CIBC ASSET MANAGEMENT

PERSPECTIVES

Quarterly economic views and asset class outlook

Winter 2024

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> "A mix of resilient growth in the US and policy easing across much of the global economy makes us cautiously optimistic for equity markets.

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Cautious optimism

Welcome to the 2024 winter edition of Perspectives.

The final two months of last year witnessed an "everything rally", with strong returns in virtually all asset classes. The catalyst, of course, was the US Federal Reserve's (the Fed) unexpectedly early pivot away from policy tightening and towards the start of an easing cycle. Underlying this pivot was a quicker decline in US consumer price inflation than widely expected. This decline also occurred with far less evidence of economic pain than was anticipated, or is usual in these episodes. Full-on Goldilocks. The disinflation process hasn't been quite so benign elsewhere. Recent activity data in Canada and Europe have been more consistent with the mild recession we expected for both economies.

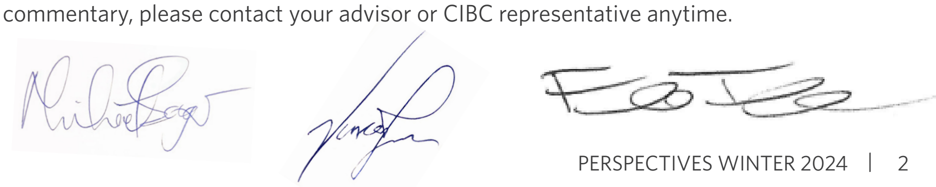
As we look forward, many of the same trends will likely persist into this year. The US economy appears resilient, with looser financial conditions, robust growth in real incomes and positive wealth effects are all supportive of consumer spending. Growth is likely to fall below its strong pace of last year, but won't dip too far under its long-term trend. And with more disinflation to come, the Fed will likely be cutting rates. The question in our minds is, how much and how soon? This is where we differ a little from the bullish market consensus; we expect the Fed to start rate cuts a little later than the consensus and to cut a little less. It's a similar outlook for central banks in Canada and Europe given a continued strong increase in labour costs.

A mix of resilient growth in the US and policy easing across much of the global economy makes us cautiously optimistic for equity markets. Volatility is expected to be higher this year than in 2023 as markets grapple with the regular flow of economic data and messaging from central banks. Unlike much of last year, when central banks and heightened recession risk presented a sustained challenge to equity investors, volatility this year suggests opportunities to deploy risk at better levels. Investors will likely be rewarded for selectivity and we continue to emphasize a focus on strong fundamentals and relatively attractive valuations. Canada and several emerging markets, excluding China, are noteworthy in this regard.

And while the strong rally in yields at the end of last year moved bonds out from the depths of the bargain bin, they remain attractive relative to recent history. As with equities, selectivity will be key, particularly early in the year as markets reprice central banks into line with our view. Fixed income is expected to offer attractive opportunities to investors as we move through 2024.

We hope you find the insights of our teams in this edition of Perspectives additive to your efforts to navigate markets in 2024.

At [CIBC Asset Management](#), we're committed to providing market and investment insights as well as best-in-class research. I hope our quarterly market recap and economic outlook are helpful as you find the right investment strategies that align with your portfolio goals and expectations. If you have any questions or would like to discuss our insights and commentary, please contact your advisor or CIBC representative anytime.



Global markets strategy

By Vincent Lépine, Francis Thivierge, Jean-Laurent Gagnon, and Daniel Greenspan

Global strategy: Better long-term outlook for financial markets, but challenges lie ahead

This quarter, we're making a significant change to our central and alternative economic scenarios. In the fall edition of Perspectives, our highest probability scenario focused on the risk of a mild global recession. In many regions (including Canada, key parts of Europe, Japan and China) this scenario came to pass. The main exception has been the US, where economic activity data remained more resilient than expected, even as inflation fell further towards the US Federal Reserve's (the Fed) policy target than predicted. Of course, this weak economic outcome did not map entirely as expected to financial markets. Even here, though, if we step outside a narrow set of technology-related stocks in the US the performance of public equities was modest for much of 2023 until speculation of an early Fed policy pivot breathed life into risk assets more broadly. And fixed income universe bond returns only regained positive territory in November 2023.

We expected recessionary risk to be at its height in the second half of last year. In this forecasting round, the fourth quarter of 2023 drops out to make room for the last quarter of 2024. Mechanistically, this leads to a more positive growth profile. Accordingly, we're changing our main economic scenario from a focus on recession (for which the probability over the next four quarters for the global economy as a whole reverts to 10%; see our *Double Dip* scenario) to one that encompasses modest growth accompanied by lingering inflation pressures. We term this scenario *Higher for Longer* and attribute a 50% probability to its occurrence in 2024. The remaining 40% probability is allocated to our *Immaculate Disinflation* scenario, under which inflation quickly returns to central bank targets with little visible macroeconomic pain. Such events are historically rare. And yet, financial markets appear almost perfectly priced to realize this outcome, as well as the rapid and substantial central bank policy easing it implies.

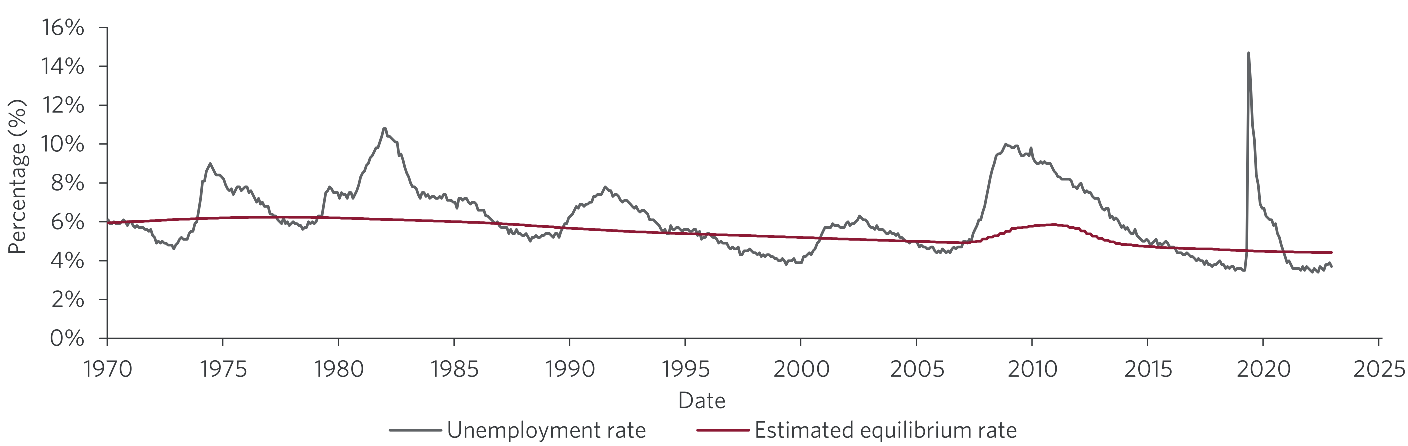
When the economy runs too hot, balance can be restored in one of three ways:

1. A sharp, recessionary contraction in demand
2. An outward shift in supply curves
3. A gradual concurrent adjustment in both supply and demand

Since the beginning of 2023, the world economy has experienced an adjustment resembling the third option. Even in the US, a gradual loosening in labour market conditions has occurred alongside a moderation in inflationary pressures. However, despite the best efforts of the Fed (and similarly the Bank of Canada and the European Central Bank) the labour market remains too tight and inflation is still running above target rates.

