trade balance.

What's more, the Canadian dollar's outlook is also tied to developments on the inflation front. At the current juncture, Canadian inflation is too low to justify additional rate increases. The Bank of Canada remains convinced that inflationary pressures will soon intensify. On the contrary, we put higher odds on a string of weaker-than-generally-expected inflation numbers over the coming months. This is owing to the negative impact of Canadian dollar strength on import prices (i.e. foreign exchange pass-through). This should force the BoC to move to the sidelines.

Overall, we believe the Canadian dollar will have difficulty staying at such high altitudes over the medium to long term. Its potential downside will be determined by (1) the speed at which the Canadian economy shifts into lower gear; (2) the extent to which inflation disappoints; (3) developments on the oil front and (4) the U.S. economy's resilience.

Euro

The euro has significantly appreciated since the beginning of 2017. On a trade-weighted basis, it is up by more than 7% on shifting expectations about ECB policy. More and more market participants believe that, before year-end, the ECB will take the first step in the policy renormalization process by reducing its purchases of sovereign bonds. As discussed in the eurozone economic outlook section, we have argued that the ECB has limited options except to reduce its purchases of sovereign bonds to buy more time. This is in light of the lack of inflationary pressures in the eurozone.

Currency-wise, however, with the euro now trading close to the upper band of its mid-term trading range, the question now becomes: are additional renormalization steps to be expected from the ECB moving into 2018? Given our outlook for the eurozone economy, as well as for inflation, we put a low probability on such a turn of events. From this point on, the euro's upside seems more limited.

Japanese Yen

The Bank of Japan is probably very pleased to see that the Japanese yen has not retraced the ground lost after it introduced its "Quantitative and Qualitative Easing (QQE) with yield-curve-control" policy about a year ago. Since then, the USDJPY bilateral exchange rate has been trading around 112—considered undervalued territory based on our proprietary valuation measure. However, Japanese monetary authorities are probably a lot less enthusiastic about the lack of inflationary pressure in Japan. While the yen's weakness has translated into higher import price inflation, there has been very little pass-through. Core CPI inflation is still close to zero, as wage inflation remains muted despite a very tight labour market.

With the BOJ's inflation target still well out of reach, it has little choice but to keep its QQE with yield-curve-control policy in place for longer. As long as it does, the upside for the Japanese yen should be limited. The problem, however, is that while the BOJ has reduced its purchases of Japanese government bonds (JGBs) owing to the introduction of yield-curve control, it is still buying too many JGBs—it already holds more than 45% of the overall stock. This could pose some challenges over time as the Bank of Japan becomes the largest holder of the government debt.

Looking forward, the Japanese yen (USDJPY) will likely be stuck in a trading range between 107 and 116. Japan is therefore expected to trail the global policy renormalization. This implies that the yen could remain under pressure relative to other major currencies unless geopolitical risks resurface and the yen serves as a safe haven.

Regional Outlook
Canada

- **The surprising Canadian growth story of 2017 will likely become a story of growth disappointment moving into 2018.**
- **We project that Canadian economic activity will decelerate from more than +4% currently to +1.6% in the fall of 2018 (i.e. four-quarter average of +2.1%).**

The Canadian economy's show of strength has been nothing short of impressive to this point in 2017. The yearly pace of real GDP growth has exceeded +4.0% for the first time in more than sixteen years. Given the solid performance of the Canadian economy, the Bank of Canada did not hesitate to deliver two back-to-back rate hikes, judging that inflation will likely soon be rearing its ugly head. Looking forward, it will be difficult for the Canadian economy to avoid a downshift into lower gear. What's more, inflation's return could take longer than Canadian monetary authorities believe.

The Canadian growth acceleration that occurred in the first half of the year was largely due to two specific developments: a surge in consumer spending and a stronger and prolonged recovery in the Canadian energy sector. In both cases, a cooldown in activity likely lies ahead.

Feeling particularly upbeat, Canadian households took advantage of ultra-low borrowing costs and went on a spending spree in the first six months of 2017. At mid-year, retail sales were growing by approximately +8% (year-over-year), as the retail sector delivered its best performance in more than four years. This is largely explained by the sharp increase in household short-term credit, following the "insurance policy" 50 bps rate cuts delivered by the BoC in early 2015. By the same token, the 50 bps rate hike just delivered should translate to a deceleration in short-term consumer credit growth and cooling consumer spending.

The Canadian economy also got a substantial boost from the recovering energy sector. Last summer, "GDP at factor cost"[1] for the energy sector grew by nearly +18% y/y, contributing 1.54% to overall GDP growth. In other words, a sector that accounts for less than 10% of the economy has been responsible for 40% of the growth over the last twelve months. Looking forward, growth prospects for the Canadian energy sector are much less promising owing to relatively weak oil prices, the strength of the Canadian dollar and weakening U.S. demand for Canadian oil.