The US labour market remains tight

US unemployment rate

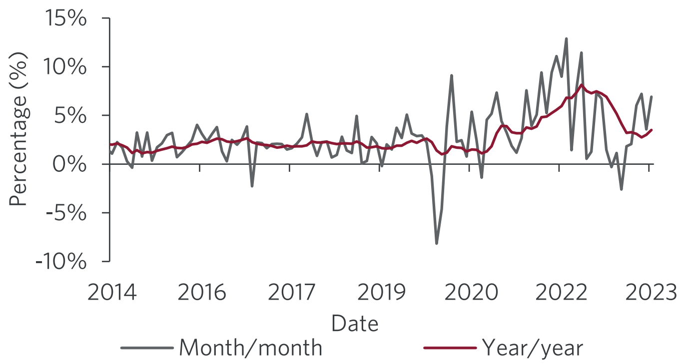


Source: Bloomberg. Equilibrium Unemployment Rate is defined as the Non-Accelerating Inflation Rate of Unemployment (NAIRU).

Under our *Higher for Longer* scenario (see alternative economic scenarios below), continued gradual rebalancing of the real economy in 2024 (characterized by GDP growth running below potential) will be insufficient to cause inflation to weaken enough to close the remaining gap to central bank policy targets in many Developed Market (DM) economies. In particular, US CPI services excluding shelter and the Cleveland Fed Trimmed Mean CPI (a measure of inflation which removes outliers) both suggest the downward trend in inflation is already stalling or even slightly reversing. Our *Higher for Longer* scenario expects this adverse inflation trend to become clearer as we move through spring.

Underlying inflation pressures remain significant

US CPI services excluding shelter



Source: Bloomberg.

Although most of our forecast probability distribution is now attached to relatively rosy outcomes for economic growth, our *Higher for Longer* scenario does identify important risks for financial markets. In particular, a core element of this scenario is that central bank policy easing cycles in DM economies will unfold more gradually than currently priced in by markets. This has important implications for the path of asset returns. In the fourth quarter of 2023, lower bond yields, higher equity prices, tighter credit spreads and a weaker US dollar (USD) collectively contributed to a significant easing in financial conditions. These were all triggered by speculation and then confirmation of a Fed policy pivot.

Recent equity and bond market rallies have loosened US financial conditions

US financial conditions

Source: Goldman Sachs, Bloomberg.

On one hand, this was good news because it reduced the risk of a financial accident and improved the outlook for economic growth. On the other hand, from the perspective of central banks looser financial conditions made the task of returning inflation back to policy targets that much harder. Looking forward, although fixed income has certainly regained its attraction as an essential part of many investor's strategic asset allocations, our *Higher for Longer* scenario argues that the rapid decline in bond yields seen during the fourth quarter was greater than can be justified by the current economic conjuncture. Under this scenario, bond yields will likely retrace at least part of their recent descent before making renewed progress later in 2024. Similarly, this scenario also argues that equity markets and other pro-risk asset classes will likely face some headwinds during 2024 within the context of a relatively favourable growth backdrop.

In response to the improved outlook for economic growth, we're shifting our tactical asset allocation bias to a more neutral stance, from cautious previously. Our strategy was positioned with an underweight to equity markets during much of 2023. This tilt was implemented partly as a means to hedge investor portfolios against heightened recession risk. In October 2023, as the importance of this risk began to diminish, we moved back to a benchmark neutral position in Canada. This market's valuation has improved in the past couple of years, reflecting strong corporate earnings growth, setting the stage for outperformance in the longer term—notwithstanding some risk of headwinds in the near term.

We remain underweight in other equity markets, including the US, reflecting less attractive valuations. But we're looking for signs that market pricing is becoming more consistent with our new *Higher for Longer* central scenario and we'll tactically invest as market opportunities become increasingly attractive. We also remain underweight in high-yield, for which spreads well inside their historical average appear inconsistent with residual recession risk.

Also in October 2023, we also implemented a tactical overweight in Canada universe fixed income. The subsequent rapid decline in bond yields, primarily in response to weaker inflation data than expected, brought them much of the way towards the 12-month target we identified at the time the position was implemented. Weaker inflation data also caused market participants to increase the number of interest rate cuts they expect to see in 2024 from the Bank of Canada (BoC) and Fed. Our *Higher for Longer* scenario envisages more gradual policy easing cycles and suggests current market pricing of both central banks is too aggressive, given the expected stickiness of inflation.

Future repricing of these expectations will likely lead to some back-up in bond yields. Given these observations, in December 2023 we took profit on part of our tactical overweight fixed income position by shifting one half of the existing overweight exposure in Canada universe bonds into Canada short-term bonds. Similar to our views on equities, we'll look to re-establish our full overweight universe bond position on evidence market pricing is becoming more consistent with our *Higher for Longer* central scenario.

Multi-asset outlook

Asset class	Current 29-Dec-23	Most likely range for the next 12 months	
		Minimum	Maximum
Canada 3 Month T-Bills rate	5.00%	3.75%	5.00%
Canada 2 Year government bond yield	3.89%	3.00%	4.00%
Canada 10 Year government bond yield	3.11%	2.80%	3.80%
US 10 Year government bond yield	3.88%	3.25%	4.50%
Germany 10 Year government bond yield	2.02%	1.25%	2.75%
Japan 10 Year government bond yield	0.61%	0.40%	1.30%
Canada 10 Year Real Return government bond yield	1.28%	1.05%	1.50%
Canada Investment Grade corporate spreads	1.31%	1.00%	1.50%
US High-Yield corporate spreads	3.29%	3.00%	4.50%
EM Sovereign (USD dominated) bond spreads	319	250	500
S&P/TSX price index (basis points)	20,958	18,800	23,000
S&P 500 price index	4,770	4,200	5,100
Euro Stoxx 50 price index	4,522	4,000	4,900
Japan Topix price index	2,366	2,100	2,600
MSCI Emerging Markets	61,542	56,000	68,000
USD/CAD	1.3243	1.3150	1.4280
EUR/USD	1.1039	1.0200	1.1400
USD/JPY	141.04	135.00	155.00
USD/CNH	7.13	6.80	7.45
Gold (US dollars per fine troy ounce)	2,063	1,800	2,200
Oil price, WTI	71.65	60.00	92.00

Source: CIBC Asset Management & Bloomberg.