The problem for the BoC, and the central banks of most small, open economies, is that the impact of changes in policy rates are typically amplified by their indirect impact on the exchange rate. This time is no different. The Bank of Canada has hiked rates by a cumulative 50 bps. However, over the same period the Canadian dollar has appreciated by more than 10% on a trade-weighted basis. Already getting hit on the trade front, Canada is about to get hit even harder.

All in all, the surprise Canadian growth story of 2017 will likely become a story of growth disappointment moving into 2018. We project that Canadian economic activity will decelerate from more than +4% currently to +1.6% in the fall of 2018 (i.e. four-quarter average of +2.1%). With inflation stuck below target, the Bank of Canada's tightening cycle should be short-lived.

[1]The sum of net value added in various economic activities is known as *GDP at factor cost.*

Is NAFTA At Risk?

With NAFTA* talks underway, concerns about the potentially negative economic impact of upcoming changes to existing trade agreements between the U.S. and Canada have resurfaced. It goes without saying that in a scenario in which the Trump administration bluntly puts an end to NAFTA, the Canadian economy would take a severe hit. This hit would be almost as negative as the one facing Mexico. However, this is not the most likely outcome. We think that these negotiations will likely result in either a watered-down NAFTA agreement or, in the worst case, in a new U.S.-Canada bilateral trade agreement. In both cases, the potential hit to the economy would certainly be more manageable. At the current juncture, we believe that NAFTA will remain. Only certain areas will be modified for political gain rather than for economic impact.

Negotiations are taking place behind closed doors and it is difficult to assess progress so far. What is being reported in the media represents more political posturing than clear indications of the ultimate policy outcome. This makes it difficult to judge the outcome at this time. The Trump administration could certainly use these negotiations to get a political win, given the lack of progress with regard to health care and taxation reforms.

Headline risk remains for the time being and the risk of the imposition of more tariffs is non-negligible. Looking ahead, the main risk is for significant changes to the mechanisms in place to address trade disputes, leaving dispute negotiations more difficult to resolve. Time will tell, but we remain more cautious on Canadian assets given this unresolved risk.

*North American Free Trade Agreement

United States

- **We project U.S. GDP growth will average 2% in the next four quarters, a below-consensus forecast.**
- **Despite tight labour market conditions, more inflation disappointment lies ahead.**

While U.S. monetary authorities remain in tightening mode, stubbornly low inflation has become an important preoccupation. Since the beginning of the year, core PCE* inflation has moved further away from the Fed's inflation objective. So far, this hasn't been enough of a disappointment to push the Fed to the sidelines. However, what happens next on the inflation front will be a determinant. Given tight U.S. labour market conditions, are we on the verge of an inflation scare in the U.S.? We don't think so. Our view is inflation will remain soft but move up gradually, restrained by the presence of several industry-specific forces such as elevated or increasing global competition.

If anything, an upward inflation surprise is more likely taking place on the wage front, with labour becoming an increasingly scarce resource across several industries. However, even on this front, odds of an inflation surprise are not that high. U.S. wages are expected to continue growing at a subdued pace relative to past episodes of labour market tightness. This is owing to the ongoing aging of the labour force (i.e. older cohorts receiving smaller wage increases as a result of decreasing productivity growth) as well as other lingering forces. These include low trend-productivity growth and the reduced bargaining power of employees (given actual or potential threats of outsourcing or replacement by machines).

While we don't expect an inflation scare over the forecast horizon, wage inflation will eventually pick up its pace over the medium term due to increasing labour scarcity. This means that the Fed will continue normalizing its policy stance at a gradual pace. Nevertheless, this should prove to be a tricky exercise given elevated debt loads and soft underlying growth. Both factors limit the numbers of hikes that can be implemented without materially slowing the economy.

We project GDP growth will average 2% in the next four quarters, a below-consensus forecast. Growth will mainly be characterized by weak non-residential investment, which should be restrained by increasing borrowing costs and subdued prospects for profits.

*personal consumption expenditures

Europe

- **We are adding shades of grey to an otherwise rosy outlook for the eurozone. The eurozone economy is expected to grow by +1.5% on average over the next four quarters, with a widening growth differential between strong economies (e.g. Germany) and weaker ones (e.g. Italy).**

For nearly two years, the eurozone economy has grown at a healthy pace. While the ECB probably deserves a pat on the back for this good performance, it is much too early to declare victory on the inflation front. Inflation is still well below the ECB's implicit target and isn't expected to hit target before 2019 (according to most forecasters, including ourselves and the ECB). This means that the ECB will have to stick to its unorthodox policy combo of sub-zero rates and Quantitative Easing (QE) for longer.