Global equity markets: Cautious and selective optimism

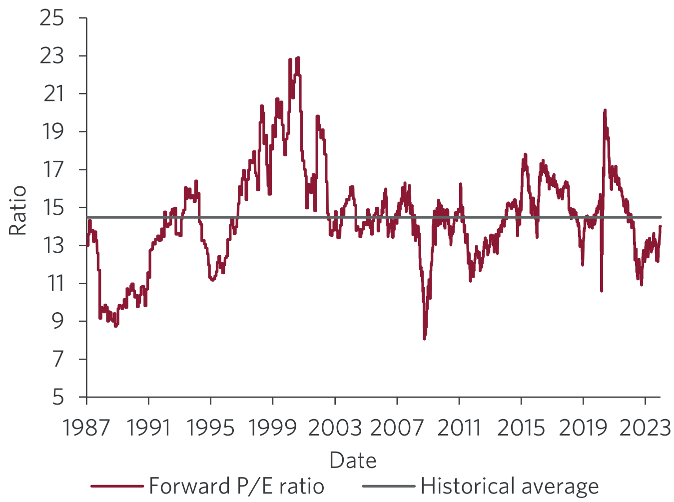
At its last two meetings of 2023, the Fed indicated that its tightening campaign was over and that 2024 will likely mark the start of a policy easing cycle. Equity markets responded with double digit returns across most regions, with cyclical and interest sensitive sectors and US small caps all performing strongly. Gains came exclusively from an expansion in price earnings (P/E) multiples.

As we look forward into 2024, a backdrop of resilient economic growth in the US and various emerging market (EM) economies, along with weaker inflation across a broad swath of countries, could offer support to equity markets early this year. Thereafter, our *Higher for Longer* base scenario suggests heightened volatility as markets curb their exuberance with respect to the extent of expected central bank policy easing.

From a fundamental perspective, we can assess the outlook for returns this year by addressing three pertinent questions. First, where will returns come from: earnings growth or valuation expansion? In Canada, Europe and EMs excluding China, economies are experiencing a mild recession and earnings have been under pressure. As we move through 2024, these markets will likely face some downside risk as markets adjust rate expectations to reflect more realistic central bank policy assumptions. Thereafter, we think they can embark on a more sustained recovery. From that point onwards, favourable comparisons with prior quarters would mechanically generate relatively strong earnings growth. Valuations in these markets are not cheap, but have been improving and are now broadly consistent with long-term averages. To some extent, they have priced in the near-term economic weakness. In the US, earnings have remained resilient, consistent with economic activity, but have slowed and there is little scope in this market for negative surprises. US valuation is more expensive and also has little room for disappointment.

Canada equity valuation appears relatively attractive

Canada forward P/E ratio



Source: LSEG Datastream.

Second, how does this expected return compare with associated risks? In 2023, one key risk was that recession and financial sector fragility would lead to heightened equity market volatility and a deep, persistent market correction. This risk was contained throughout last year and will likely remain so during this year, too. Now, markets appear almost priced for perfection, fueled by optimism that economic resilience (at least in the US) and disinflation will continue to support risk taking. We're cautiously optimistic that the early months of this year could play out this way. However, our *Higher for Longer* base scenario suggests greater caution on inflation is likely to resurface as we move through spring. The risk of more negative outcomes is fading, but markets are still facing a challenging road ahead.

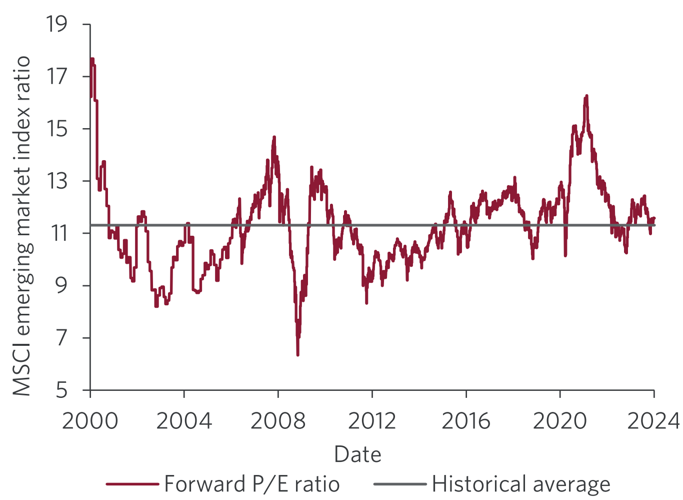
Third, how do expected equity returns compare with other asset classes? For most of the last 10 years, equities had little competition from cash and fixed income. In an environment of very low nominal interest rates, and negative real rates, many investors argued that equity markets provided an unrivalled opportunity. This situation has changed. In particular, bond yields have increased to levels adjacent to our estimates of long-term fair value, meaning fixed income once again rightfully occupies a core role within many investor's strategic asset allocation. This insight emphasizes the importance of selectivity towards equity markets, favoring those with the strongest fundamentals.

Putting it all together, our view on equities is one of cautious and selective optimism. We acknowledge the progress made in rebalancing labour markets and returning inflation closer to central bank policy targets. Our cautious optimism is reflected in our recent reallocation of cash into Canadian equities. Canada's valuation is more constructive than the US. But Canada is also a cyclical market dependent on the US economy. This tempers optimism in the near term, but does set the stage for longer-term outperformance for this market.

Several emerging markets outside of China also appear relatively attractive. They screen as relatively inexpensive against longer-term valuation metrics and either have better short-term growth prospects (some markets in Asia) or central banks that have begun, or are soon to embark upon, significant policy easing (Latin America).

Emerging market equity valuation remains relatively attractive, particularly versus US large cap

MSCI EM forward P/E ratio



Source: LSEG Datastream.

Global bond strategy: Cautious, with more attractive opportunities likely to emerge later in 2024

Global bond market performance was negative for much of 2023, but ended the year in positive territory. Continued relatively high inflation data and, in the US at least, resilient GDP growth kept bond yields elevated for most of the year. December's unexpected Fed pivot triggered a massive bond rally, driving bond returns higher. For 2023 as a whole, the WGBI index (Canadian dollars hedged) gained 5.6%.

2023 global bond returns were weak until a strong year-end rally

World Government Bond Index (CAD) returns

Source: Bloomberg.