The problem is that under the current QE policy settings, there will be no German bunds left to buy by the spring of 2018. To avoid hitting policy limits too fast, the ECB has to slow the pace it is buying sovereign bonds (i.e. tapering). This is easier said than done. Too little tapering won't buy enough time, but too much tapering could translate into rising borrowing costs for governments in the eurozone. While this might not be an issue for strong and fiscally-sound economies like Germany, it could prove disastrous for more fragile and fiscally-challenged economies like Italy.

Let's not forget that ECB QE tapering is not just about buying fewer German bunds. It also implies buying proportionally fewer sovereign bonds issued by all eurozone governments. For countries like Italy this could be problematic. Italy has a very large government debt and still very sizeable borrowing requirements. Finding the right dose of QE certainly won't be an easy task. To complicate things further, we suspect that the good times are not likely to continue rolling for Italy. After years in the doldrums, the Italian economy finally took the recovery road in late 2014. However, this recovery has essentially been export-led. This means that Italy has the most to lose if the euro gains too much ground. In short, the recent strengthening of the euro is putting the Italian economic recovery very much at risk.

The Italian recovery is also at risk because of the ECB's policy actions. The eurozone economy is doing better mainly because the ECB provided an unprecedented amount of liquidity to the banking sector in 2015 and 2016. The banking sector in turn started to lend again to households and non-financial corporations in the eurozone. Now that the ECB is providing less support to the banking sector, banks in the weaker euro economies have started to cut back on lending. This is precisely what's happening in Italy.

The bottom line is we are adding shades of grey to an otherwise rosy outlook for the eurozone. The eurozone economy is expected to grow by 1.5% on average over the next four quarters, with widening growth differentials between strong economies (such as Germany) and weaker economies (such as Italy). Policy-wise, the ECB has to slow the pace at which it is buying sovereign bonds. This promises to be a difficult balancing act, representing a potential risk in terms of financial and fiscal stability.

China

Credit Expansion: The Baton Has Been Passed

- **The Chinese economy has proven to be more resilient than expected. Our projection for real GDP growth is 6.3% by Q3 2018, a smaller growth slowdown than previously forecast.**

- **Healthy credit expansion by the household sector will offset the slowdown in credit expansion by the non-financial corporate sector.**

The prospects for growth in the Chinese economy remain relatively positive for the next year, well supported by continued strong global demand for Chinese exports. This represents an upward revision from our last quarterly forecast. Needless to say, the risk on the trade front is for increased U.S. protectionism. Another potential risk relates to the strength of the Chinese yuan. Too much currency appreciation would tighten financial conditions and affect the country's competitiveness.

As for domestic demand, growth is expected to be well supported by a buoyant consumer. Strong consumer spending is and will continue to be supported by firm wage increases, continued urbanization and a very strong credit impulse*. On the credit front, the growth in lending to households is already outpacing lending to non-financial corporations, both in growth rate and value terms. With plenty of leverage room still available, this is a trend that is expected to continue for some time. Given the forces at work, personal consumption will take on a larger share of growth in 2018, as the economy continues its rebalancing towards consumption and away from fixed investment.

Looking forward, the combination of a firm global growth environment and the rising share of domestic consumer-led growth should allow the Chinese economy to grow at +6.3% in 2018.

This year, the Chinese central bank has become increasingly prudent. It has tended towards tightening margin liquidity conditions in order to promote increased financial system stability. The Chinese central bank's policy decisions may become slightly more challenging over the next 12 months as the inflation dynamic likely shows some reacceleration, mainly driven by food prices. Our forecast calls for a below-target CPI inflation rate of 2.5% by Q3 2018. If our inflation and growth projections materialize, Chinese monetary authorities will likely keep a hawkish policy tilt.

* credit impulse = the change in new credit issued as % of GDP

Signposts

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

Canadian Signposts

- Employment growth, wage growth
- Housing activity and property prices
- Capital Investment
- Oil impact on trade balance (energy vs. non-energy)
- Short-term consumer credit

U.S. Signposts

- Fiscal policy announcements
  (tax cuts, trade negotiations, tariffs etc.)
- Wage growth (best measure is Employment Cost Index)
- Employment growth mix (by age cohorts)
- Core PCE inflationary pressures
- Domestic oil production trend (following OPEC agreement)
- New orders versus inventories
- Capital goods orders (monitor investment growth)

Chinese Signposts

- Housing sales, prices and housing starts
- GDP growth mix
  (industrial production vs. retail sales vs. services)
- Lending to households and businesses
- Fiscal and monetary policy initiatives
- North Korea geopolitical tension
- Non-financial corporation (NFC) profit margins

Other Market Signposts

- European bank lending
- ECB tapering announcements
- Government borrowing costs
- Brexit negotiations
- Italian elections
- Global Purchasing Managers' Indices
- U.K. commercial real estate activity