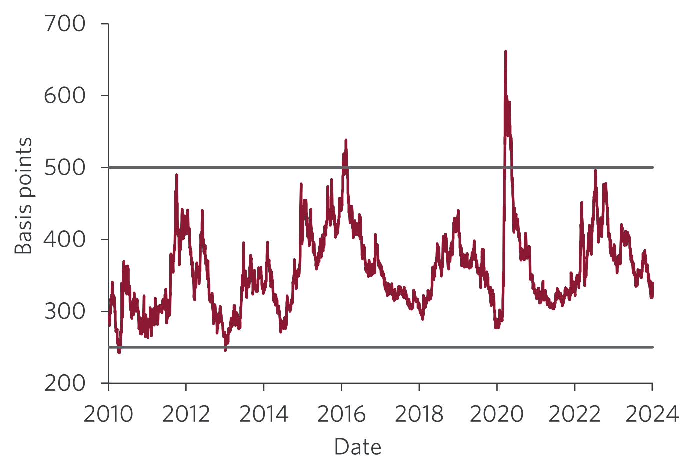
Turning to the outlook for 2024, we expect the US 10-year government bond yield to trade between 3.25% and 4.50% with a mid-point of 3.90% (this yield traded at 3.88% as at December 29, 2023). The behaviour of yields within this range will depend primarily upon economic conditions. In our *Higher for Longer* scenario, US inflation is expected to be stickier than expected by the consensus, limiting the extent of Fed policy easing. With current market rate expectations appearing too aggressive, bond markets are vulnerable to the risk of a pullback in the first half of the year, driving yields further into the top half of our expected 12-month range. A rising Treasury term premium and increasing Treasury bond issuance also argue in favour of at least a temporary correction higher in yields from current levels.

Alternatively, if our *Immaculate Disinflation* scenario plays out, inflation will continue to decelerate back to central bank targets with minimal economic pain. In this case, the US 10-year bond yield is likely to make some further incremental progress lower from current levels, implying positive returns for bonds in 2024. In the event of a 2024 recession (now our lowest probability outcome) US Treasury yields would rally a lot harder towards the bottom of our expected range, generating much more attractive returns for bonds.

Based upon our assessment of the economic outlook, our global bond strategy is defensively positioned to start the year. In particular, we advocate a neutral stance on duration reflecting our view that at least some back-up in yields is likely in the near term. Once realized, this back-up will perhaps provide opportunities to overweight duration. Similarly for EM bonds, we think investors should remain prudent and selective for the time being. Historically, periods of below trend global growth have often been associated with outflows from EM bond markets. In terms of valuation, risk premiums for both EM local currency and USD hard currency bonds are tight compared to historical norms and relative to fundamentals. Consequently, we are defensive in our EM bond exposure, waiting for better entry points.

The EMBI bond spread is tight relative to history

JP Morgan emerging Market Bond Index



Source: Bloomberg.

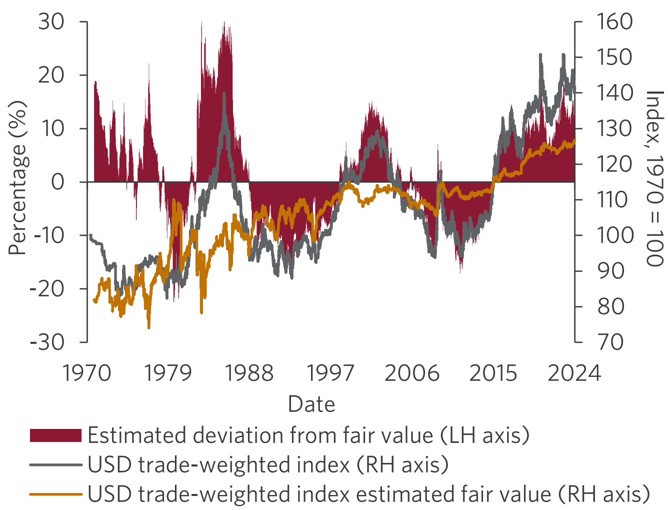
Currencies

US dollar: Still overvalued

In 2023, the USD closed out its worst year since the onset of the pandemic as market participants grew increasingly confident the Fed was preparing to aggressively cut its policy interest rate in 2024. On a trade-weighted basis, the USD finished 2023 2.0% lower than at the start of the year. Nonetheless, it still screens as significantly overvalued.

The US dollar continues to screen as expensive

USD dollar trade-weighted index, fair value and valuation gap



Source: LSEG Datastream.

Overvaluation does not mean the USD will definitely depreciate in 2024. In particular, the Fed is far from the only DM central bank expected to embark on a policy easing cycle. This means relative monetary policy expectations are not expected to move significantly against USD this year.

Global USD liquidity conditions will likely be a key determinant of the currency's direction. Under our *Immaculate Disinflation* scenario (40% probability), global USD liquidity is expected to remain abundant, leading the USD to weaken further. The outlook is different under both our *Higher for Longer* baseline scenario (50% probability) and our *Double Dip* alternative scenario (10% probability). In the former, USD is expected to hold its ground in the context of higher financial market volatility, including for currencies. In the latter, deteriorating global USD liquidity conditions suggest renewed USD strength.

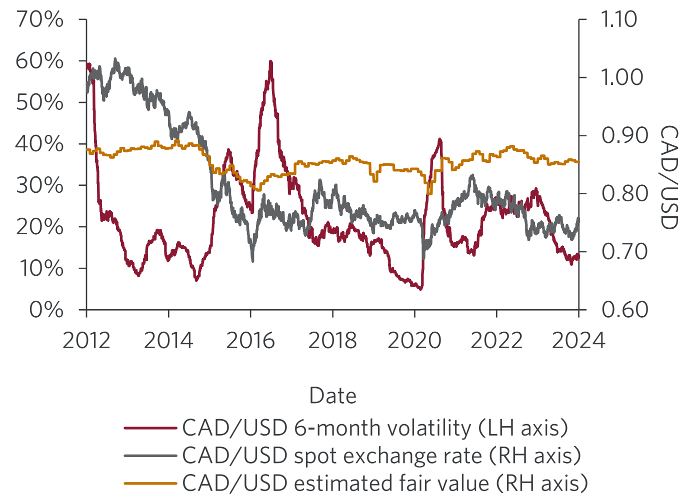
Canadian dollar: Vulnerable vs. USD

In hindsight, 2023 was not an exciting year for the Canadian dollar (CAD). Against USD, CAD did manage to eke out a modest 2.3% gain while remaining in a broad consolidation range. In addition, CAD volatility dropped to unusually low levels.

Our concern is that foreign exchange volatility rarely stays long at these levels. This suggests 2024 could be very different to 2023, with much wider fluctuations in the value of CAD against USD. With the currency currently at the top of its one-year trading range, CAD appears vulnerable to bouts of higher volatility and instability in global financial markets. For 2024 as a whole, we expect CAD to trade against the USD between $0.70 and $0.76 ($0.7551 as at December 29 2023, according to Bloomberg).

Low Canadian dollar volatility is likely to rise

CAD/USD bilateral exchange rate, fair value and 6-month volatility



Source: LSEG Datastream.

Euro: Weakness ahead

Since the European Central Bank (ECB) shifted to a regime of abundant reserves in 2015, the euro (EUR) has typically traded weak relative to its estimated fair value against USD. By contrast, over the last year, EUR gained substantial ground against USD, appreciating by nearly 15%. From a technical perspective, the currency appears increasingly stretched.

With key parts of the European economy (including Germany and France) in recession, the ECB is expected to follow the Fed and pivot to an interest rate easing bias. As a result, relative ECB-Fed policy expectations are not likely to be a key driver of EUR's value versus USD in 2024. More important will be what happens to global USD liquidity conditions. On balance, we expect tighter conditions and consequently look for the EUR/USD exchange rate to be more volatile and trade between US$1.02 and US$1.14 over the next 12 months (US$1.1039 as at December 29, 2023, according to Bloomberg).

Japanese yen: Undervalued, but still under pressure

In addition to uncertainty on the outlook for global growth and inflation, we see many reasons why the Bank of Japan (BoJ) will continue to focus on a prudent and gradual renormalization of its monetary policy stance in 2024. Domestic Japanese wage inflation has been decelerating and is now running at only 1.1% on a Y/Y basis. This is well below the 3.0% pace consistent with achievement of the BoJ's 2.0% inflation target. Labour productivity is also slowing. This combination of wages and productivity means that cost-push inflationary pressures are practically nonexistent. Furthermore, the Japanese real economy is also weakening, with domestic demand having just experienced two quarters of negative growth. These various data trends suggest Japan has yet to achieve a sustainable exit from decades of weak (and sometimes negative) inflation.

Under these conditions, the BoJ has limited leeway to relax its Yield Curve Control policy or to abandon its Negative Interest Rate policy. This means that even when accounting for anticipated Fed rate cuts, the incentive (as measured by interest rate differentials) to short the Japanese yen will remain substantial. This will be a powerful counterweight to the apparent undervaluation of the yen.

As a result, the yen is expected to remain under pressure in 2024 versus a broad set of currencies that exhibit more attractive long-term fundamentals. This includes several EM currencies in Asia and Latin America. Against USD, the yen is expected to trade between ¥135 and ¥155 (¥141.04 as at December 29, 2023, according to Bloomberg).

Commodities

Oil: Rangebound with push-pull from geopolitical and economic risks

Throughout much of 2023, oil traded in a fairly tight range of US$70 to US$80 per barrel. The only noteworthy sustained period outside this range was in the fall of 2023, which resulted from production cuts by OPEC+ in September and heightened geopolitical risk with the onset of war in Gaza in October. From a fundamental perspective, investors spent most of last year weighing uncertainty around the outlook for demand against a fairly disciplined supply side.

Looking forward, we expect the supply side to remain reasonably disciplined and supportive of the price of oil in 2024. In North America, producers are being forced to operate within their internal cash flow generation abilities. Equity markets remain difficult to access and debt is more expensive because of higher interest rates. As a result, producers are setting budgets for 2024 with limited growth that can be serviced by cash flow from operations. In addition, publicly listed energy companies will likely remain focused on deleveraging and returning cash to shareholders via dividends and buybacks rather than spending on growth initiatives. Concurrently, we expect OPEC+ to continue to work to balance the market by limiting supply growth from its member states.

In the near term, tensions remain high in the Middle East with a risk that the war in Gaza morphs into a wider regional conflict. This could eventuality have material supply implications for oil and represents an important upside price risk.

On the demand side, investors remain focused on interest rate policy in key end user countries including the US. The US 10-year government bond yield has fallen from a cyclical high close to 5.0% in October 2023 to 3.9% as of December 29 2024. Although our baseline scenario calls for little additional downside in yields over the next 12 months, a further decline would likely be a tailwind for oil demand—presenting an important upside risk for the price of oil. And in China, crude oil import quotas are up 60% Y/Y for 2024. Domestic and international passenger flights are also gradually increasing. Both trends signal a return to more robust demand for end use energy products in this economy.

Taken together, we expect oil to continue to trade in a range of US$60-US$90 per barrel in 2024. This would represent a relatively healthy price for Canadian producers because they generate meaningful free cash flow at these levels. This cashflow can be used to support further deleveraging efforts and capital returns to shareholders.

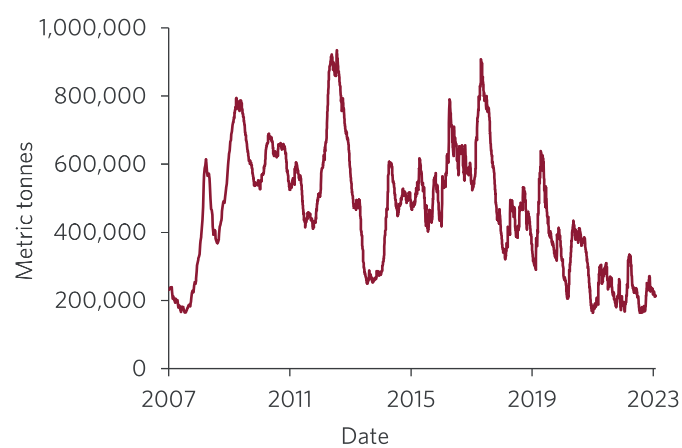
Copper: Medium-term upside

For most of last year the price of copper moved sideways, trading between US$3.60 and US$3.90 per pound. Uncertainty surrounding Chinese GDP growth kept a lid on the price. Concurrently, the supply side struggled, which prevented the price from slipping below the bottom end of the range. We expect the same dynamic to continue in 2024, with challenged supply offset by uncertain demand. Should demand prove to be more robust, the market could tighten fairly quickly.

Global supply is already relatively tight and will provide a tailwind for copper as it struggles to keep pace with global demand. Global copper inventory levels remain historically low and there has been no meaningful restocking in recent months.

Global copper inventory levels remain low

Major exchanges total copper inventories



Source: Bloomberg.

In addition, global copper miners continue to struggle with output. We've recently seen meaningful production guidance cuts from several major producers, a major mine closure in Panama that was responsible for approximately 1% of global copper supply, and a slower ramp up of supply from new mines as they struggle to reach full capacity. On the demand side, we expect to see continued targeted stimulus in China that could be supportive of copper in 2024.

Over the medium term, we continue to see a compelling case for copper price appreciation. The transition to a lower carbon economy will be copper intensive as a result of the manufacture of renewable energy producing assets and in the distribution networks necessary to deliver low carbon electricity to end users. The impact of this transition demand will outweigh slowing demand from traditional sources, including Chinese housing demand. As a result, copper prices will have to move higher to incentivize the next generation of copper supply projects into the market to satisfy demand.

Gold: Rangebound

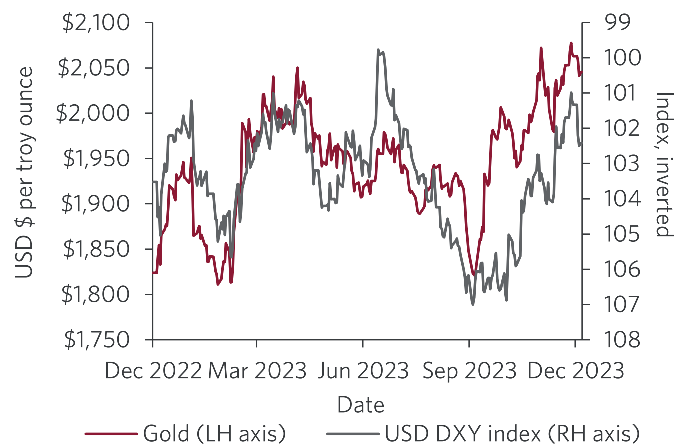
The price of gold strengthened through the fall and into the end of 2023, meaningfully breaking through US$2,000 per troy ounce in November and December. Support came from a weaker USD as well as the war in Gaza, which added a new dimension of geopolitical risk to the favourable gold narrative.

The outlook from here remains uncertain. Fears of a wider conflict in the Middle East could lend further support to gold in coming months. Recent events in the Red Sea, Lebanon and Iran have given support to this narrative. Conversely, we would expect some of the risk premium currently built into the price to come out should there be a resolution to the war.

Fundamentally, the price of gold retains a close inverse relationship with USD. Expectations around central bank interest rate policies will likely continue to be the major macro push-pull factor that will determine the near-term trends in both variables. For now, US interest rates and USD have come down from peak levels, which is supportive for gold. As this asset is non-interest bearing, lower interest rates reduce the opportunity cost of holding gold, boosting its price.

Gold often exhibits an inverse correlation to USD

Gold and DXY Index



Source: Bloomberg.

We continue to see a case for more risk-aware investors to have a small strategic portfolio allocation to gold. This encompasses heightened geopolitical and inflation risk, an expectation of higher financial and economic volatility, and a residual risk of recession. Gold is expected to represent a relatively consistent hedge to a wide range of tail risks.

Economic analysis

Vincent Lépine and Eric Morin

US: Too much priced for the Fed

Despite a gloomy start to the year, 2023 was dominated by positive US macroeconomic surprises. For many reasons—including high discretionary savings, expansionary fiscal policy and deferred student debt repayments—the US economy proved to be more resilient than expected in the face of a significant tightening in the Fed's policy stance. This resilience was a key factor keeping investors in a relatively cheerful mood throughout the year as a whole.

Looking into 2024, the market consensus view is that the US economy is on its final descent to a soft landing. Although US GDP is projected to grow at a rate a little below its long-term potential pace, recession risk has been downgraded substantially. And market hopes are high that the Fed's inflation target is now within reach.

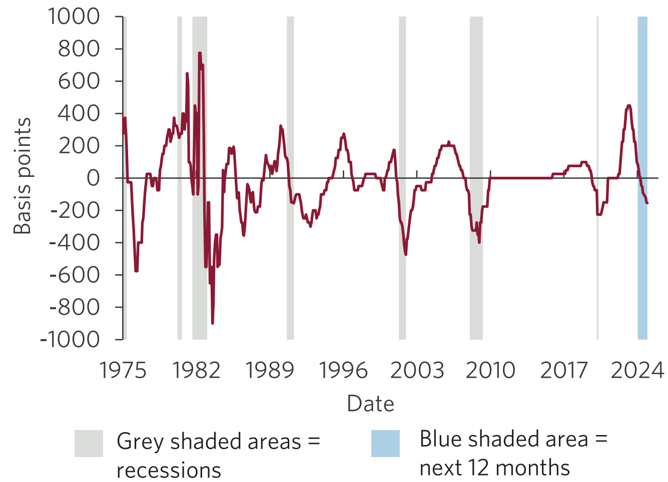
To a large extent, this view appears to be shared by the Fed. December's Federal Open Market Committee economic projections showed little sign of prospective economic pain—the Fed now expects the US unemployment rate to average 4.1% in 2024, only a little higher than the current 3.8%, and the real economy to skirt a recession—but did exhibit clear evidence that the Fed is increasingly confident inflation will return to its 2% target no later than 2025. This is important because it implies the Fed is now well-positioned to substantially ease its monetary policy stance throughout 2024. We think the odds of this outcome (defined as our *Immaculate Disinflation* alternative economic scenario) have certainly increased in recent months, as headline inflation data has printed weaker than expected and the real economy has remained resilient. We attribute a 40% probability to such a bullish turn of events being realized in 2024.

That said, our baseline *Higher for Longer* scenario (50% probability) expects a somewhat less rosy US outlook. Growth-wise, our projections are not significantly different from the consensus. Where our view differs is on the outlook for inflation.

As widely expected, the deceleration now apparent in CPI inflation will likely extend into the first half of 2024. However, we think inflation will prove to be a lot stickier moving into the second half of the year, reflecting continued growth resilience driven in part by looser financial conditions. In terms of magnitude, and similar to projections for GDP growth, our inflation forecast is not that far from the consensus. We anticipate a year/year (Y/Y) rate of 2.7% vs. the expected 2.3% from the consensus at the end of 2024. At first glance, this difference may seem trivial. In reality, the two scenarios have very different implications for financial markets. If we're correct and it becomes clear in the spring that inflation is no longer converging back to the target rate as expected by consensus, the Fed will likely have to re-engage with its previous *Higher for Longer* policy scenario.

Sticky inflation suggests the Fed's easing cycle could be short-lived

Year/year change in Fed funds rate and market implied one-year rate expectations



Source: LSEG Datastream.

A renewed, hawkish Fed pivot will likely cause market interest rate expectations and bond yields to retrace at least part of their recent descent. To bet on more aggressive Fed rate cuts, similar to current market pricing, we believe one has to expect a more severe US economic downturn. We retain a 10% probability on this outcome. By contrast, the market is priced for perfection. But from a historical perspective, every time the Fed delivered aggressive rate cuts similar to those currently priced in by market participants, the US economy fell into recession. So something is amiss. We think the trajectory of inflation holds the key.

One other element of the US economy we are watching particularly closely is the deteriorating fiscal position. Fiscal policy was unexpectedly loosened at the beginning of 2023 and became an important support to growth in the first half of the year. It was loosened even further at the back end of the year, with the federal primary deficit (which excludes interest payments on federal debt) widening to 3.8% of GDP at year-end. Given a combination of resilient economic activity and relatively high inflation, the US Treasury would typically be running primary surpluses. However, fiscal discipline has been clearly lacking and this situation is unlikely to improve in a presidential election year. Indeed, large primary deficits are projected to continue for many years.

With interest rates not expected to return to abnormally low levels seen prior to 2022, debt-servicing costs are also projected to increase. Together, these trends imply the US federal government debt load as a percentage of GDP will likely grow to a magnitude that exceeds the previous peak reached after World War II.

Apart from limiting the scope to use fiscal policy as an economic cushion in case of recession, these US debt dynamics risk making bond investors jittery. And the more concerned investors get about the US fiscal outlook, the greater the chance they demand a higher term premium. This is important: the term premium is a fundamental driver of bond yields that has been suppressed for more than a decade. With no offsetting forces, a rising term premium would worsen debt dynamics by exerting upward pressure on the federal government's borrowing costs across the maturity spectrum. It would also negatively impact valuations of public equities and other asset classes, ultimately acting to tighten financial conditions.

Canada: Already in recession

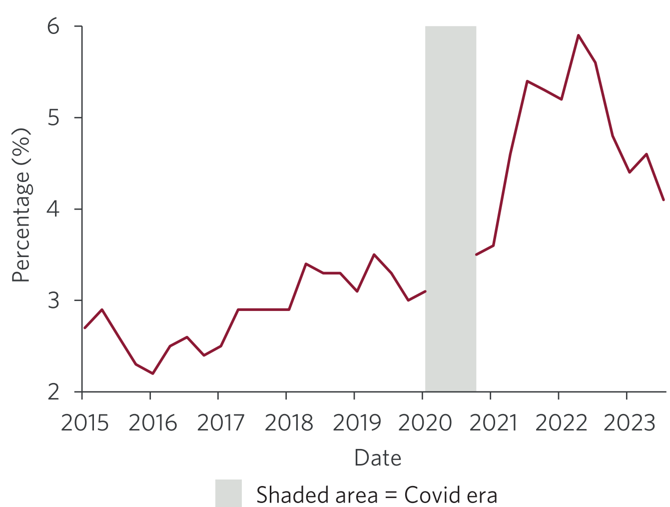
In late 2023, it became clear the Canadian economy was feeling the full impact of the heavy dose (475 basis points) of monetary policy tightening delivered by the BoC over the last two years. With a 2.0% contraction in Y/Y real GDP per capita, the economy slipped into recession in the second half of 2023. That said, the current Canadian cyclical downturn is very different from previous recessions. Unlike those in the 1990s and 2000s, this recession reflects a combination of a mild contraction in real economic activity and a surge in Canada's population. This very particular growth mix comes with both positive and negative economic implications.

On the positive side, it allows for a loosening in Canadian labour market conditions (LMCs) in the context of continued job creation. This is exceptional. Job losses are usually required to loosen LMCs. This time around, the Canadian unemployment rate has trended higher because of unusually strong population growth and, by implication, an increasing labour force despite continued growth in employment. This trend will likely remain in place.

On the negative side, strong immigration flows have so far done little to eliminate substantial mismatches in the Canadian labour market. In particular, while job vacancies have been trending lower for more than a year, they remain elevated by historical standards.

The Canadian job vacancy rate remains high

Canadian job vacancies as a share of labour force



Source: Bloomberg.

Another important negative aspect concerns the impact of the population surge on inflation. One way in which this effect works is via its influence on the price of housing (both rented and owned accommodation costs). Canada continues to exhibit significant housing supply shortages, with the result being no meaningful decline in home prices, despite the sharp tightening in mortgage lending conditions, as well as a marked increase in property taxes. The situation is even more problematic in the rental market where historically low rental vacancies are leading to a sharp acceleration in rent inflation. Canadian rental accommodation CPI rose by 7.3% in November 2023—its highest reading since the early 1980s. With shelter accounting for 40% of core CPI, bringing inflation all the way back to the BoC's 2.0% policy target rate will likely prove more difficult than projected by the market consensus.

With home prices barely correcting and mortgage rates elevated, Canadian housing affordability has taken a severe hit and housing-related expenses recently reached a 42-year high.

Canadian housing affordability looks stretched

Housing-related expenses as a percentage of household disposable Income

Source: LSEG Datastream.

With a large proportion of mortgages set to renew in the next few years, affordability could deteriorate further. This will have important implications for discretionary consumer spending and Canadian GDP growth. In this regard, the BoC is set to walk a tightrope. Cutting interest rates too much and too soon in an effort to alleviate affordability concerns would risk a reacceleration in residential property prices and a widening of imbalances. Keeping rates too high for too long would come with the risk of a more severe housing-led economic downturn and an outsized home price correction.

Along its tightrope walk, the BoC faces another important challenge: declining labour productivity. Typically, economists assume productivity trends higher at a rate of around 1% Y/Y. This allows wages to grow at a Y/Y rate of 3.0% and still be consistent with core CPI inflation running at the BoC's target rate. In recent years, neither element has held. Productivity has fallen by an annualized average of 1.5% since the middle of 2022. And wage growth has remained stubbornly elevated, averaging 4.9% over the past 18 months on a Y/Y basis. As a result, Unit Labour Cost (ULC) inflation (the net of wage inflation and productivity growth) remains far above the BoC's comfort zone.

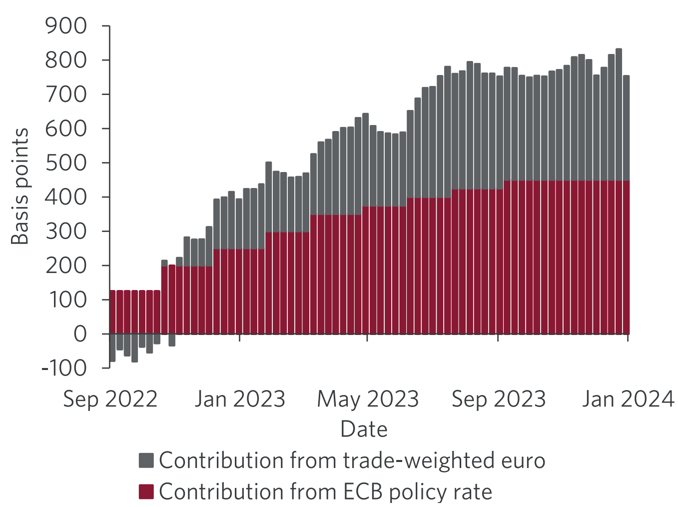
In our opinion, the bottom line conclusion that results from all these various cross-currents is that it's too early for the BoC to embark on a significant easing campaign and that too many cuts are currently priced in by market participants.

Eurozone: A difficult balancing act ahead

Similar to the Fed, the ECB is widely expected to take a dovish turn and deliver interest rate cuts in 2024. Market pricing is similarly aggressive for both central banks. But is this realistic? On the one hand, cost-push inflationary pressures are currently more intense in the Eurozone than the US, limiting the ECB's leeway to ease policy. On the other hand, the Eurozone economy has demonstrated much less resilience than the US in the face of tighter monetary and financial conditions, and likely experienced a German-led recession in the second half of 2023. Given these cross-currents, the ECB's balancing act promises to be a difficult one in 2024. As a result, the Eurozone economy is likely to remain stuck in the mud, with average real GDP growth expected to be close to flat (0.1%).

The Eurozone has experienced a sharp tightening in monetary conditions

Increase in Eurozone monetary conditions



Source: LSEG Datastream.

To a large extent, the ECB's leeway to cut rates will be determined by what happens to the euro. Over the last two years, the ECB's efforts to tighten financial conditions via interest rate increases and a reduction in the size of its balance sheet have been magnified by broad-based euro strength (exports account for 55% of Eurozone GDP, compared with 11% for the US). This also helped to control inflation by exerting downward pressures on import prices.

Going forward, euro strength will likely become increasingly problematic for the ECB. The currency now screens as significantly overvalued on a trade-weighted basis. This represents a significant hit to competitiveness, at a time when wage inflation is running well above the pace consistent with the ECB's 2% inflation target and productivity growth remains negative. With unit labour costs rising strongly, the Eurozone is losing its competitive edge. To cushion the hit, the ECB needs to weaken the euro by opening the door to rate cuts in 2024. However, with inflation projected to stay above its policy target, the extent of ECB policy easing will likely pale in comparison to current market pricing.

China: Growth disappointment to continue

Despite reopening from pandemic lockdowns towards the end of 2022, the Chinese economy disappointed in 2023. This reflected a range of factors, of which housing was by far the most important. In addition, geopolitical tensions appear to have hurt inward foreign investment, household and business confidence weakened, and labour market conditions became increasingly difficult with companies reportedly offering lower salaries to new hires than a year ago. Our GDP outlook expects annualized average quarterly growth this year of 4.5%— a rate well below the 6%-7% norm from only a few years ago.

Chinese construction activity is likely to decline further

Residential buildings under construction

Source: LSEG Datastream.

Housing woes are far from over given significant excess supply and adverse demographics. The inventory of homes available for sale increased by about 20% in 2023, reflecting rising completions and declining demand. New home prices are still declining in most cities. Unusually for a country at its stage of development, China's population is already declining, with the pace of contraction set to increase. As a result, housing construction activity should fall further in 2024.

China will have no choice but to launch more stimulus. This is easier said than done, and policymakers are facing important constraints. They do not want to see a significant depreciation in the value of the renminbi as this could damage investor confidence (although gradual currency weakness is surely one of the key remaining tools in the People's Bank of China toolkit). Interest rates are already low. A large-scale infrastructure stimulus (similar to those launched in response to the 2008 Global Financial Crisis and China's 2015 growth slowdown) is no longer in the cards. Taking this route would likely exacerbate excess supply problems the authorities have fought several years to resolve. In any case, the growth impact of any stimulus by the central government would likely be partly undermined by fiscal restraint at the local government level, due to the revenue shortfall these are experiencing due to the housing correction.

Instead, we expect China to pursue a policy of targeted stimulus focused on the renovation and upgrade of older housing units in second and third tier cities. State-sponsored energy transition and technology investment should both remain important areas of government focus (China is already the world's leader in the production of solar panels and electric vehicles). These initiatives, though, will only exert a limited impact on domestic Chinese growth. Stronger tailwinds are likely to be experienced by other economies in Asia who boast strong economic ties to China.

Economic forecasts (next 12 months)

Region	Current GDP	GDP - consensus	GDP - CAM view	Current inflation	Inflation - consensus	Inflation - CAM view	Policy rate - CAM view
Canada	0.5%	0.5%	0.3%	3.1%	2.5%	2.7%	-0.75%
United States	3.0%	1.4%	0.6%	3.1%	2.7%	2.8%	-0.75%
Eurozone	0.0%	0.5%	0.1%	2.4%	2.4%	2.7%	-0.50%
China	4.9%	4.5%	4.5%	-0.5%	1.3%	1.0%	
Japan	1.5%	0.7%	1.0%	3.3%	2.3%	2.3%	
World	2.7%	2.6%	2.6%	3.6%	3.1%	3.2%	

Source: CIBC Asset Management & Bloomberg.

Alternative economic scenarios

By Vincent Lépine and Francis Thivierge

Higher for Longer (50% probability)

This is our baseline scenario. It describes how we expect the world economy and asset markets to unfold over the next 12 months. Inflation is projected to continue to decelerate early in the year. This will allow DM central banks to deliver the first rate cuts of a new easing cycle, and for many EM central banks to continue their existing easing cycles. However, major DM central banks will likely pause policy easing earlier than currently priced by the market consensus as efforts to bring inflation all the way back to policy targets prove more challenging than anticipated.

A renewed, hawkish pivot by central banks would likely cause market policy interest rate expectations and bond yields to retrace at least a part of their recent descent. Risky assets will encounter headwinds, although support will likely come from modest positive economic growth. USD will likely gain ground, at least temporarily and on a broad-based basis.

Immaculate Disinflation (40% probability)

In this scenario, inflation returns swiftly to policy target rates with no significant economic pain. Central banks around the world would have plenty of leeway to aggressively cut interest rates, allowing for further loosening in global financial conditions and stronger GDP growth.

With financial markets posting strong returns in the final months of 2023, this year started with *Immaculate Disinflation* largely priced. The rally in markets would continue, but with limited upside for equity and bond prices as well as limited downside for bond yields. In this scenario, global USD liquidity would remain abundant, leading USD to weaken further.

Double Dip (10% probability)

This is another alternative scenario under which policy interest rates could be cut aggressively, in this case as a result of a global recession. The global economy would initially benefit from the easing in financial conditions experienced in late 2023. But it could experience a second (and more severe) weakening in economic activity later in 2024, due to a renewed tightening in global financial conditions driven by deteriorating fiscal conditions and a deeper contraction in corporate earnings.

Under this scenario, global bond markets would be expected to rally harder than under the *Immaculate Disinflation* scenario. Risky assets would likely be adversely affected, with equity prices experiencing a substantial price correction.

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